# MISCELLANEOUS TAX BILLS V

# HEARINGS

BEFORE THE

## SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

## COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-SIXTH CONGRESS

SECOND SESSION

ON

**S. 464, S. 485, S. 650, S. 1194, S. 1831, S. 1859, S. 1900, S. 1901, S. 2089, S. 2167, S. 2180, S. 2201, S. 2275; H.R. 4746, H.R. 5505, H.R. 5973**

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**FEBRUARY 29 AND MARCH 4, 1980**

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# MISCELLANEOUS TAX BILLS V

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**FRIDAY, FEBRUARY 29, 1980**

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

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the subcommittee) presiding.

Present: Senators Byrd and Nelson.

[The press releases announcing these hearings and the bills S. 464, S. 485, S. 650, S. 1194, S. 1831, S. 1859, S. 1900, S. 1901, S. 2089, S. 2167, S. 2180, S. 2201, S. 2275; H.R. 4746, H.R. 5505, H.R. 5973; and Joint Committee on Taxation description of tax bills listed for a hearing follow:]

P.R. # H-8

PRESS RELEASE

FOR IMMEDIATE RELEASE
February 19, 1980

COMMITTEE ON FINANCE
UNITED STATES SENATE
Subcommittee on Taxation and Debt Management
2227 Dirksen Senate Office Bldg.

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARINGS ON MISCELLANEOUS TAX BILLS

Senator Harry F. Byrd, Jr., Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance announced today that the Subcommittee will hold hearings on February 29, 1980 and March 4, 1980 on miscellaneous tax bills.

The hearings will begin each day at 9:30 A.M. in Room 2221 of the Dirksen Senate Office Building.

The following pieces of legislation of general application, unless otherwise noted, will be considered on February 29, 1980. Revenue estimates will be available at the time of the hearing.

S. 1900 -- Introduced by Senator Heflin. Would permit a casualty loss deduction for the fair market value of property rather than the lesser of fair market value or the basis of the property. The loss may be carried back ten years or carried forward four years. Principal beneficiaries of this bill would be owners of fruit or nut orchards which are destroyed by an act of nature.

S. 1901 -- Introduced by Senator Heflin. Same as S. 1900, except it applies to growing timber.

S. 1831 -- Introduced by Senators Talmadge and Nelson. Since 1976, a real estate investment trust (REIT) is permitted to carry forward net operating losses for eight years and is prohibited from carrying back losses. This bill would permit a REIT which terminated its REIT status prior to 1976 to carry forward operating losses for each year it was denied a net operating loss carry back because it was a REIT. The maximum years which could be carried forward would be eight years. Several REITs which terminated REIT status prior to 1976 will benefit from this legislation.

S. 2180 -- Introduced by Senator Harry F. Byrd, Jr. Provides an extension of the time within which a taxpayer must purchase and use property as a principal residence for the purpose of deferring the payment of capital gains tax on the sale of the former residence but only under certain circumstances. The principal beneficiary of this bill is Mrs. Jane Cathcart of Virginia.

S. 485 -- Introduced by Senator Cannon. Would eliminate the 2% federal excise tax on wagers and the $500 occupational tax on wagering.

S. 2089 -- Introduced by Senators Roth and Talmadge. In 1978 the investment tax credit was extended to poultry growing structures retroactively to 1971. This bill would permit poultry growers to claim the investment tax credit, regardless of the statute of limitations, for all years covered by the 1978 law.

S. 650 -- Introduced by Senator Moynihan. This bill would provide that income earned from mortgaged real estate in a pooled income trust managed by an investment banker would be tax exempt. Such income is currently tax exempt when the trust is managed by banks or insurance companies.

H.R.5505 -- "The Tax Administrative Provisions Revision Act of 1979." Sections 1 through 8 of this bill have been reported out by the Committee. The following sections remain to be considered:

Section 9 - refunds of tread rubber excise tax;

Section 10 - recognition of gain on sale of residence for certain members of the armed forces;

Section 11 - exempt status of auxiliaries of certain fraternal beneficiary societies.

Witnesses who desire to testify at the hearing on February 29, 1980 must 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 February 26, 1980.

For the list of bills to be heard on March 4, 1980 see P. R. #H-9.

Legislative Reorganization Act. --Senator Byrd stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committee 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 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 100 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 Subcommittee, but are to confine their oral presentations to a summary of the points included in the statement.

Written statements.--Witnesses who are not scheduled to make an oral presentation, and others who desire to present their views to the Subcommittee, are urged to prepare a written statement for submission and inclusion in the printed record on the hearings. These written statements should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D. C. 20510, not later than Friday, March 14, 1980.

P.R. #H-9

PRESS RELEASE

FOR IMMEDIATE RELEASE
February 19, 1980

COMMITTEE ON FINANCE
UNITED STATES SENATE
Subcommittee on Taxation and Debt Management
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The hearings will begin each day at 9:30 A.M. in Room 2221 of the Dirksen Senate Office Building.

The following pieces of legislation of general application, unless otherwise noted, will be considered on March 4, 1980. Revenue estimates will be available at the time of the hearing.

S. 1194 -- Introduced by Senator Heflin. This bill would provide that it not be required to withhold FUTA taxes on the earnings of shrimp boat workers. The principal beneficiaries are shrimp boat owners, operators, and workers.

S. 464 -- Introduced by Senator Inouye. This bill would expand the list of groups eligible for the jobs credit under Section 51(d) of the Internal Revenue Code to include "displaced homemakers" who are entering the job market.

S. 2201 -- Introduced by Senator Bellmon. This bill would provide that crop rentals may be considered in the formula method of valuing farmland under Internal Revenue Code Section 2032 for purposes of the estate tax. Currenly only cash rentals may be considered.

S. 1859 -- Introduced by Senators Percy and Dole. Substantially the same as S. 2201.

S. 2167 -- Introduced by Senator Stone. This bill would propose to tax condominium association income on the same graduated tax rate as corporations.

S. 2275 -- Introduced by Senator Gravel. Would make technical amendments in the provisions relating to general stock ownership corporations.

H.R. 4746 -- Contains various miscellaneous tax proposals. Section 1, simplification of private foundation return and reporting requirements; Section 2, treatment of payment or reimbursement by private foundations for expenses of foreign travel of government officials; Section 3, alternative minimum tax on charitable lead trust created by corporations. Section 4, extention of withholding to payments of sick pay made by third parties; Section 5, treatment of certain repayments of supplemental unemployment compensation benefits; Section 6, disclosure of tax returns to state audit agencies; Section 7, investment tax credit for certain property usedin maritime satellite communications; and Section 8, rate of interest on U. S. Retirement Bonds.

H.R. 5973 -- Sections requiring a hearing are: Section 2 - Rollover treatment for certain distributions from money purchase pension plans; Section 4 - Treatment of certain indebtedness incurred before 1965 for purposes of section 514 of the Internal Revenue Code.

Witnesses who desire to testify at the hearing on March 4, 1980 must 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 February 26, 1980.

For the list of bills to be heard on February 29, 1980 see P.R. #H-8.

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Written Testimony.--Written testimony submitted by witnesses not making oral statements should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies by March 14, 1980, to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D. C. 20510

96TH CONGRESS
1ST SESSION

# S. 464

To amend the Internal Revenue Code of 1954 to expand the category of targeted groups for whom the new employee credit is available to include displaced homemakers.

---

IN THE SENATE OF THE UNITED STATES

FEBRUARY 22, 1979

Mr. INOUYE introduced the following bill; which was read twice and referred to the Committee on Finance

---

# A BILL

To amend the Internal Revenue Code of 1954 to expand the category of targeted groups for whom the new employee credit is available to include displaced homemakers.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That paragraph (1) of section 51(d) of the Internal Revenue
4 Code of 1954 (relating to members of targeted groups) is
5 amended—
6 (1) by striking out "or" at the end of subpara-
7 graphs (E) and (F),

1 (2) by striking out the period at the end of sub-
2 paragraph (G) and inserting in lieu thereof a comma
3 and "or", and
4 (3) by adding at the end thereof the following new
5 subparagraph:
6 "(H) a displaced homemaker (as defined in
7 paragraph (7) of section 3 of the Comprehensive
8 Employment and Training Act Amendments of
9 1978 (29 U.S.C. 802)."
10 SEC. 2. The amendment made by the first section of this
11 Act shall apply with respect to amounts paid or incurred
12 after December 31, 1978, in taxable years ending after such
13 date.

96TH CONGRESS
1ST SESSION

# S. 485

To amend the Internal Revenue Code of 1954 to provide that the occupational tax on wagering shall not apply in any State in which wagering is permitted by law.

---

IN THE SENATE OF THE UNITED STATES

FEBRUARY 26 (legislative day, FEBRUARY 22), 1979

Mr. CANNON (for himself and Mr. LAXALT) introduced the following bill; which was read twice and referred to the Committee on Finance

---

# A BILL

To amend the Internal Revenue Code of 1954 to provide that the occupational tax on wagering shall not apply in any State in which wagering is permitted by law.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That (a) section 4402 of the Internal Revenue Code of 1954
4 (relating to exemptions) is amended—
5 (1) by striking "or" at the end of paragraph (2),
6 (2) by striking out the period at the end of para-
7 graph (3) and inserting in lieu thereof a comma and
8 "or", and

1 (3) by adding at the end thereof the following new
2 paragraph:
3 "(4) STATE-AUTHORIZED WAGERS.—On any
4 wager authorized under State law.".
5 (b) Subchapter B of chapter 35 of the Internal Revenue
6 Code of 1954 (relating to occupational tax) is amended by
7 redesignating section 4414 as 4415, and by inserting after
8 section 4413 the following new section:
9 "SEC. 4414. TAX NOT TO APPLY TO WAGERING AUTHORIZED
10 UNDER STATE LAW.
11 "The tax imposed by section 4411 shall not apply in the
12 case of a person authorized under the law of any State or
13 political subdivision thereof to engage in the business of ac-
14 cepting wagers or to receive wagers for or on behalf of any
15 such person.".
16 (b) The table of sections for such subchapter is amended
17 by striking out the last item and inserting in lieu thereof the
18 following items:

"Sec. 4414. Tax not to apply to wagering authorized under State law.
"Sec. 4415. Cross references.".

19 SEC. 2. The amendments made by the first section of
20 this Act shall apply with respect to taxable periods beginning
21 after June 30, 1979.

96TH CONGRESS
1ST SESSION

# S. 650

To amend the Internal Revenue Code of 1954 with respect to the treatment of certain employee's trusts organized to invest in real estate.

---

IN THE SENATE OF THE UNITED STATES

MARCH 13 (legislative day, FEBRUARY 22), 1979

Mr. MOYNIHAN introduced the following bill; which was read twice and referred to the Committee on Finance

---

# A BILL

To amend the Internal Revenue Code of 1954 with respect to the treatment of certain employee's trusts organized to invest in real estate.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. TREATMENT OF CERTAIN EMPLOYEE'S TRUSTS**
4 **ORGANIZED TO INVEST IN REAL ESTATE.**
5 (a) GENERAL RULE.—Section 401 of the Internal Rev-
6 enue Code of 1954 is amended by redesignating subsection (l)
7 as subsection (m) and by inserting after subsection (k) the
8 following new subsection:

1 "(l) Employee Benefit Trusts Organized To
2 Invest in Real Estate.—
3 "(1) In general.—A trust shall constitute a
4 qualified trust under this section if such trust is a
5 group real estate employee benefit trust. A trust shall
6 not fail to constitute a qualified trust under this section
7 merely because such trust participates in a group real
8 estate employee benefit trust if, at the close of each
9 quarter of the plan year, the adjusted cost of the par-
10 ticipation interests of the trust in group real estate em-
11 ployee benefit trusts is less than 25 percent of the ag-
12 gregate adjusted cost of all assets of the plan under
13 which the trust is created.
14 "(2) Definition.—For purposes of this subsec-
15 tion, the term 'group real estate employee benefit
16 trust' means a trust created or organized in the United
17 States which, at all times during its taxable year,
18 meets the following requirements—
19 "(A) the trust is maintained in the United
20 States;
21 "(B) the aggregate adjusted cost of all the
22 trust's property consisting of real property and in-
23 terests in real property exceeds $10,000,000;
24 "(C) at least 75 percent of the aggregate ad-
25 justed cost of all the trust's property is repre-

1 sented by real property, interests in real property,
2 cash and cash items (including receivables), and
3 Government securities;
4 "(D) the trust is adopted as a part of at least
5 10 pension or profit-sharing plans maintained by
6 at least 10 employers (determined with regard to
7 section 414 (b) and (c));
8 "(E) no pension or profit-sharing plan or
9 plans maintained by any one employer (deter-
10 mined with regard to section 414 (b) and (c))
11 owns, in the aggregate, more than 50 percent of
12 the participation interests owned by all the pen-
13 sion and profit-sharing plans participating in the
14 trust;
15 "(F) the trust is not engaged in a transaction
16 in which it leases real property or an interest in
17 real property to a person from whom the trust ac-
18 quired such property or interest;
19 "(G) no part of the trust's property consists
20 of land used in farming (as defined in section
21 175(c)(2)) by the trust;
22 "(H) all of the trust's property which con-
23 sists of real property and interests in real prop-
24 erty is subject to the management of an invest-
25 ment manager (within the meaning of section

1 3(38) of the Employee Retirement Income Secu-
2 rity Act of 1974); and
3 "(I) the written governing instrument creat-
4 ing the trust provides that—
5 "(i) the assets of the group real estate
6 employee benefit trust will not be commin-
7 gled with other property;
8 "(ii) participation in the group real
9 estate employee benefit trust is limited to
10 trusts described in section 401(a) which are
11 exempt from tax under section 501(a);
12 "(iii) the part of the corpus and income
13 of the group real estate employee benefit
14 trust which equitably belongs to a participat-
15 ing trust may not be (within the taxable year
16 or thereafter) used for, or diverted to, pur-
17 poses other than for the exclusive benefit of
18 the employees or their beneficiaries who are
19 entitled to benefits under the participating
20 trust, as provided in the participating trust;
21 "(iv) the income and corpus of the
22 group real estate employee benefit trust will
23 be allocated among and owned by the par-
24 ticipating trusts in proportion to each partici-

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1 pating trust's interest in the group real
2 estate employee benefit trust; and
3 "(v) a participating trust may not assign
4 any part of its equity or interest in the trust.
5 "(3) SPECIAL RULES.—
6 "(A) For purposes of subparagraphs (B) and
7 (C) of paragraph (2), the term 'real property' shall
8 include only real property located in the United
9 States or the Commonwealth of Puerto Rico.
10 "(B) The requirements of subparagraphs (B),
11 (C), (D), (E), and (F) of paragraph (2) are deemed
12 to be satisfied for the entire taxable year if they
13 are satisfied for at least 335 days of a taxable
14 year of 12 months, or for a proportionate part of
15 a taxable year of less than 12 months.
16 "(C) For purposes of paragraph (1) and sub-
17 paragraphs (B) and (C) of paragraph (2), a trust's
18 adjusted cost in an asset shall be equal to the
19 trust's cost of such asset (as determined under
20 section 1012), increased by the amount of any of
21 the trust's capital expenditures made with respect
22 to such asset (as determined under section 263),
23 and decreased by the amount of any acquisition
24 indebtedness incurred with respect to such asset
25 (as determined under section 514(c)(1))."

1 (b) TECHNICAL AMENDMENT TO SECTION 404(a)(4).—
2 Section 404(a)(4) of such Code is amended by adding the
3 following new sentence at the end thereof: "This paragraph
4 shall not apply in the case of a trust which would be a group
5 real estate employee benefit trust but for the fact that it is
6 created, organized, or maintained outside the United States."
7 (c) CERTAIN INDEBTEDNESS NOT TREATED AS AC-
8 QUISITION INDEBTEDNESS FOR PURPOSES OF SECTION
9 514.—Section 514(c)(4) of such Code is amended by adding
10 the following new sentences at the end thereof: "Indebted-
11 ness incurred in the manner described in paragraph (1) with
12 respect to real property and interests in real property by a
13 group real estate employee benefit trust, as defined in section
14 401(k)(2), shall be deemed to be indebtedness the incurrence
15 of which is inherent in the performance or exercise of the
16 purpose or function constituting the basis of such trust's ex-
17 emption. The preceding sentence shall not apply to any in-
18 debtedness incurred with respect to real property or interests
19 in real property (A) acquired by a group real estate employee
20 benefit trust at a price determined in whole or in part as a
21 percentage of the rents received by such trust from the leas-
22 ing of such real property or interests in real property or (B)
23 used in the business of farming at any time during the one
24 year period preceding the date of acquisition of such property
25 or interest by the group real estate employee benefit trust."

1 (d) EFFECTIVE DATE.—The amendments made by this
2 section shall take effect on January 1, 1980.

II

96TH CONGRESS
1ST SESSION

# S. 1194

To amend the Internal Revenue Code of 1954 to exclude certain service performed on fishing boats from coverage for purposes of unemployment compensation.

---

IN THE SENATE OF THE UNITED STATES

MAY 22 (legislative day, MAY 21), 1979

Mr. HEFLIN introduced the following bill; which was read twice and referred to the Committee on Finance

---

# A BILL

To amend the Internal Revenue Code of 1954 to exclude certain service performed on fishing boats from coverage for purposes of unemployment compensation.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That section 3306(c) of the Internal Revenue Code of 1954
4 (relating to the definition of employment under the Federal
5 Unemployment Tax Act) is amended—
6 (1) by striking out "or" at the end of paragraph
7 (17);

1 (2) by redesignating paragraph (18) as paragraph
2 (19); and
3 (3) by inserting after paragraph (17) the following
4 new paragraph:
5 "(18) service performed by an individual on a boat
6 engaged in catching fish or other forms of aquatic
7 animal life under an arrangement with the owner or
8 operator of such boat pursuant to which—
9 "(A) such individual does not receive any
10 cash remuneration (other than as provided in sub-
11 paragraph (B)),
12 "(B) such individual receives a share of the
13 boat's (or the boats' in the case of a fishing oper-
14 ation involving more than one boat) catch of fish
15 or other forms of aquatic animal life or a share of
16 the proceeds from the sale of such catch, and
17 "(C) the amount of such individual's share
18 depends on the amount of the boat's (or the boats'
19 in the case of a fishing operation involving more
20 than one boat) catch of fish or other forms of
21 aquatic animal life, but only if the operating crew
22 of such boat (or each boat from which the individ-
23 ual receives a share in the case of a fishing oper-
24 ation involving more than one boat) is normally
25 made up of fewer than ten individuals; or".

1 SEC. 2. The amendments made by this Act shall be ef-

2 fective on January 1, 1979.

II

96TH CONGRESS
1ST SESSION

# S. 1831

To amend the Internal Revenue Code of 1954 to provide that in certain cases the net operating loss carryover period for a taxpayer who ceases to be real estate investment trust shall be the same as the net operating loss carryover period for a taxpayer who continues to be real estate investment trust.

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IN THE SENATE OF THE UNITED STATES

SEPTEMBER 28 (legislative day, JUNE 21), 1979

Mr. TALMADGE (for himself and Mr. NELSON) introduced the following bill; which was read twice and referred to the Committee on Finance

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# A BILL

To amend the Internal Revenue Code of 1954 to provide that in certain cases the net operating loss carryover period for a taxpayer who ceases to be real estate investment trust shall be the same as the net operating loss carryover period for a taxpayer who continues to be real estate investment trust.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That (a) subparagraph (E) of section 172(b)(1) of the Internal
4 Revenue Code of 1954 (relating to net operating loss deduc-
5 tion) is amended to read as follows:

1 "(E)(i) In the case of a taxpayer which has a
2 net operating loss for any taxable year for which
3 the provisions of part II of subchapter M (relating
4 to real estate investment trusts) apply to such
5 taxpayer, such loss shall not be a net operating
6 loss carryback to any taxable year preceding the
7 taxable year of such loss and shall be a net oper-
8 ating loss carryover to each of the 8 taxable years
9 following the taxable year of such loss, whether
10 or not part II of subchapter M applies to the tax-
11 payer for the taxable year to which the loss is
12 carried or for any intervening taxable year follow-
13 ing the year of loss.

14 "(ii) A net operating loss shall not be carried
15 back to a taxable year for which part II of sub-
16 chapter M applied to the taxpayer.

17 "(iii) In the case of a taxpayer which has a
18 net operating loss for any taxable year for which
19 the provisions of part II of subchapter M do not
20 apply to such taxpayer, the number of taxable
21 years to which such loss may be a net operating
22 loss carryover under subparagraph (B) shall be in-
23 creased (to a number not greater than 8) by the
24 number of taxable years to which such loss may

3

1 not be a net operating loss carryback by reason of
2 clause (ii).".
3 (b)(1) Except as provided in paragraph (2), the amend-
4 ment made by subsection (a) shall apply to taxable years
5 ending after October 4, 1976, and to losses incurred in tax-
6 able years ending before, on, or after such date.
7 (2) For purposes of taking into account taxable years to
8 which a net operating loss may not be a net operating loss
9 carryback, clauses (ii) and (iii) of section 172(b)(1)(E) of the
10 Internal Revenue Code of 1954 (as added by this Act) also
11 shall apply to taxable years ending on or before October 4,
12 1976.

II

96TH CONGRESS
1ST SESSION

# S. 1859

To amend the Internal Revenue Code of 1954 with respect to the special valuation of farm property for purposes of the estate tax.

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IN THE SENATE OF THE UNITED STATES

OCTOBER 4 (legislative day, JUNE 21), 1979

Mr. PERCY (for himself and Mr. DOLE) introduced the following bill; which was read twice and referred to the Committee on Finance

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# A BILL

To amend the Internal Revenue Code of 1954 with respect to the special valuation of farm property for purposes of the estate tax.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That (a) paragraph (7) of section 2032A(e) of the Internal
4 Revenue Code of 1954 (relating to method of valuing farms)
5 is amended by redesignating subparagraph (B) as subpara-
6 graph (C) and by inserting after subparagraph (A) the follow-
7 ing new subparagraph:

1 "(B) VALUE BASED ON NET SHARE RENTAL
2 IN CERTAIN CASES.—
3 "(i) IN GENERAL.—If there is no com-
4 parable land from which the average annual
5 gross rental may be determined but there is
6 comparable land from which the average net
7 share rental may be determined, subpara-
8 graph (A)(i) shall be applied by substituting
9 'average net share rental' for 'average gross
10 cash rental'.
11 "(ii) NET SHARE RENTAL.—For pur-
12 poses of this paragraph, the term 'net share
13 rental' means the excess of—
14 "(I) the value of the produce re-
15 ceived by the lessor of the land on
16 which such produce is grown, over
17 "(II) the cash operating expenses
18 of growing such produce which, under
19 the lease, are paid by the lessor.".
20 (b) Clause (i) of section 2032A(e)(7)(C) of such Code (as
21 redesignated by subsection (a)) is amended by striking out
22 "may be determined" and inserting in lieu thereof "may be
23 determined and that there is no comparable land from which
24 the average net share rental may be determined".

1 (c) The amendments made by this section shall apply
2 with respect to the estates of decedents dying after the date
3 of the enactment of this Act.

II

96TH CONGRESS
1ST SESSION

# S. 1900

To amend the Internal Revenue Code of 1954 with respect to the treatment of casualty losses in the case of fruit or nut trees.

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IN THE SENATE OF THE UNITED STATES

OCTOBER 17 (legislative day, OCTOBER 15), 1979

Mr. HEFLIN introduced the following bill; which was read twice and referred to the Committee on Finance

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# A BILL

To amend the Internal Revenue Code of 1954 with respect to the treatment of casualty losses in the case of fruit or nut trees.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That section 165 of the Internal Revenue Code of 1954 (re-
4 lating to losses) is amended by redesignating subsection (j) as
5 (k) and by inserting immediately before such subsection the
6 following new subsection:
7 "(j) CASUALTY LOSSES TO FRUIT OR NUT TREES.—

1 "(1) AMOUNT OF DEDUCTION.—Notwithstanding
2 subsection (b), for purposes of subsection (a) the basis
3 for determining the amount of the deduction for any
4 loss incurred by the taxpayer in his trade or business
5 with respect to fruit or nut trees for which a deduction
6 for depreciation is allowable (determined without
7 regard to the age of the trees or their productivity over
8 their useful life) shall be not less than the fair market
9 value on the date on which the loss occurs.
10 "(2) CARRYOVER AND CARRYBACK OF EXCESS
11 DEDUCTION.—In the case of an individual, if the
12 amount of the deduction allowable under subsection (a)
13 with respect to a loss described in paragraph (1), after
14 the reduction of taxable income by the sum of any
15 other amounts deducted under subsection (a) and under
16 parts V, VI, and VII of this subchapter for the taxable
17 year, reduces the taxpayer's taxable income to zero for
18 the taxable year (hereinafter in this paragraph referred
19 to as the 'unused deduction year'), such excess attrib-
20 utable to the amount determined under paragraph (1)
21 shall be—
22 "(A) a loss deduction carryback to each of
23 the 10 taxable years preceding the unused deduc-
24 tion year, and

1 "(B) a loss deduction carryover to each of
2 the 4 taxable years following the unused deduc-
3 tion year,
4 and shall be taken into account under the provisions of
5 subsection (a) for the year to which the deduction is
6 carried by reason of this paragraph. The entire amount
7 of the unused deduction for an unused deduction year
8 shall be carried to the earliest of the 10 taxable years
9 to which (by reason of subparagraph (A)) such credit
10 may be carried and then to each of the other 13 tax-
11 able years to the extent, because of the reduction of
12 the taxpayer's taxable income to zero for the year to
13 which it is carried, such unused deduction may not be
14 taken into account for a prior taxable year to which it
15 may be carried.".
16 SEC. 2. The amendments made by the first section of
17 this Act shall apply with respect to losses incurred after
18 August 31, 1979.

II

96TH CONGRESS
1ST SESSION

# S. 1901

To amend the Internal Revenue Code of 1954 with respect to the amount deductible in the case of casualty losses of timber.

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IN THE SENATE OF THE UNITED STATES

OCTOBER 17 (legislative day, OCTOBER 15), 1979

Mr. HEFLIN introduced the following bill; which was read twice and referred to the Committee on Finance

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# A BILL

To amend the Internal Revenue Code of 1954 with respect to the amount deductible in the case of casualty losses of timber.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That (a) subsection (b) of section 165 of the Internal Revenue
4 Code of 1954 (relating to the amount of deduction for losses)
5 is amended to read as follows:
6 "(b) AMOUNT OF DEDUCTION.—
7 "(1) GENERAL RULE.—For purposes of subsec-
8 tion (a), the basis for determining the amount of the
9 deduction for any loss shall be the adjusted basis pro-

1 vided in section 1011 for determining the loss from the
2 sale or other disposition of property.
3 "(2) AMOUNT OF LOSS IN CASE OF TIMBER.—In
4 the case of any loss arising from fire, storm, or other
5 casualty of timber, such basis for determining the
6 amount of the deduction shall not be less than the fair
7 market value immediately before such casualty.
8 "(3) CARRYOVER AND CARRYBACK OF EXCESS
9 DEDUCTION.—In the case of an individual, if the
10 amount of the deduction allowable under subsection (a)
11 with respect to a loss described in paragraph (2), after
12 the reduction of taxable income by the sum of any
13 other amounts deducted under subsection (a) and under
14 parts V, VI, and VII of this subchapter for the taxable
15 year, reduces the taxpayer's taxable income to zero for
16 the taxable year (hereinafter in this paragraph referred
17 to as the 'unused deduction year'), such excess attrib-
18 utable to the amount determined under paragraph (2)
19 shall be—
20 "(A) a loss deduction carryback to each of
21 the 10 taxable years preceding the unused deduc-
22 tion year, and
23 "(B) a loss deduction carryover to each of
24 the 4 taxable years following the unused deduc-
25 tion year,

1 and shall be taken into account under the provisions of
2 subsection (a) for the year to which the deduction is
3 carried by reason of this paragraph. The entire amount
4 of the unused deduction for an unused deduction year
5 shall be carried to the earliest of the 10 taxable years
6 to which (by reason of subparagraph (A)) such credit
7 may be carried and then to each of the other 13 tax-
8 able years to the extent, because of the reduction of
9 the taxpayer's taxable income to zero for the year to
10 which it is carried, such unused deduction may not be
11 taken into account for a prior taxable year to which it
12 may be carried.".

13 SEC. 2. The amendments made by the first section of
14 this Act shall apply with respect to losses incurred after
15 August 31, 1979.

II

96TH CONGRESS
1ST SESSION

# S. 2089

To amend the Revenue Act of 1978 to provide that, with respect to the amendments allowing the investment tax credit for single purpose agricultural or horticultural structures, credit or refund shall be allowed without regard to the statute of limitations for certain taxable years to which such amendments apply.

IN THE SENATE OF THE UNITED STATES

DECEMBER 6 (legislative day, NOVEMBER 29), 1979

Mr. ROTH (for himself, Mr. HELMS, and Mr. TALMADGE) introduced the following bill; which was read twice and referred to the Committee on Finance

# A BILL

To amend the Revenue Act of 1978 to provide that, with respect to the amendments allowing the investment tax credit for single purpose agricultural or horticultural structures, credit or refund shall be allowed without regard to the statute of limitations for certain taxable years to which such amendments apply.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That subsection (c) of section 314 of the Revenue Act of
4 1978 (relating to investment credit for certain single purpose

1 agricultural or horticultural structures) is amended to read as
2 follows:
3 "(c) EFFECTIVE DATE.—
4 "(1) IN GENERAL.—The amendments made by
5 subsections (a) and (b) shall apply to taxable years
6 ending after August 15, 1971.
7 "(2) REFUND OR CREDIT.—If refund or credit of
8 any overpayment of tax resulting from the amendments
9 made by subsections (a) and (b) is prevented on the
10 date of the enactment of this paragraph or at any time
11 within one year after such date by the operation of any
12 law or rule of law (including res judicata), refund or
13 credit of such overpayment (to the extent attributable
14 to such amendments) may, nevertheless, be made or al-
15 lowed if claim therefor is filed within one year after
16 such date of enactment.".

II

96TH CONGRESS
1ST SESSION

# S. 2167

To amend the Internal Revenue Code of 1954 to provide that the taxable income of a homeowners association shall be subject to the same graduated rates of tax as a corporation.

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IN THE SENATE OF THE UNITED STATES

DECEMBER 20 (legislative day, DECEMBER 15), 1979

Mr. STONE introduced the following bill; which was read twice and referred to the Committee on Finance

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# A BILL

To amend the Internal Revenue Code of 1954 to provide that the taxable income of a homeowners association shall be subject to the same graduated rates of tax as a corporation.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That (a) the second sentence of paragraph (1) of section
4 528(b) of the Internal Revenue Code of 1954 (relating to tax
5 imposed with respect to certain homeowners associations) is
6 amended to read as follows: "Such tax shall consist of a tax
7 computed as provided in section 11 as though the homeown-

1 ers association taxable income were the taxable income re-

2 ferred to in section 11."

3 (b) The amendment made by subsection (a) shall apply

4 to taxable years beginning after December 31, 1978.

II

96TH CONGRESS
1ST SESSION

# S. 2180

To provide for a special application of section 1034(c) of the Internal Revenue Code of 1954.

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IN THE SENATE OF THE UNITED STATES

DECEMBER 20 (legislative day, DECEMBER 15), 1979

Mr. HARRY F. BYRD, JR., introduced the following bill; which was read twice and referred to the Committee on Finance

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# A BILL

To provide for a special application of section 1034(c) of the Internal Revenue Code of 1954.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That, in the case of an individual—
4 (1) who sold his principal residence (within the
5 meaning of section 1034 of the Internal Revenue Code
6 of 1954) in 1977,
7 (2) who purchased property on which to construct
8 a new principal residence (within the meaning of such
9 section)—

1 (A) the construction of which commenced
2 during such year, and
3 (B) the construction of which was terminated
4 before completion,
5 (3) who brought an action, and obtained a judg-
6 ment, against the builder who commenced construction
7 of the new residence but failed to complete it,
8 (4) who suspended construction of such residence
9 so that the partially constructed residence could be
10 used as evidence in connection with the prosecution of
11 the builder (without regard to whether it was so used),
12 and
13 (5) who failed to meet the requirements of such
14 section with respect to occupancy of the new principal
15 residence because of such suspension of construction,
16 the Secretary of the Treasury, in the administration of sec-
17 tion 1034(c) of the Internal Revenue Code of 1954 (relating
18 to rules for application of section 1034), shall apply para-
19 graph (5) of such section as if "5 years" were substituted for
20 "2 years" where it appears in the last sentence of such
21 paragraph.
22 SEC. 2. The provisions of the first section of this Act
23 shall apply with respect to taxable years beginning after
24 December 31, 1976, and before January 1, 1983.

96TH CONGRESS
2D SESSION

# S. 2201

To amend the Internal Revenue Code of 1954 with respect to the special valuation of farm property for purposes of the estate tax.

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IN THE SENATE OF THE UNITED STATES

JANUARY 22 (legislative day, JANUARY 3), 1980

Mr. BELLMON introduced the following bill; which was read twice and referred to the Committee on Finance

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# A BILL

To amend the Internal Revenue Code of 1954 with respect to the special valuation of farm property for purposes of the estate tax.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That—
4 (a) paragraph (7) of section 2032A(e) of the Inter-
5 nal Revenue Code of 1954 (relating to the method of
6 valuing farms) is amended by redesignating subpara-
7 graph (B) as subparagraph (C) and by inserting after
8 subparagraph (A) the following new subparagraph:

1 "(B) IN-KIND RENTALS.—Net in-kind rentals
2 (crop share rentals) from comparable real property
3 in the locality of the farm for farming purposes
4 may be used in the formula provided by subpara-
5 graph (A) where there is no such comparable real
6 property from which a cash rental may be deter-
7 mined. For purposes of this paragraph, the term
8 'net in-kind rental' means the excess of—
9 "(i) the value of the commodity received
10 by the lessor of the land on which such com-
11 modity is produced, over
12 "(ii) the cash operating expenses of
13 growing such a commodity which, under the
14 lease, are paid by the lessor;"; and
15 (b) in subparagraph (C), as redesignated by para-
16 graph (1), by inserting "or in-kind rental" after
17 "rental".
18 SEC. 2. EFFECTIVE DATE.—The amendments made by
19 this section shall apply with respect to estates of decedents
20 dying after the date of the enactment of this Act.

II

96TH CONGRESS
2D SESSION

# S. 2275

To amend the Internal Revenue Code of 1954 to make technical amendments in the provisions relating to general stock ownership corporations.

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IN THE SENATE OF THE UNITED STATES

FEBRUARY 7 (legislative day, JANUARY 3), 1980

Mr. GRAVEL introduced the following bill; which was read twice and referred to the Committee on Finance

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# A BILL

To amend the Internal Revenue Code of 1954 to make technical amendments in the provisions relating to general stock ownership corporations.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That (a) subchapter U of the Internal Revenue Code of 1954
4 (relating to general stock ownership corporations) is
5 amended—
6 (1) by inserting "or the estate of a deceased
7 shareholder" after "State" in section 1391(a)(4)(D)(ii);

1 (2) by striking out "INDIVIDUALS" in the caption
2 of section 1391(c) and inserting in lieu thereof "INDI-
3 VIDUAL";
4 (3) by striking out "1393" in section 1392(a) and
5 inserting in lieu thereof "1396(b)";
6 (4) by striking out "and all succeeding years" in
7 section 1392(b)(1);
8 (5) by striking out "section" in section 1393(a)(2)
9 the first time it appears and inserting in lieu thereof
10 "subchapter";
11 (6) by striking out "a GSOC" in sections
12 1393(a)(2), 1393(b)(3), 1394(c), and 1396(b) and insert-
13 ing in lieu thereof "an electing GSOC";
14 (7) by striking out "the GSOC" in section
15 1394(d) and inserting in lieu thereof "an electing
16 GSOC";
17 (8) by striking out "A GSOC" in section 1396(a)
18 and inserting in lieu thereof "An electing GSOC";
19 (9) by adding at the end of section 1396(b) the
20 following: "Such tax shall be deductible as an ordinary
21 and necessary expense of the corporation under section
22 162."; and
23 (10) by striking out "Plan" in the item relating to
24 section 1397 in the table of sections for such sub-
25 chapter and inserting in lieu thereof "Corporation".

1 (b) The last sentence of section 6039B of such Code
2 (relating to return of general stock ownership corporations) is
3 amended by inserting "electing" after "Every".
4 SEC. 2. The amendments made by the first section of
5 this Act shall apply with respect to corporations chartered
6 after December 31, 1978, and before January 1, 1984.

II

96TH CONGRESS
1ST SESSION

# H. R. 4746

IN THE SENATE OF THE UNITED STATES

SEPTEMBER 20 (legislative day, JUNE 21), 1979
Read twice and referred to the Committee on Finance

# AN ACT

To make miscellaneous changes in the tax laws.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. SIMPLIFICATION OF PRIVATE FOUNDATION**
4 **RETURN AND REPORTING REQUIREMENTS.**
5 (a) AMENDMENT OF SECTION 6033.—Section 6033 of
6 the Internal Revenue Code of 1954 (relating to returns by
7 exempt organizations) is amended by redesignating subsec-
8 tion (c) as subsection (e) and by inserting after subsection (b)
9 the following new subsections:
10 "(c) ADDITIONAL PROVISIONS RELATING TO PRIVATE
11 FOUNDATIONS.—In the case of an organization which is a
12 private foundation (within the meaning of section 509(a))—

1 "(1) the Secretary shall by regulations provide
2 that the private foundation shall include in its annual
3 return under this section such information (not required
4 to be furnished by subsection (b) or the forms or regu-
5 lations prescribed thereunder) as would have been re-
6 quired to be furnished under section 6056 (relating to
7 annual reports by private foundations) as such section
8 6056 was in effect on January 1, 1979,
9 "(2) a copy of the notice required by section
10 6104(d) (relating to public inspection of private founda-
11 tions' annual returns), together with proof of publica-
12 tion thereof, shall be filed by the foundation together
13 with the annual return under this section, and
14 "(3) the foundation managers shall furnish copies
15 of the annual return under this section to such State
16 officials and other persons, at such times, and under
17 such conditions, as the Secretary may by regulations
18 prescribe.
19 Nothing in paragraph (1) shall require the inclusion of the
20 name and address of any recipient (other than a disqualified
21 person within the meaning of section 4946) of 1 or more
22 charitable gifts or grants made by the foundation to such re-
23 cipient as an indigent or needy person if the aggregate of
24 such gifts or grants made by the foundation to such recipient
25 during the year does not exceed $1,000.

1 "(d) SECTION TO APPLY TO NONEXEMPT CHARITA-
2 BLE TRUSTS AND NONEXEMPT PRIVATE FOUNDATIONS.—
3 The following organizations shall comply with the require-
4 ments of this section in the same manner as organizations
5 described in section 501(c)(3) which are exempt from tax
6 under section 501(a):

7 "(1) NONEXEMPT CHARITABLE TRUSTS.—A
8 trust described in section 4947(a)(1) (relating to nonex-
9 empt charitable trusts).

10 "(2) NONEXEMPT PRIVATE FOUNDATIONS.—A
11 private foundation which is not exempt from tax under
12 section 501(a)."

13 (b) PUBLIC INSPECTION OF PRIVATE FOUNDATIONS'
14 ANNUAL RETURNS.—

15 (1) IN GENERAL.—The first sentence of subsec-
16 tion (d) of section 6104 of such Code (relating to public
17 inspection of private foundations' annual reports) is
18 amended to read as follows: "The annual return re-
19 quired to be filed under section 6033 (relating to re-
20 turns by exempt organizations) by any organization
21 which is a private foundation within the meaning of
22 section 509(a) shall be made available by the founda-
23 tion managers for inspection at the principal office of
24 the foundation during regular business hours by any

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1 citizen on request made within 180 days after the date
2 of the publication of notice of its availability."
3 (2) CONFORMING AMENDMENTS.—Such subsec-
4 tion (d) is amended—
5 (A) by striking out "ANNUAL REPORTS" in
6 the heading and inserting in lieu thereof
7 "ANNUAL RETURNS"; and
8 (B) by striking out "annual report" each
9 place it appears in the second and third sentences
10 and inserting in lieu thereof "annual return".
11 (c) REPEAL OF PRIVATE FOUNDATION ANNUAL RE-
12 PORTING REQUIREMENTS.—Subpart D of part III of sub-
13 chapter A of chapter 61 of such Code (relating to information
14 concerning private foundations) is hereby repealed.
15 (d) TECHNICAL AMENDMENTS.—
16 (1) Section 6034 of such Code (relating to returns
17 by trust described in section 4947(a) or claiming chari-
18 table deductions under section 642(c)) is amended—
19 (A) by striking out "section 4947(a)" in sub-
20 section (a) and inserting in lieu thereof "section
21 4947(a)(2)";
22 (B) by adding at the end of subsection (b) the
23 following new sentence: "This section shall not
24 apply in the case of a trust described in section
25 4947(a)(1).";

1 (C) by striking out "EXCEPTION" in the
2 heading of subsection (b) and inserting in lieu
3 thereof "EXCEPTIONS"; and
4 (D) by striking out "SECTION 4947(a)" in
5 the section heading and inserting in lieu thereof
6 "SECTION 4947(a)(2)".
7 (2)(A) The first sentence of section 6652(d)(3) of
8 such Code (relating to annual reports) is amended to
9 read as follows: "In the case of a failure to comply
10 with the requirements of section 6104(d) (relating to
11 public inspection of private foundations' annual re-
12 turns), on the date and in the manner prescribed there-
13 for (determined with regard to any extension of time
14 for filing), unless it is shown that such failure is due to
15 reasonable cause, there shall be paid (on notice and
16 demand by the Secretary and in the same manner as
17 tax) by the person failing to meet such requirement,
18 $10 for each day during which such failure continues,
19 but the total amount imposed hereunder on all such
20 persons for such failure with respect to any one annual
21 return shall not exceed $5,000."
22 (B) The heading of paragraph (3) of section
23 6652(d) of such Code is amended by striking out "RE-
24 PORTS" and inserting in lieu thereof "RETURNS".

1 (3) Subsection (b) of section 6104 of such Code
2 (relating to inspection of annual information returns) is
3 amended by striking out "6056,".
4 (4) Section 6685 of such Code (relating to assess-
5 able penalties with respect to private foundation annual
6 reports) is amended to read as follows:

7 **"SEC. 6685. ASSESSABLE PENALTIES WITH RESPECT TO PRI-**
8 **VATE FOUNDATION ANNUAL RETURNS.**

9 "In addition to the penalty imposed by section 7207
10 (relating to fraudulent returns, statements, or other docu-
11 ments), any person who is required to comply with the re-
12 quirements of section 6104(d) (relating to private foundations'
13 annual returns) and who fails to so comply with respect to
14 any return, if such failure is willful, shall pay a penalty of
15 $1,000 with respect to each such return."
16 (5) Section 7207 of such Code (relating to fraudu-
17 lent returns, statements, or other documents) is
18 amended by striking out "sections 6047 (b) or (c),
19 6056, or 6104(d)" and inserting in lieu thereof "sub-
20 section (b) or (c) of section 6047 or pursuant to subsec-
21 tion (d) of section 6104".
22 (e) CLERICAL AMENDMENTS.—
23 (1) The table of sections for subpart A of part III
24 of subchapter A of chapter 61 of such Code is
25 amended by striking out "4947(a)" in the item relating

1 to section 6034 and inserting in lieu thereof
2 "4947(a)(2)".
3 (2) The table of subparts for part III of sub-
4 chapter A of chapter 61 of such Code is amended by
5 striking out the item relating to subpart D.
6 (3) The table of sections for subchapter B of chap-
7 ter 68 of such Code is amended by striking out "re-
8 ports" in the item relating to section 6685 and insert-
9 ing in lieu thereof "returns".
10 (f) EFFECTIVE DATE.—The amendments made by this
11 section shall apply to taxable years beginning after December
12 31, 1979.

13 **SEC. 2. TREATMENT OF REIMBURSEMENT OF CERTAIN**
14 **TRAVEL EXPENSES FOR PURPOSES OF SECTION**
15 **4941.**

16 (a) GENERAL RULE.—Section 4941(d)(2)(G) of the In-
17 ternal Revenue Code of 1954 (relating to payment or reim-
18 bursement of certain traveling expenses) is amended by strik-
19 ing out "or" at the end of clause (vi), by striking out the
20 period at the end of clause (vii) and inserting in lieu thereof
21 ", and", and by adding at the end thereof the following:
22 "(viii) any payment or reimbursement of
23 traveling expenses for travel between a point
24 in the United States and a point outside the
25 United States, but only if such payment or

1 reimbursement with respect to any one trip
2 by an official does not exceed the lesser of
3 the actual cost of the transportation involved
4 or $2,500, plus an amount for all other trav-
5 eling expenses not in excess of 125 percent
6 of the maximum amount payable under sec-
7 tion 5702(a) of title 5, United States Code,
8 for like travel by employees of the United
9 States for a maximum of 4 days.

10 Clause (viii) of subparagraph (G) shall not apply to any
11 payment or reimbursement made by a private founda-
12 tion if more than one-half of the foundation's support
13 (as defined in section 509(d)) is normally derived from
14 any business enterprises, trade association, or labor or-
15 ganization."

16 (b) EFFECTIVE DATE.—The amendments made by this
17 section shall apply to travel beginning after the date of the
18 enactment of this Act.

19 **SEC. 3. TREATMENT OF CERTAIN CHARITABLE TRUSTS FOR**
20 **PURPOSES OF THE MINIMUM TAX.**

21 (a) GENERAL RULE.—Subparagraph (C) of section
22 57(b)(2) of the Internal Revenue Code of 1954 (relating to
23 treatment of certain charitable contributions of trusts for pur-
24 poses of the minimum tax) is amended by redesignating

1 clauses (iv) and (v) as clauses (v) and (vi), respectively, and
2 by inserting after clause (iii) the following new clause:
3 "(iv) deductions allowable to a trust—
4 "(I) all the income interests in
5 which are devoted to one or more of the
6 purposes described in section 170(c) (de-
7 termined without regard to section
8 170(c)(2)(A)),
9 "(II) all of the interests (other than
10 income interests) in which are held by a
11 corporation, and
12 "(III) the grantor of which is a
13 corporation."
14 (b) EFFECTIVE DATE.—The amendments made by sub-
15 section (a) shall apply to taxable years beginning after De-
16 cember 31, 197[illegible].
17 SEC. 4. EXTENSION OF WITHHOLDING TO PAYMENTS OF SICK
18 PAY MADE BY THIRD PARTIES.
19 (a) GENERAL RULE.—Paragraph (1) of section 3402(o)
20 of the Internal Revenue Code of 1954 (relating to extension
21 of withholding to certain payments other than wages) is
22 amended by striking out "and" at the end of subparagraph
23 (A), by adding "and" at the end of subparagraph (B), and by
24 inserting after subparagraph (B) the following new subpara-
25 graph:

1 "(C) any payment to an individual of sick
2 pay which does not constitute wages (determined
3 without regard to this subsection), if at the time
4 the payment is made a request that such sick pay
5 be subject to withholding under this chapter is in
6 effect,".
7 (b) AMOUNT TO BE DEDUCTED AND WITHHELD.—
8 Subsection (o) of section 3402 of such Code is amended by
9 striking out paragraph (3) and inserting in lieu thereof the
10 following new paragraphs:
11 "(3) AMOUNT WITHHELD FROM ANNUITY PAY-
12 MENTS OR SICK PAY.—If a payee makes a request
13 that an annuity or any sick pay be subject to withhold-
14 ing under this chapter, the amount to be deducted and
15 withheld under this chapter from any payment to
16 which such request applies shall be an amount (not less
17 than a minimum amount determined under regulations
18 prescribed by the Secretary) specified by the payee in
19 such request. The amount deducted and withheld with
20 respect to a payment which is greater or less than a
21 full payment shall bear the same relation to the speci-
22 fied amount as such payment bears to a full payment.
23 "(4) REQUEST FOR WITHHOLDING.—A request
24 that an annuity or any sick pay be subject to withhold-
25 ing under this chapter—

1 "(A) shall be made by the payee in writing
2 to the person making the payments and shall con-
3 tain the social security number of the payee,
4 "(B) shall specify the amount to be deducted
5 and withheld from each full payment, and
6 "(C) shall take effect—
7 "(i) in the case of sick pay, with respect
8 to payments made more than 7 days after
9 the date on which such request is furnished
10 to the payor, or
11 "(ii) in the case of an annuity, at such
12 time (after the date on which such request is
13 furnished to the payor) as the Secretary shall
14 by regulations prescribe.
15 Such a request may be changed or terminated by fur-
16 nishing to the person making the payments a written
17 statement of change or termination which shall take
18 effect in the same manner as provided in subparagraph
19 (C). At the election of the payor, any such request (or
20 statement of change or revocation) may take effect ear-
21 lier than as provided in subparagraph (C).
22 "(5) SPECIAL RULE FOR SICK PAY PAID PURSU-
23 ANT TO CERTAIN COLLECTIVE-BARGAINING AGREE-
24 MENTS.—In the case of any sick pay paid pursuant to
25 a collective-bargaining agreement between employee

1 representatives and one or more employers which con-
2 tains a provision specifying that this paragraph is to
3 apply to sick pay paid pursuant to such agreement and
4 contains a provision for determining the amount to be
5 deducted and withheld from each payment of such sick
6 pay—
7 "(A) the requirement of paragraph (1)(C) that
8 a request for withholding be in effect shall not
9 apply, and
10 "(B) except as provided in subsection (n), the
11 amounts to be deducted and withheld under this
12 chapter shall be determined in accordance with
13 such agreement.
14 The preceding sentence shall not apply with respect to
15 sick pay paid pursuant to any agreement to any indi-
16 vidual unless the social security number of such indi-
17 vidual is furnished to the payor and the payor is
18 furnished with such information as is necessary to
19 determine whether the payment is pursuant to the
20 agreement and to determine the amount to be deducted
21 and withheld."
22 (c) DEFINITION OF SICK PAY.—Paragraph (2) of sec-
23 tion 3402(o) of such Code (relating to definitions) is amended
24 by adding at the end thereof the following new subparagraph:

1 "(C) SICK PAY.—For purposes of this sub-
2 section, the term 'sick pay' means any amount
3 which—
4 "(i) is paid to an employee pursuant to
5 a plan to which the employer is a party, and
6 "(ii) constitutes remuneration or a pay-
7 ment in lieu of remuneration for any period
8 during which the employee is temporarily
9 absent from work on account of sickness or
10 personal injuries."
11 (d) TECHNICAL AMENDMENT.—Subparagraph (B) of
12 section 3402(o)(2) of such Code (defining annuity) is amended
13 by striking out ", but only to the extent that the amount is
14 includible in the gross income of such individual".
15 (e) REPORTING REQUIREMENTS.—Section 6051 of
16 such Code (relating to receipts for employees) is amended by
17 adding at the end thereof the following new subsection:
18 "(f) STATEMENTS REQUIRED IN CASE OF SICK PAY
19 PAID BY THIRD PARTIES.—
20 "(1) STATEMENTS REQUIRED FROM PAYOR.—
21 "(A) IN GENERAL.—If, during any calendar
22 year, any person makes a payment of third-party
23 sick pay to an employee, such person shall, on or
24 before January 15 of the succeeding year, furnish

1 a written statement to the employer in respect of
2 whom such payment was made showing—
3 "(i) the name and, if there is withhold-
4 ing under section 3402(o), the social security
5 number of such employee,
6 "(ii) the total amount of the third-party
7 sick pay paid to such employee during the
8 calendar year, and
9 "(iii) the total amount (if any) deducted
10 and withheld from such sick pay under sec-
11 tion 3402.
12 For purposes of the preceding sentence, the term
13 'third-party sick pay' means any sick pay (as de-
14 fined in section 3402(o)(2)(C)) which does not con-
15 stitute wages for purposes of chapter 24 (deter-
16 mined without regard to section 3402(o)(1)).
17 "(B) SPECIAL RULES.—
18 "(i) STATEMENTS ARE IN LIEU OF
19 OTHER REPORTING REQUIREMENTS.—The
20 reporting requirements of subparagraph (A)
21 with respect to any payments shall, with re-
22 spect to such payments, be in lieu of the re-
23 quirements of subsection (a) and of section
24 6041.

1 "(ii) PENALTIES MADE APPLICABLE.—
2 For purposes of sections 6674 and 7204, the
3 statements required to be furnished by sub-
4 paragraph (A) shall be treated as statements
5 required under this section to be furnished to
6 employees.
7 "(2) INFORMATION REQUIRED TO BE FURNISHED
8 BY EMPLOYER.—Every employer who receives a
9 statement under paragraph (1)(A) with respect to sick
10 pay paid to any employee during any calendar year
11 shall, on or before January 31 of the succeeding year,
12 furnish a written statement to such employee show-
13 ing—
14 "(A) the information shown on the statement
15 furnished under paragraph (1)(A), and
16 "(B) if any portion of the sick pay is exclud-
17 able from gross income under section 104(a)(3),
18 the portion which is not so excludable and the
19 portion which is so excludable.
20 To the extent practicable, the information required
21 under the preceding sentence shall be furnished on or
22 with the statement (if any) required under subsection
23 (a)."
24 (f) EFFECTIVE DATE.—The amendments made by this
25 section shall apply to payments made on or after the first day

1 of the first calendar month beginning more than 120 days
2 after the date of the enactment of this Act.

3 **SEC. 5. TREATMENT OF CERTAIN REPAYMENTS OF SUPPLE-**
4 **MENTAL UNEMPLOYMENT COMPENSATION**
5 **BENEFITS.**

6 (a) GENERAL RULE.—Section 62 of the Internal Reve-
7 nue Code of 1954 (defining adjusted gross income) is amend-
8 ed by inserting after paragraph (14) the following new para-
9 graph:

10 "(15) CERTAIN REQUIRED REPAYMENTS OF SUP-
11 PLEMENTAL UNEMPLOYMENT COMPENSATION BENE-
12 FITS.—The deduction allowed by section 165 for the
13 repayment to a trust described in paragraph (9) or (17)
14 of section 501(c) of supplemental unemployment com-
15 pensation benefits received from such trust if such re-
16 payment is required because of the receipt of trade re-
17 adjustment allowances under section 231 or 232 of the
18 Trade Act of 1974 (19 U.S.C. 2291 and 2292)."

19 (b) EFFECTIVE DATE.—The amendment made by sub-
20 section (a) shall apply to repayments made in taxable years
21 beginning after the date of the enactment of this Act.

22 **SEC. 6. DISCLOSURE OF TAX RETURNS TO STATE AUDIT AGEN-**
23 **CIES.**

24 (a) GENERAL RULE.—Subsection (d) of section 6103 of
25 the Internal Revenue Code of 1954 (relating to disclosure of

1 return information to State tax officials) is amended to read
2 as follows:
3 "(d) DISCLOSURE TO STATE TAX OFFICIALS.—
4 "(1) IN GENERAL.—Returns and return informa-
5 tion with respect to taxes imposed by chapters 1, 2, 6,
6 11, 12, 21, 23, 24, 31, 32, 44, 51, and 52 and sub-
7 chapter D of chapter 36, shall be open to inspection
8 by, or disclosure to, any State agency, body, or com-
9 mission, or its legal representative, which is charged
10 under the laws of such State with responsibility for the
11 administration of State tax laws for the purpose of, and
12 only to the extent necessary in, the administration of
13 such laws, including any procedures with respect to lo-
14 cating any person who may be entitled to a refund.
15 Such inspection shall be permitted, or such disclosure
16 made, only upon written request by the head of such
17 agency, body, or commission, and only to the repre-
18 sentatives of such agency, body, or commission desig-
19 nated in such written request as the individuals who
20 are to inspect or to receive the returns or return infor-
21 mation on behalf of such agency, body, or commission.
22 Such representatives shall not include any individual
23 who is the chief executive officer of such State or who
24 is neither an employee or legal representative of such
25 agency, body, or commission nor a person described in

1 subsection (n). However, such return information shall
2 not be disclosed to the extent that the Secretary deter-
3 mines that such disclosure would identify a confidential
4 informant or seriously impair any civil or criminal tax
5 investigation.

6 "(2) DISCLOSURE TO STATE AUDIT AGENCIES.—

7 "(A) IN GENERAL.—Any returns or return
8 information obtained under paragraph (1) by any
9 State agency, body, or commission may be open
10 to inspection by, or disclosure to, officers and em-
11 ployees of the State audit agency for the purpose
12 of, and only to the extent necessary in, making an
13 audit of the State agency, body, or commission
14 referred to in paragraph (1).

15 "(B) STATE AUDIT AGENCY.—For purposes
16 of subparagraph (A), the term 'State audit
17 agency' means any State agency, body, or com-
18 mission which is charged under the laws of the
19 State with the responsibility of auditing State rev-
20 enues and programs."

21 (b) EFFECTIVE DATE.—The amendment made by this
22 section shall take effect on the date of the enactment of this
23 Act.

1 SEC. 7. INVESTMENT CREDIT FOR CERTAIN PROPERTY USED
2 IN MARITIME SATELLITE COMMUNICATIONS.

3 (a) GENERAL RULE.—Paragraph (5) of section 48(a) of
4 the Internal Revenue Code of 1954 (relating to property used
5 by governmental units) is amended to read as follows:

6 "(5) PROPERTY USED BY GOVERNMENTAL
7 UNITS.—Property used by the United States, any
8 State or political subdivision thereof, any international
9 organization, or any agency or instrumentality of any
10 of the foregoing shall not be treated as section 38
11 property. For purposes of the preceding sentence, the
12 International Telecommunications Satellite Consor-
13 tium, the International Maritime Satellite Organization,
14 and any successor organization of such Consortium or
15 Organization shall not be treated as an international
16 organization."

17 (b) EFFECTIVE DATE.—The amendment made by sub-
18 section (a) shall apply to taxable years beginning after De-
19 cember 31, 1979.

20 SEC. 8. INCREASES IN INTEREST RATES PAYABLE ON UNITED
21 STATES RETIREMENT PLAN AND INDIVIDUAL
22 RETIREMENT BONDS.

23 (a) IN GENERAL.—The first section of the Second Lib-
24 erty Bond Act (31 U.S.C. 752) is amended by adding at the
25 end thereof the following new paragraph:

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1 "The Secretary of the Treasury, with the approval of
2 the President, may provide by regulations that the invest-
3 ment yield on any offerings of bonds issued under this Act
4 which are described in section 405(b) or 409(a) of the Inter-
5 nal Revenue Code of 1954 (relating to retirement plan bonds
6 and individual retirement bonds, respectively) be increased
7 for the interest accrual periods specified in such regulations
8 so that the investment yield on such bonds for such periods is
9 consistent with the investment yield on new offerings of such
10 bonds."

11 (b) EFFECTIVE DATE.—The amendment made by sub-
12 section (a) shall apply with respect to the investment yield on
13 bonds issued before, on, or after the date of the enactment of
14 this Act, but only for purposes of increasing the investment
15 yield on such bonds for interest accrual periods beginning
16 after the date of enactment of this Act.

Passed the House of Representatives September 17, 1979.

Attest: EDMUND L. HENSHAW, JR.,

*Clerk.*

II

96TH CONGRESS
1ST SESSION

# H. R. 5505

IN THE SENATE OF THE UNITED STATES

NOVEMBER 1 (legislative day, OCTOBER 15), 1979

Read twice and referred to the Committee on Finance

# AN ACT

To simplify certain provisions of the Internal Revenue Code of 1954, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. SHORT TITLE; AMENDMENT OF 1954 CODE.**
4 (a) SHORT TITLE.—This Act may be cited as the "Tax
5 Administrative Provisions Revision Act of 1979".
6 (b) AMENDMENT OF 1954 CODE.—Except as otherwise
7 expressly provided, whenever in this Act an amendment or
8 repeal is expressed in terms of an amendment to, or repeal of,
9 a section or other provision, the reference shall be considered
10 to be made to a section or other provision of the Internal
11 Revenue Code of 1954.

1 SEC. 2. PAYMENT OF INTEREST WHERE LEVY HAS BEEN
2 WRONGFULLY MADE AND MONEY RECEIVED BY
3 UNITED STATES.

4 (a) IN GENERAL.—Section 6343 (relating to release of
5 levy and return of property) is amended by adding at the end
6 thereof the following new subsection:

7 "(c) INTEREST.—Interest shall be allowed and paid at
8 an annual rate established under section 6621—

9 "(1) in a case described in subsection (b)(2), from
10 the date the Secretary receives the money to a date (to
11 be determined by the Secretary) preceding the date of
12 return by not more than 30 days, or

13 "(2) in a case described in subsection (b)(3), from
14 the date of the sale of the property to a date (to be
15 determined by the Secretary) preceding the date of
16 return by not more than 30 days."

17 (b) TECHNICAL AMENDMENT.—Subsection (a) of sec-
18 tion 6621 is amended to read as follows:

19 "(a) IN GENERAL.—The annual rate established under
20 this section shall be such adjusted rate as is established by
21 the Secretary under subsection (b)."

22 (c) EFFECTIVE DATES.—

23 (1) The amendment made by subsection (a) shall
24 apply to levies made after the date of the enactment of
25 this Act.

1 (2) The amendment made by subsection (b) shall
2 take effect on the date of the enactment of this Act.
3 SEC. 3. REPEAL OF REQUIREMENT THAT TRANSFERORS OF
4 CERTAIN PROPERTY TO EXEMPT ORGANIZA-
5 TIONS MUST FILE RETURNS.
6 (a) GENERAL RULE.—Section 6050 (relating to returns
7 relating to certain transfers to exempt organizations) is
8 hereby repealed.
9 (b) CLERICAL AMENDMENT.—The table of sections for
10 subpart B of part III of subchapter A of chapter 61 is
11 amended by striking out the item relating to section 6050.
12 (c) EFFECTIVE DATE.—The amendments made by this
13 section shall apply to transfers after the date of the enact-
14 ment of this Act.
15 SEC. 4. REPEAL OF ADDITION TO TAX IN CASE OF JEOPARDY.
16 (a) GENERAL RULE.—Section 6658 (relating to addi-
17 tion to tax in case of jeopardy) is hereby repealed.
18 (b) CLERICAL AMENDMENT.—The table of sections for
19 subchapter A of chapter 68 is amended by striking out the
20 item relating to section 6658.
21 (c) EFFECTIVE DATE.—The amendments made by this
22 section shall apply to violations (or attempted violations) oc-
23 curring after the date of the enactment of this Act.

1 SEC. 5. REPEAL OF REQUIREMENT THAT INFORMATION BE
2 FURNISHED TO THE SERVICE IN CONNECTION
3 WITH CERTAIN OPTIONS.

4 (a) GENERAL RULE.—Section 6039 (relating to infor-
5 mation required in connection with certain options) is amend-
6 ed to read as follows:

7 "SEC. 6039. INFORMATION REQUIRED IN CONNECTION WITH
8 CERTAIN OPTIONS.

9 "(a) FURNISHING OF INFORMATION.—Every corpora-
10 tion—

11 "(1) which in any calendar year transfers a share
12 of stock to any person pursuant to such person's exer-
13 cise of a qualified stock option or a restricted stock
14 option, or

15 "(2) which in any calendar year records (or has
16 by its agent recorded) a transfer of the legal title of a
17 share of stock—

18 "(A) acquired by the transferor pursuant to
19 his exercise of an option described in section
20 423(c) (relating to special rule where option price
21 is between 85 percent and 100 percent of value of
22 stock), or

23 "(B) acquired by the transferor pursuant to
24 his exercise of a restricted stock option described
25 in section 424(c)(1) (relating to options under

1 which option price is between 85 percent and 95
2 percent of value of stock),
3 shall (on or before January 31 of the following calen-
4 dar year) furnish to such person a written statement in
5 such manner and setting forth such information as the
6 Secretary may by regulations prescribe.
7 "(b) SPECIAL RULES.—For purposes of this section—
8 "(1) TREATMENT BY EMPLOYER TO BE DETER-
9 MINATIVE.—Any option which the corporation treats
10 as a qualified stock option, a restricted stock option, or
11 an option granted under an employee stock purchase
12 plan shall be deemed to be such an option.
13 "(2) SUBSECTION (a)(2) APPLIES ONLY TO FIRST
14 TRANSFER DESCRIBED THEREIN.—A statement is re-
15 quired by reason of a transfer described in subsection
16 (a)(2) of a share only with respect to the first transfer
17 of such share by the person who exercised the option.
18 "(3) IDENTIFICATION OF STOCK.—Any corpora-
19 tion which transfers any share of stock pursuant to the
20 exercise of any option described in subsection (a)(2)
21 shall identify such stock in a manner adequate to carry
22 out the purposes of this section.
23 "(c) CROSS REFERENCES.—

**"For definition of—**

**"(1) The term 'qualified stock option', see section 422(b).**

**"(2) The term 'employee stock purchase plan', see section 423(b).**

**"(3) The term 'restricted stock option', see section 424(b)."**

1 (b) TECHNICAL AMENDMENTS.—

2 (1) Subsection (a) of section 6652 is amended—

3 (A) by inserting "or" at the end of para-

4 graph (1),

5 (B) by striking out paragraph (2) and redes-

6 ignating paragraph (3) as paragraph (2), and

7 (C) by striking out "return referred to in

8 paragraph (2) or (3)" and inserting in lieu thereof

9 "return referred to in paragraph (2)".

10 (2) Section 6678 (relating to penalty for failure to

11 furnish certain statements) is amended to read as fol-

12 lows:

13 **"SEC. 6678. FAILURE TO FURNISH CERTAIN STATEMENTS.**

14 "In the case of each failure—

15 "(1) to furnish a statement under section 6042(c),

16 6044(e), 6049(c), or 6052(b), on the date prescribed

17 therefor to a person with respect to whom a return has

18 been made under section 6042(a)(1), 6044(a)(1),

19 6049(a)(1), or 6052(a), respectively, or

20 "(2) to furnish a statement under section 6039(a)

21 on the date prescribed therefor to a person with re-

22 spect to whom such a statement is required,

1 unless it is shown that such failure is due to reasonable cause
2 and not to willful neglect, there shall be paid (upon notice
3 and demand by the Secretary and in the same manner as tax)
4 by the person failing to so furnish the statement $10 for each
5 such statement not so furnished, but the total amount im-
6 posed on the delinquent person for all such failures during
7 any calendar year shall not exceed $25,000."

8 (c) EFFECTIVE DATE.—The amendments made by this
9 section shall apply with respect to calendar years beginning
10 after 1979.

11 SEC. 6. EXTENSION OF TIME FOR FILING GIFT TAX RETURN
12 FOR FOURTH CALENDAR QUARTER.

13 (a) GENERAL RULE.—Paragraph (1) of section 6075(b)
14 (relating to due date for gift tax returns) is amended to read
15 as follows:

16 "(1) GENERAL RULE.—Except as provided in
17 paragraph (2), returns made under section 6019 (relat-
18 ing to gift taxes) shall be filed on or before—

19 "(A) in the case of a return for the first,
20 second, or third calendar quarter of any calendar
21 year, the 15th day of the second month following
22 the close of the calendar quarter, or

23 "(B) in the case of a return for the fourth
24 calendar quarter of any calendar year, the 15th

1 day of the fourth month following the close of the
2 calendar quarter."
3 (b) EXTENSION OF DATE FOR FILING INCOME TAX
4 RETURN TREATED AS EXTENSION OF DATE FOR FILING
5 GIFT TAX RETURN.—Subsection (b) of section 6075 is
6 amended by redesignating paragraph (3) as paragraph (4) and
7 by inserting after paragraph (2) the following new paragraph:
8 "(3) EXTENSION WHERE TAXPAYER GRANTED
9 EXTENSION FOR FILING INCOME TAX RETURN.—Any
10 extension of time granted the taxpayer for filing the
11 return of income taxes imposed by subtitle A for any
12 taxable year which is a calendar year shall be deemed
13 to be also an extension of time granted the taxpayer
14 for filing the return under section 6019 for the fourth
15 calendar quarter of such taxable year."
16 (c) TECHNICAL AMENDMENTS.—Paragraph (2) of sec-
17 tion 6075(b) is amended—
18 (1) by striking out "the 15th day of the second
19 month after" and inserting in lieu thereof "the date
20 prescribed by paragraph (1) for filing the return for",
21 and
22 (2) by striking out "the close of" in subpara-
23 graphs (A) and (B).

1 (d) Effective Date.—The amendments made by this
2 section shall apply to returns for gifts made in calendar years
3 ending after the date of the enactment of this Act.

4 SEC. 7. TIME FOR PAYMENT OF MANUFACTURERS EXCISE TAX
5 ON RODS, CREELS, ETC.

6 (a) General Rule.—Section 6302 (relating to mode
7 or time of collecting tax) is amended by redesignating subsec-
8 tion (d) as subsection (e) and by inserting after subsection (c)
9 the following new subsection:

10 "(d) Time for Payment of Manufacturers
11 Excise Tax on Rods, Creels, Etc.—The tax imposed
12 by section 4161(a) (relating to manufacturers excise tax on
13 rods, creels, etc.) shall be due and payable—

14 "(1) in the case of articles sold during the quarter
15 ending December 31, on March 31,

16 "(2) in the case of articles sold during the quarter
17 ending March 31, on June 30,

18 "(3) in the case of articles sold during the quarter
19 ending June 30, on September 24, and

20 "(4) in the case of articles sold during the quarter
21 ending September 30, at such time as the Secretary
22 may by regulations prescribe."

23 (b) Effective Date.—The amendment made by sub-
24 section (a) shall apply to articles sold on or after the first day

1 of the first calendar quarter beginning after the date of the
2 enactment of this Act.

3 SEC. 8. TRANSFER OF DOMESTIC WINE TO CUSTOMS BONDED
4 WAREHOUSE FOR CERTAIN PURPOSES.

5 (a) TRANSFER TO CUSTOMS BONDED WAREHOUSE.—
6 Paragraph (4) of section 5362(c) (relating to withdrawals of
7 wine free of tax or without payment of tax) is amended to
8 read as follows:

9 "(4) without payment of tax for transfer to any
10 customs bonded warehouse;".

11 (b) WITHDRAWAL FROM CUSTOMS BONDED WARE-
12 HOUSES FOR USE OF FOREIGN EMBASSIES, LEGATIONS,
13 ETC.—Section 5362 is amended by adding at the end thereof
14 the following new subsection:

15 "(e) WITHDRAWAL FROM CUSTOMS BONDED WARE-
16 HOUSES FOR USE OF FOREIGN EMBASSIES, LEGATIONS,
17 ETC.—

18 "(1) IN GENERAL.—Notwithstanding any other
19 provision of law, wine entered into customs bonded
20 warehouses under subsection (c)(4) may, under such
21 regulations as the Secretary may prescribe, be with-
22 drawn from such warehouses for consumption in the
23 United States by and for the official or family use of
24 such foreign governments, organizations, and individ-
25 uals who are entitled to withdraw imported wines from

1 such warehouses free of tax. Wines transferred to cus-
2 toms bonded warehouses under subsection (c)(4) shall
3 be entered, stored, and accounted for in such ware-
4 houses under such regulations and bonds as the Secre-
5 tary may prescribe, and may be withdrawn therefrom
6 by such governments, organizations, and individuals
7 free of tax under the same conditions and procedures
8 as imported wines.

9 "(2) WITHDRAWAL FOR DOMESTIC USE.—Wine
10 entered into customs bonded warehouses under subsec-
11 tion (c)(4) for purposes of removal under paragraph (1)
12 may be withdrawn therefrom for domestic use. Wines
13 so withdrawn shall be treated as American goods ex-
14 ported and returned.

15 "(3) SALE OR UNAUTHORIZED USE PROHIBIT-
16 ED.—Wine withdrawn from customs bonded ware-
17 houses or otherwise brought into the United States
18 free of tax for the official or family use of foreign gov-
19 ernments, organizations, or individuals authorized to
20 obtain wine free of tax shall not be sold and shall not
21 be disposed of or possessed for any use other than an
22 authorized use. The provisions of paragraphs (1)(B) and
23 (3) of section 5043(a) are hereby extended and made
24 applicable to any person selling, disposing of, or pos-

1 sessing any wine in violation of the preceding sentence,
2 and to the wine involved in any such violation."
3 (c) EFFECTIVE DATE.—The amendments made by this
4 section shall take effect on the first day of the first calendar
5 month which begins more than 90 days after the date of the
6 enactment of this Act.
7 **SEC. 9. EXCISE TAX REFUNDS IN CASE OF CERTAIN USES OF**
8 **TREAD RUBBER.**
9 (a) REFUNDS FOR CERTAIN USES.—Subparagraph (G)
10 of section 6416(b)(2) is amended to read as follows:
11 "(G) in the case of tread rubber in respect of
12 which tax was paid under section 4071(a)(4)—
13 "(i) used or sold for use otherwise than
14 in the recapping or retreading of tires of the
15 type used on highway vehicles (as defined in
16 section 4072(c)),
17 "(ii) destroyed, scrapped, wasted, or
18 rendered useless in the recapping or retread-
19 ing process,
20 "(iii) used in the recapping or retreading
21 of a tire the sale of which is later adjusted
22 pursuant to a warranty or guarantee, in
23 which case the overpayment shall be in pro-
24 portion to the adjustment in the sales price
25 of such tire, or

1 "(iv) used in the recapping or retreading
2 of a tire, if such tire is by any person export-
3 ed, used or sold for use as supplies for ves-
4 sels or aircraft, sold to a State or local gov-
5 ernment for the exclusive use of a State or
6 local government, or sold to a nonprofit edu-
7 cational organization for its exclusive use,
8 unless credit or refund of such tax is allowable
9 under paragraph (3);".
10 (b) USE IN FURTHER MANUFACTURE, ETC.—
11 (1) IN GENERAL.—Paragraph (3) of section
12 6416(b) is amended by inserting after subparagraph (C)
13 the following new subparagraph:
14 "(D) in the case of tread rubber in respect of
15 which tax was paid under section 4071(a)(4) used
16 in the recapping or retreading of a tire, such tire
17 is sold by the subsequent manufacturer or produc-
18 er on or in connection with, or with the sale of,
19 any other article manufactured or produced by
20 him and such other article is by any person ex-
21 ported, sold to a State or local government for the
22 exclusive use of a State or local government, sold
23 to a nonprofit educational organization for its ex-
24 clusive use, or used or sold for use as supplies for

1 vessels or aircraft, unless credit or refund of such
2 tax is allowable under subparagraph (C);".
3 (2) TECHNICAL AMENDMENTS.—
4 (A) Subparagraph (E) of section 6416(b)(2) is
5 amended by inserting after "paragraph (3)" the
6 following: "(or in the case of the tread rubber on
7 a recapped or retreaded tire, resold for use as
8 provided in subparagraph (D) of paragraph (3)),".
9 (B) Subparagraph (C) of section 6416(a)(1) is
10 amended by striking out "(b)(3)(C)" and inserting
11 in lieu thereof "(b)(3) (C) or (D)".
12 (C) Subparagraph (A) of section 6416(b)(3) is
13 amended by inserting "(D)," after "(C),".
14 (D) Subparagraph (A) of section 6416(b)(4) is
15 amended by striking out "section 4071" and in-
16 serting in lieu thereof "section 4071 or a re-
17 capped or retreaded tire in respect of which tax
18 under section 4071(a)(4) was paid on the tread
19 rubber used in the recapping or retreading".
20 (c) STATUTE OF LIMITATIONS.—Section 6511 is
21 amended by redesignating subsection (h) as subsection (i) and
22 by inserting after subsection (g) the following new subsection:
23 "(h) SPECIAL RULE FOR CERTAIN TREAD RUBBER
24 TAX CREDITS OR REFUNDS.—The period for allowing a
25 credit or making a refund of any overpayment of tax arising

1 by reason of subparagraph (G)(iii) of section 6416(b)(2) with
2 respect to any adjustment of sales price of a tire pursuant to
3 a warranty or guarantee shall not expire if claim therefor is
4 filed before the date which is 1 year after the day on which
5 such adjustment is made."

6 (d) IMPORTED RECAPPED OR RETREADED UNITED
7 STATES TIRES.—Section 4071 is amended by adding at the
8 end thereof the following new subsection:

9 "(f) IMPORTED RECAPPED OR RETREADED UNITED
10 STATES TIRES.—

11 "(1) IN GENERAL.—For purposes of subsection
12 (a)(4), in the case of a tire which has been exported
13 from the United States, recapped or retreaded (other
14 than from bead to bead) outside the United States, and
15 imported into the United States—

16 "(A) the person importing such tire shall be
17 treated as importing the tread rubber used in such
18 recapping or retreading (determined as of the
19 completion of the recapping or retreading), and

20 "(B) the sale of such tire by the importer
21 thereof shall be treated as the sale of such tread
22 rubber.

23 "(2) EXCEPTION FOR CERTAIN TAXABLE
24 SALES.—Paragraph (1) shall not apply with respect to
25 the sale of any tire if such tire is sold on or in connec-

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1 tion with the sale of an article on which tax is imposed
2 under section 4061."
3 (e) EFFECTIVE DATE.—The amendments made by this
4 section shall take effect on the first day of the first calendar
5 month which begins more than 10 days after the date of the
6 enactment of this Act.

7 **SEC. 10. APPLICATION OF SECTION 1034 IN CASE OF CERTAIN**
8 **MEMBERS OF ARMED FORCES.**

9 (a) GENERAL RULE.—Subsection (h) of section 1034
10 (relating to sale or exchange of residence by members of
11 Armed Forces) is amended to read as follows:
12 "(h) MEMBERS OF ARMED FORCES.—
13 "(1) IN GENERAL.—The running of any period of
14 time specified in subsection (a) or (c) (other than the 18
15 months referred to in subsection (c)(4)) shall be sus-
16 pended during any time that the taxpayer (or his
17 spouse if the old residence and the new residence are
18 each used by the taxpayer and his spouse as their prin-
19 cipal residence) serves on extended active duty with
20 the Armed Forces of the United States after the date
21 of the sale of the old residence, except that any such
22 period of time as so suspended shall not extend beyond
23 the date 4 years after the date of the sale of the old
24 residence.

1 "(2) MEMBERS STATIONED OUTSIDE THE
2 UNITED STATES, ETC.—
3 "(A) FURTHER EXTENSION OF PERIOD.—In
4 the case of any taxpayer who, during any period
5 of time the running of which is suspended by
6 paragraph (1)—
7 "(i) is stationed outside of the United
8 States, or
9 "(ii) is required to reside in Govern-
10 ment-owned quarters,
11 any such period of time as so suspended shall not
12 expire before the later of the date provided for in
13 paragraph (1) or the date 1 year after the date on
14 which the taxpayer is no longer stationed outside
15 of the United States or is no longer required to
16 reside in such quarters, as the case may be.
17 "(B) REQUIREMENT OF NOTICE.—No exten-
18 sion shall be granted with respect to any resi-
19 dence by reason of subparagraph (A) for any
20 period unless the taxpayer has filed notice (in
21 such form and at such time as may be prescribed
22 by regulations) claiming the benefits of subpara-
23 graph (A) for such period. The notice described in
24 the preceding sentence, with respect to any resi-

1 dence, shall not be required to be filed more than
2 once a year.
3 "(3) EXTENDED ACTIVE DUTY DEFINED.—For
4 purposes of this subsection, the term 'extended active
5 duty' means any period of active duty pursuant to a
6 call or order to such duty for a period in excess of 90
7 days or for an indefinite period."
8 (b) EFFECTIVE DATE.—The amendment made by sub-
9 section (a) shall apply to sales of old residences (within the
10 meaning of section 1034 of the Internal Revenue Code of
11 1954) after December 31, 1979.

12 **SEC. 11. EXEMPT STATUS OF AUXILIARIES OF CERTAIN FRA-**
13 **TERNAL BENEFICIARY SOCIETIES.**

14 (a) GENERAL RULE.—Subsection (i) of section 501 is
15 amended by adding at the end thereof the following new sen-
16 tence: "The preceding sentence to the extent it relates to
17 discrimination on the basis of religion shall not apply to an
18 auxiliary of a fraternal beneficiary society if such society (1)
19 is described in subsection (c)(8) and exempt from tax under
20 subsection (a), and (2) limits its membership to the members
21 of a particular religion."
22 (b) EFFECTIVE DATE.—The amendment made by sub-
23 section (a) shall apply to taxable years beginning after Octo-
24 ber 20, 1976.

1 SEC. 12. EXTENSION OF CERTAIN TEMPORARY TAX PROVI-
2 SIONS.
3 (a) GOVERNMENT HEALTH PROVISION SCHOLARSHIP
4 PROGRAMS.—Subsection (c) of section 4 of Public Law
5 93-483, as amended, is amended—
6 (1) by striking out "1980" and inserting in lieu
7 thereof "1981", and
8 (2) by striking out "1984" and inserting in lieu
9 thereof "1985".
10 (b) NATIONAL RESEARCH SERVICE AWARDS.—Para-
11 graph (2) of section 161(b) of the Revenue Act of 1978 (relat-
12 ing to national research service awards) is amended by strik-
13 ing out "1979" and inserting in lieu thereof "1980".
14 (c) DEDUCTION FOR ELIMINATING ARCHITECTURAL
15 AND TRANSPORTATION BARRIERS TO THE HANDI-
16 CAPPED.—Subsection (c) of section 2122 of the Tax Reform
17 Act of 1976 (relating to effective date for allowance of deduc-
18 tion for eliminating architectural and transportation barriers
19 to the handicapped) is amended by striking out "January 1,
20 1980" and inserting in lieu thereof "January 1, 1983".
21 (d) CONTROVERSIES INVOLVING WHETHER INDIVID-
22 UALS ARE EMPLOYEES FOR PURPOSES OF THE EMPLOY-
23 MENT TAXES.—
24 (1) IN GENERAL.—Subsection (a) of section 530
25 of the Revenue Act of 1978 (relating to termination of

1 certain employment tax liability for periods before
2 1980) is amended—
3 (A) by striking out "January 1, 1980" in
4 paragraphs (1)(A) and (3) and inserting in lieu
5 thereof "January 1, 1981",
6 (B) by striking out "1980" in the subsection
7 heading and inserting in lieu thereof "1981", and
8 (C) by striking out "1979" in the heading for
9 paragraph (3) and inserting in lieu thereof "1979
10 and 1980".
11 (2) PROHIBITION AGAINST REGULATIONS AND
12 RULINGS ON EMPLOYMENT STATUS.—Subsection (b)
13 of section 530 of the Revenue Act of 1978 is amended
14 by striking out "January 1, 1980" and inserting in lieu
15 thereof "January 1, 1981".
16 (e) ADDITIONAL 2-YEAR DELAY IN APPLICATION OF
17 THE NET OPERATING LOSS RULES ADDED BY THE TAX
18 REFORM ACT OF 1976.—Paragraphs (2) and (3) of section
19 806(g) of the Tax Reform Act of 1976 (relating to effective
20 dates for the amendments to sections 382 and 383 of the
21 Internal Revenue Code of 1954) are amended by striking out
22 "1980" each place it appears and inserting in lieu thereof
23 "1982".

Passed the House of Representatives October 30, 1979.

Attest: EDMUND L. HENSHAW, JR.,

*Clerk.*

II

96TH CONGRESS
1ST SESSION

# H. R. 5973

IN THE SENATE OF THE UNITED STATES

DECEMBER 18 (legislative day, DECEMBER 15), 1979
Read twice and referred to the Committee on Finance

# AN ACT

To amend the Internal Revenue Code of 1954 to waive in certain cases the residency requirements for deductions or exclusions of individuals living abroad, to allow the tax-free rollover of certain distributions from money purchase pension plans, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. RESIDENCY REQUIREMENTS FOR DEDUCTIONS OR**
4 **EXCLUSIONS OF INDIVIDUALS LIVING ABROAD.**
5 (a) GENERAL RULE.—Subsection (j) of section 913 of
6 the Internal Revenue Code of 1954 (relating to deduction for
7 certain expenses of living abroad) is amended by adding at
8 the end thereof the following new paragraph:

1 "(4) WAIVER OF PERIOD OF STAY IN FOREIGN
2 COUNTRY.—For purposes of paragraphs (1) and (2) of
3 subsection (a), an individual who—
4 "(A) for any period is a bona fide resident of
5 or is present in a foreign country,
6 "(B) leaves such foreign country after Au-
7 gust 31, 1978—
8 "(i) during any period during which the
9 Secretary determines, after consultation with
10 the Secretary of State or his delegate, that
11 individuals were required to leave such for-
12 eign country because of war, civil unrest, or
13 similar adverse conditions in such foreign
14 country which precluded the normal conduct
15 of business by such individuals, and
16 "(ii) before meeting the requirements of
17 such paragraphs (1) and (2), and
18 "(C) establishes to the satisfaction of the
19 Secretary that he could reasonably have been ex-
20 pected to have met such requirements but for the
21 conditions referred to in clause (i) of subparagraph
22 (B),
23 shall be treated as having met such requirements with
24 respect to the period described in subparagraph (A)

1 during which he was a bona fide resident or was pres-
2 ent in the foreign country."
3 (b) EFFECTIVE DATES.—
4 (1) IN GENERAL.—The amendment made by sub-
5 section (a) shall apply to taxable years beginning after
6 December 31, 1977.
7 (2) APPLICATION FOR PURPOSES OF SECTION
8 911.—In the case of an individual who leaves the for-
9 eign country after August 31, 1978, rules similar to
10 the rules of section 913(j)(4) of the Internal Revenue
11 Code of 1954 (as added by subsection (a)) shall apply
12 for purposes of applying section 911 of such Code for
13 taxable years beginning in 1977 or 1978.
14 **SEC. 2. ROLLOVER TREATMENT FOR CERTAIN DISTRIBUTIONS**
15 **FROM MONEY PURCHASE PENSION PLANS.**
16 (a) GENERAL RULE.—Paragraph (6) of section 402(a)
17 of the Internal Revenue Code of 1954 (relating to special
18 rollover rules) is amended by adding at the end thereof the
19 following new subparagraph:
20 "(E) SPECIAL RULE WHERE EMPLOYER
21 MAINTAINS MONEY PURCHASE PENSION PLAN
22 AND OTHER PENSION PLAN.—
23 "(i) IN GENERAL.—In the case of any
24 distribution from a money purchase pension
25 plan which is maintained by an employer, for

1 purposes of paragraph (5)(D)(i)(II), subsection
2 (e)(4)(C) shall be applied by not taking into
3 account any pension plan maintained by such
4 employer which is not a money purchase
5 pension plan. The preceding sentence shall
6 not apply to any distribution which is a
7 qualifying rollover distribution without regard
8 to this subparagraph.

9 "(ii) TREATMENT OF SUBSEQUENT DIS-
10 TRIBUTIONS.—If—

11 "(I) any distribution of the balance
12 to the credit of an employee from a
13 money purchase pension plan main-
14 tained by an employer is treated as a
15 qualifying rollover distribution by reason
16 of clause (i), and

17 "(II) any portion of such distribu-
18 tion is transferred in a transfer to which
19 paragraph (5)(A) applies,

20 then paragraph (2) of subsection (a), and
21 paragraphs (1) and (3) of subsection (e), shall
22 not apply to any distribution (after the tax-
23 able year in which the distribution described
24 in subparagraph (A) of paragraph (5) is
25 made) of the balance to the credit of such

1 employee from any other pension plan main-
2 tained by such employer."
3 (b) EFFECTIVE DATES.—
4 (1) IN GENERAL.—The amendment made by sub-
5 section (a) shall apply to payments made in taxable
6 years beginning after December 31, 1978.
7 (2) TRANSITIONAL RULE.—In the case of any
8 payment made before January 1, 1981, in a taxable
9 year beginning after December 31, 1978, which is
10 treated as a qualifying rollover distribution (as defined
11 in section 402(a)(5)(D)(i) of the Internal Revenue Code
12 of 1954) by reason of the amendment made by subsec-
13 tion (a), the applicable period specified in section
14 402(a)(5)(C) of such Code shall not expire before the
15 close of December 31, 1980.
16 **SEC. 3. APPLICATION OF TARGETED JOBS CREDIT TO CER-**
17 **TAIN YOUTHS.**
18 (a) GENERAL RULE.—Clause (i) of section 51(d)(8)(A)
19 of the Internal Revenue Code of 1954 (defining youth partici-
20 pating in a qualified cooperative education program) is
21 amended by striking out "19" and inserting in lieu thereof
22 "20".
23 (b) EFFECTIVE DATE.—The amendment made by sub-
24 section (a) shall apply to wages paid on or after November
25 27, 1979, in taxable years ending on or after such date.

1 SEC. 4. TREATMENT OF CERTAIN INDEBTEDNESS INCURRED
2 BEFORE 1965 FOR PURPOSES OF SECTION 514.
3 (a) GENERAL RULE.—For purposes of applying section
4 514 of the Internal Revenue Code of 1954 with respect to
5 any sale of real property during 1976, indebtedness incurred
6 before January 1, 1965, by an organization to finance the
7 construction of a building on such property shall not be
8 treated as acquisition indebtedness if the parcel of real prop-
9 erty on which such building was constructed—
10 (1) was acquired by such organization before Jan-
11 uary 1, 1952, and
12 (2) is contiguous to another parcel of real property
13 which—
14 (A) was acquired by such organization before
15 January 1, 1952, and
16 (B) was used by such organization, on Janu-
17 ary 1, 1952, and at all times thereafter before the
18 date of the enactment of this Act, in a manner
19 which meets the requirements of section
20 514(b)(1)(A) of such Code (relating to property
21 used in carrying out exempt purpose).

1 (b) EFFECTIVE DATE.—The provisions of subsection (a)
2 shall apply to sales during calendar year 1976.

Passed the House of Representatives December 17, 1979.

Attest: EDMUND L. HENSHAW, JR.,
*Clerk.*

By BENJAMIN J. GUTHRIE,
*Assistant to the Clerk.*

# DESCRIPTION OF TAX BILLS LISTED FOR A HEARING

## INTRODUCTION

The bills described in this pamphlet have been scheduled for hearings on February 29 and March 4, 1980, by the Senate Finance Subcommittee on Taxation and Debt Management Generally. There are 18 Senate bills and three House-passed bills described in the pamphlet.

The first part of the pamphlet is a summary of the bills generally presented in bill numerical order for Senate bills and then for House-passed bills. This is followed by a more detailed description of the bills, setting forth present law, the issues involved, an explanation of the bills, the effective dates, and the estimated revenue effects.

# I. SUMMARY OF BILLS

## A. SENATE BILLS

### 1. S. 464—Senator Inouye

**Extension of Targeted Jobs Tax Credit to Displaced Homemakers**

Under present law, an income tax credit is provided for the hiring of certain categories of individuals. In general, the amount of the credit is equal to 50 percent of qualified first-year wages and 25 percent of qualified second-year wages.

The bill would add displaced homemakers to the categories of targeted groups eligible for the jobs credit.

### 2. S. 485—Senators Cannon and Laxalt

**Exemption From Excise Tax on Wagers and Occupational Tax on Wagering in States Authorizing Wagering**

Under present law, a 2-percent excise tax is imposed on the amount of certain wagers. In addition, an annual $500 occupational tax is imposed on a person who is liable for the excise tax or who receives wagers subject to the tax. These taxes do not apply with respect to parimutuel wagering, a wager placed in a coin-operated device, or a wager in a State-conducted lottery.

Under the bill, the 2-percent tax would not apply to any wager authorized under State law and the annual $500 occupational tax would not apply to a person authorized by State or local law to engage in the business of accepting wagers or to receive wagers on behalf of another person.

### 3. S. 650—Senator Moynihan

**Treatment of Certain Employees' Trusts Organized To Invest in Real Estate**

Generally, under present law, if an otherwise tax-exempt trust forming part of a qualified pension, profit sharing, or stock bonus plan ("qualified retirement plan") invests in debt-financed property, all or a portion of the income derived from such property is treated as unrelated to the exempt functions of the trust and therefore is subject to an income tax on unrelated business taxable income.

The bill would prescribe qualification rules for a group real estate employee benefit trust in which at least ten or more qualified retirement plans maintained by ten or more employers participate. Subject to certain investment and other conditions, a group real estate employee benefit trust would be a tax qualified trust established to invest in real estate in the United States or Puerto Rico. Unlike other

trusts forming part of qualified retirement plans, a group real estate employee benefit trust would not be subject to the tax on unrelated debt-financed income.

### 4. S. 1194—Senator Heflin

### Unemployment Tax Status of Certain Fishing Boat Services

Under present law, certain crew members of fishing boats are treated as self-employed individuals rather than as employees for purposes of the Federal Insurance Contributions Act (FICA) and income tax withholding. However, services which are not subject to FICA taxes are not exempt for purposes of the Federal Unemployment Tax Act (FUTA) if the services are related to catching halibut or salmon for commercial purposes or if the services are performed on a vessel of more than ten net tons.

The bill would exclude from coverage, for purposes of FUTA, those services of fishing boat crew members which currently are excluded for purposes of FICA and income tax withholding.

### 5. S. 1831—Senator Talmadge

### Net Operating Loss Deduction of Former Real Estate Investment Trusts

The bill would permit trusts which were former real estate investment trusts (REITs) an additional year to carryover operating losses for each year a carryback was not allowed because it was a REIT in the carryback year. The maximum carryover period would be 8 years.

### 6. S. 1859—Senators Percy and Dole and S. 2201—Senator Bellmon

### Special Estate Tax Valuation of Farm Real Property

Under present law, certain farm real estate may be included in a decedent's gross estate for estate tax purposes at its current use value rather than its highest and best use value. In general, the current use valuation may be determined under a "multiple factor" approval or by a capitalization of income formula that is primarily based on cash rentals for comparable farm land.

The bill, S. 1859, would provide that if there is no comparable land from which to determine the average gross cash rental, then the average net share rental could be substituted for the average gross cash rental in applying the formula method of valuation. The bill, S. 2201, contains substantially identical provisions.

### 7. S. 1900 and S. 1901—Senator Heflin

### Amount of Casualty Loss Deduction for Timber and Fruit or Nut Trees

Under present law, the deduction for a casualty loss is limited to the amount of the taxpayer's adjusted basis in the damaged property.

The bill, S. 1900, would provide that, in the case of fruit and nut trees, the loss limitation would be the greater of the taxpayer's adjusted basis in the damaged property or its fair market value before the casualty occurred. The bill, S. 1901, would provide similar treatment for casualty losses of timber. Under the bills, a special loss carryback rule of 10 taxable years and carryover period of 4 taxable years would apply respectively to casualty losses to fruit and nut trees and to timber.

### 8. S. 2089—Senators Roth, Helms, and Talmadge

### Waiver of Period of Limitations for Claiming Refunds for Single Purpose Agricultural Structures

Under the bill, a claim for refund filed within one year of enactment would be allowable notwithstanding expiration of the period of limitations for refunds with respect to single purpose agricultural structures qualifying for the investment tax credit under the Revenue Act of 1978.

### 9. S. 2167—Senator Stone

### Taxation of Certain Homeowners Associations at the Corporate Graduated Rates

Under present law, a qualified homeowners association is not taxed on its exempt function income. Other income, less certain deductions, is taxed at the highest corporate rate of 46 percent. The bill would permit this income to be taxed at the corporate graduated rates.

### 10. S. 2180—Senator Byrd (of Virginia)

### Replacement Period for Nonrecognition of Gain on Sale of Residence

In general, gain on the sale of a taxpayer's principal residence will not be recognized for income tax purposes if a replacement residence is purchased or constructed and certain requirements are met within specified time periods.

The bill would, under limited circumstances, require the Secretary of the Treasury to extend to five years the present two-year period during which a taxpayer must occupy and use as a principal residence a newly constructed replacement residence. The bill is intended to benefit Mrs. Jane M. Cathcart of Virginia.

### 11. S. 2275—Senator Gravel

### Technical Amendments to the Provisions Relating to General Stock Ownership Corporations

Under present law, a State is authorized to establish a general stock ownership corporation (GSOC) for the benefit of all its citizens. It is anticipated that the GSOC will be permitted to borrow money to invest in business enterprises. The cash flow from the operation of the business would be used to service and repay the loan, and the

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remaining cash would be distributed to the GSOC shareholders (i.e., all the citizens of the State). A corporation must meet certain statutory tests in order to be treated as a GSOC. Generally, a GSOC is exempt from Federal income taxation. Instead, the shareholders of the GSOC would report their proportionate part of the GSOC's taxable income on their Federal individual income tax returns.

The bill would make several technical changes in the tax law relating to GSOCs.

## B. HOUSE-PASSED BILLS

## 1. H.R. 4746

### Section 1. Simplification of private foundation return and reporting requirements

This section combines information reporting requirements for private foundations so that only one return would have to be filed to furnish information now required on two separate returns. It also provides that nonexempt wholly charitable trusts would be required to report the same information and be subject to the same disclosure requirements as exempt charitable organizations. Finally, it provides that disclosure of the name and address of an indigent or needy person receiving a grant of less than $1,000 in any year need not be made.

### Section 2. Treatment of payment or reimbursement by private foundations for expenses of foreign travel by government officials

Present law, in effect, prohibits any "self-dealing" between private foundations and "disqualified persons." Under these rules, any payment or reimbursement by a private foundation of expenses of government officials generally is classified as an act of self-dealing. However, a limited exception in existing law permits a private foundation to pay or reimburse certain expenses of government officials for travel solely within the United States.

This section of the bill broadens this existing exception to permit a private foundation (other than a foundation supported by any one business enterprise, trade association, or labor organization) to pay or reimburse government officials for certain expenses of foreign travel under similar types of limitations as apply under current law in the case of expenses for domestic travel.

### Section 3. Alternative minimum tax on charitable lead trusts created by corporations

Under present law, the alternative minimum tax may be imposed on a charitable lead trust set up by a corporation because the deduction for income paid to charity is treated as an adjusted itemized deduction preference. However, if the corporation had made a contribution to charity directly instead of through a charitable lead trust, there would be no alternative minimum tax because corporations are not subject to this tax.

This section of the bill provides that the charitable deduction of a charitable lead trust will not be considered in determining the adjusted itemized deduction preference for purposes of the alternative minimum tax if the grantor of the trust and the owner of all reversionary interests in the trust is a corporation.

### Section 4. Extension of withholding to payments of sick pay made by third parties

Under present law, no tax is specifically required to be withheld upon payments of sick pay made to an employee by a person who is not the employer for whom the employee performs services. For example, no tax is withheld from payments of sick pay made on behalf of an employer by an insurance company under an accident or health policy.

In general, this section of the bill provides for voluntary withholding from payments of sick pay made by a third party. In addition, it contains a special provision relating to sick pay paid pursuant to certain collective-bargaining agreements and contains various reporting requirements.

### Section 5. Treatment of certain repayments of supplemental unemployment compensation benefits

Under present law, if a worker who has been laid off is required to pay back supplemental unemployment compensation benefits because of the subsequent receipt of trade readjustment assistance, the worker may be entitled to tax relief in the year of repayment under a special tax computation for cases where the taxpayer restores a substantial amount held under a claim of right (Code sec. 1341). However, if the amount of supplemental unemployment compensation benefits required to be paid back by the worker is $3,000 or less, the worker may not be eligible for any tax relief for the repayment of previously taxed amounts unless itemized deductions are claimed.

This section of the bill would allow a deduction from gross income for the repayment of supplemental unemployment compensation benefits if the repayment is required because of the receipt of trade readjustment allowances.

### Section 6. Disclosure of tax returns to State audit agencies

Present law authorizes the disclosure of returns and return information to State agencies, which are charged under the laws of the State with responsibility for the administration of State tax laws, for the purpose of, and only to the extent necessary in, the administration of such laws.

This section of the bill would permit State taxing authorities to disclose Federal tax return information in their possession to State auditing agencies for the purpose of auditing the activities of the State taxing authority.

### Section 7. Investment tax credit for certain property used in maritime satellite communications

Under present law, the investment credit is not generally available for property used outside the United States or for property used by an international organization. Under the Revenue Act of 1971, these limitations were made inapplicable to interests of United States persons in communications satellites used by the International Telecommunications Satellite Organization (INTELSAT). This permitted

the Communications Satellite Corporation (COMSAT), the governmentally designated United States participant in INTELSAT, to obtain the credit on its share of qualifying investments made by the INTELSAT joint venture.

This section of the bill would similarly make the credit available for interests of United States persons in communications satellites used by the International Maritime Satellite Organization (INMARSAT), an international organization established to develop and operate a global maritime satellite telecommunications system.

**Section 8. Rate of interest on United States retirement bonds**

Under present law, the interest rate on an individual retirement bond issued by the Treasury Department or a retirement plan bond issued by the Treasury Department remains the same from the date of issuance until the bond is redeemed (generally when the owner retires, becomes disabled, or dies).

This section of the bill would authorize the Treasury Department to make upward adjustments in the interest rate on outstanding retirement bonds, so that such a bond would earn interest at a rate consistent with the yield for new issues of such bonds.

## 2. H.R. 5505 [1]

### Section 7. Change of time for paying excise tax on fishing equipment [2]

Present law imposes a 10-percent excise tax upon the sale of fishing rods, creels, reels, and artificial lures, baits, and flies by the manufacturer, producer or importer thereof. This tax generally is payable relatively soon after such fishing equipment is sold.

This section provides that the excise tax on fishing equipment sold during quarters ending on December 31, March 31, and June 30 would be payable, respectively, on March 31, June 30, and September 24. For the quarter ending September 30, the tax will be due by the date specified by Treasury regulations.

### Section 8. Excise tax treatment of domestic wines for certain uses

This section eliminates a distinction between the excise tax treatment of domestic and imported wines so that domestic wines, like imported wines, may be transferred to customs bonded warehouses without payment of tax. In addition, the provision will allow tax-free sales of wines from customs bonded warehouses to foreign embassies, international organizations and related individuals for authorized purposes, as is allowed distilled spirits under present law. These provisions will become effective for the first calendar month which begins more than 90 days after enactment.

### Section 9. Refunds of tread rubber excise tax

Under present law, a 5-cents-per-pound manufacturers excise tax is imposed on tread rubber used for recapping or retreading tires of the type used on highway vehicles. No credit or refund of the tread rubber tax is available if the tax-paid tread rubber is wasted in the recapping process, contained in a recapped tire the price of which is adjusted under a warranty, or sold in conjunction with certain otherwise tax-exempt sales. In some situations, the tread rubber tax can be avoided by exporting a tire to be recapped outside the United States and then importing the retreaded tire.

This section provides for a refund or credit of the manufacturers excise tax on tread rubber where the rubber is (1) wasted in the re-

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[1] Provisions in the House-passed bill relating to the simplification of certain procedure rules (secs. 2–6 of the bill) and extensions of expiring tax provisions (sec. 12 of the bill) were enacted as part of Public Law 96–167 (H.R. 5224) in 1979.

[2] This provision has been reported by the Senate Finance Committee in H.R. 1212 (S. Rept. No. 96–532, sec. 403).

capping process, (2) contained in a recapped tire the price of which is adjusted under a warranty, or (3) sold in conjunction with certain otherwise tax-exempt sales.

The provision also imposes the tread rubber excise tax on the tread rubber in tires which are exported for recapping and subsequently imported into the United States.

### Section 10. Nonrecognition of gain on sale of residence for certain members of the Armed Forces

Under present law, a member of the Armed Forces serving on extended active duty generally is not required to recognize gain on the sale of a principal residence if he or she purchases and uses a new principal residence within four years after the date of the sale of the old residence.

This section extends the replacement period for members of the Armed Forces who are stationed outside of the United States or who are required to reside in Government-owned quarters to the later of: (1) four years after the date of the sale of the old residence, or (2) one year after the date on which the member no longer is stationed outside of the United States or required to reside in Government-owned quarters.

### Section 11. Exempt status of auxiliaries of certain fraternal beneficiary societies

In order to qualify for tax-exempt status under Code section 501(c)(7) after October 20, 1976, a social club cannot have any provision providing for discrimination against any person on the basis of race, color, or religion in the club's charter, bylaws, other governing instrument, or any written policy statement.

This section allows social clubs which are affiliated with fraternal beneficiary societies exempt under Code section 501(c)(8), such as those operated by the Knights of Columbus, to retain their exemption even though membership in the clubs is limited to members of a particular religion.

## 3. H.R. 5973

### Section 1. Waiver of time limits in foreign residence or presence requirements for Americans working abroad[1]

This section would permit the waiver of the minimum time limits in the foreign residence or presence eligibility requirements for Americans working abroad to obtain the benefits of the deduction for excess foreign living costs or the exclusion for foreign earned income. The waiver generally would be available to Americans working abroad who could reasonably have been expected to meet those eligibility requirements, but who left the foreign country under conditions of war, civil unrest, or similar conditions which precluded the normal conduct of business.

### Section 2. Special rule for certain distributions from money purchase pension plans[2]

Under present law, if an employer maintains a tax-qualified defined benefit pension plan and a tax-qualified money purchase pension plan, and if an employee is covered by both plans, a total distribution of the balance of the employee's interest in the money purchase plan to the employee (or the employee's spouse on account of the employee's death) is not eligible to be rolled over tax free to an individual retirement account or to another qualified plan unless a total distribution is also made from the defined benefit plan in the same taxable year. This section would allow an employee (or deceased employee's spouse) to make a tax-free rollover of a total distribution from a qualified money purchase plan where the employee is also covered by a qualified defined benefit plan maintained by the same employer even though a total distribution is not made from the defined benefit plan in the same taxable year.

### Section 3. Definition of youth participating in a qualified cooperative education program for purposes of the targeted jobs credit[3]

Under present law, the targeted jobs credit may be claimed for the hiring of youths who actively participate in qualified cooperative education programs, who have attained the age of 16 but who have not

[1] In principle, this provision was approved by the Senate Finance Committee on December 6, 1979. The Subcommittee on Taxation and Debt Management Generally held a hearing on S. 873, which contains similar provisions, on November 7, 1979.

[2] As reported by the Senate Finance Committee, H.R. 1212 contains an identical provision (S. Rept. No. 96-532, sec. 405).

[3] As reported by the Senate Finance Committee, H.R. 2797, the Technical Corrections Act of 1979, contains an identical provision (S. Rept. No. 96-498, sec. 103 (a)(6)(F)).

attained the age of 19, and who have not graduated from high school or vocational school. This section would extend the availability of the targeted jobs credit to wages paid on or after November 27, 1979, to such youths who have not attained the age of 20.

### Section 4. Special rule relating to debt-financed income of exempt organizations

Generally, under present law, passive investment income and gains from the sale of investments realized by an exempt organization are not subject to tax as unrelated business income. However, income and gains realized by an exempt organization from "debt-financed property" not used for its exempt function are subject to tax in the proportion in which the property is financed by acquisition indebtedness.

This section would provide a limited exception to the debt-financed income rules. This exception would allow certain sales of real property in 1976 to be made free of the unrelated business income tax if the property had been acquired prior to 1952 and the indebtedness was incurred before 1965. The intended beneficiary of the provision is the Tillamook County YMCA of Tillamook, Oregon.

# II. DESCRIPTION OF BILLS

## A. SENATE BILLS

### 1. S. 464—Senator Inouye

### Extension of Targeted Jobs Tax Credit to Displaced Homemakers

*Present law*

In general, present law provides an income tax credit for the hiring of individuals who are members of one of seven targeted groups (Code sec. 51). Specifically, the credit is available for the hiring of: (1) recipients of Supplemental Security Income, (2) handicapped individuals undergoing vocational rehabilitation, (3) individuals of ages 18 through 24 who are members of economically disadvantaged families, (4) Vietnam-era veterans under the age of 35 who are members of economically disadvantaged families, (5) recipients of general assistance for 30 or more days, (6) individuals of ages 16 through 18 [1] who are participants in a qualified cooperative education program, and (7) convicts who are members of economically disadvantaged families (if they are hired within 5 years after the date of release from prison or date of conviction).

The amount of targeted jobs credit which may be claimed with respect to any individual is equal to 50 percent of the first $6,000 of qualifying trade or business wages for the first year of employment and 25 percent of such wages for the second year of employment.

*Issue*

The issue is whether the targeted jobs tax credit should be made available with respect to the hiring of displaced homemakers.

*Explanation of the bill*

The bill would add displaced homemakers to the categories of targeted groups eligible for the credit.

Under the bill, a "displaced homemaker" would be defined by reference to the Comprehensive Employment and Training Act of 1978 (29 USC 802). Under that Act, a "displaced homemaker" is an individual who has not worked in the labor force for a substantial number of years but has, during those years, worked in the home providing unpaid services for family members; has been dependent on public assistance or on the income of another family member but is no longer supported by that income (or is receiving public assistance on account

[1] Under a House-passed bill, H.R. 5973, the credit would be extended to 19-year olds participating in qualified cooperative education programs. As reported by the Senate Finance Committee, the Technical Corrections Act of 1979 (secs. 103(a)(6)(F) and (b) of H.R. 2797) contains an identical provision.

of dependent children in the home); and is unemployed or underemployed and is experiencing difficulty in obtaining or upgrading employment.[3]

### *Effective date*

The bill would apply with respect to amounts paid or incurred after December 31, 1978, in taxable years ending after such date.

### *Revenue effect*

It is estimated that this bill would reduce budget receipts by $350 million in fiscal year 1980, $389 million in fiscal year 1981, $266 million in fiscal year 1982, $39 million in fiscal year 1983, and less than $5 million in fiscal year 1984.

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[3] In general, an underemployed person is a person who is working part-time but seeking full-time work; or a person who is working full time but whose current annualized wage rate is not in excess of the higher of the poverty level or 70 percent of the lower living standard income level. An unemployed person is a person who is without a job for a period of at least 7 consecutive days; a person who is a client of a sheltered workshop or institutionalized in a hospital, prison, or similar institution; a person who is 18 years of age or older and whose family receives public assistance or whose family would be eligible to receive public assistance but for the fact that both parents are in the home; or a person who is a veteran who has not obtained permanent unsubsidized employment since being released from active duty. (See 20 CFR sec. 675.4).

## 2. S. 485—Senators Cannon and Laxalt

## Exemption from Excise Tax on Wagers and Occupational Tax on Wagering in States Authorizing Wagering

### *Present law*

Under present law, a 2-percent excise tax is imposed on the amount of certain wagers. For this purpose, a wager means (1) a wager placed with a person who is in the business of accepting wagers on the outcome of a sports event or contest, (2) a wager with respect to a sporting event or contest placed in a wagering pool conducted for profit, and (3) a wager placed in a lottery conducted for profit (including the numbers game, policy, and similar types of wagering). However, this excise tax is not imposed on (1) wagers placed with a parimutuel licensed under State law, (2) wagers placed in coin-operated gaming devices (e.g., slot machines) and (3) State-conducted wagering (e.g., sweepstakes and lotteries). Under present law, the 2-percent excise tax is imposed on so-called off-track betting authorized by State law.

Every person engaged in the business of accepting wagers is liable for the tax with respect to wagers on which the tax is imposed.

Under present law, a special occupational tax of $500 per year is imposed on each person who is liable for the 2-percent excise tax on wagers and on each person who is engaged in receiving wagers for such person.

### *Issues*

The issues are whether the 2-percent excise tax should be imposed on wagers which are authorized by State law and whether a person authorized under State or local law to receive wagers should be subject to the occupational tax on wagering.

### *Explanation of the bill*

Under the bill, the 2-percent excise tax on certain wagers would not apply to wagers authorized by State law. Also under the bill, the occupational tax would not apply to a person authorized by State or local law to engage in the business of accepting wagers. The exemption from the occupational tax would apply only with respect to the wagering business authorized under State or local law.

### *Effective date*

The bill would apply to taxable periods beginning after June 30, 1979.

### *Revenue effect*

It is estimated that this bill would reduce budget receipts by $12 million in fiscal year 1980, $13 million in fiscal year 1981, $14 million in fiscal year 1982, and $15 million per year in fiscal years 1983 and 1984.

## 3. S. 650—Senator Moynihan

## Treatment of Certain Employees' Trusts Organized to Invest in Real Estate

### *Present law*

Under present law, a trust maintained pursuant to a qualified pension, profit sharing, or stock bonus plan ("qualified retirement plan") is generally not subject to tax on the income or gain derived from the investment of its assets. However, such a trust, with certain exceptions, is subject to the tax on unrelated business taxable income where the trust has income from unrelated debt-financed property.[1] Debt-financed property is any property (e.g., real estate, personal property, and corporate stocks) held to produce income and as to which there is an acquisition indebtedness (e.g., debt incurred by the trust in acquiring or improving the property) at any time during the taxable year of the trust or during the prior 12 months if the property is disposed of during the year. Income from debt-financed property is subject to tax generally in proportion to the ratio of the acquisition indebtedness on the property over the adjusted basis of the property.

### *Issue*

The issue is whether qualified retirement plans should be able to jointly participate in a group real estate employee benefit trust and not be subject to the tax on unrelated debt-financed income.

### *Explanation of the bill*

The bill would extend tax-exempt treatment to a group real estate employee benefit trust. In general, a qualified trust would be one established by ten or more qualified retirement plans maintained by ten or more employers to invest primarily in real estate located in the United States or Puerto Rico.

The qualified status of a participating trust would not be affected by participation in the group real estate employee trust if the adjusted cost of its interest in a group real estate employee benefit trust was less than 25 percent of the aggregate adjusted cost of its assets at the end of each quarter of its plan year.

If a trust qualified as a group real estate employee benefit trust, it generally would be exempt from tax like a trust under a qualified retirement plan. However, unlike a trust under a qualified retirement plan, a group real estate employee benefit trust would be exempt under most circumstances from the tax on unrelated debt-financed income.

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[1] The unrelated debt-financed income provisions do not apply with respect to the investment of retirement plan funds which are either held by an insurance company in a segregated asset account (Code sec. 801(g)) or a common trust fund maintained by a bank (Code sec. 584).

To qualify as a group real estate employee benefit trust, the trust would have to be established and maintained in the United States and at all times during its taxable year would have to meet the following requirements: (1) the aggregate adjusted cost of the real property located in the United States and Puerto Rico held by a trust would have to exceed $10 million; (2) at least 75 percent of the adjusted cost of the trust's property would have to be real property located in the United States or Puerto Rico, cash or Government securities; (3) no qualified retirement plan participating in the trust could have more than a 50 percent interest in the trust; (4) the trust would not be permitted to lease real property to a person from whom it acquired such property; (5) the trust could not own land used in farming; and (6) all of the real property owned by a trust would have to be managed by an investment manager.

In addition, the instrument governing a real estate employee benefit trust would have to provide that (1) the assets of the trust could not be commingled with other property; (2) only qualified retirement plans could participate in the trust; (3) the portion of the trust which equitably belongs to a qualified retirement plan would be used for the exclusive benefit of that plan's participants and beneficiaries; (4) the income and corpus of the trust would be allocated according to a participating plan's interest and (5) a participating plan could not assign its interest in the trust.

***Effective date***

The provisions of the bill would be effective on January 1, 1980.

***Revenue effect***

It is estimated that this bill will reduce budget receipts by relatively small amounts during the next few years, probably less than $10 million annually. Eventually, it could have significant revenue effect.

## 4. S. 1194—Senator Heflin

## Unemployment Tax Status of Certain Fishing Boat Services

### *Present law*

Under present law (Code sec. 3121(b)(20)), services performed by members of the crew on boats engaged in catching fish or other forms of aquatic animal life are exempt from the tax imposed by the Federal Insurance Contributions Act (FICA) if their remuneration is a share of the boat's catch (or cash proceeds from the sale of a share of the catch) and if the crew of such boat normally is made up of fewer than ten individuals. In the case of an operation involving more than one boat, the exemption applies if the remuneration is a share of the entire fleet's catch or its proceeds, and if the operating crew of each boat in the fleet normally is made up of fewer than ten individuals.

In addition, the remuneration received by those fishing boat crew members whose services are exempt for purposes of FICA is not considered to be "wages" for purposes of income tax withholding (Code sec. 301(a)(17)) and those individuals are considered to be self-employed for purposes of the Self-Employment Contributions Act (Code sec. 1402(c)(2)(F)). However, the employer of such individuals whose services are exempt for FICA purposes, and whose remuneration is not subject to income tax withholding, is not exempt from tax under the Federal Unemployment Tax Act (FUTA) if the services performed are related to catching halibut or salmon for commercial purposes or if the services are performed on a vessel of more than ten net tons.

### *Issue*

The issue is whether the services of fishing boat crew members, which currently are exempt for purposes of FICA, also should be exempt for purposes of FUTA.

### *Explanation of the bill*

The bill would exempt, for purposes of FUTA, the services of fishing boat crew members which currently are exempt for purposes of FICA. Thus, services by members of the crew on boats engaged in catching fish or other forms of aquatic animal life would be exempt for purposes of FUTA if the remuneration for those services is a share of the boat's catch or of the proceeds of the catch and if the crew of such boat normally is made up of fewer than ten individuals. In the case of an operation involving more than one boat, services would be exempt for purposes of FUTA if the remuneration for services is a share of the entire fleet's catch or its proceeds, and if the operating crew of each boat in the fleet normally is made up of fewer than ten individuals.

### *Effective date*

The provisions of the bill would apply to services performed by fishing boat crew members after December 31, 1978.

### *Revenue effect*

It is estimated that this bill would reduce budget receipts by less than $1 million per year.

### *Prior Congressional action*

An identical bill (H.R. 3080) was the subject of hearings in the Subcommittee on Taxation and Debt Management Generally of the Senate Finance Committee during the 95th Congress (July 24, 1978).

## 5. S. 1831—Senator Talmadge

### Net Operating Loss Deduction of Former Real Estate Investment Trusts

*Present law*

Prior to the Tax Reform Act of 1976, real estate investment trusts (REITs) were not allowed to carryover or carryback net operating losses. Because of the effect that this rule had during the economic downturn in the early 1970's, many trusts terminated their status as REITs in order that they could carryover net operating losses incurred by them during those years. In such a case, a trust was allowed to carry-over its losses for five years. However, unlike other taxpayers, such trusts could not carryback the net operating loss to years before the loss year during which they qualified as a REIT.

The Tax Reform Act of 1976 made two changes that affected the net operating loss carryovers of corporations and REITs. First, it lengthened the time that corporations could carryover their net operating loss deductions from five years to seven years. This change was effective for losses incurred in years ending after December 31, 1975. Because of this effective date, losses incurred before 1976 by trusts which had terminated their REIT status were subject to the five-year carryforward of losses instead of the seven-year carryforward.

The Tax Reform Act of 1976 also changed the treatment of net operating losses of REITs. Under the 1976 Act, a REIT is permitted to carryforward a net operating loss for eight years. However, no net operating loss carrybacks are permitted. This change in rules was effective for taxable years of a REIT ending after October 4, 1976. As a result of this effective date, losses incurred before 1976 by REITs were subject to an eight-year carryforward if they retained their REIT status during the entire eight-year carryforward period. However, under the 1976 Act rule, a net operating loss incurred before 1976 could not be carried over to the 6th, 7th, or 8th carryforward year unless the corporation was a REIT for all years from the loss year through the carryover year.

Thus, where a trust which was a REIT has terminated its status in its three taxable years ending before October 4, 1976 and incurred losses in those years, less than an eight-year carryover is permitted. This is so even though the trust would have been given an eight-year carryforward had it retained its REIT status and even though it would have been given a combined eight years of carrybacks and carry-forwards had the trust never become a REIT.

*Issue*

The issue is whether a trust, which was formerly a REIT, should be allowed an additional year of carryforward of net operating losses for each year that the trust was not permitted to carry back its net operating loss deduction because it qualified as a REIT in the year to which the loss would be carried back.

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*Explanation of the bill*

The bill would allow a trust which was formerly a REIT an additional year of carryforward (with a maximum of eight years) of net operating losses for each year that it is denied a net operating loss carryback because it was a REIT. This would have the effect of allowing a former REIT to have a total of eight carryover years, as compared to all other corporations and qualifying REITs, even though the trust terminated its status as a REIT with the exception that it could carryover its pre-1976 net operating losses for only five years. each year that the trust was not permitted to carryback its net operatating loss incurred before 1976 can be carried forward to the 6th, 7th, or 8th year only if it qualified as a REIT for all years from the loss year through the carryover year.

*Effective date*

The provisions of the bill would be effective for taxable years ending after October 4, 1976.

*Revenue effect*

This bill is estimated to reduce budget receipts by a negligible amount through fiscal year 1982, $7 million in fiscal year 1983, and $15 million in fiscal year 1984. This estimate assumes that there is no significant increase in acquisitions under which net operating loss carryovers become available to acquiring corporations or continue to be available to corporations purchased by new owners.

## 6. S. 1859—Senators Percy and Dole and S. 2201—Senator Bellmon

## Special Estate Tax Valuation of Farm Real Property

### *Present law*

For estate tax purposes, real property must ordinarily be valued at its highest and best use. If certain requirements are met, however, present law allows family farms and real property used in a closely held business to be included in a decedent's gross estate at current use value rather than highest and best use value, provided that the gross estate may not be reduced more than $500,000 (Code sec. 2032A).

The current use value of qualified farm property may be determined in two ways, the multiple factor method (sec. 2032A(e)(8)), and the formula method (sec. 2032A(e)(7)(A)). The multiple factor method takes into account factors normally used in the valuation of real estate, for example, comparable sales, and any other factors that fairly value the farm property. The formula method may be used only if there is comparable land from which the average annual gross cash rental may be determined.

Under the formula method, the value of qualified farm property is determined by (1) subtracting from the average annual gross cash rental for comparable land used for farming the average annual State and local real estate taxes for the comparable land, and (2) dividing that amount by the average annual effective interest rate for all new Federal Land Bank loans.[1]

On July 19, 1978, the Department of the Treasury issued proposed regulations defining gross cash rental for purposes of the formula method.[2] Under the proposed regulations, if no comparable farm property had been leased on a cash basis, then the formula method could be applied by converting crop share rentals into cash rentals. If the crops were sold for cash in a qualified transaction, the selling price would be considered the gross cash rental. If no qualified sale occurred, then the gross cash rental would equal the cash value of the crops on the date received on an established public agricultural commodities market.

On September 10, 1979, the Department of the Treasury withdrew the portion of the regulations relating to gross cash rental proposed in July and published another proposed regulation defining gross cash rental.[3] The new proposed regulation provides that crop share rentals may not be used under the formula method. Consequently, under that

[1] Each average annual computation must be made on the basis of the five most recent calendar years ending before the decedent's death.

[2] 43 Fed Reg. 31,039 (1978).

[3] 44 Fed. Reg. 52,696 (1979).

proposed regulation, if no comparable land is rented solely for cash, the formula method may not be used and the qualified farm property may be valued only by the multiple factor method.

### *Issue*

The issue is whether qualified farm property may be valued under the formula method by using crop share rentals if no comparable land is leased solely for cash and comparable land is leased partially or completely on a crop share basis.

### *Explanation of the bills*

#### *S. 1859*

The bill, S. 1859, would provide that if there is no comparable land from which to determine the average annual gross cash rental, then the average net share rental could be substituted for the average gross cash rental in applying the formula method. The net share rental would be (1) the value of the produce grown on the leased land received by the lessor, reduced by (2) the cash operating expenses of growing the produce that are paid, under the terms of the lease, by the lessor.

#### *S. 2201*

The bill, S. 2201, contains provisions which are substantially identical to those contained in S. 1859.

### *Effective date*

The provisions of S. 1859 and S. 2201 would apply to estates of decedents dying after the date of enactment.

### *Revenue effect*

It is estimated that the bills, S. 1859 and S. 2201, would have no effect on fiscal year 1980 budget receipts, and would reduce budget receipts by less than $1 million in fiscal year 1981 and by $25 million per year in fiscal year 1982 and thereafter.

## 7. S. 1900 and S. 1901—Senator Heflin

### Amount of Casualty Loss Deduction for Timber and Fruit or Nut Trees

***Present law***

Under present law, a corporation may deduct the amount of property losses sustained during the taxable year which are not insured or otherwise recoverable (sec. 165). An individual may deduct the amount of an unrecoverable loss incurred in a trade or business, in a transaction entered into for profit, or (subject to a $100 floor per occurrence) as a casualty or theft loss (sec. 165(c)).

In the case of partial loss caused by casualty, the amount of the loss equals the difference between the value of the property immediately preceding the casualty and its value immediately thereafter (Treas. Reg. § 1.165–7(b)). However, the deduction cannot exceed the property's adjusted basis (sec. 165(b)). If business or income-producing property is completely destroyed, the amount deductible is the adjusted basis of the property (Treas. Reg. § 1.165–7(b)).

In computing the adjusted basis of property damaged or destroyed by casualty, the taxpayer's cost or other basis is adjusted for capitalized expenditures which become part of the basis, and for deductions for such items as depreciation, amortization, and depletion, which reduce the taxpayer's basis in the property.[1] In the case of timber property, adjusted basis includes the cost of purchasing a stand of timber (other than any part of the cost allocable to land), and also capitalized costs (such as those for site preparation and planting costs) in connection with the planting or seeding of trees for timber purposes.[2] In the case of fruit and nut trees, special capitalization rules apply with respect to expenditures incurred in planting and developing citrus and almond groves and, in the case of certain farming syndicates with respect to expenditures incurred in planting and developing a grove, orchard, or vineyard in which fruit or nuts are grown (sec. 278). In addition, several special deduction allowance rules may affect the determination of adjusted basis of timber and fruit and nut trees, i.e., deductions for soil and water conservation expenditures (sec. 175), expenditures by farmers for fertilizer (sec. 180), and expenditures by farmers for clearing land (sec. 182).

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[1] Depletion of timber is limited to cost depletion and is claimed at the time the timber is harvested (Regs. § 1.611–1). In addition, a taxpayer may elect capital gain treatment for income recognized from the cutting of timber (Code sec. 631(a)).

[2] Under H.R. 1212, as reported by the Committee on Finance (S. Rept. 96–582, 96th Cong., 1st Sess., December 15, 1979), seven-year amortization would be allowed for reforestation expenditures. If this legislation is enacted, basis would be adjusted to reflect amortization deductions allowed or allowable under this provision.

Present law also treats casualty losses as trade or business losses for purposes of computing a net operating loss deduction. As a result, a net operating loss which is created as a result of a casualty loss may generally be carried back as a deduction against income for the three taxable years preceding the taxable year in which the loss occurred and may be carried over as a deduction against income for the seven taxable years following the year of the loss. (sec. 172(b) and (d); Reg. § 1.172-3(a)(3)(iii)). In addition, where a casualty loss is attributable to a disaster in an area which is proclaimed by the President to be a disaster area eligible for federal assistance, the taxpayer may elect to treat the loss as having occurred in the immediately preceding taxable year and the loss may be deducted for this earlier year (Code sec. 165(h)).

### *Issues*

*S. 1900*

The issues with respect to S. 1900 are (1) whether a taxpayer suffering an otherwise deductible loss of a fruit or nut tree may deduct the fair market value of the tree at the time of the loss, even if such value exceeds the adjusted basis of the tree; and (2) if so, whether any unused amount of the deduction may be carried back 10 years and forward four years.

*S. 1901*

The issues with respect to S. 1901 are whether the amount of deductible casualty loss on timber should be measured by the fair market value of the timber immediately before the casualty, and whether special carryback and carryover rules should be provided for casualty losses from timber.

### *Explanation of the bills*

*S. 1900—Fruit and nut trees*

The bill, S. 1900, would provide that a taxpayer suffering a loss in a trade or business with respect to fruit or nut trees which are completely destroyed and for which a depreciation deduction is allowable (determined without regard to the age of the trees or their productivity over their useful life) may deduct the higher of the property's adjusted basis or its fair market value on the date the loss occurs. In the case of a partial loss, the initial determination of the amount of loss would be made as under present law by reference to the decline in value resulting from the casualty. However, under the bill, the basis limitation on the amount of the deductible loss would be applied by using the higher of the property's adjusted basis or its fair market value on the date the loss occurs.

Also, the bill would provide that in the case of an individual, any unused fruit or nut tree loss deduction could be carried back 10 years and, if not offset by income of such prior years, forward for four years.

*S. 1901—Timber*

The bill, S. 1901, would provide that the amount of deductible loss arising from a casualty loss of timber which is completely destroyed is the fair market value of the timber immediately before the casualty. In the case of a partial loss, the initial determination

of the amount of loss would be made as under present law by reference to the decline in value resulting from the casualty. However, under the bill, the basis limitation on the amount of the deductible loss would be applied by using the higher of the property's adjusted basis or its fair market value on the date the loss occurs.

In addition, the bill would treat casualty losses from timber as a separate category of deduction which would be deducted in computing taxable income after other allowable deductions authorized by the Internal Revenue Code. To the extent this deduction creates a loss in the year of the casualty, the excess deduction would be allowed to be carried back to the ten preceding taxable years and carried over to the four taxable years following the year of the casualty.[3]

### *Effective date*

*S. 1900*

The provisions of S. 1900 would apply to fruit or nut tree losses incurred after August 31, 1979.

*S. 1901*

The provisions of S. 1901 would be effective for qualifying timber losses which are incurred after August 31, 1979.

### *Revenue effect*

The revenue estimates for S. 1900 and S. 1901 are not yet available but will be furnished at the time of the hearing.

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[3] The effective carryback and carryover periods would be 11 years and 3 years, respectively, if the loss qualifies as a disaster loss and the taxpayer makes the election provided under Code section 165(h).

## 8. S. 2089—Senators Roth, Helms, and Talmadge

### Waiver of Period of Limitations for Claiming Refunds for Single Purpose Agricultural Structures

***Present law***

Property eligible for the investment tax credit includes tangible personal property (such as machinery and equipment) which is used in a trade or business or for the production of income. The investment credit is also allowed for other tangible property which is used as an integral part of manufacturing, production, extraction, or in furnishing certain utility services, even though such tangible property may otherwise be considered real (and not personal) property under local law. Farming is considered a production activity so that such items as fences, drain tiles, paved barnyards, and water wells are eligible for the credit even though these items would be considered real property under local law.[1]

Under existing law, buildings and their structural components generally are not eligible for the investment credit. Ineligible buildings have been generally considered to include any structure which encloses a space within its walls (and usually covered by a roof) which is used primarily to provide shelter or working space. Examples of buildings include factory and office buildings, warehouses, and barns (Regs. § 1.48-1(e)(1)). While the Internal Revenue Service had ruled that barns, stables, and poultry houses were buildings and were ineligible for the credit, certain single purpose structures have not been considered ineligible buildings.[2] A single (or special) purpose structure which qualifies for the credit is one which houses property used as an integral part of a production activity (including farming) where the structure is so closely related to the use of the property that it is clearly expected to be replaced when the property it houses is replaced. One characteristic of this type of structure is that it cannot be used economically for any purpose other than that related to the property it houses.[3]

The Senate Finance Committee report on the Revenue Act of 1971 stated that single purpose structures used in unitary hog-raising systems would be considered single purpose structures which qualify for the investment credit and would not be considered buildings.[4] The Internal Revenue Service continued to approach the question of eligibility of single purpose farm structures on a case-by-case basis. For example, in three recent cases, the IRS contended that structures which are designed and used for poultry-raising and egg-

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[1] Rev. Rul. 66-89, 1966-1 Cum. Bull. 7.
[2] *Ibid.*
[3] Regs. § 1.48-1(e)(1).
[4] S. Rept. No. 92-437, 92d Cong., 1st Sess. (1971), 29-30.

producing activities were not eligible for the investment credit.[5] Although the IRS was reversed in two of these cases, it was understood that the Service continued to adhere to the position that single purpose poultry-raising, livestock raising, and egg-producing structures were not generally eligible for the investment credit.

Greenhouses are structures which provide an environment for the controlled growth of flowers and other plants. These structures also provide working space for persons who care for the flowers and plants within the greenhouse. It was the position of the Internal Revenue Service that greenhouses are buildings and consequently are ineligible for the credit. This position was based on the fact that these structures provide working space for persons tending the plants. The Service's position was sustained in two Tax Court cases decided in 1972.[6] However, the Tax Court was overruled in one of these cases on appeal.[7] In this latter case, the Ninth Circuit Court of Appeals found that the workers' activities in the greenhouse were "merely supportive of, and ancillary to" the principal use of the structure of providing an environment for controlled plant growth.

To resolve these controversies, definitive rules were prescribed under the Revenue Act of 1978, under which single purpose agricultural structures were to be eligible for the investment tax credit. These provisions are effective for open taxable years ending on or after August 15, 1971 (the date on which the investment tax credit was reinstated). However, no provision was made in this legislation for the allowance of refunds which were barred by the expiration of the period of limitations.

### *Issue*

The issue is whether the period of limitations for claiming refunds should be waived with respect to investment tax credits attributable to single purpose agricultural structures which are eligible under the Revenue Act of 1978.

### *Explanation of the bill*

Under the bill, a claim for refund filed within one year of enactment would be allowable notwithstanding expiration of the period of limitations for refunds with respect to qualifying single purpose agricultural structures.

### *Revenue effect*

It is estimated that this bill will reduce budget receipt by $45 million. (This figure represents tax liabilities of prior years. The fiscal year effect depends on the date of enactment of the bill and on the promptness of taxpayers making claims for refunds, but is assumed to be in fiscal years 1980 and 1981.)

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[5] *Melvin Satrum*, 62 T.C. 413 (1974), *conacq.*, 1978–23 Int. Rev. Bull. 7 (June 5, 1978) ; *Starr Farms, Inc.* v. *U.S.*, 78–1 U.S.T.C. ¶ 9183 (W.D. Ark. 1977) ; *Walter Sheffield Poultry Co.*, T.C. Memo 1978–308.

[6] *Sunnyside Nurseries*, 59 T.C. 113 (1972) ; *Arne Thirup*, 59 T.C. 122 (1972).

[7] *Thirup et al.* v. *Comm.*, 508 F. 2d 918, 75–1 U.S.T.C. ¶ 9158 (9th Cir. 1974). This case was followed in *Stuppy, Inc.* v. *United States*, 78–2 U.S.T.C. ¶ 9664 (W.D. Mo. 1978).

## 9. S. 2167—Senator Stone

### Taxation of Certain Homeowners Associations at the Corporate Graduated Rates

***Present law***

*Homeowners associations*

Under present law, a qualified homeowners association (a condominium management association or a residential real estate association) may elect to be treated as a tax-exempt organization (Code sec. 528). If an election is made, the association will not be taxed on "exempt function income." Exempt function income means membership dues, fees, and assessments received from persons who own residential units in the particular condominium or subdivision and who are members of the association.

The association will be taxed, however, on income which is not exempt function income. For example, any interest earned on amounts set aside in a sinking fund for future improvements is taxable. Similarly, any amount paid by persons who are not members of the association for use of the association's facilities, such as tennis courts, swimming pools, golf courses, etc., is taxable. Further, any amount paid by members for special use of the association's facilities, the use of which would not be available to all the members as a result of having paid the membership dues, fees, or assessments required to be paid by all members of the association, will be taxable. For example, if the membership dues, fees, or assessments do not entitle a member to use the association's party room or to use the swimming pool after a certain time period, then amounts paid for this use are taxable to the association.

Deductions from nonexempt income are allowed for expenses directly related to the production of such income, and a $100 deduction against taxable income is provided so that associations with only a minimal amount of taxable income will not be subject to tax. However, a net operating loss deduction is not allowed, and the special deductions for corporations (such as the dividends received deduction) are not allowed.

A homeowners association is taxed on its taxable income at the highest corporate rate (46 percent). If the association has net long-term capital gain, the tax rate is 28 percent for determining the association's alternative tax for capital gains.

*Corporate tax rates*

Under present law, a corporation is taxed at graduated rates on the first $100,000 of taxable income. The corporate rates are 17 percent on the first $25,000 of taxable income, 20 percent on the next $25,000, 30 percent on the next $25,000, 40 percent on the next $25,000, and 46 percent on all taxable income above $100,000. The alternative tax rate for capital gains is 28 percent.

The Code contains rules to prevent abuse of the graduated rate structure. A controlled group of corporations is limited in the aggregate to a maximum of $25,000 of taxable income in each of the rate brackets below the 46 percent bracket (Code sec. 1561). These rules are used to prevent income splitting by such commonly controlled corporations.

### *Issues*

The issues are whether the taxable income of a homeowners association should be taxed at rates less than the highest corporate tax rate and, if so, what is the appropriate rate (or rates).

### *Explanation of the bill*

The bill would provide that the taxable income of a homeowners association would be subject to the same graduated rates of tax as would a corporation's taxable income.

### *Effective date*

The provisions of the bill would apply to taxable years beginning after December 31, 1978.

### *Revenue effect*

It is estimated that this bill would reduce budget receipts by less than $5 million per year.

### *Other possible issues for committee consideration*

The committee may wish to consider the following issues related to the bill's proposal. The basic rationale for the tax treatment of homeowners associations in the Code is that activities which would not be taxed if engaged in by homeowners individually should not be subject to tax when the individuals band together in an association. An extension of this principle would appear to be that the rate of taxation on invested funds of the association should not greatly exceed the rate that would be imposed on the funds if they were invested by individual members of the association.

On the other hand, taxation of an association at the regular corporate rates would generally result in the taxation of this income at a rate of 17 percent. Members of homeowners associations are likely to be in higher tax brackets. In addition, there are apparently no rules which would prevent abuse of the graduated rate structure by commonly controlled or related homeowners associations. The tests for commonly controlled corporations would not appear to be effective in nonprofit corporations which do not normally have stock ownership. Also, as is the case with political organizations, there appear to be almost no barriers to prevent the multiplication of organizations in order to minimize the tax burden.

In addition, if the graduated rates are to apply, the committee may wish to consider whether the $100 deduction against taxable income should be repealed.

## 10. S. 2180—Senator Byrd (of Virginia)

## Replacement Period for Nonrecognition of Gain on Sale of Residence

### *Present law*

In general, the entire amount of gain realized on the sale of real property is recognized for income tax purposes. If certain requirements are met, however, gain on the sale of a taxpayer's principal residence will not be recognized, except to the extent the adjusted sales price of the old residence exceeds the cost of the new residence (Code sec. 1034).

To qualify for nonrecognition under section 1034, the taxpayer must purchase or construct, and use a replacement residence within certain time limits. The purchase of a new residence must occur within eighteen months before or after the sale of the old residence, and the taxpayer must use the new residence as a principal residence within eighteen months after the sale of the old residence (sec. 1034(a)). The construction of a new residence must begin no later than eighteen months after the sale of the old residence, and the taxpayer must occupy and use the new residence as his principal residence no later than two years after the sale of the old residence (sec. 1034(c)(5)).

### *Issue*

The issue is whether the two-year time limit for the occupation of a newly constructed replacement residence should be extended to five years under limited circumstances.

### *Explanation of the bill*

The bill would, under limited circumstances, require the Secretary of the Treasury to extend to five years the present two-year period during which a taxpayer must occupy and use as a principal residence a newly constructed replacement residence. The period would be extended only if a taxpayer: (1) sold his principal residence in 1977; (2) bought land for a new residence; (3) began construction of a replacement residence in 1977, which construction was terminated by the builder before completion; (4) suspended construction to preserve evidence against the builder; (5) sued and obtained a judgment against the builder; and (6) did not occupy the new residence within two years of the sale of the old residence because of the suspension of construction.

The bill is intended to benefit Mrs. Jane M. Cathcart of Virginia.

### *Effective date*

The provisions of the bill would apply with respect to taxable years beginning after December 31, 1976, and before January 1, 1983.

### *Revenue effect*

It is estimated that this bill will reduce budget receipts by less than $10,000 in fiscal year 1980 or 1981.

## 11. S. 2275—Senator Gravel

## Technical Amendments to the Provisions Relating to General Stock Ownership Corporations

### *Present law*

Under present law, a State is authorized to establish a general stock ownership corporation (GSOC) for the benefit of all its citizens. It is anticipated that the GSOC will be permitted to borrow money to invest in business enterprises. The cash flow from the operation of the business would be used to service and repay the loan, and the remaining cash would be distributed to the GSOC shareholders (i.e., all the citizens of the State).

Present law provides that a corporation must meet certain statutory tests in order to be treated as a GSOC. The GSOC's corporate charter must provide for the issuance of only one class of stock, the issuance of shares only to eligible individuals, and the issuance of at least one share to each eligible individual if such eligible individual does not elect within one year after the date of issuance not to receive such share. Also, the charter must provide for certain restrictions on the transferability of the GSOC shares. The transfer restriction must provide that the share cannot be transferred until the earliest to occur of (1) the expiration of five years from issuance, (2) death, or (3) failure to meet the State's residency requirements. In no event may shares of stock of a GSOC be transferred to nonresidents. Also, no person may acquire more than 10 shares of the GSOC's stock.

An eligible individual is any individual who is a resident of the chartering State as of the date specified in the enabling legislation and who remains a resident between that date and the date of issuance of the stock.

A GSOC must make an election to obtain special tax treatment. The effect of the election is to exempt the corporation from Federal income taxation. The shareholders of the GSOC would report their proportionate part of the GSOC's taxable income on their Federal individual income tax returns.

The GSOC computes its taxable income in the same manner as a regular corporation, with certain modifications. A GSOC is required to distribute 90 percent of its taxable income for any taxable year to its shareholders by January 31 of the next succeeding year. To the extent a GSOC fails to meet this distribution requirement, a tax equal to 20 percent of the deficiency (i.e., the difference between the required distribution and the actual distribution) is imposed on the GSOC.

### *Issues*

One issue is whether, under the GSOC provisions, an estate could hold GSOC stock for distribution to a beneficiary. Another issue is whether the 20-percent tax on a deficiency (i.e., the difference between

the required GSOC distribution and the actual GSOC distribution for a year) is deductible from the GSOC's taxable income for the year it is paid. The bill would make additional changes of a technical nature.

### *Explanation of the bill*

Under the bill, an estate could be a shareholder of stock in a GSOC. The amendment would make clear that the 20-percent tax on a deficiency (i.e., the difference between the required GSOC distribution and the actual GSOC distribution for the year) would be deductible from the GSOC's taxable income for the year it is paid.

In addition, the bill would make several technical changes to the law governing GSOCs.

### *Effective date*

The provisions of the bill would apply with respect to corporations chartered after December 31, 1978, and before January 1, 1984.

### *Revenue effect*

This bill is not expected to have a direct effect on budget receipts.

## B. HOUSE-PASSED BILLS

### 1. H.R. 4746: Miscellaneous Changes in the Tax Laws [1]

#### a. Simplification of private foundation return and reporting requirements (sec. 1 of the bill and secs. 6033, 6034, and 6056 of the Code)

***Present law***

Present law requires the foundation managers of private foundations having at least $5,000 of assets to file an annual report (sec. 6056). The report (Form 990–AR) is to contain the foundation's gross income, expenses, disbursements, balance sheet, total amount of contributions and gifts received by it during the year, an itemized list of all grants or contributions made or approved, the names and addresses of the foundation managers, and a list of those foundation managers who are substantial contributors or own certain interests in businesses in which the foundation owns an interest. This report must be made available for public inspection at the principal office of the foundation (sec. 6104(d)) and is open to public inspection at the offices of the Internal Revenue Service (sec. 6104(b)). In addition, the report must be furnished to the appropriate State officials (sec. 6056(d)).

Under present law, most exempt organizations described in section 501(c)(3) of the Code (including exempt private foundations) must file an annual information return (sec. 6033). Under this provision, the return for foundations, Form 990–PF, must state items of gross income, etc., and such other information as may be required by the forms and regulations. At present, this return contains most of the information required in the annual report of the foundation managers. This annual information return also is open to public inspection at the offices of the Internal Revenue Service (sec. 6104(b)). In addition, a copy of this return must be attached to the annual report of a private foundation when the report is furnished to the appropriate State officials (Treas. Reg. sec. 1.6056–1(b)(3)). Thus, information furnished on a foundation manager's report (Form 990–AR) substantially duplicates or overlaps the return filed by the foundation (Form 990–PF) in content and availability for public inspection.

Under present law, trusts which have solely charitable beneficiaries but which are not exempt from taxation (sec. 4947(a)(1) trusts) are subject to different return and disclosure requirements from those applicable to exempt charitable trusts and organizations. A nonexempt charitable trust is not required to file an annual information return open to public inspection. Instead, this type of trust is required to file an income tax return (Form 1041) under section 6012 if its

[1] This description is from the House Report on H.R. 4746 (H. Rept. No. 96–428).

gross income for the year is at least $600 or if it has any taxable income. (Form 1041 need not be filed by a nonexempt charitable trust which is a private foundation and which has no taxable income for the year.) These tax returns are not open to public inspection. In addition, a nonexempt charitable trust, other than one which is required to distribute all its net income currently, must file an annual information return (Form 1041-A), open to public inspection, setting forth certain information concerning its charitable contributions, income and expenses, and balance sheet items, but not containing all of the information required of exempt charitable trusts (sec. 6034). If a nonexempt charitable trust is a private foundation, it also must file a return (pursuant to the regulations under sec. 6011) setting forth much of the information contained on an exempt organization's information return, but this return (Form 5227) is not open to public inspection. In addition, a nonexempt charitable trust which is a private foundation must file the annual report (Form 990-AR or an equivalent report), which is open to inspection and must be furnished to the appropriate State officials as in the case of exempt private foundations, if the trust has at least $5,000 of assets.

*Issues*

One issue is whether the private foundation reporting requirements should be simplified by combining the annual return (Form 990-PF) and annual report (Form 990-AR) into a single annual return containing the information presently required on each of the two separate forms.

Another issue is whether nonexempt charitable trusts described in section 4947(a)(1) of the Code should be required to report the same information and be subject to the same disclosure requirements as exempt charitable organizations.

A further issue is whether the disclosure of the name and address of indigent or needy persons receiving grants of less than $1,000 in any year should no longer be required.

*Explanation of provision*

The bill eliminates the requirement (under sec. 6056) for the managers of any private foundation with assets of $5,000 or more to file an annual report. Instead, the bill requires that all information currently required to be furnished on the annual report (Form 990-AR) but not on the information return (Form 990-PF) be furnished instead on the foundation's annual information return (under sec. 6033). The combined annual information return will be subject to public inspection at the foundation's office and must be furnished to the appropriate State officials under the same conditions now applicable to the annual report.

In the case of a foundation which has no principal office or whose principal office is in a personal residence, it is anticipated that the Treasury will by regulation allow the annual inspection requirement to be met by having the return available for public inspection at an appropriate substitute location or by making copies of the return available by mail free of any charge (including postage and copying) upon request.

The bill also provides that the return not be required to contain the name and address of a needy or indigent recipient (other than a disqualified person) of a gift or grant made by the foundation where the total of the gifts or grants received by the person during the year from the foundation does not exceed $1,000.

The section 6033 information reporting requirements under the bill will apply to nonexempt charitable trusts described in section 4947 (a)(1) as well as to exempt charities. If a nonexempt charitable trust is a private foundation, the trust's information return must contain all the information required of an exempt private foundation. In addition, nonexempt trusts described in Code section 4947(a)(1) will no longer be required to file a Form 1041-A (under section 6034). In the case of a nonexempt charitable trust which has no taxable income, the Treasury may prescribe regulations to treat the filing of the information return as satisfying the income tax return filing requirements (under sec. 6012). The filing by a trust of the annual information return under section 6033, in good faith, showing sufficient facts upon which to determine income tax liability will commence the period of limitations on any income tax liability if it is later determined that the trust in fact had taxable income.[2]

***Effective date***

This provision would apply to taxable years beginning after December 31, 1979.

***Revenue effect***

This provision will not have any direct effect on budget receipts.

[2] This rule is consistent with the principles of the decision in *California Thoroughbred Breeders Association* v. *Commissioner*, 47 T.C. 335 (1966), acquiesced in by the Commissioner in Rev. Rul. 69-247, 1969-1 CB 303, in which it was held that the filing of a Form 990 information return by an exempt organization disclosing sufficient facts to apprise the Service of potential unrelated business taxable income commenced the statute of limitations although a tax return (990-T) was not filed.

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**b. Treatment of payment or reimbursement by private foundations for expenses of foreign travel by government officials (sec. 2 of the bill and sec. 4941 (d)(2)(G) of the Code)**

***Present law***

The Tax Reform Act of 1969 added to the Internal Revenue Code of 1954 a provision (sec. 4941) which in effect prohibits "self-dealing" acts between private foundations and certain designated classes of persons (referred to as "disqualified persons") by imposing a graduated series of excise taxes on the self-dealer (and also on any foundation manager who willfully and knowingly engages in the self-dealing). Under this provision, the payment or reimbursement by a private foundation of expenses of a government official [1] generally is classified as an act of self-dealing (sec. 4941(d)(1)(F)).

A limited exception to this provision permits a private foundation to pay or reimburse certain expenses of government officials for travel solely within the United States (sec. 4941(d)(2)(G)(vii)). Under this exception, it is not an act of self-dealing for a private foundation to pay or reimburse a government official for actual transportation expenses, plus an amount for other traveling expenses not to exceed 1¼ times the maximum *per diem* allowed for like travel by U.S. Government employees. However, no such private foundation payment or reimbursement to government officials is permitted for travel to or from a point outside the United States.[2]

***Issue***

The issue is whether private foundations should be permitted to pay or reimburse government officials for expenses for foreign travel and, if so, under what circumstances.

***Explanation of provision***

The bill provides an additional exception to the self-dealing provisions of the Code (sec. 4941) for certain travel expenses of government officials. Travel expenses eligible for payment or reimbursement by a private foundation under this bill are those paid or incurred for travel between a point in the United States and a point outside the United States. The maximum amount which can be paid or reimbursed for any one trip by a government official is the sum of (1) the lesser of the actual cost of the transportation involved or $2,500, plus (2) an amount for all other traveling expenses not in excess of 1¼ times the

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[1] The term "government official" is defined in section 4946(c) as a person who holds a Federal elective office, a Presidential appointee to the executive or judicial branch, a Federal "super-grade" employee, a Congressional employee whose compensation is $15,000 a year or more, a State or local elective or appointive public officer whose compensation is $15,000 a year or more, or a personal or executive assistant or secretary to any of the above categories of persons. This bill does not affect that statutory definition of "government official."

[2] See, for example, Rev. Rul. 74-601, 1974-2 CB 385.

maximum amount payable under section 5702(a) of title 5, United States Code (relating to like travel by a U.S. government employee) for a maximum of 4 days.[3]

In cases where a trip takes fewer than 4 days, the maximum amount which can be paid or reimbursed for other traveling expenses is the maximum daily rate (i.e., 1¼ times the Federal *per diem*) times the number of days actually involved. In cases where a trip involves 4 or more days, the maximum amount of payment or reimbursement allowable is for 4 days.

In applying these limitations (both the $2,500 and the 4-day limitations), all parts of a trip are to be treated as a single trip. For example, assume that a government official travels from Washington to London for a conference which lasts 3 days. The official then travels from London to Tokyo for another conference that lasts 3 days. From Tokyo, the official returns to Washington. All three "legs" of the travel and both of the conference periods in this example are treated as constituting one continuing trip, which qualifies as travel between a point in the United States and a point outside the United States. The aggregate total costs of transportation from Washington to London, from London to Tokyo, and from Tokyo to Washington are subject to one $2,500 limitation, and the aggregate other traveling expenses in London and Tokyo are subject to one 4-day limitation.

The bill is to apply whether the eligible traveling expenses are advanced to the government official, are paid for directly by the private foundation, or are initially paid for by the government official and the private foundation reimburses the government official.

The committee expects that the travel would normally be in connection with a conference or similar meeting. However, the statutory provision is not limited to travel in connection with conferences or meetings. For example, the travel might be undertaken in connection with a fact-finding or research activity. Pursuant to section 4945(d)(5), a foundation can pay or reimburse eligible travel expenses of government officials only if such expenditures are for charitable, educational, or other exempt purposes specified in section 170(c)(2)(B). Thus, any payment or reimbursement by a private foundation of expenses of travel for nonexempt purposes (for example, travel for vacation purposes) would subject the foundation (and also any foundation manager who willfully and knowingly agrees to the making of the "taxable expenditure") to a graduated series of excise taxes based on section 4945.

The exception added by this bill is not available to a private foundation if more than one-half of the foundation's support (as defined in sec. 509(d)) is normally derived from any one business enterprise, any one trade association, or any one labor organization, whether such support takes the form of interest, dividends, other income, grants, or contributions. Accordingly, any payment or reimbursement by such a

[3] Under 5 U.S.C. 5702(a), in the case of travel outside the continental United States, the President or his designee has the authority to establish the maximum *per diem* allowance for the locality where the travel is performed. As of August 1979, for example, 1¼ times the daily amount so established for travel expenses in London is $143.75; for travel in Paris; $112.50; and for travel in Tokyo, $121.25.

foundation to government officials for expenses of foreign travel cannot qualify under this new provision as an exception from self-dealing. For purposes of determining whether a private foundation's support is normally derived from any one business enterprise, trade association, or labor organization, "normal" support is to be determined by applying the rules set forth in Treasury Regulations issued under section 170(b)(1)(A)(vi) which define "normal" support in the case of organizations seeking to be classified as publicly supported charities (e.g., on the basis of a 4-year moving average in the case of organizations in existence for at least 5 years).

It is intended and expected that the Internal Revenue Service will advise the involved private foundation or government official, in response to a *bona fide* and properly filed request by the foundation or official, whether a proposed payment or reimbursement of travel expenses would qualify under this new exception (or under the existing exception applicable to domestic travel), so that neither the official nor any foundation manager will have to act at peril.[5]

### *Effective date*

This provision would apply with respect to travel which begins after the date of enactment.

### *Revenue effect*

It is estimated that these provisions will not have any direct revenue effect.

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[5] This bill does not affect the requirement of present law (sec. 4941(a)(1)) that an initial self-dealing excise tax is not to be imposed on a government official, as such, unless the official knows that the transaction constitutes an act of self-dealing. Notwithstanding this protection for officials who unknowingly participate in "self-dealing," a government official who is contemplating acceptance of foundation payment or reimbursement for travel expenses may wish to seek an advance ruling from the Service as to whether such payment or reimbursement qualifies under the existing exception for domestic travel or the exception made by the bill for foreign travel.

### c. Alternative minimum tax on charitable lead trusts created by corporations (sec. 3 of the bill and sec. 57 of the Code)

#### *Present law*

The Revenue Act of 1978 imposed an alternative minimum tax with rates up to 25 percent on taxpayers other than corporations. Alternative minimum taxable income is gross income reduced by allowable deductions and increased by the amount of the taxpayer's adjusted itemized deductions and capital gains deduction. The preference for adjusted itemized deductions is generally the amount by which a taxpayer's itemized deductions (such as the charitable deduction) exceed 60 percent of the taxpayer's adjusted gross income. In general, the preference for adjusted itemized deductions was applied to charitable lead trusts (i.e., where the present interest in the trust is paid to the charity) in order that this type of trust could not be used to circumvent application of the alternative minimum tax to the grantor (or beneficiary) of the trust. Exceptions were provided where avoidance of the alternative minimum tax was not possible, e.g., estates, testamentary charitable lead trusts, and trusts created before 1978. However, no exception was provided for charitable lead trusts created by a corporation even though corporations are not subject to the alternative minimum tax. Consequently, the alternative minimum tax may be imposed on a charitable lead trust created by a corporation because the trust's charitable deduction for income paid to charity may give rise to the preference for adjusted itemized deductions.

#### *Issue*

The issue is whether an additional exception should be provided for charitable lead trusts where the grantor of the trust (and the owner of the reversionary interest in the trust) is a corporation.

#### *Explanation of provision*

The bill provides that the charitable contribution deduction of a charitable lead trust will not be treated as an itemized deduction in determining the adjusted itemized deduction preference for purposes of the alternative minimum tax if the grantor of the trust and the owner of all reversionary (or remainder) interests in the trust is a corporation.

#### *Effective date*

This provision would be effective for taxable years beginning December 31, 1975.[1]

#### *Revenue effect*

It is estimated that this provision would reduce budget receipts by less than $5 million annually.

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[1] The amendment would apply to all taxable years for which itemized deductions may be treated as a preference for minimum tax purposes. Preference treatment was first provided for certain itemized deductions under the Tax Reform Act of 1976.

### d. Extension of withholding to payments of sick pay made by third parties (sec. 4 of the bill and secs. 3402 and 6051 of the Code)

#### *Present law*

Under present law (Code sec. 105(a)), amounts received by an employee through accident or health insurance for personal injuries or sickness (commonly referred to as wage continuation payments or "sick pay") generally must be included in gross income to the extent such amounts are attributable to contributions by the employer which were not includible in the gross income of the employee, or are paid by the employer.

Under section 3402(a) of the Code, every employer who makes wage payments is required to deduct and withhold income taxes from these payments. Payments made by an employer to an employee under a wage continuation plan generally are treated as wages and subject to withholding (except to the extent that an employee receives back contributions he or she previously made to a wage continuation plan). However, no tax is specifically required to be withheld upon any wage continuation payment made by a person who is not the employer for whom the employee performs services. Thus, for example, no tax is specifically required to be withheld from wage continuation payments made on behalf of an employer by an insurance company under an accident or health policy, by a separate trust under an accident or health plan, or by a State agency from a sickness and disability fund maintained under State law (Treas. Reg. sec. 31.3401(a)-1(b)(8)(ii)(*d*) and Announcement 77-117, 1977-32 IRB 24 (Aug. 8, 1977).)

#### *Issue*

The issue is whether an individual who receives "sick pay," which is not subject to withholding because it is paid by a third party, should be allowed to have tax withheld from such pay voluntarily.

#### *Explanation of provision*

*In general*

The bill amends section 3402(o) of the Code to specifically require withholding from sick pay, if the payee so requests. For purposes of this provision, sick pay would be defined as any amount which is paid to an employee pursuant to a plan to which the employer is a party, and which constitutes remuneration or a payment in lieu of remuneration for any period during which the employee is temporarily absent from work on account of sickness or personal injuries.

Under the bill, the amount of sick pay and annuity payments subject to withholding would be an amount specified by the payee in his or her request for withholding. However, in no case could this amount be less than a minimum amount to be set forth in regulations prescribed by the Secretary. In the case of a payment which is greater, or less, than a full payment, the amount withheld is to bear the same

relation to the specified amount as such payment bears to a full payment.[1]

*Requests for withholding*

An individual who wishes to have his or her annuity or sick pay subject to withholding must make a written request to the person making the payments. This request must contain the individual's social security number and must specify the amount to be withheld from each full payment. In the case of sick pay, a request for withholding would be effective with respect to payments made more than 7 days after the date on which the request is furnished to the payor. In the case of an annuity, a request would be effective at such time (after the request is made) as the Secretary prescribes by regulations. A request for withholding may be changed or terminated by furnishing to the payor a written statement of change or termination.

*Special rule for sick pay paid pursuant to collective-bargaining agreements*

Under the bill, in the case of any sick pay paid pursuant to a collective-bargaining agreement between employee representatives and one or more employers, the amount of sick pay subject to withholding would be determined in accordance with such agreement if the agreement so provided. (That is, an employee who is a party to such an agreement would not be required to submit a written request for withholding to the payor.) However, there could be no withholding with respect to sick pay paid to an employee (who is party to a collective-bargaining agreement) who has in effect a withholding exemption certificate certifying that he incurred no tax liability for the preceding taxable year and anticipates that he will incur no tax liability for the current taxable year.

The special treatment accorded to collective-bargaining agreements would not apply to sick pay paid pursuant to such an agreement to any individual unless the individual's social security number is furnished to the payor and the payor is furnished with the information necessary to determine whether the payment is pursuant to the agreement and to determine the amount to be withheld.

*Reporting requirement*

The bill would require a person who makes a payment of third-party sick pay to an employee to furnish a written statement to the employer on behalf of whom the payment was made showing the name of the employee, the social security number of the employee (if there was withholding), the total amount of third-party sick pay paid to the employee during the calendar year, and the total amount (if any) withheld from sick pay. This statement would be due on or before January 15 of the year succeeding the year in which the payment of third-party sick pay was made. The bill defines "third-party sick pay" as any sick pay which does not constitute wages for purposes of withholding. This reporting

[1] For example, assume an individual receives sick pay of $100 per week and requests $25 per week to be withheld for taxes. After four full weeks of absence, the individual returns to work on a Wednesday. For the week he returns to work, he would be entitled to $40 of sick pay, $10 of which would be withheld for taxes.

requirement would be in lieu of the reporting requirements of section 6041(a) relating to certain payments of $600 or more. In addition, the bill would provide that a person required to furnish a statement to an employer who willfully furnishes a false or fraudulent statement, or who willfully fails to furnish a statement in the manner, at the time, and showing the information required, would, for each such failure, be subject to a penalty of $50, and, upon conviction of each such offense, could be fined not more than $1,000, or imprisoned not more than one year, or both.

Every employer who receives a statement from a person who made a third-party payment of sick pay to an employee would be required to furnish the information to the employee on another statement which shows which portion (if any) of the sick pay is excludable from gross income and which portion is not excludable. This statement must be furnished to the employee on or before January 31 of the year succeeding the year in which the payment of third-party sick pay was made.

***Effective date***

This provision of the bill would apply to payments made on or after the first day of the first calendar month beginning more than 120 days after the date of enactment.

***Revenue effect***

It is estimated that this provision would cause a one-time increase in budget receipts of less than $5 million in fiscal year 1980.

### e. Treatment of certain repayments of supplemental unemployment compensation benefits (sec. 5 of the bill and sec. 62 of the Code)

#### *Present law*

Under present law, workers who are laid off may become entitled to taxable supplemental unemployment compensation benefits [1] during periods for which they are laid off. Subsequently, they may receive trade readjustment assistance,[2] which generally is nontaxable (except to the extent otherwise provided in section 85 of the Code). When this occurs, those workers may be required to pay back the supplemental unemployment benefits they previously received.

If repayment is made by a worker, a deduction is allowable (under section 165 of the Code) for the repayment. In addition, a special relief provision, relating to the computation of tax where the taxpayer restores a substantial amount held under a claim of right, may apply (Code sec. 1341).

Under the special relief provision, if the worker pays back more than $3,000 of supplemental unemployment compensation benefits, income tax for the taxable year of repayment may be computed by claiming an itemized deduction for the repayment or, if a greater benefit is derived, the tax for the current year may be reduced by the amount of tax for the prior taxable year which was attributable to the inclusion of such benefits in gross income. However, this special tax computation is not available if the repayment does not exceed $3,000. In this case, no relief is available for the repayment of amounts previously included in gross income unless the worker claims itemized deductions for the taxable year in which the repayment is made.

#### *Issue*

The issue is whether workers who are required to repay supplemental unemployment compensation benefits because of the receipt of trade readjustment assistance should be allowed to claim a deduction from gross income in the year of repayment.

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[1] These benefits generally are paid by trusts exempt from taxation under Code sec. 501(c) (17) or by voluntary employees' beneficiary associations exempt from taxation under Code sec. 501(c) (9).

[2] Under the Trade Act of 1974, benefits are provided to workers who are separated from their jobs as a result of the adverse effect of increased imports. The worker's separation must be due to lack of work in adversely affected employment, and covered under a certification of eligibility. In the 52 weeks preceding his qualifying separation, he must have had at least 26 weeks of employment at wages of $30 or more a week in adversely affected employment with a single firm. Benefits under the Trade Act equal 70 percent of the worker's average weekly wage, but may not exceed the average weekly manufacturing wage. Benefits are reduced by 50 percent of any earnings during the week for which benefits are provided. These benefits generally are payable for up to 52 weeks, and also are provided in the form of training allowances, job search allowances, and relocation allowances.

### *Explanation of provision*

The bill amends section 62 of the Code to allow a deduction from gross income for the repayment of supplemental unemployment compensation benefits if the repayment is required because of the receipt of trade readjustment allowances under sections 231 or 232 of the Trade Act of 1974. Qualifying repayments would be those made to trusts exempt from taxation under section 501(c)(17) of the Code or to voluntary employees' beneficiary associations exempt from taxation under section 501(c)(9) of the Code.

In the case of a repayment of more than $3,000 of supplemental unemployment compensation benefits, the taxpayer will continue to have the option of computing tax for the current taxable year under existing provisions for restoration of amounts held under claim of right (Code sec. 1341).

### *Effective date*

The provision would apply to repayments made in taxable years beginning after the date of enactment.

### *Revenue effect*

It is estimated that this provision would reduce budget receipts by $5 million in fiscal year 1980 and in each year thereafter.

### f. Disclosure of tax returns to State audit agencies (sec. 6 of the bill and sec. 6103(d) of the (Code)

#### *Present law*

Under present law (Code sec. 6103(d)), returns and return information may be disclosed to State agencies which are charged under the laws of the State with responsibility for the administration of State tax laws for the purpose of, and only to the extent necessary in, the administration of such laws. Section 6103(d) sets forth specific rules with which a State agency must comply in order to receive Federal tax information. For example, the request for disclosure must be made by the head of the State tax agency in writing and the actual disclosure of the tax information may be made only to the representatives of the State tax agency who are designated in the written request to receive the information. Also, the law provides that the tax information cannot be disclosed to the Governor of a State. In addition, return information may not be disclosed to the extent that the Secretary of the Treasury determines such disclosure would identify a confidential informant or seriously impair any civil or criminal tax investigation.

Return information disclosed to State agencies is subject to strict safeguard, recordkeeping, and reporting requirements (Code secs. 6103(p)(3) and 6103(p)(4)). These requirements provide assurances that Federal tax return information will be used only for the purposes authorized by law and provide a basis for determining when violations occur.

Present law allows State auditing agencies access to Federal tax return information only when the auditing agency actually is involved in the determination, assessment, collection, or refunding of taxes (that is, tax administration activities). Thus, a State auditing agency is not authorized access to Federal tax return information when the auditing agency's role is limited to general oversight of the taxing authority.

#### *Issue*

The issue is whether State taxing authorities should be permitted to disclose Federal tax return information in their possession to State auditing agencies for the purpose of auditing the activities of the State tax authority.

#### *Explanation of provision*

The bill provides that any returns or return information obtained by a State agency pursuant to the provisions of section 6103(d) may be open to inspection by, or disclosure to, officers and employees of the State audit agency for the purpose of, and only to the extent necessary in, making an audit of the State agency which obtained the returns or return information. Under the bill, a "State audit agency" is defined as any State agency, body, or commission which is charged under the laws of the State with the responsibility of auditing State revenues and programs.

In addition, a State audit agency which receives return information would be subject to the same safeguard, recordkeeping, and reporting requirements as apply to other State agencies which receive return information and would be subject to the confidentiality requirements imposed by section 6103(a) and the civil and criminal penalties applicable in the case of unauthorized disclosure of such return information.

*Effective date*

This provision would become effective upon enactment.

*Revenue effect*

This provision will not have any impact on Federal revenues.

**g. Investment tax credit for certain property used in maritime satellite communications (sec. 7 of the bill and sec. 48 of the Code)**

***Present law***

Under present law, a credit against tax liability is provided with respect to a taxpayer's investment in certain types of depreciable business assets. Generally, the investment credit rate is 10 percent of qualified investment. Qualifying property for purposes of this investment tax credit includes tangible personal property and other tangible property used as an integral part of certain activities, including the furnishing of communications services. However, property which otherwise qualifies will generally be excluded from the credit if it is used predominantly outside of the United States or is used by a governmental unit or an international organization.

Under provisions enacted in the Revenue Act of 1971, these exclusions are made inapplicable to any interest of a United States person in communications satellites and property used by the International Telecommunications Satellite Organization (INTELSAT), an international joint venture established to develop and operate the space segment of the global commercial communications satellite system. As a result, the Communications Satellite Corporation (COMSAT) is entitled to the credit for its investments in the INTELSAT system. COMSAT, a private, for-profit corporation created pursuant to the Communications Satellite Act of 1962, is the designated United States participant in INTELSAT.

During the 95th Congress, the International Maritime Satellite Telecommunications Act (P.L. 95-564) amended the Communications Satellite Act of 1962 to designate COMSAT as the United States participant in the International Maritime Satellite Organization (INMARSAT). INMARSAT is an international organization, similar in structure and operation to INTELSAT, which is being established to develop and operate a global maritime satellite telecommunications system.

***Issue***

The issue is whether investments in property used by INMARSAT should be eligible for the investment tax credit.

***Explanation of provision***

This provision of the bill will make the international organization exclusion under the investment tax credit inapplicable to property used by the International Maritime Satellite Organization (INMARSAT). As a result, the investment tax credit will be available for investments by COMSAT or other United States persons in property owned or used by INMARSAT. This is the same treatment as was provided in 1971 for investments in the INTELSAT system.

***Effective date***

This provision would apply to taxable years beginning after December 31, 1979.

***Revenue effect***

It is estimated that this provision would have an insignificant effect on budget receipts through fiscal year 1984.

### h. Increases in interest rates payable on United States retirement plan and individual retirement bonds (sec. 8 of the bill and sec. 1 of the Second Liberty Bond Act (31 U.S.C. 752))

#### *Present law*

Under present law, a person eligible to establish an individual retirement account may purchase retirement bonds issued for this purpose by the Treasury Department. These bonds are not transferable and are subject to many of the restrictions that apply to individual retirement accounts. Retirement plan bonds are issued for H.R. 10 plans established by self-employed persons and for retirement and annuity plans established by employers for their employees. The interest rate on any such retirement bonds remains unchanged throughout its life.

By contrast, the interest rates on issued Series E savings bonds are increased whenever there is an increase in the interest rates on new issues of Series E bonds. This adjustment is made in recognition of the holder's ability to redeem the outstanding bond before maturity and to reinvest the proceeds in new Series E bonds issued with the higher interest rate.

#### *Issue*

Absent any provision authorizing adjustments in the interest rate for outstanding U.S. retirement bonds, potential purchasers may be expected to turn to various retirement plan arrangements offered in the private sector. Any net reduction in Treasury Department sales of retirement bonds will increase the amount of money that must be raised by the Treasury Department in some other manner.

The issue is whether the Treasury Department should be authorized to adjust upward the interest rate paid on outstanding retirement bonds.

#### *Explanation of provision*

The bill permits the investment yield (which term is used as identical to the interest rate) on U.S. retirement plan bonds (sec. 405 (b)) and U.S. individual retirement bonds (sec. 409(a)) to be increased for any interest accrual period so that the investment yield for that accrual period on the bonds is consistent with the investment yield for the accrual period on Series E savings bonds.

Any increased interest rates, and the accrual periods to which these rates apply, are to be specified in regulations to be issued by the Treasury Department. The bill provides that these regulations, to be effective, must be approved by the President.

#### *Effective date*

This provision would apply to interest accrual periods that begin after September 30, 1977, with respect to bonds issued before, on, or after the date of enactment, but only for the purposes of increasing the investment yield on such bonds for interest accrual periods which begin after the date of enactment.

#### *Revenue effect*

It is estimated that this provision would have no effect on budget receipts, but it will increase outlays by $6 million in fiscal 1980 and by $2 million each year thereafter.

## 2. H.R. 5505: Tax Administrative Provisions Revision Act of 1979 [1]

### a. Change of time for paying excise tax on fishing equipment (sec. 7 of the bill and sec. 4161(a) of the Code) [2]

*Present law*

Under present law (Code sec. 4161(a)), there is imposed upon the sale of fishing rods, creels, reels, and artificial lures, baits, and flies (including parts or accessories of such articles sold on or in connection therewith, or with the sale thereof) by the manufacturer, producer, or importer a tax of 10 percent of the price for which the article is sold.

Treasury Department regulations prescribing the time for making deposits of manufacturers excise taxes are found in Treas. Reg. sec. 48.6302(c)-1. If an individual is liable in any month for more than $100 of taxes reportable on Form 720 (Quarterly Excise Return) and he is not required to make semimonthly deposits, the individual must deposit the amount on or before the last day of the next month at an authorized depository or at the Federal Reserve Bank serving the area in which the individual is located. If an individual had more than $2,000 in excise tax liability for any month of a preceding calendar quarter, he must deposit such taxes for the following quarter (regardless of amount) on a semimonthly basis. The taxes must be deposited by the ninth day following the semimonthly period for which they are reported. In addition, if the semimonthly period is in either of the first two months of the quarter, any underpayment of excise taxes for a month must be deposited by the ninth day of the second month following such month. Underpayments in the third month of the quarter must be deposited by the end of the following month.

No special rules are provided to defer payment of the excise tax with respect to sales of taxable articles on credit except certain installment sales.

*Issue*

The issue is whether the payment of excise taxes imposed upon the sale of fishing equipment should be postponed in order to match more closely the collection of sales' proceeds by the manufacturer, producer, or importer.

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[1] Provisions relating to the simplification of certain procedure rules (secs. 2–6 of the bill) and extension of expiring tax provisions (sec. 12 of the bill) were enacted as part of Public Law 96–167 (H.R. 5224) in 1979. This description is from the House Report on H.R. 5505 (H. Rept. No. 96–545).

[2] Provisions which are identical to this section of the bill are also contained in H.R. 1212, as reported by the Senate Finance Committee (S. Rept. No. 96-532, sec. 403). Also, a hearing was held on S. 1549, which contains the same provisions, by the Finance Subcommittee on Taxation and Debt Management Generally on November 7, 1979.

### *Explanation of provision*

The bill provides that the manufacturers excise tax imposed on the sale of fishing equipment is payable according to the following schedule:

| *For articles sold during the quarter ending:* | *Payment of the tax is due by:* |
|---|---|
| December 31 | March 31 |
| March 31 | June 30 |
| June 30 | September 24 |
| September 30 | According to Treasury Regulations |

In the case of sales of fishing equipment made during the first two quarters of the Federal fiscal year, the bill extends the due date for payment for up to 5 months and 1 week beyond that applicable under present law. In the case of sales made during the third such quarter (ending June 30), the extension is not as long (until September 24), in order to insure that all payments for sales made through June 30 are included in Federal Government receipts for the fiscal year, which ends on September 30.

In the case of sales made during the fourth such quarter, the bill does not require any change from the payment schedule presently in effect under Treasury regulations (sec. 48.6302(c)-1). However, the bill does not preclude the Secretary of the Treasury from changing such regulations, to the extent the Secretary from time to time may deem appropriate, with respect to the due date for payment of excise taxes incurred on sales of fishing equipment made during the quarter ending September 30.

### *Effective date*

The provision would apply to excise taxes payable on fishing equipment sold on or after the first day of the first calendar quarter beginning after the date of enactment of the bill.

### *Revenue effect*

This provision would not affect the aggregate fiscal year receipts of the manufacturers excise tax on fishing equipment.

### b. Excise tax treatment of domestic wines for certain uses (sec. 8 of the bill and sec. 5362 of the Code)

***Present law***

Under present law, both imported wines and those produced in the United States are generally subject to the same excise taxes (Code sec. 5041). Domestically produced wines may be withdrawn from bonded wine cellars without payment of tax for certain purposes, including exportation, use on certain vessels and aircraft, and further processing in a customs manufacturing warehouse prior to exportation (Code sec. 5362(c)). In addition, domestic wines on which the tax has been paid or determined may be transferred for these purposes and the authorized person may receive repayment of the tax by way of drawback.

Present law allows foreign wines to be imported into the United States and sold tax-free from customs bonded warehouses for uses such as supplies on certain vessels and aircraft and the official or family use, in the United States, of foreign governments, public international organizations, and certain individuals associated with these governments and organizations. In contrast, domestic wines may not be transferred without payment of tax to customs bonded warehouses, other than manufacturing warehouses, and there is no provision which authorizes the tax-free withdrawal of domestic wines from a bonded winery for the use of certain foreign governments and related individuals. While present law permits the tax-free withdrawal from internal revenue bond of domestically produced wine for the use of certain vessels and aircraft, there is no provision authorizing the tax-free transfers of wine to a customs bonded warehouse for storage pending removal as vessel or aircraft supplies. As a result, it is presently necessary for domestic wines to be exported and then returned to a customs bonded warehouse in the United States in order for sales of these wines to be made without payment of tax to foreign embassies, legations, international organizations, and related individuals, or to accomplish a tax-free transfer of domestic wines to a customs bonded warehouse prior to the authorized withdrawal for use as supplies by certain vessels or aircraft.

The same difference in treatment had previously existed for distilled spirits, which are generally subject to separate taxing provisions. This difference was resolved for distilled spirits under legislation enacted in 1971[1] and 1977[2] so that distilled spirits may be transferred, without payment of tax, to customs bonded warehouses located in the United States and held free of tax for exempt sales, such as those to foreign governments and international organizations (and related individuals) and for certain ship and aircraft supplies. The 1971 amend-

[1] P.L. 91-659, enacted January 8, 1971.
[2] P.L. 95-176, enacted November 14, 1977.

ments also included provisions to prevent the resale or unauthorized use of distilled spirits which are sold tax-free to foreign governments, international organizations, and related individuals (Code sec. 5066).

*Issue*

The issue is whether domestic wines should be accorded the same treatment as imported wines by allowing domestic wines to be transferred without payment of excise tax to customs bonded warehouses for purposes of tax-exempt sales.

*Explanation of provision*

The bill would allow the transfer of wine without payment of excise tax to any customs bonded warehouse rather than allowing transfers only to customs manufacturing warehouses, as under present law. In addition, the bill specifies that wine entered into customs bonded warehouses may be withdrawn tax-free for consumption in the United States by and for the use of foreign governments, organizations, and related individuals, and the same prohibitions relating to the resale or unauthorized use of distilled spirits will apply to these transfers of wine. As a result, the same treatment would be accorded wine as is provided for distilled spirits under present law so that domestic wine may be sold tax-free from customs bonded warehouses for qualifying ships and aircraft supplies and for the use of foreign embassies, legations and related individuals.

*Effective date*

The provisions would be effective on the first day of the first calendar month which begins more than 90 days after enactment.

*Revenue effect*

It is estimated that the provisions would have a negligible effect upon budget receipts.

### c. Refunds of tread rubber excise tax (sec. 9 of the bill and secs. 4071, 6416, and 6511 of the Code)

*Present law*

Present law imposes a tax of 5 cents per pound on tread rubber used for recapping or retreading tires of the type used on highway vehicles (secs. 4071(a)(4), 4072(b), and 4073(c)).[1]

Tread rubber may be sold tax-free for use otherwise than in the recapping or retreading of tires of the type used on highway vehicles, or a credit or refund (without interest) of the tread rubber tax may be obtained if the tax-paid tread rubber is used or sold for use otherwise than in the recapping or retreading of tires of the type used on highway vehicles (sec. 6416(b)(2)(G)).

There are several instances under present law where a manufacturers excise tax is imposed on tread rubber when in a similar situation the manufacturers excise tax is not imposed (or a credit or refund of the tax is allowed) on new tires.

First, rubber wasted in manufacturing new tires is not subject to tax since the tax is imposed when the completed tire is sold and only upon the material actually contained in the completed tire. The tax on tread rubber, on the other hand, is imposed before the recapping or retreading of a used tire. Wastage of tread rubber in that process occurs after the tread rubber tax liability has been determined, and under present law no refund or credit is provided for any portion of the tax imposed on tread rubber which is so wasted.[2]

Second, if the sale price of a retreaded tire is adjusted by reason of a warranty or guarantee, no credit or refund of the tread rubber tax is provided.[3]

Third, no credit or refund is available for the tread rubber tax when a recapped or retreaded tire is exported, sold to a State or local government, sold to a nonprofit educational organization, or used or sold for use as supplies for vessels or aircraft (secs. 4221 and 6416(b)).

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[1] The tax on tread rubber is scheduled to expire on October 1, 1984 (sec. 4071(d)(3)), (Revenues from this tax go into the Highway Trust Fund.)

[2] In *Great Olympic Tire Co.* v. *U.S.*, 597 F.2 449, 78-1 USTC ¶ 16,316 (5th Cir. 1979), the Fifth Circuit Court of Appeals held that tread rubber wasted in the recapping process is not subject to the section 4071(a)(4) manufacturers excise tax, and that highway-type tires returned under warranty after partial use are subject to the tax without allowance for a refund or credit of the tax previously imposed on the tread rubber remaining on the returned tire. In arriving at these conclusions, the court relied upon the fact that wasted rubber never became part of tires of the type used on highway vehicles and that rubber remaining in a returned tire had become part of a tire of the type used on highway vehicles. While the section 4071(a)(4) tread rubber tax does not refer to highway-type vehicle tires, as does the section 4071(a)(1) new tire tax, the court noted that the legislative history of the tread rubber tax clearly evidences an intention to limit the tax to such tires. *See.* H. Rept. No. 10660, 84th Cong., 2d Sess., 1956-2 C.B. 1312; Rev. Rul. 65-223, 1965-2 C.B. 420.

[3] *See* note 2, *supra.*

Neither is the credit or refund available where a retreaded tire is mounted on a new vehicle that then is disposed of in any of the above ways.

While used and recapped or retreaded tires ordinarily are subject to the tire tax when imported, a different situation exists when a used tire which has been taxed in the United States is exported, is retreaded (other than from bead to bead) abroad, and then is shipped back into the United States.[4] Then there is neither a tax on the imported retreaded tire nor on the tread rubber used in the retreading, because the tire already has been taxed and the tread rubber is considered to have lost its identity.

Under present law, the general time by which a claim for credit or refund of a tax must be filed is 3 years from the time the tax return was filed or, if later, 2 years from the time the tax was paid (sec. 6511).

### *Issues*

Several issues are presented by the bill:

(1) whether a credit or refund of the tread rubber tax should be available in those instances where a credit or refund of the similar manufacturers excise tax on new tires would be available;

(2) whether the manufacturers excise tax on tread rubber should be imposed where a tire has been exported for recapping outside the United States and subsequently is imported into the United States; and

(3) whether the statute of limitations for claiming a credit or refund of the manufacturers excise tax on tread rubber should be extended where a claim for credit or refund of the tread rubber tax is filed as a result of a warranty or guarantee adjustment.

### *Explanation of provisions*

*Credit or refund of tread rubber tax*

This provision of the bill makes a credit or refund of the tread rubber tax available in three situations. These changes are intended to permit a credit or refund of the tax on the tread rubber used on a recapped or retreaded tire, under the same circumstances where a credit or refund would be available for the tax on a new tire.

First, the credit or refund would be available where rubber is destroyed, scrapped, wasted, or rendered useless in the recapping or retreading process.

Second, the credit or refund would be available where the tread rubber is used in the recapping or retreading of a tire if the sales price of the tire is later adjusted because of a warranty or guaranty. The overpayment (that is, the amount available for credit or refund) would be the same proportion of the tax paid as the adjustment in the sales price of the retreaded tire to the immediate vendee by the tire retreader.

Third, a credit or refund of the tread rubber tax would be available to the manufacturer for the tread rubber on a recapped or retreaded tire if the tire is by any person (1) exported, (2) sold to a State or local government for its exclusive use, (3) sold to a nonprofit educa-

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[4] Tires recapped from bead to bead are considered as having been newly manufactured and thus are taxable.

tional organization for its exclusive use, or (4) used or sold for use as supplies for a vessel or aircraft.

Finally, where a retreaded tire is sold by the retreader or by another manufacturer on or in conjunction with another article (for example, a truck) manufactured by it, the bill would provide that a credit or refund of the tread rubber tax is to be allowed to the manufacturer of the other article if the article is exported or sold by any person for any of the above purposes.

*Tax on imported recapped or retreaded tires*

The provision also would provide that used tires which are exported from the United States, recapped or retreaded abroad (other than from bead to bead), and then imported into the United States are to be subject to the tax on tread rubber. For this purpose, the amount of tread rubber to be taken into account is to be determined as of the completion of the recapping or retreading of the tire. The amount so determined would be either the amount which is established as actually used in recapping or retreading the tire or an average amount which is generally used on comparable tires in the industry, as determined by the Treasury Department (sec. 4701(c)).

If a retreaded tire is imported on a vehicle which is not itself subject to a manufacturers excise tax (e.g., a passenger car or a light-duty truck), then the importer of the vehicle is under existing law (Code sec. 4071(e)) treated as the importer of the tire. However, as noted, if the tire is not taxable because it was exported and recapped abroad (except from bead to bead), the importer is not liable for tax on the tread rubber on the imported tire. This provision carries the process a step further and would treat the importer of the vehicle as the importer of the tread rubber that is on a retreaded tire which is not otherwise subject to tax on the complete tire. Thus, the tread rubber would be subject to tax.

*Warranty or guaranty adjustments*

The provision also would modify the statute of limitations in cases where a claim for credit or refund of the tread rubber tax is filed as a result of a warranty or guaranty adjustment. The amendment provides that in such a case a claim for credit or refund may be filed at any time before the date which is one year after the date on which the adjustment is made, if the period for filing the claim would otherwise expire before that later date.

In other words, under this provision, the manufacturer would be assured that it will have one day less than a year after the time the adjustment is made (or deemed made) within which to file a claim for credit or refund of the relevant tax.

### *Effective date*

This provision would be effective on the first day of the first calendar month which begins more than 10 days after the date of the provision's enactment.

### *Revenue effect*

It is estimated that this provision would reduce budget receipts by less than $100,000 in fiscal year 1980, and by less than $200,000 annually during each of the next 4 fiscal years. (These amounts would otherwise go into the Highway Trust Fund—through September 30, 1984.)

### d. Nonrecognition of gain on sale of residence for certain members of the Armed Forces (sec. 10 of the bill and sec. 1034 of the Code)

#### *Present law*

Under present law, the entire amount of gain or loss realized on the sale or exchange of property generally is recognized. However, under a "rollover" provision of the Code (sec. 1034), gain is not recognized on the sale or exchange of a taxpayer's principal residence if a new principal residence, at least equal in cost to the adjusted sales price of the old residence, is purchased and used by the taxpayer as his or her principal residence within a period beginning 18 months before and ending 18 months after the date of the sale of the old residence. The basis of the new residence then is reduced by the amount of gain not recognized on the sale of the old residence.

The replacement period is suspended during any time that the taxpayer (or the taxpayer's spouse) serves on extended active duty with the Armed Forces of the United States after the date of the sale of the old residence. Currently, this suspension may not extend more than four years beyond the date of the sale of the old residence. Thus, a member of the Armed Forces generally is not required to recognize gain on the sale of a principal residence if he or she purchases and uses a new principal residence within four years after the date of the sale of the old residence.

#### *Issue*

The issue is whether the period of time in which a new principal residence may be purchased, in order to qualify for nonrecognition of gain on the sale of the old principal residence, should be extended in the case of a member of the Armed Forces who is stationed outside of the United States or is required to reside in Government-owned quarters.

#### *Explanation of provision*

This provision extends the period of time in which a member of the Armed Forces who is stationed outside of the United States or is required to reside in Government-owned quarters must purchase a new principal residence in order to qualify for nonrecognition of gain on the sale of the old principal residence. Under this provision, a member of the Armed Forces who is stationed outside of the United States or is required to reside in Government-owned quarters after the date of the sale of the principal residence generally will not recognize gain on the sale of the residence if the taxpayer purchases and uses a new principal residence within the later of four years after the date of the sale of the old residence or one year after the date on which the taxpayer is no longer stationed outside of the United States or is no longer required to reside in Government-owned quarters.

The benefits of this additional extension period will be available only if the taxpayer has timely filed, with the Internal Revenue Service, a notice of the taxpayer's intent to take advantage of the extension.

The extension of the period for replacement of a residence by a member of the Armed Forces was not intended to constitute a precedent for providing similar rules for other taxpayers because the problem of replacing a principal residence beyond the usual 18-month period by a member of the Armed Forces was considered to be a unique problem.

***Effective date***

The provision would apply to sales of old residences after December 31, 1979 by eligible members of the Armed Forces.

***Revenue effect***

This section would have no effect on budget receipts through fiscal year 1985. Beginning with fiscal year 1986, it its estimated that this program will reduce budget receipts by $10 million annually .

### e. Exempt status of auxiliaries of certain fraternal beneficiary societies (sec. 11 of the bill and sec. 501 of the Code)

#### *Present law*

Under present law, social clubs and similar nonprofit organizations, such as national organizations of college fraternities and sororities, are exempt organizations. Code section 501(c)(7) provides that these organizations must be organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes with no part of the net earnings inuring to the benefit of any private shareholder.

However, section 501(i) provides that an organization otherwise exempt from income tax as an organization described in section 501(c)(7) is to lose its exempt status for any taxable year, if at any time during that year the organization's charter, by-laws or other governing instrument, or any written policy statement, contains a provision which provides for discrimination against any person on the basis of race, color, or religion.

Exempt status is granted under section 501(c)(8) to fraternal beneficiary societies, orders, or associations which operate under the lodge system or for the exclusive benefit of the members of a fraternity operating under the lodge system, and which provide for the payment of life, sick, accident, or other benefits to the members of the society, order, or association, or their dependents.

#### *Issue*

The issue is whether exempt status under section 501(c)(7) should be provided for auxiliaries of a fraternal beneficiary society which is exempt under section 501(c)(8) and which limits its membership to members of a particular region.

#### *Explanation of provision* [5]

This provision allows certain auxiliaries of fraternal beneficiary societies to qualify for tax-exempt status under section 501(c)(7) even though membership in the auxiliaries is limited to members of a particular religion. The bill provides that the restriction on religious discrimination in section 501(i) shall not apply to an auxiliary of a fraternal beneficiary society if the society is described in section 501(c)(8), is exempt from income tax under section 501(a), and limits its membership to the members of a particular religion.

The intended beneficiaries of this provision are the affiliated corporations of the unincorporated, subordinate lodges of the Knights of Columbus, a fraternal society which claims tax-exempt status under section 501(c)(8). Generally, these affiliated corporations were formed to hold title to real property. Prior to the enactment of section 501(i) in 1976, some of the Knights' affiliated corporations have been treated as social clubs described in section 501(c)(7).

#### *Effective date*

The provision would apply to taxable years beginning after October 20, 1976, the date on which section 501(i) of the Code became effective.

#### *Revenue effect*

It is estimated that this provision would result in a negligible reduction in budget receipts.

## 3. H.R. 5973: Tax Treatment of Certain Individuals Living Abroad and Certain Pension Plan Distributions [1]

### a. Waiver of time limits in foreign residence or presence requirement for Americans working abroad (sec. 1 of the bill and sec. 913 of the Code) [2]

#### *Present law*

Prior to enactment of the Foreign Earned Income Act of 1978, an American who was present in a foreign country or countries for at least 510 full days during any period of 18 consecutive months, or who was a *bona fide* resident of a foreign country or countries for an uninterrupted period which included an entire taxable year, was entitled to exclude up to a flat amount (generally $20,000) per year of his foreign earned income (sec. 911).

The 1978 Act retained these eligibility requirements but changed the special provisions for Americans working abroad. Generally, qualifying individuals are allowed a deduction for their excess foreign costs of living. The new excess living cost deduction (new sec. 913) consists of separate elements for the general cost of living, housing, education, and home leave costs. In addition, taxpayers living and working in certain hardship areas are allowed a special $5,000 deduction in order to compensate them for the hardships involved and to encourage U.S. citizens to accept employment in these areas. As an exception to these new rules, the Act permits employees who reside in camps in hardship areas to elect to claim a $20,000 earned income exclusion (under sec. 911) in lieu of the new excess living cost and hardship area deductions. As noted above, the foreign presence or residence criteria of prior law continue to determine whether or not Americans working abroad qualify for the special deduction or exclusion.

If a taxpayer working abroad is "temporarily" away from home in pursuit of a trade or business, the taxpayer generally may deduct traveling expenses (including amounts spent for meals and lodging) for himself but generally not for family members who accompany him. The taxpayer's "home" for this purpose is generally his principal place of employment. While a determination of whether the taxpayer is "temporarily" away from home depends on all the facts and circumstances, the Internal Revenue Service often holds that the taxpayer is "temporarily" away from home if his employment is not anticipated to,

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[1] This description is from the House Report on H.R. 5973 (H. Rept. 96-689).

[2] In principle, this provision was approved by the Senate Finance Committee on December 6, 1979. The Subcommittee on Taxation and Debt Management Generally held a hearing on S. 873, which contains similar provisions on November 7, 1979.

and does not actually, last more than a year. Otherwise, the Service ordinarily views the taxpayer as not being temporarily away from home and not entitled to these deductions.[3] A number of items in the deduction for excess foreign living costs are measured with reference to the location of the individual's tax home.

### *Issue*

The issue is whether, in a case where an individual goes abroad with the expectation of meeting the foreign residence or presence requirements, but fails to meet those requirements because of extraordinary circumstances beyond his control, relief should be afforded from the time limitations.

Because of the recent civil unrest in Iran, a number of Americans who were working there with the expectation of meeting the foreign residence or presence requirements returned to the United States prior to the time that those requirements actually were met.

### *Explanation of provision*

This provision would provide that, under certain circumstances, the time limits of the foreign residence or presence eligibility requirements for the deduction for excess foreign living costs or the exclusion for foreign earned income may be waived. Three conditions must be met for the waiver to apply. First, the individual actually must have been a *bona fide* resident of, or present in, a foreign country. Second, he must leave the foreign country after August 31, 1978, during a period with respect to which the Treasury Department determines, after consultation with the State Department, that individuals were required to leave the foreign country because of war, civil unrest, or similar adverse conditions in the foreign country which precluded the normal conduct of business by those individuals. It is anticipated, for example, that such determinations ordinarily would be made in situations where the State Department issues a travel advisory recommending that U.S. citizens avoid travel to a country because of unsettled conditions there. Third, the individual must establish to the satisfaction of the Treasury that he could reasonably have been expected to meet the time limitation requirements, but for the war, civil unrest, or similar adverse conditions. An individual who could reasonably have been expected to be present in a foreign country for a period of 17 out of 18 months or a *bona fide* resident of that country for an entire taxable year would be considered to have his tax home in that country for purposes of the excess living cost deduction rather than being considered to be temporarily present in that country. If these criteria are met, the taxpayer would be treated as having met the foreign residence or presence requirements with respect to the period during which he was a *bona fide* resident or was present in the foreign country even though the relevant time limitation under existing law had not been met.

### *Effective date*

With respect to the deduction for excess foreign living costs and the $20,000 annual exclusion as amended by the Foreign Earned Income Act of 1978, the provision would apply to taxable years beginning after

[3] Rev. Rul. 60-189, 1960—1 C.B. 60.

December 31, 1977 (the general effective date for those provisions). Similar rules also are to be applied for taxable years beginning in 1977 or 1978 in the case of individuals who would otherwise be eligible for the exclusion of foreign earned income (sec. 911) as in effect prior to the 1978 Act, including taxpayers who, for 1978, elect the exclusion as amended by the Tax Reform Act of 1976.

*Revenue effect*

This provision would have no effect upon budget receipts. It forgives an unanticipated one-time tax increase of $10 million in fiscal year 1980.

### b. Special rule for certain distributions from money purchase pension plans (sec. 2 of the bill and sec. 402 of the Code)

#### *Present law*

An employee who receives a lump sum distribution from a tax-qualified pension, profit-sharing, or stock bonus plan may defer tax on the distribution by rolling over the proceeds (net of any employee contributions) within 60 days of receipt (1) to an IRA (an individual retirement account, annuity, or bond), or (2) to another employer-sponsored qualified pension, etc., plan.[1] The rollover rule also applies to the spouse of an employee who receives a lump sum distribution on account of the employee's death. A lump sum distribution from a qualified plan is eligible for favorable income tax treatment (e.g., 10-year income averaging) if no portion of the distribution is rolled over.

A lump sum distribution must be a distribution of the balance to the credit of an employee under a qualified pension, etc., plan, made within one taxable year of the recipient. Generally, the distribution must have been made on account of death, separation from service, or the attainment of age 59½. If an employer maintains more than one qualified plan of the same type, the plans are aggregated for the purpose of determining whether the balance to the credit of an employee has been distributed. Under the aggregation rules, all pension plans (defined benefit and money purchase) maintained by the employer are treated as a single plan, all profit-sharing plans maintained by the employer are treated as a single plan, and all stock bonus plans maintained by the employer are treated as a single plan.

#### *Issue*

The issue is whether a total distribution to an employee (or to the employee's spouse) from a money purchase pension plan should be eligible for rollover treatment if the employer also maintains a defined benefit pension plan covering the employee and a total distribution is not made from the defined benefit plan in the same taxable year.

#### *Explanation of provision*[2]

This provision would allow an employee who receives a total distribution from a money purchase pension plan (which is otherwise eligible for taxfree rollover treatment) to roll over the distribution to an IRA or to another qualified plan where the employer also maintains a defined benefit pension plan covering the employee even though a total distribution is not made from the defined benefit plan in the same taxable year. The provision also would apply to the spouse of an employee if the spouse receives such a total distribution on account of the employee's death.

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[1] A rollover to a plan is not permitted if any part of the lump sum distribution represents contributions made while the employee was self-employed.

[2] An identical provision is contained in H.R. 1212, as reported by the Senate Finance Committee (S. Rept. No. 96-532, sec. 405).

If the recipient rolls over a total distribution from a money purchase pension plan and, in a subsequent taxable year, receives a total distribution from a defined benefit pension plan maintained by the employer, the later plan distribution could be rolled over tax free (if it otherwise meets the requirements for a tax-free rollover) but otherwise would not be eligible for the favorable income tax treatment accorded lump sum distributions.

*Effective date*

Generally, this provision would apply to payments made in taxable years beginning after December 31, 1978. In the case of such payments made before January 1, 1981, the period for making a rollover would not expire before December 31, 1980.

*Revenue effect*

It is estimated that this provision would reduce budget receipts by less than $5 million annually.

### c. Definition of youth participating in a qualified cooperative education program for purposes of the targeted jobs credit (sec. 3 of the bill and sec. 51(d)(8) of the Code)

*Present law*

Under present law, a credit is provided for the hiring of members of certain target groups. The credit, which is elective, is equal to 50 percent of qualified first-year wages and 25 percent of qualified second-year wages. One of the target groups consists of youth who actively participate in qualified cooperative education programs, who have attained the age of 16 but who have not attained the age of 19, and who have not graduated from high school or vocational school.

*Issue*

The issue is whether the targeted jobs credit should be extended to the hiring of youths participating in a qualified cooperative education program who have attained the age of 19, but who have not attained the age of 20.

*Explanation of provision* [1]

This provision would amend section 51(d)(8)(A)(i) of the Code to provide that the targeted jobs credit would be available for the hiring of youths who actively participate in qualified cooperative education programs, who have attained the age of 16 but who have not attained the age of 20, and who have not graduated from high school or vocational school.

*Effective date*

This provision would apply with respect to wages paid on or after November 27, 1979, in taxable years ending on or after such date.

*Revenue effect*

It is estimated that this provision would reduce fiscal year 1980 budget receipts by less than $1 million, by less than $5 million annually in fiscal years 1981 and 1982, and by less than $1 million in fiscal year 1983.

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[1] An identical provision is contained in H.R. 2797, the Technical Corrections Act of 1979, as reported by the Senate Finance Committee (S. Rept. No. 96-498, sec. 103(a)(6)(F)).

### d. Special rule relating to debt-financed income of exempt organizations (sec. 4 of the bill)

*Present law*

Generally, any organization which is exempt from Federal income tax (under sec. 501(a)) is taxed only on income from trades or businesses which are unrelated to the organization's exempt purposes; it is not taxed on passive investment income or income from any trade or business which is related to the organization's exempt purposes.[1]

Before 1969, some exempt organizations had used their tax-exempt status to acquire businesses through debt financing, with purchase money obligations to be repaid out of tax-exempt profits, for example, as from leasing the assets of acquired businesses to the businesses' former owners.

The Tax Reform Act of 1969 provided (in the so-called "Clay Brown provision") that an exempt organization's income from "debt-financed property," which is not used for its exempt function, is to be subject to tax in the proportion in which the property is financed by debt. In general, debt-financed property is defined as "any property which is held to produce income and with respect to which there is acquisition indebtedness" (sec. 514(b)(1)). A debt constitutes acquisition indebtedness with respect to property if the debt was incurred in acquiring or improving the property, or if the debt would not have been incurred "but for" the acquisition or improvement of the property.[2]

The provisions relating to unrelated debt-financed income generally applied to taxable years beginning after December 31, 1969.[3] The 1969 Act provided a transitional rule under which the Clay Brown rules were to apply only where indebtedness had been incurred after the date on which similar bills were introduced in the 89th Congress (June 27, 1966) until taxable years beginning after 1971. After the transition period, the new rules were applicable to all situations of investment borrowing by exempt organizations.

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[1] There are some exceptions to the general rule that passive investment income is tax-exempt. For example, social clubs (sec. 501(c)(7)) and voluntary employees beneficiary associations (sec. 501(c)(9)) are generally taxed on such income. Also, private foundations are subject to an excise tax of 2 percent on their net investment income.

[2] There are several exceptions from the term "acquisition indebtedness." For instance, one exception is indebtedness on property which an exempt organization receives by devise, bequest, or under certain conditions, by gift. Also, the term "acquisition indebtedness" does not include indebtedness which was necessarily incurred in the performance or exercise of the purpose or function constituting the basis of the organization's exemption. Special exceptions are also provided for the sale of annuities and for debts insured by the Federal Housing Administration to finance low- and moderate-income housing.

[3] However, in extending the unrelated debt-financed income rule and other rules relating to the unrelated business income tax to churches, the 1969 Act provided that these provisions did not apply to churches for taxable years beginning before January 1, 1976.

*Issue*

The issue is whether a limited exception to the debt-financed income rules should be provided for income derived from certain sales of real property during 1976 in situations where the indebtedness was incurred prior to 1965.

*Explanation of provision*

The bill would provide a very limited exception to the debt-financed income rules. Under this exception, it is provided that, in applying the debt-financed income rules to any sale of real property during 1976, indebtedness incurred before January 1, 1965, by an organization to finance the construction of a building on such property shall not be treated as acquisition indebtedness if the parcel of real property on which the building was constructed (1) was acquired by the organization before January 1, 1952, and (2) is contiguous to another parcel of real property which (*a*) was acquired by the organization before January 1, 1952, and (*b*) was used by the organization for exempt purposes (for the entire period from January 1, 1952, until the date of enactment of the bill).

Although this provision may possibly benefit other taxpayers, it is primarily intended to provide tax-free treatment for a 1976 sale of real property by the Tillamook County Young Men's Christian Association (YMCA), Tillamook, Oregon. The real property sold by the Tillamook YMCA was property adjacent to property it used for carrying on its charitable and educational purposes.

*Effective date*

This provision would apply only to certain sales of real property during calendar year 1976.

*Revenue effect*

It is estimated that this provision would result in a one-time reduction in budget receipts of less than $50,000 in fiscal year 1980.

Joint Committee on Taxation
February 29, 1980

Revenue Loss Estimates for S. 1900 and S. 1901

Listed below are the revenue loss estimates for S. 1900 and S. 1901, both of which are scheduled for a hearing today before the Subcommittee on Taxation and Debt Management Generally. In general, the bills permit a casualty loss to be calculated on the higher of the reduction in value or the adjusted basis of fruit and nut trees (S. 1900) and timber (S. 1901). The revenue estimates for both bills were not included in the February 26th Committee pamphlet prepared for the hearing.

Reduction in Budget Receipts

Fiscal Year

| Bill | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| S. 1900 | 0 | 23 | 17 | 18 | 20 | 22 |
| S. 1901 | 0 | 476 | 274 | 306 | 339 | 374 |

59-897 O - 80 - 11

Senator BYRD. The hour of 9:30 having arrived, the committee will come to order.

The committee has today eight pieces of legislation to consider. The committee is pleased to have the distinguished Senator from Nevada, Senator Cannon, this morning and, Senator Heflin, if you would come to the table and make any comment that you would like to in regard to S. 1900 and S. 1901.

## STATEMENT OF HON. HOWARD W. CANNON, U.S. SENATOR FROM THE STATE OF NEVADA

Senator CANNON. Thank you, Chairman Byrd and members of the subcommittee. It is a pleasure for me to be here this morning to discuss the wagering tax bill. As you know, this proposal would amend the Internal Revenue Code to provide that the 2 percent excise tax on wagers and the $500 occupational tax on wagering shall not apply in any State in which wagering is permitted by law.

These taxes were originally promoted in 1951 as revenue-raising measures and as a means of curbing illegal wagering. Over the years, it has become clear that the impact of these taxes has been just the reverse.

The 2 percent and occupational taxes hinder the ability of gaming establishments which are authorized pursuant to State license and regulation and which make a good faith effort to comply with the code to compete effectively with illegal counterparts. The result is that illegal operations are actually benefited.

As pointed out by the Commisison on the Review of the National Policy Toward Gambling in its 1976 report to the Congress, if a legal bookmaker passes the tax on to his customers, the customer will most likely take his business to an illegal operator who simply ignores the tax. Yet, if the legal bookmaker absorbs the tax himself, he may well drive himself out of business.

Not only do these taxes work to the advantage of illegal operators, but they also subject legal gaming businesses to discriminatory tax treatment. These taxes do not apply to parimutuel wagering, coin-operated devices, State lotteries that base winnings on horserace results, or casino ame. They apply only to legal sports and horse bookmaking.

I wish to stress that Nevada is the only State conducting this regulated and fully policed activity which is affected by these taxes. There is no special Federal tax in the many States that conduct horse or dog racing or jai alai games and States which have legalized offtrack betting—particularly New York and Connecticut—are not subject to these taxes.

Furthermore, it should be noted that the State of Nevada in its own revenue-raising capacity already imposes a tax of 5.5 percent on these very same activities. There is a strong element of inconsistency and inequity in imposing Federal taxes on select gaming activities in a single State.

Gaming is Nevada's largest industry. It is highly regulated and licensed in the State, and the elimination of illegal gaming activities is a goal shared by both State and Federal officials.

Nevada is approaching its 50th year of legalized wagering, and that longstanding experience has shown that the effect of the excise and occupational taxes is detrimental to the enforcement of

the gaming laws, and is discriminatory among the States and within the industry. Those taxes should not apply to wagering operations which are legal and regulated by the State.

I would now like to focus on the revenue aspects of these taxes. In 1951, the Congress was advised that the estimated gain to the Treasury from these taxes was $400 million per year. I said Congress was advised; that was the estimate. In fact, the total revenues gained from these taxes in fiscal year 1979 was only $10 million, and for the past 2 years, the total cumulative figure is only $17,717,000. I have with me a breakdown for the past 4 fiscal years, taken from the IRS Commissioner's annual reports.

I would like to submit that and make that a part of the record, if I might, Mr. Chairman.

Senator BYRD. Yes. That will be made a part of the record.

[The material referred to follows:]

EXHIBIT A—COLLECTIONS NATIONWIDE FROM THE 2-PERCENT WAGERING TAX AND THE $500 OCCUPATIONAL TAX, AS SHOWN IN THE INTERNAL REVENUE SERVICE COMMISSIONER'S ANNUAL REPORTS FOR FISCAL YEARS 1976, 1977, 1978, AND 1979

| Tax | 1976 | 1977 | 1978 | 1979 |
|---|---|---|---|---|
| Wagering tax | 4,962,000 | 6,632,000 | 6,637,000 | 9,124,000 |
| Occupational tax | 900,065 | 776,000 | 1,048,000 | 908,000 |
| Total | 5,862,065 | 7,408,000 | 7,685,000 | 10,032,000 |
| Cumulative yearly total | 5,862,065 | 13,270,065 | 20,955,065 | 30,987,065 |

Senator CANNON. In 1978, the Treasury acknowledged that the revenues from these taxes are extremely minor and furthermore, that: "Experience with the several taxes on gambling does not support the conclusion that there have been any substantial direct benefits in income tax enforcement arising from the existence of the gambling taxes."

That is in a letter from Donald C. Lubick, Assistant Secretary-designate, Department of the Treasury, dated June 8, 1978 and, if I may, I would like to make that a part of the record.

Senator BYRD. That will be made a part of the record.

[The material referred to follows:]

EXHIBIT B

DEPARTMENT OF THE TREASURY,
*Washington, D.C., June 8, 1978.*

Hon. HOWARD W. CANNON,
*U.S. Senate,*
*Washington, D.C.*

DEAR SENATOR CANNON: This is in reply to your letters of March 16 to Secretary Blumenthal requesting his comments on S. 98 and S. 1411. S. 98 would increase the maximum credit for a State tax imposed on coin-operated gaming devices from 80 percent to 95 percent of the $250 per year Federal tax. S. 1411 would repeal the 2 percent tax on wagers and the $500 per year occupational tax levied on all persons accepting taxable wagers or engaged in receiving wagers for any person liable for the tax on wagers.

Repeal of the 2 percent tax on wagers would reduce revenues by $7 million. The comparable revenue loss for the $500 occupational tax would be about $1 million. Increasing the credit for State tax on coin-operated gaming devices would reduce revenues by about $2 million.

Taxes on wagers and coin-operated gaming devices reflect a public policy decision that gambling constitutes an expenditure that can reasonably be subject to taxation. In some cases this is a moral judgment. In others, an evaluation that such spending is discretionary spending. Other have advocated excise taxes on gambling as an aid to determining illegal gains which otherwise might escape income tax.

Our experience with the several taxes on gambling does not support the conclusion that in the aggregate there have been any substantial direct benefits in income tax enforcement arising from the existence of the gambling taxes. Cases of evasion schemes have been discovered as a result of gambling tax enforcement, but not enough for us to make a strong argument for retention of the tax on wagers or coin-operated gaming devices. Revenues from the taxes are extremely minor. Consequently, retention or repeal of these taxes should be determined by public opinion as to whether gambling activities shoud be taxed as a sign of social disapproval. We express no judgment on this.

Increasing the credit for State taxes on coin-operated gaming devices to 95 percent of the Federal tax, as proposed by S. 98 would, in effect, convert the Federal tax into a State tax. Consequently, as long as a Federal tax on gaming devices is not deemed a vital part of the Federal tax system, we see no reason to continue it in an attenuated form as proposed by S. 98.

Sincerely,

DONALD C. LUBICK,
*Assistant Secretary-Designate,*
*Tax Policy.*

Senator CANNON. In the 94th Congress, I introduced an amendment to eliminate the excise wagering tax for legal gaming operations. In conference, the excise tax, which was at that time 10 percent, was reduced to 2 percent. The occupational tax, which was at that time $50, was increased to $500. While the reduction of the wagering tax was certainly a step toward correcting the situation, it has proven itself to be just as effective as the 10-percent tax was in penalizing legal operators.

Where the 10-percent tax was passed on to the customer, the 2-percent tax is absorbed by the operator. The 2-percent figure is approximately the margin of profit in these wagering operations, and the effect of the tax is to remove that profit for the legal operator. Simply stated, the 2 percent tax is a disincentive to legal bookmaking operations.

The $500 occupational tax is yet another penalty. This levy applies to each ticket-writing employee of the betting establishment. As a practical matter, most employers pass it on to their workers.

In some cases, the ticket writer, who is only a salaried employee, pays it outright. In other cases, the tax is taken out of the ticket-writer's paycheck. I am sure it was never the intention of the Congress to apply a special tax on the right to work. The elimination of the occupational tax for legal operators would resolve this inequity.

The Federal occupational stamp was originally seen as a law enforcement tool, in that it serves to identify bookmakers. That purpose is already served since these individuals are either licensed by the State of Nevada, pursuant to a rather demanding inquiry and hearing, or are registered to perform their duties with law enforcement authorities.

There seems no reason to duplicate the effort when the identification information is already maintained by the State and is made available by the State.

In conclusion, the 2-percent wagering tax and the $500 occupational tax are ineffective as revenue-raising measures and as tools for the enforcement of gaming laws. They are discriminatory taxes

borne by the little guy who complies with the law, while his illegal counterpart benefits.

For these reasons, I urge that this measure be favorably and expeditiously acted upon by the committee.

Senator BYRD. Thank you, Senator Cannon.

Did you say that the total revenue from both the 2-percent tax and the occupational tax is about $10 million a year?

Senator CANNON. Yes. As I said, in the last 2 years, the cumulative amount was $17 million.

Senator BYRD. For the 2-year period?

Senator CANNON. For the 2 years. Actually it goes down because most of the people who bet with the legal bookmaker, somebody has to absorb that 2 percent and they will go back with an illegal bookie.

We found that out in the Commission of National Gaming Policy on which I and Senator McClellan served on the committee, and a number of our other distinguished colleagues. That was the conclusion that we came to a number of years ago.

Senator BYRD. Is there currently a compliance problem with the excise tax?

Senator CANNON. No. Not as far as the legal compliance is concerned. They are in compliance. At least, we have not had any complaints on that.

Obviously, if they are State licensed and regulated, the State oversees the fact that they must comply, and they do comply. The noncompliance comes in the area of the illegal bookie who completely disregards that 2-percent tax as well as the $500 occupational tax.

Senator BYRD. What the tax tends to do, then, is drive people to the illegal operation and away from the legal operation?

Senator CANNON. Yes, sir, Mr. Chairman.

Senator BYRD. It does not apply to casinos, does it? It only applies to horseracing.

Senator CANNON. It has no application to casinos whatever.

Senator BYRD. Only horseracing and dogracing?

Senator CANNON. The bookmaking, the wagering on the bookmaking and sporting events on horseracing, dogracing, other sporting events that are lawfully permitted.

Senator BYRD. As a revenue measure, this is of very little consequence, a total of $17 million in 2 years?

Senator CANNON. As a matter of fact, the cumulative effect for the last 4 years—which I will put in the record, if I may—is only $30 million for the entire 4-year period. You see, it is about $7.5 million a year.

Senator BYRD. $7.5 million is quite a difference from the $451 million which was estimated in 1951.

Senator CANNON. That is correct; yes, sir.

Actually the estimate was a little higher than that, as I recall. It was over $400 million, the estimate.

Senator BYRD. That is quite a differential, is it not?

Senator CANNON. Yes, sir.

Senator BYRD. Thank you very much, Senator Cannon.

Senator CANNON. Thank you.

Senator BYRD. At this point the prepared statement of Senator Laxalt will be made a part of the record.

[The prepared statement of Senator Laxalt follows:]

STATEMENT OF SENATOR PAUL LAXALT

Mr. Chairman, today I would like to express my support for S. 485, which I have sponsored along with my colleague, Senator Cannon. This bill would amend the IRS code of 1954 to exempt from the excise tax on wagers and the occupational tax on bookmakers any wager or bookmaker authorized under State law.

This bill would not remove all taxes on legal bookmaking. Legal bookmaking operations would remain subject to corporation taxes that each legitimate business must pay. S. 485 would remove a tax on the gross proceeds while leaving intact all net taxes. No other industry is subject to a tax on gross income, and no industry can remain competitive with such a tax.

In 1951, the Kefauver Senate hearings focused the public's attention on the widespread occurrence of illegal gaming activities and prompted Congress to pass legislation which would tax ten percent of the gross profit earned by an individual accepting wagers. An occupational tax of $50 was also applied. In 1974, Congress adjusted the percentage of tax on gross profit from 10 percent to 2 percent and raised the $50 occupational tax to $500.

The original intent of this excise tax was to discourage illegal gaming activities and provide for more competitive markets. Legislators were informed that this tax on bookmakers would generate yearly revenues in the area of $400 million. Both the original purpose of this tax and the revenues it promised to produce seemed beneficial to the enforcement of illegal gaming activities at the time.

But over the years, this tax has not produced the intended results. Rather, it has discriminated against the legal bookmaker and promoted further illegal gaming activities. Because the current 2-percent tax imposed on the gross profit of the bookmaker exceeds his profit margin, he lacks the incentive to remain a legal operator. He is tempted to illegally operate and not pay the tax. Thus, more illegal activities result and revenues are not generated.

The lack of revenue gained from the tax is another reason to remove such a tax. Contrary to the original estimates that $400 million would be generated yearly, only $10 million was gained in revenues in fiscal year 1979 and for the past 2 years the total cumulative amount is $17 million.

From my experience as Governor of Nevada, I can assure you that the Nevada state laws have the strictest control over gaming activities in the state, making federal enforcement of gaming laws unnecessary. An interesting paradox has arisen—only where the states have full control of legal gaming has the IRS enforced the law, whereas in other states, where gaming is illegal or state enforcement of laws is lax, the IRS does not vigorously prosecute the laws. I firmly believe that the states must take the lead in enforcement of gaming laws. The federal role should be tu support the states, rather than impose the entire enforcement from the top.

Mr. Chairman, I ask that the Senate proceed quickly to remove both the occupational and wagering taxes. Excise taxes should be advocated as a means of curtailing illegal gaming activities. But when such a tax discourages legal gaming and promotes the growth of illegal bookmaking, I feel it is justified to remove such a tax. Thus, I urge the passage of this legislation to abolish both occupational and wagering taxation on bookmaking.

Senator BYRD. Senator Heflin?

## STATEMENT OF HON. HOWELL HEFLIN, A U.S. SENATOR FROM THE STATE OF ALABAMA

Senator HEFLIN. Mr. Chairman, I appreciate very much the consideration you personally, and your subcommittee, have shown me in scheduling these hearings on these bills which I have introduced so soon after the introduction, and also for allowing me to come today and speak on behalf of the people of Alabama and indeed the rest of the Nation who have suffered tremendous losses due to natural disasters and have seen these losses go uncompensated.

Mr. Chairman, as I mentioned, I have introduced two separate bills to provide relief to two groups who are extremely vulnerable

to the whims of nature. One bill, S. 1900, would amend the Internal Revenue Code of 1954 with respect to the treatment of casualty losses in the case of fruit and nut trees, the other bill would have the same effect with regard to timber which is lost due to a natural or manmade disaster.

Mr. Chairman, the tremendous natural disaster caused by Hurricane Frederic as it ripped through my home State of Alabama and the neighboring States of Florida and Mississippi focused much attention on some of the shortcomings of our disaster relief programs.

While on the whole, the programs are working well and responding to the needs of large numbers of persons, certain groups, due to the unique nature of their activities, find little solace in the relief efforts.

Two groups which were particularly hard hit by this devastating storm were the pecan growers of Alabama and adjoining States and our timber producers. In Alabama, pecan growing as an industry is concentrated in south Alabama, in the Mobile area. Alabama is the third largest pecan producing State in the Nation and 80 percent of that production is in south Alabama, primarily in Baldwin and Mobile Counties.

Pecan groves, many of which have been nurtured for decades, were decimated by Hurricane Frederic. Mature nut producing trees are valued at between $250 and $300 each. Some pecan growers lost as many as 2,000 producing trees and suffered a real, uninsured economic loss of approximately $750,000 not counting the value of the current crops.

In addition, it has been estimated that in Alabama alone, over $300 million worth of timber was destroyed.

Mr. Chairman, you will note that I used the term uninsured. I mean uninsured in that there was no insurance available to the pecan growers of timber growers from governmental sources or from private sources.

Moreover, it is estimated that it will cost between $20 to $40 per tree to replace these lost pecan trees. To replace 2,000 pecan trees could require a capital outlay of approximately $100,000. It takes about 10 to 12 years for a new tree to produce enough pecans to break even. Thus, many of our pecan growers face a grim future if we do not rally to their support.

Mr. Chairman, as you know, currently our income tax laws allow a person who has suffered a casualty loss to deduct the loss from the current year's income in computing their Federal tax, but the deduction is limited to the lesser of the fair market value of the items destroyed or the person's basis in such property. For pecan and timber growers, the tax basis in trees is minimal since it is the handywork of nature along with the husbandry of the hard-working growers which produces a healthy producing tree and establishes its value.

Generally, no basis is acquired in the tree other than the initial planting cost and in many cases producers plant their own trees and get zero basis. The trees of Mr. Richard Higbee of Fair Hope, Ala., for example, were set out by his father between 1916 and 1927. He has no basis in these trees and thus no tax loss. Although

the basis may be minimal or nonexistent, the loss in real economic terms can be staggering.

Another example dramatizes what I am saying: Mr. Leslie Hatchett of Grand Bay, Ala., owned 3,350 trees which ranged in age from 4 to 100 years. He lost 2,255 of his trees for a casualty loss of $755,000 from which he can get no relief. We must help people like the Higbees and the Hatchetts.

Mr. Chairman, I am not going to dwell on examples. We have representatives of the Alabama Pecan Growers Association here to testify today and they will be able to give you a much better description of the damage suffered by this group in Alabama. I think they will have pictures to show some of the actual devastation and they will bring home to this committee and to this Congress the almost total despair faced by some of these people today. We also have representatives of the timber industry who can document the tremendous loss to these farmers.

Mr. Chairman, what I propose in my bill is to allow pecan producers and other nut and fruit producers and timber producers special consideration under the casualty loss provisions of the Tax Code. I think that the equities of the situation are such that special treatment is well justified.

First, with regard to the fruit and nut trees, trees which produce nuts and other fruits are substantially different from other types of crops. Althogh a cash crop may be destroyed by disaster, usually the producer can replant his crop either the same year or the following year and harvest his crop within a short period of time.

However, nut producers must first grow a mature tree. The leadtime just to reach the break-even point in the production of pecans is estimated at 10 to 12 years. Second, the speculative nature of the value of a cash crop as opposed to the value of the orchard simply is not the same.

The value of a producing pecan tree can be readily ascertained to a high degree of certainty which is not always the case with respect to a growing crop. Thus, the value of a tree might readily available ever though the estimated value of given year's crop of pecans might not be.

Another factor which must be considered is the nonavailability of insurance for pecan trees. I think this is extremely important. Most growing crops can be insured either through private or governmental sources, but such insurance is not reasonably available with respect to pecan trees.

Timber producers also have special problems, not the least of which is the long time from planting to harvest, again in contrast to cash crop farmers.

Mr. Chairman, the bills I am sponsoring would allow a taxpayer a deduction for a casualty loss incurred by the taxpayer in his trade or business with respect to nut or fruit trees or timber equal to the fair market value of the trees on the date on which the loss occurs. This loss deduction would not be limited to the taxpayer's basis in the trees as is currently the case.

In the event that the taxpayer's loss were greater than his income for the loss year, then the individual could carry back the excess loss deduction 10 tax years and, if necessary, he could carry the loss forward an additional 4 tax years.

The purpose of the carryback provision, Mr. Chairman, would be to generate a pool of capital by tax refunds which would enable the person who suffered the extreme loss to get back on his feet and reestablish his pecan grove or stand of timber. It is anticipated that some taxpayers would obtain refunds for taxes paid in prior years and these cash resources would enable the taxpayer to get his land back into production.

Moreover, for the next 4 years after the loss year if all of the loss was not absorbed during the 10-year carryback, the loss could be carried forward to provide some shelter for income during the period of time when the trees are totally nonproducing. After about 4 years, when the trees begin to produce, the loss deduction would cease to be available.

Mr. Chairman, it is imperative that we act with dispatch in moving these bills forward. A lifetime of hard work on the part of many Alabama pecan producers and timber owners is at stake, for if we do not act expeditiously, many of these people will be wiped out financially. If each of my colleagues here in the Senate could have joined me as I inspected the devastation wrought by Hurricane Frederic, there is no doubt in my mind that this bill would be passed with little debate.

If any of you have any doubt as to the power of nature to inflict damage, then I suggest that you examine closely pictures of the almost total devastation of many areas of my State as a result of Hurricane Frederic. We must respond to the needs of these people who have suffered such tremendous losses and I call upon this Congress to take speedy action on this proposal.

Let me summarize, in my judgment, the equities here as distinguished from other crops. First, it takes a long period of time to get back to productivity. Other crops, or other businesses, do not have that 10 to 12 years before their business becomes income producing.

Second, there was no insurance available, no insurance by the Government, no insurance by private sources that was available to these two elements of our economy.

Third, there was no Federal assistance program available at all in regard to these, such as we have in many crops where they get subsidies in other situations.

Fourth is that basically the pecan industry is a family business. Family labor over the years has never been deducted as an expense nor capilized in any way.

I think if we look at the Federal disaster relief programs, the only thing that is available to these people has been help in cleaning up. Low interest on loans, even if available would do these people no good. Even if they could borrow money at 3 percent, they have nothing with which to pay the interest, much less to pay the payments, for ten or twelve years until the tree becomes producing and begins to generate income for the farmers.

I think that the rare inequities here justify consideration.

Congressman Jack Edwards of the First Congressional District of Alabama was to be here and testify. He is ill and I ask that his statement be entered into the record.

Senator BYRD. Without objection, so ordered.

[The statement of Representative Jack Edwards follows:]

TESTIMONY OF CONGRESSMAN JACK EDWARDS, FIRST CONGRESSIONAL DISTRICT, ALABAMA

Mr. Chairman, thank you for this opportunity to testify before your Committee today in support of S. 1900 and S. 1901. I have joined Senator Heflin in introducing identical bills in the House, H.R. 5760 and H.R. 5761. I can assure you that this relief is urgently needed both for the pecan growers and for the timber growers whose livelihood was virtually destroyed by Hurricane Frederic last fall.

Hurricane Frederic totally destroyed or severely damaged nearly 300,000 pecan trees, just about two-thirds of all the pecan trees in the State of Alabama. The pecan crop was the largest single crop damaged by Hurricane Frederic. Alabama is the third largest pecan producing state in the nation, with 80 percent of that production in my Congressional District; and in one county alone in my District $33 million worth of pecan trees were lost. These trees were uninsured because there is no insurance available for them from either governmental or private sources. These losses will be felt not only by the pecan growers who were hit by the Hurricane; they will be felt throughout the entire pecan processing industry, and in the final price consumers pay for pecans and foods containing pecans.

When a cash crop such as corn or wheat is destroyed by a disaster, the grower usually can replant his crop either the same year or the next season and harvest a new crop in a relatively short time. However, fruit and nut trees are substantially different—growers must plant new seedlings and bring them to maturity before they begin to bear again, a process which takes up to 12 years at an estimated cost of $20 per tree. The problems of rebuilding the pecan growing industry have been greatly exacerbated by a severe shortage of pecan seedlings throughout the country. Graft wood was injured in the Hurricane, and the world's largest pecan nursery in Mississippi was also hit by the Hurricane. The Alabama Board of Corrections has initiated a state-funded planting program at the state prison farm in Atmore, Alabama, training inmates to plant pecan seedlings from seed-nuts. I have urged the Board of Corrections and the Horticultural Extension Department at Auburn University to encourage the growing of new varieties of pecan trees in this program which can be brought to bear years earlier than the older varieties. Still the impact on the pecan industry will be crippling.

Losses in the timber industry were just as severe. Alabama's timber losses from Hurricane Frederic totaled $334 million. In the case of timber growers, entire tracts of land must be cleared and reforested following a disaster. If timber lands cannot be properly cleared, additional timber losses often occur because of pests and plant disease. The amount of timber damaged in Alabama by Hurricane Frederic exceeded by one-third the value of the total acreage annual harvest of all wood products in the State of Alabama. If none of that wood had been salvaged, the economic impact on the State's economy would have exceeded $5.6 billion. And the salvage value of the damage timber is far below that of healthy timber, since it has to be sold for boards or pulpwood rather than as logs.

All of these losses to the pecan growers and their timber industry in Alabama represent casualty losses. But the tax as you know limits casualty loss deductions to the owners' cost basis in the property—the extent of the original investment in the trees. Since most of these pecan trees and the timber were planted years, even generations, ago; and since in most cases farmers have already elected to deduct their normal operating expenses, such as fertilizer and fuel; most farmers have little or no technical cost basis in the trees, although they have suffered disastrous economic losses. If a farmer buys land with a grove of pecan trees or timber on it, of course, he can establish his basis as a percentage of the purchase price of the property. But most of the pecan and timber growers in Alabama have raised their own trees from seedlings, in many cases on land which has been family-owned for years. For many of my constituents, their only deduction for these tremendous losses for the 1979 tax year is that allowed for the appraisal fees for determining the extent of their losses.

I am sure that you know the crippling impact a natural disaster such as this can have on the long-term economic health of a disaster area. For those of us who have a substantial forestry industry or fruit or nut growing industry in our home states, however, the problems are unique. Our bill is the best approach we have seen to providing some relief to these two industries which were so hard hit by Hurricane Frederic so that they can be rebuilt and so the the adverse impact on Alabama's economy can be minimized. While I realize that some changes may be needed in the language of our bill to clarify its scope, I will certainly work with this Committee on them in every way I can.

I urge you to act timely and favorably on this much-needed legislation. Thank you, Mr. Chairman.

Senator HEFLIN. We have three witnesses here to point up devastation and the peculiarities of these programs: Mr. Robert Swift, president, Swift Lumber Co., Atmore, Ala., who is the spokesman for the Southern Foreign Products Association; Mr. Taney Brazeal, president, Alabama Pecan Growers Association; and Mr. Goodwin Myrick, president, Alabama Farm Bureau Federation.

If the chairman would permit, I would like these gentlemen to come to the witness table and be able to give you their idea and, for the record, their thoughts on this legislation.

Senator BYRD. Thank you, Senator Heflin.

Would the three gentlemen come to the witness table, please?

I know of Senator Heflin's keen interest in this matter. He has talked to me about it on three or four different occasions and the committee wanted to work out this early hearing for him because we do realize how keenly interested he is in this measure.

We are glad to have you three gentlemen. I have some questions for the three of you, but first, why do not each of you make your presentation, if that is your wish?

## STATEMENT OF TANEY BRAZEAL, PRESIDENT, ALABAMA PECAN GROWERS ASSOCIATION

Mr. BRAZEAL. Thank you, Mr. Chairman. I am Taney Brazeal and I am a pecan grower as well as president of the Alabama Pecan Growers Association. I certainly thank you for the opportunity to be here today to speak on behalf of the Senate bill 1900.

The pecan farmers in Alabama do need help badly, and we need it now. Hurricane Frederic just wiped out the pecan growing industry along the gulf coast in Alabama and Mississippi, and northwest Florida.

Natural weather disasters can create similar destructions in other parts of the country at any time. Hurricanes can, and have, destroyed pecan trees in Georgia, Mississippi, Louisiana, Texas, South Carolina, and North Carolina.

In the past, we have had ice storms that have destroyed fruit and nut trees in central Georgia, central Mississippi, and into the Carolinas and into Virginia.

On October 12, 1962, a windstorm swept up the Wilhoumette Valley in Oregon, carrying winds of a velocity of over 100 miles an hour that uprooted hazelnut trees and fruit trees. You can also have freakish freezes that penetrate into the southern regions of the Rio Grande Valley and into Florida, devastating citrus growers.

These hurricanes, hailstorms, floods, and tornados can very quickly destroy a lifetime of work of fruit and nut growers from any section of the United States. But back to the Alabama pecan situation.

Prior to Hurricane Frederic, we were the third largest producing State of pecans in the United States; 80 percent of this production was concentrated along the coast in south Alabama.

Hurricane Frederic first blew all of the nuts off the trees. Second, it blew all of the leaves off the trees and then it blew down 75 percent of all the mature, producing trees in Mobile County; 55 percent of all the mature, producing trees in Baldwin County.

Approximately 11,000 acres of pecan trees were destroyed in a 12-hour period, a population of 144,000 mature producing trees went down overnight.

Senator BYRD. Excuse me just a minute. You say 144,000 trees?

Mr. BRAZEAL. Yes, sir. That is the estimated loss of mature, producing trees.

Senator BYRD. That is out of a total of how many pecan trees?

Mr. BRAZEAL. A total population, I think, of trees in the State of Alabama is around 400,000.

Senator BYRD. This would be more than a third of the total?

Mr. BRAZEAL. That is correct. Because of the extreme good agricultural practices carried on in Mobile and Baldwin Counties, more of the production than that was located in that particular area.

Senator BYRD. Thank you.

Mr. BRAZEAL. Now the value has been set on some aspects of the loss. The loss of the 1979 crop was placed at $10.4 million and a conservative estimate has been made on the value of what the trees would have produced during the rest of their productive life. That has been put at $110.9 million.

Losses due to the hurricane was a common situation. We feel like the pecan farmers were really hurt worse than anyone, relating to the fact that they had no insurance money to cover the loss. Insurance is not out, and has not been available.

While our business colleagues are rebuilding their businesses with the help of insurance benefits, pecan growers, on the other hand, have no solutions to their problems.

The Alabama Extension Service economists estimate that it will take $24.4 million just to replant the 144,000 trees and maintain them until they come back into production. Now, time is very important to the pecan growers, because it takes 8 to 12 years to bring the pecan tree into production. Now, the problem, from whence does the money come to replant the trees and for the farmer to sustain his family while he is waiting for the trees to come back into production?

Pecan growing in Alabama is a family farm operation. The largest farm that I know of in the county is about 1,000 acres. This is in pecan orchards, and it is a family farm situation.

To give you some other examples of the size of the family farms that we are looking at, George B. Clump, just out of Fair Hope, 1,500 mature producing trees located on 150 acres. He lost them all.

Leslie Hatchett, Grand Bay, Ala., 3,350 trees, ranging from 4 to 100 years, lost 2,250 trees.

These are the big growers that we have. Now, we have many smaller situations. An example of this is a widow living outside of Fair Hope on a 30-acre pecan orchard that she and her husband had planted over 50 years ago.

I do have some pictures here that I would like for you to see that will show you the actual destruction that we have sustained.

It is most depressing to witness the bulldozing away of a once healthy farming industry. The pecan growing industry has been one farming situation that has not created surpluses, that has not depended on acreage allotments, nor has had to depend on Federal

price supports or any other type of Federal assistance to this point, but we need help now. We are quite desperate.

Pecan farmers think that Senate bill 1900 is the most fair way to approach this problem because it puts money that we have paid into the Federal treasury back in our hands. We have contributed this money in our prosperous times.

Family farming operations we believe to be essential to the agricultural economy of the United States. I know that you are concerned, and I know that you will give us proper consideration.

Now, I have submitted a written statement with statistics and so forth.

Senator BYRD. That will be made part of the record.

Thank you.

The next witness?

Senator HEFLIN. In his written statement Mr. Byrd has many photographs. They have also attached a report of economists evaluating the loss in many, many different ways. I think it is a very thorough evaluation, fair evaluations, and I think they have really done their homework in regard to showing their losses.

Senator BYRD. That report will be very helpful, and will be made a part of the record.

Senator BYRD. Senator Heflin, may I ask you this. As I understand it, S. 1900 and S. 1901 are basically the same except one deals with pecans and fruit; the other deals with timber?

Senator HEFLIN. Yes.

Senator BYRD. Thank you.

Senator HEFLIN. Maybe at this time Mr. Robin Swift, who is representative of Southern Timber Growers Association, if you would, Mr. Swift, go ahead.

## STATEMENT OF ROBIN SWIFT, PRESIDENT, SWIFT LUMBER CO., ATMORE, ALA., ON BEHALF OF FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION

Mr. SWIFT. Thank you, Senator Heflin.

Mr. Chairman, my name is Robin Swift. I am president of Swift Lumber, Inc.

Senator HEFLIN. Let me say something, too. You might be interested—his father served in the U.S. Senate for a brief period of time. He served an interim appointment, Senator Robert Swift, about 1946.

Senator BYRD. Then your father served with my father.

Mr. SWIFT. That is correct.

Senator BYRD. I am glad to know that and pleased to have you here today.

Mr. SWIFT. Thank you.

My home is in Atmore, Ala. Our business is a family business employing 115 people.

I am active in the Alabama Forestry Association and I am first vice president of the Southern Forest Products Assocaition.

My testimony here today is on behalf of the Forestry Industries Committee on Timber Valuation and Taxation, an organization that represents thousands of owners of millions of acres of timberland.

Mr. Chairman, the importance of our timber resources in this country can hardly be overstated. It is well spelled out in my written testimony.

It is used for everything from tissue paper to structural beams. It is a renewable resource as opposed to the nonrenewable nature of oil and other minerals. The energy requirements for its manufacture are low when compared to steel and aluminum and its pollution is low when compared to other products.

Forest Service statistics show that for every dollar invested in timber management, a total of $17 is generated in other economic activities and, if produced up to potential, our timber resource could be a favorable factor in the balance of trade and could reduce the price of housing or at least hold it in line to the point that it would be a great help in fighting inflation.

Yet, with all these pluses going forward, the U.S. Forest Service projects serious shortfalls in the timber supply in the decades ahead, shortfalls that are not necessary if our production can be raised to the potential offered by our land climate and high quality tree species.

One of the great opportunities to raise this production lies in the area of privately owned timber lands, but in order to accomplish this badly-needed increase in productivity on private lands, we need to create a favorable climate for long-term investment. We need to remove some of the tax disincentives to long-term investment that presently exists.

One of the major disincentives is the present tax treatment of casualty losses—that is, limiting the loss generally to the tax basis—even though that basis may have been established many years ago, long before the inflation of recent years, and before the slow and carefully nurtured growth of the timber crop on a particular tract.

Take, for example, the situtiom of a timberowner who has an adjusted basis of $5,000 on his timber which was purchased many years ago. Assume that due to inflation and the growth of the trees, that it has increased in value to $50,000. Finally, assume that the timber is totally destroyed by fire.

The economic loss to the timber owner is $50,000, but his tax deduction is limited to $5,000.

The most recent example of massive casualty losses in timber, and one with which I am very familiar, is the damage caused by Hurricane Frederic in south Alabama and southeast Mississippi. The amount of downed timber in only four south Alabama counties is equal in value to 1½ times the annual cut for the entire State. The dollar loss was massive.

Timberowners found that their trees, although still on the property, had lost value for at least four reasons. First, there was a loss of volume because of broken and splintered stems and because there were scattered trees that were not economically salvagable.

Second, there was a loss in value because of a drop in grade of unused product, as in the case of $90 per cord poles being reduced to $10 per cord pulpwood.

Third, there was the loss of value to the landowner because of increased logging costs. These trees were down and in the dirt. They were very costly to saw, to sever from the stump, that is, and

very costly to skid because they were lapped up by the winds that blew them down.

Fourth, there was the loss of value because of the great glut on the market of a very perishable commodity. We are presently cutting what I think is the last of the storm timber that would be suitable for lumber because it has already begun to badly sap, stain, and various stages of deterioration are setting in.

The hypothetical illustration of the owner who had a $50,000 loss with only a $5,000 tax basis became very real in south Alabama and it happened over and over again, and in much larger and higher dollar figures than mentioned.

It is very disheartening for a timber grower to, overnight, have a timber stand reduced in value to a very small fraction of its former worth, to suddenly find that years of effort and careful production are gone while, at the same time, realizing that he had no insurance because none was available and also realizing that he cannot even take his full loss as a tax deduction because of the basis limitation.

At that point, it is very easy for a landowner to make a decision that he will not reinvest in the establishment of a timber stand and then his acres contribute to the already startling situation where only 1 out of 7 acres in the Southeast are being adequately regenerated today.

At that point, he becomes part of the timber supply problem and not part of its solution.

Providing reasonable tax treatment for timber casualty losses is one of the important steps which should be taken to remedy this situation. It will encourage investment in reforestation by both reducing the risk, to some extent, and providing at least some further funds for reinvestment following the casualty.

We feel that the Heflin bill, Senate bill 1901, is one of the ways in which casualty losses in timber can be addressed. My written testimony offers some relatively small, but important amendments. Our staff will be willing to work with this subcommittee in the development of this and other solutions to the casualty loss problem.

We support the thrust of the legislation and urge its favorable consideration by the Congress.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, Mr. Swift. Your statement will be made a part of the record.

Senator HEFLIN. Goodwin L. Myrick is our next witness, president of the Alabama Farm Bureau Federation.

If you ever have an evening that Mr. Myrick is in town and you want to laugh all night long, he tells the best story of anybody I know. He is sort of a modern-day Bob Burns that Arkansas produced at one time. I wish he had time today to entertain us, but I believe we want to listen to his very intelligent insight into this problem right now.

Senator BYRD. If he can equal Senator Heflin, he is going some distance. I have had the privilege of having lunch almost every day with Senator Heflin and enjoy it very much.

You may proceed.

## STATEMENT OF GOODWIN MYRICK, PRESIDENT, ALABAMA FARM BUREAU FEDERATION

Mr. MYRICK. Thank you, Mr. Chairman, Senator Heflin, members of the committee. It is a pleasure for me to be here today and as president of the Alabama Farm Bureau Federation, I am pleased to present the American Farm Bureau Federation's testimony in support of Senate bills 1900 and 1901.

The Farm Bureau membership includes farm and ranch families who produce virtually every agricultural commodity grown commercially in this country. There are over 222,000 member families in the Alabama Farm Bureau Association, the fourth largest State affiliate of the American Farm Bureau Federation.

Many of our members reside in south Alabama where the force of Hurricane Frederic was so devastating last year.

Over 80 percent of Alabama's pecan crop is produced in south Alabama. For the pecan tree growers there, many of whom are Farm Bureau members, the storm destroyed years of investment, not only in terms of money, but of time as well.

The years required to produce a mature grove of pecan trees can never be recovered. But the economic losses to the growers of fruit and nut trees and timber can be compensated by changes in the Internal Revenue Code through the provisions of S. 1900 and S. 1901 which were introduced by Senator Heflin of Alabama.

Current tax laws on casualty losses do not recognize the true losses suffered by the growers of fruit and nut trees and timber. The code limits a casualty loss deduction under section 165 to the lesser of the fair market value of the destroyed property or the adjusted basis. The original basis or cost of a tree is often minimal. Current tax treatement ignores the fact that the contributions of nature and time should be major adjustments to basis due to the unique nature of pecan groves and timber stands, as well as other types of fruit and nut trees.

Given the length of time required to produce a mature tree, at least 10 years in the case of pecans, Farm Bureau supports the provisions of S. 1900 and S. 1901 which would allow a casualty loss deduction equal to the fair market value of the property on the date on which the loss occurs. These bills would cover casualty losses for the growers of fruit and nut trees and timber, respectively.

It is a matter of equity to recognize that farmers who lose a grove of trees or a woodlot have suffered an economic loss although their original cost basis may be nominal. Hurricane Frederic is proof that casualty losses can occur quickly and completely. Such a loss should entitle the taxpayer to a deduction equal to fair market value rather than the lesser of fair market value or adjusted basis. This is particularly important for uninsured property.

The 10-year carryback and 4-year carryforward feature of both bills is desirable because it allows the farmer to adjust income during the period of reestablishment of the grove and, possibly, to adjust previous tax liabilities so as to receive a refund for reestablishment of the grove or timer stand. Carryback and carryforward provisions are used throughout other sections of the code. For instance, financial institutions, business development corporations and small business investment companies are allowed a 10-year net

operating loss carryback and a 5-year net operating loss carryover for post-1975 net operating losses.

Farm Bureau views S. 1900 and S. 1901 as essential if tree growers who suffer casualty losses are to remain in agriculture. These proposed amendments to the Internal Revenue Code would signal a commitment to assist farmers in the recovery of their casualty losses. We encourage the subcommittee's favorable consideration of both bills and thank you for the opportunity to testify.

Senator BYRD. Thank you, sir.

Now, as I understand it, it takes somewhere between 8 to 10 to 12 years for a pecan tree to become commercially profitable.

Mr. BRAZEAL. Eight to twelve years is sort of the break-even proposition for growing pecans. In other words, at the end of that time, you should begin to harvest enough pecans to pay for the expenses of maintaining the tree in an individual year.

Senator BYRD. What is the commercial life a pecan tree?

Mr. BRAZEAL. You will notice that I made reference to some trees that were destroyed that were over 100 years old, so really, pecan trees just sort of keep on as long as they are cared for properly.

Senator BYRD. Is there not a point at which they become nonprofitable from a commercial point of view?

Mr. BRAZEAL. No, sir. Not really. As long as the tree is cared for and sprayed and fertilized properly, it just sort of keeps bearing. Possibly, you know, at some very distant time in the future the tree would deteriorate and quit bearing. Really, we do not have evidence of that at this point.

Senator BYRD. How many trees are normally planted to an acre?

Mr. BRAZEAL. Well, the old manner of planting the trees were 10 to 12 per acre. Within the last few years, we have developed new varieties that we can put closer together on the acre to get more production per acre. And it requires more trees.

Now we are looking at 40 to 50 trees per acre and hopefully if we can find the money to replace these orchards, we will be looking at replacing them in a more efficient fashion.

Pecan farming had been a good segment of our agricultural industry even with the 10 and 12 trees per acre, so now, if we can find the funds to replant these orchards and using modern technology where we are putting 50 to 60 trees per acre, you see the potential that this agricultural segment has.

Senator BYRD. Now, if this legislation were passed, how do you determine the value of a pecan tree, assuming it is destroyed?

Mr. BRAZEAL. Of course, we have appraisers, real estate appraisers, and so forth, that relate to property without pecan trees and property next door that does have pecan trees, so I think this can be established in relation to what these orchards are selling for against the bare land and also in relation to established production records, and using the production of this.

Senator BYRD. Well, an orchard which is, say, 20 years old——

Mr. BRAZEAL. Is in its prime. That is a prime period of production for that orchard.

Senator BYRD. All right. Say, an orchard was 80 years old and both of them were destroyed.

Mr. BRAZEAL. How do you relate value?

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Senator BYRD. How do you relate value? They would not be equal, I would assume.

Mr. BRAZEAL. Well, I think it would relate to the production records that were established.

Senator BYRD. You would equate an 80-year-old orchard with a 20-year-old orchard?

Mr. BRAZEAL. Only in relation to the amount of nuts that each orchard were producing.

Senator BYRD. Is that the way you determine the loss by the previous production rate?

Mr. BRAZEAL. I think that would have a great deal to do with it. Also, relating to the cost of bare land in relation to the orchard situation.

Senator BYRD. Under this proposal, would the difference in ages of the trees be taken into consideration?

Mr. BRAZEAL. I am sure it would. We really have had no standard type of pecan orchard situation because they differ so greatly in age of trees, which does relate, to some extent, to the amount of production and also, they differ greatly to the variety that the orchard was planted in, which also relates to the amount of production.

I am sure that this would all be taken into consideration in establishing a fair value prior to the hurricane on the orchards.

Senator BYRD. I do not know much about pecan trees. I have only seen a few in Louisiana.

Is Louisiana a big producing State?

Mr. BRAZEAL. Yes, Louisiana is a big State. Of course, the two States that sort of lead the Nation in pecan production is Georgia and Texas. Alabama sort of comes along third, sort of a distant third.

Our area is more concentrated, our production area, along the gulf coast and the orchards along the gulf coast have been the leading area in Alabama in agricultural practices and experimentation, this type of thing, that accounts for our high percentages of production, although we do not have that high a percentage of the trees.

Senator BYRD. I do not know anything about pecan trees but I do have a knowledge of apple trees and the apple trees come into commercial production at 8, 10, or 12 years, depending on how they are taken care of, but say 10 years. But by the time they reach 35 years then they are on the borderline as to whether they are still commercially viable, in my judgment.

Many growers do not agree with me, but in my judgment, the orchardist would be wise to pull out trees after 35 years.

Mr. BRAZEAL. This is not the case with pecan trees. In Texas I know that there are trees there that are recorded as being near to 200 years old that still are in production. Pecan trees do not deteriorate with age as other fruit trees do.

Senator BYRD. Apple trees will live a long time, but they are not commercially valuable after a certain period. Pecans are in a different category?

Mr. BRAZEAL. They are in a different category. In developing these pecan orchards, it was a family-type situation and, in many instances, like I referred to Mr. Clump in the statement that I

made having 1,500 trees, he did not plant all those trees at one time. He planted 100 trees this year and 100 trees the following year, as he was able to have the resources to make this capital investment.

So this pecan industry we have in Alabama is something that has developed over a 100-year period.

If we have to redevelop our orchards in that fashion, it will probably take 200 years before we will get back to the point that we are now, or it may never develop again.

Senator BYRD. Some figures were mentioned earlier, which I cannot remember exactly, where some 2,000 trees had been destroyed?

Mr. BRAZEAL. Yes, sir.

Senator BYRD. That would have meant a loss of $700,000?

Mr. BRAZEAL. Yes, that is correct. That relates to Mr. Leslie Hatchett over in Grand Bay, which is in Mobile County. He had approximately 3,350 trees in his orchard and it was referred to as the trees were from 4 years old to 100 years old. Obviously, the 4-year-old trees were not in production and they were not lost.

The leaves were knocked off them and they were delayed, but they will survive and come on into production in time.

Now, the appraised or the estimated capital loss to him was placed at $755,000. He actually lost 2,250-odd trees out of the 3,350-odd that he had.

Senator BYRD. That would be $350 per tree, would it not?

Mr. BRAZEAL. Something in that area, I would suspect. Plus, you know, he lost the crop that he had on the trees. Our crop was only 2 to 3 weeks away from harvest.

Senator BYRD. Would the value of the crop be included under this legislation?

Mr. BRAZEAL. No, sir.

Senator BYRD. That is what I thought. It seems to me that would be going pretty far.

Senator BYRD. No, sir. It is not included in this piece of legislation. I mention that only to emphasize the farmer's general situation because he had all of his expenses of producing that crop, the cost of chemicals, the cost of fertilizer, everything with the exception of the cost of harvest.

You know, it sort of put him in an already bad situation and then he lost his trees and there is no possibility of income for a number of years.

Really, the thing that disturbs me so much about the possibility of losing the pecan industry in Alabama is that it has been a good, viable situation for the farmer.

Senator BYRD. What kind of insurance can be obtained on pecan trees?

Mr. BRAZEAL. As far as we know, absolutely none, from no source.

Senator BYRD. How about in protecting from hail damage? Does hail bother pecans?

Mr. BRAZEAL. Yes, there are some instances of hail, but really they do not bother pecans the same they would peaches or fruit.

We have some tornadoes occasionally that take out a few trees. We have had freezes, you know, in central Georgia. When I say a

freeze, I mean an accumulation of ice on the limbs that causes breakage and this sort of thing.

Senator BYRD. That would not be involved in this legislation?

Mr. BRAZEAL. No.

This specifically relates to Hurricane Frederic. Possibly it extends to other fruit and nut trees.

Senator HEFLIN. It would cover, for the future, any fruit trees.

Senator BYRD. Would it cover damage from ice as well as catastrophic breakage for ice?

Mr. BRAZEAL. The damage I have seen to the pecan trees in central Georgia and central Mississippi from the ice storm compared very similarly to some of the damage that we suffered from the hurricane. I should think yes.

Senator BYRD. Would the entire tree need to be destroyed before this bill could be utilized? That is, the breakage of limbs I assume would not be covered.

Mr. BRAZEAL. I would assume that the tree would have to be damaged to such an extent that it would have to be removed.

Senator BYRD. Let me ask you this. How do you answer the Treasury argument that permitting a casualty loss is to permit a loss deduction for depreciation which never has been subject to tax?

That is one argument that Treasury makes. How do you respond to that?

Senator HEFLIN. Our response to that is there are so many differing and unusual equities here that it overcomes any such argument like that. No. 1, you have the long period of time to bring it back into production. No. 2, you have the situation where you have no insurance and practically every other business or producers have insurance. You have none and none was available from Government or from private sources.

You have also the fact that you have a family in approach in practically all of the instances here.

I just think that the equities involved, the long-term devastation that comes about, ought to be considered as opposed to that concept that they argue.

Senator BYRD. Thank you.

[The prepared statements of the preceding panel follow. Oral testimony continues on p. 272.]

Statement of Mr. Taney Brazeal
President
Alabama Pecan Growers'Association
In Support of Senate Bill 1900
before the
Subcommittee on Taxation & Debt Management
of the
Senate Finance Committee
February 29, 1980

Mr. Chairman, Members of this Committee. On behalf of the Alabama Pecan Growers Association, I thank you for the opportunity to provide testimony calling your attention to certain facts and circumstances relevant to your consideration of Senate Bill 1900.

We call you attention specifically to the plight of the pecan growers of South Alabama, Northwest Florida and the Mississippi Gulf Coast who were wiped out by Hurricane Frederic Sept. 12, 1979. However, this legislation would provide similar relief to owners of fruit and nut trees throughout the country who are subject also to becoming victims of natural disasters.

Ice storms could destroy apples, cherries and peaches in such states as Virginia, North Carolina and Georgia. Windstorms could once again destroy the filbert trees in Oregon as they did in the early 1960's. Hail storms and freezes also bring devastation to growers. The pecan growing industry itself spreads along the Gulf Coast, across the south and into the west and central regions of the nation.

Hurricane Frederic swept across this coastal area at recorded winds of up to 150 miles per hour and although fortunately, the deaths were few the devastation was almost beyond belief. Whereas most hurricanes leave a narrow path of severe destruction in the wake of the eye, Hurricane Frederic's eye was flattened to a width of about 50 miles. Along that broad path from Pensacola, Florida to Pascagoula, Mississippi area, the report was the same--destruction that was soon to be valued in the billions of dollars.

It is expected that when the final figures are in months, and perhaps even several years from now, Hurricane Frederic will prove to be the costliest hurricane in history from the standpoint of property damages

and cost of cleanup operations.

The damages throughout the path of Hurricane Frederic were so varied, so severe and, in many cases, so long lasting, that we would not begin to cite them all. Neither do we suggest that it was the pecan growers alone who suffered irreparably from the disaster. However, as we shall point out later in this testimony, the pecan growers are unique in that they suffered so much loss of future production and that they found themselves with no compensation for severe lossess, and no means of replacing them.

The damage to the pecan growing industry was both in terms of the dollar value in the area and also the impact on the individual pecan growers. Alabama is the third largest pecan producing state in the nation and 80% of that production is in South Alabama, primarily Baldwin and Mobile County.

First, let us look at the over all economic impact of Hurricane Frederic on the pecan industry in South Alabama. John Boutwell and J. Lavaughn Johnson, economists with the Alabama Cooperative Extension Service, Auburn University prepared just such an assessment in October 1979. Because this is the major known study of the impact available to us and because we are quoting from it so extensively in this testimony, we are attaching to this statement a copy of the complete report.

Boutwell & Johnson assessed the total direct impact of the loss in the two Alabama counties of Baldwin and Mobile at $36.8 million. They assessed the loss of the 1979 pecan crop alone at more than $10.4 million and the cost of the cleanup operation at $7.9 million. Their assessment of loss in property was $18.5 million a figure we consider to be very conservative since it was based on an average value of only $140 per tree which is a low value.

When the value of the trees was approached using real estate appraisal values, the total loss would be much greater. Using average values cited by Larkin H. Harris, a real estate appraiser, and included in Boutwell-Johnson report, the loss of property would be closer to $40 million. That property loss figure would raise the total direct impact to $58.3 million, a substantial impact in such a small geographical area when it is taken into consideration that the figure is only for one phase of the South Alabama economy.

In addition to the direct impact, Boutwell & Johnson found that the disaster had a number of secondary effects.

Because commercial pecan production requires the use of specialized, expensive machinery and equipment both for maintenance and harvest, there is a secondary economic effect on the machinery industry. Farm machinery dealers in the two counties were averaging sales in pecan equipment of $350,000 per year plus an additional $150,000 a year in repair and maintenance of equipment. They report $300,000 of this business lost in 1979 with little or no market for pecan equipment until production is resumed at the earliest in 1987 and more likely in 1991. This secondary effect is greater for following years because of the trend toward use of modern farm machinery.

Boutwell & Johnson report another loss of some $1.7 million in 1980 to the chemical industry because of the loss of sales in chemical insecticides, fungicides and herbicides. They project that chemical sales to the pecan industry will not reach 1979 levels again until the year 2005. Fertilizer and lime sales are expected to slowly increase but since maximum levels of use do not occur until the tree is 15 yo 20 years old, it will remain at low levels also until 2005.

The other secondary economic effect cited by Boutwell & Johnson is labor. The pecan industry uses two types of labor. Production labor during the growing season was valued at $528,000. Harvest labor estimated at $615,000. "More important than the magnitude of this loss is the sector of the economy that it affects.", they reported. "The majority of this hand labor comes from low-income families. Pecan labor income greatly increases their spendable income during the harvest months. The money they earn is spent quickly so it affects an immediate boost to the local economy."

There is also a very significant secondary effect not included in Boutwell & Johnson report. That is the pecan shelling and processing industry which has built up in Mobile and Baldwin County based on the high quality nut general to this area and the early harvest date along the Gulf Coast. Without the source of supply of nuts on which this growing industry was based, there will be a very high secondary effect on this industry. Although it is too early to project accurately the dollar loss, our discussions with leaders in this industry indicate it will be substantial.

Another example of a tertiary effect will be that on some industries based on the pecan industry which then expanded into related fields. One pecan shelling and processing industry located in Baldwin County primarily because of the pecans. From there, it branched out to include a large business of importation of Brazil nuts through the port of Mobile. Without the pecan basis on which this industry was built, we do not yet know what will happen to the import segment of that operation.

The loss of the 1979 crop valued at $10.4 million is a substantial impact alone. In reaching that figure, Boutwell & Johnson found that farmers had already spent $3 million on the 1979 crop, or a total of about $275 an acre. In arriving at those figures, the Auburn economists

took into account such items as depreciation and interest on equipment. They concluded that "out-of-pocket costs are higher".

In making their study to assess the loss, Boutwell & Johnson found that Baldwin and Mobile County pecan farmers in general grow a better variety of pecan than in other areas of Alabama. That, coupled with the fact that their pecan crop generally comes in about two weeks ahead of the rest of the state, accounted for an average price in these two counties that was higher than the rest of the state.

Boutwell & Johnson found that clean up costs alone would reach at least $7.9 million. The cost of the clean up per acre ranged from $300 to $600 and depended on whether trees had to be completly removed or cut back.

As we indicated earlier, the damage to pecan orchards was severe and extensive. How severe? Boutwell & Johnson report that 75% of all the pecan trees in Mobile County and 55% of those in Baldwin County were blown down and completely destroyed. The total acres of pecan trees completely destroyed in both counties was 11,050 acres.

Another 4,500 acres in the two counties was so severely damaged as to require heavy pruning which may or may not save those trees. How successful that operation will be cannot be known for perhaps another five years. The percantage of the pecan orchards severely damaged was 30% in Baldwin County and 15% in Mobile County.

The reason for the difference in severely damaged trees is that higher percentage of the trees in Mobile County were completely destroyed.

Only 10% of the trees in Mobile County and only 15% of those in Baldwin County escaped with minor damage. The acreage involved in minor damage was 800 acres in Mobile County and 1650 acres in Baldwin County.

It is the loss of production from the destroyed pecan trees that reflects so well the real casualty to pecan growers. Boutwell & Johnson assessed that loss in these two counties alone at $110.9 million. That is a very conservative estimate. We believe losses are even higher.

The factor which makes this estimate so conservative is use of 70¢ per pound as the value of lost production for all years from 1980 to 2000. The 70¢ per pound represents the five year average for the Alabama Gulfcoast. However, the 1979 prices had already been fairly well established at 85¢ per pound before the hurricane. The last year that prices in Baldwin and Mobile Counties were as low as 70¢ a pound was 1977. With the prevailing inflation rates, the continually healthy demand for pecans, and the unusually high quality of the Gulfcoast pecans it would be reasonable to expect that the price per pound for nuts would have been far greater in the coming years than the old 1977 price.

By simply applying the 1979 value of 85¢ to the years 1980-1999 with no factor for price increases (assuming that operating costs most likely would also rise proportionately) we arrive at anticipated production loss of $134.6 million.

We have discussed here the damage in terms of dollars and the damage in terms of trees and acres. But the greatest impact is that on the individual farmers. The people.

There is not enough time nor space to cite all of the examples of how this disaster has impacted on individual pecan growers. We would like to mention a few random examples.

Attached to this report is a newspaper report of the damage to the pecan orchard of George B. Klumpp of Baldwin County. Total destruction of four orchards containing more than 1,500 mature trees.

18-A—Press Register Mobile, Sunday, Sept. 16, 1979

EXTENSIVE CROP DAMAGE RECORDED — Hurricane Frederic, which left a path of destruction in Baldwin County Wednesday night, took a high toll on area croplands. Pecan grower George B "Bernie" Klumpp said the high winds totally destroyed his four orchards which contained more than 1,500 mature trees. (Mobile Press Register photo by Graham Heath).

Entire pecan groves were destroyed by Hurricane Frederic. The photograph above from the Mobile Press Register, Sunday, Sept. 16, 1979, only four days after the hurricane, tells the story of the plight of one pecan grower.

Leslie Hatchett of Grand Bay in Mobile County owned 3,500 pecan trees ranging in age from 4 to 100 years. He lost 2,255 trees for a real casualty loss to him of some $755,000.

Another pecan grower in Baldwin County recently told of his plight. "For 29 years I've built up my pecan orchards for me and my children. Now it is all gone. Now I've got nothing and no place to go. I'm forced to abandon our life's program." This pecan farmer does not have the funds to replant. Nor does he have the 10, 15 or 20 years to wait to re-establish production.

The loss has been great for pecan growers of all income groups. An older, black farmer in Baldwin County some years ago proudly planted pecan trees. He described his work to another farmer down the road: "Look there young man. See them trees. Me and my boys set them out straight as can be. That's my retirement. The boys can have the farm but those pecan trees are for me in my old age." Now, most of his pecan trees are down and he has no way to recover that loss nor any income to look forward to in the future. Since planting the pecans for his old age, he has since lost his sight adding to the bleak future for this man who had tried to plan ahead.

It is the cost and difficulty of getting back into production, both in terms of dollars and years, that is a major problem in the seemingly hopeless situation of the pecan growers devastated by Hurricane Frederic. Here we are not talking about one year's cash crop--although that was a $10.5 million loss for 1979 alone. There are several factors at work. They include the cost in time and money to replant and re-establish orchards, the inflation factor along with the growing interest rate which severely affects the pecan growers ability to finance this long term operation, and even the availability of nursery stock to replant even if all the other factors were

not present.

Boutwell & Johnson project that even if these difficulties were overcome that it would be the year 2000 before pecan production in these two South Alabama counties again reaches the 12.3 million pounds expected to be harvested in 1979. (Incidentally, the estimate for the 1979 crop destroyed can be considered highly accurate because the full grown nuts were well established on the trees and harvest was only a few weeks away so that growers already knew the expected production.)

Boutwell & Johnson's estimate of the year 2000 to regain production was based 2,500 new plantings in 1979, and 5,000 new plantings in 1980 and 5,000 more in 1981. Based on our observation of planting in 1979 and what we have been told to expect for 1980, we are well behind the projected schedule. We will be well in the 21st Century before pre-hurricane Frederic production is reached again in Baldwin and Mobile Counties.

A pecan is not expected to begin production, according to Boutwell & Johnson, until about the eighth year. Some will require up to the twelfth year before reaching full production. This means that pecan growers must plant, maintain, fertilize, spray and, in general, manage a pecan orchard for from eight to twelve years before they may expect a crop. Not only is that cost high, it represents operating funds which must be financed. It represents, pushing off into unknown economic waters with no reliable charts for inflation or interest rates for the years ahead.

The competition for financing today is, perhaps, the major factor in any business enterprise. With increasing pressures for consumer financing and other relatively short-range financing, the pecan grower is at a disadvantage in the money market place. With prime lending rates as of February 22, 1980 at 16.5%, the future for financing a farming operation which requires eight years to begin production is even more bleak. A rate

of 18 to 20 percent on a 90-day charge account, high as that is, is one thing. But 18 to 20% a year for eight years for a pecan grower is economically prohibitive. Given those kinds of expectations, today's Baldwin and Mobile County pecan grower might well have a better chance of striking oil or gas on his land than of establishing a profitable pecan orchard.

Boutwell & Johnson have determined that the delay in planting caused by the lack of available transplants makes the re-establishment of the Gulfcoast pecan industry quite costly. They estimate that replanting of the 144,000 destroyed pecan trees cannot be completed before 1985. In fact, we are running behind that schedule already.

They break down costs into establishment (meaning initial planting, etc.) and annual maintenance until nuts are harvested in year eight following planting. Their projected costs per acre for establishment ranges from $511 per acre for 1979 to $823 an acre for 1984 on close spacing of 32' to 40' and from $374 per acre in 1979 to $728 an acre in 1986 for wide spacing of 30' to 60'. Using wide spacing will require two additional years to replant the same number of trees as close spacing.

Maintenance costs are estimated at from $232 per year per acre for the first year for close spacing to $452 for the eighth year or 1986. For wide spacing, they project maintenance costs per acre of from $153 for 1979 to $298 for 1986. The 1979 costs were derived from actual budgets. Costs for following years include anticipated 10% inflation factor.

Projected costs for Mobile and Baldwin Counties for 1980 to 1986 according to Boutwell & Johnson is $24.4 million to restablish 6,135 acres. That cost includes tree replacement and maintenance to bearing age. At the closer spacing anticipated for re-planting, the 6,135 acres would re-establish the 144,000 trees destroyed in the hurricane.

The economists project an average cost per acre of $3979 and an average cost per tree using 24 trees to the acre spacing of $166 per tree. Again, this is a conservative projection because inflation factors raise the cost per acre each year and if planting does not follow the schedule then total costs will rise. For example, the cost per acre rises for $2516 in 1980 to $4452 by 1986. These costs do not include a charge for land or management.

The projected replacement rate, based on maximum availability, ranges from only 100 acres for 1980 to up to 2100 acres in 1986. Replanting of 100 acres in 1980 means in practical terms, that perhaps one of the many pecan growers in Baldwin and Mobile Counties could find enough transplants to replant. Please note, for example, that in this data updated in January 1980, that they now figure replacement on the basis of only 2400 trees for 1980 instead of the 5,000 estimated in October, 1979. The lack of availability of transplants is a serious factor.

(Please note an apparent discrepancy in the number of trees expected to be replanted in the year 1980. Most tables in the Boutwell & Johnson study set that figure at a high of 5,000. However, Table 11 on Page 25, treats the replanting on a more realistic basis of 2,400 for 1980 based on availability. The reason for the apparent discrepancy is that the authors in January updated that table and it has been substituted in the report for the earlier one. To avoid any more confusion than necessary, we have continued to use his 5,000 tree replanting schedule for all other discussions and tables except for the one recently updated on cost of re-establishment. Note general remarks throughout the testimony calling attention to the fact that planting is not on shcedule.

The plight of the South Alabama pecan farmer today is a hopeless one. No trees, no insurance (none was available), no money to replant, in

many cases not enough time left in a person's working years to replant, and not enough nursery trees available if growers could afford them.

As this committee meets today, bulldozers are leveling off pecan orchards, families are thrashing about the problems of what to do. For too many of them, the answer is fast becoming that of selling equipment for whatever they can get out of it. The personal impact not only of the loss but of the question of what to do is also taking its toll. Pecan growing is frequently a family operation that spans two or more generations. The distress of one Baldwin County family is multiplied when the sons, who have been doing the pecan growing, decide to sell out the equipment and give it up and the elderly mother still owns the land tries desperately to hold on.

Pecan growing is very much a family operation. We know that from our first hand personal knowledge of the industry and the statistics reaffirm it as well. In fact, Boutwell & Johnson found that in Mobile County there are more acres in home orchards than in commercial pecan production. The economists found approximately 5,000 acres of orchards were home owned and farmed as compared to 3,000 acres of commercial orchards. The ratio of home owned orchards in Baldwin County was less with 3,000 acres of home owned orchards compared to 8,000 acres of commercially grown pecans. The total acreage for both counties shows a very high percentage of home owned with 8,000 of 19,000 acres or 42% of all acres being home owned. (See Table #1, Page 3, Boutwell & Johnson.)

To understand how that high a percentage could be accurate, one must look to the history of the development of the pecan growing industry in South Alabama. Like many farm products, the pecan began with a few trees and a few farmers. Some of the earliest memories of pecan trees in the

South were as yard trees often refered to as "tax trees" because owners sold part of the product for money to pay their yearly property taxes on the home or farm.. There were still enough pecans left for fruit cakes, the legendary Southern pecan pies, candies, and for just cracking and eating either plain or salted, buttered, and roasted in the skillet.

As the pecan flourished, more trees were planted, first a few at a time and then entire orchards. More pecan trees soon brought the need for modern methods of nut production and with it modern equipment, fertilizer and insecticides. Within a few generations, mostly since the early 1900's a backyard "egg money" type operation evolved into a healthy, growing industry still centered for a large part around the family labor and management but increasingly a commercial operation.

It is precisely that growth as a family operation which accounts for the plight of pecan growers such as the man in Baldwin County discussing his loss with the accountant preparing his 1979 income tax. What basis was in the trees? What did they cost to plant? The answer: "Pappa and Mamma put them out. They bought them for 25¢ a piece and I don't even have a record of that." Provable loss under current tax law? None.

The fact that the pecan growing industry in South Alabama is such a family related business means that the average pecan grower does not have readily available, nor affordable business and tax service. The family operated pecan growing business, like the one in Baldwin County operated by a woman and her two sons, finds itself seeking professional assistance only at tax time. That is usually too late and there is not much that can be done except accurately report what has happened on that farm that year. Tax planning is just not practical. How can a 35 year-old pecan farmer make a wise decision about whether or not to incorporate his business, for example, when grandpa still owns the land and may not have decided just yet

who is going to inherit it when he dies?

A home operated industry can be a healthy one. The pecan growers are a fine example. While we continually learn of the general difficulties of the farm economy and especially that of family operated crop farming, the pecan grower is an exception. His future in South Alabama was bright when the natural disaster of Hurricane Frederic struck last September.

The pecan grower in general, and, as Boutwell & Johnson pointed out, the grower in Baldwin and Mobile Counties particularly, had a ready market at a favorable price. And if the price was not that favorable, he could put his pecans in cold storage and carry them over to the following year for sale.

The pecan market is highly competitive, it is not influenced by speculation such as trading in other commodities; nor is it influenced by government controls. Pecan production is one of the last free markets.

The pecan grower has been doing well with a good, healthy, growing industry. There have been no surpluses, no set asides, no price supports. Unlike other segements of the agricultural industry, pecan growers have never received any specific federal assistance before Hurricane Frederic. It is with a mixture of pride and despair that we report that pecan growers are today receiving their first benefits from federal assistance--the U.S. Army Corps of Engineers is providing some assistance in removing our destroyed pecan trees--part of their general program of debris removal following Hurricane Frederic.

We are here today to request government assistance because it is so badly needed, because it is fair and equitable and, equally important, because we have no place else to go.

Tax law and regulations to the contrary, the loss to a pecan

grower of our pecan trees is a very real loss. It is a loss that can be described in fair market value per pecan tree. We are not proposing any formula for arriving at fair market value nor any conclusions as to what that fair market value would be at this time. It is fairly certain that it would be higher than the average per tree value which Boutwell & Johnson used for the purpose of assessing the total economic impact of the loss of pecan trees during the hurricane.

We suggest that the principle of allowing tax losses which reflect the realities of our economic life is fair and equitable. We remind you that the basis of income taxation is profit and that the practice of deductions for casualty loss is long standing. It is the circumstances of a terrible, natural disaster combined with the complexities of a largely family operated farm industry that has left pecan growers bankrupt and hopeless. We can not help but believe that had anyone been able to foresee this situation that the tax law would have already contained some kind of provisions to recognize real loss.

We respectfully request that this Committee give a favorable report on Senate Bill 1900 and that members urge their colleagues in the Congress to give prompt passage. Relief is needed badly and it is needed now. Other industries, small businesses, and home owners are now well on the way to recovering from the disaster of Hurricane Frederic. They have collected their insurance and are re-building.

Pecan growers, however, are in a state of continuing disaster. We have weathered the shock of seeing thousands of tree years of growth flattened like corn stalks. Now, we are in the midst of the secondary shock of learning that we have no means to rebuild.

Passage of Senate Bill 1900 will do at least two very important

things. First, and this is no frivolous argument, it will give hope to the despairing pecan grower. It will give the grower, large and small, at least one substantial straw to grasp.

Secondly, and the matter which with you are primarily concerned, Senate Bill 1900 would allow the pecan grower a casualty loss based on fair makdet value. This loss could be carried backward for up to 10 years and, if necessary, forward for 4 years. Through tax adjustments, arrived at through sound, acceptable means of establishing fair market value, it would be possible for the pecan grower to recoup some taxes in order to form a capital reserve to finance the re-establishment of his orchards.

We realize that we are asking for a departure from the established methods of setting casualty loss at fair market value or cost, whichever is lowest. Why should the pecan grower's trees be established at fair market value when the commercial building, for example, lost in the hurricane is set at cost? The answer is insurance. Rather the lack of it. That is the difference. The building owner has available to him insurance at a reasonable cost to protect him from losses usch as those from Hurricane Frederic. The pecan grower has no such insurance. It is not available.

Because so many pecan growing operations are family operations, they have already been somewhat at a disadvantage under tax regulations in that self-labor is not allowable as an expense and also in that practially no family operations are set up to allow depreciation on the trees. Thus we find an apparently inequitable contrast where the city doctor, lawyer or businessman who several years ago purchased a pecan orchard and set up an advantageous bookkeeping system, has been able to depreciate his trees since owning them and now, with the hurricane, is able to deduct the remaining basis as a casualty loss. Many of those type losses which will show up on 1979 tax returns will, in effect, indicate an individual

tree value greater than that suggested by Boutwell & Johnson. The pecan grower, on the other hand, whose orchard is his life's work and his family's bread and butter, can not prove, under present regulations, any loss that approaches the fair and realistic value of what was owned by him and is now destroyed.

Even the individual home owner with a pecan tree as a shade tree in the front yard is in a better position under current tax regulations than the pecan grower. If an appraisal indicates that a home in the city is less valuable after the hurricane and the loss of the pecan tree, he can claim that loss. The home owner's loss will be based on current market values of his property, not on the cost of that shade tree.

Viewed from a simple, common sense approach, the pecan grower is asking for a position under tax laws which will treat his losses as fairly as those of the home owner with a shade tree or the recent purchaser of an established pecan orchard. In the case of the pecan grower, that tax situation will, without a doubt, determine whether or not the pecan industry will survive in South Alabama. It will determine whether or not individual pecan growers will continue at their life's work or be forced off the family farm, along with their employees, and into the open job market to swell the unemployment rolls.

# AN ASSESSMENT OF THE ECONOMIC IMPACT OF HURRICANE FREDERIC ON THE PECAN INDUSTRY IN BALDWIN AND MOBILE COUNTIES

Prepared by

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October 1979

Obtaining an accurate assessment of the damage to the pecan industry is a difficult task due to the lack of statistical data. This report is based on the best information available from secondary data, conversations with growers, shellers and others in the pecan industry, along with logical deduction.

The report contains information pertaining to the following topics:

1. Status of the Pecan Industry Prior to Frederic - - - - includes the estimated acreage of trees in the two-county area, average yields as provided by growers, average prices as provided by growers and shellers, value of the 1979 crop loss, and estimated costs of production.

2. Loss in Value of Production to the Year 2000

3. Cost of Cleanup - - -examines the extent of damage and the costs of various types of cleanup operations. Total cost of two-county pecan damage cleanup is estimated.

4. Value of Pecan Trees Damaged

5. Costs of Re-establishing Pecan Trees

6. Secondary Effects on The Economy

STATUS OF THE PECAN INDUSTRY
PRIOR TO FREDERIC

Table 1

ESTIMATED PECAN ACREAGES AND YIELDS
FOR MOBILE AND BALDWIN COUNTIES

| COUNTY | COMMERCIAL ORCHARDS No. acres | Av. yield | HOME ORCHARDS No. acres | Av. yield |
|---|---|---|---|---|
| Mobile | 3,000 A. | 886 lbs/A. | 5,000 A. | 240 lbs/A. |
| Baldwin | 8,000 A. | 965 lbs/A. | 3,000 A. | 240 lbs/A. |
| 2-County Total | 11,000 A. | 920 lbs/A. | 8,000 A. | 240 lbs/A. |

Table 2

ESTIMATED TOTAL PRODUCTION
AND VALUE OF CROP, 1979

| County | Total Pounds Production | Total Value* |
|---|---|---|
| Mobile - Commercial | 2,658,000 | $ 2,259,300 |
| Home | 1,200,000 | 1,020,000 |
| Baldwin - Commercial | 7,720,000 | 6,562,000 |
| Home | 720,000 | 612,000 |
| TOTAL | 12,298,000 | $ 10,453,000 |

*Value = Total pounds x $ .85 per pound

Table 3

GROWER AVERAGE YIELDS
EXPRESSED AS POUNDS PER ACRE*

| | Baldwin County | | | Mobile County | | | |
|---|---|---|---|---|---|---|---|
| | 1 | 2 | 3 | 1 | 2 | 3 | 4 |
| 1974 | 959 | 347 | ** | ** | 477 | 625 | 1000 |
| 1975 | 928 | 1093 | ↓ | 1123 | 785 | 833 | 1200 |
| 1976 | 857 | 1187 | | 506 | 231- | 750 | 1000 |
| 1977 | 1027 | 1715 | | 984 | 1522 | 1300 | 1500 |
| 1978 | 686 | 467 | | 342 | - | 250 | 200 |
| Grower Averages | 943 | 1115 | 836 | 739 | 754 | 877 | 1175 |
| County Averages | 965 lbs | | | 886 | | | |
| 2-County Average | 920 lbs. | | | | | | |

* Provided by members of the Alabama Pecan Growers Association
** No records for 1974

Table 4

PECAN PRICES - COMPARISON OF BALDWIN-MOBILE PRICES
WITH ALABAMA AVERAGE PRICES

| Year | State Average | Baldwin-Mobile* Average |
|---|---|---|
| | (¢/lb.) | (¢/lb.) |
| 1974 | 50 | 57 |
| 1975 | 35 | 53 |
| 1976 | 84 | 87 |
| 1977 | 50 | 70 |
| 1978 | 55 | 81 |
| 1979 | | 85** |

*Furnished by grower and sheller records

**Forecast

NOTE: Pecans in the Baldwin-Mobile area are harvested about 2 weeks prior to other pecan producing regions in the country. Also, most of the nuts harvested in the Baldwin-Mobile area are the Stuart variety which is a good quality nut. These two factors account for the favorable price differential experienced by Baldwin-Mobile pecan growers.

Table [illegible]

PECANS, IMPROVED VARIETIES, RECOMMENDED MANAGEMENT PRACTICES
BASED ON 60 X 60 FOOT SPACING, 100 ACRE ORCHARD, LARGE TREES
ESTIMATED COSTS AND RETURNS PER ACRE, ALABAMA GULFCOAST, 1979

| | UNIT | PRICE OR COST/UNIT | QUANTITY | VALUE OR COST |
|---|---|---|---|---|
| 1. GROSS RECEIPTS | | | | |
| PECANS | LBS. | .85 | 920.00 | 782.00 |
| TOTAL | | | | 782.00 |
| 2. VARIABLE COSTS | | | | |
| PREHARVEST | | | | |
| NITROGEN | LBS. | 0.21 | 100.00 | 21.00 |
| PHOSPHATE | LBS. | 0.20 | 15.00 | 3.00 |
| POTASH | LBS. | 0.10 | 30.00 | 3.00 |
| ZINC | LBS. | 0.22 | 24.00 | 5.28 |
| LIME | TONS | 16.00 | 0.50 | 8.00 |
| INSECTICIDE | APL. | 5.75 | 8.00 | 46.00 |
| FUNGICIDE | APL. | 9.00 | 10.00 | 90.00 |
| HERBICIDE | APL. | 5.25 | 3.00 | 15.75 |
| MACHINERY | ACRE | 12.14 | 1.00 | 12.14 |
| TRACTORS | ACRE | 23.33 | 1.00 | 23.33 |
| INTEREST ON OP. CAP. | DOL. | 0.12 | 105.04 | 12.60 |
| SUBTOTAL, PRE-HARVEST | | | | 240.11 |
| HARVEST COSTS | | | | |
| PECAN CLEANING | LBS. | 0.05 | 920.00 | 46.00 |
| MACHINERY | ACRE | 1.96 | 1.00 | 1.96 |
| TRACTORS | ACRE | 2.51 | 1.00 | 2.51 |
| SUBTOTAL, HARVEST | | | | 50.47 |
| TOTAL VARIABLE COST | | | | 290.58 |
| 3. INCOME ABOVE VARIABLE COSTS | | | | 491.42 |
| 4. FIXED COSTS | | | | |
| MACHINERY | ACRE | 57.01 | 1.00 | 57.01 |
| TRACTORS | ACRE | 26.69 | 1.00 | 26.69 |
| TOTAL FIXED COSTS | | | | 83.70 |
| 5. LABOR COSTS | | | | |
| PREHARVEST LABOR(TRAC & MACH) | HOUR | 4.00 | 8.80 | 35.19 |
| HARVEST LABOR(TRAC & MACH) | HOUR | 4.00 | 4.41 | 17.65 |
| TOTAL LABOR COSTS | | | | 52.84 |
| 6. TOTAL COSTS | | | | 427.12 |
| 7. NET RETURNS TO LAND AND MANAGEMENT | | | | 354.88 |

FERTILIZER RATES USED (100-15-30) BASED ON MEDIUM LEVEL OF SOIL FERTILITY
INSECTICIDES & FUNGICIDES APPLIED ACCORDING TO EXTENSION SERVICE COMMERCIAL
PECAN SPRAY SCHEDULE AT RATES FOR LARGE PECAN TREES ( >35 FT.).

BUDGET IDENTIFICATION NUMBER --- [illegible] 100 1
ANNUAL CAPITAL MONTH 11

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Table 5b

PECANS, IMPROVED VARIETIES, RECOMMENDED MANAGEMENT PRACTICES
BASED ON 60 X 60 FOOT SPACING, 100 ACRE ORCHARD, LARGE TREES
ESTIMATED COSTS AND RETURNS PER ACRE, ALABAMA, 1979

| OPERATION | ITEM NO. | DATE | TIMES OVER | LABOR HOURS | MACHINE HOURS | FUEL, OIL, LUB., REP. PER ACRE | FIXED COSTS PER ACRE |
|---|---|---|---|---|---|---|---|
| DRY FERT SPREAD | 1,71 | FEB | 1.00 | 0.145 | 0.093 | 0.46 | 0.76 |
| PCN SPRAYER(SP) | 5,34 | APR | 2.00 | 0.488 | 0.313 | 2.93 | 7.24 |
| HERB APPL | 1,75 | APR | 1.00 | 0.149 | 0.095 | 0.26 | 0.49 |
| NURSE TANK | 8,99 | APR | 2.00 | 0.477 | 0.306 | 1.70 | 1.46 |
| PCN SPRAYER(SP) | 5,34 | MAY | 2.00 | 0.488 | 0.313 | 2.93 | 7.24 |
| NURSE TANK | 8,99 | MAY | 2.00 | 0.477 | 0.306 | 1.70 | 1.46 |
| PCN SPRAYER(SP) | 5,34 | JUNE | 1.50 | 0.366 | 0.234 | 2.20 | 5.43 |
| ROTARY MOWER | 1,92 | JUNE | 1.00 | 0.553 | 0.354 | 1.01 | 1.61 |
| HERB APPL | 1,75 | JUNE | 1.00 | 0.149 | 0.095 | 0.26 | 0.49 |
| NURSE TANK | 8,99 | JUNE | 1.50 | 0.358 | 0.229 | 1.28 | 1.09 |
| PCN SPRAYER(SP) | 5,34 | JULY | 1.50 | 0.366 | 0.234 | 2.20 | 5.43 |
| NURSE TANK | 8,99 | JULY | 1.50 | 0.358 | 0.229 | 1.28 | 1.09 |
| PCN SPRAYER(SP) | 5,34 | AUG | 2.00 | 0.488 | 0.313 | 2.93 | 7.24 |
| ROTARY MOWER | 1,92 | AUG | 1.00 | 0.553 | 0.354 | 1.01 | 1.61 |
| HERB APPL | 1,75 | AUG | 1.00 | 0.149 | 0.095 | 0.26 | 0.49 |
| NURSE TANK | 8,99 | AUG | 2.00 | 0.477 | 0.306 | 1.70 | 1.46 |
| PCN SPRAYER(SP) | 5,34 | SEPT | 1.00 | 0.244 | 0.156 | 1.47 | 3.62 |
| NURSE TANK | 8,99 | SEPT | 1.00 | 0.239 | 0.153 | 0.85 | 0.73 |
| ROTARY MOWER | 1,92 | OCT | 1.00 | 0.553 | 0.354 | 1.01 | 1.61 |
| PECAN SHAKER | 3,69 | OCT | 1.00 | 0.859 | 0.550 | 4.02 | 6.98 |
| PECAN HARVESTER | 1,76 | OCT | 1.00 | 0.806 | 0.516 | 1.74 | 7.74 |
| TRUCK | 8 | OCT | 1.00 | 1.400 | 1.000 | 0.50 | 1.85 |
| PECAN SHAKER | 3,69 | NOV | 1.00 | 0.859 | 0.550 | 4.02 | 6.98 |
| PECAN HARVESTER | 1,76 | NOV | 1.00 | 0.806 | 0.516 | 1.74 | 7.74 |
| TRUCK | 8 | NOV | 1.00 | 1.400 | 1.000 | 0.50 | 1.85 |
| TOTALS | | | | 13.209 | 8.662 | 39.94 | 83.70 |

FERTILIZER RATES USED (100-15-30) BASED ON MEDIUM LEVEL OF SOIL FERTILITY
INSECTICIDES & FUNGICIDES APPLIED ACCORDING TO EXTENSION SERVICE COMMERCIAL
PECAN SPRAY SCHEDULE AT RATES FOR LARGE PECAN TREES ( >35 FT.).

BUDGET IDENTIFICATION NUMBER--- 96 000511 100 1
ANNUAL CAPITAL MONTH 11

Production Expenses 1979
Pecan growers had already spent approximately $275 per acre in out-of-pocket or pre-harvest variable expenses. Referring to the previous budget, there were $240 in pre-harvest variable expenses and $35 per acre in pre-harvest labor costs.

Expanding this to the two-county acreage (11,000 acres) gives a total figure of $3,025,000.

Fixed costs in the budget of $84 per acre are not included in this figure. Technically, this figure allows for depreciation, interest and insurance on tractors and equipment. However, many growers had cash obligations due on this equipment. Therefore, the $3,025,000 under-estimates total out-of-pocket costs.

LOSS IN VALUE OF PRODUCTION

TO THE YEAR 2000

Table 6

ANTICIPATED RECOVERY SCHEDULE FOR

ALABAMA GULF COAST PECAN INDUSTRY

| Year | Action taken or Anticipated Yield |
|---|---|
| 1979 | Begin orchard cleanup; plant 2500 trees |
| 1980 | Continue orchard cleanup; plant 5000 trees |
| 1981 | Plant 5000 trees; harvest .4 mil. lbs. from lightly damaged trees |
| 1982 | Plant 10,000 trees; harvest 1.2 mil. lbs. from lightly damaged trees |
| 1983 | Plant 25,000 trees; harvest 1.6 mil. lbs. from lightly damaged trees |
| 1984 | Plant 50,000 trees; harvest 2.0 mil. lbs. from lightly damaged trees |
| 1985 | Plant 50,000 trees; harvest 2.1 mil. lbs. from lightly damaged trees |
| 1986 | Harvest 2.4 mil. lbs. from salvaged trees (light & heavy damage) |
| 1987 | Harvest 3.0 mil. lbs. from salvaged trees & 1979 planting |
| 1988 | Harvest 3.6 mil. lbs. from salvaged trees & new plantings |
| 1989 | Harvest 4.2 mil. lbs. from salvaged trees & new plantings |
| 1990 | Harvest 4.9 mil. lbs. from salvaged trees & new plantings |
| 1991 | Harvest 5.6 mil. lbs. from salvaged trees & new plantings |
| 1992 | Harvest 6.3 mil. lbs. from salvaged trees & new plantings |
| 1993 | Harvest 7.0 mil. lbs. from salvaged trees & new plantings |
| 1994 | Harvest 7.7 mil. lbs. from salvaged trees & new plantings |
| 1995 | Harvest 8.5 mil. lbs. from salvaged trees & new plantings |
| 1996 | Harvest 9.3 mil. lbs. from salvaged trees & new plantings |
| 1997 | Harvest 10.1 mil. lbs. from salvaged trees & new plantings |
| 1998 | Harvest 10.9 mil. lbs. from salvaged trees & new plantings |
| 1999 | Harvest 11.7 mil. lbs. from salvaged trees & new plantings |
| 2000 | Harvest 12.5 mil. lbs. from salvaged trees & new plantings |

NOTE: Contacts with suppliers of nursery stock indicate that trees sufficient to replant the lost acreage will not be available for several years. New plantings are based on the anticipated availability of nursery stock.

Table 7

VALUE OF ANTICIPATED PRODUCTION LOSS

FOR ALABAMA GULFCOAST PECAN INDUSTRY, 1979-2000

| Year | Lost Production | | Value Per Pound | | Value of Loss |
|---|---|---|---|---|---|
| 1979 | 12.3 mil. lbs. | x | $ .85/lb. | = | $ 10.5 mil. |
| 1980 | 12.3 mil. lbs. | x | .70/lb.* | = | 8.6 mil. |
| 1981 | 11.9 mil. lbs. | x | .70/lb. | = | 8.3 mil. |
| 1982 | 11.1 mil. lbs. | x | .70/lb. | = | 7.8 mil. |
| 1983 | 10.7 mil. lbs. | x | .70/lb. | = | 7.5 mil. |
| 1984 | 10.3 mil. lbs. | x | .70/lb. | = | 7.2 mil. |
| 1985 | 10.2 mil. lbs. | x | .70/lb. | = | 7.1 mil. |
| 1986 | 9.9 mil. lbs. | x | .70/lb. | = | 6.9 mil. |
| 1987 | 9.3 mil. lbs. | x | .70/lb. | = | 6.5 mil. |
| 1988 | 8.7 mil. lbs. | x | .70/lb. | = | 6.1 mil. |
| 1989 | 8.1 mil. lbs. | x | .70/lb. | = | 5.7 mil. |
| 1990 | 7.4 mil. lbs. | x | .70/lb. | = | 5.2 mil. |
| 1991 | 6.7 mil. lbs. | x | .70/lb. | = | 4.7 mil. |
| 1992 | 6.0 mil. lbs. | x | .70/lb. | = | 4.2 mil. |
| 1993 | 5.3 mil. lbs. | x | .70/lb. | = | 3.7 mil. |
| 1994 | 4.6 mil. lbs. | x | .70/lb. | = | 3.2 mil. |
| 1995 | 3.8 mil. lbs. | x | .70/lb. | = | 2.7 mil. |
| 1996 | 3.0 mil. lbs. | x | .70/lb. | = | 2.1 mil. |
| 1997 | 2.2 mil. lbs. | x | .70/lb. | = | 1.5 mil. |
| 1998 | 1.4 mil. lbs. | x | .70/lb. | = | 1.0 mil. |
| 1999 | .6 mil. lbs. | x | .70/lb. | = | .4 mil. |
| 2000 | - | | | | |
| | | | | | $110.9 mil. |

*5-year av. price for Alabama Gulfcoast

## COST OF CLEANUP

Pecan growers were in the process of cleanup operations during the first week of October. Not enough growers had completed cleanup operations to obtain a precise estimate. Growers were able to provide some estimates however of what they believed the costs were expected to be.

Four different types of cleanup and salvage operations are discussed.

1. Removal of older trees that are completely blown down -
   These are 60-year old trees in excess of 18 inches in diameter. These trees have to be pushed up out of the ground by bulldozers. The trunk is generally cut in two places with a chain saw separating the tree into root, trunk, and top. The trunks and tops are rolled by a bulldozer to a central location to be burned. A farm tractor is also used to drag fallen limbs. Bulldozer costs have been about $45-65 per hour. The ASCS is reported to allow up to $75 per day for a man with a chain saw.

   Growers who have begun cleanup operations report that it involves 2 bulldozers and drivers, one man with a chain saw and 1 farm tractor with driver. Growers estimate these costs will be about $50 per tree or $600 per acre.

   This cost does not include disposal of the stumps. The stumps will not burn. Therefore, extra costs will be incurred in either burying these stumps or hauling them off.

2. Removal of 30-year old trees that have blown down -
   These trees are smaller in diameter (12"-18") and can be removed more easily. The same type of operations are involved as with the 60-year old trees. Growers estimate that cleanup operations will involve 1 bulldozer and driver, 1 large farm tractor and driver, 1 chain saw and 2 hired hands. Total costs, including stump disposal, is estimated to be $300 per acre.

3. Salvage operations for 30-year old trees -
   This involves trees that have been partially blown over but can be straightened and put back into production. Grower estimates, based on some actual operations, indicate that it requires 3 men working for 3 days with a farm tractor and 2 chain saws to complete this salvage operation on 15 trees. Based on these estimates such an operation will probably cost about $350 per acre.

4. Topworking older trees -
   Some of the older trees were not severely damaged with only the limbs and tops of the trees being broken. No topworking has been performed due to the higher priorities for other cleanup operations. Whenever topwork operations begin, it will involve renting a crane with a bucket (cherry picker) and using chain saws to repair the damage. The cost will primarily depend on the lease rate for the cherry picker. It is estimated that the cost will be roughly $300 per acre.

These costs can be applied to the total area to get an estimated cleanup cost. Table 1 shows an estimated 19,000 acres in the two-county area. It is assumed that 75 percent of these were older trees and 25 percent were trees in the 30-year age category or less.

Table 8 summarizes the estimated extent of damage to trees as reported from survey results.

Table 8

ESTIMATED EXTENT OF DAMAGE TO PECAN TREES
IN BALDWIN AND MOBILE COUNTIES

| Damage to Trees | Mobile County % loss | Mobile County Acres | Baldwin County % loss | Baldwin County Acres |
|---|---|---|---|---|
| Completely blown down | 75 | 6,000 | 55 | 6,050 |
| Requiring heavy pruning | 15 | 1,200 | 30 | 3,300 |
| Minor damage | 10 | 800 | 15 | 1,650 |
| Total | 100 | 8,000 | 100 | 11,000 |

Cost computations of damage:

| | | | |
|---|---|---|---|
| Blown down: | 6,000 ac. x 75% x $600/ac. | = | $2,700,000 |
| | 6,050 ac. x 75% x $600/ac | = | 2,722,500 |
| | 6,000 ac. x 25% x 300/ac | = | 450,000 |
| | 6,050 ac. x 25% x 300/ac | = | 453,750 |
| Heavy pruning: | 1,200 ac. x $350/ac | = | 420,000 |
| | 3,300 ac. x 350/ac | = | 1,155,000 |
| Minor damage: | No costs involved | = | 0 |
| | Total estimated cleanup costs | | $7,901,250 |

VALUE OF TREES DAMAGED

The value of a pecan tree depends on numerous factors which are difficult to quantify. Aesthetic values come into play. A pecan tree on a residential lot or a grove of trees on a golf course or in a sub-division undoubtedly adds to the value of that real estate, but determining an overall accurate value for such factors is impossible. The attached report by Mr. Harris perhaps incorporates some of these factors.

Our evaluation of pecan trees is based solely on their value in a commercial operation. Two basic appraisal approaches were employed.

1. Income approach
2. Comparable sales approach

Income Approach

Pecan trees will yield a stream of income over a number of years. Pecan trees damaged by Frederic had a remaining potential income stream. Trees damaged were of various ages, but it seems reasonable that the average tree would have had at least a 20-year remaining life.

Baldwin and Mobile pecan growers provided information which indicated a 920 pound average yield. Using the past 5-year average pecan price of 70¢ per pound, this gives an annual gross income potential of $644 per acre. Costs of production were estimated by growers to be approximately $427 per acre. Subtracting costs from gross income gives a net return potential of $217 per acre over the next 20 years.

Simple multiplication yields an income potential of $4,340 over the next 20 years ($217 per acre per year x 20 years). However this income stream has to be discounted to a present value. An analogy can be made by comparing an interest bearing note to a pecan tree. A $10,000 note at 10 percent compound interest will be worth approximately $16,000 in 5 years. However the value of that note today is worth only $10,000. Similarly an acre of pecan trees will yield $4,340 over 20 years but the value is not that great today.

The $4,340 future value should be discounted by some interest rate or discount factor to get a present value. The $16,000 financial note discounted by 10% for 5 years gave a present value of $10,000. If we similarly discount the $4,340 future pecan income by a 10% discount factor for 20 years, the present value is $1,847. See Table 9 which is attached to see where the discount factor was obtained.

$217/yr. x 8.514* = $1,847

*This is the discount factor associated with a 10% rate at 20 years.

Assuming 12 trees per acre, this gives a value of $154 per tree.

Comparable Sales Approach

Information on sales of tracts of land were obtained with the cooperation of the Federal Land Bank offices in Robertsdale and Mobile. This source was chosen because the records were easily accessible and were public document.

Most of these sales were relatively small tracts. It should be pointed out that FLB sales prices might have been a little lower than realty company prices. The primary reason for this is that FLB makes loans based on the income potential of the property. Additional factors associated with a piece of land may not necessarily add to the

Table 9

## PRESENT VALUE OF A UNIFORM SERIES

| Years | 5% | 6% | 7% | 8% | 9% | 10% | 12% | 14% | 16% | 20% |
|---|---|---|---|---|---|---|---|---|---|---|
| 1 | .952 | .943 | .935 | .926 | .917 | .909 | .893 | .877 | .862 | .833 |
| 2 | 1.859 | 1.833 | 1.808 | 1.783 | 1.759 | 1.736 | 1.690 | 1.647 | 1.605 | 1.528 |
| 3 | 2.723 | 2.673 | 2.624 | 2.577 | 2.531 | 2.487 | 2.402 | 2.322 | 2.246 | 2.106 |
| 4 | 3.546 | 3.465 | 3.387 | 3.312 | 3.240 | 3.170 | 3.307 | 2.914 | 2.798 | 2.589 |
| 5 | 4.329 | 4.212 | 4.100 | 3.993 | 3.890 | 3.791 | 3.605 | 3.433 | 3.274 | 2.991 |
| 6 | 5.076 | 4.917 | 4.767 | 4.623 | 4.486 | 4.355 | 4.111 | 3.889 | 3.685 | 3.326 |
| 7 | 5.786 | 5.582 | 5.389 | 5.206 | 5.033 | 4.868 | 4.564 | 4.288 | 4.039 | 3.605 |
| 8 | 6.463 | 6.210 | 5.971 | 5.747 | 5.535 | 5.335 | 4.968 | 4.639 | 4.344 | 3.837 |
| 9 | 7.108 | 6.802 | 6.515 | 6.247 | 5.995 | 5.759 | 5.328 | 4.946 | 4.607 | 4.031 |
| 10 | 7.722 | 7.360 | 7.023 | 6.710 | 6.418 | 6.145 | 5.650 | 5.216 | 4.833 | 4.192 |
| 11 | 8.306 | 7.887 | 7.499 | 7.139 | 6.805 | 6.495 | 5.938 | 5.453 | 5.029 | 4.327 |
| 12 | 8.863 | 8.384 | 7.943 | 7.536 | 7.161 | 6.814 | 6.194 | 5.660 | 5.197 | 4.439 |
| 13 | 9.394 | 8.853 | 8.358 | 7.904 | 7.487 | 7.103 | 6.424 | 5.842 | 5.342 | 4.533 |
| 14 | 9.899 | 9.295 | 8.746 | 8.244 | 7.786 | 7.367 | 6.628 | 6.002 | 5.468 | 4.611 |
| 15 | 10.380 | 9.712 | 9.108 | 8.560 | 8.061 | 7.606 | 6.811 | 6.142 | 5.575 | 4.675 |
| 16 | 10.838 | 10.106 | 9.447 | 8.851 | 8.313 | 7.824 | 6.974 | 6.265 | 5.668 | 4.730 |
| 17 | 11.274 | 10.477 | 9.763 | 9.122 | 8.544 | 8.022 | 7.120 | 6.373 | 5.749 | 4.775 |
| 18 | 11.690 | 10.828 | 10.059 | 9.372 | 8.756 | 8.201 | 7.250 | 6.467 | 5.818 | 4.812 |
| 19 | 12.085 | 11.158 | 10.336 | 9.604 | 8.950 | 8.365 | 7.366 | 6.550 | 5.877 | 4.843 |
| 20 | 12.462 | 11.470 | 10.594 | 9.818 | 9.129 | 8.514 | 7.469 | 6.623 | 5.929 | 4.870 |
| 25 | 14.094 | 12.783 | 11.654 | 10.675 | 9.823 | 9.077 | 7.843 | 6.873 | 6.097 | 4.948 |
| 30 | 15.373 | 13.765 | 12.409 | 11.258 | 10.274 | 9.427 | 8.055 | 7.003 | 6.177 | 4.979 |

income potential but may, in fact, add to the property value for reasons other than income potential.

FLB sales allows one to compare sales price differentials between tracts of land having pecan acreage with open land. Sales data was obtained for the past 3 years and these sales are listed in the attachments. A rough estimate of the difference in land values (pecan land vs. open land) was obtained by (1) multiplying total acreages of pecan land by its respective selling price and getting an average price per acre; (2) multiplying total acreage of open land by its respective selling price and getting an average price per acre, and (3) getting the difference in these 2 average prices.

The analysis showed the following:

Baldwin County

| | |
|---|---|
| Average price per acre with pecans | $3,298 |
| Average price per acre without pecans | 2,275 |
| Differential | $1,023 |

Mobile County

| | |
|---|---|
| Average price per acre with pecans | $3,623 |
| Average price per acre without pecans | 1,952 |
| | $1,661 |

Again, assuming 12 trees per acre, this translates into a $85-140 per tree value. This is approximately the same value shown using the incomes approach.

Conversations with accredited rural appraisers in the Albany, Georgia area (a major pecan producing area) indicated that values placed on trees in that area were about $500-1,000 per acre or in the $50-100 per tree range. The higher values placed on trees in the Baldwin-Mobile area can be explained somewhat by the fact that Baldwin-Mobile producers generally receive a price premium for their pecans and when this is extended over a 20-year period, one would naturally expect a higher tree value.

SELECTED FEDERAL LAND BANK SALES OF FARM PROPERTIES
1976-79 IN BALDWIN COUNTY

| Tracts with Pecans | | Tracts without Pecans | |
|---|---|---|---|
| Date | Sales Info | Date | Sales Info |
| Oct. 76 | 34 acres<br>$3,617/Ac ($4,412)[1/] | Feb. 77 | 71 acres<br>$1479/ac. (1,745) |
| Mar. 77 | 10 acres<br>$2,500/ac ($2925) | Jul. 77 | 25 acres<br>$2,000/ac (2300) |
| Apr. 77 | 10 acres<br>$4,500/ac (5265) | Jan. 78 | 60 acres<br>$1833/ac (2034) |
| Jul. 77 | 7 acres<br>$5,143/ac (5914) | Jan. 79 | 20 acres<br>$1,900/ac (1,476) |
| May 78 | 10 acres<br>$3,490/ac (3804) | Jan. 79 | 20 acres<br>$2,900/ac (3016) |
| Apr. 79 | 13 acres<br>$3,400/ac (3,502) | Feb. 79 | 40 acres<br>$2,737/ac (2846) |
| Jun. 79 | 60 acres<br>$2,216/ac (2,260) | June 79 | 10 acres<br>$2,250/ac (2318) |
| July 79 | 40 acres<br>$2,862/ac (2,890) | Aug. 79 | 20 acres<br>$3,250/ac (3250) |

1/ Sales prices were adjusted by a 7 percent annual inflation factor to get all sales on an October 1979 price basis. For example, the October 1976 sales price of $3,617/acre occurred 3 years ago. It was multiplied by 1.22 (7% for 3 years) to bring it to an estimated $4,412 sales price in October 1979. These adjusted sales prices (in parenthesis) were used in the analysis of comparing pecan land sales prices with open land sales prices.

SELECTED FEDERAL LAND BANK SALES OF FARM PROPERTIES
1976-79, MOBILL COUNTY

**Tracts with Pecans**

| Date | Sales Info |
|---|---|
| May 77 | 20 acres<br>$2,750/ac (3218)1/ |
| Mar. 78 | 40 acres<br>$3,325/ac (3674) |
| Jan. 79 | 13 acres<br>$3,477/ac (3640) |
| Oct. 79 | 9 acres<br>$4,222/ac (4333) |

**Tracts without Pecans**

| Date | Sales Info |
|---|---|
| Dec. 76 | 40 acres<br>$1.500/ac (1800) |
| July 77 | 40 acres<br>$2,000/ac (2300) |
| Mar. 78 | 160 acres<br>$1,517/ac (1676) |
| Mar. 78 | 20 acres<br>$2,750/ac (3039) |
| Apr. 78 | 23 acres<br>$1,966/ac (2163) |
| Jul. 79 | 10 acres<br>$2,900/ac (2930) |

1/ Sales prices were adjusted by a 7 percent annual inflation factor to get all sales on an October 1979 price basis. For example, the May 1977 sales price of $2,750 per acre occurred 2.3 years ago. This price was multiplied by 1.17 (7% x 2.3 years) to get an estimated $3,218 sales price in October 1979. These adjusted sales prices (in parenthesis) were used in the analysis of comparing pecan land sales prices with open land sales prices.

**Larkin H. Harris Real Estate, Inc.**

Larkin H. Harris
Thomas W. Harris
William L. Harris
Brokers

TO WHOM IT MAY CONCERN:

Appraisal Approach to Evaluating Pecan Tree Acreage Using Real Estate Values.

Steps normally used:

1) Total purchase price, or appraised value, of total acreage involved.

2) Base for land values for any given location.

3) Count of pecan trees.

4) Number of pecan trees on total acreage.

5) Value of pecan trees. (Total purchase price less land value.)

6) Total value of pecan trees divided by number of trees, thus deriving at value per tree.

Pecan acreage was selling in Baldwin County areas from $4,500 to $6,500 per acre prior to Hurricane Frederick.

The average value of tree prior to Hurricane normally fell in the following price ranges:

| | |
|---|---|
| 10 to 15 year old trees | $200 to $250 per tree |
| 16 to 20 year old trees | $250 to 300 per tree |
| 21 to 30 year old trees | $300 to $350 per tree |
| 31 to 40 year old trees | $350 to $400 per tree |

I, Larkin H. Harris, the undersigned, an experienced appraiser of pecan tree acreage, hereby certify that the above procedure is the approach that I use and have used for the past many years to justify my appraisal work, and believe it is a very realistic and fair method to abide by.

Larkin H. Harris
Larkin H. Harris

Factors that justify my appraisal and personal qualifications:
* Sales of similar properties and numerous similar appraisals.
* BS and MS Degrees in Agriculture from Auburn University.
* Manager/owner for 28 years of farm of 1,600 acres and 3,000 trees.
* Teacher of Vocational Agriculture for 11 years.
* Director and Officer of the Southwest Alabama Pecan Association, Director of the Southeastern Pecan Growers Association and Federated Pecan Association of America for 15 years.

COSTS OF RE-ESTABLISHING PECAN TREES

### Re-Establishment of Orchards

About 12,000 acres of pecans were destroyed by Frederic which translates to 144,000 trees. This number of trees is not presently available for replanting nor will their be in the immediate future. It is estimated that trees will be available for replanting in the Alabama Gulfcoast as shown by the following schedule:

1979 - 2500 trees or 100A
1980 - 5000 trees or 210A
1981 - 5000 trees or 210A
1982 - 10,000 trees or 415A
1983 - 25,000 trees or 1000A
1984 - 50,000 trees or 2100A
1985 - 50,000 trees or 2100A

The predominant tree spacing prior to hurricane Frederic was from 80' x 80' to 60' x 60' resulting in 10-12 trees per acre. Orchards that are replanted will be on a closer spacing -- probably 30' x 60' resulting in 24 trees per acre. Some orchards will also be established on a 32' x 40' spacing (34 trees/A) but there are no estimates available at this time to determine what amount of this particular spacing will be used.

Table 10 gives the expected costs per year for establishing and maintaining an acre of pecans until they begin bearing. Budgets were prepared showing 1979 costs. Due to inflation, these costs are expected to rise at an annual rate of 10% per year. This rise in costs is already calculated for years 1980-92 in Table 10.

Table 11 takes the yearly figures in Table 10 for a 30' x 60' spacing and projects the 7-year total cost of taking an acre of trees up to bearing age (8 years). Because of cost inflation, it becomes progressively more expensive over time to grow pecans. We project that the replanting of the 144,000 destroyed pecan trees cannot be completed until 1985. This delay in planting (because of the lack of available transplants) is quite costly in re-establishing the Gulfcoast pecan industry. The bottom of Table 11 estimates the total cost of replacing the destroyed trees.

Total acres replanted (about 6000A) is about half of the estimated acres destroyed (12,000A) because of the 30' x 60' closer spacing used in the replanted orchards.

Table 10

PROJECTED YEARLY PER ACRE COSTS FOR ESTABLISHING
AND MAINTAINING PECANS UNTIL THEY BEGIN BEARING*

| | Close Spacing (32' x 40') | | Wide Spacing (30' x 60') | |
|---|---|---|---|---|
| | Establishment | Maintenance | Establishment | Maintenance |
| 1979** | $ 511 | $ 232 | $ 374 | $ 153 |
| 1980 | 562 | 255 | 411 | 168 |
| 1981 | 618 | 280 | 452 | 185 |
| 1982 | 680 | 309 | 497 | 203 |
| 1983 | 748 | 339 | 547 | 224 |
| 1984 | 823 | 373 | 602 | 246 |
| 1985 | | 411 | 662 | 271 |
| 1986 | | 452 | 728 | 298 |
| 1987 | | 497 | | 327 |
| 1988 | | 547 | | 360 |
| 1989 | | 601 | | 396 |
| 1990 | | | | 437 |
| 1991 | | | | 481 |
| 1992 | | | | 529 |

* Establishment costs occur in year 1. Maintenance costs represent an average of years 2-7 until nuts are harvested in year 8.

** 1979 costs come from actual budgets. Costs for following years include 10 percent inflation factor (ie. 1979 costs x 1.10)

PER ACRE COST OF ESTABLISHING AND MAINTAINING
PECANS TO BEARING AGE*, 30 x 60 FOOT SPACING

| Tree Age | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
|---|---|---|---|---|---|---|---|
| 1 yr. | $411** | 452 | 497 | 547 | 602 | 662 | 728 |
| 2 yrs. | 185 | 203 | 224 | 246 | 271 | 298 | 327 |
| 3 yrs. | 203 | 224 | 246 | 271 | 298 | 327 | 360 |
| 4 yrs. | 224 | 246 | 271 | 298 | 327 | 360 | 396 |
| 5 yrs. | 246 | 271 | 298 | 327 | 360 | 396 | 437 |
| 6 yrs. | 271 | 298 | 327 | 360 | 396 | 437 | 481 |
| 7 yrs. | 298 | 327 | 360 | 396 | 437 | 481 | 529 |
| Cash Cost Until Bearing Age | $1838 | $2021 | $2223 | $2425 | $2691 | $2961 | $3258 |
| Cash Cost Plus Accumulated Interest Charges (@ 10%)*** | $2516 | $2763 | $3041 | $3351 | $3689 | $4053 | $4452 |

* Trees are assumed to bear in the 8th year.

** These costs are taken from Table 10 and reflect a 10% inflation rate.

*** These cost figures do not include a charge for land or management.

PROJECTED COSTS FOR MOBILE AND BALDWIN COUNTIES, 1980-92

| Year | Acres Planted | Per Acre Cost to Bearing Age | Total Cost |
|---|---|---|---|
| 1980 | 100 | $2516 | $251,600 |
| 1981 | 210 | 2763 | 580,230 |
| 1982 | 210 | 3041 | 638,610 |
| 1983 | 415 | 3351 | 1,390,665 |
| 1984 | 1000 | 3689 | 3,689,000 |
| 1985 | 2100 | 4053 | 8,511,300 |
| 1986 | 2100 | 4452 | 9,349,200 |
| | 6135 acres | | |
| Total cost of tree replacement and maintenance to bearing age | | | $24,410,615 |

Average cost per acre $\frac{\$24,410,615}{6135 \text{ acre}}$ = $3979/AC

Average cost per tree $\frac{\$3979/AC}{24 \text{ Trees/AC}}$ = $166/Tree

PECANS, IMPROVED VARIETIES, RECOMMENDED MANAGEMENT PRACTICES
ESTIMATED ESTABLISHMENT COSTS PER ACRE (YEAR 1)
BASED ON 30 X 60 FOOT SPACING, ALABAMA GULFCOAST, 1979

| | UNIT | PRICE OR COST/UNIT | QUANTITY | VALUE OR COST |
|---|---|---|---|---|
| 1. GROSS RECEIPTS | | | | |
| TOTAL | | | | 0.0 |
| 2. VARIABLE COSTS | | | | |
| PREHARVEST | | | | |
| TREES | EACH | 6.00 | 24.00 | 144.00 |
| LIME | TONS | 20.00 | 2.00 | 40.00 |
| FERTILIZER | CWT. | 6.50 | 2.00 | 13.00 |
| ZINC | LBS. | 0.25 | 48.00 | 12.00 |
| HERBICIDE | APL. | 4.50 | 2.00 | 9.00 |
| HIRED LABOR | HR. | 4.00 | 20.00 | 80.00 |
| PRUNING | ACRE | 3.50 | 1.00 | 3.50 |
| WATERING | ACRE | 20.00 | 1.00 | 20.00 |
| MACHINERY | ACRE | 0.83 | 1.00 | 0.83 |
| TRACTORS | ACRE | 5.65 | 1.00 | 5.65 |
| INTEREST ON OP. CAP. | DOL. | 0.12 | 205.56 | 24.67 |
| SUBTOTAL, PRE-HARVEST | | | | 352.65 |
| HARVEST COSTS | | | | |
| SUBTOTAL, HARVEST | | | | 0.0 |
| TOTAL VARIABLE COST | | | | 352.65 |
| 3. INCOME ABOVE VARIABLE COSTS | | | | -352.65 |
| 4. FIXED COSTS | | | | |
| MACHINERY | ACRE | 3.07 | 1.00 | 3.07 |
| TRACTORS | ACRE | 6.67 | 1.00 | 6.67 |
| TOTAL FIXED COSTS | | | | 9.74 |
| 5. LABOR COSTS | | | | |
| PREHARVEST LABOR(TRAC & MACH) | HOUR | 4.00 | 2.95 | 11.81 |
| TOTAL LABOR COSTS | | | | 11.81 |
| 6. TOTAL COSTS | | | | 374.20 |
| 7. NET RETURNS TO LAND AND MANAGEMENT | | | | -374.20 |

TREE SIZE AT PLANTING IS 4-6 FEET HIGH
FERTILIZATION RATE (26-26-26)

BUDGET IDENTIFICATION NUMBER --- [illegible]
ANNUAL CAPITAL MONTH 11

59-897 0 - 80 - 15

PECANS, IMPROVED VARIETIES, PRE-PRODUCTION
BASED ON 30 X 60 FOOT SPACING, 50 ACRE ORCHARD, NONBEARING TREES
ESTIMATED MAINTENANCE COSTS PER ACRE, ALABAMA, 1979

| | UNIT | PRICE OR COST/UNIT | QUANTITY | VALUE OR COST |
|---|---|---|---|---|
| 1. GROSS RECEIPTS | | | | |
| TOTAL | | | | 0.0 |
| 2. VARIABLE COSTS | | | | |
| PREHARVEST | | | | |
| AMMONIUM NITRATE | CWT. | 6.50 | 1.00 | 6.50 |
| FERTILIZER | CWT. | 6.80 | 1.00 | 6.80 |
| ZINC | LBS. | 0.22 | 24.00 | 5.28 |
| LIME | TONS | 16.00 | 0.25 | 4.00 |
| INSECTICIDE | APL. | 5.25 | 4.00 | 21.00 |
| FUNGICIDE | APL. | 8.10 | 5.00 | 40.50 |
| HERBICIDE | APL. | 5.25 | 3.00 | 15.75 |
| TRAINING | ACRE | 7.50 | 1.00 | 7.50 |
| REPLANTING | ACRE | [illegible] | 1.00 | 3.00 |
| MACHINERY | ACRE | 1.57 | 1.00 | 1.57 |
| TRACTORS | ACRE | 4.64 | 1.00 | 4.64 |
| INTEREST ON OP. CAP. | DOL. | [illegible] | [illegible] | 7.23 |
| SUBTOTAL, PRE-HARVEST | | | | 123.77 |
| HARVEST COSTS | | | | |
| SUBTOTAL, HARVEST | | | | 0.0 |
| TOTAL VARIABLE COST | | | | 123.77 |
| 3. INCOME ABOVE VARIABLE COSTS | | | | -123.77 |
| 4. FIXED COSTS | | | | |
| MACHINERY | ACRE | 4.11 | 1.00 | 4.11 |
| TRACTORS | ACRE | 7.64 | 1.00 | 7.64 |
| TOTAL FIXED COSTS | | | | 11.75 |
| 5. LABOR COSTS | | | | |
| PREHARVEST LABOR(TRAC & MACH) | HOUR | 4.00 | 4.38 | 17.53 |
| TOTAL LABOR COSTS | | | | 17.53 |
| 6. TOTAL COSTS | | | | 153.05 |
| 7. NET RETURNS TO LAND AND MANAGEMENT | | | | -153.05 |

FERTILIZER RATES USED (36-15-00) BASED ON MEDIUM LEVEL OF SOIL FERTILITY
INSECTICIDES & FUNGICIDES APPLIED AT MINIMAL RATES TO CONTROL PESTS
WHICH COULD SLOW DOWN TREE GROWTH.

BUDGET IDENTIFICATION NUMBER --- 96 000510 [illegible]
ANNUAL CAPITAL MONTH 11

PECANS, IMPROVED VARIETIES, RECOMMENDED MANAGEMENT PRACTICES
ESTIMATED ESTABLISHMENT COSTS PER ACRE (YEAR 1)
BASED ON 32 X 40 FOOT SPACING, ALABAMA GULFCOAST, 1979

| | UNIT | PRICE OR COST/UNIT | QUANTITY | VALUE OR COST |
|---|---|---|---|---|
| 1. GROSS RECEIPTS | | | | |
| TOTAL | | | | 0.0 |
| 2. VARIABLE COSTS | | | | |
| PREHARVEST | | | | |
| TREES | EACH | 6.00 | 34.00 | 204.00 |
| LIME | TONS | 20.00 | 2.00 | 40.00 |
| FERTILIZER | CWT. | 6.50 | 2.00 | 13.00 |
| ZINC | LBS. | 0.25 | 68.00 | 17.00 |
| HERBICIDE | APL. | 6.00 | 2.00 | 12.00 |
| HIRED LABOR | HR. | 4.00 | 25.00 | 100.00 |
| PRUNING | ACRE | 5.00 | 1.00 | 5.00 |
| IRRIGATION | ACRE | 55.00 | 1.00 | 55.00 |
| MACHINERY | ACRE | .85 | 1.00 | 0.85 |
| TRACTORS | ACRE | 5.73 | 1.00 | 5.73 |
| INTEREST ON OP. CAP. | DOL. | 0.12 | 281.84 | 33.82 |
| SUBTOTAL, PRE-HARVEST | | | | 486.40 |
| HARVEST COSTS | | | | |
| SUBTOTAL, HARVEST | | | | 0.0 |
| TOTAL VARIABLE COST | | | | 486.40 |
| 3. INCOME ABOVE VARIABLE COSTS | | | | -486.40 |
| 4. FIXED COSTS | | | | |
| MACHINERY | ACRE | 3.10 | 1.00 | 3.10 |
| TRACTORS | ACRE | 6.75 | 1.00 | 6.75 |
| TOTAL FIXED COSTS | | | | 9.85 |
| 5. LABOR COSTS | | | | |
| PREHARVEST LABOR (TRAC & MACH) | HOUR | 4.00 | 3.69 | 14.76 |
| TOTAL LABOR COSTS | | | | 14.76 |
| 6. TOTAL COSTS | | | | 511.01 |
| 7. NET RETURNS TO LAND AND MANAGEMENT | | | | -511.01 |

TREE SIZE AT PLANTING, [illegible]-6 FEET HIGH
IRRIGATION SYSTEM INSTALLED COST: [illegible] PER ACRE
FERTILIZATION RATE (20-20-20)

MODULE [illegible] --- [illegible]
[illegible] CAPITAL [illegible]

PECANS, IMPROVED VARIETIES, PRE-PRODUCTION
BASED ON 32 X 40 FOOT SPACING, 50 ACRE ORCHARD, NONBEARING TREES
ESTIMATED MAINTENANCE COSTS PER ACRE, ALABAMA, 1979

| | UNIT | PRICE OR COST/UNIT | QUANTITY | VALUE OR COST |
|---|---|---|---|---|
| 1. GROSS RECEIPTS | | | | |
| TOTAL | | | | 0.0 |
| 2. VARIABLE COSTS | | | | |
| PREHARVEST | | | | |
| AMMONIUM NITRATE | CWT. | 6.80 | 1.50 | 10.20 |
| FERTILIZER | CWT. | 6.50 | 1.00 | 6.50 |
| ZINC | LBS. | 0.22 | 34.00 | 7.48 |
| LIME | TONS | 16.00 | 0.25 | 4.00 |
| INSECTICIDE | APL. | 5.25 | 4.00 | 21.00 |
| FUNGICIDE | APL. | 8.10 | 5.00 | 40.50 |
| HERBICIDE | APL. | 8.00 | 3.00 | 24.00 |
| TRAINING | ACRE | 10.00 | 1.00 | 10.00 |
| IRRIGATION | ACRE | 55.00 | 1.00 | 55.00 |
| REPLANTING | ACRE | 2.00 | 1.00 | 2.00 |
| MACHINERY | ACRE | 1.82 | 1.00 | 1.82 |
| TRACTORS | ACRE | 5.44 | 1.00 | 5.44 |
| INTEREST ON OP. CAP. | DOL. | 0.12 | 87.97 | 10.56 |
| SUBTOTAL, PRE-HARVEST | | | | 198.50 |
| HARVEST COSTS | | | | |
| SUBTOTAL, HARVEST | | | | 0.0 |
| TOTAL VARIABLE COST | | | | 198.50 |
| 3. INCOME ABOVE VARIABLE COSTS | | | | -198.50 |
| 4. FIXED COSTS | | | | |
| MACHINERY | ACRE | 4.65 | 1.00 | 4.65 |
| TRACTORS | ACRE | 8.96 | 1.00 | 8.96 |
| TOTAL FIXED COSTS | | | | 13.62 |
| 5. LABOR COSTS | | | | |
| PREHARVEST LABOR(TRAC & MACH) | HOUR | 4.00 | 4.90 | 19.59 |
| TOTAL LABOR COSTS | | | | 19.59 |
| 6. TOTAL COSTS | | | | 231.71 |
| 7. NET RETURNS TO LAND AND MANAGEMENT | | | | -231.71 |

FERTILIZER RATES USED (51-15-30) BASED ON MEDIUM LEVEL OF SOIL FERTILITY
INSECTICIDES & FUNGICIDES APPLIED AT MINIMAL RATES TO CONTROL PESTS
WHICH COULD SLOW DOWN TREE GROWTH.

BUDGET IDENTIFICATION NUMBER --- 96 000510 103 1
ANNUAL CAPITAL MONTH 11

SECONDARY EFFECTS ON THE ECONOMY

SECONDARY ECONOMIC EFFECTS

*Machinery Industry - Commercial pecan production requires the use of specialized, expensive machinery and equipment to care for the trees during the growing season and harvest the nuts at the end of the season. Farm machinery dealers in the two counties were averaging sales in pecan equipment in excess of $350,000 per year. In addition, repair and maintenance for pecan equipment provided another $150,000 in business to these machinery dealers.

Estimates from dealers show that $300,000 of this business will be lost in 1979. Furthermore, there will be little or no market for pecan equipment in these two counties until significant production can be resumed - at the earliest 1987, more likely in 1991.

*Chemical Industry - Commercial pecan production is a heavy user of chemical insecticides and fungicides. Growers used approximately 10 sprays per year at an average cost in 1979 of $136.00 per acre for the chemical materials. Due to inflation this cost is expected to be $150/A in 1980. Very few or none of these materials will be used on the Gulf Coast in 1980 resulting in a $1,650,000 loss to the chemical industry. Reduction in the use of herbicides will result in an additional $50,000 sales loss, raising the 1980 total sales loss to the chemical industry to $1.7 million.

Chemical sales to the pecan industry will gradually increase as pecan trees are brought back into production, but sales (in 1979 value dollars) cannot be expected to reach the 1979 levels again until 2005.

Fertilizer and lime sales can be expected to be off 75 percent in 1980 resulting in a loss of $350,000 in sales. As orchards are replanted, fertilizer use will increase but will remain at lower levels than 1979 until 2005. (NOTE: Chemical and fertilizer usage are based on the size of the tree and maximum levels of use do not occur until the tree is 15-20 years old)

*Labor - Two types of labor are involved in pecans. Production labor is needed during the growing season and this amounted to approximately 132,000 man-hours in the two counties valued at $528,000. There were no estimates available on what proportion of this labor is done by owner-operators and what portion is done by hired labor. A reasonable assumption would be a 50-50 split. Regardless of the split, the amount of labor needed by the industry will be drastically reduced until sufficient trees are available for replanting - around 1984.

The other type labor is harvest labor. Estimates from growers and buyers show that at least 50 percent of the commercial pecan production and all of the home orchards are still harvested by hand. Some of the production from home orchards is picked up by the owner and no harvest fee is charged. However, assuming that half of the expected total production this year (6,150,000 lbs.) would have been picked up by hand at an average "piece meal" rate of $ .10 per pound, lost income from hand harvest labor amounts to $615,000.

More important than the magnitude of this loss is the sector of the economy that it

affects. The majority of this hand labor comes from low-income families. Pecan labor income greatly increases their spendable income during the harvest months. The money they earn is spent quickly so it affects an immediate boost to the local economy. No estimates are available on how many people are involved in pecan harvesting but the 1979 crop would have provided approximately 25,000 man-days of harvest work.

## TOTAL DIRECT IMPACT ON COMMERCIAL GROWERS

| | |
|---|---|
| 1979 Crop Loss | $10,453,000 |
| Cleanup Cost | $ 7,901 250 |
| Loss in property | |
| Value ($140/tree x 12 trees x 11,000) | $18,480,000 |
| Total Estimated Loss | $36,834,250 |

**Chairman:** Andrew C. Sigler, Champion International Corporation, Stamford, Connecticut • **Senior Vice Chairman:** A. Felton Andrews, Andrews Timber Company, Memphis, Tennessee • **Vice Chairman:** Bradford S. Wellman, Seven Islands Land Company, Bangor, Maine • **Treasurer:** Charles H. Gebhardt, The Mead Corporation, Dayton, Ohio • **General Counsel:** William K. Condrell, Washington, D.C.

*Forest Industries Committee on*

# TIMBER VALUATION AND TAXATION

1250 Connecticut Avenue, Washington, D.C. 20036 (202) 223-2314

SUMMARY AND STATEMENT OF

G. ROBIN SWIFT, JR.
PRESIDENT
SWIFT LUMBER, INC.

ON BEHALF OF THE

FOREST INDUSTRIES COMMITTEE ON
TIMBER VALUATION AND TAXATION

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

SENATE FINANCE COMMITTEE

FEBRUARY 29, 1980

FORREST INDUSTRIES COMMITEE ON
TIMBER VALUATION AND TAXATION

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

SENATE FINANCE COMMITTEE

FEBRUARY 29, 1980

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SUMMARY STATEMENT OF

G. ROBIN SWIFT, JR.



Mr. Chairman, the Forest Industries Committee on Timber Valuation and Taxation is an organization of forestland owners of all sizes and from all regions of the country. We are delighted that these hearings are being held on the subject of casualty losses.

Casualties represent a major problem for timber owners, principally for two reasons:

1. They face the constant risk that their timber will be destroyed in whole or in part by disease, insects, hurricanes, ice storms, floods, or other casualties. They face this risk alone. Commercial insurance against such casualties is not available for timber owners.

2. Current tax treatment of casualty losses is inadequate for timber owners, with the result that they often do not have sufficient cash following the casualty to make reinvestments in timber.

The risk of casualties and the lack of cash for reinvestment have the effect of reducing timber plantings and, ultimately, timber supply. Unless steps are taken to increase timber supply, we will be unable to meet the projected demands for timber in the decades to come.

Under current law, casualty loss deductions for timber owners are generally limited to the adjusted basis in the property.

This deduction will often be far lower than the taxpayer's true economic loss.*/

There are many alternative means of changing the Internal Revenue Code to address this problem. The Forest Industries Committee on Timber Valuation and Taxation is currently in the process of studying these alternatives and looks forward to working closely with the Congress as action progresses in this area.

The approach presently being discussed--Senator Heflin's bill, S. 1901--is sound legislation and we recommend its favorable consideration by the Congress. S. 1901 would do a great deal to relieve the impact of casualty losses on timber owners.

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*/ Under current law, the casualty loss deduction which a timber owner is permitted to take is equal to the lesser of the decline in the fair market value of the property (the taxpayer's "economic loss") and the amount of the adjusted basis. Because of the long holding period for timber, the effects of inflation, and the fact that it is a growing resource, the adjusted basis of the timber will often be small in relation to its current fair market value. Under such circumstances, the true economic loss suffered by the timber owner who is the victim of a casualty will generally be far greater than his adjusted basis. But his casualty loss deduction will be limited to the lower figure, *i.e.*, the adjusted basis.

STATEMENT OF

G. ROBIN SWIFT, JR.

Mr. Chairman, the Forest Industries Committee on Timber Valuation and Taxation speaks on behalf of more than five million forestland owners of all sizes and from all regions of the country. In addition, the Committee works with 64 Cooperating Associations, the names of which are attached to this testimony as Appendix A.

The principal public policy objective of our Committee is the attainment and preservation of equitable Federal tax provisions that reflect the long-term nature of forest investments and the unique risks involved.

The risks for investments in timber are many. By the time the timber is ready for harvest, the market for wood products may not be favorable. Taxes on harvested timber may have increased to such an extent that the owner's after-tax return on his investment may have been drastically reduced.*/

Perhaps no risk is more frightening, however, than the risk that the timber owner's investment will be destroyed in whole or in part by disease, insects, hurricanes, ice storms, floods, or other casualties.

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*/ Consider for example, the effect of the virtual doubling of the maximum capital gains tax rate (and imposition of the so-called "minimum" tax) between 1969 and 1977.

In this testimony, we urge this Subcommittee to begin serious consideration of legislation to address the risk of casualty losses faced by timber owners. We support enactment of Senator Heflin's bill, S. 1901.

## I. The Importance of an Adequate Timber Supply

As indicated above, our Committee strongly supports tax provisions which reflect the uniqueness of timber investments. Such provisions will help to ensure an adequate timber supply for our nation in the future. This is a vital national goal.

### A. Forest Service Projections

During the last three decades, the Forest Service has periodically conducted studies of the projected supply and demand for timber in the nation. Each of these studies has concluded that demand is expected to increase rapidly. In fact, the most recent Forest Service projection is that domestic demand for paper and wood products will double by the year 2030. Specifically, demand for paper and wood products is expected to reach 28.7 billion cubic feet in the year 2030, up from 13.3 billion cubic feet in 1976. Table I summarizes the projected supply/demand situation, and shows that by the year 2030, demand is expected to exceed supply by 4.4 billion cubic feet per year.

Table I

Summary of U.S. supply and demand for softwoods and hardwoods in 1976 and for 2030*/

| Category | - Billion Cubic Feet - 1976 | 2030 |
|---|---|---|
| Softwoods | | |
| Total U.S. demand | 10.3 | 19.9 |
| Exports | 1.3 | 1.0 |
| Imports | 2.4 | 3.9 |
| Demand on U.S. forests | 9.2 | 17.0 |
| Supply from U.S. forests | 9.2 | 13.5 |
| Supply/demand balance | 0.0 | -3.5 |
| Hardwoods | | |
| Total U.S. demand | 3.0 | 8.8 |
| Exports | 0.2 | 0.4 |
| Imports | 0.3 | 0.6 |
| Demand on U.S. forests | 2.9 | 8.6 |
| Supply from U.S. forests | 2.9 | 7.7 |
| Supply/demand balance | 0.0 | -0.9 |
| All timber | | |
| Total U.S. demand | 13.3 | 28.7 |
| Exports | 1.5 | 1.4 |
| Imports | 2.7 | 4.5 |
| Demand on U.S. forests | 12.1 | 25.6 |
| Supply from U.S. ferests | 12.1 | 21.2 |
| Supply/demand balance | 0.0 | -4.4 |

Source: U.S. Forest Service

One of the principal reasons why insufficient timber supplies are projected for the future is because there are currently inadequate levels of reforestation on our nation's private forestlands.

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*/ Assumes price rises similar to those experienced from late 1950's to mid-1970's.

It is estimated that only one out of seven acres in the Southeast and one out of nine acres in the South Central region are being adequately regenerated.

B. Hazards of Forest Investments

Reforestation remains inadequate because a variety of factors have dissuaded forestland owners from making timber investments. Private non-industrial landowners make comments like the following:

1. I'll die before the trees are old enough to cut.
2. The initial capital investment costs (land preparation, roads, plantings) and annual maintenance costs are too high to justify waiting 20-40 years for a return.
3. There is no annual income in timber growing like rents or dividends on other investments.
4. I'm scared that Uncle Sam will take whatever profits I make away from me with confiscatory taxes.

In addition, there is the constant fear that disaster will strike--that trees will be killed or infected by pine beetles, or tussock moths, or budworms; or that an Act of God, such as an ice storm, hurricane or flood will destroy or severely damage the investment.

Hurricane Frederic, which ravaged the Gulf Coast States on September 12, 1979, provides a vivid reminder of the impact which hurricanes and other disasters can have on timberland owners. The estimated timber damage in Alabama

alone as a result of the hurricane was $333.4 million. This amount exceeds the average annual timber cut in Alabama of $225 million.

It is estimated that only 40 percent of the damaged timber will be able to be salvaged. The remainder will be lost due to deterioration or insect infestation.

In Mississippi the loss was also substantial--$116.9 million.

There were many instances where stands of excellent sawtimber, which were valued at approximately $200 per thousand board feet the afternoon before the hurricane hit, were reduced to pulpwood valued at $15 per cord the following morning.

Hurricane Camille, which struck the Gulf Coast almost exactly one decade earlier, had an impact almost as great as Hurricane Frederic.

Hurricanes are not the only source of casualty losses for timber owners. Fires, for example, can wipe out an investment overnight. The Forest Service estimates that between 1973 and 1977, there were an average of 162,879 fires reported each year on all commercial forestlands, burning an average of 3.1 million acres per year.

C. Need for Additional Capital

In response to the problem of inadequate investments, timber owners, in cooperation with the Forest Service, initiated a study of timber productivity in 1976. This forest productivity project evaluated the need for additional investments in timber growth on over 400 million acres of commercial forestland in 25 states.

It was found that in the 25 states there are a total of 138.6 million acres which have investment opportunities which could provide a 10 percent after-tax return. The capital needed for this acreage is $10.1 billion and would improve annual growth by 10.9 billion cubic feet.

But this additional $10.1 billion in timber investments will not be made unless the incentives are sufficient. Steps must be taken by the Congress to reduce the disincentives discussed above.

Only if this is done will we be able to anticipate and prepare for the timber supply needs of the United States by the year 2030 and beyond. We cannot wait until the shortage is upon us to take remedial action. We will never find a way to grow a tree in that short a time.

Providing reasonable tax treatment of timber casualty losses is one of the important steps which should be taken. It will encourage investment in reforestation by both reducing the risk to some extent and providing at least some further funds for reinvestment following the casualty.

D. Importance of Timber Growing to National Economy

Over 5,000 consumer products are derived from our forests--commodities which are essential to education, communication, sanitation and health and many of which contribute in unique ways to the maintenance of the American standard of living. A side benefit is that growing forests contribute significantly to the overall ecosystem.

Forest Service statistics show that for every dollar that is invested in timber management, a total of $17 is generated in other economic activity. This is illustrated in Table II.

Table II

Estimated value added and employment by total and that attributable to timber in timber-based economic activities, 1972.

| Economic activity | Value Added (MMM$) Attributed to timber | Employment (MM People) Attributed to timber |
|---|---|---|
| Timber management | 2.9 | 0.1 |
| Harvesting | 3.1 | 0.2 |
| Primary manufacturing | 8.8 | 0.4 |
| Transportation and marketing | 9.3 | 0.8 |
| Secondary manufacturing | 12.5 | 0.9 |
| Construction | 11.9 | 0.8 |
| Total | 48.5 | 3.2 |

Source: U.S. Forest Service, Unpublished

The reference to "timber management" in Table II indicates that the value of timber that was harvested in 1972 was $2.9 billion on the stump. Harvesting added $3.1 billion in value, primary manufacturing added $8.8 billion, etc.

An incentive to help private non-industrial forest owners manage their lands rather than neglecting them will benefit the entire nation. The "ripple" through other industries will create wealth and add to the national tax base.

E. Environmental Considerations

Unlike other basic resources, forests are renewable. Timber, a storehouse of solar energy, is most compatible with man's use in his present environment because of its strength, it versatility, its ease of production, and its biodegradability.

In addition to the quality of renewability, wood has significant environmental advantages over other materials in the processing stage. Timber products are produced and processed with much lower energy requirements and with relatively little adverse environmental effect. Processing steel for construction, for instance, takes 8.4 times the energy of processing lumber for the same purpose. For aluminum, it takes 45 times the energy.

Production of wood substitutes also creates more air, water and solid waste pollution than does the production of wood. Much of wood fiber can be recycled. What is not is biodegradable and returns to the earth. Charts I and II compare the low energy and pollution cost of processing solid wood products compared with other substitutes.

Chart I

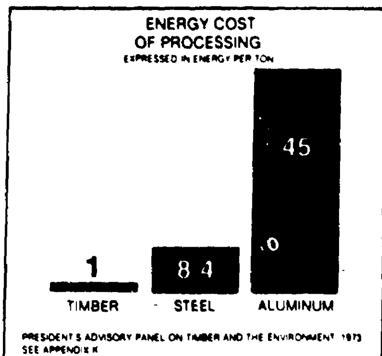
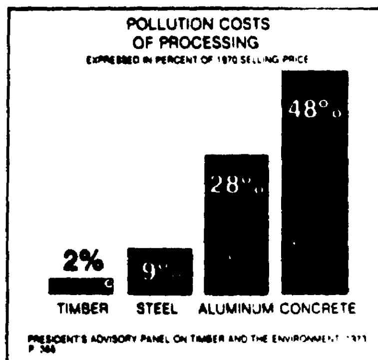



Chart II




Moreover, timberlands help provide a home for our wildlife, support livestock herds, provide recreational opportunities, and are an important element in the conversion of carbon dioxide to oxygen.

F. Impact of Timber Supply on Cost of Living

Shortfalls of timber supply have in the past exerted pressure on the price of wood building materials and housing. The President's chief inflation-fighter, Alfred Kahn, stated in 1979 that ". . . inflation in housing has been a result . . . of limitations on the supply side. The soaring price of lumber has played a major role."

The effects of the increase in the price of housing reverberate through the entire economy.

C. Balance of Payments

The increased prices for our wood products make them less competitive in domestic and world markets. The failure to increase our domestic timber production will result in our increasing dependence on imports of wood from other countries, particularly Canada. Lee Smith's article in the November 5, 1979, issue of Fortune magazine, entitled "The Neglected Promise of Our Forests", outlined the potential for timber production and the extent of the problem:

> The United States is peculiarly well endowed to be the most efficient producer of useful wood in the world. Competitors, chiefly Canada, Scandinavia, the U.S.S.R., and Brazil, all have special strengths, but no other country has such a favorable combination of advantages as the U.S., including high-quality species of trees, warm climate, relatively low labor costs, an extensive transportation network, and abundant factories to turn trees into everything from Pampers to rocking chairs.
>
> Yet the U.S. trade deficit in forest products has tripled in the seventies. Last year it reached a record $2.9 billion, 7.4 percent of the nation's total $39-billion trade deficit. In an era when the U.S. is being drained of dollars to pay the staggering cost of foreign oil, it is paying a needlessly hefty sum to import wood and paper despite its enormous stands of trees.

II. Timber Casualty Losses: Current Law, The Impact on Timber Owners, and the Heflin Remedy

As discussed above, the threat of casualty losses is one of the many reasons why some forestland owners are

reluctant to make investments in timber. This section of our testimony will review the current tax treatment of casualty losses, why timber owners are uniquely impacted, and how S. 1901 would address the problem.

A. Current Law

Under current law, a taxpayer is permitted to receive a deduction for casualty losses. The amount of the deduction is equal to the lesser of the decline in fair market value of the property and the amount of the adjusted basis. A summary of the tax treatment of timber casualty losses is attached as Appendix B.

Take, for example, the situation of a timber owner who has an adjusted basis of $5,000 in his timber which was purchased many years ago. Assume further that due to inflation and the growth of the trees that it has increased in value to $50,000. Finally, assume that the timber is totally destroyed by fire. The economic loss to the timber owner is $50,000, but the taxpayer's deduction is limited to $5,000.

B. Why Timber Owners Are Uniquely Impacted by Current Tax Treatment of Casualty Losses

1. Long Growing Period

Mark Twain was once asked, "How do you start a forest?" He is reported to have responded, "You start a long time ago."

Depending on the region, tree species and forest management practices, timber crops take between 30 and 100 years to reach harvestable size. During this lengthy growing period, the timber will be increasing in value because of inflation and the nature of the investment, i.e., the fact that it is a growing resource.

As a result, there will often be a great disparity between the adjusted basis in the timber and its fair market value immediately prior to the casualty. Under such circumstances, the casualty loss deduction (which is limited to the timber's adjusted basis) will generally be far less than the true economic loss suffered by the timber owner.

2. Insurance Unobtainable

For most assets, even if there is a disparity between the adjusted basis and the fair market value, the owner is not overly concerned because he is able to obtain insurance to protect against an unforeseen disaster. Timber, however, is an exception to this general rule. Commercial insurance against fire, hurricanes, floods, ice storms and other losses resulting from weather is not available for timber owners.

C. Heflin Bill (S. 1901)

Senator Heflin's bill (S. 1901) is directed at reducing the impact of casualty losses on timber owners. Under the bill, for purposes of determining casualty loss deductions, the basis would be considered to be at least

equal to the fair market value of the timber immediately prior to the time the casualty was suffered. Thus, taking the example discussed on page 11, where the timber owner has an economic loss of $50,000 but his adjusted basis is only $5,000, he would be permitted to take a $50,000 deduction.

The Forest Industries Committee on Timber Valuation and Taxation is in the process of undertaking a careful review of this legislation and its impact on timber owners. Based on our analysis thus far, we would recommend the following changes in S. 1901.

1. On page 2 of the bill, in the paragraph on "carryover and carryback of excess deduction," the question has been raised as to whether the reference to "individual" applies to corporations as well. If not, it should be be amended to do so.
2. The bill should be made elective.
3. If the basis in the timber is reduced by the amount of the deduction, the basis reduction should stop at zero. There should not be a negative basis.

While there are a number of ways in which the casualty loss problem can be addressed, the Heflin approach would do a great deal to relieve the impact of casualty losses on timber owners. We support the thrust of the legislation and urge its favorable consideration by the Congress.

The Forest Industries Committee will be continuing its study of the impact of S. 1901 on timber owners. We look forward to working further with this Congress as action progresses on this important legislation.

III. Conclusion

All tree planters, from the small tree farmer to the giant corporation, have one thing in common--a very uncommon faith in the future. To spread that faith, we must take steps to encourage sufficient investment in timber growing to meet tomorrow's needs.

A variety of changes in the tax law are necessary to achieve this goal, including amendments to the casualty loss provisions. In this area, Senator Heflin's bill (S. 1901) is a logical starting point and we support its enactment.

# APPENDIX A
## COOPERATING ASSOCIATIONS

### NATIONAL ASSOCIATIONS

American Institute of Timber Construction

American Paper Institute

American Plywood Association

American Pulpwood Association

American Wood Preservers Association

American Wood Preservers Institute

Associated Cooperage Industries of America, Inc.

Federal Timber Purchasers Association

Fine Hardwoods-American Walnut Association

Hardwood Dimension Manufacturers Association

Hardwood Plywood Manufacturers Association

National Christmas Tree Growers Association

National Forest Products Association

National Hardwood Lumber Association

National Oak Flooring Manufacturers Association

National Particleboard Association

### REGIONAL ASSOCIATIONS

Appalachian Hardwood Manufacturers, Inc.

Forest Farmers Association

Industrial Forestry Association

Northeastern Lumber Manufacturers Association, Inc.

Northern Hardwood and Pine Manufacturers Association, Inc.

Pacific Logging Congress

Southeastern Lumber Manufacturers Association

Regional Associations (continued)

Southern Forest Products Association

Southern Hardwood Lumber Manufacturers Association

Southwest Pine Association

Western Forest Industries Association

Western Forestry and Conservation Association

Western Timber Association

Western Wood Preservers Institute

Western Wood Products Association

## STATE ASSOCIATIONS

Alabama Forestry Association

Alaska Loggers Association, Inc.

Arkansas Forestry Association

Associated Oregon Industries

California Forest Protective Association

Eastern North Carolina Lumber Manufacturers Association, Inc.

Florida Forestry Association

Georgia Forestry Association, Inc.

Kentucky Forest Industrial Association

Louisiana Forestry Association

Lumber Manufacturers Association of Virginia

Maine Forest Products Council

Maine Hardwood Association

Minnesota Timber Producers Association

Mississippi Forestry Association

Mississippi Pine Manufacturers Association

Missouri Forest Products Association

State Associations (continued)

New Hampshire Timberland Owners Association

New York Forest Owners Association

North Carolina Forestry Association

Oklahoma Forestry Association

Oregon Forest Protection Association

Society for the Protection of New Hampshire Forests

South Carolina Forestry Association

Southern Oregon Timber Industries Association

Tennessee Forestry Association

Texas Forestry Association

Timber Producers Association Inc. of Michigan and Wisconsin

Virginia Forestry Association

Washington Forest Protection Association

PROFESSIONAL AND PUBLIC INTEREST ASSOCIATIONS

Association of Consulting Foresters

National Council of Forestry Association Executives

Society of American Foresters

# APPENDIX B

# SUMMARY OF TAX TREATMENT OF TIMBER CASUALTY LOSSES



## VI

## CASUALTY LOSSES

### SECTION 165 OF THE CODE

Casualty losses fall within section 165(a) of the Code, which states the general rule that all uncompensated losses are deductible from ordinary income in the year sustained:

> There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Deductions under section 165(a) are limited by section 165(c) to three situations in the case of individuals (the limitations do not apply to corporations):

§ 165(c)(1) losses incurred in a trade or business;

§ 165(c)(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

§ 165(c)(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft . . . .[213]

Non-business casualty losses are specifically included in section 165(c)(3); business casualty losses are covered by section 165(c)(1); and casualty losses on property held for investment are covered by section 165(c)(2). Thus as to both individuals and corporations, casualty losses of timber owners are generally deductible under the Code.

It should be noted that sections 165(a) and 165(c)(1) and (2) are not limited to casualty losses. Only in the case of individuals holding non-business, non-investment property (*i.e.*, § 165(c)(3)) must it be demonstrated that losses come within the meaning of the term "casualty" in order to establish the right to a deduction.[214] For this reason the timber owner, whose timber holdings are almost always business or at least investment property, need not normally be concerned about whether his loss qualifies as a "casualty" loss from the point of view of establishing deductibility. Nonetheless, the definition of "casualty" may be important to him for two reasons. First, as will be seen below, specific Treasury Regulations have been issued (§ 1.165-7) which give the method for computing deductions for *all*

[213] Losses described in this paragraph are allowed only to the extent that the amount of loss to the individual exceeds $100.

[214] One writer has suggested that this is the proper way to read section 165(c)(3) but that "the Service in regulations and in rulings, many court decisions and some texts fail clearly to recognize that this section 165(c)(3) applies only to nonbusiness, non-investment property owned by individuals . . . ." Whitaker, *Timber Casualties*, 1 Timber Tax Journal 26 (1965).

"casualty losses," whether or not incurred in a trade or business or in any transaction entered into for profit. These regulations are applicable only if the loss is caused by a "casualty" within the meaning of that term as used in the regulations. And second, as will also be explained below, it may be necessary to demonstrate that a loss is caused by a "casualty" in order to avoid the application of section 1231(a), which requires that certain "non-casualty" losses from involuntary conversions be netted against section 1231 capital gains before being deducted from ordinary income.

## DEFINITION OF CASUALTY

As the language of section 165(c)(3) indicates, fires, storms and shipwrecks are "casualties" within the meaning of the Code. The term "casualty" has been limited to these and similar occurrences. Generally, courts have required that the loss must be sudden, unexpected or unusual, as contrasted with gradual deterioration through a steadily operating force.[215] The emphasis has been on suddenness. Consequently, if for example timber is first damaged by fire and then is gradually destroyed by insects or disease, the fire would be considered a casualty, but it is likely that the disease or insect infestation would not be.

In *Burns v. United States*,[216] it was held that loss of an elm tree afflicted with Dutch Elm disease was not a loss by casualty. The court there expressed the view that "loss occasioned by disease, however contracted, is not a casualty within the meaning of the statute."[217] *Appleman v. United States*,[218] held that loss due to the death of elm trees from phloem necrosis was not a "casualty" loss within the meaning of section 165(c)(3). The reason given was that "the element of unexpectedness was entirely lacking."

Termite damage has been considered in a number of cases. In some a deduction was allowed where it was found that the loss had the necessary degree of suddenness to qualify as a casualty.[219] The Service at one time took that position (Rev. Rul. 59-277, 1959-2 C.B. 73), but reconsidered it and in Rev. Rul. 63-232, 1963-2 C.B. 97, stated flatly that termite damage would not be considered deductible under 165(c)(3).

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[215] *See* cases cited in Deming, *Establishing Casuality and Disaster Losses*, 21 N.Y.U. Inst. on Fed. Tax 143, 144 (1963).

[216] 174 F. Supp. 203 (N.D. Ohio 1959), *aff'd* 284 F.2d 436 (6th Cir. 1960).

[217] 174 F. Supp. at 210.

[218] 338 F.2d 729 (7th Cir. 1964).

[219] *See* the cases cited in *Leslie C. Dodge*, 25 T.C. 1022 (1956), and *E.G. Kilroe*, 32 T.C. 1304 (1959).

The Tax Court has held that destruction caused by a mass attack of southern pine beetles on loblolly pine trees was both unexpected and sufficiently sudden to qualify as a casualty loss.[220]

## GENERAL REQUIREMENTS FOR DEDUCTION UNDER SECTION 165(a)

Under the regulations,[221] to be deductible under section 165(a) a loss must be:

(1) evidenced by closed and completed transactions;

(2) fixed by identifiable events; and

(3) actually sustained during the taxable year.[222]

The regulations go on to state that the loss must be bona fide and that "substance and not mere form shall govern in determining a deductible loss." The amount of the loss must be ascertainable and measurable, and a deduction may not be taken as long as there is a reasonable possibility of recovery or reimbursement.[223] Proper adjustment must be made for any salvage value and for any insurance or other compensation received.[224]

The requirements that a deductible loss be "evidenced by closed and completed transactions" and "fixed by identifiable events" do not mean that the loss must be sudden. Take again the example of timber which is damaged by fire and subsequently destroyed by insects or disease. Although the disease or insect destruction might not be sufficiently sudden to qualify as a "casualty," nevertheless, in *Oregon Mesabi Corp. v. Commissioner*,[225] the Tax Court held that such loss was deductible. The principal practical difficulty in such cases is in demonstrating when the loss occurred. In *Oregon Mesabi*, deductions over a period of six years were allowed. The test was stated by the court as follows: "[Petitioner] is entitled to deduct as a loss in each

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[220] *Herbert H. Nelson*, 27 T.C.M. 158 (1968). *Compare William R. Miller*, 29 T.C.M. 741 (1970), in which the taxpayer was denied a casualty deduction for the loss of ornamental trees which died several months after his yard was graded and leveled. In the Tax Court's view, the trees' death from root suffocation was the result of "progressive deterioration" not a *sudden* casualty.

[221] Treas. Reg. § 1.165-1(b).

[222] An exception to this requirement is provided in section 165(h) of the Code and § 1.165-11 of the regulations, which allow a taxpayer who suffers disaster loss after the close of his tax year but before the due date for filing his return to claim the loss in the year just ended. This applies only if the President determines that disaster assistance by the Federal Government is warranted.

[223] Treas. Reg. § 1.165-1(d).

[224] Treas. Reg. § 1.165-1(c)(4).

[225] 2 T.C.M. 475 (1943).

year that proportion of the cost of the timber which by fair and reasonable estimates can be found to have been destroyed in each year."[226]

It seems clear that the burden of proof is on the taxpayer to establish both the right to a deduction and the amount of the deduction.[227]

Deduction may be made for trees partially destroyed by casualty, as well as those totally destroyed.[228] Deduction may also be made for casualty damage to land, though the courts have required that losses for land and timber must be computed separately.[229] In *Broadhead v. Commissioner,*[230] the Tax Court allowed a deduction when fire so damaged land that it was no longer valuable for the growing of timber. Actual damage to the land must occur, however, in order for a decrease in the value of the land to be deductible as a loss under section 165. In *Squirt Co. v. Commissioner,*[231] a freeze which destroyed 230 acres of taxpayer's citrus trees did no actual damage to the soil, but nevertheless substantially reduced the fair market value of the taxpayer's land by triggering a general reduction in the demand for citrus land in the area because of a fear of future freezes. The taxpayer's deduction based on the decline in market value of his land was denied by the Tax Court, and the decision was affirmed on appeal by the Ninth Circuit. The Tax Court cited Treasury Regulation § 1.165-7(a)(2)(i) which provides that in measuring loss of market value for purposes of section 165, the deduction is "limited to the actual loss resulting from the *damage to the property.*"[232]

In the case of damage to standing timber, the Service has ruled that no deduction will be allowed if the damage does not render the trees unfit for use.[233] According to the ruling, damage which is not measurable in units of timber destroyed is not deductible, but is in the nature of a contemplated loss of future profits or potential income due to a reduction in the rate of growth or the quality of the timber. Such damage, according to the Service, does not meet the requirements for a casualty loss — an actual loss of tangible or measurable property.

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[226] *Id.* at 479.

[227] Blomeley v. Commissioner, 23 T.C.M. 514 (1964); Harper v. United States, 274 F. Supp. 809 (D.S.C. 1967).

[228] Krome v. Commissioner, 9 T.C.M. 178 (1950).

[229] Knepp v. Commissioner, 23 T.C. 716 (1955). *See also* Rev. Rul. 71-254, 1971-1 C.B. 78.

[230] 25 T.C.M. 133 (1966).

[231] 51 T.C. 543 (1969), *aff'd per curiam*, 423 F.2d 710 (9th Cir. 1970).

[232] The taxpayer in *Squirt Co.* was entitled to a deduction for the cost of clearing the dead or damaged trees from the land. *See also* Carloate Industries v. United States, 354 F.2d 814 (5th Cir. 1966).

[233] Rev. Rul. 73-51, 1973-1 C.B. 75.

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## AMOUNT OF DEDUCTION

Regulations promulgated to deal specifically with casualty losses give the following general rule for determining the amount deductible in casualty cases:[234]

> General rule — In the case of any casualty loss whether or not incurred in a trade or business or in any transaction entered into for profit, the amount of loss to be taken into account for purposes of section 165(a) shall be the lesser of either—
>
> (i) The amount which is equal to the fair market value of the property immediately before the casualty reduced by the fair market value of the property immediately after the casualty; or
>
> (ii) The amount of the adjusted basis prescribed in § 1.1011-1 for determining the loss from the sale or other disposition of the property involved.

In other words, the amount of the deduction is the lesser of the decline in fair market value of the property and the amount of the adjusted basis (reduced by any insurance or other compensation received).[235] Thus if market value is $100,000 immediately before a fire and $50,000 immediately after, but the adjusted basis of the property is $40,000, the deduction for the casualty loss would be limited to $40,000. If on the other hand the adjusted basis is $60,000, the full amount of the decline in market value ($50,000) could be deducted.

"Fair market value" is to be ascertained by competent appraisal.[236] "This appraisal must recognize the effects of any general market decline affecting undamaged as well as damaged property which may occur simultaneously with the casualty in order that the deduction . . . shall be limited to the actual loss resulting from damage to the property."

The "adjusted basis" is generally the cost of the property (§ 1012 of the Code), adjusted "for expenditures, receipts, losses, or other items properly chargeable to capital account," and for such items as depreciation and depletion (§ 1016). Whenever a casualty loss is sustained and taken as a deduction, the basis of the property must be reduced by the amount of the deduction. In the event that the amount of the loss is greater than the taxpayer's basis in the property, the deduction is limited to the amount of the basis and the new adjusted basis becomes zero.

The general rule given above for computing the amount of deduction applies to both business and non-business casualty losses. This

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[234] Treas. Reg. § 1.165-7 (b)(1).

[235] The most recent (and unsuccessful) challenge to this rule as it applies to the loss of standing timber is the case of Ward v. United States, 428 F. 2d 1288 (Ct. Cl. 1970), *cert. denied* 400 U.S. 1009 (1971), in which the Court of Claims extensively reviews the rule's history and purpose.

[236] Treas. Reg. § 1.165-7(a)(2)(i).

was not always the case. In *Helvering v. Owens,*[237] a casualty case involving partial loss to non-business property, the Supreme Court determined that the allowable loss was the decrease in the market value of the property, limited to the total adjusted basis of the property. The Commissioner accepted this test, but only with regard to *non-business* property. Up until 1956, casualty losses to *business* property were required to be computed by applying to the adjusted basis of the property a percentage equal to the relationship which the actual loss bears to the market value prior to the casualty. However, in *Alcoma Association v. United States,*[238] the Court of Appeals for the Fifth Circuit rejected this formula, finding that the test approved by the Court in *Owens* was "equally applicable to business as to non-business property." New regulations were subsequently issued,[239] applying the same test (the lesser of the decrease in market value and the amount of the adjusted basis) to both business and non-business casualty losses.[240]

## THE "PROPERTY" INVOLVED

The regulations dealing with casualty losses include the following provision:[241]

> A loss incurred in a trade or business or in any transaction entered into for profit shall be determined under subparagraph (1) [the general rule for the amount of the deduction] . . . by reference to the single, identifiable property damaged or destroyed.

As applied to timber, what is the "single, identifiable property damaged or destroyed"? Does it encompass all of a timber owner's trees, or the trees on the particular tract where a casualty loss occurs, or those trees which are actually damaged or destroyed, or only the exact number of board feet of timber damaged or destroyed? This has been the most hotly contested question in timber casualty law. The answer can have a substantial impact on the amount of the deduction. The origin of the dispute goes back many years.

In *Knapp v. Commissioner,*[242] a case involving partial destruction by freeze of ten tracts of land planted in citrus trees, the taxpayers argued that the deductions should be computed by reference to each entire

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[237] 305 U.S. 468 (1939).

[238] 239 F.2d 365, 367 (1956).

[239] T.D. 6445, Jan. 15, 1960.

[240] The regulations presently in effect provide one exception to this rule: if business property is totally destroyed by casualty, and if the fair market value before the casualty is less than the adjusted basis, then the loss is the adjusted basis. Treas. Reg. § 1.165-7(b)(1).

[241] Treas. Reg. § 1.165-7(b)(2)(i).

[242] 23 T.C. 716 (1955).

tract, taking the land and trees as a unit. The Tax Court, however, accepted the Commissioner's contention that the loss must be figured separately for the land and the trees and that only those trees which have a basis for tax purposes may be considered in determining deductions for tree losses. The tables included in the Tax Court's opinion indicate that the Commissioner determined the adjusted basis (which limits the amount of deduction) of the property in *Knapp* with respect to *each individual tract* as defined by the taxpayer, and trees which had a basis but which were not damaged were not excluded from this computation. However, the Commissioner then allowed as a deduction only the same percentage of this adjusted basis figure which the decline in market value of the trees on each tract bore to the precasualty value.

The following year the Fifth Circuit decided *Alcoma Association, supra,* another case dealing with partial casualty loss to citrus groves. There the court rejected the formula used in *Knapp* and allowed the taxpayer to deduct the entire decrease in market value of the property up to the full amount of the adjusted basis *of the entire property.* Apparently the court did not consider whether portions of the property might have separate bases. Indeed, as recent cases have noted, the court in *Alcoma* mentioned that *Owens,* 305 U.S. 468 (1939) (the principal case relied upon), involved property which had an "indivisible basis," whereas:

> The same is not necessarily true of a citrus grove, where the destruction of some of the trees throughout the grove, or perhaps of all the trees in a portion of the grove, leaving the rest of the trees productive, *might allow for the matching of the destroyed property with particular portions of the "basis"; clearly for some kinds of property physical separability means that each portion has its own "basis."* Again the Commissioner does not urge this distinction, and we will therefore not explore this possibility. [239 F.2d at 369; emphasis added.]

According to the court, the Commissioner did not urge this distinction; however, it is certainly arguable that the formula urged by the Commissioner in *Alcoma* (the same portion of the adjusted basis which the loss is to the precasualty market value) was in essence merely an attempt to limit the deduction *to the basis of the taxpayer in the portion of the property which was damaged.* If this is true, then whether or not the Commissioner actually made the argument that unlike *Owens, Alcoma* involved property with a "divisible basis," such argument would seem to be the logical premise for the formula advanced.

In *Carloate Industries v. United States,*[243] another case involving casualty damage to a citrus grove, the Fifth Circuit affirmed the holding of the Tax Court in *Knapp* that in determining casualty deductions, the trees must be treated separately from the land. The question

[243] 354 F.2d 814 (1966).

as to whether the deduction should be computed with reference only to the damaged trees was not considered, since in *Carloate* all the trees were destroyed.[244]

*Broadhead v. Commissioner*,[245] involved a fire loss to part of a taxpayer's timber lands. The Commissioner argued that the deduction was limited to the basis of the particular acres of timber which were destroyed. Relying on *Alcoma*, the taxpayers initially claimed that the loss should be limited only to the basis in the entire property. However, on brief the petitioners accepted the Commissioner's formula, arguing only a factual question. The Tax Court said that it would "accept the methods now advocated by both parties and decide the issue here purely as a question of fact without exploring possibilities not suggested by the parties."[246]

In *Rosenthal v. Commissioner*,[247] the Tax Court squarely faced in a timber case the problem of what is the "single, identifiable property" under section 1.165-7(b)(2) of the regulations. *Rosenthal* involved a partial casualty loss to timber property. The taxpayers took the position that all the timber on the tract where damage occurred should be considered as the "single identifiable property damaged or destroyed." The Commissioner contended that this phrase referred only to the particular board feet of timber lost.

The Tax Court ruled in favor of the Commissioner, holding:

> Under the theory of *Bessie Knapp, supra*, as well as the underlying theory[248] of the deductible amount of casualty losses to property connected with a trade or business or transaction entered into for profit, we conclude that *where property is such that it is normally allocated a specific basis upon its disposition, as in the case of timber, a casualty loss of such property should likewise be limited to the basis of the specific property lost in the casualty*. This, in effect is the holding of *Bessie Knapp, supra*. This holding is not contrary to the holding of *Alcoma Association v. United States, supra*, because of the limited basis of the decision in that case and the statements made in that case by the Court as to the limited scope of the holding. [48 T.C. at 527-28; emphasis added.]

The decision of the Tax Court was confirmed by the Second Circuit in a lengthy opinion which drew an even longer dissent from Circuit Judge Moore. In addition to dealing with the issues which the Tax Court had discussed, the Court of Appeals also analyzed, and rejected,

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[244] *See also* Rev. Rul. 68-531.

[245] 25 T.C.M. 133 (1966).

[246] *Id.* at 155.

[247] 48 T.C. 515 (1967).

[248] "The underlying theory . . . is that the loss is limited by an amount which would otherwise at some other time be deductible for income tax purposes. If the deduction has already been taken in some other manner, it is not again allowable as a casualty loss . . . . In effect in the instant case, to allow a deduction for more of the basis of the timber of the joint venture than that applicable to the trees damaged would be to allow a deduction for a loss to trees that were not damaged." 48 T.C. at 527.

the taxpayer's argument that the basis in the entire tract should be the limit on the loss because the entire tract is a "vital organic unit" experiencing a continual process of growth and regeneration with the health of the timber affected by removal of certain trees. The court noted that a taxpayer may not borrow basis from unharmed property in order to increase the amount of his loss deduction. For example, the court stated, it is clear that the taxpayer may not apply his basis in the land to his loss of trees. Yet, according to the court, acceptance of the "organic unit" theory proposed by the taxpayer would require just that, since the health of the timber is even more dependent upon the soil in which it is rooted than on the existence of other trees.

While *Rosenthal* was before the Tax Court, Rev. Rul. 66-9 was issued. That ruling, which was based on advice given by the Service to another timber owner and his wife (Stiles and Virginia Harper), took the same position advocated by the Commissioner in *Rosenthal* — *i.e.*, in timber cases the "single, identifiable property" is the particular quantity of timber damaged or destroyed, and the amount of the deduction is limited to the adjusted basis of that quantity of timber. According to the ruling, the adjusted basis of the timber destroyed may not include any portion of the basis attributable to the land, other improvements, or to any timber not rendered worthless by the casualty.[249]

The position taken by the Service in Rev. Rul. 66-9 was approved in *Harper v. United States.*[250] In that case, brought by the Harpers for recovery of the deficiency assessed against them, Judge Russell (U.S. District Court for South Carolina) held that the "single, identifiable property damaged or destroyed" was the "measurable unit of marketable timber" (*i.e.*, board foot) and that the deduction must be limited to the adjusted basis of the "measurable units" damaged or

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[249] Rev. Rul. 66-9, 1966-1 C.B. 39, 40:
Basis Limitation of Casualty Loss Deduction

* * *

In the case of a casualty loss to timber, the "property involved" and the "single, identifiable property" destroyed is the quantity of timber which is rendered unfit for use by reason of the casualty. The amount of the casualty loss allowable is limited to the adjusted basis prescribed in Section 1.1011-1 of the regulations for determining the loss from the sale or other disposition of that quantity of timber. The adjusted basis of the quantity of timber destroyed is determined by multiplying the unit adjusted basis by the quantity of timber destroyed.

* * *

Accordingly, the amount allowable as a deduction for casualty loss due to destruction of timber by hurricane may not exceed the adjusted basis for determining loss from the sale or other disposition of the quantity of timber which by fair and reasonable estimates is found to be unfit for use by reason of the hurricane. Such adjusted basis does not include any portion of the basis (or adjusted basis) attributable to the land, other improvements, or to any timber not rendered worthless by the hurricane.

[250] 274 F. Supp. 809 (1967).

destroyed. The court's rationale was that "adjusted basis" is the statutory basis for determining three things: (1) "gain or loss from sale or other disposition" of property, (2) the proper depletion allowance, and (3) allowable casualty loss. Because the definition of "adjusted basis" is similar in all three instances, the term should be applied the same way in each instance, and for purposes of depletion and recognition of gain or loss from sale or other disposition, the "adjusted basis" is "established for each specific unit of merchantable timber rather than taken for the whole lot of timber on the five tracts as a single unit." As to the taxpayers' argument that a sale is so different from a casualty loss that it is inappropriate to use the same formula for calculating loss in both situations, the court responded that this argument "is completely answered by the language of section 165(b) . . . which prescribes that casualty loss shall be determined in the identical manner in which loss from sale shall be ascertained."

The court distinguished *Owens* and *Alcoma*, relied on by the taxpayers. *Owens* was said to involve damage to a single property having an indivisible basis. As to *Alcoma*, the court stated that there the Commissioner did not urge "physical separability," whereas here he did. The court also observed that *Alcoma* involved a citrus grove and that "there may well be a distinction" between timber and a citrus grove.

The taxpayers appealed to the Court of Appeals for the Fourth Circuit, arguing that the decision: (1) is contrary to *Alcoma* and *Owens*; (2) ignores the fact that a casualty loss is different from a sale or similar disposition in that a casualty loss "does not create a merchantable economic unit of timber"; (3) disregards the fact that the taxpayer may not be able to recoup his remaining basis for the timber because of the effect that the casualty may have on the value of the remaining timber (the problem being analogous to severance damages in the case of condemnations); (4) makes improper use of the depletion basis, which is for depletion only and not for limitation of casualty loss; and (5) discriminates against the timber investor as compared to investors in other properties. The Court of Appeals, however, affirmed *per curiam* "for the reasons fully stated in the District Court's opinion."[251] The court also noted: "Significantly, as the Government points out, taxpayers have failed to show that the storm damage will in any way affect the marketability of the remaining trees."[252]

To sum up, the situation at present is that the Service has taken the position that the "single, identifiable property" in timber casualty cases is the particular quantity of timber which is damaged or destroyed. The Tax Court, a federal district court and the Courts of

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[251] Harper v. United States, 396 F.2d 223 (4th Cir. 1968).

[252] *Id.* at 224.

Appeals for the Second and Fourth Circuits have upheld the Service.[253]

However, it should be pointed out that in at least two respects, the factual cases in *Harper* and *Rosenthal were not as favorable to the taxpayer's contentions as they might have been.*

First, the taxpayer in *Rosenthal* was contending that the "property" involved was the tract where the loss occurred. The tract consisted of 24,605.6 acres, of which part had been acquired at one time and part at another. It was only considered as one "tract" because the taxpayer had set it up on its books that way.[254] It does not appear that there were any natural geographical boundaries or other features which might have strengthened the taxpayer's argument that the "single, identifiable property" was this "tract."

Second, in neither *Rosenthal* nor *Harper* was the taxpayer able to prove that the casualty decreased the market value of trees which were *not* physically damaged or destroyed. The taxpayer in *Harper* contended that such damage occurred, but the court rejected this claim because a valuation made after the casualty indicated that the market value of the remaining timber was the same as before the casualty. If in another case it could be shown that a partial casualty loss to a tract of timber *has* adversely affected the marketability of the remaining undamaged timber on the tract, it would be much more difficult for a court to exclude the decline in value of the remaining timber from the computation of allowable loss. It is submitted that the loss should be treated comparably to severance damage caused by condemnation, where the taxpayer is permitted to include in his computation of deduction not just the basis of the condemned property, but also the basis of severed property whose value is affected by the condemnation.[255]

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[253] This position has not at this time been carried over to citrus trees, and the court in *Harper* indicated that a different rule may be appropriate in such cases.

[254] The word "tract" is very broadly defined under the regulations, which clearly recognize that the term "tract" may be broader than "property" (§ 1.614-1(a)(3)): "The term 'tract or parcel of land' is merely descriptive of the physical scope of the land to which the taxpayer's interest relates. It is not descriptive of the nature of his rights or interests in the land. All contiguous areas (even though separately described) included in a single conveyance or grant or in separate conveyances or grants at the same time from the same owner constitute a single separate tract or parcel of land. Areas included in separate conveyances or grants (whether or not at the same time) for separate owners are separate tracts or parcels of land even though the areas described may be contiguous. If the taxpayer's rights or interests within the same tract or parcel of land are dissimilar, then each such dissimilar interest constitutes a separate property. If the taxpayer's rights or interests (whether or not dissimilar) within the same tract or parcel of land relate to more than one separate mineral deposit, then his interest with respect to each such separate deposit is a separate property."

[255] Rev. Rul. 68-37, 1968-1 I.R.B. 16. *But see* Rev. Rul. 73-51, discussed at p. 95, which holds that a casualty which reduces the fair market value of trees but does not render them unfit for use is not deductible.

## APPLICATION OF SECTION 1231

Section 1231(a) provides the following general rule:

> If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 9 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 9 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets ....

Does this have any application to timber casualties? If so, then the value of the right to ordinary loss deduction under section 165 could be nullified, as the timber owner could be required to offset the casualty loss against capital gains during the year. Section 1231(a)(1) applies to gains or losses from "compulsory or involuntary conversion"; section 1231(a)(2) specifically provides that "losses upon the destruction, in whole or in part ... of property used in the trade or business ... shall be considered losses from a compulsory or involuntary conversion." This language is broad enough to include casualty damage. Attention is then focused on the phrase "property used in the trade or business." Does this include timber?

Section 1231(b)(2) states that "such term includes timber ... with respect to which section 631 applies." This clearly covers timber property as to which an election under 631 has been made. But in addition, the general definition of "property used in the trade or business" states that such term includes "real property used in the trade or business, held for more than 9 months" (section 1231(b)(1)).[256] Consequently, casualty losses of many timber owners would seem to fall within the general rule of section 1231(a).

Indeed this was the holding of the Court of Appeals for the Ninth Circuit in the recent case of *Weyerhaeuser Co. v. United States.*[257] That case involved destruction during the years 1954 through 1957 of timber, plant facilities, machinery, equipment, and offices, all of which

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[256] It can be argued from the regulations that although the statute states that "property used in the trade or business" *includes* timber with respect to which section 631 applies, this is in fact the only timber property which that phrase includes. Regulation § 1231-1(a): ".... The non-capital assets subject to section 1231 treatment are ... (2)timber ... but only to the extent that section 631 applies thereto ... " Regulation § 1.1231(c): "Section 1231 applies to recognized gains and losses from the following: ... (3) The cutting or disposal of timber ... to the extent considered arising from a sale or exchange by reason of the provisions of section 631 and the regulations thereunder."

[257] 402 F.2d 620 (1968).

had been held for use in Weyerhaeuser's business for more than six months. The losses were caused by various destructive agencies, including fire, storms, blasts and beetles. All were spoken of as "casualties" by the court. The Government took the position that all the losses had to be set off against section 1231(a) gains, whereas Weyerhaeuser contended that only insured losses should be so treated. The court ruled in favor of the Government, holding that "section 1231(a) covered both insured and noninsured casualty losses."[258]

In 1958 Congress amended section 1231(a) to make it specifically inapplicable "to any loss, in respect of which the taxpayer is not compensated for by insurance in any amount, arising from fire, storm, shipwreck, or other casualty ...." This amendment exempted casualty losses from the netting requirements of section 1231(a) provided the loss was completely uninsured. Casualty losses that were insured, even if for only 1% of the loss, continued to be subject to the netting requirements of section 1231(a).

In 1969, the Congress took another look at the 1958 amendment and decided there was no sound reason for distinguishing between insured and uninsured casualty losses for purposes of section 1231. Therefore, it repealed the 1958 amendment and replaced it with what is now the rule for dealing with casualty losses that are subject to section 1231(a). The rule is that irrespective of whether or not insurance exists, all casualty losses of "property used in the taxpayer's trade or business" and "capital assets" and all gains arising from casualties to such property and assets (*e.g.*, due to receipt of insurance proceeds) are first netted against each other. If the losses for the year exceed the gains, the net amount of the loss is then deducted from ordinary income, and if the gains exceed the losses, the net amount of the gain is then netted with other losses and gains arising under section 1231(a).

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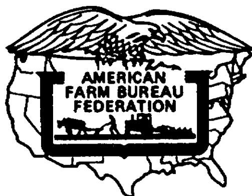
[258] *Id.* at 629-30.




**★FARM BUREAU★**

"the nation's largest general farm organization"

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
TO THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE COMMITTEE ON FINANCE
RE THE TREATMENT OF CASUALTY LOSSES IN THE
CASE OF FRUIT OR NUT TREES AND TIMBER

Presented by
Goodwin Myrick, President, Alabama Farm Bureau Federation

February 29, 1980

Washington Office—425 - 13th Street, N.W., Washington, D.C. 20004. Phone 202-637-0500

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1. The Internal Revenue Code limits a casualty loss deduction under Section 165 to the lesser of the fair market value of the destroyed property or the adjusted basis.

2. In the case of the destruction of fruit and nut trees and timber, the current casualty loss treatment is insufficient because the basis in such property is often minimal.

3. Farm Bureau supports S. 1900 and S. 1901 which would allow a casualty loss deduction equal to the fair market value of the property on the date on which the loss occurs. The ten-year carryback and four-year carryfoward feature of both bills is also a desirable provision.

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As president of the Alabama Farm Bureau Federation, I am pleased to present the American Farm Bureau Federation's testimony in support of S. 1900 and S. 1901. Farm Bureau is the largest general farm organization in the United States, representing more than three million member families in 49 states and Puerto Rico. Farm Bureau membership includes farm and ranch families who produce virtually every agricultural commodity grown commercially in this country.

There are over 222,000 member families in the Alabama Farm Bureau Federation, the fourth largest state affiliate of the American Farm Bureau Federation. Many of our members reside in south Alabama where the force of Hurricane Frederic was so devastating last year.

Over 80 percent of Alabama's pecan crop is produced in south Alabama. For the pecan tree growers there, many of whom are Farm Bureau members, the storm destroyed years of investment, not only in terms of money, but of time as well. The years required to produce a mature grove of pecan trees can never be recovered. But the economic losses to the growers of fruit and nut trees and timber can be compensated by changes in the Internal Revenue Code through the provisions of S. 1900 and S. 1901 which were introduced by Senator Heflin of Alabama.

Current tax laws on casualty losses do not recognize the true losses suffered by the growers of fruit and nut trees and timber. The Code limits a casualty loss deduction under Section 165 to the lesser of the fair market value of the destroyed property or the adjusted basis. The original basis or cost of a tree is often minimal. Current tax treatment ignores the fact that the contributions of nature and time should be major adjustments to basis due to the unique nature of pecan groves and timber stands, as well as other types of fruit and nut trees.

Given the length of time required to produce a mature tree, at least ten years in the case of pecans, Farm Bureau supports the provisions of S. 1900 and S. 1901 which would allow a casualty loss deduction equal to the fair market value of the property on the date on which the loss occurs. These bills would cover casualty losses for the growers of fruit and nut trees and timber, respectively.

It is a matter of equity to recognize that farmers who lose a grove of trees or a woodlot have suffered an economic loss although their original cost basis may be nominal. Hurricane Frederic is proof that casualty losses can occur quickly and completely. Such a loss should entitle the taxpayer to a deduction equal to fair market value rather than the lesser of fair market value or adjusted basis. This is particularly important for uninsured property.

The ten-year carryback and four-year carryforward feature of both bills is desirable because it allows the farmer to adjust income during the period of reestablishment of the grove and, possibly, to adjust previous tax liabilities so as to receive a refund for reestablishment of the grove or timber stand. Carryback and carryforward provisions are used throughout other sections of the Code. For instance, financial institutions, business development corporations and small business investment companies are allowed a ten-year net operating loss carryback and a five-year net operating loss carryover for post1975 net operating losses (Code Section 172(b)).

Farm Bureau views S. 1900 and S. 1901 as essential if tree growers who suffer casualty losses are to remain in agriculture. These proposed amendments to the Internal Revenue Code would signal a commitment to assist farmers in the recovery of their casualty losses. We encourage the Subcommittee's favorable consideration of both bills and thank you for the opportunity to testify.

Followup Statement of Mr. Taney Brazeal
President
Alabama Pecan Growers Association
In Support of Senate Bill 1900
before the
Subcommittee on Taxation & Debt Management
of the
Senate Finance Committee
March 12, 1980

Mr. Chairman, Members of the Subcommittee: The Alabama Pecan Growers Association, speaking on behalf of pecan growers in South Alabama, Northwest Florida and along the eastern Mississippi Gulf Coast devastated by Hurricane Frederic, appreciate the opportunity given us to provide testimony February 29, 1980 in support of Senate Bill 1900. We also appreciate your invitation to provide this additional written statement following the oral statements by other witnesses including the representative of the Treasury Department.

We wish to address briefly two of the issues which arose during the oral statements. They are the question of partial damage to fruit trees raised by the gentleman from West Virginia, and the question of whether or not pecan growers are not in fact seeking a loss for anticipated income as argued by the representative of the Treasury Department.

The question of damage to trees as opposed to total destruction is one easily resolved. Pecan growers, like the apple growers described by Mr. Michael E. Caryl, encounter various weather conditions which result in partial damage to the trees which affect production for several years. Although we well sympathize with that situation, it would be our recommendation that the casualty loss we request under Senate Bill 1900 be restricted to cases in which the trees are totally destroyed requiring removal. We would recommend that the casualty loss be based on the fair market value of that tree at the time of the loss. Although the trees' production, including any crop which might be on the trees at the time, would very likely be one of the factors used in arriving at a fair market value, we are not requesting a casualty loss for the crop itself.

We believe that the difficulties of fixing a fair value for partial damage would make the plan unworkable for all practical purposes.

It is the severe losses brought about by total destruction during severe natural disaster for which we are seeking a casualty loss. We are not asking for compensation for what some might consider the ordinary hazards of our particular agricultural enterprise; we are not requesting that the federal government share with us the ordinary risks of growing crops; we are urging that tax regulations fairly and properly reflect the realities of the tremendous casualty losses suffered by destruction caused by a natural disaster.

We respond to the statements by the representative of the Treasury Department with two lines of thought.

First, pecan growers are not attempting to obtain casualty status for loss of future crop income as the Treasury Department representative suggested. Our position is that destroyed trees have market values which are real and which can be determined. The particular market values for trees would be wide ranging depending on variety, production record, maintenance, age and other factors. The average fair market value of pecan trees lost during Hurricane Frederic was set at about $154 by the Boutwell & Johnson study. A real estate appraiser, whose estimates were included in the same study, set the average value at between $200 and $400 per tree depending on age. On the other hand, when we look at the loss of income from destroyed trees, we get a much higher per tree figure. When Boutwell & Johnson calculate the loss of future crops from trees destroyed by Hurricane Frederic they arrive at a total figure of $110.9 million. That estimate was based on the low value of 70¢ per pound for pecans in 1977. Were we to use the 1979 value of 85¢ a pound the crop loss rises to $134.6 million. Using Boutwell & Johnson's figures of 144,000 trees destroyed, the average loss per tree

would range from $770 to $935 per tree. That would indicate that the actual loss in crops per tree is considerably higher than the estimated fair market value of the tree at the time it was destroyed.

There is another factor to be considered by committee members in relation to the issue of whether this is a casualty loss based on appreciation. Obviously, a producing pecan tree becomes more valuable with the passage of time <u>assuming it has proper care and maintenance.</u> That proper care and maintenance is provided in most cases by the pecan grower and his family both in terms of actual labor and also in the more important aspect of management. Since neither of those items--self labor or management--are allowable under present tax regulations, the value of a 20-year-old tree reflects substantial contributions by the owner which have not been previously allowed. It is not the initial small cost of the nursery stock which makes a 20-year-old pecan tree valuable; it is the proper care and management of that tree for 20 years and perhaps two generations of a family.

It is not equitable to tell the family pecan grower that he cannot deduct the cost of his labor and management for 20 years and then also tell him at the end of that 20-year period that he should not be allowed to benefit from those labors. Were he to sell his pecan grove he would be required to pay a profit or capital gains tax on the price from the sale. It is not equitable to tell the family farmer on one hand that the tree that results from 20 years of efforts represents a profit on which he must pay income taxes and turn right around and deny that when that same tree is totally destroyed that it represents a casualty loss equal to that market value.

We would call to the attention of the committee another seemingly contradictory situation. That is the matter of casualty loss for pecan trees as opposed to

the principle on which oil depreciation allowances are based.

The Treasury Department would complain that pecan growers seek a casualty loss for future profits. Assume, for the sake of argument, that there was some basis for that argument. Is it any less equitable to allow a casualty loss to a family farmer who has lost his trees than to allow a tax break to the successful oil producer on the grounds that oil exploration is risky and he might have--did not--but might have failed to make that profit which is, in effect, being adjusted substantially.

If, through depletion allowances, we allow the oil producer a tax break on profits because of losses which he did not suffer, but risked, why should we not allow the pecan grower relief from casualty losses which he actually suffered, not risked, from a natural disaster?

We would maintain further that with the modern, technological advances in oil exploration, the risk of bringing in new oil and gas production are, in proportion to the total economic value of the industry, not as great nor as threatening to the company's economic viability as are the risks of the farmer at the mercy of nature. The oil explorer may not always find oil but he can be assured that nothing is going to happen to it while he is looking. Nature is helping or hindering the farmer every day of the year.

Senator BYRD. There are two additional witnesses on this legislation. Mr. Loy of Martinsburg, W. Va. and Mr. Michael Caryl of Martinsburg, W. Va.

Would you two want to come forward at this point.

Would you want to remain? Do whatever you prefer.

Senator HEFLIN. We will give them room, anyway.

Senator BYRD. Give them room and then we will hear from the Treasury.

Mr. Loy and Mr. Caryl?

## STATEMENT OF MICHAEL E. CARYL, ESQ., MARTINSBURG, W. VA.

Mr. CARYL. Mr. Chairman, Mr. Loy is not here. I will be presenting the statement.

My name is Michael Caryl. I am a practicing attorney in Martinsburg, W. Va. My appearance here today is on behalf of my client, Tri-County Fruit Growers. It is an organization whose members are 50 family owned and operated orchards in the most eastern counties of West Virginia.

The West Virginia fruit industry is of substantial importance to our State's economy, particularly the economy of the eastern panhandle. Nationlly, West Virginia's apple production ranks 7th and its peach production 13th among all the States.

In 1979, the dollar value of that production was $23 million with regard to the apples and $4 million with respect to the peach production.

As one might imagine, the statistics relating to the employment attributed to that industry are quite impressive. I think it is important to point out, Senator, that fruitgrowing is not a desk-and-telephone type paper industry.

Senator BYRD. What?

Mr. CARYL. It is not a paper enterprise. It involves tremendous capital.

First of all, it requires the acquisition of prime agricultural land which in our areas is seldom available for less than $2,000 an acre. Additionally, one might expect between $20 to $35 a tree being invested before there is a single dollar of revenue realized.

At that rate, a grower may have as much as $5,000 an acre invested before there is any return whatsoever and typically the break-even point in the life of an apple orchard is 8 to 10 years after it is set out.

Additionally because of the seasonal nature of the apple and fruitgrowing operation, an apple orchard requires a large influx of working capital. It is against that background of massive capital requirements that we need to assess the risk of sudden catastrophic losses in orchards resulting from various acts of nature.

Now, although a mature apple or peach tree, when viewed by the untrained eye may appear to be tough, gnarled, and impervious to damage by even the most extreme forms of precipitation, any orchardist can tell you that a severe hail can destroy not only a current year's production, but can destroy the tree's ability to produce for many years to come by scarring the youngest, fruit-producing wood of the tree itself.

One member of our organization reported that, in a 30-minute period, a severe hailstorm tore the bark off hundreds of valuable trees and damaged them to such an extent that it was 5 years before the trees had recovered to what might be considered a normal level of production.

Senator BYRD. Would this legislation be involved in that case? Would the fruitgrower be permitted a casualty loss for hail?

Mr. CARYL. Senator, I believe it would and should not due to the damage to the ripening crop. I realize that that is not to be deducted as a loss, but I believe that as long as it can be ascertained what the value was prior to the event and subsequent to the event, even though it may be, in some cases, only partial damage, I believe this bill should cover it.

Senator BYRD. I believe this is getting pretty far afield when you are going to permit losses for partial damage. If these trees came back—you say it took 5 years. That is a long time. That is pretty devastating to the individual. But the trees did come back. The trees were not pulled out.

Mr. CARYL. Senator, that was 5 years of lost production and there is a great deal of damage that eventually is permanent. The trees are scarred and disease sets in, insects, and whatnot. There is a lot of this damage that is inevitable and maybe not in such a long period that the tree is totally destroyed.

This is particularly the case with another type of damage which is known as southwest winter injury and this occurs on a day, possibly like today, where there is a cover of snow, a bright sunshine, particularly in our area, coming from the southwest angle, reflecting off that snow into the tree which can raise the surface temperature on the bark to 40 degrees or so. Then, as night falls, the temperature would plummet into the teens and the horticultural scientist tells me that causes a severe damage to the wood, the bark of the tree itself and it is inevitable that the tree will be destroyed and its production is diminished immediately.

There is a third type of sudden weather-related damage that is an example we were confronted with just last year, Senator. That was the very early snow we had in October. And there, because the trees are still full foliated, the leaves are still on them, there is a much greater surface for the wet, clinging snow to bear on and many branches are broken and again, with the ultimate result that the tree is destroyed.

One local orchard had that type of damage this past October to 27 percent of all its producing trees.

Describing the type of damage that we can suffer in the fruit industry, we believe that the current tax treatment is wholly inadequate to properly compensate the fruitgrowers, not only for the direct out-of-pocket losses, but for the tremendous risks that they face in investing huge sums of money in the hope that Mother Nature will not, in one-half hour on a July afternoon, devastate the major portion of the investment.

This can be seen when one appreciates the fact that any orchardist has far more obligations than just those reflected in the cost of his damaged trees. His ability to meet these other obligations to fulfill all the capital requirements that I described can be completely undermined for many years because of this type of damage

and the ultimate effect, Mr. Chairman, is often foreclosure and loss to the land speculators of another family-operated agricultural enterprise.

And if I might respond to the question that you raised about the Treasury Department's objection about this, that it is just a deduction for appreciation, I might point out that there is nothing sacrosanct about cost as a measure of this loss, and I point and direct your attention to the oil depletion allowance, or the percentage depletion allowance in oil and other extractive industries. There, as you know, deductions are permitted far in excess of any investment cost.

The principal rationale, as I understand it, for percentage depletion is because of the great risks that we have always been told about that a great deal of capital must be invested and you might come up with a dry hole.

Senator, I would submit that the chances of loss and the predictability of risk is much greater in fruit as compared to the extractive industries. Geologists are able to ascertain with some degree of certainty where the natural resources are, but no meteorologist would ever dream of attempting to predict what the weather would be 25 years in the future and that is what we are talking about because you cannot move an orchard. Once you have made the investment, it is there and you are at the mercy of Mother Nature.

Senator, we are not asking the subcommittee to provide compensation for risk incurred in advance of losses that actually is available to these industries. All we are asking is that when these catastrophic losses occur, the injured orchardist be accorded more reasonable tax relief to partially cushion the blow of otherwise nearly total loss of his enterprise and Senator, although I strongly believe that a case can be made for including the value of the current year's crop in measuring the amount of loss deductible under section 165, at the very least, that section should be amended as provided in S. 1900 to permit deduction of the loss of actual value resulting from sudden weather events without regard to the adjusted basis of damaged trees.

This is the minimum relief justified as an important step in preserving family agricultural enterprises, such as those people I represent here today. And these are the people who, we should not forget, are the traditional backbone of our Nation.

Thank you, sir.

Senator BYRD. Fruitgrowing is a very hazardous business. I am aware of that.

Tell me this. How would the value of the fruit tree as distinguished from the pecan tree, how would the value of that tree be determined?

Mr. CARYL. I think it would be pretty much the same procedure. It would be in the value of similar land with or without an orchard of a given age.

Of course, unlike, apparently, the case of pecan trees, there is a range of productive life for an apple tree or peach tree and that, of course, should be taken into consideration in appraising the value both before and after one of these catastrophic events.

But I think the principal way would be to appraise the value of similar land with or without an orchard on it.

Senator BYRD. Hail insurance is still available, is it not?

Mr. CARYL. Hail insurance is available, Senator. My clients tell me that most of them consider it most inadequate in attempting to make what they consider reasonable settlements. Again, that only refers to the current crop and does not refer to any permanent or long-term damage.

Senator BYRD. That is right. I do not know about its being inadequate, but I know it is very expensive.

Thank you.

[The prepared statement of Mr. Caryl follows:]

STATEMENT OF MICHAEL E. CARYL TO THE TAXATION AND DEBT MANAGEMENT SUBCOMMITTEE OF THE FINANCE COMMITTEE OF THE UNITED STATES SENATE, 96TH CONGRESS, FIRST SESSION, FRIDAY, FEBRUARY 29TH, 1980.

SUBJECT: S. 1900

By way of introduction, I am a practicing attorney in Martinsburg, Berkeley County, West Virginia. My appearance here today is on behalf of my client, Tri-County Fruit Growers, an organization whose members are fifty family-owned and operated orchards in the most eastern counties of West Virginia.

The West Virginia fruit industry is of substantial importance to our State's economy, particularly in the Eastern Panhandle, where the industry is principally situated. Nationally, West Virginia's apple production ranks 7th and its peach production 13th among all of the states. This translates, in 1979, into 6.2 million bushel of apples and 500,000 bushel of peaches worth $23 million and $4 million respectively. The statistics relating to the employment directly or indirectly attributed to this industry are equally impressive. Nevertheless, fruit growing is not a desk-and-telephone type, paper industry, and economic activity of such a magnitude is not attained without massive capital investment.

The conduct of a successful apple or peach orchard operation requires the acquisition of large tracts of prime farm land often available at no less than $2,000 an acre.

Moreover, the accountants familiar with the eastern West Virginia fruit industry advise me that as much as $20.00 to $35.00 a tree is typically invested before a single dollar of fruit production revenue is realized. At such a rate, an apple grower may have more than $5,000 an acre invested in his orchard before he realizes any return whatsoever. Additionally, in today's economy, an orchard of less than 50 acres is not considered economically viable. Finally, in addition to the substantial investment in capital equipment which is necessary, orchard operations often require a large influx of working capital because of the seasonal nature of their revenue flows.

It is against this background of massive capital requirements, that we must assess the risk of sudden catastrophic losses in orchards resulting from acts of nature, particularly hail, frost, early or late snow and violent temperature fluctuations.

Although mature apple and peach trees, when viewed by the untrained eye, may appear to be tough, gnarled and impervious to damage by the most extreme forms of precipitation. Nevertheless, any orchardist or horticultural scientist can tell you that a severe hail can destroy not only the currently ripening crop, but also can destroy the trees' ability to produce for years to come by scarring the youngest fruit bearing part of the wood of the tree itself. One member of our organization reported that in a 30-minute period a

severe hail tore the bark off hundreds of their apple trees and damaged them to such an extent that it was five years before the trees had recovered to what might be considered a normal level of production. In that case, the orchardist estimated that 14,000 bushel of ripening fruit was lost for the year of the storm and production was reduced for the next five years by an average of 38%. Although hail usually strikes on a random basis, the severe damage it can inflict establishes it as a major risk in the orchard business. Moreover, although random, it does occur with significant frequency as the local grower who suffered hail damage in 12 of 20 years can attest. Typically, a tree-damaging hail can be expected every five to seven years.

Another common form of sudden weather-caused permanent injury to fruit trees in our area is what is known as southwest winter injury. This occurs when the ground is covered by snow and bright, sunshine reflecting off that snow can raise the temperature on the southwest side of fruit trees to 45-50° fahrenheit. The damage suddenly occurs when the temperature typically would plummet with nightfall into the mid-teens. Permanent bark damage is frequently the result of such an event.

Permanent damage in the form of broken branches can result when, as in October of last year, an early and extremely wet snow blankets the still fully foliated fruit trees, causing many branches to be completely broken under its

clinging weight. One local orchard experienced such damage to 27% of all of its producing trees.

Another type of weather-related damage to fruit trees in our area comes in the form of frost. A late frost, or a frost following unusually early warm weather can inflict massive damage in an apple or peach orchard. Unlike hail, a given instance of frost damage will be experienced over a large fruit producing territory as illustrated by industry-wide statistics. For example, in April of 1976, West Virginia's fruit producing region experienced severe frost conditions in 6 days in the month of April, when temperatures dropped below the so-called critical temperature of 30° F necessary to avoid a 90% kill of then-ripening buds. The result was a 17% decline in state-wide apple production and a 46% drop in peach production. That the 1976 frost may have damaged more than the current year's crop is suggested by the fact that 1977 production remained well below the 1975 pre-frost level.

There should be no question that frost is the type of damage contemplated under Section 165 of the Internal Revenue Code. Horticultural scientists tell me that the damage inflicted by frost is not of a cumulative nature, but rather, depending upon the stage of the development of the fruit producing portion of the tree, a drop below a certain critical temperature will suddenly and immediately destroy its bearing capacity.

The current tax treatment of such losses is wholly inadequate to properly compensate the fruit grower, not only for his direct, out-of-pocket losses, but also for the tremendous risk he faces in investing huge sums of money in the hope that mother nature will not, in one chilly night in April, or in a half hour of a July afternoon devastate a major portion of his investment. The present limitations to adjusted basis of any deductions for such losses is unrealistic and inequitable.

This can be seen when one appreciates the fact that any orchardist has many more obligations that just those reflected in the cost of the damaged tree. Because of these obligations, his actual loss from severe hail or frost is far more than the adjusted basis of the damages trees. His ability to meet other obligations incurred to fulfill all of the capital requirements outlined above can be completely undermined for several years by this type of damage. The ultimate effect often is foreclosure and a loss to the land speculators of yet another family-operated agricultural enterprise.

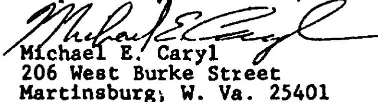
Not only is the current tax treatment of such orchard losses unrealistic, but it is inequitable as well when one considers other similarly risky industries. The principal rationale for permitting percentage depletion deductions far in excess of actual invested costs in the extractive industries is the risk and uncertainty faced by natural resource producers when compared to the massive capital investment

required of them. As illustrated above, the risks are also great and the capital requirements imposing in the fruit industry. In view of such comparable circumstances, why shouldn't the tax laws afford family orchard enterprises at least some degree of the same protection which has long benefited multi-national energy companies?

We are not here asking the subcommitttee to provide compensation for risks incurred in advance of losses, such as is available to the extractive industries. Rather, all we are asking is that when these catastrophic losses do occur, the injured orchardist be accorded more reasonable tax relief to partially cushion the blow of otherwise nearly total loss of his enterprise.

Although, a strong case could also be made for including the value of a current year's crop in measuring the amount of the loss deductible under Section 165, at the very least, that section should be amended, as proposed in S. 1900, to permit deduction of the loss of fair market value resulting from sudden weather events without regard to adjusted basis of the damaged trees. This is the minimum relief justified as an important step in preserving family agricultural enterprises such as those of the people I represent here today. Who, we should not forget, are the traditional backbone of our nation.

Respectfully submitted,



Michael E. Caryl
206 West Burke Street
Martinsburg, W. Va. 25401

Senator BYRD. I think the committee will need the testimony of the Treasury. Secretary Halperin, would you address yourself to both S. 1900 and S. 1901?

Mr. HALPERIN. Yes, Senator. I would be glad to.

Senator BYRD. After that, I would like to get your view, but I do not want to hold these gentlemen up, get your view on S. 485, Senator Cannon's bill. But let's get Senator Heflin's two bills at this point.

[The prepared statement of Daniel I. Halperin follows. Oral testimony continues on p. 300.]

FOR RELEASE UPON DELIVERY
Expected at 9:30 A.M.

STATEMENT OF
DANIEL I. HALPERIN
DEPUTY ASSISTANT SECRETARY (TAX LEGISLATION)
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
FEBRUARY 29, 1980

Mr. Chairman and Members of the Committee:

We welcome the opportunity to present the views of the Treasury Department concerning eight bills: S. 1900, S. 1901, S. 1831, S. 485, S. 2180, S. 2089 and §§ 9, 10 and 11 of H.R. 5505, and S. 650.

Let me say first, however, that the mix of bills we have before us today are, unfortunately, excellent examples of our tendency to continually complicate the tax laws by adding special interest provisions without regard to a general, overall view of the law. The time spent in considering these proposals, whether or not enacted, detracts from the ability of the Treasury and Congress to deal with problems of more general need, including the backlog of regulations.

As we have indicated in previous testimony, the Treasury does not object to a portion of S. 1831 and §§ 9 and 11 of H.R. 5505. We think that S. 485 and S. 650 raise issues that deserve serious consideration and they may not be objectionable in a modified and more general form. The Treasury opposes the remaining bills.

Summary of Positions

S. 1900: This bill would amend the Code provisions relating to casualty losses by providing a special rule for fruit or nut trees. A taxpayer would be permitted to deduct an amount not less than the fair market value of the

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property, rather than be limited to the adjusted basis of the loss property as under current law. The Treasury Department opposes S. 1900. Permitting a loss deduction for untaxed appreciation is contrary to basic tax policy. It would be as if a loss deduction were allowed for earned but unpaid wages that had never been included in the employee's income. Moreover, we believe that no special case for relief exists for owners of these trees as opposed to other victims of casualties who would remain subject to the general rule, such as small businessmen and farmers.

S. 1901: This bill would permit a deduction for a casualty loss in the case of timber equal to the fair market value of the timber rather than its adjusted basis. The Treasury Department opposes S. 1901 for the same reasons set forth with respect to S. 1900 above.

S. 1831: This bill would affect the net operating loss carryover period of a real estate investment trust (REIT) or a former REIT. The bill would allow REITs an eight year carryover period for all pre-1976 losses and would permit a disqualified REIT to increase its carryover period by the number of taxable years to which the carryback of the loss is barred because of prior REIT status. The Treasury supports the change with respect to pre-1976 REIT net operating losses but opposes extending the carryover period for losses incurred by a disqualified REIT. An inability to utilize expiring net operating losses is not an isolated phenomenon and it is inappropriate to add additional complexity to the Code by creating a limited exception in this area for a special interest group.

S. 485: This bill would exclude from the 2 percent wagering tax any wager authorized under state law and would exempt persons engaged in accepting wagers from the $500 per annum special tax if such persons are authorized to engage in such business by law. The Treasury does not oppose the principle of S. 485 but suggests that the tax either be maintained or repealed in its entity. As currently drafted, the bill would cause the application of the tax to turn on state law, a result inconsistent with the goal that the revenue system should be of uniform application throughout the county.

S. 2180: This bill would provide a special application of the rules relating to the nonrecognition of gain on the sale of a principal residence, by extending the replacement period for construction of a new residence. The Treasury opposes S. 2180. This is an ad hoc solution intended to provide special relief for a particular taxpayer and, as such, invites other taxpayers to seek similar relief.

S. 2089: This bill would allow a claim for credit or refund of the investment tax credit for single purpose

agricultural or horticultural structures, as provided in the Revenue Act of 1978, without regard to the statute of limitations, provided that the claim is filed within one year of enactment of S. 2089. The Treasury opposes S. 2089. Reopening years closed by the statute of limitations is an unfortunate precedent which will impose an overwhelming administrative burden on both the taxpayer and the Internal Revenue Service.

Sections 9, 10 and 11 of H.R. 5505: Section 9 of H.R. 5505 would permit a credit or refund of the tax paid on manufacturer's sales of tread rubber under certain circumstances, change the statute of limitations for filing a claim for refund, and impose a tax on the tread rubber on imported tires. The Treasury supports § 9 of H.R. 5505. Section 9 of H.R. 5505, however, contains one technical error in that, as currently drafted, the statute of limitations for filing a refund claim ends one day less than one year after the warranty adjustment. The statute should run for one year.

Section 10 of H.R. 5505 would extend the replacement period for sales of a principal residence for certain members of the Armed Forces. The Treasury opposes § 10 of H.R. 5505. Creation of a special exception to the rules on replacement periods will create added pressure for other exceptions. Moreover, no showing of special need which could not be argued by a number of other groups has been presented.

Section 11 of H.R. 5505 would affect the tax exempt status of auxiliaries of certain fraternal beneficiary societies. The Treasury does not oppose § 11 of H.R. 5505.

S. 650: This bill would create a narrowly drawn exception to the provisions of the Code relating to unrelated trade or business income for collective, debt-financed real estate investments by pension trusts through the vehicle of a group trust. The Treasury opposes S. 650, which would create a complex exception to a rule of general applicability, without any sound justification for the exception. It perhaps would be appropriate to examine whether it is sound as a general matter to apply the debt financed property rules to real estate investments by pension trusts.

## S.1900, S. 1901--EXCEPTION TO THE GENERAL RULE FOR CASUALTY LOSSES FOR FRUIT AND NUT TREES AND TIMBER

S. 1900 and S. 1901 propose an exception to the general rule with respect to casualty losses. Under current law such losses are limited to the taxpayer's adjusted basis in the loss property. S. 1900 provides that the basis for determining the amount of a deduction for any casualty loss incurred

in a trade or business with respect to fruit or nut trees would be the fair market value of the trees immediately before the casualty. S. 1901 would afford similar treatment to timber. In addition, such losses would be eligible to be carried forward for 10 years and back for four. These provisions would be effective with respect to losses incurred after August 31, 1979.

The Treasury Department is opposed to enactment of these bills.

The owners of fruit and nut trees and timber present no more sympathetic a case than other victims of casualties and disasters, such as homeowners, small businessmen and farmers. We therefore believe special treatment for these taxpayers is inequitable.

Further, a basic principle of tax policy generally limits a taxpayer's loss to his basis in the loss property. To permit a deduction based on market value rather than basis would permit appreciation which has never been subject to tax to be deducted. In addition, these bills would require loss property to be valued after it has been destroyed, a necessarily subjective process which will lead to controversy between taxpayers and the IRS.

Assume a taxpayer owns a fruit or nut tree which cost him $100 and just prior to a hurricane was worth $1,000. If the hurricane destroys the tree, the taxpayer understandably considers himself poorer by $1,000 as a result of the loss due to the hurricane and believes that the tax system should compensate him for a $1,000 loss. However, the taxpayer has forgotten that the $900 profit which was created as the $100 tree appreciated to a value of $1,000 was never subject to tax. As far as the tax system is concerned, this increment in value never existed. If the appreciation of $900 was taken into account as income then it would be perfectly appropriate to allow a loss of $1,000. In the absence of taxing this increase in value, the net loss of $100 is more readily achieved by limiting the casualty loss deduction to the adjusted basis immediately prior to the casualty.

## S. 1831--NET OPERATING LOSS CARRYOVER PERIOD FOR TAXPAYERS CEASING TO BE REAL ESTATE INVESTMENT TRUSTS

S. 1831 would affect the net operating loss carryover period of a real estate investment trust (REIT) or a former REIT. Although we do not oppose the bill's change in the treatment of pre-1976 REIT net operating losses, we do oppose the bill's extension of the carryover period for losses incurred by a disqualified REIT.

Under current law, if a REIT incurs a net operating loss in a qualified year after 1975, the loss may be carried over for eight years. Pre-1976 losses, however, may be carried over for five years, with an extension of up to three years as long as the REIT has remained continuously qualified in all years following the year of loss. The bill would treat pre-1976 losses the same as post-1975 losses, and would allow an eight-year carryover perod for all REIT losses, regardless of the year the loss is incurred or the REIT's qualified status in subsequent years.

We do not opoose this change, which affects only those pre-1976 losses that were incurred by qualified REITs. The REIT industry suffered its greatest losses in 1973 and 1974. Recovery has been slow, and many of these large losses will expire unused, regardless of qualification. Although we are leery of a change that may encourage trafficking in REIT losses, there has been no substantial trend in this direction that would warrant denying the benefit of this aspect of the bill to the industry as a whole.

We are, however, opposed to the second part of the bill. A net operating loss can never be carried back to a year in which a REIT was qualified. If a disqualified REIT incurs a loss and cannot carry back the loss to any one of the three preceding years because of its prior REIT status, the bill would increase the disqualified REIT's net operating loss carryover period by the number of taxable years to which the loss is barred as a carryback. The carryover period could not be increased to more than eight years.

Once a REIT becomes disqualified, it is taxed as a normal corporation or trust, as the case may be. We see no reason to give an advantage to a REIT that has chosen to be taxed as a normal corporation merely because it once was a REIT, particularly since many REITs become disqualified so that they can manage their assets more flexibly, without being subject to REIT restrictions on their operations.

From an historic point of view, REITs that disqualified themselves before 1976 expected the same five year carryover period for operating losses that normal corporations had. The bill would, in effect, change the efffective date of the extended seven year carryover period introduced by the Tax Reform Act of 1976 with respect to disqualified REITs, without a similar benefit for normal corporations. In addition, the bill could add an extra year to that seven-year period for losses incurred by disqualified REITs, also a benefit denied to normal corporations. We think this unjustified.

How long a carryback or carryover period should be is not an easy question to answer. Certainly the net operating

loss carryover and carryback provisions have been changed before, but each time a change is suggested, we must ask whether the change benefits a sufficiently broad group of taxpayers to be justified. The Code is splintered enough; if every special interest group receives benefits tailored particularly to it, the problems of complexity and unevenness in the tax law will never be solved.

Although the REIT industry seeks redress for expiring net operating losses, expiring net operating losses are not an unusual occurrence. To grant former REITs relief for expiring net operating losses because of their prior tax treatment is to ignore similar situations in which carrybacks are routinely unavailable: subchapter S corporations that terminate their status and partnerships that incorporate are two examples of entities for which the carryover period is not extended because of the unavailability of carrybacks. If there is a line to be drawn among these situations, it is not an obvious one, and we think that taxpayers are better served by our attention to more general legislation, rather than to arbitrary distinctions.

We therefore oppose that part of the bill that extends the net operating loss carryover period of a disqualified REIT.

## S. 485--EXEMPTION OF WAGERING ACTIVITY AUTHORIZED BY STATE LAW FROM WAGERING TAXES

S. 485 would exclude from the 2 percent wagering tax any wager authorized under State law. The $500 per annum special tax on persons engaged in the business of accepting taxable wagers, or persons accepting wagers on behalf of the former, also would be repealed where such individuals were authorized to engage in such business under the law of any State or political subdivision.

The tax on wagers is one of two excises on gambling, the other being the $250 a year occupational tax on coin-operated gaming devices. The latter tax is scheduled to be repealed as of July 1 of this year. The wagering tax in turn is limited largely to bets on sports events and the "numbers." State operated lotteries are exempt.

The taxes on wagering and those engaged in the business of accepting wagers bring in only a modest amount of revenue. In fiscal year 1979, the 2 percent tax on wagers produced $9.1 million and the occupational tax $900,000. The exemption proposed by S. 485, which it is assumed would be applicable only to Nevada, would probably reduce revenues by $8 million out of the $12 million estimated for fiscal year 1980 under current law.

While not of revenue significance, the tax on wagers can be viewed as a means of raising at least some revenue from a form of spending which is considered socially undesirable by many. No judgment is expressed on this factor. Of immediate interest is the possible aid that the tax may provide in determining income which is not reported on income tax returns.

Experience with the tax on wagers, and the soon to be repealed tax on coin-operated gaming devices, does not indicate any substantial direct benefits in income tax enforcement resulting from the existence of these taxes. Income tax evasion schemes have been discovered as a result of gambling tax enforcement activities, but not enough to make a strong case for their retention.

The Federal Government also obtained a more direct enforcement tool against significant illegal gambling subsequent to enactment of the wagering tax. Public Law 91-542 enacted in 1970 makes it a criminal offense to engage in a gambling business in violation of State or local law if it involves five or more principals or managers and continues in operation in excess of thirty days or has a gross revenue of $2,000 in any single day.

It should also be mentioned that the Commission on the Review of the National Policy Toward Gambling in its final report in 1976 concluded that the wagering tax had not been an effective deterrent to illegal gambling (*Gambling in America*, p. 26).

Continuation or repeal of the wagering tax should depend on whether it is public policy to utilize the tax as a sign of social disapproval. S. 485 would appear to meet this criterion of social disapproval by repealing the wagering tax only in States where the occupation is legal. To do so, however, would mean that the application of the tax depended on State law. The Federal revenue system should be uniform throughout the country and its application not determined by the activities any given State considers legal or illegal. The tax either should be maintained as is or repealed entirely.

## S. 2180--TIME PERIOD FOR REPLACEMENT OF PRINCIPAL RESIDENCE

S. 2180 would provide for a special application of the Code provision relating to the nonrecognition of gain on the sale of a principal residence. The law presently provides that a taxpayer who decides to construct a new or replacement residence will have a period of up to 2 years after the date

of sale of the old residence to construct and use the new residence as his principal residence, instead of the usual 18 months when the new residence is acquired by purchase. S. 2180, which would not amend the Internal Revenue Code, provides that in applying this provision a taxpayer will have 5 years instead of only 2 years to use a constructed new residence if the taxpayer:

(1) sold his old principal residence in 1977,

(2) purchased property on which to construct a new principal residence (presumably also in 1977) the construction of which commenced during 1977 and was terminated before completion,

(3) brought an action, and obtained a judgment, against the builder who commenced construction of the new residence but failed to complete it,

(4) suspended construction of the residence so that the partially constructed residence could be used as evidence in connection with the prosecution of the builder (without regard to whether it was so used), and

(5) failed to meet the requirements relating to occupancy of the new principal residence because of the suspension of construction.

Each year there are undoubtedly many taxpayers who, for a variety of reasons, fail to meet the literal requirements of those provisions because they are unable to occupy a new or replacement principal residence within the time allowed. The penalty for failure may seem severe, and in many cases the taxpayer's situation may be quite sympathetic. It is our responsibility, however, to strike a reasonable balance between the provision of relief in all sympathetic cases, on the one hand, and the need to keep generally applicable provisions of the Code from becoming inordinately complex on the other. In our view, these provisions have reached, if not exceeded, the bounds of reasonable complexity.

The Code already provides special relief to taxpayers who choose to construct a new residence by adding an extra 6 months to the period in which they must occupy the new residence. Moreover, taxpayers who choose to construct a new residence should realize that delays may ensue, and that they must assume the risk that construction may not be completed in time to occupy the new residence and satisfy the requirements for nonrecognition of the gain. We think, on balance, that the relief presently provided for these taxpayers is adequate, and that no change should be made in the application of this provision.

For these reasons, we oppose the enactment of S. 2180.

## S. 2089--ALLOWANCE OF REFUND OR CREDIT FOR THE INVESTMENT TAX CREDIT ON SINGLE PURPOSE AGRICULTURAL OR HORTICULTURAL STRUCTURES

This bill would allow a credit or refund with respect to the investment tax credit for single purpose agricultural or horticultural structures for taxable years now closed by the statute of limitations or in cases where the taxpayer claimed the credit and, having litigated that issue, lost a court decision on the merits.

The Revenue Act of 1978 provided that single purpose agricultural or horticultural structures qualified for the investment tax credit for taxable years ending after August 15, 1971. S. 2089 allows a claim for credit or refund for the year the property is placed in service, notwithstanding that the statute of limitations has now closed that year or the claim is barred by res judicata.

The Treasury opposes S. 2089 because it will create an unreasonable administrative burden, particularly where the original return of the taxpayer has been destroyed.

The Internal Revenue Service retains tax returns for individual taxpayers for only seven years. Thus, the returns for 1971 and 1972 are no longer on file and those for 1973 will be destroyed early in 1981. The Service will be unable to verify information for the taxpayer claiming the credit for those years. Where the property with respect to which the credit was claimed has been disposed of, there may be no realistic way to substantiate elgibility for the credit.

In addition, more than one year will be affected by the filing of a claim for refund or credit for many taxpayers. Prior and subsequent years can be affected where there is a carryback or carryforward of the credit. If the property was disposed of prior to the end of its useful life, the taxpayer may even be required to pay additional tax in a subsequent year as a result of recapture. For example, a taxpayer may have placed a structure in service in 1972, claiming a useful life of 8 years for tax purposes and disposed of it in 1976. If such taxpayer now claims a credit for 1972, he would also be required to recompute the credit in 1976, when the property was disposed of, file an amended return for that year, and pay tax as a result of recapture of the investment tax credit. The burden on the taxpayer and the Service from such computations would be extreme.

We therefore oppose S. 2089 which would permit taxpayers to reopen the statute of limitations with respect to certain closed taxable years.

## SECTION 9 OF H.R. 5505--EXCISE TAX REFUNDS FOR CERTAIN USES OF TREAD RUBBER

Under current law, a manufacturers excise tax of five (5) cents per pound is imposed on tread rubber used for recapping or retreading tires of the type used on highway vehicles. An excise tax also is imposed on new tires. In several instances under current law the tax on tread rubber is imposed when in a similar situation, the tax on new tires is not imposed (or a credit or a refund is allowed if the tax has been paid). For example, present law does not tax new tires which are destroyed or scrapped before actual sale. New tires also are exempt from tax if exported, sold to a State or local government, or sold to a private nonprofit school. Essentially, § 9 of H.R. 5505 would correct these disparities by expanding the availability of a credit or refund of the tread rubber tax.

Under the bill, a credit or refund of the tread rubber tax would be made available in three situations: (1) where rubber is destroyed, scrapped, wasted or rendered useless in the recapping or retreading process; (2) where a sale of a recapped or retreaded tire is adjusted pursuant to a warranty or guaranty; and (3) where a recapped or retreaded tire, or a newly manufactured article associated with a recapped or retreaded tire, is (a) exported, (b) sold to a State or local government for its exclusive use, (c) sold to a nonprofit educational organization for its exclusive use, or (d) used or sold for use as supplies for a vessel or aircraft.

In cases where a credit or refund of the tread rubber tax would be available on account of a warranty or guaranty adjustment, the bill would modify the existing statute of limitations to provide that a claim for credit or refund may be filed at any time prior to the expiration of one year after the date when adjustment was made, if the period for filing the claim otherwise would expire sooner. (As presently drafted § 9 of H.R. 5505 requires that a claim for a credit or refund be filed "before" the expiration of one year after the date when the warranty adjustment is made. To be consistent with similar provisions of the Code, the bill should be changed to allow a claim to be filed "on or before" the expiration of such one year period.)

Finally, the bill would provide that if a tire is exported from the United States, recapped or retreaded abroad, and then imported into the United States, the person importing the tire shall be subject to the tax on tread rubber for tread rubber incorporated into the tire, unless the tire is sold on or in connection with a vehicle that is subject to the manufacturers excise tax under Code section 4061.

The manner in which the adjustment in tax on account of a warranty or guaranty adjustment would be computed under H.R. 4726 should be clarified. The procedure for computing tax adjustments for new tires is set forth in Rev. Rul. 76-423, 1976-2 C.B. 345. Under that ruling, a tire manufacturer is entitled to a credit or refund based only upon the price adjustment made to the manufacturer's immediate vendee pursuant to a warranty or guaranty with respect to a defective tire. Section 9 of H.R. 5505 should be interpreted to require that the tax adjustment allowed on account of warranties or guaranties follow this principle set forth in Rev. Rul. 76-423.

In conclusion, the Treasury Department supports § 9 of H.R. 5505, provided that the computation of tax warranty adjustments will be consistent in principle with Rev. Rul. 76-423. There seems to be no good reason for the disparities under current law between the application of the excise tax on new tires and of the excise tax on recapped or retreaded tires. In addition, the bill would close a loophole that encourages manufacturers to export their retread work on tires. These changes are sound and merit adoption.

The annual revenue loss from the proposed amendment should not exceed $300,000.

## SECTION 10 OF H.R. 5505-- EXTENSION OF REPLACEMENT PERIOD WITH RESPECT TO SALE OF PRINCIPAL RESIDENCE FOR CERTAIN MEMBERS OF THE ARMED FORCES

Section 10 of H.R. 5505 would amend the Code provisions relating to nonrecognition of gain on the sale of a principal residence by extending the period during which an individual must purchase a new residence to avoid recognition of gain on the sale of an old residence in the case of members of the Armed Forces who are stationed overseas or who are required to reside in government-owned quarters. Generally, the normal 18-month replacement period (2 years in the case of a taxpayer who is constructing his new residence) is suspended during any time that the taxpayer serves on extended active duty with the Armed Forces after the date of sale of the old residence, except that the period as suspended may not extend beyond the date 4 years after the date of the sale of the old residence. Section 10 of H.R. 5505 would provide that the period as suspended shall in any event not expire before (1) the end of the 4-year period after the date of the sale of the old residence or (2) the date one year after the date on which the taxpayer is no longer stationed outside the United States or is no longer required to reside in government-owned quarters, whichever is later. Taxpayers electing the benefit

of this provision are required to file a notice not more than once a year.

The Treasury Department is opposed to enactment of § 10 of H.R. 5505. Members of the Armed Forces are presently granted a substantially longer replacement period than other taxpayers generally. The rationale underlying these provisions generally is that gain realized on the sale of a personal residence should not be recognized provided the taxpayer reinvests an amount at least equal to the proceeds of the sale in similar property within a reasonably short period of time. The replacement period is important because it establishes the parameters of a reasonable period of time during which taxpayers may be treated as having maintained their economic position, notwithstanding the sale, and not have converted the proceeds to uses for which nonrecognition treatment is not justified. More importantly, collection of the tax ought not be deferred if no reinvestment has taken place within some reasonable time. Under § 10 of H.R. 5505, replacement may be deferred indefinitely. There could be some real difficulty collecting the tax, plus interest, if the period extends too long and the proceeds have been dissipated. For this reason, the Treasury Department believes the 4-year replacement period presently granted to members of the Armed Forces serving on extended active duty should not be extended further. In addition, should this provision be amended as proposed in § 10 of H.R. 5505, there would be great pressure to similarly amend the provision applying to any individual whose tax home is outside the United States. The Treasury Department is opposed to any further liberalization of the replacement period rules. The administrative and audit burden created by a lengthy replacement period is not alleviated by the notice requirement.

## SECTION 11 OF H.R. 5505
## TAX EXEMPT STATUS OF AUXILIARIES OF CERTAIN FRATERNAL BENEFICIARY SOCIETIES

Section 11 of H.R. 5505 would affect the tax exempt status of auxiliaries of certain fraternal beneficiary societies. The bill would limit the application of 501(i) which prohibits discrimination on the basis of religition by social clubs. Evidently the Knights of Columbus which limits its membership to practicing Catholics has certain affiliated organizations which have their tax exemption under 501(c)(7). The Treasury has no objection to this limitation on the prescription against discrimination contained in section 501(i).

S. 650--ELIMINATION OF UNRELATED DEBT-FINANCED PROPERTY RULES FOR REAL ESTATE INVESTMENTS BY CERTAIN GROUP TRUSTS

Exempt organizations, including pension trusts, generally are taxable on income they derive from borrowed funds (so-called "unrelated debt-financed income"). S. 650 would create a narrowly drawn exception for real estate investments by "group real estate employee benefit trusts" on behalf of at least ten qualified pension or profit-sharing plans.

It is said that S. 650 is needed to rectify an existing competitive imbalance among financial intermediaries that offer investment services to qualified pension trusts. For example it is asserted that, through so-called "common trust funds," bank managers of pension assets can make collective real estate investments for pension trusts; and, where the real estate is debt-financed, distribute income to the participating trusts free of its characterization as "unrelated debt-financed income." This position evidently is based on a private ruling letter, issued several years ago to a bank administrator of a common trust fund, holding that the fund could carry on a tax-free activity which, in the hands of the participating pension trusts, would constitute an unrelated trade or business. The Treasury questions the correctness of that ruling. Moreover, to the extent it may be consistent with existing common trust fund regulations, the Treasury has initiated a review of those regulations to ascertain whether that result can and should be reversed by amendments to the regulations. As a matter of policy, we think the character of income in the hands of a collective investment vehicle, such as a common trust fund (or a life insurance company segregated asset account), should remain the same in the hands of the participants as it would be if they had made the investment directly.

By the same token, the Treasury sees no reason why debt-financed income from activities of a group trust should be treated any differently than similar income earned by a single pension trust acting alone. Substantial incremental complexity is inevitably the result when Congress, having embodied a basic policy in the Internal Revenue Code, chips away at the policy with piece-meal exceptions, such as that contained in S. 650, without regard for the purpose of the general rule.

In support of S. 650, its proponents urge that with continuing inflation there is a need to permit real estate investments, as well as investments in portfolio securities, by

qualified pension trusts. This is not adequate. The existing provisions of the Code do not preclude real estate investments by pension trusts. They do not even preclude leveraged real estate investments. They simply subject debt-financed investments to tax on a portion of the income, subject to proportionate allowances for expenses (including straight-line depreciation), derived from such investments. The fact that debt-financing is not an essential -- but only a conventional -- method of financing real estate investments is underscored by the fact that there are other members of the public who urge only that the laws be amended to widen the number of vehicles through which pension trusts may make collective, unleveraged real estate investments. *

Nevertheless, the Treasury is willing to consider the wisdom of generally applying the rules relating to debt-financed income to real estate investments by pension trusts. Taxation of debt-financed income was adopted in part in response to a particular form of tax abuse that had developed involving debt-financed acquisitions by exempt organizations; and, in part, in response to the preception that the ability of exempt organizations to make debt-financed investments was an inappropriate side benefit to their exemption.

This legislation in its present form, as adopted in 1969, responded to the decision of the Supreme Court in Commissioner v. Clay Brown, 380 U.S. 563 (1965). In that case, the owners of a business had sold their stock to an exempt organization for $1,300,000, consisting of a $5,000 down payment and a nonrecourse, non-interest bearing note for the balance, payable solely out of profits from the operation of the business and secured by interests in the business assets transferred. The corporation was liquidated, and its assets were "leased" to a new operating company in effect run by the sellers. The transferee's obligation on the promissory note was satisfied through payment to the sellers of 90 percent of the "rents" received under the operating lease.

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* Specifically, the Treasury understands that representatives of exempt organizations and, to some extent, qualified pension plans, are urging that revisions be enacted to section 501(c)(2), which describes certain exempt title-holding companies, to permit the use of such organizations as vehicles for collective real estate investments.

The Court held that the transferors were entitled to report the amounts received in the transaction as capital gain, rather than ordinary income. The attractiveness of the transaction was enhanced by the fact that the transferors continued to operate the business. More importantly, however, the actual operating income of the business was attributed to the exempt organization transferee in a form -- rent -- that it could receive tax-free, with the result that, whereas before the transaction the corporation's business profits were subject to corporate income taxes, after the transaction those profits, which largely were required to be applied toward the purchase price for the business, could be received tax-free. The ability to use the tax-free income stream from operation of the business to fund the purchase money obligation meant that tax exempt organizations could acquire formerly taxable businesses with little or no financial commitment on their part; and, perhaps as importantly, that exempt organizations had more resources to commit to such transactions than similarly situated taxable purchasers. This frequently was referred to before the 1969 legislation as the "sale of a tax exemption."

Thus, one compelling underlying reason for the 1969 legislation was the need to combat sale-lease-back transactions involving exempt organizations.

But the legislative response was justified on broader grounds. There are a variety of different justifications for exempting the various categories of exempt organizations. Exemption usually is not justified on the ground that it will operate to exempt the portfolio income of such organization. Thus far, however, Congress generally has seen fit to exempt the investment income of most such organizations as an acceptable by-product of exempting the organizations in general. However, it was felt to be unacceptable to offer exempt organizations the opportunity to compound the potential benefits of earning investment income tax-free by permitting them to finance investment activities with debt. This was regarded as paricularly troubling in the case of charities, contributions to which were deductible for Federal tax purposes. A corollary of the incentive to charitable contributions available through the charitable contribution deduction was that charities would be rendered responsive to their public benefactors. Thus, a second rationale for the 1969 amendment was the desire to curb the ability of exempt organizations to employ leveraging to increase the benefit of exemption on financial investments, which in the case of public charities would reduce their responsiveness to the public.

Consequently, in 1969, Congress fashioned a broad amendment that required all exempt organizations to pay tax on income from most debt-financed property, subject to limited exceptions. These rules apply not only to transfers of operating businesses, as in the Clay Brown case itself, but also to almost all forms of debt-financed investment property including real estate. These broad revisions reflected concern not only for transactions of the Clay Brown sort, but also for the growth of exempt organizations through debt-financed investments.

It seems premature to embark upon a reassessment of these basic rules. Since 1969 there have been some modest efforts to circumvent, but in fact very little complaint, about the application of these rules to exempt organizations and pension trusts. Nevertheless, the real question raised by S. 650 is whether the 1969 legislation is sound in its application to real estate investments by pension trusts.

Consider, first, the premise that the 1969 legislation was needed to forestall unwarranted growth by exempt organizations through leveraging. Here, one might argue that, whereas with an exempt organization the ability to earn a tax-free return on financial investments is simply an incidental benefit of an exemption conferred in service of some other policy, for qualified pension trusts, exempting income on portfolio investments is essential to carry out the underlying purpose for their exemption. If so, it may not be as essential as it is with other exempt organizations to insure that investment returns are not augmented through the use of indebtedness. We do not say that this must be so, but only that the distinction may be drawn.

One might also distinguish between investments in real estate and investments in operating businesses such as that involved in the Clay Brown case itself. In the case of the sale of an operating business there may be substantial differences between rates of return after tax to exempt and taxable purchasers. Moreover, where the exempt organization is permitted to acquire a business with little or no down payment plus a non-recourse note payable only out of operating profits, it may be quite willing to confer a portion of the benefits of its exemption on the seller of the business through a higher price. In real estate, by contrast, the ability of an exempt organization to recover its investment on a pre-tax rather than on an after-tax basis may to a substantial degree be matched by the ability of taxable investors to recover their investment through depreciation. As a result, the ability of an exempt organization to outbid taxable investors for such investments through the "sale of the organization's exemption" may not be the

same as in the Clay Brown case. Again, I do not say that this distinction is compelling, but only that it is plausible.

Where, then, does this leave us? As I noted at the outset we oppose revisions along the piece-meal lines contained in S. 650 itself. Moreover, the arguments I have outlined as possible bases for considering a somewhat broader revision need more detailed elaboration. To our knowledge such analysis has not, to date, been forthcoming from those interested members of the public who urge that Congress adopt S. 650. It seems to us that further work is needed.

For one thing, if consideration were given to relaxing the taxation of the debt-financed income in the case of real estate investments by qualified plans, controls would be essential to insure, notwithstanding the limitation to real estate, that opportunities for Clay Brown type boot-strap acquisitions do not arise again. S. 650, while precluding the acquisition by a qualified group real estate employee benefit trust of property that is leased back to the transferor, does not preclude the transferor from receiving a non-recourse purchase money obligation from the qualified group trust. The use of non-recourse, take-back financing was an essential ingredient in Clay Brown; three-party financing should be required in any legislation permitting leveraged real estate investments by pension trusts. More generally, and while it is a subject on which we defer to the judgment of the Department of Labor, it seems to us that legislation of this sort cannot properly be considered without an assessment of the general wisdom of encouraging pension assets to be invested on a leveraged basis in real estate equities. The use of leverage in a real estate investment, while enhancing an investor's ability to benefit from rises in prices for real estate generally, may also entail greater vulnerability to economic fluctuations, a matter of serious concern where the security of assets held to meet pension liabilities is involved.

In short, there are a variety of issues that are raised by, or need to be taken into account in considering, legislation such as S. 650. But, to return to the point at which I started, it seems to us that S. 650 cannot be justified by the fact that it is needed to preclude discrimination from real or imagined gaps in the debt-financed rules. If these gaps cannot be justified on policy grounds they should be eliminated, not expanded.

## STATEMENT OF DANIEL I. HALPERIN, DEPUTY ASSISTANT SECRETARY OF THE TREASURY (TAX POLICY)

Mr. HALPERIN. Mr. Chairman, obviously one has a great deal of sympathy for what we have heard this morning. However, it seems to us that these difficulties really have nothing to do with the tax system. These people are making a case for Federal relief, perhaps some form of Federal insurance because of the unavailability of private insurance, but these difficulties do not have anything to do with a tax loss.

The casualty loss provision is designed for cases in which people pay taxes on particular dollars, invest these tax-paid dollars in a particular asset and experience an uninsured casualty. They may use these dollars to buy a car and find that the car is destroyed the day after it was purchased. They really do not have the benefit of that $10,000 of so which might have been paid for the car. It has just disappeared and the policy is that such individuals should not pay taxes on that money.

In these bills, we are talking about a loss of income that has not been recognized for tax purposes. The trees have appreciated in value. These farmers have not realized the income represented by such appreciation, nor have they paid taxes on that income. It is then lost before it is recognized.

It is similar to, for example, lost wages. An employee works for an employer, is owed some money, and the employer does not pay him. He does not have the income, of course, and it does not appear on the tax return. We do not turn around and also permit him to subtract an equal amount.

Perhaps it is not too different from the case of somebody who is in an accident, is disabled and unable to work for 3 or 4 years. No income is coming in during that period. If that is a loss, we ought to give him a tax deduction and permit him to carry it back to recover the income taxes paid in the prior years.

I think that is essentially what is being requested here. There is no loss which should be recognized in the tax system. If there were insurance on these trees and the farmers recovered their value from the insurance company, they would have taxable income. Since they do not have insurance, there is no taxable income and, in effect, they have a lower tax burden than if they had experienced an insurable loss.

By then permitting a loss for tax purposes on top of it, the tax burden is lowered twice, and we see no argument for these bills if one is talking about the tax system.

If we are talking about whether there is a case to be made here for Federal disaster relief of some sort, we think that is a totally different matter.

Senator BYRD. Explain again about the automobile. You mentioned an automobile.

If a person buys a $10,000 automobile today that is smashed up, is there a loss?

Mr. HALPERIN. Take the case of someone who earns $10,000 in a year, pays taxes on it, and buys a car which is destroyed immediately in an uninsured casualty. The tax system says that you really have no net income in that year. You earned the $10,000, you invested in the car, your car was destroyed and the net income

that you have earned that year is zero. That is what the casualty loss recognizes. Or if you earn $100,000 and it costs $10,000 for the car, your net income is $90,000.

Senator BYRD. How does that differ? I guess I should have realized that the tax law worked that way. I did not.

How does that differ from a farmer who puts $10,000 into trees and those trees are destroyed?

Mr. HALPERIN. He gets that $10,000 loss. That is what the present law allows.

If the farmer put $10,000 into the trees and the trees were lost, the farmer would get a $10,000 deduction. What these bills would provide, however, is that if those trees were worth $100,000 just before they were lost, the farmer would be entitled to a $100,000 deduction. That is the same thing as somebody being able to say that if I could work next year I would earn $50,000 but since I am disabled and cannot work, I ought to have a tax deduction for the $50,000.

The problem is that there is value which has not been taxed. This is untaxed appreciation. This is the element of value which cannot be deducted under current law but which these bills would permit as a deduction.

Senator BYRD. If a person has a home and has valuable trees on his home property and those trees are destroyed, is there a casualty loss involved there

Mr. HALPERIN. Yes; there is, but it is limited to the amount spent for the trees. The casualty loss cannot be greater than the amount that you have actually invested in the trees.

Senator BYRD. You buy a home and pay for the home and the tree comes along with the home?

Mr. HALPERIN. You have to try to figure out what portions of the price of the home was spent for the tree. There obviously are some difficulties.

It may be a better rule not to allow any loss unless there is a decline in the value of the entire house. Under present law, however, we will allow a casualty loss for the destruction of the tree alone, but no more than the allocable cost of that particular tree.

Senator BYRD. Do you feel that there might be a middle ground, so to speak, between the law as it now is and what Senator Heflin's bills recommend?

Mr. HALPERIN. Mr. Chairman, as far as the tax system is concerned—and I think as far as we ought to go in dealing with this problem through the Internal Revenue Code, I believe that current law is correct.

Whether or not there is a case for Federal aid is something that we have no opinion on.

Senator BYRD. In the tax field?

Mr. HALPERIN. I think that in the tax field there is no argument for any change or for any liberalization of the casualty loss deduction. The actual investment loss is recognized. We never permit a deduction for income expected in the future which is never actually recognized.

Senator BYRD. Do you have any further statements that you would want to put in the record in this regard?

Mr. HALPERIN. As to this? We have testimony dealing with all of the 10 bills before you.

Senator BYRD. We want to get to that.

Mr. HALPERIN. I have no further statement. Included in our written statement is our position on S. 1900 and S. 1901.

Senator BYRD. Senator Heflin?

Senator HEFLIN. I would like to respond to Mr. Halperin's statement. He, in effect, stated that under certain circumstances a business might have damage due to a sudden loss, like a fire, and you might have insurance which would make you whole in order that you can then move forward to bring in income from your business.

These insurance proceeds are not taxable, the insurance payments to bring you back to whole, if they are put back in the business and I think that this is a situation here that is similar to that.

Mr. HALPERIN. If it brings you back to whole means, brings you back to the value of the trees as it existed, or value of the business as it existed prior to the casualty, if that reflects unrealized appreciation which previously has not been taxed, then the insurance proceeds would be taxable.

If the people who suffered this destruction were able to have insurance and did recover on those insurance policies they would have taxable income. They may be able to avoid it through an investment of the proceeds, but there is taxable income there.

Senator BYRD. What has been going through my mind since the hearing began, particularly since Mr. Caryl from Martinsburg spoke, is I feel that I will need to disqualify myself in so far as voting on this measure is concerned. I do have some apple not much acreage, but I do have some apple acreage which could be affected by this legislation.

With that in mind, I would like to encourage both Senator Heflin and the Treasury to add to this record anything that either of you would want to add so that the record would be complete.

But I think as far as my one vote is concerned, I would need to disqualify myself.

Senator HEFLIN. I would like to mention one other thing for the record while the Treasury Department is here. The method of accounting here causes an inequity. The normal labor, if it could have been expensed over the year, as a corporation would have been able to do, would have been helpful. But here you have a particular instance of family labor which has not been expensed and which goes into the fair, reasonable market value.

Senator BYRD. Thank you, Senator Heflin.

Anything additional in this regard?

Senator HEFLIN. Thank you.

Senator BYRD. Thank you.

Thank you, gentlemen.

Mr. Halperin, why do you not just stay there?

The next legislation to be considered is S. 2089.

Mr. HALPERIN. Mr. Chairman, would you like me to comment on Senator Cannon's bill?

Senator BYRD. Yes; suppose you do that.

Mr. HALPERIN. I think, as Senator Cannon indicated, that the gambling tax has not been of significant use in tax enforcement or in the general enforcement of the criminal laws. In fact, since the gambling tax on wagering went into effect in 1970 there has been other, more direct, legislation which enables the Federal Government, through the Justice Department, to get involved in dealing with illegal gambling under State law. We see neither any serious reasons in the tax policy or Federal enforcement policy to retain the present tax.

Senator BYRD. You see no need to retain it?

Mr. HALPERIN. No, sir, but we would prefer that it be repealed in its entirety. Senator Cannon's bill would repeal it only where gambling is legal under State law. As was pointed out, most illegal gamblers do not bother to pay the tax.

We do not think that the IRS ought to be involved: One, in determining whether gambling is legal or illegal under State law; and two, in seeking out those who are engaged in illegal gambling. We believe the Federal tax law should be uniform throughout the country.

Senator BYRD. Have you discussed this with Senator Cannon? Is that satisfactory to him?

Mr. HALPERIN. I have not discussed it with him but we are suggesting that the entire tax be repealed, not just in the States where such wagering is legal.

Senator BYRD. He probably would not object to that. I do not know. I cannot speak for him.

Mr. HALPERIN. I do not see why he should.

Senator BYRD. Why do you not consult with his staff and see, since you favor the repeal of the law, and he wants most of it repealed, I do not think you are very far apart, and you probably can work it out.

Mr. HALPERIN. Some people might feel that by eliminating the tax an inappropriate statement is being made about gambling and may be uncomfortable about eliminating whatever that statement is. But I think that is really not a reason to keep this tax on.

Senator BYRD. Anyway, you are not opposed to what Senator Cannon wishes to do? You just want to go a little bit further than that?

Mr. HALPERIN. We would not like to see it in the form that he suggested because it requires the IRS to make distinctions nationwide, so we would prefer to go all the way and we would be glad to consult with his staff.

Senator BYRD. If you can get together with Senator Cannon and if he approves your proposal to repeal the whole thing, I would certainly support that, but if not, I will support Senator Cannon's position.

Mr. HALPERIN. Fine, Mr. Chairman.

Senator BYRD. Next will be a panel of Mr. Edward H. Ralph, executive secretary, Delmarva Poultry Industry; Mr. Joe Hatfield, vice president, National Broiler Council; Mr. Michael K. Blevins, Society of American Florists; and Mr. Goodwin L. Myrick, president, Alabama Farm Bureau Federation.

This is in relation to S. 2089. Each will have 5 minutes to present his views in regard to S. 2089.

Mr. Ralph?

Mr. HATFIELD. Mr. Ralph is not here today, Mr. Chairman?

Senator BYRD. Would you identify yourself?

Mr. HATFIELD. I am Joe Hatfield.

Senator BYRD. All right.

## STATEMENT OF JOE HATFIELD, VICE CHAIRMAN, NATIONAL BROILER COUNCIL

Mr. HATFIELD. Mr. Chairman, my name is Joe Hatfield. I appear before this subcommittee today as a broiler producer/processor from Baldwin, Ga., and as vice chairman of the National Broiler Council. My statement is presented on behalf of the following national, regional, and State poultry and egg associations.

National Broiler Council, National Turkey Federation, Poultry and Egg Institute of America, Pacific Egg & Poultry Association, Southeastern Poultry & Egg Association, Alabama Poultry & Egg Association, Arkansas Poultry Federation, Delmarva Poultry Industry, Inc., Florida Poultry Federation, Georgia Poultry Federation, Maine Poultry Federation, Mississippi Poultry Association, North Carolina Poultry Federation, Pennsylvania Poultry Federation, Texas Poultry Federation & Affiliates, Virginia Broiler Producers Association, Virginia Egg Council, Virginia Poultry Federation, and Virginia Turkey Association.

All of the organizations on whose behalf I appear today strongly support S. 2089 as introduced by Senators Roth, Talmadge, and Helms. We are hopeful that this legislation will provide final clarification of congressional intent to allow the investment tax credit for structures built and used for food and plant production, including poultry houses, retroactive to August 15, 1971.

The first expression of congressional intent came when the investment credit was restored in the Revenue Act of 1971. The Senate Finance Committee in its report accompanying the 1971 Act specifically referred to this matter and noted that the reinstated investment credit would be applicable to structures specifically designed and closely related to the use of the equipment it houses.

The report used as an example a unitary system for raising hogs which is similar to the system used for the production of poultry and eggs. Despite this expression of intent, subsequently supported by favorable court decisions, the Internal Revenue Service continued to deny the credit to poultry producers.

Congressional intent was expressed even more clearly when an amendment to the Revenue Act of 1978 defined single purpose agricultural or horticultural structures to be treated in section 38 property and stated that the amendments "shall apply to taxable years ending after August 15, 1971."

We assumed that this most recent clarification would finally convince IRS of the intent of Congress to allow the credit and to apply it retroactively to 1971 since the 1978 amendment was merely a clarification of existing law that such facilities have always qualified for the credit.

However, IRS takes the position that a refund claim is not timely unless made before the latest of 3 years from the filing date of the tax return or 2 years from the payment of taxes. The only

exception would apply to those producers who challenged the Service's position.

We do not believe that it was the intent of Congress to place a premium on taxpayer opposition to prior Service rulings and to penalize those who did not challenge the IRS. It should be pointed out that the amount of credit on any one poultry facility is generally less than $5,000—an amount which does not warrant extensive litigation by individual poultry producers, but is nevertheless significant to an individual grower and his family.

There is absolutely no question in our minds that the Congress intended that the credit be retroactive to taxable years which ended on or after August 15, 1971. We believe that S. 2089 will provide the mechanism for qualified producers to claim the credit to which they are entitled for single purpose agricultural or horticultural structures.

I appreciate the opportunity to appear before this subcommittee today. The poultry and egg associations represented are grateful for this forum to present their views on legislation which, if enacted, should clarify once and for all the intent of Congress with regard to the investment tax credit for poultry houses. We urge your favorable consideration of S. 2089.

Senator BYRD. Thank you, Mr. Hatfield.

Mr. Blevins?

## STATEMENT OF MICHAEL K. BLEVINS, SOCIETY OF AMERICAN FLORISTS

Mr. BLEVINS. Thank you, Mr. Chairman.

My name is Michael Blevins. I am director of government affairs for the Society of American Florists.

I have submitted in advance a detailed statement on S. 2089.

Senator BYRD. It will be published in the record.

Mr. BLEVINS. Thank you, sir. I will summarize that statement here this morning.

I am here today representing over 900 commercial floriculture growers who produce 90 percent of the flowers and plants grown in the United States today. The Society of American Florists also represents more than 7,000 wholesalers and retailers of floriculture products; in total, over 93 percent of the entire American floriculture industry is represented by SAF through either direct or affiliate membership.

The floriculture industry is, by nature, a small business industry. It consists of largely family-owned and operated enterprises. It is on behalf of this kind of constituency that I am here today.

SAF commends the committee for its consideration of S. 2089 which would further clarify the Revenue Act of 1978 with regard to investment tax credits, specifically to the time period of eligibility for these credits.

SAF views the investment tax credit as an excellent method of stimulating business investment to expand and modernize production facilities and, in the process, increase the productivity and new job opportunities.

After several years of working with Congress and of litigating the issue in the courts, SAF was pleased to see the Revenue Act of 1968 enacted by the 95th Congress which specified that green-

houses qualified as special use structures eligible for the investment tax credit.

Senator BYRD. Why are we going back to 1971?

Mr. BLEVINS. Well, sir, our appearance here today is precipitated by the problems of the implementation of the Act of 1978. As you know, the act states that the amendments recognizing the eligibility of greenhouses and other special structures—and I quote from the act—"shall apply to taxable years ending August 16, 1971." Thus, any agricultural or horticultural structure constructed or expanded since that time should qualify for the credit.

Unfortunately, the IRS has seen fit to restrict valid claims by imposing the 3-year statute of limitations on those claims. Consequently, this enforcement pre-empts valid claims for investment tax credits in those years beyond that 3-year limit going back to 1971.

SAF does not believe that the Finance Committee nor the Congress intended the IRS to respond to the law in this way. Many valid claims made early in the 1970's are beyond the 3-year limitation and this is not the intent of Congress when it enacted the Revenue Act of 1978.

For this reason, SAF strongly urges the members of the committee to take affirmative action on S. 2089 which will further clarify and enforce the will of Congress and it will allow the investment tax credit for greenhouses and other qualified structures to be void of the constraints which are currently being applied by the Internal Revenue Service.

Senator BYRD. Thank you, Mr. Blevins.

[The prepared statement of Mr. Blevins follows:]

STATEMENT OF

MICHAEL K. BLEVINS

ON BEHALF OF

THE SOCIETY OF AMERICAN FLORISTS

AND ORNAMENTAL HORTICULTURISTS

ON

S.2089, TO AMEND THE REVENUE ACT OF 1978

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

COMMITTEE ON FINANCE

UNITED STATES SENATE

FEBRUARY 29, 1980

Mr. Chairman, my name is Michael K. Blevins and I am director of government affairs for the Society of American Florists (SAF). I am here today representing over 900 commercial floricultural growers who produce over 90 percent of the flowers and plants grown in the United States. SAF also represents more than 7,000 wholesalers and retailers who distribute and sell the floricultural product to the American consumer. The American floriculture industry is engaged in the growing, transporting, and marketing of floral products which are used in homes and offices, for decoration, to create interior environments, for sentimental reasons, and for special occasions. In total, over 93 percent of the American floriculture industry is represented by SAF through either direct or affiliate membership.

The floriculture industry is by nature an industry of small businessmen. Almost all of the SAF membership is of the family-owned, "Mom and Pop" type operation, and it is on behalf of this constituency that I submit the following comments.

SAF commends the Committee for its consideration of S.2089, to amend the Revenue Act of 1978, which further clarifies the investment tax credit as it relates to single purpose agricultural or horticultural structures. Specifically, S.2089 addresses the applicable time period of eligibility for these structures. SAF lent its support in the past efforts to enact the investment tax credit and we are pleased to support S.2089. Our interest in the investment tax credit and S.2089 stems from several factors which make it increasingly difficult for the floral producer to continue to function--factors such as inflation, tight money and high interest rates, rising labor costs, skyrocketing energy costs, increasingly vigorous foreign competition, increasing social security and other payroll taxes, and mounting federal regulatory controls.

As I mentioned earlier, most businesses in the floriculture industry are small, and the problems I have just listed hit small businesses most severely. Yet these small businesses are least able to cope with rising costs, foreign competition, and increased burdensome government controls.

The floriculture industry recognized some years ago that stimulating business investment to expand and modernize production facilities was vital. Such stimulation would increase productivity and create new jobs which are essential to the health of our industry in particular, and to American business and industry in general. We realized that without this incentive the floriculture industry would be particularly hard hit and many of its small businesses would fail. The floriculture producer requires heavy capital investment to establish initial production facilities and to implement constantly changing technological developments. It is these advances which enable the American floriculture industry to compete with foreign growers who often operate in more favorable climates with vastly lower production costs.

You may remember that SAF took action to spur this essential investment stimulant when the investment tax credit was enacted as part of the Revenue Act of 1962. Under that Act, the investment tax credit did not apply to buildings but it did apply to certain special purpose structures. However, at that time, the Internal Revenue Service failed to recognize greenhouses as eligible for the investment tax credit even though they were qualified by definition then and have been recognized since as special purpose structures with a singular use.

At that time SAF pointed out that a greenhouse constitutes an essential and integral part of the production of flowers and plants. Without its uniquely designed controlled environment, many flowers and plants could not be produced in adequate quantities or quality to be economically practical. A greenhouse is not

a building in the normal sense which can be used for various purposes. The greenhouse itself, because of its translucent construction and environmental watering, fertilizing, insect and disease control equipment contained as part of the structure's overall configuration, is a uniquely designed special purpose structure which becomes an integral part of the the production of floral crops. Thus, SAF contended greenhouses did meet the technical requirements that it be a special purpose structure and, therefore, eligible for the investment tax credit. We further contended that greenhouses served as an ideal example of the kind of structure which Congress could refer to in enacting the investment tax credit as a stimulant to increased productivity and job opportunities. Unfortunately, in 1962, the IRS did not concur with the greenhouse example.

In 1971, when the investment tax credit was reinstated as part of the Revenue Act of 1971, the Senate Finance Committee further clarified the types of real property eligible for the credit, and again the singular and specialized nature of commercial greenhouses fit the Committee's criteria; that is, they perform a unique integral function in the production of a product, the same as does a hog or chicken-raising structure or a liquor aging-structure. Unfortunately, those actions by the Senate Finance Committee and the Congress did not resolve the problem. The Internal Revenue Service still refused to recognize the unique purpose of a greenhouse and, therefore, its eligibility for the investment tax credit, despite rulings from the U.S. Circuit Court (Thirup v. Commissioner, 508 F. 2d 915 (9th Cir. 1974), greenhouse) and a Federal District Court (Stuppy v. United States S. 2nd, 77-0659-cv-2-3, (W.D. Mo. 1978), that greenhouses did qualify for the credit. The IRS's position led to numerous audit disputes and resulted in litigation across the country.

This litigation was particularly burdensome to the small businesses of the floricultural industry. The claims in dispute were often small compared to the astronomical legal costs involved in pursuing litigation. The result, in many cases, was that many valid claims were dropped by taxpayers because the financial burdens of litigation were too heavy a burden to bear.

In 1978, however, Congress passed the Revenue Act of 1978 which finally clarified by force of law the fact that greenhouses and certain other structures were eligible for the investment tax credit. This Act was a great encouragement to the American floriculture producer and to the American small businessman. Because this provision was seen as a clarification of existing law, the eligibility of greenhouses for the investment tax credit was made applicable to taxable years ending after August 15, 1971, the date when the investment tax credit was reinstated. SAF is pleased to have worked closely with the Senate Finance Committee, Congress, and many other organizations and individuals in support of the Revenue Act of 1978. We at SAF viewed the passage of the Revenue Act of 1978 as a confirmation in undisputable terms of our industry's extensive efforts to clarigy and enforce what had been the intent of Congress all along.

Our appearance here today is percipitated by the implementation of the Revenue Act of 1978 which has revealed a problem with a technicality--one which we think can be easily resolved by passage of S.2089. As you know, the Act of 1978 clearly states that the amendments recognizing the eligibility of greenhouses and certain other special purpose structures "shall apply to taxable years ending after August 15, 1971." Thus, any horticultural structure constructed or expanded since that time should qualify for the credit. Unfortunately, the IRS has seen fit to restrict valid claims by imposing the three year statute of limitations on claims. Generally a claim for the credit can be made until three years after the tax return

is filed or two years after the payment of the tax. Consequently, this enforcement by the Internal Revenue Service pre-empts valid claims for investment tax credits in those taxable years beyond the statute of limitations back in August 15, 1971. SAF does not believe this Committee or Congress intended the IRS to respond to its directive in this manner. We further believe that the intent of Congress is most clearly found in the following statement taken verbatim from the Act:

> "(5) SPECIAL RULE FOR APPLYING SECTION 47.--For purposes of section 47, any single purpose agricultural or horticultural structure shall be treated as meeting the requirements of this subsection for any period during which such structure is held for the use under which it qualified under this subsection.
> "(6) LIVESTOCK.--The term 'livestock' includes poultry."
> (c) EFFECTIVE DATE.--The amendments made by subsections (a) and (b) shall apply to taxable years ending after August 15, 1971.

This entire period was a time of great growth and expansion for the floriculture industry--the period of the "green plant boom"-- and yet claims for this period are beyond the three-year statute of limitations. This, SAF contends, is clearly not the intent of Congress.

For this reason, SAF strongly urges the members of the Committee to take affirmative action on S.2089 which will further clarify and enforce the will of Congress and allow the investment tax credit for greenhouses and other qualified structures to be void of arbitrary and unjustified constraints which are currently being applied.

Passage of this measure will mean that many small businessmen in the floriculture industry and others will be able to receive consideration for investment tax credits granted them as far back as 1971 but heretofore denied because of technicalities.

Passage of S.2089 is needed to once-and-for-all clarify the intent of Congress. At the same time, indications from our members are that credits for this period in

question will serve as a welcome stimulant to business expansion today--a time when it is needed urgently. SAF agrees with the sponsors of S.2089 that this further clarification is necessary and justified and we pledge our help to the Committee in any way possible to see that this S.2089 is enacted.

Senator BYRD. Mr. Myrick.

## STATEMENT OF GORDON S. MYRICK, PRESIDENT, ALABAMA FARM BUREAU FEDERATION

Mr. MYRICK. Thank you, Mr. Chairman. I am here representing the American Farm Bureau Federation. We appreciate the opportunity to offer support for S. 2089, a bill to clarify the retroactive application of the investment tax credit to special purpose agricultural structures.

The investment tax credit is an important business incentive for farmers and ranchers. However, the Internal Revenue Service has been reluctant, at best, to allow the use of the credit—even since its restoration for single-purpose structures on August 15, 1971. This issue is of great concern to many of our members who have poultry, livestock or nursery operations.

Farm Bureau supported the provisions of the Revenue Act of 1978 which reemphasized the intent of Congress to allow use of the investment credit for single-purpose agricultural facilities. We now offer our support to legislation that will clearly allow retroactive application of the credit August 15, 1971, despite IRS attempts to limit refunds based on this credit to 3 years.

The number of inquiries that Farm Bureau has received on the issue of the retroactive application of the investment credit is second only to the amount of mail we have received on repeal of the carryover basis.

We urge the subcommittee to approve S. 2039. Thank you for the opportunity to present Farm Bureau's views on this legislation.

Senator BYRD. Thank you, sir.

Would Treasury respond?

## STATEMENT OF DANIEL L. HALPERIN—Resumed

Mr. HALPERIN. Thank you, Mr. Chairman. Our statement on this bill is on page 9 of my testimony. We are opposed to the bill. As the previous witness has pointed out, in the last Congress the bill to clarify the treatment of the investment credit for single purpose agricultural structures was made retroactive. There are always difficulties with retroactive legislation, one of which is pointed out by our presence here today. There are taxpayers who cannot claim the credit in early years. Some of the people lost in court in litigating the issue against the IRS. Some have not kept the statute of limitations for filing a refund claim open back to 1971. These taxpayers have been unable to get the advantage of the retroactive effective date.

Now the suggestion is made that these early years be reopened. In a sense, the statute of limitations is always unfair. It allows the mere passage of time to cut off entitlement to a refund or credit.

But we do need some cutoff point. Facts on all claims are not always readily available. The IRS does not keep individual tax returns for longer than a 7-year period and it would not have returns back to 1971 for individuals. It would also not have them for 1972, either, and very shortly even some later years returns would be destroyed.

It would not be possible to verify claims in all circumstances. I think that we ought to maintain the sanctity of the statute of limitations.

The bill last year did give retroactive relief, but that retroactive relief should be limited to those cases where the taxable years are still open. We cannot continue to increase the administrative burden that we impose on the IRS by changes of this kind. I think it would be an unfortunate precedent to reopen the statute.

Thank you.

Senator BYRD. Thank you.

Thank you, gentlemen.

The next piece of legislation to be considered is S. 650. The witness will be Thomas J. Gochberg, president of Smith, Barney Real Estate Corp., accompanied by Mr. John V. Lindsay and Mr. Theodore S. Lynn.

Welcome, gentlemen.

## STATEMENT OF THOMAS J. GOCHBERG, PRESIDENT, SMITH, BARNEY REAL ESTATE CORP., ACCOMPANIED BY JOHN V. LINDSAY AND THEODORE S. LYNN

Mr. GOCHBERG. Thank you, Mr. Chairman.

My name is Thomas J. Gochberg. I am a director of Smith Barney, Harris Upham Holdings and the president of Smith, Barney Real Estate Corp. I am also a trustee of a group trust formed to invest in real estate for employee pension and profit-sharing plans.

I respectfully ask that my complete statement and attached technical memorandum be made a part of the record.

Senator BYRD. It will be made a part of the record.

Mr. GOCHBERG. As a result of the large fluctuations in the stock and bond markets, and as encouraged by ERISA, qualified tax exempt pension and profit sharing trusts have been seeking to prudently diversify their holdings. Investment of some of their funds in real estate has appealed to many such pension trusts. This can permit an important hedge against inflation, and thereby protect the value of retiree pensions. It also can provide some stability to a pension plan's overall investment portfolio.

Most pension and profit sharing trusts are of insufficient size to permit satisfactory diversification of real estate investments by themselves. They therefore seek to pool a portion of their funds in common or group trusts.

Under various provisions of the Code and rulings by the IRS, real estate "pooled trusts" for pension and profit-sharing plans are afforded certain tax exemptions. As is more fully explained in the technical memorandum I am leaving with you, the tax treatment is unfairly inconsistent. All of the real estate income of a bank or insurance company managed pooled real estate pension plan trust is tax exempt. This is so whether or not the real estate is acquired

subject to a mortgage. However, identical income of such a pooled trust managed by an ERISA qualified investment manager other than a bank or insurance company is subject to a tax. This is the unrelated business income tax that is imposed on earnings from mortgaged real estate. This inconsistency is unfair and, we believe, must be corrected.

Unlike most other investments, debt financing is inherent in real estate investments. Often a real estate investment is desirable because it can be made by assuming an existing mortgage on the property at favorable interest rates. Sometimes the seller may insist on taking back a purchase money mortgage for its own reasons. Other times a property can be acquired only if the purchaser is willing to enter into an installment sale.

There is no justifiable basis for determining the tax treatment of a real estate pooled trust for qualified pension plans on the basis of whether a bank or insurance company is the manager. ERISA qualified managers such as investment banking firms are certainly as competent. The present discrimination on behalf of banks and insurance companies imposes an unfair and unnecessary tax on pooled real estate trusts for pension plans managed by other ERISA qualified managers. All agree that this discrimination was never intended and that so decreasing the income ultimately available for distribution to retiring employees is an unfair result.

Passage of Senate bill 650 will remedy this inconsistent and inequitable treatment. It provides that indebtedness incurred by a qualified group trust for employee pension and profit sharing plans in connection with real estate investments is excluded from the definition of "acquisition indebtedness."

Therefore, rental income and capital gains of qualifying pooled trusts for pension plans will not be subject to the unrelated business income tax. It should be noted, however, that this income is eventually taxed, since the employee beneficiaries pay a tax on their distribution from pension and profit-sharing trusts. The bill is sufficiently detailed so as not to have an unduly broad application, and specifically prohibits sale-leaseback transactions and debt-financed bootstrap acquisitions.

Mr. Chairman, one additional point, if I may. The staff report description of this bill is correct in stating that the revenue effect will be relatively small in the next few years if this bill is passed. However, in my opinion, the revenue effect will continue to be small thereafter.

Group real estate investments managed by banks and insurance companies are, as we have explained, now tax free. Without Senate bill 650, such funds would continue to dominate the industry. Thus, there would be little revenue from funds managed by others.

Simply stated, there would be few other funds that would be taxpayers.

In conclusion, Mr. Chairman, the effect of the passage of Senate bill 650 will be to treat all qualified pooled real estate trusts for employee pension and profit-sharing plans in the same manner. It will eliminate a discrimination that everyone agrees is unintended and it will permit greater security and income for retiring employees.

Mr. Chairman, we thank you.

Senator BYRD. Thank you, sir.

Mayor Lindsay, do you have any comment?

Mr. LINDSAY. I am sorry. I had to step out with Senator Moynihan's staff assistant for just a moment.

We are very grateful for this opportunity to testify on this bill. I am grateful to you for hearing the president of Smith, Barney Real Estate on a matter that we think is basically unfair and should be rectified.

We appreciate it very much.

Mr. Gochberg is an old friend and Mr. Lynn an old law partner and we think this is a matter of equity that we hope very much that this body will rectify as soon as possible.

Senator BYRD. Thank you.

We will see whether the Treasury has the same view.

## STATEMENT OF DANIEL L. HALPERIN—Resumed

Mr. HALPERIN. Thank you, Mr. Chairman.

Our comments on this bill in some detail begin on page 13 of our statement. As we indicate there we do not necessarily object to the result that is sought here, but we think that it ought to be justified, if it can, on broader grounds.

Essentially the argument which you have heard today is based on the fact that if debt-financed real estate investments can be made through insurance companies, apparently because of an oversight in the statute, and are made through bank common trust funds, apparently on the basis of a private ruling issued a number of years ago which seems to us to be certainly questionable, if not incorrect.

Senator BYRD. Am I clear that you have no particular objection, that Treasury has no particular objection, to this legislation?

Mr. HALPERIN. Well, Mr. Chairman, let me say this. We do not necessarily object to the result that is sought. We do object to the provisions and way in which exceptions are being carved out.

Essentially it has been pointed out that insurance companies and banks are able to make these investments, or they think they are able to, and therefore we ought to allow the investment brokerage industry the same advantage. What they propose is setting up a rather complicated new provision involving investments by group trust subject to a lot of conditions. We think that is an unfortunate example of the way we continue to proliferate special provisions in the Internal Revenue Code.

Senator BYRD. I wonder if it might not be reasonably simple to get together and work out something less complicated.

Mr. HALPERIN. No problem, as far as we are concerned. What we are saying is that if one can make the argument, as a matter of policy, that pension funds which invest in real estate on a leverage basis should not be taxed, it should matter in what form they do it.

The real question for you to consider is whether we want to tax the income that pension funds earn on leveraged real estate investments. We see good arguments why the answer to that question is no, and if the answer is no, we ought to take a broad approach to this bill and not continue to proliferate narrow exceptions.

That is essentially what we are saying.

Senator BYRD. Do you have any objection to that approach?

Mr. LYNN. The fact of the matter is that there are essentially billions of dollars now invested in pooled funds for real estate pension plans managed by banks and insurance companies. As a practical matter, the policy issue whether debt-financed real estate ought to be tax free has been passed by the facts of the matter.

ERISA-qualified pension managers, such as investment banking firms, are now discriminated against. Getting into a policy discussion as to whether or not the general subject should or should not be changed would lead us to a course of action such that years will pass, the banks and the insurance companies will continue to manage this money and the investment banking houses and others will simply be out of business.

Senator BYRD. Let me ask this question, then.

Why is there, in the current law, a distinction between the investment banking firms and banks and insurance companies?

Mr. HALPERIN. With respect to insurance companies, I think there was a statutory oversight in the 1969 amendment. Nobody raised it and it was not brought up.

The question whether banks are entitled to this treatment under present law seems to be based, as we understand it, upon a private ruling issued by the Service issued on a related question a couple of years ago.

Senator BYRD. They are exempt, are they not?

Mr. HALPERIN. We think it is highly questionable whether banks are really exempt under present law.

Senator BYRD. They are exempt under the ruling, are they not?

Mr. HALPERIN. The private ruling on unrelated questions would indicate that they are. I think that the ruling is wrong.

Senator BYRD. Whether or not the ruling is right or wrong, would you make it clear to this committee, are they exempt or are they not exempt under the ruling?

Mr. HALPERIN. I think a reading of the ruling, a private ruling, Mr. Chairman might so indicate. It is not, however, the rule. It is a ruling issued to one person in one situation. It cannot be used by everybody in every case. It cannot be taken as a general statement of the law.

Senator BYRD. Why should there be a distinction between investment banking firms and banks and insurance companies? I am asking for information. I do not know. Why should there be?

Mr. HALPERIN. There should not be. I totally agree.

Senator BYRD. If that is the case, are you not arguing on behalf of their legislation?

Mr. HALPERIN. I do not think it is good for us to say that we made one mistake and rather than correct it we ought to extend it to everybody else.

Senator BYRD. Do you think it should be uniform?

Mr. HALPERIN. I think it should be uniform.

Senator BYRD. Then, to make it uniform, the Congress has to take away from the banks and insurance companies something, or give to the investment banking firms, something. Is that right?

Mr. HALPERIN. That is correct, Mr. Chairman.

Senator BYRD. You have no particular objection to what they seek, but you do not like the way they seek it?

Mr. HALPERIN. That is right. However, I think also that if you are going to permit this, there is no reason why a single pension plan which wants to go out and buy real estate on its own should be forced to get together either with a banker or an insurance company or 10 others.

Senator BYRD. You would recommend that the proposal be amended to take care of the single pension plan, would you?

Mr. HALPERIN. If the conclusion is reached, and as I said, I think there are good arguments which can be made that the exemption is justified, it ought to be across the board and not limited to particular kinds of investment vehicles.

Senator BYRD. Do you have any objection to making it across the board?

Mr. LYNN. Mr. Chairman, we certainly have no objection to making it across the board. However, as a practical matter, it is a much more limited step that we are proposing and Congress has, on occasion—for example, the real estate investment trust concept—looked to group investments in real estate in a different manner than specific investments in real estate.

And, as I say, as a practical matter, we like pooled real estate investments for pension plans because it provides better management, more sophisticated management, more diversification, and we think pension plans are probably better served by pooled investment in real estate.

But if Treasury wishes to remove the tax completely from all real estate investments, certainly we would have no objection.

We would support this bill, however, because we think it is limited and has a likelihood of passage rather than a general study of the entire subject for all pension plans. It might take a great deal of time.

Mr. LINDSAY. I might add a word.

The banks and insurance companies have, pursuant to Federal law, been filing their Federal tax returns taking this exemption, which was proper, since 1969. As I understand it, the Internal Revenue Service and Treasury Department have never challenged it. It has been going on, and would have gone on but for this event, I suppose, forever.

And it is a little odd now to suggest the Treasury Department basically disagrees with the interpretation of the ruling when they have not disagreed before. They could have easily challenged it when tax returns were filed, and did not.

Mr. HALPERIN. Mr. Chairman, as I understand it, the question of the proper treatment of pension plans, participating in bank common trust funds had been under examination by the Service before this issue arose. In any event, it is not something that necessarily appears on the face of the return. It is also not something that, even if it did, is an issue that has been faced in any kind of public forum nor through a published revenue ruling, nor in a regulation.

I think that it is something that needs to be considered on a lot broader basis than is contained in this bill.

Senator BYRD. I know nothing about the issue, but it just seems to me——

Mr. HALPERIN. Let me say this, Mr. Chairman, if that ruling is right, and means what it has been suggested to mean, pension finds cannot only invest in real estate on a debt financed basis without paying taxes but a bank could, through a common trust fund, place a group of pension plans into a manufacturing business, or open a real estate office.

Mr. LYNN. I think there are also published rulings, not only a private ruling, exempting bank managed common trust funds from tax. Revenue Rulings 66-297 and 67-301 are, I believe, published rulings.

Senator BYRD. The Treasury has answered my query as to whether all of these should be treated alike and Treasury says it should be treated alike. If that is the case, you are going to have to take something away from two groups or give something to another group. And I do not think the Congress is going to take away something from two groups that already have it, so it seems to me logical to give the investment banking firms the same consideration that the banks and insurance companies have.

That is the way it appears to me at the moment.

All right.

I want to ask, for the record, who are the investment banking firms which would be involved in this legislation?

Mr. LYNN. The specific banking firm we are representing is Smith, Barney, Harris Upham. They have a pooled real estate group trust for pension and profit-sharing plans.

I believe there are others, but I am not really qualified to name them at the moment.

Certainly if the legislation passes, then the ERISA qualified investment managers other than banks and insurance companies would be available to employee pension plans two a much greater extent than currently.

Senator BYRD. Thank you. Thank you, gentlemen.

[The prepared statement and appendix of Mr. Gochberg follows:]

[Statement by Thomas J. Gochberg with regard to Senate Bill 650 before the Senate Subcommittee on Taxation & Debt Management Generally - February 29, 1980]

Mr. Chairman and members of this distinguished Subcommittee, my name is Thomas J. Gochberg. I am a Director of Smith Barney, Harris Upham Holdings and President of Smith, Barney Real Estate Corporation. I am also a trustee of a group trust formed to invest in real estate for employee pension and profit sharing plans. I respectfully ask that my complete statement and attached Technical Memorandum be made a part of the record. [Hand to clerk.]

As a result of the large fluctuations in the stock and bond markets, and as encouraged by ERISA, qualified tax exempt pension and profit sharing trusts have been seeking to prudently diversify their holdings. Investment of some of their funds in real estate has appealed to many such trusts. This can permit an important hedge against inflation, and thereby protect the value of retiree pensions. It also can provide some stability to a pension plan's overall investment portfolio.

Most pension and profit sharing trusts are of insufficient size to permit satisfactory diversification of real estate investments by themselves. They therefore seek to pool a portion of their funds in common or group trusts.

Under various provisions of the Code and rulings by the IRS, real estate "pooled trusts" for pension and profit sharing plans are afforded certain tax exemptions. As is more fully explained in the Technical Memorandum I am leaving with you, the tax treatment is, however, unfairly inconsistent.

All of the real estate income of a bank or insurance company managed pooled real estate pension plan trust is tax exempt. This is so whether or not the real estate is acquired subject to a mortgage. However, identical income of such a pooled trust managed by an ERISA qualified investment manager <u>other than</u> a bank or insurance company <u>is</u> subject to a tax. This is the unrelated business income tax that is imposed on earnings from mortgaged real estate. This inconsistency is unfair and, we believe, must be corrected.

Unlike most other investments, debt financing is inherent in real estate investments. Often a real estate investment is desirable because it can be made by assuming an existing mortgage on the property at favorable interest rates. Sometimes the seller may insist on taking back a purchase money mortgage for its own reasons. Other times a property can be acquired only if the purchaser is willing to enter into an installment sale.

There is no justifiable basis for determining the tax treatment of a real estate pooled trust for qualified pension plans on the basis of whether a bank or insurance company is the manager. ERISA qualified managers such as investment banking firms are certainly as competent. The present discrimination on behalf of banks and insurance companies imposes an unfair and unnecessary tax on pooled real estate trusts for pension plans managed by other ERISA qualified managers. All agree that this discrimination was never intended and that so decreasing the income ultimately available for distribution to retiring employees is an unfair result.

Passage of Senate Bill 650 will remedy this inconsistent and inequitable treatment. It provides that indebtedness incurred by a qualified group trust for employee pension and profit sharing plans in connection with real estate investments is excluded from the definition of "acquisition indebtedness." Therefore, rental income and capital gains of qualifying pooled trusts for pension plans will not be subject to the unrelated business income tax. (It should be noted that this income is eventually taxed, since the employee beneficiaries pay a tax on their

distribution from pension and profit sharing trusts.) The Bill is sufficiently detailed so as not to have an unduly broad application, and specifically prohibits sale-leaseback transactions and debt-financed bootstrap acquisitions.

The effect of the passage of Senate Bill 650 will be to treat all qualified pooled real estate trusts for employee pension and profit sharing plans in the same manner. It will eliminate a discrimination that everyone agrees is unintended. And it will permit greater security and income for retiring employees.

Thank you.

Submitted by Thomas J. Gochberg in connection with his appearance before the Subcommittee on Taxation & Debt Management Generally on February 29, 1980.

TECHNICAL MEMORANDUM Re: S.650

A Bill to amend the Internal Revenue Code of 1954 with respect to the treatment of certain employee's trusts organized to invest in real estate.

February 29, 1980

As a result of the enactment of the Employee Retirement Income Security Act of 1974 ("ERISA)(which contains provisions requiring prudent diversification of investments) and the wide fluctuations in stock and bond markets, many pension and profit-sharing trusts are seeking to diversify a portion of their investments into real estate. Because many of these trusts are of insufficient size to permit them to undertake satisfactorily diversified real estate investments themselves, they prefer to place a portion of their assets in pooled funds for investment by professional real estate managers.

Under present law, the tax treatment of these pooled funds is primarily dependent upon the legal form of the manager. A fund which is managed by a bank (a "Common

Trust") is exempt from all federal income tax.1/ A fund which is managed by an insurance company (a "Segregated Asset Account Fund") is also exempt from all federal income tax.2/ However, a fund which meets certain requirements of the Internal Revenue Service and which is managed by an ERISA qualified manager other than a bank or insurance company (a "Group Trust") is subject to tax on certain types of income.3/

Generally, the income of a Group Trust is only taxable if it is "unrelated business taxable income."4/ Rental income from real property and gain from the sale of real property constitute unrelated business taxable income to the extent the property is debt-financed.5/ Unlike most other investments, debt financing is inherent in real estate investments and is often unavoidable.6/ As a practical mat-

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1/ Section 584(b) of the Internal Revenue Code of 1954, as amended (the "Code"). See Revenue Ruling 67-301, 1967-2 C.B. 146.

2/ Sections 801(g) and 804 of the Code.

3/ See Revenue Ruling 56-267, 1956-1 C.B. 206, listing the requirements for qualification as a Group Trust and the tax status of a Group Trust.

4/ Sections 501, 511 and 512 of the Code.

5/ Sections 512(b) and 514 of the Code.

6/ For example, the acquisition of an apartment building may be particularly attractive as an investment because it can be acquired subject to an existing mortgage at interest rates more favorable than those presently existing.

ter, therefore, Group Trusts formed for investing in real estate will almost certainly have income and gains which will be subject to the payment of income tax.

There is no justifiable basis for taxing Group Trusts managed by ERISA qualified managers other than banks and insurance companies differently than Common Trusts (managed by banks) and Segregated Asset Account Funds (managed by insurance companies). The present differentiation in tax treatment not only substantially decreases the amount of income ultimately available for distribution to employee beneficiaries, but also places Group Trusts at a serious competitive disadvantage.

Senate Bill 650 would remedy the inconsistent tax treatment by exempting from tax the rental income and capital gains of Group Trusts formed for investment in real estate. This is technically accomplished by amending Sections 401, 404 and 514 of the Internal Revenue Code.

The amendment to Section 401 would redesignate the existing subsection (1) as subsection (m) and add a new subsection (1). This new amendment would codify the Internal Revenue Service definition of a Group Trust (contained in Revenue Ruling 56-267, *supra*.), and would also codify the

Internal Revenue Service ruling policy that a Group Trust is to be treated as a qualified pension or profit-sharing trust. The provisions would be limited to a Group Trust in which at least ten different pension and profit-sharing trusts (none of which control the Group Trust) have pooled a portion of their assets for investment into real estate and whose assets are managed by an investment manager subject to the provisions of ERISA. Other provisions that are intended to insure that the Group Trust will be of sufficient size to diversify its investments include the requirement that the Group Trust have at least $10 million invested in real estate and that only a minor portion of the Group Trust's funds be invested in assets other than real estate.

The amendment to Section 404 would add a sentence at the end of subsection (a)(4) providing that the Group Trust must be created, organized and maintained in the United States. (This is an existing Internal Revenue Service requirement.)

The amendment to Section 514 would add two sentences to the end of subsection (c)(4) providing that indebtedness incurred by a Group Trust in connection with its acquisition of real estate be excluded from the definition of "acquisition indebtedness" (and, therefore, income

received from such property be excluded from the definition of debt-financed income).

Additionally, the amendments to Sections 401 and 514 contain provisions which would prevent a Group Trust from trading on its tax exemption by taxing debt-financed "bootstrap" acquisitions and by prohibiting the Group Trust from engaging in sale-leaseback transactions. These amendments also prohibit the Group Trust from engaging in farming activities.

The effect of these amendments would be to treat the rental income and capital gains of all similarly situated pooled funds in the same manner. Adoption of Senate Bill 650 will be of benefit to all employee pension and profit-sharing trusts and will be consistent with the provisions and the spirit of the Employee Retirement Income Security Act of 1974.

Senator BYRD. The next legislation to be considered is H.R. 5505, Mr. William J. Lehrfeld on behalf of the Knights of Columbus.

Welcome, sir. You have 5 minutes.

## STATEMENT OF WILLIAM J. LEHRFELD, ON BEHALF OF THE KNIGHTS OF COLUMBUS

Mr. LEHRFELD. Thank you.

My name is William Lehrfeld. I serve as tax counsel for the Knights of Columbus.

The legislation in question would protect an exemption for auxiliaries of subordinate lodges of the Knights of Columbus. The auxiliaries hold the real title and improvements, such as the pool or the club house. If these organizations are treated as social clubs and they limit their membership to members of the Knights of Columbus, they will be denied tax-exempt status unless this legislation is enacted.

The Knights of Columbus, as you know, limits its membership to individuals who are Catholics. The Knights of Columbus, itself, is a fraternal society which is not a social club but in order for their unincorporated fraternal subordinate lodges to hold title to real property, they must incorporate an auxiliary organization.

Since 1956, the Internal Revenue Service has treated many of these auxiliaries as social clubs. Because the clubs do not allow as members anyone other than a member of the Knights of Columbus, they, in effect, discriminate on account of religion. Under existing law, this discrimination causes these auxiliaries to lose their tax-exempt status under section 501(i).

The bill simply modifies the limitation on tax exemption for social clubs so if you have a fraternal society that limits its membership to members of a particular religion, auxiliary organizations of that society which do likewise do not lose their tax-exempt status.

I do not believe there is any revenue effect as far as this bill is concerned. Section 501(i), as you can see from our testimony that is in the record, was originated by Congressman Waggonner from Louisiana in 1976. Mr. Waggonner, at the time the bill was considered, raised the question of the Knights of Columbus and application of the proposed law. Members of the joint committee staff told him that there was no concern about the Knights of Columbus because they were a fraternal society, not a social club, and unaffected by the bill.

Apparently because of a lack of information, they did not realize that these auxiliaries existed and, as a consequence, 501(i) when enacted in 1976 did not take this matter into account.

Senator BYRD. Thank you, Mr. Lehrfeld.

Do you have a comment?

Mr. HALPERIN. We have no objection to the change Mr. Lehrfeld is seeking.

Senator BYRD. That seems to be a reasonable approach, as far as I am concerned. I will support that.

Mr. LEHRFELD. Thank you.

Senator BYRD. Thank you.

[The prepared statement of Mr. Lehrfeld follows. Oral testimony continues on p. 345.]

WILLIAM J. LEHRFELD
ATTORNEY AT LAW
1126 SIXTEENTH STREET, N. W
WASHINGTON, D. C. 20036
(202) 659-4772

PREPARED STATEMENT

OF THE

KNIGHTS OF COLUMBUS

NEW HAVEN, CONNECTICUT

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
COMMITTEE ON FINANCE,
UNITED STATES SENATE

ON

SECTION 11 OF H.R. 5505

FEBRUARY 29, 1980

WILLIAM J. LEHRFELD
ATTORNEY AT LAW
1128 SIXTEENTH STREET, N W
WASHINGTON, D. C. 20036
(202) 659-4772

Mr. Chairman, my name is William J. Lehrfeld, the tax counsel of the Knights of Columbus, whose headquarters are in New Haven, Connecticut. I appear today in support of Sec. 11 of H.R. 5505 which was originally introduced as H.R. 4201 by Mr. Cotter of Connecticut.

Sec. 11 of H.R. 5505 amends Sec. 501(i) of the Internal Revenue Code (IRC) dealing with the denial of tax exemption to social clubs under certain circumstances. If the governing instrument of a club requires that it discriminate in membership because of race, color or religion, the exemption is denied. Sec. 501(i) is effective for the taxable years of clubs beginning after October 20, 1976. The proposed amendment would not apply that rule to certain forms of religious discrimination where it involves an auxiliary of a fraternal benefit society which, like the Knights of Columbus, limits its membership to individuals of a particular religion. In our case, it is Catholicism.

Sec. 501(i) today only applies to "social clubs" described in Sec. 501(c)(7) of the Code and prior to 1969 many auxiliaries of fraternal societies have been treated as social clubs by the Internal Revenue Service pursuant to Rev. Rul. 56-305, C.B. 1956-2, 307.

Fraternal benefit societies, and their local lodges, on the other hand, are described in Sec. 501(c)(8) of the Code are not subject, generally, to the provisions of Sec. 501(i).

The Knights of Columbus has, for its governing body, the Supreme Council, state councils for each of the 68 jurisdictions in North America, and over 6,200 local councils which comprises its lodge system.

Membership in the Knights of Columbus is open to practicing Catholics over the age of 18, regardless of race, color or national origin. Since its founding, the Knights of Columbus has never supported, promoted or accepted any form of racial discrimination in its membership practices. However, there is incontrovertible membership criteria. An individual must be Catholic and one who practices his religion. We do not believe that limiting the membership of the Knights of Columbus to practicing Catholics is an invidious discrimination against Jews, Methodists, Presbyterians or others. Members of these religions with their own traditions, doctrines, and moral responsibilities are not precluded from organizing their own fraternal societies and enjoying the same tax benefits available to the Knights of Columbus. We believe that the Knights of Columbus does not deny any non-Catholic any inherent or

important right, duty or power to function in the secular world by the non-Catholic ineligible for membership in our Order.

The Knights of Columbus is a fraternal beneficiary society which operates under the lodge system. Its Supreme Council, on its own behalf and for its local councils, holds a group ruling recognizing our exemption from federal income tax under Sec. 501(c)(8). It is updated annually under Revenue Procedure 77-38 (C.B. 1977-2, 571). The part of the lodge system maintained on the group ruling are the state and local councils. The Supreme Council of the Knights of Columbus does not have any rights over the income or assets of any subordinate organization which is part of its lodge system. We control policy of the Order, names, rituals, suggest programs, assure uniformity in membership criteria and administration; however, we do not "own" or directly control the finances or affairs of the local council.

The lodge system is unincorporated. For that reason, many lodges have found it necessary to create an auxiliary, known in our vernacular as a "home corporation," in order to hold title to any real property and improvements such as clubhouse, pool, bowling alley, etc., they desire to own. In Rev. Rul. 56-305, C.B. 1956-2, 307, IRS held that a corporation of a fraternal lodge should be treated as a social club when engaging in social activities with members

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of the lodge. The "home corporations" are not part of the Supreme Council's group ruling primarily because they are not subordinate to the Supreme Council. In actuality, they are subordinate only to the local council and, more or less, act as their adjunct.

Many years ago, some "home corporations" were treated as titleholding companies under IRC Sec. 501(c)(2) because their exclusive function was to hold title to the real estate, collect income from its operation, and turn over to the local council (the lodge) any net earnings after the payment of expenses. A titleholding company can only do that; it may not carry on any activities since it is supposed to be nothing more than a landlord. Our home corporations found this limitation on activities both burdensome and impractical. Thus, prior to 1969, utilizing Rev. Rul. 56-305, many obtained private letter rulings recognizing their exemption as social clubs under Sec. 501(c)(7). After the passage of the Tax Reform Act of 1969 and its enactment of Sec. 501(c)(10) exempting non-insurance fraternals, some district offices issued determination letters that "home corporations" were entitled to exemption under Sec. 501(c)(10) because the corporation did not provide insurance benefits to their members. Of course, the Supreme Council is the only part of of the Order legally authorized to insure its members so this

exemption provision seemed an apt place for these adjuncts of our subordinate councils. Now, however, the National Office of the IRS has decided that these auxiliaries must be either social clubs (Sec. 501(c)(7)) or titleholding companies (Sec. 501(c)(2)) and is attempting to revoke all Sec. 501(c)(10) rulings to our auxiliaries. Because of Sec. 501(i), they are, in turn, denying the auxiliary Sec. 501(c)(7) status. And finally, if the auxiliary does any more than hold title to property, e.g., actually operate a pool or clubhouse, they are denied Sec. 501(c)(2) status.

Until passage of Sec. 501(i), this welter of confusion over the proper classification of these auxiliaries meant little since regardless of which paragraph of Sec. 501(c) was applied (e.g., Sec. 501(c)(2), (7), (8) or (10)), the result was almost always the same: an income tax exemption for most of their net earnings.

The Knights of Columbus is a religious-centered fraternal society as are its local councils and, in turn, the "home corporations" controlled by the councils. The governing instrument of the Supreme Council provides that no one may be admitted to membership unless he is a practicing Catholic.

Sec. 501(i) denies tax exemption to Sec. 501(c)(7) organizations if they discriminate on account of religion.

On several occasions following the passage of Sec. 501(i), there was correspondence between the Internal Revenue Service and concerned members of this Committee including the sponsor of Sec. 501(i), Mr. Waggonner of Louisiana. We believe, as did Mr. Waggonner, that Congress intended only to affect true "social" clubs where religion had no role in the origination or maintenance of the club and the religious composition of the members was itself rather diverse. He was concerned that if an individual was black-balled because he was a member of a particular religion or race, and the governing instrument of that club required or encouraged that, the club should not enjoy an income tax exemption. See attached correspondence. That is not the case in dealing with an auxiliary of a religious oriented fraternal society. Our "home corporations" are not centers for the pleasure and recreation of the members, but a place where the fraternal, religious, civic, charitable and social activities of the council <u>and</u> the auxiliary can be conducted. Accordingly, exempting certain forms of religious discrimination by adding Sec. 11 of H.R. 5505 does not in any way, overturn or impede the legitimate purpose of Sec. 501(i).

One final point. We wish to make it clear that by supporting this legislation, we do not agree with the Internal Revenue Service that our auxiliaries must be social clubs and can't be Sec. 501(c)(10) fraternal organizations. This legislation is needed now so that if it is finally determined by a court of law that the auxiliaries which carry on fraternal and charitable activities may not be exempt under Sec. 501(c)(10), and must be exempt under Sec. 501(c)(7), that Sec. 501(c)(7) status will not be denied by operation of Sec. 501(i).

COLUMBUS CLUB OF ARLINGTON, INCORPORATED
5115 LITTLE FALLS ROAD
ARLINGTON, VIRGINIA

June 28, 1977

Honorable Joseph L. Fisher, M.C.
U.S. House of Representatives
404 Cannon House Office Building
Washington, D. C. 20515

Dear Mr. Fisher:

The Columbus Club of Arlington, located at 5115 Little Falls Road, Arlington, Virginia, is a "social club" described in Section 501(c)(7) of the Internal Revenue Code. The members of the Columbus Club of Arlington, numbering some 1800, are members of the Edward Douglass White Council of the Knights of Columbus. The Knights of Columbus is a fraternal benefit society described in Section 501(c)(8) of the Code which operates under the lodge system, and the Edward Douglass White Council is a lodge within that system.

The Edward Douglass White Council is an unincorporated association, the membership of which are the individual members of the Knights of Columbus. Because unincorporated associations are not permitted, under Virginia law, to own real estate, it became necessary to incorporate a nonprofit organization to hold title to properties such as we have at 5115 Little Falls Road. Despite the identity of membership and interest, the Edward Douglass White Council is treated as a tax exempt organization described in Section 501(c)(8) of the Code (like the parent Knights of Columbus), but the Columbus Club of Arlington, which owns the real estate used by our member Knights, is treated as a "social club" exempt from federal income tax under 501(c)(7) of the Code.

The Congress recently enacted a provision of law which denies tax exempt status to social clubs if they discriminate in their membership on the grounds, _inter alia_, of religion. (Public Law 94-568). Section 501(g) denies exempt status to a

COLUMBUS CLUB OF ARLINGTON, INCORPORATED
5115 LITTLE FALLS ROAD
ARLINGTON, VIRGINIA

Section 501(c)(7) organization if the charter, by-laws, or other governing instrument, or any other written policy statement of such organization, contains a provision which provides for discrimination against any person on the basis of, inter alia, religion. Because only practicing Catholics may be members of the Knights of Columbus Council and because membership in the Columbus Club is limited to members of the Council, there seems to be a direct conflict between the language of this discrimination provision and the right of the Columbus Club to enjoy exempt status.

We would appreciate your assistance in ascertaining whether the Assistant Secretary for Tax Policy, or other high official of the Treasury Department or Internal Revenue Service, has concluded that this particular provision of law will adversely affect church-related organizations such as the Columbus Club of Arlington. Because of our very substantial interest in this matter, an early reply would be appreciated.

Very truly yours,

COLUMBUS CLUB OF ARLINGTON

Harry W. Benson
President

Internal Revenue Service | Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply to: E:EO:T:R:1-2

Date: AUG 1 1977

Honorable Joseph L. Fisher
House of Representatives
Washington, D. C. 20515

Dear Mr. Fisher:

This is in reply to your letter of July 5, 1977, concerning the correspondence you received from Mr. Harry W. Benson of June 28, 1977, with regard to the impact of Public Law 94-568 on the exempt status of the Columbus Club of Arlington.

Section 501(i) of the Internal Revenue Code of 1954, as added by Public Law 94-568, prohibits exemption to any organization described in section 501(c)(7) of the Code if, at any time during the taxable year, the charter, bylaws, or other governing instrument of such organization or any written policy statement of such organization contains a provision which provides for discrimination against any person on the basis of race, color, or religion.

A possible interpretation of this statute as indicated in Mr. Benson's letter could lead to the conclusion that an organization described in section 501(c)(7) of the Code which restricts its membership to members of a specific religion would lose its exempt status. However, no regulations have been published to date under section 501(i). Before such regulations are adopted they will be published in proposed form in the Federal Register and the public will be given the opportunity to comment on them.

We would also like to call to your attention section 501(c)(2) of the Code which provides for the exemption from Federal income tax of corporations organized for the

exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization exempt under sections 501(c) or 501(d).

We trust this information is sufficient. If we can be of any further assistance, please let us know.

Sincerely yours,

(Signed) E. D. Coleman

E. D. Coleman
Chief, Exempt Organizations
Technical Branch

Enclosure

JOE D. WAGGONNER, JR.
4TH DISTRICT, LOUISIANA

PARISHES:
BOSSIER RED RIVER
CADDO SABINE
CLAIBORNE VERNON
DE SOTO WEBSTER

COMMITTEE ON
WAYS AND MEANS

**Congress of the United States**
**House of Representatives**
**Washington, D.C. 20515**

February 24, 1978

Stuart E. Seigel, Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N. W.
Washington, D. C. 20224

Dear Mr. Seigel:

As you may know, I was the sponsor for H. R. 1144, a bill to liberalize the federal income tax treatment of social clubs. H. R. 1144 was enacted as P. L. 94-568 on October 20, 1976. Apart from liberalizing the treatment of the exempt status of social clubs, Section 2(a) of the law enacted Section 501 (g) dealing with the prohibition of discrimination by certain social clubs. The purpose of this letter is to bring to your attention a matter which we thought was resolved during the course of the enactment of this provision, but which apparently has created some unforseen problems.

The letter is being directed to you, since you will have the principal responsibility in making policy decisions relating to the regulations which will be promulgated under Section 501(g) to take into account its proper scope and interpretation.

The Knights of Columbus are a national Catholic fraternal society, exempt from federal income tax under Section 501 (c)(8) of the Internal Revenue Code. Because the lodge system of the Knights of Columbus is unincorporated, many of the local councils of the Knights of Columbus organize a council corporation or home corporation to facilitate ownership of real property and improvements where fraternal, social and civic activities may be conducted. Upwards of 2,000 of these "home corporations" are exempt from federal income tax under Section 501(c)(7) of the Code as "social clubs." They have expressed their concern to me, and I recite their concern to you, that the provisions of Section 501(g) may adversely affect the exempt status of these related corporations. This adverse effect certainly was not my intention when Section 501(g) was added to H. R. 1144.

To be a member of the Knights of Columbus, one must be a practicing Catholic, and that requisite is contained in the governing instrument of the Knights of Columbus and in all

governing instruments with respect to the subordinate lodges. In order to be a member of a home corporation, an individual must be an active member of the Knights of Columbus, meaning that he must be a practicing Catholic. Because only practicing Catholics may be members of these home corporations, there appears to be a problem under Section 501 (g) in that it prohibits exempt status for organizations which "provide for discrimination against any person on the basis of religion."

When Section 501(g) was being drafted, in March of 1976, during the course of several days of public hearings, March 1, 1976 and March 3, 1976, different committee members brought up the question of the status of organizations like the Knights of Columbus which have a form of religious discrimination by only permitting members of one religion to join their organization. It was indicated at this time that there would be no problem with the Knights of Columbus because they were a fraternal society and not a social club. Apparently, we did not have all of the information available at the time which would have permitted us to consider this new subsection in a more appropriate context.

In my judgement, organizations which "discriminate" by providing that only members of a particular religion may join a club is not the type of discrimination which Section 501(g) was intended to proscribe. In my judgement, Section 501(g) was intended to proscribe basically homogenous clubs whose composition was not religiously centered or oriented, i.e., religion had no role in the origination or maintenance of the club, and the religious composition of the members was diverse, and the membership simply blackballed someone for membership because they were a member of a particular religion or race.

I would appreciate a response from you concerning what you believe the tax policy considerations are in permitting situations such as those described from not adversely affecting organizations such as the Knights of Columbus, and whether you believe the regulations could be drafted to take into account their particular situation.

I look forward to hearing from you on this matter.

All good wishes,

Joe D. Waggonner, Jr.
JDW:dgp

CHIEF COUNSEL
Internal Revenue Service
Washington, DC 20224

MAR 9 1978

The Honorable Joe D. Waggonner, Jr.
House of Representatives
Washington, D.C. 20515

Dear Mr. Waggonner:

This is in further response to your letter of February 24, 1978, relating to P.L. 94-568, which added section 501 (i) to the Internal Revenue Code. You suggested that section 501 (i), which prohibits discrimination by certain social clubs (described in section 501 (c) (7)), was not intended to prevent an organization from limiting its membership to adherents of a particular religion. The question that you raise is very troublesome, and is one that I believe is not free from doubt.

We have recently learned, primarily as a result of your letter, of the extent to which an alternative interpretation might affect religiously oriented fraternal societies such as the Knights of Columbus. We are studying this problem to ascertain the organizations that could be affected by the prohibition of religious discrimination and to determine whether these organizations might qualify for exemption under paragraphs other than section 501 (c) (7). In addition, we are attempting to determine whether, in the absence of clear statutory authority or guidelines, we can distinguish between religiously oriented clubs and clubs that discriminate against members of a particular religion.

This problem is compounded because the reason for the adoption of a discriminatory provision by the organization may not be readily apparent. It is our understanding that many social clubs were formed by individuals with similar religious backgrounds and adopted religious practices consistent with those of their membership. In such cases it is difficult to determine whether

a discriminatory provision in the club's governing instrument is the result of the religious orientation of the club or is intended to promote social exclusivity.

In view of the above, we are unable to determine at this time whether regulations could be drafted to effect the result you desire. However, we will, of course, consider the situation described in your letter in the development of the regulations.

Sincerely,

/s/ Stuart E. Seigel
Stuart E. Seigel

Senator BYRD. Is Miss Jane Cathcart present?

Mr. MILES. Mr. Chairman, my name is Robert Miles. I represent Miss Cathcart. She went to put coins in the meter—she was afraid of getting her automobile booted. She is not back yet, Mr. Chairman.

Senator BYRD. Suppose we delay a moment until she gets back.

The committee is glad to have Senator Nelson with us.

The next piece of legislation is S. 1831 and the distinguished Senator from Wisconsin, my close friend with whom I sit side by side every day on this committee is here to introduce the witnesses.

Senator NELSON. Mr. Chairman, Mr. George Kline is chairman of the board of First Wisconsin Mortgage Trust Co. of Milwaukee and Mr. Sheldon Fink accompanies him. They are here to testify on S. 1831.

Gentlemen, I am pleased to present you to the chairman of this subcommittee who handles the hearings on all these pieces of legislation, and we are pleased to have you here this morning.

Mr. KLINE. Thank you, Senator.

Senator BYRD. Welcome, gentlemen. You are in good hands when you are in Senator Nelson's hands. We are glad to have you.

Mr. KLINE. Thank you, Senator.

We in Wisconsin will defer to our Georgia friends and let them go first, if that is in accordance with your wishes.

Senator BYRD. You may proceed.

Mr. WHITAKER. Thank you.

## STATEMENT OF LLOYD WHITAKER, CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CMEI, INC.

Mr. WHITAKER. Mr. Chairman, Senator Nelson, my name is Lloyd Whitaker. I am chairman, president and chief executive officer of CMEI, Inc., corporate successor to Cousins, Mortgage & Equity Investments, which formerly was a qualified real estate investment trust.

My company is one of the entities affected by Senate bill 1831 and I appreciate very much the opportunity to appear before the committee this morning to speak in favor of this legislation.

The effect of the bill is to grant an additional period of up to, but in no case more than, an additional 3 years within which certain

former REITS may utilize net operating losses incurred in 1974 and 1975 as a result of the real estate recession.

In that connection, Mr. Chairman, our real estate recession was to the real estate industry what Hurricane Frederic was to the pecan growers of south Alabama; and the disasters that befell those pecan growers as described by Senator Heflin and those who testified is not unlike the wasteland that occurred in the real estate industry in 1974 and 1975.

My prepared testimony sets out the affirmative reasons why we support this legislation.

Because Treasury has chosen to oppose a portion of the bill, I would like simply to summarize the major points of my prepared testimony in order to leave some time, if I may, following Mr. Halperin's remarks to address directly Treasury's opposition.

I think it is important, at the outside, to understand that the losses in question arose out of a nationwide real estate recession that was sufficiently broad, deep and long as to damage virtually every member of the REIT industry—and there is a definable REIT industry.

The survivors are just now beginning to stabilize, but most have not yet recovered the capital that was lost in the mid-1970's.

Now, because our 1974-75 net operating loss carryovers are about to expire, these entities are facing the added spectre of paying tax of what is, economically, a recovery of capital as distinguished from economic income.

The effect, without corrective legislation, will be a Federal excise of 46 cents on each dollar of capital recovery after these losses have expired.

Losses incurred in 1975 under present law expire this year, 1980.

Because of the unusual depth of the recession in the 1970's and because the losses that were sustained were borne by tens of thousands of small and relatively unsophisticated individual shareholders in REITS, we believe that sound and humane tax policy might well justify an unusually long period of time within which to recover lost capital without the imposition of such a Federal excise.

Nevertheless, we are not asking for preferential treatment as to the period in which we can recover our lost capital without adverse tax consequences. Rather, we are asking only for equal treatment with other taxpayers.

Or, to use a favorite phrase, we are asking for tax equity. Under present law, former REITS such as our trust which suffered recession-related losses are entitled to only 5 years within which to recover those losses. In contrast, continuing REITS which suffered identical recession-related losses are entitled to 8 years in which to utilize their losses.

Similarly, regular real estate corporations which suffered recession-related losses are entitled to 8 years; 3 years of carryback and 5 years of carryforward, in which to average their losses against income for tax purposes.

This bill would give former REITS an equal period of time, 8 years, in which to utilize unrecovered net operating losses. The concession sought in this legislation is "tax equity" in the form of a loss-carryover extension.

This relief is grounded, fundamentally, in the principle of self-help. If we generate future profits to achieve the recovery of lost capital, we ask you give us the same benefits that are available to other taxpayers before the recovery is taxed away.

In summary, we believe that the entirety of the bill merits favorable consideration by the committee since the effect of the bill is merely to grant similar entities the same loss utilization period that is available to other taxpayers.

Thank you.

I will now defer the remainder of my time to Mr. Kline.

Senator BYRD. Mr. Kline.

## STATEMENT OF GEORGE H. KLINE, CHAIRMAN OF THE BOARD, FIRST WISCONSIN MORTGAGE TRUST

Mr. KLINE. My name is George Kline. I am chairman of the board of the First Wisconsin Mortgage Trust. I am accompanied by my tax counsel, Sheldon Fink.

I speak in favor of Senate bill 1841.

The First Wisconsin Mortgage Trust is a real estate investment trust which sold shares publicly, generally to small investors, and then borrowed substantial amounts from various bank lenders.

We are in a different position than Mr. Whitaker. Mr. Whitaker testified that his REIT was "deREITED" in the tax year ending 1975.

S. 1831, the bill before us, has two parts: one, to treat those who "deREITED" subsequent to 1975, as in my case, and the other as in Mr. Whitaker's case for those who "deREITED" earlier.

I make this distinction because neither today's agenda, as I read it nor the staff description of Senate 1831 seems to speak to this particular point.

I have also read Mr. Halperin's statement of the Treasury and was delighted to see that on page 5 of his prepared statement that the Treasury did not oppose that portion of the bill which pertained to the First Wisconsin REIT and those similarly situated.

As a matter of fact, Mr. Halperin did such a superb job of condensing the situation that I thought I would adopt his language and, with your permission, not go into my prepared text which details those, but rather use Mr. Halperin's summary.

On page 5, he says under current law if an REIT incurs a net operating loss in a qualified year after 1975, the loss may be carried over for 8 years. Pre-1976 losses, however, may be carried over for 5 years with an extension of up to 3 years as long as the REIT has remained continuously qualified in all years following the year of loss.

The bill would treat pre-1976 losses the same as post-1976 losses and would allow an 8-year carryover period for all REIT losses regardless of the year in which the loss was incurred or the REIT's qualified status in subsequent years.

He goes on to say, we do not oppose this change which affects only those pre-1976 losses which were incurred by qualified REIT's.

The REIT industry suffered its greatest losses in 1973 and 1974. Recovery has been slow and many of these large losses will expire unused regardless of qualifications. That is the end of my quote.

I certainly can say "amen" to Mr. Halperin's analysis. However, as Mr. Whitaker pointed out, Mr. Halperin is opposed to the second part of the bill and I would like to speak 2 or 3 seconds to that.

I am concerned that the difference in tax laws that would treat REIT's situated here as REIT's situated as Mr. Whitaker's differently. It violates the principles of tax equity.

I would think when Mr. Whitaker's REIT "deREITed" in his tax year ending in 1979, they did, for management reasons which they considered valid and cogent at the time and we all face these same difficult decisions.

My trust made a somewhat different decision and deferred its "deREITing" until 1977. Hence, gentlemen, I speak in favor of S. 1831 and urge favorable consideration of the entire bill.

Thank you.

Senator BYRD. What is Treasury's comment?

STATEMENT OF DANIEL L. HALPERIN—Resumed

Mr. HALPERIN. I guess both witnesses have indicated where we stand. Mr. Whitaker and I have carried on some correspondence about this for awhile and I suppose it would be useful for us to face the issues at the same point in person. I certainly agree, Mr. Chairman, that like entities ought to be treated alike. The question is to try to identify who is like whom. We have different treatment of operating losses depending on the nature of the entity. Certainly there is nothing magic about a 7-year carryforward, or an 8-year carryforward, or a 5-year carryforward, and we have changed it a number of times. However, we have to recognize that losses do expire. We have never been able to have an unlimited carryforward because of the obvious administrative problems.

Unfortunately, we have different rules for different types of entities as to when those losses expire.

What Mr. Whitaker is dealing with is a corporation which incurred a loss in 1975 at a point when it was a regular corporation for tax purposes. It did not have any special status. It was entitled at this point to the same net operating loss treatment as any other regular corporation that incurred a net operating loss in 1975. He attempts to distinguish his case from that of a regular corporation. He says that his corporation was different from most regular corporations because in earlier years, 1972, 1973, it was a REIT and therefore we should be treated like a REIT which experienced losses in 1975 and not as a regular corporation which experienced losses in 1975. In other words, they want to retain their former status for the purpose of determining the length of the loss carryforward period.

Senator BYRD. Let me see if I understand this. They were a REIT in 1975 and they are now a regular corporation, no longer a REIT?

Mr. HALPERIN. That is true, but I think the year in which they ceased to be a REIT was earlier than 1975, 1973, or 1974.

Mr. WHITAKER. 1974.

Mr. HALPERIN. They were a REIT through 1974 and became a regular corporation in 1975 and have continued as a regular corporation until now.

Senator BYRD. The loss occurred in 1975.

Mr. HALPERIN. Yes.

Mr. WHITAKER. We actually continued as a business trust rather than as a corporation but the effect is the same. When we "deREITed" we were no longer a qualified real estate investment trust, but we were still a business trust which is, for tax purposes, taxed as an ordinary corporation.

Senator BYRD. Why should you be treated as a REIT, then?

Mr. WHITAKER. Our position, Mr. Chairman, is we were denied any carryback years because as a REIT during those REIT years we had only carryforward, no carryback.

When we "deREITed", we did not acquire any carryback years and, in fact, we are asking in our plea for tax equity only for an extension of the carryforward period to balance those carryback years which we did not receive because of technical reasons.

We did not "deREIT" to make a tax decision. We "deREITed" because the technicalities of qualification did not permit hands-on dealing with foreclosed real estate.

Senator BYRD. When you were a REIT, you got whatever advantage there were in being a REIT and when you "deREITed", or when you became a regular corporation, why would you not assume the same tax status as a regular corporation?

Mr. WHITAKER. That is what we are asking for exactly, Mr. Chairman. We are asking for an 8-year period. An ordinary corporation has a 5-year carryback period and a 5-year carryforward period.

We, as a "deREITed" REIT, if you will, have only the 5-year carryforward period and because it is technically impossible to give us a carryback period for REIT years, we are asking that the 3 additional years be added on to our carryforward period as a self-help means of permitting this entity, which has been through its own Hurricane Frederic, to recussitate itself, to use these losses, which are real dollar losses incurred by our shareholders.

Senator BYRD. They were losses as a REIT.

Mr. WHITAKER. They are REIT related losses that were incurred subsequent to "deREITing".

Senator BYRD. Subsequent to "deREITing".

Mr. WHITAKER. Subsequent to "deREITing".

Treasury has taken the position that they have no opposition to the additional carryforward period which incurred for an entity that incurred the losses as a REIT and subsequently "deREITed".

What we are saying is that the distinction Mr. Halperin seeks to make is one of form and not of substance. There is truly a continuation of the same taxpayer, the entity that was a qualified real estate investment trust, qualified, "deREITed" for nontax reasons and is the same taxpayer going forward that was the taxpayer previously.

Senator BYRD. Senator Nelson.

Senator NELSON. So the loans that were made on which you subsequently sustained a loss were loans made while you were a REIT?

Mr. WHITAKER. That is correct.

Senator NELSON. The loss did not occur while you were a REIT?

Mr. WHITAKER. That is right.

Senator NELSON. Once you change "deREITed"—you say for nontax purposes—there was a default with respect to the loan you

made while you were a REIT. The default occurred after you became a new entity.

Is that what you are saying?

Mr. WHITAKER. The default occurred before we "deREITed", Senator, but under the law, the tax law, the less for tax purposes required to occur at the time of foreclosure. We had no choice.

Senator NELSON. You are only talking about losses that occurred while you were a REIT.

Mr. WHITAKER. No, sir.

The default occurred while we were a REIT. The loss was realized in our case subsequent to "deREITing", but it was the same asset. You are correct.

It is the law that triggers when the tax loss is realized.

Senator NELSON. I was using default to cover both.

If you had a default, technically the default occurred while you were a REIT, the loss that you had to take occurred after you had created a new entity.

Mr. WHITAKER. That is correct. We had made that decision in order to take a hands-on approach with that real estate that was coming back to us by the way of foreclosure and the foreclosure did not occur until subsequent to the time of the formal "deREITing".

Senator NELSON. I do not understand the difference between the two entities. Are they, however, the same owner, same assets, same everything?

Mr. WHITAKER. Yes, sir.

Senator NELSON. All you have done is change the legal entity itself?

Mr. WHITAKER. If I could use an analogy for a minute, if you assume that there were two identical REIT's, each with a history of having existed for a number of years. REIT No. 1, like Mr. Kline's REIT, sustained heavy economic losses in 1974 and 1975 during a period that it was technically still a qualified REIT.

Thereafter, in 1976—in his case, 1977—a decision was made to "deREIT." Treasury says it has no opposition to that extension of a carryforward period to 8 years.

Mr. HALPERIN. The decision to permit an 8-year carryforward for REIT losses was made in 1976. What we really have at issue here is a rather narrow application of that provision to a particular case.

We are not dealing with the question whether it is proper to give REIT losses an 8-year carryforward. That decision was made in 1976 but does not apply to this particular situation. We see no reason to distinguish that case from the cases to which the 8-year carryforward applies.

Mr. WHITAKER. If I could be permitted to finish my analogy, because I think it is a very telling one. The other REIT in my analogy has the same operating history since it was formed; it, too, was profitably engaged in business. Its shareholders paid taxes on its profits. But it "deREITed" in 1974, before it technically accrued any losses.

Those losses occurred, therefore, subsequent to the "deREITing" process, but in all other particulars it is identical, and Treasury is seeking to say because the form of the entity is different, although there is no question that in both instances there is a continuity of the same taxpayer, because the form of one entity was different,

since it had chosen to "deREIT" a "deREITing" had occurred, that it should be denied the 8-year carryforward period the logic for which, as I mentioned earlier, is based on the fact that there is no available carryback period so that you extend an 8-year carryforward period, thereby achieving tax equity with other taxpayers.

Mr. KLINE. Let me add a word, if I might, Senator. I would argue, and I think it is true, that Mr. Whitaker's REIT is the same, identical legal entity that it always was. It has not changed at all.

The only thing that has changed is its tax status, but this is the same trust, with the same shareholders, with the same everything that it always was.

Senator BYRD. I thought it was once a REIT, but now a regular corporation.

Mr. WHITAKER. That is correct, but it was in both instances, Mr. Chairman, it was a trust. The only difference was whether it was a qualified REIT or not.

Mr. HALPERIN. They could be the same legal entity with the same State law relationships and same shareholders. The REIT is a tax animal. It has nothing to do with what they look like under State law.

Mr. WHITAKER. What we did, because our loans were defaulting and because we were required to foreclose on the collateral for those loans which was real estate, we had to "deREIT" because we were not permitted under the qualification rules applicable to real estate investment trusts to manage real estate directly and it was our business judgment that no one can manage foreclosed properties better than we can, because the sponsor for our REIT was a developer.

We were in the real estate business and we felt that we could minimize our real dollar losses by taking a hands-on approach with our real estate; and we are similarly situated to many, many other REITS.

What we are saying is that when the decision to "deREIT" was made is irrelevant for purposes of the consideration of the merits of the legislation that has been proposed.

Senator NELSON. Do I understand—I did not hear your name, sir.

Mr. Halperin, was there a new rule promulgated on carryforward for REIT's in 1976, did you say?

Mr. HALPERIN. Yes; it was, Senator Nelson.

Senator NELSON. So at the time that the Atlanta Corp. "deREITed," they did not know that subsequently an 8-year carryforward would be available to them if they had remained a REIT. Is that correct?

Mr. HALPERIN. That is correct.

Senator NELSON. I am trying to determine the public policy distinction that Treasury makes and understand the public interest that Treasury believes it is protecting by ruling one way on a REIT that was in existence when you promulgated the rule and another way against a similar, if not identically situated entity, who "deREITed" a few years earlier.

Mr. HALPERIN. Senator Nelson, the question we are really facing is which of two, or more than two, rules as to the carryover and carryback of losses should govern. It seems to us that it is the status of the entity in the year in which the loss occurred that

should apply. Mr. Kline's entity incurred a loss in a REIT year and therefore is entitled to the special rule for REIT losses.

Mr. Whitaker's entity incurred a loss in a year in which it was a regular corporation. Its argument is that it really was not a regular corporation but that it is a regular corporation that was formerly an REIT and should receive special treatment.

That is the distinction. He proposes that you treat regular corporations that were once REIT's not like regular corporations but as if they were still REIT's for purposes of determining the appropriate carryover rule.

The basis of that argument is that, unlike other regular corporations, they did not have the advantage of the 3-year carryback because they were REIT's in the earlier years and the statute has always denied a carryback to an REIT year. We think that distinction leads you to a lot of other difficult cases. There are other regular corporations that will not have any carryback years. They might have been partnerships in the earlier years or they might have been subchapter S corporations. Losses cannot be carried back to subchapter S corporations. They may not even have been in existence in earlier years.

They have suggested to us in the past that there is a distinction here because this REIT was in existence and actually earned some taxable income. I think that distinction really does not stand up because there are two things you can say about that taxable income. One, it was not taxed to the REIT; it was taxed to the shareholders of the REIT. An REIT is a passthrough entity for tax purposes. We could find many, many new corporations which have losses and whose shareholders earned some profits in earlier years on which they paid taxes. So, in that sense, this case is not really different from another new corporation.

Second, we do not look to the amount of income they may have paid taxes on. The benefits of this carryforward could be far in excess of the amount of losses they may have been able to offset if the carryback had been permitted.

We think we get ourselves in an awful lot of trouble if we start trying to particularize too much. There may be some sympathy here. I do not deny it, and you can make the argument, particularly since they made a difficult business decision in 1975 without knowing what its consequences would be when the tax law changed subsequently.

I think if we continue to try to differentiate in case after case on an individual basis, without applying any general rules, we are headed for a lot of trouble. We think the status of the corporation in the year of the loss ought to govern and we ought not to try to figure out if we can make a lot of distinctions beween those corporations based upon what their earlier status might be.

That is essentially our position.

Senator BYRD. You feel then that it would establish a precedent that could cause some difficult problems for the future?

Mr. HALPERIN. I could certainly see the next step. If I were a former subchapter S corporation that incurred a loss, I would be in here asking for an extension of the carryover period. I do not see why the argument cannot be made that new corporations really do

not have a carryback, and therefore ought to have an 8-year carry-forward.

Senator NELSON. I do not follow the subchapter S case. That is the case where the investor in the subchapter S writes off the corporations losses from his personal income, from the day he starts.

Mr. HALPERIN. Senator Nelson, my case is a subchapter S corporation with a profit, the tax on which is paid by the shareholders. In a later year it became a regular corporation and, for some reason, you had an unexpected loss. That loss cannot be carried back against the income of the earlier years where the tax was paid by the shareholders of the subchapter S corporation. It can only be carried forward.

Similarly, if you change from a partnership to a regular corporation, you would be in the same situation.

Senator NELSON. Let me say, Mr. Halperin, I am simply asking these questions for information purposes. I do not have an opinion on the position that Treasury has taken.

I am just trying to get it clear what the public policy question is.

I agree with you and I understand Treasury's position. I know Treasury appears before the Finance Committee on a regular basis, month-in, month-out, year-in, year-out and it is necessary that Treasury not allow a multiplicity of exceptions in the Internal Revenue Code.

There are far too many in it already. It becomes impossible to administer or understand and so forth and so on.

I am trying to get clear in my mind the public policy question here and the question of whether in fact this exception would create a problem.

Supposing at the time the statute was changed, which I understand was 1976——

Mr. HALPERIN. The statute was changed in 1976.

Senator NELSON [continuing]. Allowing the carryforward.

Mr. HALPERIN. For 8 years, yes.

Senator NELSON. By statute?

Mr. HALPERIN. By statute.

Senator NELSON. It could not be carried back, in any event, without a statutory change, is that what you are saying? It could not be applied to the Atlanta corporation without a statutory change?

Mr. HALPERIN. That is correct.

Senator NELSON. This was by statute, not by regulation, the carryforward of 8 years.

Mr. HALPERIN. Congress, in 1976, made the decision that since REIT's do not have carrybacks, they should be entitled to a longer carryforward. And Mr. Whitaker is saying that since a former REIT does not have a carryback, it is within the purpose of the 1976 legislation. I am suggesting that if he is, so are a lot of other people. If we allow this, we ought to look at the broader picture and decide whether we really want to say that the total period in all cases is 11 years and, if you are really not entitled or do not have the use of any part of the 3-year carryback, you should be entitled to the full 11 years as a carryforward.

I will not suggest it is an unreasonable decision, but I will suggest if it is going to be made, it should be made on a broad basis and we should not come up with a special rule here because they were a REIT in an earlier year and therefore said to be different than any normal business corporation.

That is essentially our position. I do not think we can make a policy argument that giving an extra few years carryover in any particular case is bad tax policy. I think the judgment as to how long the carryforward period or carryback period should be is the combination of trying to get equity by determining the real taxable income of the entity and the administrative problems of too long a period.

Certainly there is nothing magic about picking one other than the other. We are just suggesting that if we are going to have a number of those rules, we have to have some general distinctions between when one applies and when the other applies and not an ad hoc proliferation of rules.

Senator NELSON. I understand that. I was about to ask the question.

It is not the position of the Treasury that the change in the entity, the "deREITing" of the Atlanta entity gave it any tax advantage one way or the other.

Mr. HALPERIN. It may or may not have. I would accept the argument that they probably did not do it for tax reasons because what they were looking for was the greater flexibility that a regular corporation would have and which a REIT did not have.

It may, or may not, give you tax advantages. Normally REIT's are the ones which have the tax advantages over the regular corporation and they sought those tax advantages in 1972 and 1973 and decided it was not worth having them, so they gave them up.

Senator NELSON. Would there have been violated any general orderly concept if at the time the 1976 statute was passed it had provided that any REIT that had "deREITed" and sustained the loss it sustained as a new entity based upon its loans as a REIT, if the statute had read that way, would that have been illogical or improper or a bad tax policy posture creating loopholes and so forth throughout the system?

Mr. HALPERIN. I think there is a certain amount of equity in that suggestion but I think, as an administrative matter, we would not want to have to determine when the loss actually was realized.

If you are going to draw that kind of distinction, you are going to have to decide whether, at the time they "deREITed," they had economically incurred the losses. From an administrative point of view, I would find that change not a fortunate one, although I can understand the equity.

Senator NELSON. That is the point I was getting at. I realize statutes have to be administerable and that runs to more than just form. It becomes substantive, if they really are not.

I was just trying to get it clear in my mind if the statute had provided that. I was trying to get at the question whether that would be treated as an unfair advantage in any way, as you see it. Narrowly an organization that had its default and took its loss as a new entity and changed for the purpose of managing the property which they originally had as a REIT.

Mr. HALPERIN. What you are suggesting, Senator Nelson, is that those were REIT losses and REIT losses get 8-year carryforwards and that is what the distinction ought to be, rather than the status of the corporation in the year they were taken into account for tax purposes. Certainly that decision can make sense. I will not quarrel with it.

Senator NELSON. That was the point I was getting at, that you had an entity that had a REIT loss, a default. The loss occurred when they changed legal identity for nontax reasons.

Now you have the one that stayed a REIT somewhat longer.

Mr. HALPERIN. There is no distinction in this bill. These losses could be losses that were economically incurred at a later date. The bill would not so restrict it in the way that you suggest.

Senator NELSON. That is all I have.

Senator BYRD. Well, as I understand it, Wisconsin is in the clear and Georgia—we will give a little additional thought.

Mr. WHITAKER. Wisconsin and Georgia, in this instance, represent the tip of the segments of a real, identifiable industry on its own. We are not the only REIT that deREITed and incurred losses. There is a substantial number of the REIT industry that did this, just as in Mr. Kline's case. Of course, Wisconsin is typical of a number of REIT's that incurred losses in REIT years and subsequently deREITed.

Of course, the deREITing was all because of the economic recession. There were no profits. We have literally been struggling for survival for 5 years and that is why we need the extension because we have not had an opportunity, really, to try to regenerate ourselves.

Mr. HALPERIN. Mr. Whitaker, as I understand it, there are a couple of hundred million dollars of potential losses that will be expiring if this legislation is not enacted. On the other hand, the revenue estimate of the cost of these amendments is quite small. I suppose that the people who did the revenue estimates are assuming that you will not make any money in the next 3 years.

Mr. WHITAKER. All we are asking for is the chance to try. That is why I characterize this as self-help legislation. We have got to make a profit.

Mr. HALPERIN. Do you have any feeling as to what the actual numbers involved really are?

Mr. WHITAKER. Mr. Halperin, I would like to be able to tell you that we would be able to utilize in the 3-year-extension period we seek the full $37 million in losses expiring in August of this year. By our own projections, even if we are successful with this legislation and our 1980 losses are extended to 1983, a substantial portion of that $37 million will expire in 1983.

But we are asking for a fighting chance, if you will, to try to make a profit to offset those losses to recapture that capital.

Senator BYRD. The committee will give it full consideration.

Thank you, gentlemen.

Mr. WHITAKER. Thank you very much, Mr. Chairman and Senator Nelson.

[The prepared statements of Messrs. Whitaker and Kline follow. Oral testimony continues on p. 368.]

TESTIMONY ON S.B. 1831
PROPOSED AMENDMENT TO § 172(B)
OF THE INTERNAL REVENUE CODE
TO EXTEND NET OPERATING LOSS CARRYOVER PERIOD
FOR CERTAIN FORMER REAL ESTATE INVESTMENT TRUSTS

BY

LLOYD T. WHITAKER
CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER
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BEFORE

UNITED STATES SENATE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT GENERALLY
FRIDAY, FEBRUARY 29, 1980

MR. CHAIRMAN...

MY NAME IS LLOYD T. WHITAKER, AND I APPRECIATE THE OPPORTUNITY TO APPEAR BEFORE THIS COMMITTEE AND TO SPEAK IN FAVOR OF SENATE BILL 1831.

I AM CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF CMEI, INC., WHICH IS THE CORPORATE SUCCESSOR TO COUSINS MORTGAGE AND EQUITY INVESTMENTS, A GEORGIA BUSINESS TRUST THAT FORMERLY WAS A QUALIFIED REAL ESTATE INVESTMENT TRUST.

S.B. 1831 IS A RIFLE-SHOT TYPE CORRECTIVE LEGISLATION, AIMED AT ELIMINATING A SPECIFIC INEQUITY THAT APPLIES TO A DETERMINABLE NUMBER OF ENTITIES, VIRTUALLY ALL OF WHICH ARE PUBLICLY HELD.

SPECIFICALLY, THE PURPOSE OF THE BILL IS TO AMEND SECTION 172(B) OF THE INTERNAL REVENUE CODE BY INCREASING THE PERIOD WITHIN WHICH CERTAIN FORMER REAL ESTATE INVESTMENT TRUSTS, OR REITS, CAN CARRY OVER NET OPERATING LOSSES INCURRED DURING THE REAL ESTATE RECESSION THAT COMMENCED IN LATE 1973 AND CONTINUED THROUGH THE MID-70'S. GENERALLY, THE CARRYOVER PERIOD FOR LOSSES INCURRED DURING 1974 AND 1975 WOULD BE INCREASED FROM 5 TO 8 YEARS.

IN ITS TAXABLE YEAR ENDED AUGUST 31, 1975, OUR TRUST FOUND ITSELF IN EXTREME FINANCIAL DIFFICULTY AS A RESULT OF LARGE SCALE DEFAULTS IN ITS PORTFOLIO OF ACQUISITION, DEVELOPMENT AND CONSTRUCTION LOANS. IN THIS RESPECT OUR TRUST WAS NOT ALONE.

MANY, PROBABLY MOST, OTHER SIMILAR TYPE REITS ALSO WERE SUFFERING CALAMITIES AS A RESULT OF THE DEPRESSED CONDITIONS PREVAILING IN THE REAL ESTATE BUSINESS DURING THOSE YEARS IN THE MID-70'S. UNABLE TO COPE WITH OUR ECONOMIC PROBLEMS -- PARTICULARLY THE NEED TO TAKE A "HANDS ON" APPROACH AND DEAL DIRECTLY WITH FORECLOSED PROPERTY --

AND AT THE SAME TIME, CONTINUE TO SATISFY THE STRINGENT REQUIREMENTS FOR REIT QUALIFICATION UNDER THE REVENUE CODE, OUR TRUSTEES DETERMINED TO ABANDON OUR QUALIFIED REIT STATUS AND BEGIN TO DEAL DIRECTLY WITH FORECLOSED REAL ESTATE WITHIN OUR OWN ORGANIZATION.

BY THAT TIME THE TRUST HAD BEGUN, IN WHOLESALE FASHION, TO TAKE POSSESSION AND OPERATING CONTROL OF THE REAL ESTATE SECURING ITS BAD AND DEFAULTED LOANS. THE NECESSARY RESULT OF THIS EFFORT WAS THE REQUIRED RECOGNITION, IN 1975, OF SUBSTANTIAL BAD DEBTS FOR INCOME TAX PURPOSES AND, HENCE, WE INCURRED A VERY LARGE NET OPERATING LOSS FOR TAXABLE YEAR 1975. IN OUR CASE, ALL OF THE $37 MILLION OF 1975 NET OPERATING LOSS REMAINS UNUSED TODAY AND ALL OF THIS LOSS CARRY-FORWARD WILL EXPIRE LATER THIS YEAR, IN AUGUST OF 1980, UNLESS S.B. 1831 IS ENACTED.

WE HAVE ESTABLISHED THROUGH APPROPRIATE INQUIRIES THAT A LARGE NUMBER OF OTHER FORMER REITS RECOGNIZED A SUBSTANTIAL PROPORTION OF THEIR RECESSION RELATED LOSSES IN 1974 AND 1975. LIKE OUR TRUST, MANY OF THESE ENTITIES HAVE BEEN UNABLE TO UTILIZE ANY SIGNIFICANT PART OF THOSE LOSSES TO DATE, AND WE ALL STAND IN JEOPARDY OF LOSING THIS BENEFIT UNLESS REMEDIAL LEGISLATION IS PASSED.

IT IS IMPORTANT TO NOTE THAT THE LOSSES ABOUT WHICH WE ARE CONCERNED ARE REAL DOLLAR LOSSES; LOSSES OF THE CAPITAL INVESTED BY REIT SHAREHOLDERS WHO, IN THE MAIN, WERE AND CONTINUE TO BE SMALL INVESTORS WHO WERE LOOKING FOR THE SECURITY OF A PROFESSIONALLY MANAGED, DIVERSIFIED, REAL ESTATE LOAN PORTFOLIO WITH A SEEMINGLY "ASSURED" INCOME STREAM.

IT IS EQUALLY IMPORTANT TO UNDERSTAND THAT ANY POTENTIAL FUTURE RECOVERY OF THIS LOST CAPITAL WILL RESULT IN THE RECOGNITION, BY CMEI AND THE OTHER AFFECTED ENTITIES, OF TAXABLE INCOME, UNLESS NET OPERATING LOSS CARRYOVERS ARE AVAILABLE AS AN OFFSET AGAINST RECOVERIES.

THE EFFECT, WITHOUT THE AVAILABILITY OF AN OFFSET FOR CARRIED LOSSES, WOULD BE THE EQUIVALENT OF A TAX ON THE RECOVERY OF CAPITAL.

IN THE ULTIMATE SENSE, ANY LIMITATION ON THE CARRYOVER PERIOD FOR NET OPERATING LOSS UTILIZATION RESULTS IN A TAX ON CAPITAL THAT MAY BE RECOVERED AFTER THE ASSIGNED CARRYOVER PERIOD HAS EXPIRED. CLEARLY, HOWEVER, SOME TIME LIMITATION ON THE LOSS CARRYOVER PERIOD CAN BE JUSTIFIED, IF ONLY AS A MATTER OF ADMINISTRATIVE CONVENIENCE.

EXISTING LAW LIMITS FORMER REITs, SUCH AS CMEI, TO A TOTAL LOSS UTILIZATION PERIOD OF 5 YEARS FOR ITS 1975 NET OPERATING LOSS, WHILE OTHER TAXPAYERS, BY NO MEANS LIMITED TO TRUSTS THAT CONTINUE TO "QUALIFY" AS REITs, HAVE OR HAD AN 8 YEAR PERIOD TO UTILIZE 1974 AND 1975 LOSSES. THIS INEQUALITY IS UNJUSTIFIABLE, AND SHOULD BE CORRECTED FOR REASONS OF TAX EQUITY ALONE.

IN THIS INSTANCE, TAX EQUITY IS NOT A HOLLOW PRINCIPLE. MANY ENTITIES, LIKE CMEI, HAVE STRUGGLED FOR THE PAST THREE OR FOUR YEARS FOR BARE SURVIVAL. THOSE ENTITIES THAT HAVE SURVIVED ARE JUST NOW STABILIZING AND ARE BEGINNING TO LAY PLANS FOR SOME FORM OF FINANCIAL RECOVERY.

IN ALL CASES THE RECOVERY PROCESS WILL TAKE MUCH LONGER THAN THE STABILIZATION PROCESS, AND THE LOSS CARRYFORWARDS ARE IMPORTANT ELEMENTS IN FUTURE PLANNING. FOR EXAMPLE, UNDER OUR MOST OPTIMISTIC PROJECTIONS, A SUBSTANTIAL AMOUNT OF CMEI'S 1975 LOSS WILL REMAIN UNRECOVERED AT THE END OF 1983, THE YEAR IN WHICH OUR LOSSES WOULD EXPIRE EVEN IF THE BILL WERE ENACTED.

WITHOUT THIS BILL, HOWEVER, THERE IS NO HOPE OF RECOVERING EVEN A SMALL PORTION OF THE 1975 LOSSES; AND WITHOUT THE BILL, OUR CHANCES OF EVER RECOVERING A SIGNIFICANT PORTION OF SHAREHOLDERS' LOST CAPITAL ARE SEVERELY REDUCED, SINCE ROUGHLY ONE-HALF OF FUTURE PROFITS WILL BE

PAID OUT IN TAX IF THE LEGISLATION IS NOT PASSED.

THE 1980 DATE CURRENTLY APPLICABLE FOR THE EXPIRATION OF 1975 LOSSES GREATLY EXACERBATES OUR PROBLEM BECAUSE NOTHING REALISTICALLY CAN BE EXPECTED TO HAPPEN BETWEEN NOW AND THE CURRENT EXPIRATION DATE LATER THIS CALENDAR YEAR WHICH WILL ENABLE US TO USE THIS LOSS.

FURTHERMORE, THE EXPIRATION OF OUR NET OPERATING LOSSES WILL REDUCE OUR ABILITY TO OBTAIN NEW FINANCING FOR NEW UNDERTAKINGS, SINCE SUBSTANTIAL OLD REIT RELATED DEBT STILL EXISTS, AND WE WILL NOT BE ABLE TO REPAY ANY LOANS OUT OF PRE-TAX CASH FLOW.

THUS, UNLESS S.B. 1831 IS ENACTED OUR NEAR TERM ABILITY TO GENERATE PROFITS AT ALL WILL BE SEVERELY RESTRICTED, AND THERE IS VALID REASON FOR CONCERN FOR OUR SELF-REGENERATION EFFORTS MAY FAIL ENTIRELY.

I WOULD EMPHASIZE THAT OUR STOCK, LIKE THAT OF MOST REITs, WAS WIDELY HELD IN 1975 BY SMALL, SAVINGS-ORIENTED INVESTORS. FOR THE MOST PART, THESE ARE STILL OUR SHAREHOLDERS, AND ANY RECOVERY THAT WE MAY BE ABLE TO MAKE WILL INURE PRINCIPALLY TO THE BENEFIT OF THESE NUMEROUS SMALL INVESTORS.

IN CONCLUSION, S.B. 1831 IS A BILL THAT IS DIRECTLY TARGETED TO CORRECT A SPECIFIC INEQUITY. THE RELIEF WE SEEK IS A SELF-HELP TOOL IN THAT WE MUST, ON OUR OWN, GENERATE PRE-TAX PROFITS BEFORE ANY EXTENSION OF THE LOSS CARRYFORWARD PERIOD CAN HAVE ANY MEANING WHATSO-EVER. HOPEFULLY, THIS BILL WILL PROVIDE GREATLY NEEDED ASSISTANCE, AT MINIMUM PENALTY THROUGH LOSS OF REVENUE TO THE GOVERNMENT, TO ENABLE AN ENTIRE SEGMENT OF THE REAL ESTATE INDUSTRY AND THE INVESTING PUBLIC TO REGAIN FINANCIAL HEALTH.

I BELIEVE VERY FIRMLY THAT THE PROVIDING OF SUCH RELIEF, UNDER THESE CIRCUMSTANCES, IS A LEGITIMATE AND PROPER FUNCTION OF GOVERNMENT, AND I ASK AND RESPECTFULLY URGE YOUR PROMPT AND FAVORABLE ACTION ON S.B. 1831.

RESPECTFULLY,

LLOYD T. WHITAKER

STATEMENT OF GEORGE H. KLINE BEFORE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF SENATE FINANCE COMMITTEE IN SUPPORT OF
SENATE BILL NUMBER 1831

My name is George H. Kline. I am Chairman of the Board of the First Wisconsin Mortgage Trust. I speak in favor of Senate Bill 1831.

The First Wisconsin Mortgage Trust is a real estate investment trust which sold shares publicly, generally to small investors, and then borrowed substantial amounts from various bank lenders.

The equity investment and the borrowed funds were in turn invested in construction mortgages and similar investments.

Beginning in 1974, First Wisconsin, like many other REITs, began to experience substantial operating losses. Such losses not only consisted of operating losses but to a large extent consisted of bad debt losses resulting from foreclosures of defaulting mortgage loans, including loans secured by condominium and similar inventory type property.

Such losses were real dollar losses. Moreover, the losses were locked in the REIT and could not be passed through or claimed as deductions by the REIT's shareholders. In addition, the restrictive tax rules applicable to qualified

REITs in 1974 and 1975 did not permit any carryback or carryforward of such losses.

First Wisconsin found itself in the position of having to foreclose on numerous defaulted construction and other loans secured by inventory-type properties; however, if First Wisconsin became the direct owner of such properties, as a result of foreclosures, it would immediately become disqualified as a REIT for tax purposes.

Congress recognized this situation and adopted the foreclosure property provision added to section 856 (e) of the Code, effective January 1, 1974. Under such provisions, a qualified REIT could acquire inventory-type property by foreclosure and elect to designate such property as foreclosure property and thereby avoid loss of its qualified status.

The foreclosure property was placed in a separate bookkeeping pool for tax accounting purposes and the pool profits or losses were thereafter separately determined.

If pool sales activities subsequently resulted in a pool profit, the trust incurred taxable income which was taxed at ordinary corporate rates and other available REIT losses could not be offset against such segregated profits.

Here is an example of how it works: If a REIT foreclosed on a construction loan, the REIT incurs a bad debt loss and the foreclosure bid price becomes the new cost basis of the property in the hands of the REIT for tax "pool" purposes.

Thus, if a foreclosure bid price on a $1 million loan is $400,000, the REIT would realize a $600,000 bad debt loss as a result of the foreclosure (that is, $1 million minus $400,000) and the property would have a $400,000 cost basis in the hands of the REIT.

The $600,000 bad debt loss would be accounted for by the REIT outside of the pool. If the REIT eventually marketed the property, the REIT might realize sales proceeds of, say, $600,000, and thus realize a $200,000 ostensible profit in the pool (that is $600,000 minus the new $400,000 basis.)

This $200,000 "profit" would be subject to regular tax rates because of the foreclosure property rules, notwithstanding the fact that the REIT had substantial additional operating losses outside of the pool and, more significantly, notwithstanding the fact that the pool profit with respect to such project was illusory.

In this example, the REIT actually incurred a $400,000 loss on the specific investment (that is, $1 million less the $600,000) and yet would be subjected to tax on a $200,000 profit because of the manner in which the foreclosure property rules operated.

First Wisconsin, in an effort to maintain its qualified status, availed itself of the foreclosure property election rules duing 1974, 1975 and 1976. By 1977 the trust found itself holding a substantial amount of pool property on

which it realized approximately $1 million of artificial pool profits, notwithstanding the fact that First Wisconsin was in a substantial overall loss position and in fact had incurred actual losses with respect to this foreclosed property.

The foreclosure property tax accounting rules apply only to qualified REITs. Thus, if a REIT becomes disqualified, the segregated effect of the foreclosure property pool accounting is eliminated and the artificial pool profits can be offset by the overall current losses and available net operating loss carryforwards of the REIT.

Thus, in order to avoid a substantial tax liability at a time when First Wisconsin was in fact a substantial loss operation, First Wisconsin was forced to disqualify itself in 1977 in order to mesh its artificial pool profit with its real losses.

Obviously there was no other choice but to disqualify.

As a separate matter in 1976 Congress also recognized that a qualified REIT was not permitted a net operating loss deduction and could not carry back or carry forward such losses. As a result, to aid troubled REITs and to provide some parity with other business entities, in 1976 Congress amended the Code to permit a qualified REIT to carry over net operating losses for eight taxable years. Congress did not provide a carryback because of the administrative difficulties attached thereto.

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However, while Congress permitted qualified REITs to have an eight-year carryforward period, the Code provided that if a REIT elected to disqualify itself during the extended carryforward period, such period was reduced to five years for pre-1976 losses.

This leaves First Wisconsin in the following position:

The foreclosure property rules created tax liabilities with respect to an artificial profit position. This created the business necessity for us to disqualify.

However, the eight-year net operating loss carryforward period was only available to those who continued to be qualified, and REITs which in substance were forced to disqualify were substantially cut back with regard to the available carryforward period.

Because of this, First Wisconsin lost about $12 million of tax loss carryforward at the end of 1979, and will lose about $19 million of losses at the end of 1980.

We have been diligently trying for five years to turn the Trust around and we are beginning to think that we are going to be successful. However, current economic conditions are such that such turnaround will fall far short of our being able to utilize any and certainly not any significant portion of these $31 million of carryforward.

Moreover, we believe that our loss situation stems from an alleged mismanagement by our bank sponsor and its

subsidiary, our adviser. As a result, in early 1975 we filed a suit against our sponsor to recover some of the very losses which were incurred and which form the bulk of our loss carryforward.

Such suit is finally set for trial in September of this year. Any amount that we may receive in 1981 or 1982 in recovery or settlement of such suit (which would represent a recovery of previous losses) will be subject to tax without the benefit of an offset by way of the carry forward of the 1974 and 1975 losses because of the expiration of the carry-over period in 1980.

The carry-over period for these losses expired in 1979 and with further expire in 1980 solely because we disqualified, and we disqualified solely because we had to do so to avoid an artificial tax liability.

On the other hand, qualified REITs obtain the benefit of the full eight-year carryforward period.

We do not see any public interest or policy reason for such a distinction between qualified and disqualified REITs.

We have, therefore, sought legislative assistance to correct this situation. Basically Senate Bill 1831 provides for the same eight-year carryforward provision to be applicable to disqualified REITs as to qualified REITs.

The bill is thus based on equity and we urge its passage.

Senator BYRD. The next piece of legislation is S. 2180, Mrs. Jane Cathcart, accompanied by Mr. Robert Niles.

Good morning, Ms. Cathcart. Would you take a seat, please? We are glad to have you, and we are glad to have you, Mr. Niles.

## STATEMENT OF JANE M. CATHCART, ACCOMPANIED BY ROBERT MILES, ESQ.

Mr. NILES. Good afternoon, Senator Byrd. I represent Mrs. Cathcart, Mr. Chairman, and this bill refers to section 1034 of the code, the Internal Revenue Code.

Specifically, it provides for nonrecognition of gain on the sale of a principal residence if the seller occupies a new residence within 18 months, or constructs a new residence and occupies it within 2 years.

Mrs. Cathcart attempted to comply explicitly with the provisions of the code in that she bought land near Warrenton, Va., and contracted with a contractor to build a home and it was under construction.

The contractor unfortunately talked Mrs. Cathcart into giving him the entire contract price and then left the construction in a very sad state and went to Florida where he is not reachable.

The contractor was indicted for fraud and extradited from Florida back to Virginia. As a consequence of the criminal proceedings, the Commonwealth attorney asked Mrs. Cathcart not to proceed with the construction so that in case the actual situation might be viewed by a jury at some time.

The criminal charges were dropped later for reasons which are not germane here.

We would submit, since Mrs. Cathcart endeavored, and other people in this case, endeavored to comply, that they expended all the money, that they should be given special consideration, especially if they do restart and build a residence and reexpend the money.

In other words, Mrs. Cathcart is in a position where she is going to spend twice as much money, at least, as she would have done in 1977 and, in fact, she is in the process of building the home now, and inflation has further penalized her because she is going to have to spend at least twice as much, as much as three times.

We would submit that it is only fair and equitable that substantial compliance with the code and completion after the term, if it is beyond the failure to use the residence in a 2-year period, it is beyond the control of the taxpayer and should be given consideration.

Senator BYRD. As I understand it, the requirement was not complied with through no fault of Mrs. Cathcart.

Mr. NILES. Absolutely no fault.

Senator BYRD. She made every effort to comply. Construction was begun on the home, as I understand it. The contractor defaulted on the contract. The contractor was then prosecuted, was he not?

Mr. NILES. He was indicted, Mr. Chairman.

Senator BYRD. He was indicted. For what?

Mr. NILES. For embezzlement.

Senator BYRD. For embezzlement of Ms. Cathcart's funds?

Mr. NILES. That is correct, Mr. Chairman.

Senator BYRD. She had no funds then with which she could meet the requirements?

Mr. NILES. She was financially embarrassed, Mr. Chairman, but the reason she did not complete the home within the 2-year period was at the request of the Commonwealth attorney who asked her to leave the structure in the exact state as the contractor left it.

Senator BYRD. So that the Commonwealth attorney could prosecute the contractor for embezzlement?

Mr. NILES. That is correct, Mr. Chairman.

Senator BYRD. It seems to me that the taxpayer, under these conditions, where it is impossible, you might say, to comply with the technicality of this particular section of the tax law, that there should be some redress in that regard.

I might say for the record that I introduced this legislation. In nearly 15 years in the Senate it is the only legislation of this type that I have ever introduced, but it just seemed to me, in fairness to the taxpayer, that this proposal should be presented to the Congress.

Now, this proposal has been very narrowly drawn and my understanding is it would apply only to this individual case.

Mr. NILES. That is correct, Mr. Chairman. We appreciate that.

I would submit that similar cases should get the same treatment. The law as passed gave the Internal Revenue Service no discretion on this matter and, I would submit——

Senator BYRD. I think so. I think it should apply in cases where the taxpayer, through no fault of her own, or his own, was unable to comply with the law. There ought to be some redress for that if they subsequently comply.

Mr. NILES. Yes, Mr. Chairman.

Senator BYRD. I drew this narrowly because I felt—I understood the Treasury would look with disfavor on a broader proposal. I would hope the Treasury would not oppose this narrowly drawn proposal.

Do you want to comment, Mr. Halperin?

## STATEMENT OF DANIEL L. HALPERIN—Resumed

Mr. HALPERIN. Mr. Chairman, as you can see from page 8 of our testimony that we have opposed S. 2180. It may be that this is the one case in which an exception is warranted and so therefore the argument that we need generalized rules and cannot look to particular factual situations, does not apply here.

However, there are many other cases where an appealing argument can be made. You have before you today section 10 of 5505, on which you have not heard testimony, that seeks a more general extension of the reinvestment period for members of the Armed Forces.

One can argue for a lot of other cases where people have very good reasons for failing to meet the statute. In the interest of disclosure, I would like to point out I will be paying taxes because I could not meet the test for what I believe are very good reasons—perhaps not as good as these.

Senator BYRD. Wait a minute here. You are not questioning the fact that the party made every effort to comply and that the house was started.

Mr. HALPERIN. I do not question that.

Senator BYRD. That the contractor took the money and was indicted for embezzlement and an official of the State of Virginia urged, if not demanded, that the house not be completed even if the money were available because of the evidence that the State's attorney needed to prosecute the case.

You are not denying any of that, are you?

Mr. HALPERIN. I am not denying it. As I say, Senator Byrd, it may be that if we are going to pick one case out in the whole universe this may be the most sympathetic case.

Senator BYRD. Let me ask you this. Would it be better to have a more general solution?

Mr. HALPERIN. We are concerned, as you can see in our testimony on H.R. 5505, about delaying the period for people who do not actually replace at some point——

Senator BYRD. But this is being replaced. If this were not replaced, I would not be interested in advocating this bill.

Mr. HALPERIN. I understand that, Senator. But if you look at the question raised by the Armed Forces——

Senator BYRD. Unless you want to. I do not see what that has to do with this.

Mr. HALPERIN. I am trying to respond to your question as to whether we would like a more generalized statute and I think that any generalized rule that extended the reinvestment period, as this does, is not something that we would like to see happen, so we are not in favor of long extensions of the reinvestment period, regardless of the reason, because there are difficulties in administering it.

If somebody sells a house, for example, in 1980 and we determine 5 or 6 years later that they owe taxes in 1980, because they did not reinvest the proceeds, it is just not administratively feasible to go back 6 and 7 years and try to collect the tax. So we think that the period needs to be kept short.

Senator BYRD. I agree.

Mr. HALPERIN. We agree it does create hardship in some circumstances and we think that is the balance one has to seek. Your suggestion here is, I guess, that you generally agree with that, but that this case goes beyond the point where you are willing to abide by the general rules.

Senator BYRD. Let me ask you this.

What about a change in the statute where the Internal Revenue itself would have leeway in making the decision as to whether it is fair and appropriate. I think what we need to do, of course, and I am sure all of us agree with this, we need to be fair to the Government, we need to be fair to all the taxpayers, but at the same time, we need to be fair to the individual taxpayer.

What would be the objection to giving the Internal Revenue Service some leeway in these hardship cases, in these cases where there is obviously good and just cause? Somebody ought to be able to have the right to redress these areas.

Mr. HALPERIN. As a matter of principle, I certainly, agree that it would be better if the Service had discretion in certain situations. I

think that one should be careful, though, that the standards for exercising that discretion be made quite clear. Otherwise, we would have a lot of people being unhappy about how the Service might exercise it in particular cases.

Senator BYRD. That is why I thought perhaps you would be willing to go along with particularly narrowly defined cases that have to come before the Congress in each incident.

Mr. HALPERIN. There is a question of fairness to everybody if the only way one can have their situation treated specially is through the legislative process. Obviously there are only a limited number of cases where Congress has the time and limited number of resources to consider.

Senator BYRD. In other words, you are taking the position, are you, that taxpayers should not have any opportunity for redress?

Mr. HALPERIN. There is always the trade-off, Mr. Chairman, between deciding each particular case on its facts to do complete equity and having a generally administerable rule that can be applied across the board. Clearly, fairness, if that were the only consideration, would push you in the first direction.

At some point, you cannot have as much fairness. An administerable tax law will have some inequitable applications, and that is not a very nice thing to say to the people upon whom the inequity falls. But I think that is a fact.

Senator BYRD. Then you are saying that those same people ought not to have recourse to the Congress to change those inequitable situations.

Mr. HALPERIN. I think, in fact, that is where you have to come out, that you cannot do complete equity in every situation. In a situation where we have over 80 million tax returns filed annually, we have to do the best we can, but we have to recognize it is not a perfect world.

I suppose we can try to come as close to it as we can, but undoubtedly we will produce certain situations which are inequitable. Some may be so inequitable that we could recognize that special relief ought to be granted. I am certainly not going to say that we have the last word as to whether that line has been reached.

I understand your views and we will be glad to give some thought to it along the lines that you have suggested.

Senator BYRD. Well, I would think that from what you say and if I were in your position, in Treasury's position and in the Internal Revenue Service's position, that a narrowly drawn piece of legislation applying to a particular case would be preferable to a broader one. And it would have to be reviewed by the Congress and approved by the Congress before it could be enacted, of course.

I would hope—it just occurs to me that this is the first time in 15 years that I have been willing to introduce a piece of legislation like this. In principle I do not believe in special relief bills, and when Mrs. Cathcart, the one time she came to see me, I had great reluctance and I did not make any commitment to do it.

I thought a long time about it, but the more I thought about it, I thought if a taxpayer is wronged, then somebody, if not the Internal Revenue, the courts cannot do it, then somebody ought to at

least—that taxpayer should have somewhere she can go to when she does have such a good case.

That is the only reason that I was willing to do it. As I say, I do not favor legislation of this type, but I think in this case it is an unusual one and it is justified.

Mr. HALPERIN. Mr. Chairman, I suppose if everyone were willing to restrict themselves to once every 15 years, there would be fewer problems.

Senator BYRD. I do not plan to introduce any more.

I thank all of you very much. I am glad that you were here.

Mr. NILES. Thank you very much. We appreciate appearing before our Senator.

[The prepared statement of Mrs. Cathcart follows:]

STATEMENT OF MRS. JANE M. CATHCART

Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to appear before you today to support Section 2180, a bill to provide an extension of time to comply with Section 1034 of the Internal Revenue Code of 1954.

Section 1034, allows non-recognition of gain on the sale of a principal residence if a new principal residence is constructed and used within two years of such sale.

Taxpayer sold her residence in February 1977. She contracted to have a new house constructed on land she owned. The Contractor commenced construction on the house and promised completion and occupancy well before the deadline for qualification set by Section 1034. Unfortunately, taxpayer paid the entire contract price to the Contractor before the construction had passed the preliminary stages. Upon receiving all of the money, the Contractor absconded and removed himself from Virginia to Florida. Taxpayer was thus unable to comply with the rule of Section 1034 that she use the new residence within two years of the sale of the previous residence.

We submit that circumstances beyond taxpayer's control should not disqualify one from availing himself of the benefits of Section 1034 if there has been substantial compliance.

One can think of other examples which could unfairly disqualify a taxpayer, such as, a new home could be destroyed by fire, flood, or other act of God. In such a case the taxpayer would be unable to use the new residence and would not qualify. In each of the cases the money would have been expended as envisioned by the Code, and in addition would have to be re-expended in order for taxpayer to have a home to use. Such unfortunate circumstances subject the taxpayer to a double penalty: loss of the tax credit and the property loss. This is not equitable.

We ask that sincere consideration be given to those who strive to comply with Section 1034 but are prevented from doing so by circumstances beyond their control.

SUMMARY

1. Section 1034 allows no discretion for special circumstances.
2. Taxpayers can show substantial compliance, expend the funds, but still be unable to qualify.
3. I.R.S. should be able to allow the credit in cases of substantial performance, where taxpayer unable to qualify because of special circumstances.

Senator BYRD. The committee stands in recess.

[Whereupon, at 12:30 p.m. the subcomittee recessed, to reconvene at the call of the Chair.]

# MISCELLANEOUS TAX BILLS V

TUESDAY, MARCH 4, 1980

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

The subcommittee met, pursuant to notice, at 9:30 a.m. in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the subcommittee) presiding.

Present: Senators Byrd and Dole.

Senator BYRD. The hour of 9:30 having arrived, the committee will come to order.

The committee today will consider six pieces of legislation. The formal statement of the various witnesses will be incorporated in full in the record. The oral testimony will be limited in time.

The first witness today, and the committee is delighted to have him, will be the distinguished Senator from Florida, Mr. Stone.

Welcome, Senator Stone. We are pleased to have you. I understand that you will comment on S. 2167.

We will be glad to have you proceed as you wish.

## STATEMENT OF HON. RICHARD STONE, A U.S. SENATOR FROM THE STATE OF FLORIDA

Senator STONE. Thank you.

Mr. Chairman, I appreciate the chance to testify before your committee and may I say later on this morning, Mr. Doug Klein, director of programs of the Community Association Institute, will also testify on behalf of my bill, S. 2167.

This bill is similar to H.R. 4511 introduced in the House by Congressman Norman Mineta, and it provides that the taxable income of condominium associations be subject to the same graduated rates of tax as a corporation.

Presently, and I believe without any merit or equity, this income is taxed at a flat rate of 46 percent, which is much higher than what an individual would be taxed if he or she earned the same income, and is not consistent with the principle that Congress set forth when it clarified the tax status of homeowner associations in the Tax Reform Act of 1976.

We now have a situation where HUD and States such as Florida and California are requiring condominiums to set up reserve accounts, at the same time the present tax structure discourages their creation. I would urge the committee to give fair treatment to these associations by taking early action on my legislation.

After that, and concurrent with action on that, I would like to work with the committee to develop legislation that would classify the interest on reserve accounts which are required by State law to be classified as exempt functions income, provided that the interest would remain in the reserve account and be used only for maintenance and replacement of the association's property.

But that is another bill that we would need to put some staff work on.

Senator BYRD. If I might interrupt at that point, that is not involved in this particular bill?

Senator STONE. No, it is not, but I wanted to alert the committee to the fact that, first and foremost, we need to give normal treatment to condominium association income and then, as to the interest earned in those particular accounts required by law to be set up, I think that we ought to consider giving that interest exempt-function status.

But today what I am urging the committee to do is simply to take the earnings of the condominium associations and tax them at the corporate rate, the graduated corporate rate.

Right now, and where I cannot see the slightest coloration of equity or merit, they are taxed at a flat 46 percent regardless of whether there is $1 earned or $1,000 earned.

Senator BYRD. It is taxed at the highest corporate rate?

Senator STONE. That is right, and they deserve to have the graduated corporate rate. If anything, they deserve more than that. That is why I alerted the committee to the fact that as to some of the earnings here, they should not be any tax at all. It is just maintenance money and designed and required for that purpose.

Senator BYRD. Thank you, Senator Stone.

Senator STONE. Thank you so very much.

Senator BYRD. At a later hour, Mr. Klein will be permitted to testify. At the moment, we will not go to that bill at the moment.

Senator STONE. Thank you so very much, Mr. Chairman.

Senator BYRD. Thank you, Senator Stone. I am delighted to have you.

The next witness will be the distinguished Senator from Illinois, Mr. Percy.

Senator Percy, we are delighted, the committee is delighted, to have you today.

This legislation, as I understand it, has been introduced by both the Senator from Illinois and the Senator from Oklahoma, Mr. Bellmon?

Please proceed.

## STATEMENT OF HON. CHARLES H. PERCY, A U.S. SENATOR FROM THE STATE OF ILLINOIS

Senator PERCY. Thank you, Mr. Chairman.

Mr. Chairman, the testimony that I will give this morning really depends upon our acceptance of two principles. The first principle being that agriculture is extraordinarily important to this country, is absolutely vital to our balance-of-payments situation. It certainly constitutes one of our largest exports and that the incentive that we have provided for the American farmer in a

variety of ways has given us the most productive agriculture in the world today.

We export more than all other exporting nations put together and there are only six nations out of 165 at the U.N. that actually export food at all. So that is the first premise, and the second premise is that the family farm is the heart of our agricultural system.

The incentive provided by family ownership of a farm and the ability of that farm to stay in the family and to have our young farmers be able to succeed their parents is an integral part of this and that is the heart and backbone of Midwestern agriculture, and certainly in the State of Illinois, which is the largest exporting State in the Nation.

I, therefore, deeply appreciate the opportunity to bring to your attention a very serious inequity on the implementation of a provision in our estate tax laws, the special use valuation for family farms.

A recent IRS interpretation of the law has posed a new threat to family farmers which was clearly not the intent of Congress and should be corrected as soon as possible.

In 1976, we enacted the Tax Reform Act which made a fundamental change in estate tax policy for family farms. Prior to 1976, family farms, like other property, were valued at their highest and best use for estate tax purposes which made the continuation of farming financially impossible. Many family farmers were put out of business; they were forced to sell their land to pay the tax bill.

The Tax Reform Act recognized the importance of keeping the family farm intact by writing into the law a special provision—the special use valuation—which valued the family farm on its income potential as a farm; not on its value as a subdivision or its speculative agricultural value when it does not bear a reasonable relationship to its earning capacity. This act eased the estate tax burden on the heirs of family farms and made it possible for them to continue contributing to the agricultural productivity of the Nation. I fully supported this change.

Unfortunately, as too often happens with laws of good intent, the 1976 act is complex and its administration has been difficult. And, in one particular case before the subcommittee today, I believe it has been grossly unfair.

As you know, Mr. Chairman, the Tax Reform Act provided a formula to calculate the special-use valuation and another method which I will discuss later.

The formula simply divides the net annual gross cash rent for comparable farmland in the area of the farm in question by the average annual effective interest rate charged by Federal land banks on new agricultural loans to farmers and ranchers. The estate tax value is the average of the resulting amount for the five most recent calendar years ending before the decedent's death.

Mr. Chairman, so the committee may readily understand the difference that the formula makes for evaluating the farm for estate tax purposes, I am submitting the statistics from an actual appraisal in Champaign, Ill. The formula, in this instance, resulted in a difference of $503,200 in the value of the farm.

I would ask unanimous consent that the entire example be incorporated in the record.

Senator BYRD. Without objection, so ordered.

[The material referred to follows:]

Addendum

to statement by Senator Charles H. Percy

The statistics below are taken from an actual appraisal of a 200-acre farm south of Champaign, Illinois. The valuation under the formula provided by the Tax Reform Act of 1976 Section 2032A (e)(7) is based on cash rents paid each year on a cash-rented farm in the same township. If no cash-rented comparable farmland could have been located by the appraiser, crop share values could not have been substituted in the formula under the IRS interpretation of the statute and fair market value would have been used. The statistics below show the $503,200 difference in the value of the farm under the two valuation methods.

Formula provided by the Tax Reform Act (2032A (e)(7):

5-year average per acre cash rent = $86.80

Less: 5-year average real estate taxes = 15.37

$71.43

Divided by: the average Federal Land Bank interest charge for previous five years = 8.08 %

$86.80 less $15.37 = $71.43 / Divided by 8.08% = $884.03 per acre

For estates that do not qualify for the formula, fair market value is used:

Fair market value $3,400.00 per acre

Value of farm:

| | | |
|---|---|---|
| Formula | $176,800 | |
| Fair Market | $680,000 | |
| Difference | $503,200 | Savings under the formula is the estate tax not paid on $500,000 (the most the special use valuation may reduce the estate). |

Senator PERCY. It demonstrates what we are really talking about, the difference between heirs being able to carry on that farm or having to be forced to liquidate the farm just to be able to pay taxes.

A problem has arisen in Illinois, Kansas, South Carolina, Oklahoma, and several other States where little farmland is cash rented. Most farmland in these States is share leased on a percentage basis in which the lessor and lessee divide the expenses and profits of the farm operation.

It gives the tenant a real feeling of participation and gives him the incentive to maximize his yield. That is the way most Midwestern farms operate.

The Internal Revenue Service in 1978 recognized that cash rent figures would be difficult to find in many States and allowed crop share leases to be substituted in the formula when no farm property existed in the particular locality that was both comparable and leased on a cash basis.

However, last September, the IRS reversed itself in new proposed regulations and prohibited the use of crop share lease figures in the special formula. If these regulations are finalized, the estate will not be permitted to use the formula if no comparable cash rents can be found.

The 1976 act provided a second method to value farm property in such cases. But I have been told by experts in Illinois that it is overly complicated and confusing. It requires five factors to be used in valuing the farm. But the law does not state how one should weigh the factors. One such factor when applied to farms not located near metropolitan areas would provide values substantially the same as the fair market value method used prior to 1976. The use of this method would in many cases result in much higher values than those figured by the special formula.

The intent of Congress in providing the formula in the first place was to reduce subjectivity in farm valuation; eliminate the potential nonagricultural value and eliminate any amount by which land is bid up by speculators in situations where nonagricultural use is not a factor in inflated farmland values.

Mr. Chairman, since this alternative method does not accomplish these objectives, it simply underscores the inequity in the IRS ruling. Why should an Illinois farm worth an identical amount as one in Virginia be subject to a substantially higher estate tax?

Mr. Chairman, I am happy that we have been able to save the family farm in Virginia and I would like to see us do the same in Illinois.

I am certain the Congress did not intend to deny equal treatment to farmers in Illinois, Kansas, and other areas where share leasing of farmland is predominant and local cash rents are difficult, if not impossible, to find.

According to data compiled by the University of Illinois last year, only about 12 percent of farmland in Illinois is cash-rented. That figure is only 10 percent in central Illinois, the heart of our productive land.

The same situation exists in Kansas. The Kansas Farm Bureau has documented that cash rental arrangements are very rare. Most land lease arrangements in Kansas are crop-share. In addition,

data being required by IRS field service personnel would disallow most of the comparable cash rentals that can be located in Kansas.

S. 1859, which I introduced with Senator Dole and which is cosponsored by Senators Kassebaum and Thurmond, allows the use of crop-share rentals in the special formula. This bill is identical to one introduced by Congressman Ed Madigan of Illinois, which has 33 cosponsors.

Mr. Chairman, I understand there are several ways crop-share rental values could be estimated for use in the formula. This issue will be discussed more fully by Mr. Robert Bellatti, a representative of the Illinois Bar Association, who will be testifying later this morning. He will suggest that crop-share rentals based on areawide averages be used rather than actual crop-share rentals from particular comparable real property in the locality of the farm. I urge the committee to carefully consider this testimony.

The clarification of this formula is clearly consistent with the intent of Congress to allow family farms to continue to exist after the death of the original owner. I hope the distinguished members of the Finance Committee will agree and act quickly on this bill.

Mr. Chairman, at this time, I would also like to submit for the record a statement by Senator Kassebaum in support of S. 1859 and also a statement by Representative Madigan.

[The statements of Senator Kassebaum and Mr. Madigan follow:]

STATEMENT BY SENATOR NANCY LANDON KASSEBAUM

Mr. Chairman, I appreciate this opportunity to submit my comments on S. 1859. As you know, this legislation is particularly important to the rural areas of Kansas, Illinois and many other States.

Before 1976, property included in a decedent's gross estate was valued at its fair market value on the date of the decedent's death. A key factor in determining the fiar market value was the highest and best use to which the property could be put. The IRS interpreted this to mean that use that would bring the highest selling price in the event of sale. This resulted in numerous problems for farming families. The IRS would value the land at its highest possible return and all too often heirs of farm land were forced to sell their property in order to pay estate taxes.

Congress concluded that some relief was necessary. Therefore, in the Tax Reform Act of 1976, Section 2032A was added to the Internal Revenue Code. This section provided for evaluation or real property based on its current use rather than its highest and best use. The change was intended to insure that land used for farming both before and after the owner's death would be valued as farmland rather than at an artifically inflated value that could force dissolution of family farms. This Congressional action recognized the unreasonableness of inflating estate taxes by including speculative valuations of farm land in the tax base.

Although section 2032A was a welcome improvement in estate tax law, it is not complete. Subsection (e)(7), now establishes the formula for valuing farms by requiring, in part, the use of "the average annual gross cash rental for comparable land". In Kansas, little farmland is rented on a cash basis. Instead, it is most often share leased on a percentage basis under which the lessor and lessee divide the expenses and profits of the farm operation. In July of 1978, the IRS began drafting proposed regulations regarding the valuation of farm real property. The initial proposal contained a section permitting the use of crop-share leases in the formula if cash leases were not available. This approach was supported in Kansas and other rural States where crop-share rental is the predominant method of leasing agricultural land. However, in September of 1979, the IRS reversed itself and issued regulations prohibiting the use of crop-share rentals for determining the value of farm land. The effect of implementing these regulations would be to make the election of special use valuation virtually impossible in areas where crop-share leases are predominant. Experts, testifying at a Symposium on Farm Estate Issues held by the Department of Agriculture, indicated that the cash rental market is limited and does not accurately reflect market conditions.

The IRS has taken the position that those estates that do not qualify for the use valuation formula in Section 2032(e)(7) can fall back on the alternate valuation provided in Section 2032A(e)(8). However, this section is much more subjective and is more difficult and cumbersome to apply. It will also likely result in much more litigation. Certainly, it would be in our best interests to prevent such a result, S. 1859 would avoid this inequity by allowing the use of crop-share rentals. This bill, introduced by Senator Percy and cosponsored by myself, Senator Dole and Senator Thurmond, would make the statute consistent with congressional intent, as expressed in the Tax Reform Act of 1976, to facilitate the continued operation of family farms following the death of the original owner. Without this modification, we will again be confronted with the forced sales of productive farm land in order to pay estate taxes.

I would like to applaud the efforts of Senator Wallop and Senator Bellmon who have introduced their own bills designed to address this problem. I believe that S. 1859 represents the best approach, and I urge the members of this subcommittee to act expeditiously on moving forward this important legislation.

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STATEMENT BY HON. EDWARD MADIGAN, CONGRESSMAN FROM ILLINOIS

Mr. Chairman: My interest in the legislative proposals that are the subject of your committee's hearings today began last June when several constituents informed me that the Internal Revenue Service was refusing to allow income from share leases to be substituted for income from cash rents in the Internal Revenue Code section 2032A special use valuation formula for farm estate property established in the Tax Reform Act of 1976. Proposed regulations published on September 10, 1979, announced that the IRS intends to make this policy official.

It should be noted that the Department of Treasury has attempted, through proposed regulations, to circumvent congressional intent with respect to this section of the Internal Revenue Code more than once. Proposed regulations published in July 1978 attempted to remove farm estate property from coverage under section 2032A if it could not be shown that an actual higher use other than farming existed for the property in question. In effect, the Treasury Department attempted to deny the benefits of special use valuation to farm estates where land values had been unrealistically inflated by speculation even though the conference report on the Tax Reform Act of 1976 specifically stated that the section was intended to remove the inflationary effect of land speculation from farm estate values. Under pressure, the department reversed its policy and will not require a showing of higher use.

The most recent regulatory proposal by the Department of Treasury for section 2032A also ignores congressional intent with respect to this statute. These regulations, issued on September 10, 1979, propose to prevent the substitution of income from share leases for income from cash rents in the section 2032A(e)(7) formula. The effect of this proposed definition of gross cash rent will be to disqualify many of the farm estates in my congressional district from the 2032A(e)(7) formula.

Approximately 90 percent of the farm property leased in my state of Illinois is leased on a share basis in which the land owner, or lessor, supplies land and buildings, pays any real estate taxes, pays an agreed percentage of the cost of the seed, fertilizer, herbicide and insecticide, and then receives an agreed percentage of the crop. The lessee supplies all of the labor and machinery, and an agreed share of the cost of the seed, fertilizer, herbicide and insecticide, and then receives an agreed share of the crop. In central Illinois share leases are generally on a 50-50 basis, the lessor and lessee each paying 50 percent of the costs and receiving 50 percent of the crop.

The decision to lease farm property on a cash rent or a share lease basis is a management decision. Land owners in my congressional district prefer the share lease basis because their farms are large and productive. The share lease agreement allows the land owner to share in production and market decisions that could mean a difference of thousands of dollars. Very few cash rented farms exist in the 21st congressional district. Those that do exist are often concessionary agreements between relatives that do not reflect true use value.

The effect of the Treasury Department's proposed regulations is to discriminate against farm estates in areas where the share lease is the traditional method of leasing farm property. Nothing in the Tax Reform Act of 1976 or in the committee reports on this bill suggests that Congress intended to limit the application of special use valuation based on farm leasing methods.

The Treasury Department has recognized share leases as an alternative to cash rents in the section 2032A(e)(7) formula. Previous regulations have allowed income from share leases to be substituted for income from cash rents. The rationale for the

department's decision to begin to deny this substitution is not clear. However, it is known that individuals there are displeased with the tax reductions resulting from the formula. It appears that not only does the department wish to ignore congressional intent and deny this special valuation in as many instances as possible, it also hopes to create a situation in which its own amendments to reduce the benefits of this section can be offered.

H.R. 5408, which I have introduced into the House of Representatives to allow income from share leases to be substituted for income from cash rents in the section 2032A(e)(7) formula when no comparable cash rents exist near the farm property seeking to be valued for estate tax purposes, has been cosponsored by 33 of my colleagues. Interest in this legislation grows as more individuals become aware of the effect of the Treasury Department's proposed regulations of September 10, 1979.

I appreciate this opportunity to present my views and commend the chairman of this subcommittee, Senator Byrd, for his leadership and initiative on this issue of importance to the heirs of farm estates.

Senator BYRD. Thank you, Senator Percy. Let me ask you this. What is the difference between S. 2201 and S. 1859?

Senator PERCY. I wonder if I could have Lucinda Oliver of my staff respond to that?

Ms. OLIVER. Mr. Chairman, there is no substantial difference in the legislation. The terminology, I believe, is the only difference. Where our legislation states crop share, I believe the Bellmon legislation states in-kind rentals.

Senator BYRD. So either piece of legislation is satisfactory to you? It accomplishes the same purpose, is that it?

Ms. OLIVER. That is correct.

Senator PERCY. As far as we are able to determine, it does accomplish the same purpose.

I think IRS would interpret the two terms as identical.

Senator BYRD. Is the failure of the IRS to permit crop rentals for special use valuation purposes due to the way the IRS interprets the law, or is this method clearly prohibited in the law?

Senator PERCY. It is not clearly prohibited.

Ms. OLIVER. Senator, the statute provides that if no cash rentals are available, one may use what is called the five-factor method. The five-factor method, however, has been disregarded by those working in the estate tax field because no one really understands it.

Senator PERCY. There is a conflict among experts, as I understand it, as to how you really apply it.

Ms. OLIVER. That leaves us with the formula, and under the IRS interpretation, only cash rents may be used.

Senator BYRD. I agree with Senator Percy that it is very important to protect, in every reasonable and appropriate way, the family farm. The committee will be interested, at a later time, to get the view of the Treasury but in the meantime, Senator Percy, thank you for your presentation today and we are glad to have you.

Senator PERCY. Thank you, Mr. Chairman.

Senator BYRD. Is Senator Bellmon here?

He is not.

Senator Heflin, we might as well go to the panel then on dealing with S. 2201 and S. 1859. The panel will consist of Ms. Grace Ellen Rice, assistant director, National Affairs Division, American Farm Bureau Federation; Mr. James Powell, chairman, Taxation Committee, National Cattlemen's Association accompanied by Mr. Tad Davis, Esq.; and Mr. George Brode, Jr., chairman, Federal Taxation

Section, Illinois Bar Association, accompanied by Mr. Robert M. Bellatti.

Let me see. Is the third witness here?

You are Mr. Powell?

Mr. JONES. I am Mr. Jones, substituting for Mr. Powell.

Senator BYRD. Is Mr. Brode here?

Mr. BELLATTI. Mr. Brode is unable to be with us.

Senator BYRD. All right.

I think it might be well to ask Mr. Hank Gutman of the Treasury Department if he would come to the witness table so the Chair could put questions to him at the same time that it queries the witnesses.

The panel may proceed.

## STATEMENT OF GRACE ELLEN RICE, ASSISTANT DIRECTOR, NATIONAL AFFAIRS DIVISION, AMERICAN FARM BUREAU FEDERATION

Ms. RICE. Mr. Chairman, I am Grace Ellen Rice, assistant director of National Affairs of the American Farm Bureau Federation. I was with Mr. Robert B. Delano, president of the American Farm Bureau Federation, this morning. He is from the Northern Neck of Virginia and he extended his best regards to you.

The American Farm Bureau Federation, as you have heard many times, is a voluntary farm and ranch organization representing over 3 million member families throughout the United States.

Senator BYRD. Ms. Rice, if you do not mind, if you would delay just a moment. Senator Heflin has a meeting of the Judiciary Committee, and I would like to recognize Senator Heflin at this time.

## STATEMENT OF HON. HOWELL HEFLIN, A U.S. SENATOR FROM THE STATE OF ALABAMA

Senator HEFLIN. Mr. Chairman, I have a statement that I would like to put in the record pertaining to the shrimp industry in Alabama and I have also a statement of Congressman Jack Edwards, who is unable to be here, that we would like to put in the record.

By not being here and not testifying, I do not want it considered that I am not 100 percent behind this. It is just that we do have an important matter that is there that I have to be there, so if you will relay to the other members of the committee that my not staying here and testifying, it does not indicate any lack of interest.

Senator BYRD. The committee recognizes that, and recognizes the responsibilities of the Senator from Alabama with regard to the Judicary Committee.

Those presentations will be received and made a part of the record and the record will note that the absence of the Senator from Alabama does not, in any way, indicate any lessening of enthusiasm for the legislation.

Senator HEFLIN. Thank you, Mr. Chairman.

[The prepared statements of Hon. Howell Heflin and Hon. Jack Edwards follow:]

STATEMENT OF SENATOR HOWELL HEFLIN

Mr. Chairman, I want to thank you and your Subcommittee very much for allowing me to appear today to testify in favor a bill I introduced early during the last session which is intended to correct what I believe is an inequity in the Internal Revenue Code which now exists with respect to the shrimping industry in Alabama and to perhaps other segments of the fishing industry generally.

As you know, Mr. Chairman, under the Tax Reform Act of 1976, criteria were established under which certain crewmen would not be considered employees of the operator or owner of a fishing boat. The Internal Revenue Service, has, in effect, declared shrimping boat crew members to be self-employed if the crewman (1) does not receive any cash remuneration, (2) if the crewman receives a share of the catch or a share of the proceeds from the sale of the catch, (3) if the amount of the crew share depends on the amount of the boat's catch and (4) provided the operating crew of the boat is normally made up of fewer than ten individuals. These criteria were made applicable for the purpose of withholding federal tax and Federal Insurance Contributions Act tax and consequently exempt the employer—in this case the boat owner or operator, from making these withholdings.

The inconsistency of which I am concerned appears in the Internal Revenue Code as it pertains to the Federal Unemployment Tax Act. This tax is applicable to employers only and they pay based on the payroll of their employees. Under the Act some fisherman employers are already exempt from the payment of federal contributions for unemployement purposes, for example, if the services performed by the crewmen are related to catching halibut or salmon for commercial purposes or the services are performed on a vessel of more than ten net tons. Shrimp boat owners and operators on the other hand find themselves paying unemployment taxes on those who for most tax purposes are classified as self-employed. Though these are different taxes, there is no reason for inconsistency in exemptions. If a person is considered self-employed under the criteria of one, there is no reason why an employer should be required to pay unemployment tax on that self-employed individual. Exclusion from coverage under FICA should be extended to mean an exclusion from coverage under FUTA in this instance. Either a man is self-employed or he is not. It is inconsistent to declare a man self-employed under one Act and claim that the same man is an employee under another Act.

The legislation I have introduced would simply amend Section 3306(c) of the Code by using the same criteria to determine self-employment of the crewman for unemployment tax purposes as used to determine self-employment of the crewman under the Tax Reform Act of 1976. Specifically, first, the crewman must not receive any cash remuneration; second, the crewman must receive a share of the boat's catch of fish or a share of the proceeds from the sale of the catch; third, the amount of the crewman's share must depend on the amount of the boat's catch; and fourth, the operating crew of the boat must normally be made up of fewer then ten individuals.

Mr. Chairman, this legislation would exclude these boat owners and operators from the excessive burden of paying unemployment tax on those crewmen defined as being self-employed under the Tax Reform Act of 1976 and bring some consistency to the enforcement of and compliance with these two laws. Employers need some relief from excessive government intervention and regulations. Enactment of my proposal would be tax reform in its finest sense. Tax consistency and equity and fairness would be a welcome reform and a welcome relief.

Mr. Chairman, we have with us today a representative of the Alabama shrimping industry who would like to further elaborate on the problems they face and the equities of this measure.

Again, I want to thank you for allowing us to appear before your Subcommittee today and testify and I would like to at this time ask the Committee to hear from our witness from Alabama.

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STATEMENT OF CONGRESSMAN JACK EDWARDS

Mr. Chairman, thank you for this opportunity to testify before your Committee today in support of S. 1194, introduced by Senator Heflin. I have introduced identical legislation in the House, H.R. 1581, and I am hopeful that this legislation can be enacted in this Congress.

These bills would exempt labor performed on small fishing boats (defined as those with crew members numbering less than ten) from coverage under the Federal Unemployment Tax Act, if the crew members are paid by a share of the boat's catch or a share of the proceeds of the catch, and if the amount of pay received depends entirely on the amount of the boat's catch.

This is not a new issue. As you will recall, the Tax Reform Act of 1976 clarified the status of independent fishermen for purposes of federal income tax and social security reporting. Under that Act, crew members on boats with fewer than ten crewmen are treated as self-employed for income tax and social security purposes if their sole pay is a share of the catch or the proceeds from the catch. The 1976 Act also requires boat operators to report the weight distributed to each crewman, or in cases of distributions of the proceeds of a catch, the dollar amount distributed to each crewman.

Under prior law, these crewmen had been treated as regular employees for social security and income tax purposes, and the reason for the changes made by the 1976 Tax Reform Act was to reduce the burdensome reporting requirements for boat operators. When crewmen were treated as employees, there were many problems with the income tax and social security reporting and collecting because crewmen often work on different boats from day to day, and because the type of pay received varies from a regular wage to a portion of the catch itself to a portion of the money received from the catch. The administrative problems were enormous and it was generally agreed that these fishermen on small boats are actually independent contractors, rather than employees, and should be treated as self-employed day laborers. Unfortunately, since the 1976 law failed to address the unemployment tax as well, the paperwork and administrative problems are still nearly as heavy for boat operators as they were before the Tax Reform Act was enacted. The omission of the unemployment compensation tax in the 1976 provisions has also led to some confusion on the part of the fishermen and their families who were covered by the changes included in the 1976 Act.

The problems involved in determining independent contractor status are extremely complicated, and these issues have been studied time and again in recent years. However, in the case of independent fishermen working on these small fishing boats, the determination has already been made by the Congress that they are self-employed, yet the inconsistency in their tax treatment is defeating the purpose of that decision. For those reasons, I would urge this Committee to take early and favorable action on this legislation.

Thank you for your consideration.

Senator BYRD. You may proceed.

STATEMENT OF GRACE ELLEN RICE—Resumed

Ms. RICE. Thank you, sir.

As I was saying, we are the country's largest farm and ranch organization, representing over 3 million member families. We were an active organization in 1976 during the deliberation of the Estate and Gift Tax Reform Act and the Revenue Act of 1978. One of the provisions of that law is the special use valuation of agricultural land for estate tax purposes. Section 2032A of the Internal Revenue Code promised to be quite helpful to farm and ranch families. However, we are concerned about the Internal Revenue Service's proposed regulations, as published September 10, 1979, which limit the application of a previously proposed method of valuing farm real estate under section 2032A(e)(7).

The definition of gross cash rentals contained in earlier proposals published on July 19, 1978, permitted crop share rentals to be treated as cash rentals if no actual cash rentals of comparable real property in the locality existed.

I think Senator Percy's statement has pretty well stated our problems there.

This option to substitute crop-share figures for cash rent figures in the valuation formula was, and is, essential in some areas of the country where farming is conducted primarily under crop-share arrangements.

Unfortunately, the proposed regulations published in September 1979 no longer afford this option to farmers and ranchers. In areas of the country where crop share arrangements predominate, such

as Kansas and Illinois, it would be impossible, if the September 1979 proposals are adopted, to take advantage of the special use valuation under 2032A(e)(7). This leaves the alternative of a more cumbersome valuation procedure under 2032A(e)(8).

The voting delegates of the member State Farm Bureaus to the 61st annual meeting of the American Farm Bureau Federation recognized the dilemma presented by the elimination of the crop-share option and adopted the following policy:

We believe both crop share and cash rentals should qualify in determining special use valuation of farmland under section 2032A of the Internal Revenue Code.

In January 1980, the American Farm Bureau Federation and the Kansas Farm Bureau Federation presented testimony to the Internal Revenue Service on this problem and asked IRS to reexamine its decision to eliminate the use of crop-share rentals. Final regulations have not been issued yet, but we have no reason to expect that the IRS will modify its position.

Farm Bureau supports S. 1859, introduced by Senators Percy and Dole, and S. 2201, introduced by Senator Bellmon, to allow the use of crop share or in-kind rentals in the special use valuation formula of 2032A(e)(7). Such legislation would solve the problem presented by the proposed IRS regulations issued last September.

We urge the subcommittee to approve S. 1859 and S. 2201. Thank you for the opportunity to present Farm Bureau's views on this legislation.

Senator BYRD. Thank you, Ms. Rice.

## STATEMENT OF B. H. JONES, NATIONAL CATTLEMAN'S ASSOCIATION

Mr. JONES. My name is B. H. "Bill" Jones, National Cattleman's Association. The subcommittee is very familiar with NCA and in our testimony we do outline the representation as far as the association is concerned.

With your permission, Mr. Chairman, I will brief the statement and then ask that the complete statement be included in the record.

Senator BYRD. The complete statement will be included in the record.

Mr. JONES. That does include appendix A which is a recommended bill that would go a little bit further than the two bills that we are testifying on. We also ask that that be included with the statement.

The National Cattleman's Association commends Senators Percy, Dole, and Bellmon for their introduction of S. 1859 and S. 2201. The concept of permitting crop shares to be used in the rental valuation formula of section 2032A is keeping with and fosters the original intent of the Congress.

During the 14-month period between the publication of the first proposed Treasury regulations and the new proposed Treasury regulations, many farm and ranch estates have elected the benefit of section 2032(a) using the rental evaluation formula and making subsequent tax and financial decisions on the assumption that crop share leases could be used to value qualified farm real property as outlined in the first proposed Treasury regulations.

Now, the subcommittee, of course, has been told before that the original regulations in 1978 would have allowed the use of the crop shares but in September 1979 Treasury reversed this position. In answer to one of the questions you asked, Senator Byrd, during that period of time when Treasury changed its mind, the Congress had not in the interim made any change in the provision of section 2032A as it was passed in 1976 and therefore, it must be concluded that the Treasury action was arbitrary and certainly it is in need of congressional clarification.

Senator BYRD. What you are saying, as I understand it, Treasury interpreted the law one way in 1978 and the opposite way in 1979?

Mr. JONES. Yes. I think their interpretation in 1978 has to tell us that there is no limitation inherent in the statute as far as crop shares are concerned.

To address additional problems created by the new proposed Treasury regulations and by IRS interpretation of section 2032A in certain areas of the country, the NCA urges that the amendments to section 2032A contained in S. 1859 and 2201 be broadened to eliminate the comparability issue.

Senator BYRD. To be broadened to do what?

Mr. JONES. To include and solve the comparability issue which is a problem also.

While S. 1859 and S. 2201 addresses the crop share issue, they do not resolve some of the other problems that have been encountered by farm and ranch estates which have made special farm use valuation election under 2032A. In some areas of the country, IRS agents are making it very difficult for farm and ranch estates to use the rental valuation formula by asserting that any land shown to be comparable for purposs of the formula are not comparable because they do not have identical roads, buildings, and provisions in the leases.

The upshot of this is that, in these instances, some IRS agents are interpreting comparable to mean identical. This has caused attorneys in those areas to assert that if a farm estate elects to use the rental evaulation formula, the matter will have to be litigated in the court.

This is certainly not what Congress had intended.

To correct these problems which some farm and ranch estates are encountering, and to solve the problems created by the new, proposed regulations, NCA urges additional amendments be made to the rental evaluation provisions. Attached to the statement is a bill containing proposed amendments which would solve these problems.

Senator BYRD. Did you take this up with the sponsors of the legislation?

Mr. JONES. Yes. We have visited with the sponsors about this, Senator Byrd. The proposed bill would also remove the existing uncertainty of the comparable land criteria which permits IRS agents to assert that there is no comparable land and thus deny the use of this rental evaluation formula to qualified farm and ranch land.

The proposed expansion that we have here, sir, is attached to the back of our statement which you have. It is a very simple sugges-

tion just amounting to one page and would solve the comparability problem which we are running into in the country.

Senator BYRD. What is the attitude of the sponsors toward that change?

Mr. JONES. In our preliminary discussions with them, they were receptive to this but we have not given them the detailed language that we have here. We expect to discuss that with them today.

Senator BYRD. Thank you.

The next witness?

## STATEMENT OF ROBERT BELLATTI, FEDERAL TAXATION SECTION, ILLINOIS BAR ASSOCIATION

Mr. BELLATTI. Mr. Chairman, thank you very much for the opportunity to testify. My name is Robert M. Bellatti and I am here on behalf of the Illinois State Bar Association.

I am vice chairman of the Federal Taxation Section of that association and I specialize in farm estate planning and administration as a tax attorney in Springfield, Ill.

I am also going to ask that my statement in full be admitted to the record, but I will attempt to brief that and hit only the points that I think need particular emphasis.

As has been explained by Senator Percy and some of the other speakers, the special use valuation formula provides two alternative methods of valuing a family farm for estate tax purposes.

There is a mathematical formula, or cash rental formula, that has been discussed. It is that formula that is at issue in this legislation.

The other formula for valuing farms or other closely held businesses under section 2032[a] is the five-factor formula, but unfortunately this formula does not appear to either be beneficial or workable in the case of the average family farm.

For all practical purposes, special use valuation is not available to a family farm unless it can be valued under the mathematical formula method of special use valuation currently provides that the net rental part of the formula must be determined by reference to cash rentals. The current Treasury Department position is in farms in regions of the country where no farms are rented on a cash basis, the mathematical formula is unavailable.

In Illinois and several other States, there are many farm communities that no farms at all are rented on a cash basis.

Since there is no policy justification for denying the saving benefit of special use valuation to family farms in these communities, this situation is inequitable and appears to require statutory correction.

S. 1859 and 2201 both provide the statutory relief. These bills provide that in the case of a farm located in a community where no farms are rented on a cash basis, the farm may be valued under the mathematical formula by reference to net crop-share rentals rather than by reference to cash rentals. These bills should be very helpful in ending the discrimination against farms located in communities where all farms are rented on a crop-share basis.

The Illinois State Bar Association believes that if either of these proposed bills is enacted in its present form, the benefits of special use valuation might still be denied to many farms as a result of

requirements that the Treasury Department might impose by regulation. The first set of proposed regulations issued under section 2032A permitted reference to crop share rentals.

The crop share information required under those proposed regulations could only be obtained by invading the private income tax returns and records of a neighboring farmer in a very detailed fashion. As a practical matter, it would generally be impossible to obtain this information from a neighboring farmer or even to find an appraiser who would attempt to obtain that information.

It was the withdrawal of the proposed regulation permitting reference to crop-share rentals that led to the introduction of this corrective legislation. However, the inequity addressed by this proposed legislation will not be eliminated if this legislation permits the Treasury Department to impose the same type of proposed regulation on crop-share rentals that was previously issued and then withdrawn under the current statute.

In order to make special use valuation generally available to all family farms that otherwise qualify, it is the position of the Illinois State Bar Association that in cases where there are no comparable farms rented on a cash basis in the locality, the executor should be permitted to elect to determine the net crop-share rental for comparable property based upon areawide averages of rent crop-share rental for farms of comparable soil quality.

The areawide averages of net crop share rentals could be determined from statistical information that is published annually by various public sources, for example, the U.S. Department of Agriculture, State departments of agriculture or State universities. It is further the position of the Illinois State Bar Association that language should be added to the proposed bills to specifically provide for reference to such areawide averages of net crop share rentals at the election of the executor.

The Illinois State Bar Association will be pleased to suggest specific statutory language to add to these bills to provide for reference to areawide averages in implementing the special use valuation of family farms under the estate tax laws.

I thank you very much for the opportunity to testify this morning.

Senator BYRD. Thank you.

All three of you, I take it, advocate broadening the legislation now under consideration?

Mr. JONES. Yes, Senator Byrd: We would, in two ways. Both in the way that the Illinois Bar advocates and really what our proposal here was actually to be able to use any in-kind rentals. And the second way, then, to get away from the comparability problem that we run into, particularly in Kansas and Nebraska.

Senator BYRD. I am not a lawyer, but could you not get away from that latter problem by saying comparable does not mean identical?

Mr. JONES. You can, sir, but our experience with the IRS agents is that this is exactly the way they are interpreting it.

Senator BYRD. The law says it does not mean identical.

Mr. JONES. But the word comparability still, I am afraid, would give us problems.

Senator BYRD. Why do you not get together with the sponsors and see what language you could work out and then the committee could consider it?

Mr. JONES. Fine.

Senator BYRD. If the three of you will just stay there, and let me get Treasury's view on this.

[The prepared statement of Messrs. Jones and Bellatti follow:]

STATEMENT OF B. H. JONES, VICE PRESIDENT, NATIONAL CATTLEMEN'S ASSOCIATION

The National Cattlemen's Association commends Senators Percy, Dole and Bellmon for their introduction of S. 1859 and S. 2201. These bills will allow crop shares to be used in valuing qualified farm and ranch land under the rental valuation formula of Section 2032A and will reverse the position of the Treasury Department adopted in new Proposed Treasury Regulations that crop share rentals can not be used in valuing such land under this rental valuation formula. The concept of permitting crop shares to be used in the rental valuation formula of Section 2032A is in keeping with and fosters the original intent of Congress.

To address additional problems created by the new Proposed Treasury Regulations and by IRS interpretation of Section 2032A in certain areas of the country, the National Cattlemen's Association would urge that the amendments to Section 2032A contained in S. 1859 and S. 2201 be broadened to eliminate the "comparability" issue.

*Congress intended rental valuation formula of section 2032A to be generally available, and to provide relief for farm and ranch estates*

In recognition of the need to provide relief to farm and ranch estates, Congress, in 1976, enacted a provision amending the Internal Revenue Code (Section 2032A) to permit certain real property used for farming and ranching purposes to be valued for federal estate tax purposes on its agricultural use value rather than on its "fair market value". Two methods were provided in Section 2032A for valuing such farm and ranch real property. One used a five factor test. The second stipulated that the value of farm and ranch real property which qualified for the special use valuation would be determined by dividing "the excess of the average annual gross cash rental for comparable land used for farming purposes and located in the locality of such farm over the average annual State and local real estate taxes for such comparable land by the average effective interest rate for all new Federal Land Bank loans." Each average annual computation is made on the basis of the five most recent calendar years ending before the farmer's or rancher's death. The stated Congressional reasons for providing such mathematical formula were: (i) to reduce subjectivity and controversy, (ii) to eliminate values which might be attributable to the potential for conversion to nonagricultural use; and (iii) to abolish "as a valuation factor any amount by which land is bid up by speculators in situations where nonagricultural use is not a factor in inflated farmland values." H.R. Rep. No. 94-1380, 94th Cong., 2d Sess., 24-25 (1976).

Thus, it was the clear intent of Congress that this rental valuation formula specified in Section 2032A be available for valuation of farms and ranches which qualified for such special use valuation.

*Proposed Treasury regulations severely restrict use of rental valuation formula*

Proposed Treasury Regulations issued in July, 1978, (Prop. Regs. § 20.2032A-4(b)(2) (ii) and (iii)) specified that crop shares could be converted into cash equivalents for purposes of the rental valuation formula under Section 2032A. However, in September of 1979, new Proposed Treasury Regulations were issued which reversed this position and denied the use of crop share rentals in the rental valuation formula. The result of the new Proposed Treasury Regulations is to deny estates of farmers and ranchers the right to elect to value farm and ranch land using the rental valuation formula when the only comparable land in the locality is subject in whole or part to crop share rental arrangements. Since a large portion of the nation's leased farmland is subject to crop sharing or similar non-cash rental arrangements, the effect of this change in Treasury's interpretation of Section 2032A will be to prevent the use of the rental valuation formula to numerous estates of farmers and ranchers who live in areas where cash rentals are not used.

There have been no amendments made by Congress to this provision of Section 2032A to support such change in interpretation by Treasury. Moreover, the earlier Proposed Treasury Regulations permitting the use of crop share and in-kind rentals to determine gross cash rental value is in keeping with and properly expresses the

intent of Congress to provide remedial and needed relief to farm and ranch estates. Furthermore, during the 14 month period between the publication of the first Proposed Treasury Regulations and new Proposed Treasury Regulations, many farm and ranch estates have elected the benefits of Section 2032A using the rental valuation formula and have made subsequent tax and financial decisions on the assumption that crop share leases could be used to value qualified farm real property as outlined in the first Proposed Treasury Regulations.

*S. 1859 and S. 2201 would permit crop shares to be used in rental valuation formula*

Both S. 1859 and S. 2201 would correct the problems created by and the interpretation contained in the new Proposed Treasury Regulations by permitting crop share rentals to be used in determining the value of farm and ranch land under the rental valuation formula of Section 2032A. The National Cattlemen's Association (NCA) commends Senators Percy, Dole and Bellmon for introducing these bills and supports the concept embodied in these bills. NCA strongly feels that there is need for clarity and simplicity, as originally intended by Congress in providing a rental valuation formula, in valuing farm and ranch land under Section 2032A and that S. 1859 and S. 2201 would correct a major problem created by the new Proposed Treasury Regulations.

*Additional problems created by new proposed Treasury regulations and by IRS interpretation of section 2032A should be resolved*

While S. 1859 and S. 2201 address the crop share issue, they do not resolve some of the other problems that have been encountered by farm and ranch estates which have made a special farm use valuation election under Section 2032A. In some areas of the country, IRS agents are making it very difficult for farm and ranch estates to use the rental valuation formula by asserting that any lands shown to be "comparable" for purposes of the formula are not "comparable" because they do not have similar or identical roads, buildings, and provisions in the leases. The upshot is that in these instances some IRS agents are interpreting "comparable" to mean "identical". This has caused a few attorneys in these areas to assert that if a farm estate elects to use the rental valuation formula, the matter will have to be litigated in court. This is certainly not what Congress intended.

*Proposed bill would solve problems of rental valuation formula*

To correct these problems which some farm and ranch estates are encountering and to solve the problems created by the new Proposed Treasury Regulations, NCA would urge additional amendments be made to the rental valuation provision of Section 2032A. Attached as Exhibit A is a bill containing proposed amendments which NCA believes would solve these problems. The thrust and purpose of this proposed Bill is to make the rental valuation formula of Section 2032A available to all qualified farm and ranch land by computing the special use value based upon the agricultural productive capacity of such land measured by the rental value of such land, whether determined by cash rentals or the conversion of any "in kind" rentals, such as crop shares or the like, into cash amounts.

The proposed Bill would add desired certainty to the rental valuation formula by deleting the present "comparable land" standard and substituting instead the provision that the valuation formula would apply to the rental value of the qualified farm or ranch land being valued. This would mean that appraisers would value the qualified farm or ranch land on the amount of gross rental it would produce, based upon its actual farming or ranching use, measured on an arms' length basis, and determined on a cash, crop share or other basis. Applicable real estate taxes attributable to such land would then be subtracted from the gross rental amount. Thus, if the qualified farm land had been used for growing wheat, the rental value of such land for purposes of the valuation formula would be based upon the amount of gross rentals (whether cash or crop shares or other "in kind" amounts which could be converted into cash amounts) which such land would produce if rented on an arms' length basis for growing wheat during the relevant valuation period.

The proposed Bill would remove the existing uncertainty of the "comparable land" criterion which permits IRS agents to assert there is no comparable land and thus deny use of this rental valuation formula to qualified farms and ranch land. It would also eliminate the very serious problem presented in the new Proposed Treasury Regulations (Prop. Regs. § 20.2032A-4(b)(1)) that "rentals from any property which qualifies for special use valuation provided by Section 2032A may not used to compute gross cash rentals under this section. . . ." The effect of this provision in the new Proposed Treasury Regulations is to deny use of the rental valuation formula to qualified farm and ranch land when all farmers and ranchers in a locality conduct their operations, as they will undoubtedly be advised to do by their

tax counselors, to satify the Section 2032A requirements. Certainly, this was not the intention of Congress in passing Section 2032A and this Bill would eliminate this injurious interpretation.

Finally, the proposed Bill would retain the feature contained in present law which allows the executor of a deceased farmer or rancher's estate to elect either the rental valuation formula or the five factor formula under Section 2032A.

### CONCLUSION

NCA commends Senators Percy, Dole and Bellmon for their introduction of S. 1859 and S. 2201 and supports the concept contained in these bills which would permit crop shares to be used in the rental valuation formula under section 2032A.

### EXHIBIT A

### A BILL

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

Paragraph (7) of Section 2032A(e) of the Internal Revenue Code of 1954 is amended to read as follows:

"(7) METHOD OF VALUING FARMS—

(A) IN GENERAL—Unless the executor elects to have the value of the farm for farming purposes determined under paragraph (8), the value of a farm for farming purposes shall be determined by dividing—

(i) the excess of the amount of the average annual gross rental value of the qualified real property used for farming purposes over the amount of the average annual State and local real estate taxes for such qualified real property, by

(ii) the average annual effective interest rate for all new Federal Land Bank loans.

For purposes of the preceeding sentence, each average annual computation shall be made on the basis of the 5 most recent calendar years ending before the date of the decedent's death.

(B) APPLICATION—The formula provided by subparagraph (A) shall be applicable regardless of whether the qualified real property or any portion thereof has in fact been rented or whether such qualified real property has been rented on a cash, crop shares, or other basis."

However, NCA would suggest that the amendments to Section 2032A in these bills be broadened to eliminate the "comparability" problem and would urge adoption of the additional amendments contained in the attached proposed Bill.

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## STATEMENT OF ILLINOIS STATE BAR ASSOCIATION

My name is Robert M. Bellatti. I am a tax attorney specializing in farm estate planning and administration and I am Vice-Chairman of the Federal Taxation Section of the Illinois State Bar Association. I am here today on behalf of the Illinois State Bar Association to speak in support of Senate bills 1859 and 2201. These bills have been introduced to correct an inequity in the implementation of the special use valuation for family farms under the estate tax laws.

The Tax Reform Act of 1976 added Section 2032A to the Internal Revenue Code to provide for special use valuation of family farms. According to the Committee Reports in 1976, the purpose of special use valuation was to reduce the number of forced sales of family farms to pay estate taxes. The traditional method of valuing farms for estate tax purposes reflects speculation to such a degree that the tax value placed on the land does not bear a reasonable relationship to its earning capacity. The Committee Reports also indicate that special use valuation was intended to reduce subjectivity and controversy in valuing the family farm for estate tax purposes.

Section 2032A provides two different alternative methods of valuing farm real property for estate tax purposes. The mathematical formula under Section 2032A(e)(7) provides that the estate tax value of farm real property shall be determined by dividing the net rentals earned on comparable farm real property in the same locality by the Federal Land Bank interest rate. Both factors of the formula are determined from averages for the five years preceding the year of death.

If the estate does not qualify for the mathematical formula or the Executor elects not to use it, Section 2032A(e)(8) provides a five factor formula to determine the estate tax value of the family farm. Unfortunately, this five factor formula does not appear to be either beneficial or workable in the case of the average family farm.

For all practical purposes special use valuation is not available to a family farm unless it can be valued under the mathematical formula.

The mathematical formula method of special use valuation currently provides that the net rental part of the formula must be determined by reference to cash rentals. The current Treasury Department position is that for farms in regions of the country where no farms are rented on a cash basis, special use vaulation is unavailable. In Illinois and several other states, there are many farm communities in which no farms are rented on a cash basis. Since there is no policy justification for denying the saving benefit of special use valuation to farms in these communities, the situation is highly inequitable and requires statutory correction.

Senate bills 1859 and 2201 both provide statutory relief from this inequitable discrimination. These bills provide that in the case of a farm located in a community where no farms are rented on a cash basis, the farm may be valued under the mathematical formula by reference to net crop share rentals rather than by reference to cash rentals. These bills should be very helpful in ending the discrimination against farms located in communities where all farms are rented on a crop share basis.

The Illinois State Bar Association believes that if either of these proposed bills is enacted in its present form, the benefits of special use valuation might still be denied to many farms as a result of requirements that the Treasury Department might impose by regulation. The first set of proposed regulations issued under Section 2032A permitted reference to crop share rentals. The crop share information required under those proposed regulations could only be obtained by invading the private income tax returns and records of a neighboring farmer in a very detailed fashion. As a practical matter, it would generally be impossible to obtain this information from a neighboring farmer or even to find an appraiser who would attempt to obtain that information.

It was the withdrawal of the proposed regulation permitting reference to crop share rentals that led to the introduction of this corrective legislation. However, the inequity addressed by this proposed legislation will not be eliminated if this legislation permits the Treasury Department to impose the same type of proposed regulation on crop share rentals that was previously issued and then withdrawn under the current statute.

In order to make special use valuation generally availabale to all family farms that otherwise qualify, it is the position of the Illinois State Bar Association that in cases where there are no comparable farms rented on a cash basis in the locality, the Executor should be permitted to elect to determine the net crop share rental for comparable property based upon areawide averages of net crop share rental for farms of comparable soil quality. The areawide averages of net crop share rentals could be determined from statistical information that is published annually by various public sources (e g. the U.S. Department of Agriculture, state departments of agriculture or state universities). It is further the position of the Illinois State Bar Association that language should be added to the proposed bills to specifically provide for reference to such areawide averages of net crop share rentals at the election of the Executor.

The Illinois State Bar Association will be pleased to suggest specific statutory language to add to these bills to provide for reference to areawide averages in implementing the special use valuation of family farms under the estate tax laws.

Mr. GUTMAN. Would you like me to address the bills in general?

Senator BYRD. I would like for you to address the two bills, which are virtually identical, as I understand it.

Mr. GUTMAN. Certainly, Senator. I would be happy to.

Senator BYRD. Why do you not address those two bills?

## STATEMENT OF HARRY L. GUTMAN, DEPUTY TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. GUTMAN. You have heard a description of what these bills do. Essentially, to reiterate, they allow the use of crop-share rentals to be converted into cash rentals for purposes of using the formula to determine the value of farmland.

Senator, I am going to say at the outset, we object to the the bills in their current form. But if the committee were willing to accept

some suggestions that I am going to make later on, and I can do that either now or later, at your convenience——

Senator BYRD. Fire away with your suggestions.

Mr. GUTMAN. Fire away now? Fine.

Let me put the problem in some perspective, at least as far as we see it. We have seen a number of different formulations of what this section, section 2032A, was intended to do. I think we have a view that might differ a little bit from the view expressed by my fellow panel members.

As you recall, under the law in effect prior to 1976, as Senator Percy said, property was valued at its higher and best use. Fair market value did not necessarily reflect the use of property for farming where the farmland could have been used for some other purposes, for example, recreational development or commercial development if the farmland were situated close to a city.

The 1976 law, in our view, was intended to permit farms to be valued at their use for farm purposes. That is, to extract from the value of the farm any commercial or other type of developmental value, so you would arrive at a value that a farmer would pay for the farm to farm it. It seems very sensible. That is what the law was intended to do.

Let me give you an example so we can put it in some concrete terms. Let us assume we have a farmer who lives 20 miles outside of Washington and he actively manages his farm. Let's say that he has received offers of $1,000 an acre from his neighboring farmers who want to take the land and use it for farming. He also knows that if he went to a developer, because he is so close to the city, he would be able to get $1,500 an acre.

Here is the situation: $1,500 an acre from the developer, $1,000 an acre from another farmer.

Now, it is our view that what Congress intended to do in 1976 was to take out the $500 speculative commercial development value so that the property should be valued, not at its highest and best at $1,500 an acre, but $1,000 an acre. There is no indication in the legislative history that Congress intended to do anything other than that.

What Congress was trying to do, again, was to establish a value for the farmland as a farm, used as a farm. There are a number of ways that you can go about doing this. Obviously in most areas of the country the best way you can go about doing this is to look and see what another farmer would pay for the farmland, having in mind farm use.

The reason I keep emphasizing this point, Senator, is that it becomes very relevant when we see how this formula, to which everyone is referring, actually is working in practice.

Senator BYRD. It says, in accordance with the rentals received. You have not got to rentals?

Mr. GUTMAN. I have not gotten there yet. I am trying to set the stage because it is a little complicated.

Senator BYRD. Are you speaking now of the five-factor formula?

Mr. GUTMAN. I am speaking now in general of what the section is trying to accomplish. I think what the section is trying to accomplish is to allow the value of farmland at its use in farming.

There are two ways the section goes about doing that. I will move right into that.

One is through a so-called five-factor formula. In fact, the opinions of my panelists to the contrary notwithstanding, all that five-factor formula is meant to represent, in our view and in the view of the Internal Revenue Service, is simply generally accepted farm appraisal techniques.

You go out and appraise the farmland as farmland.

Senator BYRD. Excuse me a minute, but the five-factor formula does not take the place, does it, of the cash rental?

Mr. GUTMAN. Yes, it can.

If an individual qualifies to use of the formula as presently interpreted, that is there are cash rentals on comparable property, then the individual is permitted to use the formula to determine value.

If the individual does not qualify under the formula, or if the individual elects not to use the formula, which, as I will point out, is a very unlikely circumstance, then his land will be valued under the so-called five-factor approach.

But the five-factor approach, Senator, is simply meant to codify generally accepted farm appraisal techniques to come up with the value of $1,000 an acre in the example that I gave you about the farmer whose property is outside Washington.

Now, since the mathematical formula is meant to arrive objectively at something close to the five-factor formula, you would expect that the results would be the same, or close to the same, whether you used the formula approach or whether you use the five-factor approach.

Senator BYRD. The formula approach is what?

Mr. GUTMAN. The formula approach would take gross cash rentals, and subtract the real estate taxes and divide by the Federal land bank interest rate. An objective and relatively simple method to determine farm value.

Senator BYRD. This legislation wants to do the same thing.

Mr. GUTMAN. With regard to crop-share rentals.

Senator BYRD. Crop-share rentals. What is the matter with that?

Mr. GUTMAN. There is, in principle, no difference. There should be no distinction drawn between whether property is rented for cash or whether property is rented in kind. That is certainly true, although there are administrative problems with converting in-kind rentals into cash. They were sufficient to allow Congress to make the distinction we believe Congress made in 1976.

Senator BYRD. Just a moment. As I understand it in 1978, the Internal Revenue Service permitted that to be done, and in 1979 it reversed itself.

Mr. GUTMAN. That is precisely right. Upon re-examination of the legislative history and the language of the statute Treasury decided it simply did not have the statutory authority to permit in-kind rentals to be converted into cash.

The statute is very clear in stating gross cash rentals. The legislative history is replete to references to cash rentals. Nowhere in the legislative history is there any indication that in-kind rentals could be converted into cash for purposes of this formula. As a

matter of interpretation, we felt simply we did not have the right to be able to do this.

Senator BYRD. You had interpreted it that way?

Mr. GUTMAN. We had interpreted it that way at first and then we thought we were wrong and could not do it. If one examines the statutory language and legislative history there is absolutely no support for the position that we initially took. I quite concede that.

Senator BYRD. But you originally took the position?

Mr. GUTMAN. We did.

Senator BYRD. It is so clear. I do not see why you took it in the first place.

Mr. GUTMAN. We are capable of making mistakes as well as anybody else, Senator.

Senator BYRD. It must not be that clear, then.

Mr. GUTMAN. No. We would have liked to be able to maintain that position. Upon reflection, we thought simply the law did not permit us to do that.

We do not believe we can promulgate regulations that will exceed the authority granted by the law, so we had to withdraw those regulations.

Those were only proposed regulations, Senator. They were not final regulations. We got comments on them. Part of the reason you put things out in proposed form is to get comments so that you can re-examine the positions you have taken.

Senator BYRD. From what groups did you get information that caused you to change?

Mr. GUTMAN. On this one, if I recall correctly—and I would have to go back and examine the record, but my recollection is that we got a comment from the American Bankers Association with regard to the difficulty of converting in-kind rentals into cash.

Also in the context of re-examination of the regulation, we began to review it. But, I am not sure that is really the issue here, Senator. If I could say so, we did go out with this regulation. We withdrew it because we thought it was wrong. Our discussion now is whether there should be legislative relief to put us back in the position where the original proposed regulation was.

Senator BYRD. Do you favor or oppose that?

Mr. GUTMAN. We oppose the legislation as it is presently drafted. The reason we oppose it as presently drafted is that we believe the formula itself is not working properly. The formula is resulting in values significantly below the value of farmland used as a farm. In other words, let me go back to my example of the farmer——

Senator BYRD. What I am trying to get clear is do you object to using the share basis?

Mr. GUTMAN. At this time, Senator, we would object to using crop-shares, yes, because we think the formula itself is not working right and we do not want to be a party to expanding a formula that is not working correctly.

As a matter of principle, certainly, crop-share rentals ought to be entitled to the same availability as cash rentals. But when they are both in a formula that is not operating correctly, then it is our position that the formula ought to be changed. We do not want to see it expanded to cover more bad situations. We believe the formu-

la as presently operating does not comport with Congressional intent in 2032A in providing special valuation formulas.

If we could go back to the example, let me point out precisely what I mean. We have a farmer whose land is worth $1,500 an acre for development purposes. Another farmer would pay $1,000 for that land to farm it.

Under the formula, most probably—and I think if you ask Mr. Bellatti or some of the others who have engaged in this type of reporting they would support this, that value would come out to be $500 an acre or thereabouts.

The Internal Revenue Service did a survey of all district offices in the country. The results of that survey are appended to my testimony as appendix A. You will see in a significant number of the districts in the country the values that were being reported under the formula were less than 50 percent of the value that somebody could get if he went out and sold the land to another farmer. We do not believe that is what Congress intended.

Indeed, there was never any claim by the farmers in the context of the 1976 act that they ought to be getting preferential treatment. All the farmers said that they wanted to get in 1976 was to have their land valued at the farm value. What is the best evidence of that, Senator? It seems to me what another fellow would pay for it.

Senator BYRD. It would not necessarily need to be a farmer paying for it. The Arabs have been buying a lot of farmland.

Mr. GUTMAN. For farm purposes, I assume. They are not doing it for development purposes. They have got to make money on the farm, do they not?

Senator BYRD. They are doing it to have someplace to put all their money that they are getting from the American people for oil.

Mr. GUTMAN. They still want to make a profit on that. They are still going to be rational businessmen and invest in a way that they are going to get an adequate rate of return on their property.

Senator BYRD. They get no return when they buy gold.

Mr. GUTMAN. They get no return until they realize——

Senator BYRD. Unless there is appreciation in price, they get nothing from it. So they are using it as a hedge against the decline in the dollar, as I visualize it.

Mr. GUTMAN. Using the gold that way? I expect that is right.

Senator BYRD. The land, too. Both.

Give me, if you will, the five-factor formula. What are the five factors involved?

Mr. GUTMAN. If you will let me look at the Code, please.

Senator BYRD. I understand.

Mr. BELLATTI. I would like an opportunity to respond to this at some point, but I do not want to interrupt the gentleman from the Treasury Department.

Senator BYRD. We will get to you in a minute.

Mr. GUTMAN. Senator, the statute reads, in any case in which subparagraph 7(A), which is the formula, does not apply, the following factors shall apply in determining the value of any qualified real property.

First, capitalization of income, capitalizing the income at an appropriate capitalization rate.

Senator BYRD. What is the appropriate capitalization rate?

Mr. GUTMAN. An appropriate capitalization rate is going to depend on various localities but in most cases, the capitalization rate is the reciprocal of the usual rate of return on equity. I would guess the rate would be about 25 times earnings. Historically, based on farm income, the appropriate interest rate to be applied would be 4 percent rather than the 8 or 9 percent which is presently in the formula.

That is what is giving rise, by the way, to the difference in values.

Anyway, one is capitalization of income; second is capitalization of the fair rental value of the land; third is assessed land values in States which provide differential or use value assessments; fourth is comparable sales of other farm or closely held business land in the same geographic area far enough removed from a metropolitan or resort area, so nonagricultural use is not a significant factor in the sales price; fifth is any other factor which fairly values the farm.

Senator BYRD. The fifth is what?

Mr. GUTMAN. Any other factor which fairly values the farm.

Senator BYRD. Any other factor?

Mr. GUTMAN. That fairly values the farm. In other words, this is simply a codification, Senator, of what I think are generally accepted farm appraisal principles.

If people are worried about what that means, we will be happy to clarify that by means of regulation, or we could suggest to the Service a press release be issued.

There is no magic about this; this is not a great mystery. It is common farm value technique. Appraisers have been valuing farmland for years.

Senator BYRD. Thank you.

I notice Senator Bellmon is here.

The committee is very glad to have you. Would you want to participate, or want to make a comment?

## STATEMENT OF HON. HENRY BELLMON, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

Senator BELLMON. Mr. Chairman, I have a prepared statement. If there is no objection, I would simply insert it in the record and not interfere with the panel's testimony.

Senator BYRD. Thank you, Senator Bellmon. Your statement will be inserted in the record.

Senator BELLMON. Thank you, Mr. Chairman.

Senator BYRD. Thank you, Senator Bellmon.

[The prepared statement of Hon. Henry Bellmon follows:]

### STATEMENT OF SENATOR HENRY BELLMON

Mr. Chairman, it is a pleasure to have the opportunity to testify before the Subcommittee on Taxation and Debt Management on S. 2201, a bill to allow landowners to use crop rental in the special valuation formula contained in Section 2032 A of the Internal Revenue Code if comparable cash rentals are not available.

Under the estate tax laws in effect prior to 1976, all property was included in a descendant's gross estate at its fair market value. In determining fair market value,

it was presumed that the property would change hands between a willing buyer and seller on the basis of a price which reflected the potential "highest and best use" of the property. This price did not necessarily reflect the actual use of the property by the descendant.

This valuation method resulted in higher estate taxes for descendants whose estates included farm land which was used for farming purposes but whose fair market value was higher than its agricultural production would justify. In many cases, this higher tax made it difficult for the family of the descendant to maintain an economic farming unit because the income from farming was not sufficient to pay an estate tax based on a speculative use of the land rather than the agricultural use of the land.

In 1976, the Congress recognized that it was inappropriate to value farm land on the basis of its potential highest and best use and changed the law to allow a special valuation of farm property. This provision allows valuation on the basis of use of the property as a farm, not on the property's speculative value under a highest and best use approach.

The provision enacted by Congress in 1976 includes a method that is available only for farms, which involves the use of a mathematical formula, and is intended to reduce subjectivity in farm valuation. The formula very simply computes the value of a tract of land by taking its cash agricultural rental value and dividing it by the Federal Land Bank interest rate. The formula yields the value of the land based upon agricultural production.

Because of the extremely strict and narrow interpretation of Section 2032 A by IRS, very few estates containing agricultural land have been eligible to take advantage of the special use valuation. I can understand the Department of Treasury's concern for the loss of revenues which occurs when farmers' and ranchers' heirs and devisees qualify for the special use valuation and accordingly, the Services desire the restriction of the use of Section 2032 A.

It is my understanding that Treasury will propose that a smaller percentage than the current FLB rate be used to capitalize the rental value to increase tax revenues. I personally preferred the Federal Land Bank interest rate because I believe its use in the formula best reflects the value of land for agricultural purposes. However, my chief concern is that the subcommittee approve S. 2201 in a form that can be approved by the Congress and signed into law by the President.

Under the Code as it is now being interpreted by IRS, it is often impossible for heirs and devisees to maintain an inherited farming or ranching operation because of large tax liabilities based on speculative land values. The family farm has always been the backbone of American agriculture. I urge the Subcommittee to approve S. 2201 so that family farm operations can be passed from generation to generation.

Mr. Chairman, I appreciate the opportunity to testify before your subcommittee and I would be pleased to respond to questions.

Senator BYRD. Mr. Bellatti.

Mr. BELLATTI. Thank you very much.

I would like to try to clarify one point. There were actually two different bills that went together in 1976 in section 2032(a), a House bill and a Senate bill. There were also committee reports on each of those bills.

The cash rental formula generated from the House bill and the committee report of the House which was adopted as part of the Joint Committee report made it quite clear that in addition to a concern of farms located in metropolitan areas, or some other area where nonfarm uses inflated the value, the House report also indicated a concern where neighboring farmers, through agricultural speculation--mainly we are talking about the scarcity of land. They do not make any more of it. That inflated the value.

The auction paid by farmers would be higher than what a new farmer starting out could afford to pay for that land based on purely its income production.

The Senate bill was the genesis for the five-factor formula and it was quite clear in the Senate report that the primary emphasis was on the metropolitan area farm.

So I think you need to understand that to realize the different goals of the two formulas and why I have made the statement and Senator Percy has made the statement and others have made the statement that the five factor formula, because of its orientation, does not help the average family farm located in rural communities.

It does help the farm located in a metropolitan area possibly, but it is a rather confusing and difficult formula to use even in that context.

In the example given by Mr. Gutman and the Treasury Department, I would like to add one other factor. He indicated that a subdivider may pay $1,500 an acre, a farmer at auction may pay $1,000 an acre. I would like to throw in that the earning capacity of that farm might be somewhere between $500 and $700 an acre.

We are talking about a rough example but the point I want to illustrate is that the farmer who is there at the auction paying $1,000 an acre is not some young squirt starting out in farming. It is somebody who owns 400 or 500 acres, maybe much more, who acquired those acres at a much cheaper cost and can spread the inflated cost of this new ground over his other holdings.

And it is for that reason that the cash rental formula, which would produce, I would tend to agree with the example given, and it is consistent with Senator Percy's example in his appendix, that the value might come out around $500, $600, $700 an acre in that example under the cash rental formula.

What I would submit is that this is a fair way to do it in the context of the legislation because the legislation is set up for the family farm that is going to continue to be held and the purpose of the legislation is to prevent the forced sale of the family farm.

Senator BYRD. As I recollect—and I am taking this from memory; I may be wrong—there is a penalty on the family farm if it is not held a certain number of years, is there not? If it is not farmed for a certain number of years?

Mr. BELLATTI. That is correct. All the saving is recaptured and an additional penalty is on the basis.

Mr. JONES. Fifteen years.

Mr. GUTMAN. You have to hold it for 10 years. It phases out at 20 percent a year after 10 years and there is no interest on the recapture amount, is there?

Senator BYRD. I do not know.

Mr. BELLATTI. That is correct.

Mr. JONES. That is correct.

Mr. GUTMAN. It is not quite putting you back where you were.

Mr. BELLATTI. There is a failure to adjust basis. If you have a recapture tax, you pay taxes if paid on the higher fair market value, but when you go to sell the farm you do not get treated that way for capital gains purposes.

That sort of replaces the interest as a penalty.

Senator BYRD. Let me see if I understand this right.

This benefit or the advantage, if there is an advantage in areas, I guess, the advantage only goes to those who continue to hold and work the farm. If they do not do that for a period of 10 years—actually 15 years—then whatever benefit there is does not exist. Is that right?

Mr. JONES. That is correct.

Mr. BELLATTI. Correct.

Mr. JONES. Mr. Chairman, I am very disappointed in Treasury here because, again, it seems Treasury is attempting to confuse the issue. It was clearly the intent of the Congress that either of these alternatives would be available, either the formula or the five factors

That was clearly the intent of Congress.

These bills address the formulas to overcome a problem with respect to the regulations. Therefore, we are talking about the formula. We are not talking about the five factors.

So Treasury should not confuse that issue.

The second thing is that Mr. Gutman says that it is not working. If it is not working, no one has documentation that it is not working. I begin to see why they come out with that argument, though, if they are making their surveys based on sale prices because, again, this is not the intent of Congress. The intent of Congress was that the land be valued on what it could produce or earn, not what it sold for regardless of who bought it.

That was the reason the formula was set up as it is because it measures what the farm will produce in value for agricultural production. It does not, and should not, be connected with sales values which is what they have evidently run their surveys on.

Senator BYRD. Mr. Gutman.

Mr. GUTMAN. Senator, if I could respond to that. First, we are talking precisely about the formula. Our suggestions go to a change in the denominator of the formula, that is, a change in the calculation of the interest rate that one applies in utilizing the formula which we believe will give values that are much more in line with farm values.

Second, with regard to the speculative aspects of the discounts from fair market value that I have been talking about, those have not been made up, Senator. Those are taken from returns which have been filed, every 2032A return that was filed during the first 14 months of the existence of the statute.

The fair market values to which I am referring are not fair market values that the Internal Revenue Service has assessed. These are fair market values put down on those returns by the executors. The discounted values that I am referring to, the special use values, are the special use values which were calculated by those very same executors. The implication that any of this has been made up, Senator, is just wrong.

Senator BYRD. The interest rate factor assumes a 4-percent interest rate. Why do you get 4 percent?

Mr. GUTMAN. Let me go back to what I think would be the appropriate way to phrase this.

Senator BYRD. No one can get a 4-percent interest rate today.

Mr. GUTMAN. It would be very nice if one could.

Senator BYRD. As a matter of fact, Treasury, if I recall——

Mr. GUTMAN. The only place you can get is——

Senator BYRD. Is 12 percent. Treasury itself charges 12 percent.

Mr. GUTMAN. That is true.

You can actually get it, though, in section 6166, I believe, for a portion of the interest.

What we would propose to do with regard to the denominator of this formula, Senator, is to say that the denominator of the formula would equal the greater of 4 percent or the annual rate of return on equity from farm property. The place where you see what farmers are really willing to accept is by taking a look at what their real income from farm property is. There are statistical data compiled by the Agriculture Department that show farm income by States. The data also show net proprietor equities, how much the farmers in the aggregate in that State have actually invested. So you can calculate the rate of return on farmland from this data.

Senator BYRD. I do not understand the interest rate factor, though. You are talking about a 4-percent interest rate.

Mr. GUTMAN. The point is this. The fact that one can go out and borrow or not borrow at 8 or 9 percent or whatever the Federal Land Bank discount rate is does not have very much to do with what the value of farmland is.

Senator BYRD. You want to use the interest rate but you want to make it 4 percent?

Mr. GUTMAN. Calling it an interest rate, Senator, is another way of describing the capitalization of earnings multiple. You can turn it around the other way and say you multiply income by 25 or 20 or 12½ or some other number, thus the capitalization rate.

The generally accepted way of determining the value of income-producing property is to apply an appropriate capitalization rate to it. The question is, what is appropriate capitalization rate?

Historically if you know farmland is selling for $1,000 an acre and you are applying a capitalization rate, giving you values of $200 an acre, you know something is wrong, and that is happening in some cases under the application of this formula.

What we are trying to do is arrive at an interest rate that would have the formula result in a value comparable to the value that one would get if you would just want to sell the land to another farmer. That is what the exercise is all about.

Senator BYRD. What you are doing, as I see it, then, the 4 percent is really pulled out of a hat to make it whatever you think the figure should be.

Mr. GUTMAN. The 4 percent is not pulled out of a hat.

Senator BYRD. How did you get the 4 percent?

Mr. GUTMAN. I will tell you how we get the 4 percent. If you take a look at the following factors, you can calculate a rate of return on farm production. Now, the way you can do that is looking at net farm income, gathered by the Agriculture Department.

You can get net farm income, subtract from that Government payments, because the Government payments relate to a lot of different things—not necessarily the production of farm income—and you can divide that result, farm income, by proprietor's equities.

You will find, I think, that that division will result in numbers between 3 and 6 percent. And what we are saying is that the denominator of this fraction ought to be the greater of 4 percent, set a floor there, or whatever comes out when you divide net farm income by proprietor's equities.

That is a rational way of determining what rate of return is acceptable to people in various States. That is a historical rate of return. It makes sense.

Senator BYRD. We will get back to that in just a moment.

Senator Dole is here. Senator Dole.

Senator DOLE. I would simply like to put my statement in the record in support of S. 1859 which I am cosponsoring with Senator Percy. I know Senator Byrd is just as busy as any of us, but the Judiciary Committee has a judicial nomination to vote on in a few minutes so I cannot stay. Nevertheless I appreciate very much Senator Byrd scheduling this hearing to take a look at S. 1859. I would like to note to those concerned about this general subject matter, that it was largely through the efforts of Senator Byrd and to some extent through my own efforts, that we were able to repeal the carryover basis rule.

Repeal of carryover basis is another thing Treasury never fully appreciated, although they appreciate it more now than they did.

I do not quarrel with Treasury's motives, but I think S. 1859 will redress another mistake made by the Treasury in their ruling in September of 1979.

It is not necessary to pass legislation to address this problem. It could be handled by administrative action.

Since that has not happened, I hope that we will favorably consider the bill as introduced.

I ask that my statement be made a part of the record.

Senator BYRD. Thank you, Senator Dole. Your statement will be made a part of the record.

[The statement of Hon. Bob Dole follows:]

STATEMENT OF SENATOR BOB DOLE

Mr. Chairman: The Senator from Kansas is gratified that action on the windfall profits tax has been completed, so that we can turn our attention to other vital issues. One issue that is of great concern to a number of States, particularly in the Midwest, is the availability of the special use valuation for estate tax purposes. I am glad that we are now taking up this issue, although it is regrettable that the press of business prevented earlier consideration of S. 1859.

The special use valuation, section 2032A of the Internal Revenue Code, is the subject of the Percy-Dole bill, S. 1859. Senator Bellmon's bill, S. 2201, contains similar provisions. Basically, the point of both bills is to guarantee that crop share rentals may be used in the formula method of determining current use value of qualified farm property. For purposes of estate tax, family farms can then be valued at current use value rather than highest and best use value. Mr. Chairman, the matter of using crop share rentals in the special use valuation of farm real property could have been settled by administrative action. It still could be settled by administrative action, if the Treasury Department would reconsider its proposed regulation of September 10, 1979. This regulation reversed the position Treasury took in its first proposed regulation on this subject, dated July 19, 1978.

To determine current use value of qualified farm property under the formula method, the average annual gross cash rental of comparable land must be determined. In its 1978 regulation, the Treasury said that gross cash rental could be measured by converting crop share rentals into cash rentals. In the 1979 regulation, Treasury disallows use of crop share rentals for this purpose. This Senator would hope that the Treasury would revert to its 1978 position. On January 16 the Internal Revenue Service held a hearing on the 1979 proposed regulation, and this would be a good opportunity for the Treasury to reconsider its position.

Mr. Chairman, the Percy-Dole bill will resolve this situation if administrative action is not taken. The bill provides that if gross cash rental cannot be determined, crop share rental may be substituted. The distinction is important. In many States, including the State of Kansas, it is rare to find farm land leased on a cash basis.

Crop share leases are more common in these States, so that it is discriminatory to exclude such leases for computing special use valuation.

In passing the Revenue Act of 1976 Congress clearly intended special use valuation to be available to farmers. An interpretation that ignores the typical practice in many farm States clearly frustrates the intent of Congress. This Senator would urge the Treasury Department to redraft its proposed regulation to include crop share rentals. I also urge my colleagues to support the legislation before us, which would resolve this dispute once and for all.

Senator BYRD. Mr. Gutman.

Mr. GUTMAN. Senator, you know, in terms of how this formula works out I would expect that every State farm bureau would want to test their numbers against the real farm values in their States.

We know for example, in Oklahoma, where we did do some checking, that the numbers when you apply this new formula, come out to be very close indeed to the sales price of farmland in Oklahoma as farmland.

In any event, I would not want the discussion over what is the appropriate interest rate to obscure the fact that under present law, the values are coming in very, very low.

Indeed, in 1976 when this provision was passed, the revenue loss was estimated to be $14 million a year. Based on the figures we have, over the first 14 months of the application of the statute, the revenue loss would be $140 million a year. There is something going on here that was not anticipated.

In summary, we have no objection to making crop share rentals available in a formula that works right. If the formula is not working right, we do not want it to work wrong for even more people. We would like to get the formula fixed. That is our position.

Senator BYRD. Thank you, Mr. Secretary.

The issue that is before us at the moment is whether to permit crop share rental as if it were cash rental.

I thank the panel.

Mr. Gutman, would you stay where you are?

Mr. GUTMAN. Certainly, Senator. I am not sure I could move.

Senator BYRD. The next piece of legislation, S. 1194, Mr. Alan Jordan on behalf of the Alabama Shrimpers Association.

Prior to your testimony, Mr. Jordan, Mr. Robert L. Leggett, senior partner, Leggett, Lanier & Associates has a statement for the record on behalf of the Shellfish Institute of North America. Without objection, I will insert that into the record at this point.

[The prepared statement of Mr. Leggett follows:]

STATEMENT OF ROBERT L. LEGGETT

Mr. Chairman. Members of the Subcommittee. My name is Robert L. Leggett. I am senior partner in the firm of Leggett, Lanier and Associates, and I appear here this morning in behalf of our client, the Shellfish Institute of North America.

The Institute is the national trade association representing producers, processors and distributors of oysters, clams, crabs, mussels and other shellfish. Chartered in 1908, the Institute is comprised of over 350 participants in the shellfish industry in the United States, a majority of whom are boat owners and operators potentially affected by this legislation.

I should point out, too, Mr. Chairman, that until my retirement last year I was Chairman of the Subcommittee on Fisheries and Wildlife Conservation and the Environment of the Committee on Merchant Marine and Fisheries in the House of Representatives. From my years in that capacity, and now representing the Institute, I believe that I speak with familiarity of and empathy with the owners and

operators of fish harvesting boats who may benefit from enactment of the legislation you are now considering.

Mr. Chairman, it has become abundantly clear in recent years that the very commercial viability of the small fish harvester is being consistently threatened by a conflux of complexities far and beyond his control: from the disputes over the extent of territorial fishing waters, to the growing capital intensity of this industry required to maintain and fuel modern and efficient equipment, to the pollution of our vital coastal waters from which these small businessmen attempt to provide the American public with fish food products that are sanitary, nutritious and, perhaps most important, affordable.

With such conditions facing the same harvester in mind, I believe it is readily understandable that the membership of the Shellfish Institute of North America embraces efforts by the Congress to keep the U.S. fishing industry alive and competitive. S. 1194 is noteworthy in that regard, and the Institute seeks your favorable consideration.

Specifically, the Institute supports and appreciates the basic recognition contained in S. 1194 that the profitable harvesting of shellfish within the current complexities I have just mentioned requires creative approaches to the use and staffing of fishing boats. One such approach is just that set forth in this bill—the concept of members of the boat crew participating in the proceeds of the catch in lieu of acting solely as employees with the necessary administrative requirements, including unemployment taxes.

Moreover, the Institute believes that the provisions of S. 1194 are balanced and imminently fair to both the boat owner/operator and the crew member. This is underscored by the bill's restriction of application to boats using less than 10 crew members, a provision which clearly recognizes and distinguishes the small harvesting operation.

Finally, Mr. Chairman, the Institute wishes to express its deep appreciation to Senator Heflin for his leadership and understanding in recognizing the needs of the small fish harvester and to your Subcommittee for its willingness to consider this important legislation.

Senator BYRD. You may proceed for 5 minutes, Mr. Jordan.

## STATEMENT OF H. ALLEN JORDAN, ON BEHALF OF THE ALABAMA SHRIMPERS ASSOCIATION

Mr. JORDAN. All right, sir. Thank you.

Mr. Chairman and members of the committee, my name is Allen Jordan and I am a certified public accountant and a partner in a large south Alabama CPA firm which represents significant commercal fishing interests. I am also a boatowner myself, having an interest in four recently constructed shrimp trawlers.

S. 1194 offers remedy to a most perplexing and controversial problem for boatowners that has existed since the Tax Reform Act of 1976 changed the employment status for crewmembers of commercial fishing vessels and created an inequity in the shrimping industry.

Under the Tax Reform Act of 1976, criteria were established under which certain crewmen would not be considered employees of the owner or operator of the boat. In effect, the Internal Revenue Service has declared shrimp boat crews to be self-employed provided that: One, the crewman does not receive any cash remuneration; two, the crewman receives a share of the boats' catch of fish or a share of the proceeds from the sale of the catch; three, the amount of the crewman's share depends on the amount of the boats' catch; and four, the operating crew of the boat is normally made up of fewer than 10 individuals.

These criteria were made applicable for purposes of withholding Federal tax and Federal Insurance Contributions Act tax; and consequently exempts the employer—in this case, the boatowner or operator.

The inequity to which I referred lies in the IRS Code regarding the Federal Unemployment Tax Act. This tax is applicable to employers only. Shrimp boatowners and operators find themselves paying unemployment taxes on those who, under another law, are classified as self-employed.

Though these are different taxes, there is no reason for inconsistency in exemptions. If a person is considered self-employed under the criteria of the one, there is no reason why an employer should be required to pay unemployment tax on that self-employed individual.

Exclusion from coverage under FICA should be extended to mean an exclusion from coverage under FUTA. Either a man is self-employed or he is not. It is inconsistent to declare a man self-employed under one act and claim that same man is an employee under another act.

Shrimp boat crewmen are definitely independent of boatowners and can be considered truly self-employed. A crewman has no obligation to a boatowner and is free to perform his services for whomever he desires. In our area, the demand for crewmen is very high. The majority of boatowners operate 12 months of the year, thus eliminating any real unemployment period.

This legislation, S. 1194, would simply amend section 3306(c) of the Internal Revenue Code of 1954—relating to the definition of employment under the Federal Unemployment Tax Act—by using the same criteria to determine self-employment of the crewman for unemployment tax purposes as used to determine self-employment of the crewman under the Tax Reform Act of 1976, namely:

One, the crewman does not receive any cash remuneration;

Two, the crewman receives a share of the boats' catch of fish or a share of the proceeds from the sale of the catch;

Three, the amount of the crewman's share depends on the amount of the boats' catch; and

Four, the operating crew of the boat is normally made up of fewer than 10 individuals.

Mr. Chairman, this legislation would consequently exclude these boatowners and operators from the excessive burden of paying unemployment tax on those crewmen defined as being self-employed under the Tax Reform Act of 1976 and bring some consistency in the enforcement of and compliance with these two laws.

I appreciate very much the opportunity to appear before this committee and express my thoughts with respect to this legislation.

Thank you.

Senator BYRD. Thank you, Mr. Jordan.

What is the Treasury's view on this?

STATEMENT OF HARRY L. GUTMAN—Resumed

Mr. GUTMAN. The Treasury is opposed to this bill, Senator.

If I might just go back a minute to try and explain what is really happening here. In the 1976 act the wages that were paid by boatowners to fishermen under the circumstances described here were exempted from the Federal Insurance Contributions Act and also from income tax withholding.

There is a big difference between FUTA, the Federal Unemployment Tax Act and the Social Security Tax Act and the Income Tax

Act. Under FICA if these individuals were not deemed to be employees, of course, they were deemed to be self-employed. They had to make contributions as self-employed individuals. In any event, they got benefits under the Social Security Act. Taking them out of income tax withholding did not relieve them of the obligation to pay income taxes. They still had to do that.

Taking them out of the FUTA tax base, however, means they would not get unemployment compensation if they become unemployed. The reason is that most States will follow the Federal exclusion and take these wages out of the State wage base. As a result there will be no unemployment coverage for these so-called self-employed individuals under FUTA because most States do not allow self-employed individuals to elect to get unemployment coverage.

The result here is significantly different from the result which occurs under the 1976 act changes. That is, these individuals simply will not get any unemployment coverage at all.

There have been some other problems arising under various State laws that I can get into if you want me, but I do not think they are particularly germane at this point.

The gentleman raised another point with regard to the nature of the employment relationship. Historically these employment relationships have been interpreted as creating employer-employee relationships under maritime law and that has been the standard that has been applied. The exception that came in 1976 was a really limited exception to the standard definition.

Finally, with regard to this particular proposal there is at the moment a National Commission for Unemployment Compensation which is involved in studying issues involving unemployment compensation. The Labor Department tells us this is one of the issues they are going to study. We would at least prefer that action on this bill be deferred until that study is completed.

Senator BYRD. Let me ask you this.

If someone works as a fisherman, say for 3 months, and then that is during the season and then for what period of time can that individual draw unemployment compensation?

Mr. GUTMAN. I am afraid I do not know the answer to that, Senator.

Senator BYRD. All right.

Do you happen to know, Mr. Jordan?

Mr. JORDAN. Senator, as I said in my report, the season is 12 months of the year. The boats can operate 12 months of the year. Therefore, there is no real unemployment period in the shrimping industry.

Granted, the boats have to be down for awhile for equipment repair, et cetera, but this all goes into a part of the crewmembers' skill in performing services for a boatowner. He is free to perform his services for whomever he wishes.

Therefore, there is no "season" or "nonseason." There are peak periods and more productive periods, but the boats can operate 12 months of the year.

Senator BYRD. Suppose an individual does not want to work 12 months of the year. Suppose he only wants to work 3 months a

year? Over what period of time can he draw unemployment compensation?

Mr. JORDAN. He could draw unemployment compensation if he is relieved of his duties or fired under our Alabama law. He could draw for whatever period of time until he was able to seek work again and work was available to him.

Exactly what time frame in months, I could not answer that.

Mr. GUTMAN. I believe that depends on State law. I think generally the period is 26 weeks but I am not entirely sure.

Senator BYRD. I think that is right, yes.

Senator Gravel has five questions that he would like to have answered for the record by both you, Mr. Jordan and by you, Mr. Gutman.

Mr. GUTMAN. I would be happy to. Alaska is the State that has the problem to which I was alluding. I would be happy to answer that for the record.[1]

Senator BYRD. Thank you.

Senator BYRD. Thank you, Mr. Jordan.

Mr. JORDAN. Thank you, Mr. Chairman.

Senator BYRD. The next panel will deal with H.R. 4746.

The panel will consist of Mrs. Nancy McClaskey Glasgow, president, National Association of Foundations; Mr. David E. Hughes, second vice president, Union Mutual Life Insurance Co.; Mr. Robert Cronson, auditor general of Illinois representing the National State Auditors' Association; Mr. Robert D. Bourne, on behalf of the Communications Satellite Corp., accompanied by Mr. Harold J. Heltzer.

The Chair has a problem. I have a special order in the Senate for 11 o'clock which means that I will need to leave within 6 or 7 minutes.

I guess if we have not completed by then, we will need to take a recess and I will come back just as soon as I take care of this special order.

I might say that all of the testimony from the panel will be put into the record as if delivered, the full testimony. You might want to be brief, because I have talked with Treasury and Treasury does not oppose the legislation.

As a matter of fact, Treasury probably approves it, but Treasury can speak for itself in that regard.

In any case, I understand they will not be testifying against the legislation, so you are in pretty good shape.

Why do you not proceed as you wish, bearing in mind the problem that we face here in getting to the Senate?

Mrs. Glasgow.

## STATEMENT OF NANCY McCLASKEY GLASGOW, PRESIDENT, NATIONAL ASSOCIATION OF FOUNDATIONS

Mrs. GLASGOW. A summary of the position of the National Association of Foundations, Inc. on H.R. 4746, pending before the Subcommittee on Taxation and Debt Management of the Select Committee on Finance of the U.S. Senate: One, the National Association of Foundations, Inc. supports simplifying the reporting requirements for private donor foundations.

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[1] See appendix at end of hearing.

Two, the Association wishes to strongly emphasize the fact that private donor foundations are private trusts and, as such, deserve some measure of protection from the glare and pressure of the general public.

Three, it is the intention of the association to cooperate with Government officials wherever possible and to remind them they are dealing in a very sensitive area of private individuals of considerable private means, in most cases operating from their own private homes.

Four, to remind those having jurisdiction over the private donor foundations that that which is private is not public.

Five, the National Association of Foundations, Inc. hereby formally requests the following paragraph from the explanation of H.R. 4746 of the statement of the Joint Committee on Taxation be made a part of the bill:

> In the case of a foundation which has no principal office, or whose principal office is in a personal residence. It is anticipated that the Treasury will, by regulation, allow the annual inspection requirement to be met by having the return available for public inspection at the appropriate substitute location, or by making copies of the return available by mail free of any charge upon request.

Mr. Chairman and distinguished members of the Finance Committee, it is an honor and a pleasure to be permitted to testify before the Subcommittee on Taxation and Debt Management and to present the position of the National Association of Foundations, Inc. on the vital issues raised by the bill, H.R. 4746. The association does not oppose the combining of the annual report and the annual information return of private donor foundations as long as no additional information is required. Our member foundations wish to simplify their paperwork as much as possible but, at the same time, do not wish to tell all to the general public.

As taxpayers in more than one category, they desire to be sure that whatever information is disclosed to the proper Government officials is kept carefully and in strict accordance with the law.

The National Association of Foundations, Inc., is concerned with the words,

> This report must be made available for public inspection at the principal office of the Foundation, section 6104(d) and is open for public inspection at the principal office of the foundation.

This is the clause that worries us. I am sure you know about the Hearst case and what a hard time the Hearst foundation had as a result of the situation. Banks have been robbed for many years, but no one has been successful in getting at the private donor foundations until the recent Hearst case.

In the recent 1970s, I made a visit to the headquarters of the Federal Bureau of Investigation and told them that I was concerned that the radicals of the country might make an attempt to get the private donor foundations and force money from them and this is exactly what happened.

Only a few of the very large private donor foundations maintain any offices. There are only about 125 with assets of over $100 million.

The next group are the many who use the offices and facilities of a bank or law office for the foundation. Many of the middle-sized and smaller foundations are in this group. The rest of the private

donor foundations, which is the bulk of them, work directly from their homes. Under the present conditions, many of the private donor foundations are terminating as they think conditions are no longer favorable for the continued operation of their foundation.

It is my estimate that there are no fewer than 15,000 general private foundations functioning in the United States today. This number will continue to decline as the tax laws and inflation and general living conditions make it harder and harder for them to operate.

The police, who are duly authorized law enforcement officers cannot enter into your home without proper papers, so why should anyone from the American public be given the right to enforce such an unconstitutional rule on the wealthy?

Thank you.

Senator BYRD. Thank you.

The committee at this point will need to take a 20-minute recess. The Chairman will be back just as soon as he can.

[A brief recess was taken.]

Senator BYRD. The committee will come to order. The Chair regrets the delay.

Let me see. Mr. Hughes.

## STATEMENT OF DAVID E. HUGHES, SECOND VICE PRESIDENT, UNION MUTUAL LIFE INSURANCE CO.

Mr. HUGHES. Thank you, Mr. Chairman. I am David Hughes, second vice president of the Union Mutual Life Insurance Co. in Portland, Maine. I am appearing today on behalf of the American Council of Life Insurance and the Health Insurance Association of America.

We appreciate this opportunity to be able to express our support for section 4 of H.R. 4746. This section is the one that relates to withholding of income taxes from, and the reporting of, sick pay benefits made by insurers and other third parties.

But at the same time, we would like to request that the effective date of this section be changed to apply only to payments made after December 31, 1980.

We have some serious practical problems in putting into place the mechanisms needed to implement section 4 within the timeframe currently specified in this bill. In its present form, section 4 of the bill will require the insurers to report to employers all sick pay payments made to employees on or after the first of the month following 120 days after its enactment.

While actual withholding is a voluntary and optional thing on the part of the employees, the reporting requirements apply across the board to all employer-sponsored plans. The result of this is that it requires a system be established for capturing and recording all information and, in its present form, section 4 will require this system be fully operational within 120 days.

This is a virtual impossibility from a practical standpoint, particularly with regard to sick pay plans involving individual insurance policies.

I would like to give you a brief sketch of some of the steps that would be needed, the pragmatic steps in order to comply, to illustrate why this delayed effective date is needed.

The first thing we will have to do as insurers is design and implement a method of identifying which individual disability policies now in force, or to be sold in the future, are in fact parts of an employer-sponsored plan. Currently insurers simply do not have the capability of making this identification.

It is important that the system be designed with great care and the second thing we have to do in this process is to test the system to insure that we do not inadvertently release confidential policyholder information to employers which will be a violation of the beneficiary's right to privacy.

For example, there is a real danger of releasing on an unwarranted basis individual benefit information to employers where the employer in fact is not sponsoring the plan, in direct violation of the policyholder's right of privacy.

Next, we must prepare, produce and disseminate new forms to obtain the needed information and train our benefits examiners across the country in the proper use of these forms.

Once again, these are all very pragmatic nuts and bolts kinds of problems and the essential point is the time needed.

In some cases, these new forms that we will have to design will have to be filed and approved in advance by the 50 State insurance departments, something that in itself may take some time.

Finally, we must develop a computer system for reporting and recording all of this information and other claims information. Even the largest insurers in the Nation right now currently do not have their disability claims systems on a computerized basis.

Again, as presently written, section 4 would require that all of these practical steps be accomplished and in effect within 120 days. Since all of this required information must be accurately reported to appropriate employers within 15 days after the close of the year, it is imperative that sufficient up-front time be provided to assure that once a system is operational it actually works right.

In order to allow companies sufficient time to develop such a system the effective date of section 4 should be changed to apply to only payments made after December 31, 1980.

Again, I would like to stress and reiterate our support for section 4 of this bill and that we urge that the committee favorably report the bill.

However, we would like an amendment extending the effective date of that section and urge that the bill be passed, with such an extension, as quickly as possible.

We appreciate having the opportunity to present our views. I would be happy to attempt to answer any questions the subcommittee may have.

Thank you.

Senator BYRD. I want to ask a question at this point. Which member of the panel is addressing section 2? Is anyone prepared to address section 2?

As one member of the committee, I want a detailed explanation of that before I proceed further with the bill after this hearing.

The next witness will be Mr. Cronson.

## STATEMENT OF ROBERT G. CRONSON, AUDITOR GENERAL, STATE OF ILLINOIS

Mr. CRONSON. Thank you, Mr. Chairman.

I am Robert Cronson, auditor general of the State of Illinois, and I appear today on behalf of the State of Illinois and on behalf of the National State Auditor's Association of which I am president-elect.

Section 6 of H.R. 4746 enables State auditors to audit State revenues by authorizing access to State-maintained Federal tax information where that tax information: Is used by the State to collect State revenues and is necessary to an authorized audit of State revenues or revenue programs.

Please note that this legislation concerns only that Federal tax information which is already under the control of State officials and is not self-enacting. State auditors will still need State legislative approval to carry on the audit activities involved.

States which have a State income tax and cooperate with the Federal Government in the administration and enforcement of tax laws cannot properly audit and review State revenues because Federal tax provisions prohibit disclosure of Federal tax information to any one except State officials who have a direct responsibility for the administration or enforcement of State tax laws.

Senator BYRD. Would you change that aspect of the present law?

Mr. CRONSON. Yes, sir.

Senator BYRD. How would you change it?

Mr. CRONSON. We would add State auditors as persons to whom disclosure of information held by State revenue agencies may be made.

The post-auditors are independent of the administration and enforcement of the tax laws and therefore can never have direct responsibility for the administration and enforcement of them.

Under this bill, all of the protections and restrictions which apply to persons who now have access to Federal tax information would apply to State auditors. State auditors, however, will not maintain tax information nor disclose specific tax information.

They merely need to follow an audit trail through this tax information in order to assure the proper receipt, collection and deposit of State revenues. They do not need the tax information as tax information, but as evidence of the proper receipt, deposit, and control of State revenues.

The Federal Government, as a part of revenue sharing, now requires that all State revenues be audited. This is impossible in those States which use the Federal tape match program with the Internal Revenue Service. If required revenue audits are to be accomplished, H.R. 4746 is essential.

I previously forwarded to you a letter from the Office of Revenue Sharing to the State of Missouri which describes this problem in detail.

This legislation has wide support among the States. In my own case, the Illinois Legislature has adopted a joint resolution of support for this concept, which requests the Congress of the United States to enact such legislation.

I am also specifically authorized to appear in support of this legislation today by the State auditors of Alaska, Georgia, Rhode Island, Texas, Virginia, Wyoming, and Oregon.

This legislation also has the support of a number of associations, including the National Association of State Auditors, Comptrollers, and Treasurers; the National Intergovernmental Audit Forum; the State Auditors' Coordinating Council; the National Conference of State Legislators and the National State Auditors Association.

The Department of the Treasury, the Comptroller General, and the Office of Management and Budget have either endorsed this bill or have stated that they have no objections to it. For further details, I have filed with the committee a discussion paper developed by the National State Auditors' Association.

I believe that this is sound legislation which provides the necessary checks and balances for a responsive program and legislation which is essential to State governments if they are to maintain the proper oversight and accountability necessary for an effective and responsive government.

I appreciate the opportunity to be here this morning, sir, and I would appreciate the committee's favorable consideration.

Senator BYRD. Thank you.

Mr. Bourne.

## STATEMENT OF ROBERT D. BOURNE, ON BEHALF OF THE COMMUNICATIONS SATELLITE CORP., ACCOMPANIED BY HAROLD J. HELTZER

Mr. BOURNE. Thank you, Senator Byrd.

My name is Robert D. Bourne and I am here on behalf of the Communications Satellite Corp. I am pleased to appear before you in connection with your consideration of H.R. 4746. With me is our outside tax counsel, Mr. Harold Heltzer.

Section 7 of H.R. 4746 would amend section 48(a)(5) of the Internal Revenue Code to conform the investment tax credit provisions to a recent amendment of the Communications Satellite Act of 1962. Let me briefly discuss the reasons why we believe this amendment is necessary.

Comsat was created pursuant to the Communications Satellite Act of 1962. By virtue of that act, Comsat was instrumental in establishing the International Telecommunications Satellite Organization (Intelsat) and serves as the designated U.S. participant in Intelsat. Intelsat is an international organization consisting of more than 100 countries that operates the space segment of the global commercial communications satellite system.

During the 95th Congress, the International Maritime Satellite Telecommunications Act was enacted to amend the Communications Satellite Act (Pub. Law 95-564). It designates Comsat as the U.S. participant in a new international organization called the International Maritime Satellite Organization (Inmarsat) which has been established to develop and operate a global maritime satellite telecommunications system. Inmarsat came into existence on July 16, 1979 and is similar in structure and operation to Intelsat. The Inmarsat facilities will serve the maritime commercial and safety needs of the United States and foreign countries.

Comsat's initial investment share in Inmarsat is approximately 23.4 percent.

Under the Internal Revenue Code, property generally is not eligible for an investment tax credit if it is owned or used by an international organization or by any agency or instrumentality of such an organization. However, in 1971, the Senate Finance Committee concluded, and Congress agreed, that to exclude Comsat's interest in Intelsat property from the investment tax credit would tend to frustrate the purpose of the Communications Satellite Act to establish the Intelsat system as expeditiously as possible (S. Rep. No. 92-437, 92nd Cong., 1st Sess., p. 31). To remedy this problem, the Revenue Act of 1971 extended eligibility for the investment tax credit to Comsat's investment in property owned or used by Intelsat.

Section 7 of H.R. 4746 would, in exactly the same manner, extend eligibility for the investment tax credit to Comsat's investment in property owned or used by Inmarsat. It would thereby conform the investment credit provisions of the Internal Revenue Code to the recent amendment of the Communications Satellite Act. We believe that this is appropriate because the goals and purposes in establishing Intelsat and Inmarsat are similar and the position of Comsat in both organizations is similar.

Section 7 of H.R. 4746 would further the Congressional intent to establish a global maritime satellite system on an economically viable basis. In the committee reports accompanying Pub. Law 95-564 it was recognized that there is a limited market projected for maritime satellite telecommunications services in the near and middle-term future, and every effort should be made to effect economies of operation of the maritime satellite system (H. Rep. No. 1134, Part I, p. 10):

The Committee has structured H.R. 11209 in a manner designed to minimize the overhead of the designated entity, so that an economically viable system can be provided to the United States. In view of the limited market projected for maritime satellite telecommunications services in the near and middle term future, every effort must be made to effect economies of operation of the satellite communications system. This committee is of the view that the designation of Comsat as the entity to represent the United States in Inmarsat, will best fulfill the above concerns of the Committee.

For these reasons, we urge that section 7 of H.R. 4746 be enacted to conform the Internal Revenue Code to the latest amendments to the Communications Satellite Act and permit an investment credit in connection with Comsat's investment in property owned or used by Inmarsat.

Thank you very much.

Senator BYRD. Thank you.

This is a multifaceted piece of legislation. It has all sorts of things in it. I think we are going to have to study this bill pretty carefully, which is not to say that I have any opposition to what any of you have said. But until we started getting into this, I did not realize how many different subjects are being covered.

Maybe Treasury wants to address itself to this?

### STATEMENT OF HARRY L. GUTMAN—Resumed

Mr. GUTMAN. Well, Senator, I will be happy to go through it with you, if you like. In the interests of time, perhaps you would just

prefer to have my statement inserted in full in the record. We did go through each section of the bill in detail in our statement.

Senator BYRD. It will be accepted for the record.[1]

In that connection, let me begin to ask some questions, then.

Section 8 deals with rate of interest on retirement bonds. What is that about?

Mr. GUTMAN. I would like Mr. Melton who is with me to answer that one, Senator, if he could.

Mr. MELTON. Mr. Chairman, there are two types of retirement bonds authorized by statute, individual retirement bonds and retirement plan bonds. The restrictions on these bonds are very similar to the restrictions on H.R. 10 or self-employed Keogh-plan-type retirement arrangements.

Under current law, the interest rates on these bonds cannot increase. It stays the same from the time the bond is issued until the time it is redeemed. On the other hand, Series E savings bonds provide for an interest increase as new issues come out. There are a number of reasons for that. The proposals here would allow Treasury, with the approval of the President, to increase the interest rate on individual retirement bonds and retirement plan bonds when new issues come out so that the interest rate on an outstanding bond for the period after a new issue comes out would be the same as the new issue interest rate.

Senator BYRD. If a bond is bought today, just take a rate of 8 percent, and a new issue comes out 2 years from now at 10 percent, then the holder of the 8-percent bond automatically gets 10 percent?

Mr. MELTON. If the Treasury by regulations provides, with the approval of the President, then the bondholder would get 10 percent thereafter—not retroactively, but he would get an effective rate of 10 percent after the new issue comes out.

Senator BYRD. What is the purpose of this?

Mr. MELTON. To encourage investment in these individual retirement bonds. As I said, Series E savings bonds automatically provide for that interest increase. If you have a Series E bond, you can redeem it without penalty if you buy a newly issued bond so under Series E you can get the higher interest rate effect without changes by regulation.

Senator BYRD. What is the rate on Series E now?

Mr. MELTON. I do not know. I would not want to hazard a guess. It is not terribly high.

Senator BYRD. What is the rate on retirement bonds now?

Mr. MELTON. I do not know.

Senator BYRD. Section 1, as I understand it, Mrs. Glasgow, is the purpose of that to reduce or eliminate paperwork requirements?

Mrs. GLASGOW. As I understand it, Senator, that is the purpose, but we are concerned that no further requirement is required that would ask to volunteer more information, because the hearings on the House side and the hearings of the Ways and Means Committee, and the people who introduced the bill, the men who brought it in, Congressman James Jones of Oklahoma introduced the bill. It was sponsored, and he was urged to do this by two men who

[1] See p. 473.

worked for Ralph Nader, who were very extreme in their views and more or less self-appointed to tell the foundations what to do.

So it was of concern to people in the foundation field that this would be too extreme for the foundations, forcing them to disclose more than had been required by the law. So I see some of that has been deleted, but they would have no objection to the current situation as long as no additional information is required.

I spoke to the committee staff on the House side and explained the situation to them and reading the material, I think it would be all right. I do not think they would object to it.

Senator BYRD. You favor section 1 as it is now?

Ms. GLASGOW. All right as is, if they would include the part that I read, the first part of my statement, about people not having to admit strangers to their personal home. That is what we are concerned about at this point, not having to volunteer any more information than is already on the forms that they fill out now.

Senator BYRD. What is Treasury's comment on section 1?

Mr. GUTMAN. We support section 1, Senator Byrd. It eliminates overlapping return requirements and is a good thing.

Senator BYRD. Why should nonexempt foundations be subject to similar disclosure requirements as exempt foundations?

Mr. GUTMAN. I am sorry?

Senator BYRD. Would nonexempt foundations be subject to the same disclosures as exempt foundations?

Mr. GUTMAN. They would be required, if they are non-exempt, wholly charitable trusts, to file the same reports as private foundations.

Senator BYRD. Now, in section 4 here, the sick pay, is withholding of sick pay a good idea?

Mr. GUTMAN. We think it is a very good idea.

Senator BYRD. Who addressed section 4?

Mr. HUGHES. I did.

We have no objection to the substantive provisions of section 4 that provide that an employee may voluntarily choose to have withholding in order to avoid any kind of tax burden that he had not planned for at the end of the year. We have no objection to any of the substantive provisions of section 4 at all.

Senator BYRD. In regard to section 6, as I understand it, State auditing agencies have limited access to Federal return information at the present time.

Mr. CRONSON. No, sir. They have none.

Senator BYRD. None.

Mr. CRONSON. None, and let me point out, Senator, if I may in the State of Illinois, which is an example, we have now had a State income tax for 10 years, and the revenue from that tax measure has never been audited simply because of the present provisions of the Internal Revenue Code.

That is 20 percent of the revenues in our State.

Senator BYRD. Say that again? I did not catch that.

Mr. CRONSON. The revenues from the State income tax in Illinois have never been audited because of the requirements of the Internal Revenue Code, which means that 20 percent of the State's revenues in my State are not being audited.

Senator BYRD. The State returns are not being audited?

Mr. CRONSON. Yes, sir.

Senator BYRD. Is that not under the jurisdiction of the State?

Mr. CRONSON. It is, but the State files contain Federal tax information, and the position of the Bureau is that it prohibits any access to those files at all.

Senator BYRD. What does Treasury think about this?

Mr. GUTMAN. We do not oppose this change, Senator.

Senator BYRD. How widespread would that mean the opening up of tax returns?

Mr. CRONSON. Again, if I may use my own State, I can only give you an approximate figure, but because of the various interchange agreements that are in effect, all of the employees of the Illinois Department of Revenue, the Federal employees that are applicable to that district, the Iowa Department of Revenue, et cetera, all of the States in that general area now have access to each other's tax returns.

We are talking about several hundred people. To open this up to my office we would be adding four people to that number.

Senator BYRD. Suppose some subsequent occupant of the position you hold has 400 people to do the work of those four? I assume it would be opened up at that point to 400 people, would it not?

Mr. CRONSON. No, not at any given time. You only need a restricted number of people to conduct the audit of the revenue side of this question.

What we are really talking about is the ability to pull a selected sample of tax returns and verify that the dollar figure on the bottom of that tax return that should have been paid to the State was, in fact, deposited in the Treasury, and that does not require a large number of people.

Mr. GUTMAN. Senator, if I may interject, there are civil and criminal penalties for violation of the disclosure rules that would be applicable to any person who got access to information under these circumstances.

Mr. CRONSON. That is correct, sir. The present penalties applicable to anyone who has access to these will become applicable to any employees of the State auditors who have access to them.

Senator BYRD. Thank you.

In regard to section 2, treatment of payment or reimbursement by private foundations for expenses of foreign travel or Government officials, what is that all about?

Mr. GUTMAN. Would you like me to explain that one? I would be happy to try to explain that.

Senator BYRD. I would just as soon eliminate that and have that one go on a separate bill and hold a hearing on it.

You might go ahead and explain it.

Mr. GUTMAN. We have no opposition to the bill, Senator, but I do not think we would have any objection to treating it that way either, if you would like to hear more testimony on it.

Senator BYRD. Give me something very briefly. We do not have the time to go into it fully today. Give me a brief summary of what that does.

Mr. GUTMAN. I will try to do it from memory.

Senator BYRD. Why do we not just eliminate that from this bill and it can be handled in a separate piece of legislation. We will hold a separate hearing on it.

Thank you. Thank you very much.

[The prepared statements of the preceding panel follow. Oral testimony continues on p. 444.]

STATEMENT OF THE

AMERICAN COUNCIL OF LIFE INSURANCE
AND
HEALTH INSURANCE ASSOCIATION OF AMERICA

ON

H. R. 4746 - Section 4

SICK PAY INCOME TAX WITHHOLDING AND
REPORTING

PRESENTED BY

DAVID E. HUGHES

BEFORE THE

SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT
OF THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

March 4, 1980

My name is David E. Hughes, Second Vice President, Union Mutual Life Insurance Company. I am appearing today on behalf of the American Council of Life Insurance and the Health Insurance Association of America.

I appreciate this opportunity to express our support for section 4 of H. R. 4746, relating to the withholding of income taxes from, and the reporting of, sick pay payments made by insurers and other third parties, but at the same time to request that the effective date of section 4 be changed to apply to payments made after December 31, 1980.

The Council and the HIAA have over 600 member companies which, in the aggregate, write more than 90% of the commercial health insurance written in the United States. Many of our companies issue contracts to employers under their accident and health plans which provide payments to employees for personal injuries or sickness.

Section 4 of H. R. 4746 would amend section 3402(o) of the Internal Revenue Code to provide for voluntary withholding of income taxes from sick pay payments made to employees under accident and health insurance policies used to fund employer-sponsored wage continuation plans. The approach is similar to the voluntary withholding currently provided for pensions and annuities, including disability pensions. Voluntary withholding will enable an employee to tailor the withholding to his particular tax situation and will allow most insurers to comply with the law without too much difficulty.

Section 4 would also amend section 6051 of the Internal Revenue Code to require third party payors, including insurers, to submit to the employer of each employee who receives a sick pay payment, a yearly report of the sick pay paid to the employee and the amount withheld, if any. The employer would be required to compute the taxable portion of such payment and include this amount, and any amount withheld, on the W-2 statement he gives to the employee and sends to the Internal Revenue Service. We believe this approach represents the most workable and efficient system for getting accurate tax information to employees as regards sick pay benefits. Moreover, it appears to reflect the intent of Congress regarding the manner in which sick pay payments are to be reported, as expressed when the sick pay tax rules were revised in 1964. (H. Rept. 749, 88th Cong., 1st Sess., p. 45 (1963); S. Rept. 830, 88th Cong., 1st Sess., p. 50 (1964))

However, a careful review of section 4 by insurance company operations people have revealed serious problems in putting in place the mechanisms needed to implement that section within the time specified. In its present form, section 4 of the bill will require insurers to report to employers all sick pay payments made to employees on or after the first of the month following 120 days after its enactment. While actual withholding will be voluntary and optional, the reporting requirement will apply across-the-board to all employer-sponsored plans. This requires a system for capturing and recording

all information to be fully operational in 120 days, which is a virtual impossibility -- particularly with regard to sick pay plans involving individual insurance policies.

Individual disability insurance policies may be issued in one of three basic situations:

a) as strictly individual policies with the insured paying the entire premium,

b) as individually purchased policies which are paid for through a multiple billing/salary deduction system for administrative ease (with the policyholder paying the entire premium), or

c) as part of a multiple billing system in which the employer actually pays all or part of the premium. Only these policies, in which the employer contributes to the premium, would be affected by enactment of H.R. 4746.

Thus, insurers must do the following in order to comply:

1. design and implement a method of identifying which individual disability policies now in force or to be sold in the future are part of an employer-sponsored plan (currently, few, if any, insurers have this capability);

2. test this system to assure that confidential policyholder information is not reported to employers in violation of the beneficiaries' rights of privacy (e.g. unwarranted reporting to one's employer of benefits paid under a strictly individual policy);
3. prepare, produce, and disseminate new forms to obtain needed information; train benefits examiners on their use;
4. in some cases, file new forms for approval of state insurance departments before using them (e.g. new insurance application forms asking for employment-related information);
5. develop a computer system for recording and reporting this and other claims information. (Even the largest insurers' individual disability claims operations are strictly manual at the present time, as are many group claims operations.)

Since all required information must be accurately reported to appropriate employers within 15 days after the close of the year, it is imperative that sufficient up-front time be provided to assure that a system is utilized which will work. In order to allow our companies sufficient time to develop such a system, the effective date of section 4 should be changed to apply to payments made after December 31, 1980.

Again, let me reiterate our basic support for section 4 of H.R. 4746 and urge that you favorably report the bill with an extended effective date for that section as quickly as possible.

I appreciate having the opportunity to present our views. I would be happy to attempt to answer any questions the Subcommittee may have.

Hon. Harry F. Byrd, Jr., Chairman
The Subcommittee on Taxation and Debt Management
The Senate Finance Committee

Summary of the position of The National Association of Foundations, Inc. on H.R. 4746 pending before the Subcommittee on Taxation and Debt Management of the Select Committee on Finance of the United States Senate.

1. The National Association of Foundations, Inc. supports simplifying the reporting requirements for Private Donor Foundations.
2. The Association wishes to strongly emphasize the fact Private Donor Foundations are private trusts and as such deserve some measure of protection from the glare and pressure of the general public.
3. It is the intention of the Association to cooperate with government officials wherever possible and to remind them they are dealing in a very sensitive area of private individuals of considerable private means, in most cases, operating from their own private homes.
4. To remind those having jurisdiction over the Private Donor Foundations that which is private is not public.
5. The National Association of Foundations, Inc., hereby formally requests the following paragraph from the explanation of H.R. 4746 of the statement of The Joint Committee on Taxation be made part of the Bill: " In the case of a foundation which has no principal office or whose principal office is in a personal residence, it is anticipated that the Treasury will by regulation allow the annual inspection requirement to be met by having the return available for public inspection at an appropriate substitute location or by making copies of the return available by mail free of any charge upon request."

Mr. Chairman, distinguished Members of the Senate Finance Committee it is an honor and a pleasure to be permitted to testify before the Subcommittee on Taxation and Debt Management and to present the position of The National Association of Foundations, Incorporated, on the vital issues raised by the Bill, H.R. 4746.

The Association does not oppose the combining of the Annual Report and the Annual Information Return of Private Donor Foundations as long as no additional information is required. Our Member Foundations wish to simplify their paper work as much as possible, but at the same time do not wish to tell all the the general public. As taxpayers in more than one category, they desire to be sure whatever information is disclosed to the proper government officials is kept carefully and in strict accordance with the law.

The National Association of Foundations, Inc., is concerned with the words, "This report must be made available for public inspection at the principal office of the foundation (Sec. 6104-d) and is open to public inspection at the principal office of the foundation." This is the clause that worries us. I am sure you know about the Hearst case and what a hard time the Hearst Foundation had as a result of the situation. Banks have been robbed for many years but no one had been successful in getting at the Private Donor Foundations until the recent Hearst case. In the early 1970's I made a visit to the headquarters of the Federal Bureau of Investigation and told them I was concerned that the radicals of the country might make an attempt to get at the Private Donor Foundations and force money from them. This is exactly what happened.

Only a few of the very large Private Donor Foundations maintain any offices. There are only about 125 with assets of over a hundred million dollars.

The next group are the many who use the offices and facilities of a bank or law office for the, foundation. Many of the middle size and smaller foundations are in this group. The rest of the Private Donor Foundations which is the bulk of them, work directly from their home. Under the present conditions many of the Private Donor Foundations are terminating as they think conditions are no longer favorable for the continued operation of their foundation. It is my estimate there are now fewer than fifteen thousand genuine Private Donor Foundations functioning in the United States today. This number will continue to decline as the tax laws and inflation and general living conditions make it harder and harder for them to operate. The Police who are duly authorized law enforcement officers cannot enter your home with out proper legal papers so why should anyone from the American Public be given the right to enforce such a unconstitutional rule on the wealthy? Under the present law anyone from a college professor to a dope addict can write a letter to a Private Donor Foundation and gain entry even to the family home!

The National Association of Foundations, Inc., was listed in the telephone book from 1957 to 1978. It became necessary for us to have our listing removed from the Telephone Directory because of the hate telephone calls we received starting in the early 1970's and continuing until we finnally had our listing removed by the C & P Telephone Company. My former lawyer and his secretary and myself after - considerable thought decided it would be best for all to avoid any further contact with the public. My lawyer, Mr. L. Lawrence De Nicola, is now with the Court in Alexandria. My present lawyer, Hon. Felthan Watson, a former official of the Department of Justice, has been admitted to practice before the Supreme Court of the United States.

Since being removed from the Telephone Book we are no longer harassed by telephone callers. We now know from first hand experience what Private Donor Foundations can be subjected to from the American Public. The Foundation Center will give out no information over the telephone. Therefore the suggestion of permitting the public access to the homes of the wealthy on the excuse of tax exempt status is totaly and completely out of the question! I respectfully urge the Subcommittee to consider the conditions in the nation and the world today and view the recommendations made by the two henchmen of Ralph Nader for what they are a shabby attempt to get the establishment. The National Association of Foundations, Inc., is permitted to present an Amicus Curie Brief to the Supreme Court if the occasion should ever arise.

" I am the good sheperd; the good sheperd lays down his life for the sheep. The hired hand - who is no sheperd nor owner of the sheep- catches sight of the wolf coming and runs away, leaving the sheep to be snatched and scattered by the wolf. That is because he works for pay; he has no concern for the sheep." St. John, Chapter 10.

I was graduated from the Honeywell Foundation, a English Form School, in Bethesda, Maryland in 1950. I have been associated with the Private Donor Foundations ever since. My older sister married the grand-son of the late Senator William Andrews Clarke, of Montana, who founded Consolidated Anaconda Copper. He endowed the Corcoran Gallery of Art building the wing to house his collection spending over twenty million at the time. I was told during the 1960's the Clarke Collection was worth over a hundred million dollars, by the Curator of the Corcoran. Senator Clarke left six Foundations of one hundred thousand each to maintain the art.

I served with my father the late Dr. Charles L. McClaskey, Juris Doctor, when he represented the John A. Hartford Foundation, from 1953-1957, and from 1957 when he founded The National Association of Foundations, Incorporated. The officers of the Association serve without salary.

Respectfully submitted,

Nancy McClaskey Glasgow

Mrs. Nancy Katherine McClaskey Glasgow
President, The National Association of Foundations, Inc.
Blood Princess of the Irish, Countess of Clare, Vis -Countess Melville.

UNITED STATES SENATE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE COMMITTEE ON FINANCE

TESTIMONY OF
ROBERT G. CRONSON
AUDITOR GENERAL OF ILLINOIS

CONCERNING

H.R. 4746 (Section 6 )

March 4, 1980

Thank you for the opportunity to offer testimony in support of H.R. 4746.

I appear today on behalf of the State of Illinois, of which I am the Auditor General, and on behalf of the National State Auditors' Association, of which I am President-elect.

Section 6 of H.R. 4746 enables State Auditors to audit state revenues by authorizing access to state maintained federal tax information where that tax information:

- is used by the state to collect state revenues; and
- is necessary to an authorized audit of state revenues or revenue programs.

Please note that this legislation concerns only that federal tax information which is already under the control of state officials and is not self enacting. State auditors will still need state legislative approval to carry on the audit activities involved.

States which have a state income tax and cooperate with the federal government in the administration and enforcement of tax laws cannot properly audit and review state revenues because federal tax provisions prohibit disclosure of federal tax information to any one except state officials who have a direct responsibility for the "administration or enforcement" of state tax laws.

The post audit functions at the state level rests on the idea that the authority which sets policy and grants the funds must ultimately review the results of the programs and the expenditures to ensure that the activities are in accordance with public mandates. Post auditors are independent of the administration and enforcement of the tax laws and therefore can never have direct responsibility for the administration and enforcement.

Under this bill, all of the protections and restrictions which apply to persons who now have access to federal tax information would apply to State Auditors. State Auditors, however, will not maintain tax information nor disclose specific tax information. They merely need to follow an audit trail through this tax information in order to assure the proper receipt, collection and deposit of state revenues. They do not need the tax information as tax information, but as evidence of the proper receipt, deposit, and control of state revenues.

The federal government, as a part of revenue sharing, now requires that all state revenues be audited. This is impossible in those states which use the federal tape match program with the Internal Revenue Service. If required revenue audits are to be accomplished H.R. 4746 is essential. I previously forwarded to you a letter from the Office of Revenue Sharing to the State of Missouri which describes this problem in detail. ~~(copy attached)~~

This legislation has wide support among the states. In my own case, the Illinois legislature has adopted a Joint Resolution of support for this concept, which requests the Congress of the United States to enact such legislation. A copy is attached.

I am also specifically authorized to appear in support of this legislation today by the State Auditors of Alaska, Georgia, Rhode Island, Texas, Virginia, Wyoming and Oregon.

This legislation also has the support of a number of national associations, including:

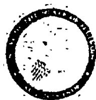
- The National Association of State Auditors, Comptrollers, and Treasurers
- The National Intergovernmental Audit Forum
- The Midwest Intergovernmental Audit Forum
- The State Auditors' Coordinating Council
- The National Conference of State Legislatures
- The National State Auditors' Association

The Department of the Treasury, the Comptroller General, and the Office of Management and Budget have either endorsed this bill or have stated that they have no objections.

For additional detail, I have filed with you a Discussion Paper developed by the National State Auditors' Association.

I believe that this is sound legislation which provides the necessary checks and balances for a responsive program, and legislation which is essential to state governments if they are to maintain the proper oversight and accountability necessary for an effective and responsive government. I would appreciate your favorable consideration.

Attachments



STATE OF ILLINOIS
OFFICE OF THE AUDITOR GENERAL
524 SOUTH SECOND STREET
SPRINGFIELD
62706

ROBERT G. CRONSON
AUDITOR GENERAL

February 1, 1980

Honorable Harry Byrd
Member of Congress
417 Russell Senate Office Building
Washington, D.C. 20510

In Re: H.R. 4746

Dear Senator Byrd:

I enclose a copy of a letter from Kent A. Peterson, Acting Director, Office of Revenue Sharing, Office of the Secretary of the Treasury to Governor Teasdale of Missouri.

Mr. Peterson's letter points out:

1) that Missouri state law prohibits access by the State Auditor of Missouri to the documents necessary to conduct an audit of, among others, the revenues derived from state corporate and personal income tax;

2) that as a result thereof, the audit report relating to Missouri's revenues does not include an audit of state income tax revenues;

3) that as a result of the exclusion of such income tax revenues from the audit report, the audit report is not acceptable under the provisions of the Revenue Sharing Act.

As a necessary result of this determination of the Office of Revenue Sharing, the State of Missouri must eventually become ineligible to participate in revenue sharing.

Mr. Peterson's letter urges Governor Teasdale to take steps to rectify this situation by securing the passage of legislation which would insure the access necessary to permit an audit which will meet the requirements of the Revenue Sharing Act.

In point of fact, both Governor Teasdale and the Missouri Legislature are powerless to implement Mr. Peterson's recommendation, because of the provisions of the Internal Revenue Code.

This identical situation is true in the State of Illinois. In fact, the resolution of this problem was the specific subject of S.B. 803 which passed the Illinois General Assembly in 1977 but was amendatorily vetoed by the Governor of Illinois for reasons expressed in his veto message as follows:

"Senate Bill 803 gives the Auditor General access to confidential documents and was designed in large part to open state income tax returns to inspection in connection with an audit of the Department of Revenue. I agree with the principle that this bill seeks to establish. Independent audits of Department operations not only provide meaningful checks upon ongoing activities, but also promote efficiency in government. It is thus with great reluctance -- and due only to the complexities of federal-state relations -- that I am constrained to exclude the Illinois Income Act from the provisions of this bill.

"The enforcement efforts of the Department of Revenue in the income tax area are heavily dependent upon the 'Agreement on Coordination of Tax Administration'. By virtue of this Agreement, the Internal Revenue Service provides the Department with information on federal audits as well as data for federal-state computer cross-checks to determine whether individuals have filed with both agencies. The information also represents the only method available to the Department to verify adjusted gross income figures listed on the returns.

"It has been estimated that the information secured by the Department on the basis of this Agreement accounts for the collection of $3.5 million in tax revenues that would otherwise go uncollected. Moreover, public awareness of the compliance effort has immeasurable impact on voluntary obedience to our income tax laws. There is no doubt that the Department's ability to maintain the agreement is critical to our tax collection efforts.

"Under federal law, tax information can only be disclosed to state tax officials charged with responsibility for the administration of state tax laws. Neither federal tax returns nor information extracted from them may be disclosed, except in connection with certain judicial or administrative proceedings, without violating the Agreement. Given the federal government's concern for uniformity of treatment between states, the fact that the flow of information under the Agreement is relatively one-sided (from the federal government to the State of Illinois) and the trend at the federal level to curtail, rather than expand, access to tax data, the Agreement cannot be amended to cover the instant situation. Finally, because the federal tax information that we receive is inextricably intertwined with state tax data, the Internal Revenue Service believes that an audit would not be possible without disclosure of the federal information.

59-897 O - 80 - 28

"The Internal Revenue Service has indicated that my approval of this bill in full would result in the recommendation that disclosure of federal tax records to the Department of Revenue be suspended." (emphasis added)

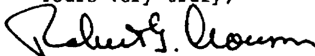
Thus the State of Illinois as well as the State of Missouri as well as a number of other states face the distinct possibility of being excluded from participation in Revenue Sharing because of their failure to provide audits of the revenues from state income taxes. This failure is in turn based on federal statutory proscriptions prohibiting these state auditors from access to the material necessary to perform such audits.

It is this precise reason which prompted the National State Auditors Association to request legislation to amend the applicable provisions of the Internal Revenue Code so as to permit such access by appropriate state audit officials. This legislation is presently before the Senate Finance Committee in Section 6 of H.R. 4746, having passed the House of Representatives in September of 1979.

On behalf of the National State Auditors Association and each of those individual states which administer a state income tax, may I most respectfully urge your careful consideration of this measure at your early convenience.

Please be assured that representatives of our Association would be pleased and grateful for the opportunity to appear before your Committee to provide information and to respond to any questions about this proposal.

Yours very truly,



ROBERT G. CRONSON
Auditor General

Chairman, National State
Auditors Association Committee
on Access to Federal Tax Data

RGC:ew
Enclosure

OFFICE OF THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20226

DIRECTOR
OFFICE OF REVENUE SHARING

JAN 2 2 1980

RECEIVED
JAN 23 1980
STATE AUDITORS OFFICE

( ) RETURN RECEIPT REQUESTED

Dear Governor Teasdale:

I am writing you concerning a matter I feel is important to you, and is of concern to me. As you are undoubtedly aware, the 1976 Amendments to the Revenue Sharing Act considerably enlarged the audit requirements of recipients receiving $25,000 or more in annual entitlement payments.

In our review to determine how each State intends to meet the audit requirements, it came to our attention that the State Auditor of Missouri would file a comprehensive report covering all funds. We have also learned that this report is expected to contain a disclaimer of opinion by the State Auditor because of a scope limitation, i.e., the amount of unaudited revenue disclaimed will be of such a magnitude that an opinion on the financial statements of the State as a whole cannot be rendered. Since the Revenue Sharing Act, as amended, requires that all funds of a recipient be examined, the Office of Revenue Sharing cannot accept scope limitations as meeting the audit requirements of the Act.

We have been informed by the State Auditor that the unaudited revenue appears in the State's report as a result of his office being denied, by State law, access to adequate details and underlying source documents for a majority of the revenue of the State. This revenue consists specifically of State corporate income taxes, State individual income taxes, State sales and use taxes, and the State motor fuel taxes.

I cannot overemphasize the urgency of rectifying this situation. The Act does provide for a waiver of the audit requirements where a recipient is taking steps to obtain an auditable status of all funds. Accordingly, I urge you to give careful consideration to submitting legislation to this session of the State Legislature which would provide the State Auditor with adequate access to tax returns and related documents, and thereby, enable the State of Missouri to comply with the audit requirements of the Revenue Sharing Act.

I understand that the question of whether the State Auditor should be allowed access to motor fuel, special fuel and city sales taxes is presently the subject of litigation. However, the resolution of this matter through court action could take a year or more and the final determination might be adverse. Therefore, it would seem that what is needed is an Act that would unequivocably

remove any barriers that presently exist with regard to the State Auditor's authority to examine any revenue documents.

Mr. Glenn E. Funkhouser, of our Audit Division, will be pleased to provide advice and assistance to you or your staff concerning this matter. I will appreciate being informed of any action you propose in this matter.

Sincerely,

(signed) Kent A. Peterson

Kent A. Peterson
Acting Director
Office of Revenue Sharing

The Honorable
Joseph P. Teasdale, Governor
State of Missouri
State Capitol
Jefferson City, Missouri 65101

cc: James F. Antonio, State Auditor
Norman L. Merrell, President Pro Tem, State Senate
Kenneth J. Rothman, Speaker of the House, Missouri

STATE OF ILLINOIS
EIGHTIETH GENERAL ASSEMBLY
SENATE

Senate Joint Resolution No. 59

Offered by Senators Harber Hall, Vadalabene, Mitchler, Berning and Senator Hynes, President of the Senate; and Senator Shapiro.

WHEREAS, Section 3 of Article VIII of the Constitution of Illinois requires the General Assembly to provide for the audit of the obligation, receipt and use of public funds of the State by the Auditor General; and

WHEREAS, It is essential to the accomplishment of this mandate of the Illinois Constitution that there be conducted independent audits of the revenues received by the Illinois Department of Revenue pursuant to the Illinois Income Tax Act; and

WHEREAS, The United States Internal Revenue Service has indicated that such audits could result in the suspension of the disclosure of federal tax records to the State of Illinois on the basis that confidential information would be released; and

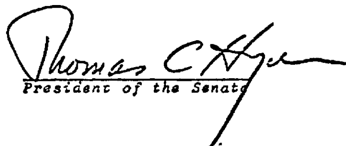
WHEREAS, Illinois and other states are dependent upon federal tax information essential for verification of state income tax records; therefore, be it

RESOLVED, BY THE SENATE OF THE EIGHTIETH GENERAL ASSEMBLY OF THE STATE OF ILLINOIS, THE HOUSE OF REPRESENTATIVES CONCURRING HEREIN, that we strongly urge the Congress of the United States to enact legislation which will ensure that every state agency authorized by a state constitution or state law to conduct post audits of state revenue or state programs shall have access to federal tax returns or information from such returns held or maintained by any

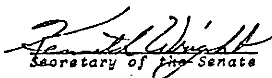
*agency of such state and which are necessary to the conduct of the authorized post audit, and that access to such returns or information by state auditors should be subject to the same restrictions of confidentiality and disclosure as are applicable to the state officials who initially acquire the federal tax returns or information from the federal government; and be it further*

*RESOLVED, That a copy of this resolution be immediately transmitted by the Secretary of State of Illinois to the Secretary of the Senate of the United States, the Clerk of the House of Representatives of the United States, and to each member of the United States Congress from Illinois.*

*Adopted by the Senate, April 19, 1978.*

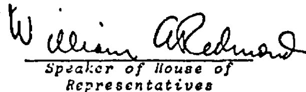


*President of the Senate*



*Secretary of the Senate*

*Concurred in by the House of Representatives, June 29, 1978.*



*Speaker of House of Representatives*

*Clerk of House of Representatives*

FILED
INDEX DIVISION
JUL 11 1978
IN THE OFFICE OF
SECRETARY OF STATE

STATE POST AUDIT OF
STATE INCOME TAX REVENUES
FEDERAL TAX INFORMATION CONSEQUENCES

DISCUSSION PAPER

H.R. 3372 (96th Congress)
Now H.R. 4746, § 6 (96th Congress)

SYNOPSIS

This legislation will enable state post auditors to audit state revenue collections and revenue programs associated with their state income tax. Access is limited to federal tax information maintained by the state tax agency and does not affect information maintained by the Internal Revenue Service. The legislation has the support of (or "no objection by") the Comptroller General, Department of the Treasury, Office of Management and Budget, and numerous state agencies, including state departments of revenue.

WHAT H.R. 3372 DOES

This legislation provides that a state post audit agency may have access to federal return information which is maintained by a state tax agency if (and only if):

- The state audit agency is charged by law with the responsibility of performing post audits of the tax revenues and tax programs of the state.
- The access is necessary for official audit purposes and then only as necessary to the conduct of an authorized audit.

When disclosure is granted, the audit agency and its employees and agents are subject to the same protective restrictions and confidentialities as apply to the state taxing authority and its employees and agents.

HISTORY

This legislation was introduced in the 95th Congress as H.R. 10628. H.R. 3372 is identical to H.R. 10628 except that:

- All changes recommended by the Department of the Treasury have been incorporated (i.e., deletion of section (b) of H.R. 10628).

DISCUSSION

PROBLEM PERSPECTIVE

H.R. 3372 is the logical consequence of enforcement relationships between state income tax programs and the federal income tax programs.

The imposition of a tax is a legislative function. Once a taxing program is established, its administration and enforcement is an executive function and subject to legislative oversight. This oversight process permits those who authorize the tax to stay informed as to how the tax program is working and to assure its accountability. H.R. 3372 is necessary to provide the means for oversight of state revenue programs.

RELATION BETWEEN STATE AND FEDERAL TAX PROGRAMS

The states are just beginning to use the income tax as a major revenue source. The federal income tax is a well established revenue program, and has had a major influence on the development of state tax programs. State income tax programs are being patterned after, tied to, and coordinated with the existing federal program. This approach is both sensible and mutually beneficial for:

- It eliminates duplication.
- It simplifies the citizen's participation and enables him to utilize the same accounting system, record keeping system, etc. for both taxing systems.
- It makes enforcement of both systems easier through the exchange of comparable information.

This cooperative enforcement program necessitates the joint use of state and federal tax records. At the state level, the federal tax information given to and maintained by the state is used to establish and verify state tax liability and the collection of state taxes.

NEED FOR LEGISLATIVE OVERSIGHT

Without legislative oversight, the legislature cannot review tax levels, revenue collections, or existing tax programs.

At the federal level, tax oversight is covered by the Joint Tax Committee and the General Accounting Office, both of which have access to federal tax information. Both also acquire access to state tax records through the Internal Revenue Service under exchange agreements with the states.

At the state level, tax oversight is carried out through the post audit program. However, state auditors are denied access to state tax records because of the possible disclosure of state-acquired federal tax information.

NATURE OF STATE POST AUDIT PROGRAM

The state post audit function rests on the concept that the authority which sets basic state policy and grants the funds must ultimately review the results and the expenditures to ensure that they are in accordance with public mandates. For this reason, post audit programs are being established, by law or Constitution, under the auspices of the legislative branch. They consist of a state official (sometimes elected, sometimes appointed) who is given the responsibility and duty to review all expenditures, receipts, and uses of public funds and report the results of those reviews to the legislature.

These offices are being created with great independence and are being staffed by qualified professionals. They are not designed as enforcement arms, but as evaluators to compile information on "the workings of state government" to the end that improvement can be effectuated and to ensure the quality of state fiscal operations. Extensive checks are built into the audit programs to assure their objectivity and propriety.

INTERNAL REVENUE SERVICE POSITION

The Internal Revenue Service has taken the position that if states allow their independent post auditor to have access to the state's income tax records, there is a significant chance those auditors will obtain or come in contact with federal return information. The Internal Revenue Service has concluded that such access is prohibited by the present provisions of the Internal Revenue Code. The Internal Revenue Service has also concluded that if a state auditor were to have access to state tax records which in-

cluded federal information, such access would require cancellation of the exchange agreement between the state and the Internal Revenue Service.

The Internal Revenue Service bases its position on the fact that only agencies or persons which have a direct responsibility in the enforcement or administration of tax laws may have access to federal return information. The state post auditor can never fit this criteria. The state post auditor in order to perform independent examinations and reviews must not have any responsibility for the administration, management, enforcement, creation, etc. of tax laws.

Generally, cancellation of a federal-state agreement would cost the state involved millions of dollars since the state would have to establish significantly larger audit and enforcement staffs to do the audit and enforcement work represented by the federal information which it now acquires. Cancellation would also directly increase on the burdens placed on taxpayers since they would have to provide considerably more original information rather than allowing the state to rely on existing federal tax information.

PROTECTIONS ON CONFIDENTIALITY

The access provided under H.R. 3372 will not compromise any existing confidentality requirements and does not violate the federal Privacy Act. The increase in the number of persons who would have possible access to state controlled federal return information would be minimal in comparison to the number of persons who now have access to that same information. In addition, auditors do not collect or maintain this information but merely review it (on a sampling basis and only as necessary) as part of an audit trail. The need for disclosure is random. It is but one of a number of intermediate steps, none of which are concerned with the information as tax information, but only as revenue information related to state financial procedures.

For that small amoutn of information which may be seen during any audit, state auditors would be held to the same standards and penalties as employees of the tax agency which received the information in the first instance.

CONCLUSION

Without H.R. 3372, states will not have auditability or accountability over their state revenues and will have a difficult, if not impossible, time maintaining adequate control over their taxing activities. Legislative oversight of the states' taxing programs will be impossible and thus state legislatures will not be able to adequately respond to public needs in the taxing area.

This legislation merely enables the states to carry on the same kind of fiscal controls and legislative oversight that the federal government now does with the federal tax program.

It is worth nothing that the federal government has now ruled that as a condition to receiving federal revenue-sharing funds, a state must conduct accurate audits of all of its revenues. This mandate includes revenues derived through a state's income tax program. Without H.R. 3372, a state will not be able to fulfill that mandate.

SUPPORT OF H.R. 3372

The policies and principles embodied in H.R. 3372 are supported (or given a "no objection" position) by:

- The Department of the Treasury
- The Comptroller General of the United States
- The Office of Management and Budget
- The National Association of State Auditors, Comptrollers and Treasurers
- The National Intergovernmental Audit Forum
- The Midwest Intergovernmental Audit Forum
- The State Auditors' Coordinating Council
- The National Conference of State Legislatures

INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA—UAW

DOUGLAS A. FRASER, PRESIDENT    EMIL MAZEY, SECRETARY-TREASURER

VICE PRESIDENTS

PAT GREATHOUSE • KEN BANNON • ROBERT WHITE • IRVING BLUESTONE • ODESSA KOMER • MARC STEPP • MARTIN GERBER

IN REPLY REFER TO
1757 N STREET, N. W.
WASHINGTON, D. C. 20036
TELEPHONE (202) 828-8500

February 29, 1980

Hon. Harry F. Byrd, Jr.
Chairman, Subcommittee on Taxation and
Debt Management Generally
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Enclosed is testimony which the International Union, UAW is submitting on H.R. 4746 which, we understand, is among several bills now under Subcommittee consideration. I am submitting this in writing rather than having requested the opportunity to testify in person after talking to the staff on the non-controversial nature of the provision in which we are interested. Also, while the provision about which we are concerned involves no revenue costs, it is quite important to hundreds of thousands of our members and will greatly simplify compliance with the existing provisions of the Internal Revenue Code. We would appreciate it if you would share our statement with the other members of the Subcommittee and the full Finance Committee.

Thank you very much for your courtesy.

Sincerely,

Howard G. Paster
Legislative Director

HGP:cd
opeiu-494

STATEMENT OF HOWARD G. PASTER, LEGISLATIVE DIRECTOR
INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE,
AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW)

H. R. 4746

DEDUCTION RELIEF FOR TAX OVERPAYMENT CAUSED BY
RETROACTIVE RECEIPT OF TRADE READJUSTMENT ALLOWANCE BENEFITS

Submitted to the Subcommittee on Taxation
of the Committee on Finance
United States Senate

February 29, 1980

On behalf of the International Union, United Automobile, Aerospace & Agricultural Implement Workers of America, (UAW) I appreciate the opportunity to submit this statement in support of Section 5 of H.R. 4746. Section 5 of H.R. 4746 is aimed at solving the practical problems that arise under present law when workers seek, in effect, to get back the taxes they have paid on taxable unemployment benefits that they are required to repay when they receive nontaxable unemployment benefits under the Trade Act of 1974. The UAW had extensive experience with this problem as a result of the recession of 1974-1975, and we can assure this Committee that the problems under present law are substantial. We believe that the House-passed provision represents a simple and sensible solution that will improve the administration of the tax laws. It makes relief more readily available by providing a simple deduction from gross income to replace the rather cumbersome deduction-or-credit rules of present Code section 1341. Since relief is already available under present law, <u>this bill involves no loss of revenue at all</u>. Recent sharp increases in unemployment related to rising imports make the need for this legislation more immediate and more dramatic.

In order that you may understand how this bill would improve the administration of the tax laws, let me explain the problem in somewhat greater detail. In recent years thousands of auto workers who received regular taxable benefits from their supplemental unemployment benefit ("SUB") plans were also eligible for trade readjustment allowance ("TRA") benefits under the Trade Act of 1974, 19 U.S.C. §§ 2291-2292, because foreign competition contributed importantly to their unemployment. In many cases these TRA benefits were paid after the workers had already received and paid taxes on their SUB plan benefits. Under their SUB plans these workers were entitled to SUB benefits only to the extent they did not get state or federal unemployment benefits, including TRA benefits. Therefore, the late receipt of TRA benefits triggered an obligation to repay SUB plan benefits on which these workers had already paid taxes.

Under present law when income is received under a claim of right and repaid in a subsequent year, relief is available under Code section 1341 in the subsequent year in the form of a credit or a deduction. Procedures for claiming this relief, however, have provem cumbersome and difficult to communicate. In 1976 it took the IRS six single-spaced pages to explain to us how section 1341 would apply to UAW members. We tried to pass this information along to our members in language that could be understood by someone other than a tax lawyer, and it took us five single-spaced pages to put it into English. Many of our members found present law so confusing that they simply did not bother to claim the relief

to which they were entitled. Moreover, an itemized deduction in a subsequent year (the only relief presently available when the amount repaid is not more than $3,000) is frequently of no tax benefit to taxpayers, such as many auto workers, who have relatively limited itemized deductions.

Section 5 of H.R. 4746 provides a simple deduction from gross income which would be available in SUB plan repayment cases presently covered by section 1341. Any worker who has paid taxes in one year on SUB plan benefits and who must repay part or all of those benefits in a subsequent year because of the receipt of retroactive TRA benefits will be allowed a deduction from gross income under section 62 equal to the amount of previously taxed SUB benefits that are repaid. The deduction would be claimed as an "above the line" item in the year(s) and the amount(s) of the repayment(s). (If repayment of SUB benefits is made in the year of receipt, the worker would continue to be entitled, as at present, to exclude the repaid amount from gross income.)

Thank you.

HGP:cd

opeiu-494

Senator BYRD. S. 464 will be discussed by a panel consisting of Ms. Diana McLaughlin, Displaced Homemakers Network, and Ms. Millie Jones, director, Women in Transition Project.

Each will have 5 minutes. You may proceed, and welcome.

## STATEMENT OF DIANA H. McLAUGHLIN, VICE PRESIDENT, DISPLACED HOMEMAKERS NETWORK, INC.

Ms. MCLAUGHLIN. Senator, ladies and gentlemen. As vice president of the Displaced Homemakers Network, Inc., I would like to address you today in support of Senate bill 464, Senator Inouye's amendment to the Internal Revenue Code of 1954, which would provide employee tax credits to employers of displaced homemakers.

Senator BYRD. Excuse me. I forgot something on that last piece of legislation.

I got a communication from Howard E. Pester, legislative director, UAW, and I ask unanimous consent that it be inserted at the end of the testimony on the last piece of legislation.

Ms. MCLAUGHLIN. The Displaced Homemakers Network, Inc., was established in October 1978 to provide technical assistance, advocacy, communications services, legislative reference, and data collection for displaced homemakers themselves and displaced homemaker service providers. The network represents close to 400 employment programs for displaced homemakers in the United States.

The network was established as a result of a 3-year effort begun by Tish Sommers and Laurie Shields to create services across the United States for persons who had been homemakers for a substantial number of years and who, upon the death of a spouse or dissolution of their marriages, had to make a quick transition into the paid work force.

Sommers and Shields, displaced homemakers themselves, initiated legislation first in California and then, through grassroots organizing, dramatized the need for funding for services throughout the United States. Working with Congresswoman Yvonne Burke and Senator Birch Bayh, they were successful in establishing an amendment to the reauthorization of CETA to provide training funds for CETA-eligible displaced homemakers.

This legislation resulted in $5 million which the Department of Labor is currently disbursing to programs throughout the United States.

As you know, $5 million is a very small sum to prepare the Nation's more than 4 million displaced homemakers to the job market. Displaced homemakers face age and sex discrimination in their efforts to return to paid employment. They have skills which are not credentialed and are often rusty or out of date. Often they lack the assertiveness and self-esteem which convince employers to hire them. Also, they desperately need jobs.

In a national survey of displaced homemaker programs conducted in 1979, the network found that 75 percent of the displaced homemakers served in these programs had annual incomes of less than $5,000 even though more than one-half of them were supporting dependent children.

Senator Inouye's bill would provide an incentive for employers to hire displaced homemakers. The job development efforts of the hundreds of programs across the United States would be greatly assisted by this bill. In the many communities where such services do not presently exist, regular CETA manpower programs, which identify displaced homemakers as a significant segment for services, could utilize this tax incentive to interest employers in hiring displaced homemakers. Vocational education programs supported through Federal moneys could also utilize S. 464 in their job development and job placement work.

The provision of tax credits for employers who train displaced homemakers is an especially important aspect of this amendment. Homemakers frequently have skills acquired at home or in their volunteer work but have little recent paid work experience. The network has found on-the-job training to prove or "credential" the former homemaker's skills which otherwise go unrecognized by employers. To provide a tax incentive for training displaced homemakers on-the-job would increase these opportunities considerably.

As a former displaced homemaker myself, I can attest to the difficulties which face displaced homemakers as they seek to find jobs. As a staff member of a displaced homemaker program whose role it is to seek training, I know that my job would be much easier could I inform a prospective employer that he/she could look forward to a tax incentive upon hiring a displaced homemaker or training her.

As vice president of an organization representing displaced homemakers nationally, I urge you to respond favorably to Mr. Inouye's proposed legislation. I would be happy to answer any questions you might have and to further indicate the wealth of support this bill receives from my constituency.

Thank you for this opportunity to bring the expertise and experience of the network to your deliberations.

Senator, we support this bill because it has a lot of incentive. Displaced homemakers do not want to be on public assistance, they want to be paying taxpayers and they would like nothing more than to be self-sufficent.

Senator BYRD. Thank you.

Ms. Jones.

## STATEMENT OF MILDRED JONES, DIRECTOR, WOMEN IN TRANSITION PROJECT

Ms. JONES. Mr. Chairman, members of the subcommittee, thank you for the opportunity to express my support for Senate bill 464 which would include displaced homemakers among the currently targeted groups for whom employers can receive tax credits.

It is probably unnecessary to detail for you how displaced homemakers have fallen through the cracks. When a woman loses her job as a homemaker, she is not eligible for unemployment insurance. Unless she has children under age 18 or is disabled, the divorced, separated or widowed woman is ineligible for welfare. Unless disabled, the widow must be 60 years of age to be eligible for social security payments. Neither alimony nor child support are dependable sources of income.

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According to a 1975 study, only 14 percent of divorced women are awarded alimony and less than half collect it regularly; 44 percent of divorced mothers are awarded child support and less than half receive it regularly. In short, the displaced homemaker is too young for social security and frequently seen as too old for entry into the job market. In order to become economically independent, displaced homemakers desperately need jobs.

The displaced homemaker who has not been in the labor force for some years, if ever, faces not only age and sex discrimination, but also the scarcity of jobs in a competitive market in which she cannot claim recent paid work experience. The problems are made even more difficult because many employers are not aware of the assets displaced homemakers bring to the workplace: The skills they have developed through homemaking, childrearing, and volunteer work; the maturity and dependability tested through years of unpaid service to family members. Many are deemed unemployable simply by virtue of never having been previously employed.

As a former job development specialist at the Center for Displaced Homemakers in Baltimore and now director of one of six new programs in the State of Maryland, I am convinced that a tax credit for employers of displaced homemakers would open up new jobs for them in the private employment sector. At the model program in Baltimore, we had some State funding which provided stipends for displaced homemakers while they received training as interns.

I would like to relate an experience of a displaced homemaker in such a paid training situation. This woman had expressed interest in gaining more knowledge and developing additional job-related skills in the area of graphic arts. With the incentive of having the woman's stipend paid through the program's training funds, I was able to convince the owner of a small graphic arts business to accept her in a 3-month internship. Her performance was such that she was hired before the internship ended, thereby providing her both with a full-time job and the money she needed to enroll in graphic arts classes at night at a nearby community college.

In another case, a displaced homemaker was receiving clerical training through an internship in the office of a small insurance company when a full-time employee left the company, creating a vacancy. The intern was immediately hired to fill this position.

In addition, because of a positive experience with this woman, the employer has sought other displaced homemakers as interns and as employees. Paid internships have given me as a job developer something concrete to offer the potential employer; a tax credit allowed the private employer, especially the small business owner, would similarly open doors.

Permit me to share one final experience, which began with a telephone contact for a displaced homemaker interested in interior decorating. Leaving no stone unturned, I contacted a wallpaper and plumbing supply store. An unlikely place for interior decorating, right? Wrong—the employer was willing to accept a displaced homemaker intern.

Later he contacted us with detailed plans to expand on a large scale to include consultants to work with housing developers planning and coordinating colors, especially in bathroom fixtures. On

the basis of his experience with this intern, he concluded displaced homemakers would be the best candidates for the jobs, and hired several on a full-time basis.

The possibilities for job development in the private sector are unlimited. I know what can be done—I have done it. With a little imagination, and an incentive like the tax credit to offer as the initial motivator, job developers can convince employers to take a chance on that middle-aged widow who has no prior paid work experience, to take a chance on the 50-year-old homemaker who has been out of the work force 20 years and whose husband has just left her, to take a chance on the woman who has struggled alone to raise her children on AFDC.

I firmly believe, and my personal experiences more than convince me, that a tax credit incentive would prove invaluable in creating and expanding a wider job market for the displaced homemaker. It is an investment that she will more than repay as an economically independent, self-supporting taxpayer.

Thank you very much.

Senator BYRD. Thank you.

Before calling on Treasury, I want to say for the record, in addition to Ms. McLaughlin and Ms. Jones, that the following are available for questions by the committee: Ms. Louise Archer, Women's Equity Action League; Ms. Georgiana Missler, YWCA; Ms. Thelma Rutherford, National Association of Social Workers; Ms. Lorayne Baldus, American Home Economics Association; and Ms. Judy Schub, National Federation of Business and Professional Women's Clubs.

[The prepared statements of Senator Daniel K. Inouye, Louise Archer, Thelma Rutherford, Lt. Gov. Jean King, Diana McLaughlin, Julia Arri, Kinsey Green, and Leona Chanin follow:]

STATEMENT BY SENATOR DANIEL K. INOUYE

Mr. Chairman: I am pleased to testify on behalf of my bill, S. 464, to assist displaced homemakers. This legislation would add the displaced homemaker to the current list of those who are benefiting from the Targeted Jobs Credit Program of the 1978 Revenue Act (P.L. 95-600). The Targeted Jobs Credit was created to encourage employers to hire employees from seven specifically enumerated groups: vocational rehabilitation referrals, economically disadvantaged youth, economically disadvantaged Vietnam-era veterans, SSI recipients, general assistance recipients, youths participating in a cooperative education program, and economically disadvantaged ex-convicts. It is my belief that the displaced homemaker is also a disadvantaged group that deserves special attention under this program.

"Displaced homemaker" is a relatively new term for those women who spent most of their lives as housewives or dependent upon the income of another, and who must reenter the job market due to a loss of that financial support. Many of these women are widowed or divorced mothers who must financially support their children for the first time in their lives. Many do not have marketable job skills or employment histories. Many are poor and destitute.

The Comprehensive Employment and Training Act (CETA) defines a displaced homemaker as one who:

(1) Has not worked in the labor force for a substantial number of years but has, during those years, worked in the home providing unpaid services for family members; and

(2)(i) Has been dependent on public assistance or on the income of another family member but is no longer supported by that income; or

(ii) Is receiving public assistance on account of dependent children in the home; especially where such assistance will soon be terminated; and

(3) Is unemployed or under employed and is experiencing difficulty in obtaining or upgrading employment.

The American homemaker is the very foundation upon which our economy has been built. These women have devoted a large part of their lives to care of their children and husband, only to be displaced later because of the death of their spouses or divorce or separation. Due to the lack of job experience and training, and her age, the displaced homemaker is at a definite disadvantage in attempting to reenter the labor market.

Encouraging private employers to hire displaced homemakers by virtue of a tax credit would be the needed first step in providing these women a starting point back into our working society. The bill provides for a tax credit of $3,000 for the first year of employment, $1,500 for the second.

Senators Baucus, Bayh, Matsunaga, Melcher and Zorinsky have joined me in cosponsoring this bill. I respectifully request that prompt and favorable attention be given to this measure by your Subcommittee.

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TESTIMONY ON INCLUSION OF DISPLACED HOMEMAKERS IN THE CATEGORY OF TARGETED GROUPS FOR WHOM THE NEW EMPLOYEE CREDIT IS AVAILABLE, AMENDING THE INTERNAL REVENUE CODE OF 1954

Good morning. I am Louise R. Archer, a displaced homemaker and presently a legislative assistant for the Women's Equity Action League. WEAL is a nationwide women's rights organization founded in 1968 and dedicated to improving the social, economic and legal status of women.

I am appearing before you today in support of S464, a proposal to include displaced homemakers in the category of targeted groups for whom the new employee credit is available. You are familiar with the startling statistics. Others have outlined the problems in general. Therefore, I would like to take this opportunity to relate to you a brief summary of my own experiences as a displaced homemaker. My recent successes and frustrations clearly demonstrate the need for the tax incentive provided in the proposed legislation before this subcommittee today.

After working as a fulltime homemaker for twenty-three years, I became a widow. Three years ago, I was suddenly faced with the problems of raising a teenage son, paying mortgage and utility bills, and assuming the sole responsibility of maintaining at least a minimal standard of living for my family. I suddenly faced the exercise of all the management and decision-making activities associated with maintaining a household. There was no longer a partner to share this burden or provide financial support. I found that I was economically dependent upon a system that hadn't kept up with the times.

Military Annuity—I receive a modest stipend as a widow under the Retired Serviceman's Family Protection Plan. This amount is fixed, with no cost-of-living adjustments.

Social Security—I receive social security because I support a child under the age of 18. These payments, while extremely important to us, have never kept up with inflation. In 20 months from now, he will turn eighteen and this support will stop. Both of us will need to become financially self-sufficient. He is youthful and energetic. In spite of my new-found self-confidence, I am frightened.

When my grief subsided, I assessed our economic condition and it became clear to me that I would have to find full time employment and soon. Little did I know then that for a mid-life woman, out of the active work force for over twenty years, this was easier said than done.

Studying the classified advertisements, I found typing jobs in abundance, so I took evening typing courses at our local high school. I took Civil Service exams and filled out Federal employment forms . . . never easy, but even more difficult when one has to put a marketable value on 24 years of homemaking service. After visits to several personnel offices, my frustration grew. I found little interest on the part of any employer in a person as old as I was and who had been too long out of the paid labor force. My job credentials were shaky, to say the least.

In 1978, Displaced Homemaker Centers were getting a lot of media coverage, and these reports indicated that these centers offered the kind of assistance that I so desperately needed. I went to New Alternatives, a women's career counseling center in Maryland. The center is financed by a combination of state and federal funds. I was soon attending workshops on skill identification, self-assessment, résumé writing and job-search methodologies. Over a period of six months, I gradually developed a sharply increased sense of self-confidence. I even began to prepare to act as a peer counselor for women new to the center's programs. All of the women in these counseling sessions have one objective in mind—to find a productive and meaningful job—and they all experience the same sense of frustration in attempting to reenter the paid labor force. This legislation is essential to their productivity.

I prepared for re-entry through a paid administrative intership program sponsored by the Ford Foundation at WEAL Fund, the sister organization to the Women's Equity Action League. I worked full time at jobs with duties ranging from clerical and receptionist to administrative management and special projects. At the end of this five-months internship, old work skills had been resharpened and new work skills had been learned. I joined the ranks of those seeking full-time employment. Now, finally, I feel that I am in a position to make productive use of my college education and the skills that I gained so long ago as an officer in the United States Navy.

In spite of the two years of sustained effort on my part, and on the part of the forementioned women's organizations, job offers are not readily forthcoming. Private industry is disinclined to hire a mid-life women reentering the work force, even with the retrained skills such as mine. The federal government is also less than enthusiastic about hiring me at a level equal to my education and skills. I cannot turn back and I do not want to remain dependent on the government for a subsistence level existence. I have pride in myself and my talents. I want to translate that into a job. S. 464, with a minimum of government expenditure, can provide the bridge for women like me who need help with the first step onto the job ladder.

At a time in our nation's economic development, when concern for declining American productivity is a major concern, a bill that provides a tax incentive to private industry to place displaced homemakers in meaningful, productive jobs is an excellent idea and a sound economic measure. Helping dependent citizens to become productive wage earners can only speak well for us as a nation. Involving the private sector is essential. Thank you for your consideration of and support for this vital legislation.

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NATIONAL ASSOCIATION OF SOCIAL WORKERS, INC.,
*Washington, D.C., March 4, 1980.*

On behalf of the 80,000 members belonging to the largest professional association of social workers in the world, the National Association of Social Workers would like to emphasize the need for S. 464 as introduced by Senator Inouye. Presently being considered by the Senate Finance Committee's Subcommittee on Taxation and Debt Management, this legislation would expand the list of groups eligible for tax credits under section 51(d) to include displaced homemakers entering the job market. NASW feels strongly that displaced homemakers have the ability to add a unique contribution to the work force if given increased opportunities for employment and necessary training. Granting employers tax incentives would enhance the opportunities for successful transition from homemaker to employee for this most important population.

By definition, displaced homemakers are individuals who, because of family responsibilities, have never been in or have been absent from the labor force for a number of years. This occurs as a result of the death or disability of their spouse, separation, or divorce. These women often receive insufficient coverage or no coverage at all from their spouse's pension. In addition, these primarily middleage women face barriers to job training, employment counseling and supportive services as they enter the labor force.

Two-thirds of NASW's members are women—many having had the experience of entering the labor force at a late age themselves. Many social workers forced to return to work after years in the home have found it difficult to re-enter the job market due to the economic situation and subsequent reduction in available opportunities. Other NASW members have been involved in programs providing counseling and assistance to displaced homemakers.

The transition from homemaking to paid employment is not for self satisfaction or to earn pin money supplementing another income. Displaced homemakers are in desperate need of jobs to support themselves and their dependents. A look at a few facts outlines the financial needs and inadequacies of available support:

Widows must have been married 10 consecutive years in order to receive social security.

Only 14 percent of divorced women are granted alimony by the court, less than half receive it on a regular basis.

Only 44 percent of divorced women with children are granted child support, and less than half receive it regularly.

Most life insurance policy benefits are used up within two years of widowhood.

If a divorced, separated, or widowed woman has no children under age 18 and is not disabled, she in ineligible for welfare until she exhausts nearly all her remaining assets.

Women experiencing a radical loss of income in their later years in life discover a world of employment which treats them as a marginal labor force. Homemakers who have not been in the labor force for some years, if ever, face not only sex and age discrimination, but the general scarcity of jobs in a competitive market where they can not claim recent work experience. Many who do break the barriers of age and sex discrimination are still likely to be employed in menial or low-level occupations providing only minimal income.

Employers are reluctant to hire displaced homemakers on the basis of their age and lack of paid work experience. The potential contributions homemakers can offer to a job situation are overlooked too often. Studies have proven chronological age and inexperience in wage earning to be poor indicators of job productivity. Women re-entering or coming into the workforce for the first time were found to be outstanding employees with work records showing lower turnover, higher productivity and less absenteeism. The years of experience in the home and volunteering in the community have given these women a well rounded background of diverse skills and interests.

NASW strongly recommends careful consideration of this bill making displaced homemakers a category of targeted tax income groups encouraging private sector employers to train and hire these women with a broad range of skills and assets not adequately recognized. Passage of S. 464 would begin to reduce the "risk" and stigma attached to utilizing displaced homemakers in the labor force.

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## Testimony by Jean King, Lieutenant Governor, State of Hawaii

Senator Byrd and members of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance:

I would like to urge you to pass S. 464 which would expand the list of groups eligible for the jobs credit under Section 51(d) of the Internal Revenue Code to include "displaced homemakers" who are entering or reentering the job market.

When Senator Daniel Inouye of Hawaii wrote to me about federal legislation giving tax credits to certain disadvantaged groups, I encouraged him to include "displaced homemakers" in this legislation.

A "displaced homemaker", is generally an individual who has worked without pay as a homemaker for family members for a substantial numbers of years, is not gainfully employed, has had or would have difficulty finding employment, and who has either depended on the income of a family member and has lost that income, or has depended on government assistance as the parent of dependent children but is no longer eligible for that assistance.

These women are eager to work but often find it extremely difficult to obtain employment, sometimes because of prejudice based on their age or their sex. Economic incentive is often the quickest and most painless way to discourage prejudice.

Women who spend a number of years managing a home often develop managerial and organizational skills which tend to go unrecognized by society. As a result of their years of devotion to home and family they are often among the most conscientious and responsible segment of society. When these women move out of their homes and into the labor market they take these skills and characteristics with them.

There are a number of advantages in encouraging employers to hire displaced homemakers:

(1) The employers themselves will benefit because they will have responsible, conscientious, eager, and efficient employees.

(2) The displaced homemakers will benefit because they will be able to support themselves and and their families.

(3) Society will benefit because these women, who often would have no choice but to go on welfare, will instead be useful, productive members of society.

I strongly urge you to pass this bill. Thank you very much.

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## Additional Testimony of Displaced Homemakers Network

(Submitted to the Subcommittee on Taxation and Debt Management, Hon. Harry F. Byrd, Jr., Chairman, by Diana McLaughlin Vice President)

Dear Senator Byrd, Thank you for the opportunity to testify before your subcommittee on March 4 on behalf of S. 464, Senator Daniel Inouye's tax credit bill for employers of displaced homemakers.

During the hearing S. 464, we appreciated your soliciting the opinion of representatives of the Treasury Department on the bill's impact and revenue effect. Regarding their comments on the retroactive nature and estimated cost of this legislation, we want to submit the following clarifying remarks:

(1) The Displaced Homemakers Network supports S. 464 solely for its incentive nature, i.e., the jobs that would be opened to displaced homemakers if employers received a tax credit for hiring them. No doubt this was Senator Inouye's intent when the legislation was first introduced in February, 1979. Now that a full year has passed since its introduction, a mistaken appearance of "windfall" and "retroactive" could be attached to the effective date (following December 31, 1978). This objection could easily be answered by adjusting the proposed effective date to December 31, 1979, or to some other current date that will enhance the incentive nature of the bill, and will eliminate any possible retroactive use by employers. We heartily endorse such a change by the subcommittee.

(2) At the hearing, a Treasury Department spokesperson quoted an estimated $389 million as the revenue effect of this bill in fiscal year 1981. It has since come to our attention that this estimate, by the Joint Committee on Taxation, was based on incorrect figures: included in the calculations were the estimated total number of displaced homemakers, rather than the number of CETA-eligible displaced homemakers, as required by this legislation. The number of CETA-eligible displaced homemakers is 68 percent of the total displaced homemaker population. The estimated revenue effect is therefore similarly decreased to $246 million, not $389 million, as stated at the hearing.

We would further like to point out to you, Senator Byrd, and to the members of your subcommittee, that such revenue estimates contain no offsetting factors. In this case, the estimated loss of tax revenues from the employer was not offset by the income taxes paid by the now employed displaced homemaker. For every year's tax credit of $3,000 earned by an employer, about $500 is paid in income taxes by a displaced homemaker with one dependent working at mimimum wage; $1,300, if working at $5 per hour. Finally, if the displaced homemaker cannot become economically independent by becoming an employed taxpayer, ultimately she will be or become dependent on government assistance. Over and over, we hear from displaced homemakers, who say, "I don't want to be on welfare—I just need a little boost so I can help myself." With the help of job development fostered by S. 464, displaced homemakers can be a revenue asset rather than a liability.

For the record, Senator Byrd, we request that this clarification become a part of our previously submitted testimony. If we can provide you or your committee with any additional information, we would welcome the opportunity to do so.

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THE NATIONAL FEDERATION OF BUSINESS AND PROFESSIONAL WOMEN'S CLUBS, INC., OF THE UNITED STATES OF AMERICA,
*Washington, D.C., March 3, 1980.*

Hon. HARRY F. BYRD, Jr.,
*Chairman, Subcommittee on Taxation and Debt Management,*
*Senate Committee on Finance, Washington, D.C.*

DEAR SENATOR BYRD: The National Federation of Business and Professional Women's Clubs, Inc., which represents over 160,000 working women nationwide, supports efforts to assist displaced homemakers in gaining meaningful employment. There is an increasing number of women, who, because of death of a spouse or divorce, are displaced in mid-life from their traditional family roles. Many of these women have no financial security or source of income. These displaced homemakers are frequently unable to enter or reenter the labor force because of age or sex discrimination. In addition, they are handicapped when seeking employment because they have little or no recent paid work experience.

We endorse S. 464 which would amend the Internal Revenue Code to give a tax credit to employers who hire displaced homemakers. This measure provides a necessary incentive for employers to hire displaced homemakers. The bill would add displaced homemakers to the list of groups already targeted for this type of assistance. In the long run, we think this a sound investment, because the displaced homemakers who are able to secure employment become financially independent taxpayers who are no longer dependent on public income transfer programs.

The National Federation has a history of support for measures to assist displaced homemakers. In 1978-79, a plank was added to our National Platform to "promote the development of programs and services to aid displaced homemakers." This plank was carried over to the 1979-80 National Platform. Individual Business and

Professional Women's Clubs across the country have also been active in local and state efforts to aid displaced homemakers. Clubs have supported state legislation, provided volunteer services to displaced homemaker programs and assisted in the development of proposals to get displaced homemaker programs established in their area. The BPW Foundation administers the Kelly Second Career Scholarship Program which aids displaced homemakers. The Foundation also provided office space and support services to the Displaced Homemakers Network during its first year of operation.

We urge your favorable consideration of S. 464.

Sincerely,

JULIA K. ARRI, *National President.*

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*February 27, 1980.*

Hon. HARRY F. BYRD,
*Washington, D.C.*

DEAR SENATOR BYRD: On behalf of the 50,000 members of the American Home Economics Association. I urge you to support S. 464, an amendment to the Internal Revenue Code which would allow employers a tax credit for each displaced homemaker they hired.

Our members have worked for displaced homemaker legislation for five years and we believe that S. 464 is a cost-effective means to stimulate jobs in the private sector for these middle-aged homemakers deprived of emotional and financial security after years of contributions to their families and communities.

We urge your support and thank you for allowing our member, Lorayne Baldus, the opportunity to testify before your committee today,

Sincerely,

KINSEY B. GREEN,
*Executive Director.*

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AMERICAN JEWISH CONGRESS,
*New York, N.Y., February 26, 1980.*

Senator HARRY F. BYRD, JR.,
*Chairman, Subcommittee on Taxation and Debt Management,*
*Senate Finance Committee, Washington, D.C.*

DEAR SENATOR BYRD: A major priority of the American Jewish Congress during the past several years has been advocating for expanded services and opportunities for displaced homemakers. Our efforts have consisted of preparing educational materials conveying the nature and extent of displaced homemakers' problems, and implementing conferences on this issue both at the national level, and, through our regional American Jewish Congress affiliates, at local levels. We continue to work independently as well as in coalition with other groups to bring this issue to the public's attention.

We are in support of S. 464, which would amend the Internal Revenue Code of 1954 to add displaced homemakers to the groups who would benefit from a provision allowing tax credits to employers who hire members of those groups. This proposal is in harmony with the spirit and intent of our position that our government must develop increased employment opportunities to enable displaced homemakers to become economically independent.

Sincerely,

LEONA F. CHANIN,
*Cochair, Governing Council.*

Senator BYRD. Would Treasury comment on this proposal, Mr. Gutman?

Mr. GUTMAN. Certainly.

STATEMENT OF HARRY L. GUTMAN—Resumed

Mr. GUTMAN. As you know, Senator, the targeted jobs credit was enacted as an experimental program. It has a 3-year lifespan, assuming the technical corrections bill passes.

During the time the targeted jobs credit was debated in the Congress, there was a substantial amount of debate over who ought

to be the targeted groups. The result of that debate, which I think probably reflected some good pulling and tugging on the part of the Congress was the designation of seven specific targeted groups.

Since the enactment of the targeted jobs credit, there have been other groups, as well as this group, whose representatives have argued that those groups ought to be one of the targeted groups. And many of these claims, I think on any objective basis, have a considerable amount of merit.

However, we would prefer to wait and try to assess the utility of the targeted jobs credit concept itself in a cost-benefit analysis which Treasury will be doing.

Senator BYRD. When does it expire?

Mr. GUTMAN. It expires at the end of 1981, assuming the technical corrections bill passes. It presently applies to payments made prior to December 31, 1980 and I believe there is a 1-year further provision in the technical corrections bill. But the point is this. We would like to see whether in fact this is a cost-effective way of providing employment incentives to the targeted groups prior to the time that we expand the groups.

The only other point I would like to make with regard to this bill is to point out the bill is retroactive as drafted. It would apply with respect to amounts paid or incurred after December 31, 1978, in taxable years ending after that day.

The purpose, of course, of the targeted jobs credit is to provide an incentive for people to hire disadvantaged groups or targeted groups. It is a little difficult to understand why the bill should be retroactive if the benefit did not exist at the time that the disadvantage individual was hired an employer could not been said to have been relying on it in doing the hiring. So it looks a little bit like a windfall. Even if the bill does go further, we would hope that the retroactive aspects of it would be eliminated.

Senator BYRD. What do you estimate the cost of this bill to be?

Mr. GUTMAN. I have to take it from the hearing pamphlet, Senator; $350 million in fiscal 1980, $359 million in fiscal 1981, $256 million in 1982 and declining balances thereafter.

Senator BYRD. Should I assume that the figures you just mentioned for 1980 and 1981 are not in the President's budget, or are they in the President's budget?

Mr. GUTMAN. They are not in the President's budget.

Senator BYRD. Thank you.

Ms. MCLAUGHLIN. Senator, may I say something?

Senator BYRD. Surely.

Ms. MCLAUGHLIN. I feel that the displaced homemakers have waited long enough for help. They are a targeted group and they are a group that we are most interested in, as I am sure you are, too. But they have waited a long time for help. The time is now.

It is not to wait for more years to come. We would not object to the retroactive; that would not bother us, but we feel we need help now.

Senator BYRD. Thank you.

Ms. MCLAUGHLIN. Thank you.

Senator BYRD. Thank you.

The committee has one more bill, S. 2157.

A 5-minute time limitation for Mr. Doug Kline, vice president, Community Association Institute.

We will discuss this and that will end the hearing.

I might say prior to Mr. Dowden's speaking, with regard to S. 4746, instead of taking section 2 out of that bill I think the thing to do is call another hearing specifically for section 2. Call a hearing on the bill, but specifically for section 2.

Mr. GUTMAN. Senator, I am prepared to address that, if you would like.

Senator BYRD. All right. Thank you.

## STATEMENT OF C. JAMES DOWDEN, COMMUNITY ASSOCIATIONS INSTITUTE

Mr. DOWDEN. Thank you, Senator.

It is my pleasure to appear before the committee today representing Frank Francois our president who, unavoidably at the last moment, was not able to be with us. I do have his prepared testimony to submit for the record and in the interests of time and your schedule I would just like to briefly highlight some of the key points.

Senator BYRD. The statement will be included in the record.

Mr. DOWDEN. First, Community Associations Institute is a national nonprofit membership organization of condominium associations and those professionals involved in creating and operating condominums and there is more background information in our prepared testimony.

Senator, we favor the passage of S. 2167 and support the companion legislation on the House side as well. I speak today on behalf of and with the unanimous approval of our national board of trustees.

Our problem with the existing provisions of the code is that the effort in 1976 was to correct an inequity as a result of a series of IRS rulings that directed that condominium associations and homeowner associations were to be taxable as corporations.

This committee's report at the time of the passage of the Tax Reform Act of 1976 indicated that it was desirable to encourage condominium and homeowner associations to set aside funds for the repair and maintenance of their common facilities and that it was desirable to tax those organizations in the same manner that one would tax individual owners.

The effect, however, of that legislation in the few years that we have had to study it has been to impose a penalty tax on the savings that are set aside for that maintenance function and that repair function.

Our survey and the survey of others, such as the Institute of Real Estate Management, indicate that many associations of owners across the country are simply not setting aside such funds for future repair and replacement of major common facilities.

Such facilities include roadways, outdoor lighting booths, and building structures.

Those associations which are setting aside funds are endeavoring to do so through rather sophisticated techniques to avoid the tax at the higher tax rate called for under section 528. Those sophisticated techniques require rather substantial professional advice and

consultation not always available to many of these associations and frankly we are concerned.

Section 528 endeavors to put community associations on an equal footing with other owners in exempting from taxation these reserve funds but taxes, interest, income, and other income not derived from the maintenance assessment, at the higher 46-percent rate. We think that is unfair.

Unfortunately, we find that the impact is that those associations are not saving funds for their repair function. We would encourage the committee to again establish that associations of owners should be treated as it relates to their assessment incone as single owners are treated and on the unrelated income not related to the function of maintenance and repair that they be treated as taxable corporations are treated, at the graduated corporate tax rates.

I have had a brief opportunity in the back of the room to review the Treasury's position on the larger question and I would like to offer two or three quick comments.

There appears to be a concern by the Department that that tax exemption or lower tax on unrelated income would create, in effect, a tax haven where owners who would otherwise have disposable assets could contribute those assets to the corporation and thus avoid the tax, or have those assets taxed at a much lower rate. It just does not happen that way!

Section 528 imposes an income and expenditure test on the association in order to be eligible for that section and that income test and the expenditure test assures us that this approach cannot be used as a tax haven for higher income individuals.

Further, the Treasury's position is that there is no reason to facilitate or encourage community associations to save funds. We could not disagree more.

Condominium associations must have the funds set aside to repair the roof the day the roof goes, or repair the boiler or fix the roads, replace major facilities that are integral to the existence of that housing. It was Congress position in the passage of section 528 that we should encourage that savings as a matter of public policy.

There seems to be a concern that higher income individuals will be able to slide out from under the tax obligation on their investment by having this lower tax rate option for the associations. The average condominium today, according to the National Association of Realtors, is selling at $35,000. That means the individual purchaser is at an income level of approximately $17,000.

That is not a rich person. That is not a person at a tax rate over 46 percent.

Mr. Chairman, we appreciate the opportunity to appear before you. I have with me Doug Kline, the director of CAI's Program and Research Department. We are prepared to answer any questions you may have.

Senator BYRD. Thank you.

You say the average condominium is $35,000?

Mr. DOWDEN. According to the most recent survey I have seen, the average condominium sold last year, sold at a cost of $35,000.

Senator BYRD. The average house would be twice that?

Mr. DOWDEN. The average single family house according to the survey sold at about $15,000 higher.

Senator BYRD. What is Treasury's position on this?

STATEMENT OF HARRY L. GUTMAN—Resumed

Mr. GUTMAN. Senator, Treasury is opposed to this bill.

Let me go back a minute and focus on something which the gentleman has pointed out that is absolutely correct. The perfect rule here would be to have conduit, or flow-through treatment, from the homeowners association to the individuals. What we are trying to do is substitute the individual tax treatment at a different entity.

In other words, we do not want to subject individuals to greater expenses because they own condominiums and there is a condominium association which is involved with common management. Neither, on the other hand, do we want individuals who would incur expenses as individual homeowners, to be able to get a tax break, by joining a condominium association.

So the issue that is posed is, short of going to a strict conduit, which would be like a partnership and difficult to administer, how do you come up with the right rate at which to tax investment income?

We do not believe that the present limitations in the statute are sufficient to guarantee that if the tax rate were very low at the condominium association level, people would not be encouraged to put portfolio investments in there.

If I am in a 50-percent tax rate and I know it is going to cost me $100 for example to do a particular repair as an individual and that repair is not deductible, I know I have to earn $200 in order to make the repair. On the other hand, if I can put money into a condominium association where it would be taxed at 17 percent, the lowest corporate rate, I am essentially saving the difference between the 17-percent rate and the 50-percent rate when the expense is paid by the condominium association.

That gives the association, vis-a-vis the individual homeowner, somewhat of an advantage. I think this is a line-drawing problem. Plainly, to the extent that the participants in a condominium association are taxed at a marginal rate below 46 percent, the 46-percent rate is too high. To the extent they are taxed above 46 percent, why then the rate goes the other way.

I think it is a difficult question. On balance, we believe that there is some room in the statute to be able to accumulate portfolio investments and allowing a lower rate of tax would encourage this.

It is not something we think should be encouraged or is demanded by the equities we are considering here. We believe the 46-percent rate is appropriate.

Senator BYRD. What do you mean by portfolio investment rate? As a layman, I do not consider this a portfolio investment.

Mr. GUTMAN. I understand, Senator. The statute just says, in order to be a homeowners association, among other things, 60 percent of the income has to consist of amounts received by membership fees or assessments and 90 percent of the expenditures has to be for the purpose of the organization.

There is a lot of room to play in there; 40 percent of the income could come from investment assets, if one puts aside money. I make a contribution to a condominium association, I know I am

not going to be able to get that money out until I sell my condominium, but under the terms of my condominium association, I might be able to get the accrued reserve amount back or my purchaser can buy that accrued reserve from me. In any event, that money can sit and it can earn interest at the 17-percent tax rate under the lowest corporate rate, whereas if I am in the 50-percent bracket it is going to be taxed to me at 50 percent.

Senator BYRD. I thought that purpose was to use those funds for repairs and what has to be done in regard to keeping up the condominium.

Mr. GUTMAN. That is right, but if I am an individual, own a house, and am in a 50-percent tax bracket for every dollar repair that I make, I have to earn $2. There is no reason to favor a condominium association over individual homeowners.

If I am the same individual and a member of a condominium association and I put aside some income earning assets and they are only taxed at 17 percent, I have not had to pay the same amount for that repair. That is where the inequity is.

Senator BYRD. When condominium associations were taxed on earned income at the highest corporate rate, as I recollect the corporate tax was not, then, graduated. Was it?

Mr. GUTMAN. That is true.

One could, if one wanted, simply say the only reason the highest corporate tax rate is applied here is just as a matter of historical consistency. But we think there are other reasons why it is appropriate to apply the higher rate rather than the graduated corporate rate.

Senator BYRD. I would think you could look at S. 2167 as merely bringing condominium association taxation in line with the changes in corporate tax.

Mr. GUTMAN. You could do that, Senator, except the purpose of the change in 1978 to the graduated corporate income tax rate was to encourage capital formation in the hands of small business. I do not see that that rationale applies in a situation of accruing funds for maintenance expenses of personal residences.

Mr. DOWDEN. Senator, I wonder if I could just comment. I think there are a couple of problems with Treasury's position and the most serious is a lack of understanding of how condominiums are required to function by both statute and by the legal documents.

The condominium association assessment process is mandatory on every owner. There is an annual decision made by the association board and by the owners themselves on how much they are going to assess themselves and how much of that amount is going to be set aside for future repair and replacement.

In 1974, through a series of Internal Revenue Service rulings the Department held, in effect, the maintenance of the exterior of the unit was enhancing the profit of the individual owner when he sold a unit and therefore these corporations should be taxed, in effect, at the normal corporate rate.

That is why we wound up with legislative corrective actions in 1976.

There is no provision and absolutely no way under any provision of any State statute, that an owner can get their reserve funds

back. None. The only provision that would permit this would be if they dissolve the corporation.

If, on the sale of the unit, the individual determines that his total investment in the unit is $x$ dollars, then he can endeavor in the marketplace to recover $x$ dollars of that investment and make whatever profit he can out of the sale, but there is no provision for the refund of that reserve money once it is entered into the association's accounting process.

We are very concerned, frankly, about the problem that is going to occur when condominiums have to face major repairs. Condominiums are only 18 years old in this country. There were not any before 1962 and we are now coming up to that day in time when roofs are going to have to be repaired, driveways are going to have to be repaired, and this is a penalty tax which has no relationship at all to the income of the owners within those communities. The logic just does not hold true.

Senator BYRD. As I understand it also, a condominium owner does not have the same leeway in making changes on the condominium that a homeowner would have making changes on his or her home.

Mr. DOWDEN. He can make no changes to the exterior of his unit at all.

Senator BYRD. Make no major changes inside without the approval of the association?

Mr. DOWDEN. Depending on the nature of the change, that is frequently true.

Mr. GUTMAN. Senator, may I point out one thing? The graduated corporate tax rate starts at 17 percent on the first $25,000 of taxable income. The income tax rates start at 14 percent and the marginal rate becomes 18 percent once one reaches $3,800 of taxable income.

If one applies the graduated corporate tax rate to condominium associations, it is plain that there is under taxation with regard to the people who are members of the condominium association.

Senator BYRD. The way it is now there is also overtaxation.

Mr. GUTMAN. There may well be. I pointed that out. I concede that.

Senator BYRD. It works both ways.

Mr. GUTMAN. It may work both ways.

My point is, Senator, if one moves to the graduated corporate rate here, there is certainly an inducement to require assessments. In fact, anybody would be silly if he did not want, in essence, to overassess himself for amounts that he knew that he was going to have to pay because the tax rate would be lower on the funds that are accumulated to do that.

Senator BYRD. I do not see that a condominium owner puts the money into this fund. He does not get it back.

Mr. GUTMAN. It is the same thing if you own a house. Is anyone suggesting, for example, that we are worried about an individual homeowner's inability to be able to repair his home in 18 years and therefore, we ought to give him a tax break? Why is the condominium industry any different?

Mr. DOWDEN. The difference is that there are 100 owners living in my building and they had to collectively make a decision to

repair the roof. When it is my house I could walk away from the building with no loss to me at all, and it is between me and the mortgagee.

We have to make a collective decision in a corporate-like fashion in order to protect those owners in that building who, at some point in the future, will be especially assessed on a one-time basis and have to come up with substantial funds on short notice to repair that building or that roof.

It is just not the same type of housing.

Frankly, from our point of view, we have always maintained at CAI that we believe the error was made in determining they were taxable in the first instance based on their consideration of maintenance and repair. Given the determination that they are taxable, at the very least, that repair and maintenance function should be taxed at the normal corporate rate and not penalized.

Senator BYRD. Yes. It does seem that a condominium owner has many disadvantages that a homeowner does not have.

Mr. GUTMAN. The question is whether we reward him with a tax advantage. I do not understand why the tax system should be used in this way, to essentially reward him.

Obviously, the right answer would be to tax him on his accrued amounts at his individual rate. Short of that, we have to come up with some sort of compromise. Perhaps the 46 percent rate is too high. Also, it is perfectly clear the 17-percent rate is too low.

Senator BYRD. Is there any further comment?

If not, that will be taken under advisement.

[The prepared statement of Mr. Francois follows:]

TESTIMONY OF FRANCIS B. FRANCOIS, PRESIDENT, COMMUNITY ASSOCIATIONS INSTITUTE

A BILL To amend the Internal Revenue Code of 1954 to provide that the taxable income of a homeowners association shall be subject to the same graduated rates of tax as a corporation.

Mr. Chairman and members of the committee, my name is Francis B. Francois and I am the President of the Community Associations Institute. I also am a member of the Prince Georges (MD) County Council and President of the National Association of Counties. I have with me today James Dowden, who is the Executive Vice President of the Community Associations Institute and heads our staff.

CAI is a nonprofit research and educational membership organization created to help those individuals and professionals involved in creating and operating condominium and homeowner association developments. CAI was incorporated in the fall of 1973 and was staffed in September, 1974. The Institute has over 3,000 active members, today, representing every aspect of the process of creating and operating condominium developments including homeowner associations, builders and developers, property managers, professional colleagues and public officials. Our membership spreads to every section of the country with condominium activity and we currently have some twenty local chapters operating in major metropolitan areas.

CAI was created specifically to provide a neutral service organization to meet the information and technical assistance needs of increasing numbers of practitioners and owner leaders in the growing condominium and planned unit development field. Our corporate structure is such that no one segment of the industry or the consuming public dominates our decision-making or policymaking process. We are not advocates for any one interest group involved in condominiums or planned unit developments but rather are advocates for the successful process for creating and operating condominiums and homeowner associations in cluster developments.

CAI's ongoing program today is largely devoted to periodic newsletters on events of interest in the field, handbooks, special reports, other materials to guide practitioners through this process and an extensive program of workshops and national conferences to better educate those individuals involved in this process. From time to time, the Institute is involved in more direct research and contract-related

activities that are intended to expand the state of the art in the condominium field. Last year, for instance, the Institute completed two research projects financed by the Department of Housing and Urban Development—one project was designed to demonstrate the feasibility of utilizing the condominium approach to provide ownership housing for lower income families, and the second project produced a manual on community associations for local officials. However, more than 90% of the total financial support of the Institute is derived from member fees and charges.

I am speaking today at the direction and on behalf of the Executive Committee of the Board of Trustees of CAI.

*Growth of condominium and homeowner associations.*—The number of condominium and homeowner associations had doubled since 1975. It is estimated that there are now in excess of 40,000 housing projects across the country involving the shared use or ownership of land and facilities. Each such project has an association of homeowners responsible for maintenance and repair of shared facilities and grounds.

*What is a community association.*—The homeowner association in a condominium or planned unit development, referred to as a Community Association, is a nonprofit entity under state law and is organized to maintain such shared facilities as open space, streets, street lights, hallways, etc. and such services as landscape and exterior maintenance, trash collection, etc. The typical Association budget is $75–125,000 per year of which an average of $10,000–12,000 is set aside for future replacement or repair of capital items. These reserves are required by some states and are also necessary for FHA insured condominiums as well as condominiums and homeowner associations eligible for FNMA and FHLMC mortgage purchase programs.

*Review of Federal tax situation of community associations.*—The Tax Reform Act of 1976 added Section 528 of the Internal Revenue Code to allow condominium and homeowners associations to establish reserves for future major repairs and replacement without the adverse tax treatment that would have resulted under earlier IRS Revenue Rulings. Most associations can also elect to be treated as taxable corporations. A few associations are tax exempt under Section 501(c)(4) of the Code.

*Purpose of section 528.*—The enactment of Section 528 was intended to recognize and deal with the unique problems of condominium and homeowners associations and their volunteer boards of directors.

Section 528 has been beneficial to those associations electing to use its provisions which protect the long-term capital reserves. We are confident that when IRS publishes final regulations, several other minor problems will be resolved. Yet most associations do not use Section 528.

*Problem with section 528.*—The single most important problem with the provisions of Section 528 is that associations electing to come under the Section are taxed at a 46 percent rate on miscellaneous income. Miscellaneous income consists of many minor items such as revenue from the poolside vending machine, income from the coin laundry vendor or a charge for the use of the party room. But the largest component of the miscellaneous income is interest earned by associations on the long-term capital repair and replacement funds. Interest from these reserve accounts, which Congress encouraged associations to establish and maintain by enacting Section 528, is taxed under Section 528 at present at the highest corporate rate of 46 percent. As a result, only 20 to 25 percent of all associations file under Section 528.

### OPTIONS PRESENTLY AVAILABLE TO ASSOCIATIONS: CORPORATE FILING

A number of sophisticated tax theories are being used by some condominiums and homeowners associations today. The two most prevalent are the trust fund theory and the capital contributions theory. Many tax experts believe that both theories, if correctly applied, can provide a means for an association to set aside reserve funds without adverse tax consequences. The association could then file as a corporation or trust and subject net income to the graduated corporate rates. For most associations, the tax rate would be 17 percent as opposed to the 46 percent rate under Section 528. Figure 1 demonstrates the difference. Filing as a corporation has certain other advantages, such as the ability to use operating losses to offset interest income or the use of investment tax credits and the use of loss carryforwards, all of which are denied to the association if it files under Section 528.

For most volunteer-run associations, however, these complicated and sophisticated methods cannot be used without expensive professional tax counsel, and even then associations face some risk of reversal upon audit.

### OPTIONS AVAILABLE TO ASSOCIATIONS—USE OF TAX EXEMPT INVESTMENTS

Many associations using Section 528 invest their long-term reserve funds in tax exempt municipal bonds. Bonds paying around 6 percent provide an effective income nearly equal to the interest rate on long-term certificates of Deposit issued a few months ago. (Comparison today is difficult since many local governments are avoiding issuances until there is a better investment climate.) Figure 2 illustrates the difference to the association and to the U.S. Treasury of this practice.

### EFFECT OF ENACTMENT OF S. 2167

We believe that enactment of S. 2167 will have a positive effect on associations and their reserve funds. Many Associations currently filing as corporations will elect to use Section 528. Figure 3 illustrates the difference. Using Section 528 is simpler and less risky, and any minor advantage to filing as a corporation is offset by the cost of professional counsel in using more sophisticated and complicated techniques.

In addition, associations using Section 528 and investing in tax exempt securities are likely to switch to higher yielding investments if S. 2167 is enacted. Figure 4 shows the benefit to the association and to the U.S. Treasury.

### CONCLUSION

Enactment of S. 2167 completes what Congress set out to do in 1976; namely, provide fair tax treatment of condominiums and homeowner associations, recognizing their nonprofit volunteer nature, encouraging setting aside of reserves and providing a special, relatively simple place for them in the Tax Code.

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*Figure 1.—Filing form 1120 as a corporation*

| | |
|---|---|
| Income from members | $100,000 |
| Less reserves/capital contribution | 10,000 |
| Interest income | 1,000 |
| Total income | 91,000 |
| Less expenses | 90,000 |
| Taxable income | 1,000 |
| Tax at 17 percent | 170 |
| Less loss carry forward, credits, etc. | |
| After tax income to association | 830 |

*Filing form 1120-H as a qualified association—*

| | |
|---|---|
| Interest income | $1,000 |
| Less 528 deduction | 100 |
| Taxable income | 900 |
| Tax at 46 percent | 414 |
| After tax income to association | 586 |

*Figure 2.—Filing form 1120-H as qualified association*

| | |
|---|---|
| Interest income from certificate of deposit | $1,000 |
| Less specific 528 deduction | 100 |
| Taxable income | 900 |
| Tax at 46 percent rate | 414 |
| After tax income to association | 586 |
| Interest income from tax exempt municipal bond | 600 |
| Taxable income | 0 |
| Tax at 46 percent | 0 |
| After tax income to association | 600 |

*Figure 3.—Difference to association and U.S. Treasury between corporate filing now and 1120-H filing after enactment of S. 2167*

| | |
|---|---|
| Filing form 1120 as a corporation: | |
| Income from members | $100,000 |
| Less reserves/capital contributions | 10,000 |
| Interest income | 1,000 |
| Total income | 91,000 |
| Less expenses | 90,000 |
| Taxable income | 1,000 |
| Tax at 17 percent | 170 |
| Minimum after tax income to association | 830 |
| Maximum revenue to U.S. Treasury | 170 |
| Filing form 1120-H as a qualified association assuming enactment of S. 2167: | |
| Interest income | $1,000 |
| Less specific 528 deduction | 100 |
| Taxable income | 900 |
| Tax at 17 percent rate | 153 |
| After tax income to association | 847 |
| Revenue to U.S. Treasury | 153 |

*Figure 4.—Comparison of after tax income to association and revenue to U.S. Treasury before and after enactment of S. 2167*

| | |
|---|---|
| Before S. 2167: Filing form 1120-H as qualified association under present legislation: | |
| Interest income from tax exempt municipal bond | $600 |
| Tax income | 0 |
| Net after tax income to association | 600 |
| Revenue to U.S. Treasury | 0 |
| After S. 2167: Filing form 1120-H as qualified association assuming enactment of S. 2167: | |
| Interest income from certificate of deposit | $1,000 |
| Less specific 528 deduction | 100 |
| Taxable income | 900 |
| Tax at 17 percent rate | 153 |
| Net after tax income to association | 847 |
| Revenue to U.S. Treasury | 153 |

Senator BYRD. Let's get back to this 4746, section 2, treatment of payment or reimbursement by a private foundation for expenses of foreign travel by Government officials.

What is it all about?

Mr. GUTMAN. All right.

Under present law, the private foundation rules prohibit so-called self-dealing between foundations and people who are called disqualified persons. Under the private foundation rules, payment to Government officials are generally prohibited because the Government officials are generally classified as falling within this ambit of self-dealing.

There is presently an exception in the statute which permits private foundations to pay the travel expenses of Government officials within the United States, from one point in the United States to another point in the United States. This bill would permit a private foundation to pay the travel expenses of a Government official from a point in the United States to a point outside the United States subject to the restrictions which are presently applicable in the statute.

Senator BYRD. Why should they pay the expenses of a Government official?

Mr. GUTMAN. Why should a private foundation pay the expenses of a Government official?

Senator BYRD. Yes.

Mr. GUTMAN. Where the charitable organizations is doing the paying and the official is a Government official, one could fear less for the opportunities of aggrandizement. That is not exactly the case of a foundation using tax-exempt income to pay a high salary to the founder's son. If we assume that Government officials are operating properly, it may be that the private sector is the only place where funds are available to be able to finance a particular fact-finding mission.

Senator BYRD. Instead of expanding it, why do you not recommend contracting it?

Mr. GUTMAN. We have not been convinced of an abuse potential here.

Senator BYRD. You have not?

Mr. GUTMAN. No. Not in the particular area of foundations which are subject to reporting requirements.

Senator BYRD. Do you recall the Ford Foundation?

Mr. GUTMAN. I certainly do.

Senator BYRD. You are familiar with the Ford Foundation?

Mr. GUTMAN. Yes, sir.

Senator BYRD. Do you recall what happened in 1968 by the Ford Foundation when they took Government officials and sent them around the world on a vacation? And you do not call that abuse?

Mr. GUTMAN. That certainly sounds like abuse to me.

Senator BYRD. It certainly sounds like abuse to me. I can see all types of abuses possible in this.

Mr. GUTMAN. There are substantial limits within the statute as to how much can be expended and how long someone can be away. Within those constraints we have not had any objection. We have no objection to the provision.

Senator BYRD. It is strange that Treasury has not objected to those provisions. I can see tremendous abuse. These are tax exempt foundations, is that not correct?

Mr. GUTMAN. That is correct, Senator.

Senator BYRD. They get this tax-exempt money and go out and use that to take Senators and Congressmen and members of the executive branch and what have you all over the country, all over the world?

I think there could be a tremendous abuse in that.

I guess one reason maybe there is not so much opposition to it is because maybe many Members of the Congress and executive branch have been utilizing it. I do not know.

Anyway, I frankly take a very dim view of expanding that section. I saw what happened in 1968 and I think it is a terrible abuse and I think most persons feel the same way.

As a matter of fact, that was one reason that the foundation regulations were tightened so.

There is a bill that is not before this committee today, S. 2275, introduced by Senator Gravel.

Mr. GUTMAN. We have submitted testimony on that bill.

Senator BYRD. It is not on this agenda.

What is your position on that?

Mr. GUTMAN. We have no opposition to that bill. It essentially makes necessary technical corrections to the GSOC positions.

Senator BYRD. Treasury feels that is OK?

Mr. GUTMAN. Yes.

Senator BYRD. I will submit a letter from Senator Gravel on this matter and from F. David Lake dealing with this matter.

[The material referred to follows:]

U.S. SENATE,
*Washington, D.C., February 21, 1980.*

Senator HARRY F. BYRD, Jr.,
*Chairman, Subcommittee on Taxation and Debt Management Generally, Committee on Finance, U.S. Senate, Washington, D.C.*

DEAR MR. CHAIRMAN AND FELLOW SUBCOMMITTEE MEMBERS: During consideration of the Tax Reduction Act of 1978 by the Senate Finance Committee I offered an amendment which created a new subchapter U in the Internal Revenue Code dealing with general stock ownership corporations. That amendment provided special tax treatment for broadly owned corporations organized to comply with the

limitations of subchapter U. The amendment was included in H.R. 13511 as passed by the Finance Committee and the Senate. It was retained by the Conference Committee and has become a part of the Internal Revenue Code.

In reviewing Subchapter U with a view toward the adoption of regulations and the creation of the first general stock ownership corporation several errors in the legislative language became apparent. In order to correct these drafting errors I have introduced a bill, S. 2275, which is the topic of hearings in the subcommittee. It is my understanding that these amendments are purely technical in nature and that they have been approved by both the staff of the Joint Committee on Taxation and the Department of Treasury. I should like to explain the changes in subchapter U made by the provisions of this bill and encourage prompt committee action on the legislation.

Section 1391(a)(4)(D)(ii) limits transfers of GSOC stock to resident individuals of the chartering state. This provision was designed to ensure that artificial persons such as corporations, trusts and partnerships do not become holders of GSOC stock. In restricting ownership of GSOC stock we were trying to ensure that the benefits of subchapter U flow to individuals rather than corporations or other artificial accumulations of people. However, in our efforts to limit ownership of GSOC stock we failed to provide for the situation in which a shareholder dies and the stock passes to his estate for distribution to his heirs. A literal reading of the statute would indicate that GSOC stock could not be held by an estate in any event. This was not the intent of the sponsor. In order to simplify administration of the estate of a deceased GSOC shareholder the estate should be allowed to hold stock during the period of administration. To rectify this omission section (a)(1) of S. 2275 provides that GSOC stock may not be transferred to "any person other than a resident individual of the chartering State or the estate of a deceased shareholder."

In an effort to ensure internal consistency within subshapter U section (a)(2) of the bill changes the caption in section 1391(c) from plural to singular since the term defined within that subsection is singular.

The cross reference in section 1392(a) to section 1393 was incorrect and should be a cross reference to section 1396(b) since 1392(a) deals with the exemption from federal corporate income tax for electing GSOCs an exception to which is the liability for deficiency tax under section 1396(b). The cross reference change is made by section (a)(3) of S. 2275.

Section 1392(b)(1) is amended by S. 2275 to delete the words "and all succeeding years." Section 1392(b) deals with the effect of filing an election under subchapter U. It provides that during the years an election is in effect the corporation is not subject to the federal corporate income tax, but is subject to the deficiency tax under section 1396. The language deleted by (a)(4) of the bill suggests that special tax treatment continues in years succeeding years in which an election was made, but for which years no election is in effect. The deleted language is misleading since the intent of the legislation was to provide special tax treatment for GSOCs only during those years for which an election is in effect. This is not to suggest that GSOCs must file a new election each year. Once filed an election remains in effect until terminated either voluntarily or involuntarily. Once an election is terminated a GSOC may not subsequently reelect GSOC status under subchapter U.

S. 2275(a)(5) corrects an error in section 1393(a)(2) by changing the reference "section" to "subchapter" in order to clarify that taxable income of a GSOC is to be determined for purposes of subchapter U (rather than only section 1393) without regard to the deductions allowed by part VIII of subchapter B (other than deductions allowed by section 248, relating to organizational expenditures).

S. 2275(a)(6), (7), (8), and 2275(b) all make changes which insert the word "electing" prior to GSOC in sections of subchapter U. These changes are necessary because the limitations and special rules of subchapter U are only relevant if the corporation makes the election permitted by the subchapter and thereby becomes an electing GSOC. If the GSOC does not file an election or the election is terminated the corporation is taxed under the general rules applicable to all corporations. In drafting references were made to GSOCs in relation to special rules and limitation of subchapter U without clarifying that these special rules and limitations apply only to GSOCs which have elected to be taxed under the provisions of subchapter U and have a current election in effect. The bill corrects this omission.

Section (a)(9) of the bill clarifys that the 20 percent deficiency tax provided in section 1396 of the Code is a deductible item to the corporation. Section 1396 in early drafts of GSOC legislation (September 29, 1978 and October 5, 1978) provided for special rules applicable to earnings and profits of electing GSOCs. Following Senate passage of the bill technical amendments to the legislation included a change in section 1396 to provide the current rules on minimum distributions

without provision for deductibility of the deficiency tax. No mention of a penalty tax is found in the Finance Committee press release of September 21, 1978 announcing Committee action on GSOCs. First mention of the penalty tax may be found in proposed draft report language dated September 22, 1978. After describing the deficiency tax that proposed draft notes that the amount paid is "allowed as a deduction to the GSOC for the year in which it is paid." Memo from outside counsel dated October 12, 1978 points out that the legislative history of the Tax Reduction Act should indicate that the deficiency tax is deductible. My floor statement on GSOCs of October 14, 1978 says, in discussing the deficiency tax, "The amount of such tax is allowed as a deduction to the GSOC for the year in which it is paid." The Finance Committee Report on H.R. 13511 provides that the deficiency tax is to be deductible to the GSOC for the year in which it is paid. The General Explanation of the Revenue Act of 1978 provides at page 323 that the deficiency tax is to be deductible "for the year in which it is paid rather than the year of accrual."

Finally, the table of sections for subchapter U is corrected by changing the reference in the description of section 1397 from General Stock Ownership Plan to General Stock Ownership Corporation

These amendments are effective with respect to corporations which are organized after December 31, 1978 and before January 1, 1984. This provides for effective dates identical to the effective dates applicable to subchapter U generally.

I would encourage prompt consideration of these technical amendments by the subcommittee and ask that they be included in legislation scheduled for floor action at the earliest possible time.

Thank you for your courtesy in this matter.

Sincerely yours,

MIKE GRAVEL.

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WILMER & PICKERING,
*Washington, D.C., February 28, 1980.*

SENATOR HARRY F. BYRD, Jr.,
*Chairman, Subcommittee on Taxation and Debt Management Generally, Committee on Finance, U.S. Senate, Washington, D.C.*

DEAR MR. CHAIRMAN: We understand that the Subcommittee on Taxation and Debt Management Generally intends to hold hearings on S. 2275, a bill introduced by Senator Gravel on February 7, 1980. S. 2275 would correct several drafting errors and make certain technical changes in subchapter U of the Internal Revenue Code, a provision dealing with "General Stock Ownership Corporations" which was enacted as part of the Revenue Act of 1978.

Our firm represented the State of Alaska in connection with the original legislation and continues to represent the State in connection with its consideration of state legislation that would provide for the formation of a general stock ownership corporation complying with the provisions of subchapter U.

By letter dated February 21, 1980 to the Chairman, Senator Gravel set forth a detailed explanation of the technical changes. We concur that the proposed changes are technical in nature, are within the spirit of the original legislation and should be given favorable consideration.

Sincerely yours,

F. DAVID LAKE, Jr.

Senator BYRD. If there is nothing further to come before the committee, it will stand in adjournment. Thank you.

Mr. GUTMAN. Senator, could my whole statement be in the record?

Senator BYRD. Oh, yes.

Mr. GUTMAN. We have been all over the place.

Senator BYRD. Oh, yes. Your entire statement will be published in the record.

[The prepared statement of Harry L. Gutman follows:]

STATEMENT OF HARRY L. GUTMAN, DEPUTY TAX LEGISLATIVE COUNSEL

Mr. Chairman and Members of the Subcommittee: I am pleased to be here today to present the views of the Treasury Department on the following bills: S. 464, S. 1194, S. 1859, S. 2167, S. 2201, S. 2275, H.R. 4746 and section 4 of H.R. 5973.

SUMMARY OF POSITIONS

S. 464 would amend the targeted jobs credit to expand the categories of target groups to include "displaced homemakers." The Treasury Department recommends that consideration of S. 464 be deferred.

S. 1194 would exclude from coverage under the Federal Unemployment Tax Act (FUTA) the services of fishermen who are employed on a fishing boat with an operating crew of fewer than 10 individuals and who do not receive cash remuneration except for a share of the boat's catch. The Treasury Department is opposed to S. 1194.

S. 1859 and S. 2201 would permit the use of crop share rentals in the estate tax special use valuation formula. The Treasury Department is opposed to both S. 1859 and S. 2201. However, if amended as described below, the Treasury would not oppose the bills.

S. 2167 would provide that the taxable income of a homeowners association would be taxed at the graduated rates prescribed for corporations. The Treasury Department is opposed to S. 2167.

S. 2275 would make a number of technical changes in the Internal Revenue Code provisions governing General Stock Ownership Corporations (GSOC's). The Treasury Department does not oppose this bill.

H.R. 4747—MISCELLANEOUS CHANGES

Section 1 of H.R. 4746 would simplify the private foundation return and reporting requirements and make private foundation information returns more readily accessible to the public. The Treasury Department supports section 1.

Section 2 of H.R. 4746 would permit private foundations to reimburse government officials for certain types of foreign travel. The Treasury Department does not oppose section 2.

Section 3 of H.R. 4746 would remove the charitable contribution deduction from the computation of adjusted itemized deductions for purposes of the alternative minimum tax on a charitable lead trust where the grantor of the trust is a corporation. The Treasury Department does not oppose section 3.

Section 4 of H.R. 4746 would provide for voluntary withholding from sick pay. The Treasury Department supports section 4.

Section 5 of H.R. 4746 would allow a deduction from gross income for the repayment of supplemental unemployment compensation benefits if the repayment is required because of the receipt of trade readjustment allowances. The Treasury Department does not oppose section 5.

Section 6 of H.R. 4746 would give state auditing agencies access to Federal tax return information in the hands of state taxing authorities for the purpose of auditing the activities of the taxing authority. The Treasury Department does not oppose section 6.

Section 7 of H.R. 4746 would extend the investment tax credit to the International Maritime Satellite Organization ("INMARSAT"). The Treasury Department does not oppose section 7.

Section 8 of H.R. 4746 would allow the interest rate on retirement plan bonds and individual retirement bonds to be increased. The Treasury Department does not oppose section 8.

H.R. 5973

Section 4 of H.R. 5973 would provide a limited exception to the definition of "acquisition indebtedness" for purposes of determining whether the disposition of real property by a tax-exempt organization gives rise to taxable unrelated debt-financed income. This section would benefit the Tillamook County Young Men's Christian Association of Tillamook, Oregon. The Treasury Department opposes section 4 of H.R. 5973.

S. 464—TARGETED JOBS CREDIT FOR DISPLACED HOMEMAKERS

Under the targeted jobs credit provisions of the Revenue Act of 1978, an employer may elect to claim a credit for certain wages paid to an individual who qualifies as a member of any one of seven target groups. The purpose of the credit is to encourage prospective employers to hire members of these disadvantaged groups.

S. 464 would expand the categories of target groups for whom the credit is available to include a new group, "displaced homemakers," as defined in paragraph (7) of section 3 of the Comprehensive Employment and Training Act Amendments of 1978. A "displaced homemaker" is there defined as an individual who:

(1) has not worked in the labor force for a substantial number of years but, during those years, has provided unpaid services for family members in the home,

(2) either has been dependent on public assistance or the income of another family member but is no longer supported by that income, or is receiving public assistance on account of dependent children in the home, and

(3) is either unemployed or underemployed and experiencing difficulty in obtaining or upgrading employment.

S. 464 would be retroactive, applying with respect to amounts paid or incurred after December 31, 1978, in taxable years ending after that date.

The targeted jobs credit was enacted as an experimental program with a three-year life. (The three-year duration assumes enactment of H.R. 2797, the Technical Corrections Act of 1979.) There was substantial debate within the Congress concerning target groups. The result of this debate, which reflected the considered judgment of the Congress, was the designation of seven target groups.

After the enactment of the Revenue Act of 1978, representatives of a number of other relatively disadvantaged groups sought to have their groups added to the list of eligible target groups. Many of these additions may be meritorious. However, in order to ensure that each receives the thorough consideration to which it is entitled, we believe all proposed amendments that would produce significant changes in the present provisions of the targeted jobs credit should be considered together. For this reason, and because we believe a large number of individuals would be included in the new target group, the Treasury Department believes that consideration of S. 464 should be deferred in favor of a more comprehensive examination of the targeted jobs credit when the current program has been in effect for three years.

In your consideration of this program, the Treasury Department requests that retroactive effective dates, such as provided in S. 464, be deleted. The targeted jobs credit is intended to be an incentive for employers to hire certain individuals who qualify as members of target groups. Providing a retroactive effective date for wages paid to members of a new target group hired before the date of amendment would clearly be inconsistent with this purpose. The credit could not have affected an employer's decision to hire these individuals.

### S. 1194—FUTA EXEMPTION FOR CERTAIN FISHERMEN

S. 1194 would amend section 3306(c) of the Internal Revenue Code of 1954 to exclude from the definition of covered employment under the Federal Unemployment Tax Act (FUTA) service performed by crew members of certain fishing vessels. The amendment would exempt the owners or operators of fishing boats from the payment of FUTA taxes if there are normally fewer than 10 crew members on the boat, the crew members do not receive cash remuneration except for either a share of the catch or a share of the proceeds from the sale of the catch, and each crew member's share depends on the amount of the boat's catch. These crew member would then not be considered to be employees of the fishing boat operators, and it is likely that they would not be eligible for unemployment benefits.[1]

This provision is patterned after sections 3121(b)(20) and 3401(a)(17) of the Code, which were enacted in 1976 and provide the same exclusion from taxation for purposes of the Federal Insurance Contributions Act (FICA) and income tax withholding, respectively. The intent of S. 1194 appears to be to make the treatment of fishermen consistent for the purposes of Social Security, income tax withholding and unemployment compensation.

Historically, maritime workers have had unique employment relationships, but under maritime law, which is applied in determining their status for employment tax purposes, captains and crew members are nearly always considered to be employees of the owners of the vessels. Thus, this bill would unfairly relieve employers from paying the FUTA tax for the services of crew members, but would not alter their existing employer-employee relationships which, in fact, do not reflect self-employment.

Further, the consequences of a FUTA exclusion would be more detrimental to the individual worker than the FICA exclusion under present law. Individual crew members excluded from the term "employment" under FICA will nevertheless be covered under the Social Security system as self-employed individuals. By contrast,

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[1] The proposed exclusion would be in addition to, and not a substitute for, the present fishermen exclusion under section 3306(c)(17) of the Code. Under section 3306(c)(17), the employers of fishermen are not exempt under FUTA from the payment of Federal unemployment taxes if the services performed are related to the catching of salmon or halibut for commercial purposes, or if the services are performed on vessels of more than 10 net tons. S. 1194 would thus broaden the exclusion of fishermen under FUTA to include fishermen on vessels that exceed 10 net tons and commercial salmon or halibut fishermen.

such crew members, if excluded from FUTA coverage, could not obtain unemployment compensation coverage as self-employed persons, since all States provide that only employers may elect coverage of services performed for them. Exclusion of these workers from FUTA coverage by their employers, unlike the FICA exclusion, would therefore leave such workers without any protection, if, as experience has demonstrated, a Federal exclusion is quickly followed by State exclusions.

We believe there was good reason for limiting the 1976 changes in the employment status of fishermen to the Social Security and withholding tax provisions of the Code. The change proposed in S. 1194 is not in the best interest of the individual workers. Furthermore, this bill involves the broader issue of whether workers employed under unusual earnings agreements, such as those described in the bill, should be excluded from unemployment compensation coverage. The National Commission on Unemployment Compensation is currently undertaking a study of policies regarding unemployment compensation coverage. Consequently, Federal action, if any, on S. 1194 should be deferred pending the issuance of a report from the National Commission. For these reasons, the Treasury Department opposes S. 1194.

### S. 1859 AND S. 2201—ESTATE TAX, SPECIAL USE VALUATION FOR FARMS

Where a "family farm" contributes a large part of a decedent's estate, the estate may now take advantage of a special valuation method intended to determine the value of the land for use in farming (special use valuation) even if someone would pay more to use the land for non-farm purposes.

S. 1859 and S. 2201 each would amend the formula method of valuing farms under the special use valuation provision to permit in-kind or crop share rentals to be taken into account.

The Treasury objects to the bills in their current form. However, we would not object if the changes described below were made as well.

Under the estate tax laws in effect prior to 1976, all property was included in a decedent's gross estate at its fair market value. Fair market value did not necessarily reflect use of the property for farming if the farm land could have been used for other, more profitable, commercial purposes. In such cases, the estate tax was higher than the tax would be if the land were valued solely as a farm.

In 1976, Congress changed the law to allow special valuation of farm property for estate tax purposes. This provision (section 2032A of the Code) allows valuation on the basis of the use of the property as a farm.

Section 2032A includes two methods for valuing family farms. The first method involves the use of a mathematical formula, and is intended to minimize subjectivity in farm valuation. The second method, available to all property which is eligible for special use valuation (i.e., farms and real estate used in certain closely-held businesses), involves the application of a list of commonly accepted appraisal factors to the property, including the capitalization of income from the property.

An example may help to illustrate the 1976 change in the law, the issue addressed by S. 1859 and S. 2201, and the problem we have with the current law.

Farmer A has a farm about 20 miles outside of Washington, D.C. which he actively manages. A has received offers of $1,000 an acre for his land from farmers in the vicinity who want to use his land for farming. However, A knows that other farmers in the area have sold their land to real estate developers for condominiums and shopping centers at $1,500 per acre.

If Farmer A had died before December 31, 1976, then the Internal Revenue Service could have argued that his farm land should be valued for estate tax purposes at $1,500 per acre because that was the price that developers were willing to pay.

Section 2032A was added to the Code to prevent the $1,500 valuation of Farmer A's land. To illustrate, if under the application of commonly accepted appraisal factors, the value of A's farm land, used as farm land, is $1,000 per acre (also the amount other farmers, who would have continued to use the land in farming, were willing to pay A for his land), section 2032A enables the executors of Farmer A's estate to reduce the estate tax valuation. However, to do so the executors are required to engage in a factual determination involving some subjective factors. The formula method of valuation in section 2032A avoids this subjectivity.

The formula starts with the average annual gross cash rental for comparable land and subtracts the average state and local real estate taxes of comparable land. The result is then divided by the average annual effective interest rate for all new Federal Land Bank loans and the result is the value of the farm for estate tax purposes.

Two problems arise under the formula, one which the sponsors of S. 1859 and S. 2201 seek to remedy and another which concerns the Treasury.

The problem addressed by each bill is the limitation of the formula to areas where there are gross cash rentals for comparable land. In many areas of the country, farm land is rented on an "in-kind" or crop share basis, rather than for cash. In these areas, the mathematical formula is not available. In other words, if land comparable to A's was not rented for cash, A's estate would not be entitled to use the formula. While the land may nonetheless by valued under section 2032A by using the commonly accepted appraisal approach, this method is not as simple or as objective as the formula.

The formula is designed to produce a farm use value roughly equivalent to that which would be derived by appraisal. However, as currently stated, the formula significantly understates farm use value. This occurs because the interest rate, which is the effective interest rate charged by the Federal Land Bank, is too high. For example, assume a realistic four percent interest rate would be applied under the appraisal factor method to determine that Farmer A's land was worth $1,000 per acre as farm land.

The mathematical formula would give a value to the land of less than $500 per acre, a more than 50 percent reduction from the appraised value of the land for farming. Thus, the formula reduces Farmer A's estate taxes far below the amount intended by section 2032A.

This example is neither unusual nor overstated. Filings with the IRS show that farms having no potential use other than farming are nonetheless being valued at a substantial discount under the formula. Of 54 Internal Revenue Service offices reporting values determined by estate executors (not by the IRS) in a nationwide survey (attached as Appendix A), 20 offices reported average values below 40 percent of the fair market value of the land as a farm. The remaining offices also reported substantial discounts. In some areas, the executor's own calculation of the discount from the value of the land as farm land has been as high as 80 percent. We believe that even these figures do not fully reflect the effect of this discount since in most examined cases, fair market value as reported by the executor has been found to be lower than the finally agreed value. Indeed, section 2032A was estimated to cost $14 million per year when enacted. However, current figures show that unless this problem is corrected, the cost may be as much as $140 million per year.

We recognize that the goals of simplicity and objectivity will be more readily achieved if the simple, mathematical formula approach is expanded. Although the calculation of the value of in-kind or crop share rentals will introduce an element of subjectivity into the formula, we are willing to accept this approach if the formula is revised so that it will reflect more clearly the value of the farm as farm land.

We believe the undervaluation problem in the current formula can be remedied by providing a more realistic rate of capitalization. We would propose that the interest rate in the denominator of the formula be changed to equal the greater of four percent or the annual rate of return on equity from farm property. The annual rate of return on equity would be derived from two statistical tabulations prepared and published annually by the Department of Agriculture, "State Farm Income Statistics" and "The Balance Sheet for The Farming Sector." Specifically, the rate of return on equity from farm production would be determined, on a state-by-state basis, by subtracting government payments from net farm income and dividing the result by proprietors' equities. Each of these three figures is readily available from Department of Agriculture publications. The Agriculture Department data would guarantee a fair value based upon the land's use as farm. It would not increase the value to reflect non-farm use or reduce the value by using an unrealistic interest rate. It would not decrease the number of estates eligible to use the formula or take away any of the objectivity or certainty currently available in applying the formula. In other words, this proposal would merely modify the formula so that the valuation of a farm under the formula would reflect more accurately the farm's fair market value as a farm.

If S. 1859 or S. 2201 were amended to include this change in the interest rate, we would not object to either bill.

S. 2167—RATE OF TAX ON HOMEOWNERS ASSOCIATIONS

S. 2167 would amend Code section 528, relating to certain real estate management and condominium associations ("homeowners associations"), so that tax would be imposed on such associations at the graduated rates for corporations. Currently, the income of a homeowners association is taxed at the "highest rate of tax" for corporations, 46 percent. The Treasury Department is opposed to S. 2167.

Section 528 was added by the Tax Reform Act of 1976. It was enacted to insure that participants in homeowners associations could arrange to defray collectively the expenses of maintaining their personal residences, without being subjected to

more onerous tax treatment than those who paid directly the expenses of maintaining their homes. Before 1976, it was unclear whether corporations organized as condominium or residential real estate management associations would be treated as exempt organizations or associations taxable as corporations. If taxed as corporations, homeowners who maintained homes through an association would be taxed twice, once when they earned the income and a second time when it was received by the corporation.

To alleviate this uncertainty Congress enacted Code section 528. That section essentially provides that an eligible, electing association will not be taxed on amounts received from members to defray the expenses of maintaining common property. However, this exemption would offer an opportunity for tax advantage if homeowners were permitted to contribute portfolio assets to the homeowners association and use the tax-free income from those investments to defray the expenses of maintaining their residences. Similarly, a homeowners association might be used as a shield for the conduct of an unrelated business, the pre-tax profits from which could be applied to the maintenance of the participants' common expenses. Accordingly, the statute provides that all income derived by a homeowners association, other than through dues, fees or assessments received from its members, is to be taxed to the association as a corporation.

Before the Revenue Act of 1978, which added the graduated rate schedule for corporations, a homeowners association was taxed on its income without allowance for the pre-1979 surtax exemption. Out of consistency with the statute as it existed before 1979, therefore, homeowners associations were not permitted to use the graduated rate schedule.

Taxation of investment or trade or business income of a homeowners association is essentially a surrogae for attributing the income to members of the association and taxing it at their individual marginal rates. Where the average rate of the participants is less than the 46 percent top corporate rate, the income of the association might be said to be "overtaxed." Where the average rate of the participants exceeds the 46 percent top corporate rate, even without the change by S. 2167, the association income would, in effect, be undertaxed.

Short of conduit treatment, there is no absolutely correct solution to this problem. However, there is no particular reason to encourage homeowners associations to have large investment portfolios. Application of the graduated corporate rate would, in many cases, subject association income to tax at rates lower than those of the participants. It would, therefore, encourage accumulation of investment assets. By the same token, use of the top corporate tax rate would discourage accumulation and eliminate any incentive to shift income from one year to the next to achieve taxation at a lower rate. On balance we believe the latter course is preferable.

Finally, the rationale for enacting a graduated corporate rate was to encourage capital formation, particularly in the hands of small business. That rationale furnishes no justification for imposing a graduated rate on homeowners associations which are not organized as profit-making enterprises.

The Treasury Department therefore opposes S. 2167.

S. 2275—GSOC TECHNICAL CORRECTIONS

S. 2275 makes a number of technical corrections in the provisions of the Code (sections 1391-1397) governing General Stock Ownership Corporations ("GSOC's"). These provisions were added to the Code as part of the Revenue Act of 1978.

In general, a GSOC is a corporation which is established and owned by the residents of a state and which is intended to borrow funds to acquire profitable enterprises for the benefit of the residents. The income of the GSOC is taxed on a pass-through basis to the resident-shareholders and not to the GSOC.

Most of the changes made by this bill merely correct typographical and other errors. In addition, two of the changes fill gaps in the statutory scheme so as to facilitate a GSOC's ability to function as intended.

First, the GSOC provisions now prohibit transfers of GSOC shares to any individual who is not a resident of the chartering state, thus appearing to prohibit the transfer of shares to an estate upon the death of a shareholder. The bill corrects this oversight.

Second, the Code requires that at least 90 percent of a GSOC's taxable income be distributed to the shareholders, who are taxable on 100 percent of the GSOC's income whether or not it is distributed to them. A penalty tax of 20 percent is imposed on any shortfall in this distribution requirement. The legislative history indicates that this penalty tax is to be deductible by the GSOC in computing its taxable income, but the statute is silent. The bill remedies this inconsistency by expressly providing for deductibility. If the penalty tax were not so deductible, the

shareholders would be taxed on the amount of the tax, even though they had not received a distribution of that amount.

The Treasury Department is not opposed to S. 2275.

### H.R. 4746—MISCELLANEOUS CHANGES

*Section 1 of H.R. 4746—Simplification of private foundation reporting requirements*

Under current law, private foundations are required to file both an annual return and an annual report. In addition, non-exempt charitable trusts which have solely chartiable beneficiaries are subject to different return and disclosure requirements from those applicable to exempt charitable trusts and organizations.

Section 1 of H.R. 4746 would consolidate the two reporting requirements for private foundations into one return requirement. The requirement to file an annual report would be eliminated. In addition, non-exempt wholly charitable trusts would be required to file the same report as private foundations, thereby consolidating certain requirements and making the information returns of such trusts subject to public disclosure. Finally, the proposal would provide that a private foundation would not be required to list on its return the name and address of a needy or indigent recipient receiving grants of less than $1,000 in any year.

The Treasury Department supports section 1 of H.R. 4746.

*Section 2 of H.R. 4746—Private foundation reimbursements*

Under current law, a private foundation is prohibited from engaging in certain self-dealing transactions. Self-dealing transactions include payments to a government official. A limited exception is provided which permits the payment or reimbursement of traveling expenses of a government official solely from one point in the United States to another point in the United States. This exception does not allow for the payment or reimbursement of traveling expenses outside the United States.

Section 2 of H.R. 4746 would expand this exception to provide that a foundation may reimburse a government official for travel between a point in the United States and one outside the United States. The bill further includes limitations on the availability of the exception which are similar to those under current law in the area of expenses for domestic travel.

The Treaury Department does not oppose section 2 of H.R. 4746.

*Section 3 of H.R. 4746—Alternative minimum tax on charitable lead trust with corporate grantor*

Under the alternative minimum tax, capital gains and adjusted itemized deductions constitute the two tax preferences. The latter preference excludes a number of itemized deductions and the remaining itemized deductions are preferences to the extent they exceed 60 percent of adjusted gross income less the excluded deductions.

Although trusts and estates are generally subject to the alternative minimum tax, certain charitable contributions of trusts and estates are treated favorably for minimum tax purposes. For example, charitable contributions are considered untainted in the case of certain wholly charitable trusts, pooled income funds and testamentary lead trusts. However, there is generally no exception for the charitable deductions of inter vivos lead trusts.

Section 3 of H.R. 4746 would provide that the charitable deductions of a charitable lead trust will not be considered in determining the adjusted itemized deduction preference for purposes of the alternative minimum tax if the grantor of the trust and the owner of all reversionary interests in the trust is a corporation.

The Treasury does not oppose section 3 of H.R. 4746.

*Section 4 of H.R. 4746—Voluntary withholding under wage continuation plans*

Under present law amounts received by an employee through accident or health insurance for personal injuries or sickness generally are includible in gross income to the extent such amounts (1) are attributable to contributions by the employer which are not includible in the gross income of the employee, or (2) are paid by the employer.

Withholding is not required on sick pay payments provided by third parties, such as insurance companies, even if the recipient so requests.

Section 4 of H.R. 4746 provides that a taxpayer who is to receive sick pay may request that the third party paying such amount withhold a specified percentage (but no less than the minimum prescribed by regulations) from these payments. A number of special rules relating to the information which must be provided to the third party payor, the treatment of requests under collective bargaining agreements

and the timing of information reporting on these withheld amounts are included in the provision.

The Treasury Department supports section 4 of H.R. 4746.

*Section 5 of H.R. 4746—Repayments of supplemental unemployment compensation benefits*

Under current law a worker who receives supplemental unemployment compensation benefits (SUB) payments under a claim of right is entitled to a loss deduction if the taxpayer is required to repay the SUB payments in a subsequent year. Alernatively, if the SUB payment exceeds $3,000, the worker may elect to reduce taxes in the year of repayment by the amount of the decrease in the prior year's (or years') taxes which will result from the exclusion of the SUB payment from gross income in the prior year (or years).

Section 5 of H.R. 4746 would allow the loss deduction for a repayment of a SUB payment which is required on account of the receipt of a trade readjustment allowance ("TRA") to be taken into account in computing adjusted gross income under the Code. As under present law, the deduction would be taken in the year of repayment.

The Treasury Deparment does not oppose section 5 of H.R. 4746.

*Section 6 of H.R. 4746—Disclosure of Federal tax information to State auditing agencies*

The Internal Revenue Code currently gives state auditing agencies access to Federal tax return information only when the agency is actually involved in the determination, assessment, collection or refund of taxes (i.e., tax administration activities), and not when the agency's role is limited to general oversight of the taxing authority.

Section 6 of H.R. 4746 would amend the Code to give state auditing agencies access to Federal tax return information in the hands of state taxing authorities for purposes of tax administration and for the purpose of auditing the activities of the taxing authority.

The Treasury does not oppose section 6 of H.R. 4746.

*Section 7 of H.R. 4746—Investment tax credit for INMARSAT*

Under current law, the investment tax credit is not generally available for property used outside the United States or for property used by an international organization.

Section 7 of H.R. 4746 would make the investment tax credit available for the interests of United States persons in comunications satellites used by the International Maritime Satellite Organization (INMARSAT), an international organization established to develop and operate a global maritime satellite telecommunications system.

The Treasury is not opposed to section 7 of H.R. 4746.

*Section 8 of H.R. 4746—Interest on U.S. retirement bonds*

Under current law, the interest rate on an individual retirement bond or a retirement plan bond remains the same from the date of issuance until the bond is redeemed. However, the interest rate on outstanding Series E Bonds is increased whenever there is an increase in the interest rate on new issues of Series E Bonds.

Section 8 of H.R. 4746 would allow the Treasury Department, with the approval of the President, to make upward adjustments in the interest rate on outstanding retirement bonds, so that such bonds would earn interest at a rate consistent with the yield for new issues of such bonds after the effective date of the interest rate increase.

The Treasury Department is not opposed to section 8 of H.R. 4746.

H.R. 5973

*Section 4 of H.R. 5973—Special rule relating to debt-financed income of exempt organizations*

Section 4 of H.R. 5973 provides a limited exception to the definition of "acquisition indebtedness" for purposes of determining whether the disposition of real property by a tax-exempt organization gives rise to taxable unrelated debt-financed income. The Treasury opposes this provision of H.R. 5973.

In general, income that an exempt organization receives from investment property is taxable in the proportion that the property is financed by debt. If the property is sold, gain on the sale also is taxable in the proportion that the property is debt-financed. This proportion is determined by the highest "acquisition indebtedness" on the property for the twelve-month period preceding the date of disposition.

The circumstances under which the proposed exception would apply are limited and detailed. Basically, it would exclude a sale of real property during 1976 that had been financed before 1965, provided certain other narrow requirements are met.

We believe Congress clearly intended to tax sales of "debt-financed property." We also believe Congress intended that the test whether property was debt-financed at sale was to be judged by looking at the twelve-month period preceding the date of sale. An exempt organization planning to dispose of income producing property may extinguish the acquisition indebtedness on the property and sell it without tax only after a twelve-month waiting period.

These rules were enacted in 1969, and, after a transitional period, have applied to dispositions of all debt-financed property since 1972. Exempt organiations have had more than enough time to adjust to this provision and we have no reason to believe that they have not done so. We, therefore, consider the special retroactive exception of section 4 to be discriminatory and unwarranted.

I shall be happy to answer any questions you may have.

## APPENDIX A

Average Discount on Fair Market Values from Section 2032A Elections (based upon values reported by executors electing section 2032A and shown by IRS district)

[In percent]

| | |
|---|---|
| Midwest region: | |
| Springfield, Ill | 62 |
| Chicago, Ill | 61 |
| Des Moines, Iowa | 50 |
| Fargo, N. Dak | 47 |
| Milwaukee, Wis | 62 |
| Omaha, Nebr | 45 |
| St. Louis, Mo | 49 |
| Aberdeen, S. Dak | 47 |
| St. Paul, Minn | 47 |
| Central region: | |
| Cincinnati, Ohio | 57 |
| Cleveland, Ohio | 49 |
| Detroit, Mich | 62 |
| Indianapolis, Ind | 51 |
| Louisville, Ky | 51 |
| Parkersburg, W. Va | 46 |
| Mid-Atlantic region: | |
| Philadelphia, Pa | 76 |
| Newark, N. J | 63 |
| Baltimore, Md | 60 |
| Richmond, Va | 55 |
| Wilmington, Del | 59 |
| North Atlantic region: | |
| Albany, N.Y | 23 |
| Boston, Mass | 67 |
| Brooklyn, N.Y | 42 |
| Buffalo, N.Y | 46 |
| Burlington, Vt | 68 |
| Hartford, Conn | 70 |
| Manhattan, N.Y | 39 |
| Portsmouth, N.H | 32 |
| Providence, R.I | 26 |
| Southwest region: | |
| Albuquerque, N. Mex | 65 |
| Oklahoma City, Okla | 64 |
| Austin, Tex. (Houston POD—81) | 67 |
| Dallas, Tex | 64 |
| Wichita, Kans | 39 |
| Cheyenne, Wyo | 71 |
| Denver, Colo | 63 |
| Little Rock, Ark | 44 |
| New Orleans, La | 44 |

| | |
|---|---|
| Western region: | |
| Boise, Idaho | 52 |
| Helena, Mont | 47 |
| Seattle, Wash | 40 |
| Portland, Oreg | 57 |
| Fresno, Calif. (IRS Service Center) | 55 |
| Salt Lake City, Utah | 46 |
| Los Angeles, Calif | 29 |
| Phoenix, Ariz | 59 |
| San Francisco, Calif | 40 |
| Southeast region: | |
| Greensboro, N.C | 44 |
| Jacksonville, Fla | 65 |
| Nashville, Tenn | 66 |
| Atlanta, Ga | 43 |
| Birmingham, Ala | 67 |
| Columbia, S.C | 57 |

Mr. GUTMAN. There was one other bill.

Senator BYRD. What is that?

Mr. GUTMAN. Section 4 of H.R. 5973 which is a section to which Treasury is opposed. Unless you would like me to go through it at this point, I will just let our statement stand for itself.

Senator BYRD. That is not on the agenda, is it?

It was listed.

Mr. GUTMAN. No one wanted to testify except us, I guess.

Senator BYRD. Are you testifying for or against it?

Mr. GUTMAN. Against it.

Senator BYRD. No one testified for it. I do not think it would have too big of a chance. That is a part of your statement?

Mr. GUTMAN. It is a part of our statement, yes, sir.

Senator BYRD. The subcommittee is adjourned.

[Thereupon, at 1 p.m. the subcommittee recessed, to reconvene at the call of the Chair.]

[By direction of the chairman the following communications were made a part of the hearing record:]

CONTINENTAL BANK,
*Chicago, Ill., February 28, 1980.*

Mr. MICHAEL STERN,
*Staff Director, Senate Finance Committee,*
*Washington, D.C.*

DEAR MR. STERN: The Senate Finance Taxation Subcommittee will meet on March 4, 1980 to consider eight pending miscellaneous tax bills, one of which will be H.R. 4746. We wish to provide you with comments on one provision of H.R. 4746.

Continental Illinois National Bank and Trust Company of Chicago ("Continental Bank") is a national banking association with its principal office at 231 South LaSalle Street, Chicago, Illinois 60693. Continental Bank is authorized to conduct a trust business in the State of Illinois and is trustee or co-trustee of many charitable trusts.

Section 1 of H.R. 4746 is entitled "Simplification of Private Foundation Return and Reporting Requirements" and many of the discussions of the bill in the various tax services have referred to Section 1 as being non-controversial for this reason. We submit that one aspect of Section 1 is controversial and may not be considered a simplication of reporting requirements.

The aspect we have in mind is new Section 6033(d)(1). This new section would require Section 4947(a)(1) wholly charitable non-exempt trusts to file Form 990, Return of Organization Exempt from Income Tax, in lieu of Form 1041, which is the Fiduciary Income Tax Return. Preparation of Form 990 requires considerably more time and effort than preparation of Form 1041. Furthermore we believe many banks and trust companies, like Continental Bank, have a far greater number of pre-1969 Section 4947(a)(1) non-exempt charitable trusts than exempt charitable trusts. So the impact of requiring a Form 990 rather than Form 1041 is much greater than one might otherwise expect.

Contributions by individuals to existing Section 4947(a)(1) trusts are non-tax deductible for the reason they are not tax exempt. Therefore, there is no inflow of new

funds to these trusts from the public and as a result, there is no great underlying need for public disclosure as to their operations. On the other hand, these Section 4947(a)(1) trusts have been determined to be "public charities" because of their linkage with an exempt public charitable organization. For the most part, the only way such a determination could have been made is by a conclusion on the part of the Internal Revenue Service that the exempt public charity will be monitoring or supervising the operations of the Section 4947(a)(1) trusts. Most states also require such trusts to register as Charitable Trusts under the state Charitable Trust Act.

In short, we believe new Section 6033(d)(1) is a substantive change in the law, is controversial and is not a simplification of reporting procedures. We believe such a change should not be included in a bill identified as a bill simplifying the tax law but, rather, should be included in a bill which is clearly identified to the public as one which will increase the reporting requirements for non-exempt "public" charitable trusts.

Sincerely,

ROBERT E. L. WALKER.

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BAKER & HOSTETLER,
*Washington, D.C., March 7, 1980.*

Hon. HARRY F. BYRD, Jr.,
*Chairman, Subcommittee on Taxation and Debt Management Generally, Committee on Finance, U.S. Senate, Washington, D.C.*

DEAR SENATOR BYRD: This is in reference to the hearing with respect to the above bill on March 4, 1980, before the Subcommittee on Taxation and Debt Management Generally.

Section 1 of H.R. 4746 provides, in effect, for the combination of the annual report (on Form 990-AR) and the tax return (on Form 990-PF) required to be filed by private foundations. This is a simplifying change.

However, in making this change, the bill would amend section 6033 of the Internal Revenue Code, relating to returns, to include the present provisions of section 6056, relating to annual reports. This picks up and includes section 6056(d)(3) which now requires private foundations to file annual reports with "such state officials and other persons, at such times and under such conditions, as the Secretary may by regulations prescribe." Thus, this requirement would also apply to tax returns required to be filed by private foundations.

My concern is that these provisions in H.R. 4746 are of a very unusual nature. They would authorize the Treasury Department (or, by delegation, the Commissioner of Internal Revenue) to require tax returns to be filed with private persons or private organizations—a requirement which is unprecedented in our tax system.

It is noteworthy that the Internal Revenue Service on August 27, 1979, proposed an administrative rule under present law which would require many private foundations to file, under penalties of law, their Annual Reports with a private organization, the Foundation Center in New York City. It is understood that the Service received a substantial number of letters objecting on various grounds to this additional requirement. By action taken on February 14, 1980, the Internal Revenue Service withdrew the proposed administrative rule to require such filing of Annual Reports.

Nevertheless, the problem remains that if H.R. 4746 is enacted, it would presumably enable the Service to establish similar requirements in the future for the required filing of tax returns with a private person or private organization.

Enclosed is a copy of the Internal Revenue Service announcement of February 14, 1980, which gives reasons for the withdrawal by the Service of the previously proposed requirement that Annual Reports on Form 990-AR be filed with a private organization. The reasons given should apply with at least equal, if not greater, weight as grounds for rejection of the even more drastic proposal in H.R. 4746 for the required filing of tax returns with a private person or organization. If at some time in the future the Treasury Department determines that such a unique requirement is essential to sound tax administration and justified on grounds of public policy and need, then it may apply to the Congress for specific legislation providing such required filing. In the meantime, standby authorization for the Treasury (or the Commissioner) to institute such an unusual filing requirement is unnecessary and may be dangerous.

Accordingly, it is suggested that there be eliminated from the Bill the language permitting the administrative promulgation of such required filing. This change

simply involves striking "and other persons" from the proposed amended IRC § 6033(c)(3).

Very truly yours,

NORMAN A. SUGARMAN.

Enclosure.

PROPOSAL TO DESIGNATE A DEPOSITORY FOR ANNUAL REPORTS OF PRIVATE FOUNDATIONS; ACTION ON PROPOSAL

Agency: Internal Revenue Service, Treasury.

Action: Action on proposal.

Summary: As a result of a Notice published August 27, 1979, in the Federal Register at page 50128 (44 FR 50128), 186 persons or organizations commented on the proposal to designate The Foundation Center as a depository for certain private foundation annual reports. The comments, both pro and con, have been given careful consideration by the Internal Revenue Service. For the reasons discussed below it has been decided not to implement this proposal.

For further information contact: Edmund J. Butler of the Exempt Organizations Technical Branch, Office of the Assistant Commissioner (Employee Plans and Exempt Organizations): 202-566-4050 (not a toll-free number).

SUPPLEMENTARY INFORMATION

*Rationale for decision*

Implementation of the proposal would result in conferring a private benefit on a non-governmental entity at the expense of other private organizations. While the expense to an individual organization that would result from designating The Foundation Center as a depository might be minor, no assurance can be given that other depositories or libraries would not request a similar designation. The Service would be obligated to give equal consideration to all such requests. If several organizations were to be designated as depositories, the additional paperwork burden on affected private foundations will be increased to an unwarranted degree.

The prinicpal public benefit accruing from implementation of the proposal is alleged to be quicker access to grant-maker information if the annual reports were sent directly to a depository. However, each I.R.S. regional service center microfilms three copies of the annual reports, keeps one and sends the others to the Philadelphia Service Center and to the National Office Freedom of Information Reading Room. The microfiche cards must be shipped within thirty days of receipt of the report. The Service will provide photocopies from or film copies of these microfiche cards for a fee to any citizen who requests them. Allowing for delays in mailing and processing, annual reports of any foundation can be in the hands of interested parties within 60 days of the time they are filed. Direct filing of these reports with a depository would not speed up this process sufficiently to provide an appreciable public benefit.

Section 6652(d)(3) of the Code requires a penalty to be assessed against any organization that does not meet the filing requirements of section 6056. This penalty would apply to failure to file with a designated depository. Enforcement of this provision would be impractical in the light of the funds available to the Service for handling exempt organization matters.

This document does not meet the criteria for significant regulations set forth in paragraph 8 of the Treasury Directive appearing in the Federal Register for Wednesday, November 8, 1978.

JEROME KURTZ, *Commissioner.*

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COMMITTEE OF BANKING INSTITUTIONS ON TAXATION

(Comments Submitted to the Senate Finance Taxation and Debt Management Subcommittee)

The following comments and recommendations regarding H.R. 4746, entitled "Miscellaneous Tax Changes Bill," are respectfully submitted by the Committee of Banking Institutions on Taxation. The Committee's membership consists of representatives of various Trust Companies and Banking Institutions and its objectives are (a) to cooperate in assisting in the administration of tax laws; (b) to disseminate among its members information pertaining thereto; and (c) to act as a clearing house for communications to or instructions from Federal and State tax authorities.

59-897 O - 80 - 31

These comments and recommendations relate to Section 1 of the "Miscellaneous Tax Changes Bill," as passed by the House on September 17, 1979, wherein private foundation and charitable trust (exempt and nonexempt) reporting requirements would be simplified.

We applaud your efforts in this regard and heartily approve of the proposed combining of the Return of Private Foundation Exempt from Income Tax, Form 990-PF, and the Annual Report of Private Foundation, Form 990-AR, into a single return (Form 990-PF) containing the information presently required on each of these two separate documents.

The proliferation of returns required of private foundations is not only time-consuming but tends to add confusion to an already highly complex area. At present, one needs a chart to determine which returns are required of various types of charitable trusts.

The combining of these two documents (990-AR and 990-PF) should, therefore, result in improved tax reporting compliance by private foundations and also improve the Internal Revenue Service's audit capabilities. In addition, tax compliance would be enhanced since more information would be available for inspection by State officials and the public.

We have no objections to extending the requirements of filing a 990-PF to a nonexempt charitable trust described in Internal Revenue Code Section 4947(a)(1), i.e., one deemed to be a private foundation. It should be noted here that Income Tax Regulations Section 53.6011-1(d) presently require a nonexempt 4947(a)(1) private foundation trust to file Form 5227, Return of Nonexempt Charitable or Split-interest Trust Treated as a Private Foundation. The filing of Form 990-PF instead of Form 5227 makes sense since we would now have a uniform return for all private foundations, be they exempt or nonexempt.

However, the extension of the requirement to file Form 990, Return of Organization Exempt from Income Tax, to nonexempt 4947(a)(1) trusts looked upon as public charities, would be contrary to your intention of simplifying reporting requirements. At present, such trusts are only required to file a U.S. Fiduciary Income Tax Return, Form 1041, attaching thereto either a copy of the determination letter issued by the IRS stating that the trust is not a private foundation by reason of Section 509(a)(3) or a statement that they qualify as a public charity in accordance with the requirements of TIR 1111, as ultimately incorporated into the Income Tax Regulations Section 1.509(a)-4(i)(4).

Corporate fiduciaries, such as our members, have numerous nonexempt charitable 4947(a)(1) trusts classified as public charities as opposed to the few classified as private foundations. As such, the imposition of filing Form 990 would vastly increase our reporting requirements since Form 990 is most obviously more time-consuming and complex to prepare than Form 1041.

We, therefore, respectfully suggest that such trusts should not be required to file Form 990. However, in order to achieve your purpose of full disclosure, we suggest that in addition to filing a Form 1041 there be attached thereto a listing of the trust's assets as of the beginning and/or end of its taxable year setting forth the market value of said assets. Further, we suggest that the law be amended so that this Form 1041, along with its attachments, be made available for public inspection or to State officials.

To enhance your efforts in streamlining the reporting requirements for charitable trusts, we have a few suggestions in respect to Section 664 trusts even though H.R. 4746 did not address itself to this area. A Section 664 charitable remainder unitrust and annuity trust is presently required to file Form 1041-B, Form 5227 as required by Regulations Section 53.6011-1(d), and Form 1041-A as required by Internal Revenue Code Section 6034. Once again, we have a proliferation of required forms and thus, we respectfully suggest the combining of Form 1041-B and Form 5227 into a single return (Form 1041-B) containing the information presently required on each of these two separate documents.

In addition, we respectfully suggest that a Section 664 trust should not be required to file Form 1041-A since the information requested is a duplication of that requested by Form 1041-B and further since one-half of this form, namely Parts II and III, is not pertinent to a 664 trust.

Finally, since your efforts in streamlining tax administration for charitable trusts would result in the filing of only one return, we respectfully suggest one more step to complete your goal, i.e., providing for a uniform filing date for both exempt and nonexempt trusts, namely the 15th day of the fifth month following the close of the charitable account's taxable year.

Once again, in the sake of simplicity without sacrificing full disclosure, we urge that Form 1041 be retained as the reporting vehicle for nonexempt 4947(a)(1) trusts,

classified as public charities, by adopting the above suggestions and by possibly adding a few additional pertinent questions to Form 1041.

Uncalled-for complexity in our tax laws will be the bane of self-compliance under which our present tax structure operates. Let's not needlessly add more complexity to an already complex area. If the corporate fiduciaries which we represent feel this way, imagine how individual trustees and corporate trustees in small organizations would feel, many of whom I would venture a guess are not even conversant with Form 990.

Respectfully Submitted,

ALBERT G. DOUMAR,
*Chairman of the Fiduciary Committee.*

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F & W FORESTRY SERVICES, INC.,
*Albany, Ga., March 3, 1980.*

Mr. MICHAEL STERN,
*Senate Finance Committee,*
*Washington, D.C.*

DEAR MR. STERN: It is my desire to have this letter included in the testimony concerning Senate Bill No. 1901.

We have in the State of Georgia an epidemic situation of the southern pine bark beetle. This beetle is killing such a large portion of our loblolly pine forest that it is impossible to harvest it all, even for salvage purposes.

Below I will give you three examples that have occurred on lands belonging to clients:

Owner Number One has about 100,000 acres of land, and we have recently surveyed the damage done by the southern pine beetle. It is in excess of $7,000,000. Much of this timber can never be salvaged.

Owner Number Two has 800 acres of land. He is a retired gentleman and had put this land in trust for his grandchildren. He lost 300 acres of this tract to the southern pine beetle in 1974. This year we are having to salvage every merchantable pine tree on the remaining 500 acres. The loss between market value and salvage value is above $50,000. He had no base in this timber and, therefore, he should be able to claim a casualty loss between the salvage and fair market value.

Owner Number Three is an 81-year old man who is a small town attorney. He had owned and personally cultivated this 1,000 acres of timber for 35 years. The southern pine beetle has ruined in excess of 150 acres of very valuable timber with a loss of $93,750, as computed between fair market value and salvage value. Once again his base is non-existent, as he has grown this timber for these many years after purchasing it at a very low base.

The United States Forest Service and many other reliable sources predict a shortage of timber by the 1990's unless something is done to encourage timber production, particularly in the South on lands of non-industrial owners. If we expect these owners to regenerate these acres which will average a cost of $150 per acre, a cost which must be capitalized, then he should be allowed tax credit on the difference in salvage value and fair market value of the timber. I urge Congress to pass Senator Heflin's Bill No. 1901 to correct this tax inequity.

Respectfully submitted,

ELEY C. FRAZER III.

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THE NATIONAL FEDERATION OF
BUSINESS AND PROFESSIONAL WOMEN'S CLUBS, INC.
OF THE UNITED STATES OF AMERICA,
*Washington, D.C., March 3, 1980.*

Hon. HARRY F. BYRD, Jr.,
*Chairman, Subcommittee on Taxation and Debt Management,*
*Senate Committee on Finance, Washington, D.C.*

DEAR SENATOR BYRD: The National Federation of Business and Professional Women's Clubs, Inc., which represents over 160,000 working women nationwide, supports efforts to assist displaced homemakers in gaining meaningful employment. There are an increasing number of women, who, because of death of a spouse or divorce, are displaced in mid-life from their traditional family roles. Many of these women have no financial security or source of income. These displaced homemakers are frequently unable to enter or reenter the labor force because of age or sex

discrimination. In addition, they are handicapped when seeking employment because they have little or no recent paid work experience.

We endorse S. 464 which would amend the Internal Revenue Code to give a tax credit to employers who hire displaced homemakers. This measure provides a necessary incentive for employers to hire displaced homemakers. The bill would add displaced homemakers to the list of groups already targeted for this type of assistance. In the long run, we think this a sound investment, because the displaced homemakers who are able to secure employment become financially independent taxpayers who are no longer dependent on public income transfer programs.

The National Federation has a history of support for measures to assist displaced homemakers. In 1978-79, a plank was added to our National Platform to "promote the development of programs and services to aid displaced homemakers." This plank was carried over to the 1979-80 National Platform. Individual Business and Professional Women's Clubs across the country have also been active in local and state efforts to aid displaced homemakers. Clubs have supported state legislation, provided volunteer services to displaced homemaker programs and assisted in the development of proposals to get displaced homemaker programs established in their area. The BPW Foundation administers the Kelly Second Career Scholarship Program which aids displaced homemakers. The Foundation also provided office space and support services to the Displaced Homemakers Network during its first year of operation.

We urge your favorite consideration of S. 464.

Sincerely,

JULIA K. ARRI, *National President.*

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WRITTEN TESTIMONY IN SUPPORT OF S. 464

On March 25, 1977, the Nebraska Legislature passed the Nebraska Equal Opportunity for Displaced Homemakers Act.

The Commissioner of Education and the Department of Education began the implementation process of the legislation which resulted in the establishment of two pilot multipurpose service centers for Nebraska displaced homemakers. On February 27, 1980, the lawmakers of Nebraska passed legislation supporting the continuation of the displaced homemaker program. We are proud of the foresight shown by our Legislators who continue to recognize the plight of the "displaced homemaker."

We are now asking the members of the Finance Subcommittee on Taxation and Debt Management to use this same kind of "foresight" concerning the "plight" of the displaced homemaker by supporting S. 464 which amends the Internal Revenue Code of 1954 to expand the category of targeted groups for whom the new employee credit is available to include displaced homemakers.

Displaced homemakers are women with rusty or non-existent job skills who are forced back into the job market due to divorce or the death of a spouse. These women become the sole daily caretakers of their families and must assume financial responsibilities and commitments which either were formerly shared by both marital partners or were entirely provided by their spouses.

Displaced homemakers are triply handicapped in the job market.

(1) Recovering from one of life's greatest traumas: Life Adjustment Scale, a respected and often quoted study, shows that widowhood (100 stress points), divorce (75 stress points), and separation (65 stress points), are the three single most traumatic life events—the next highest, at 63, is going to jail. Other traumatic events, such as serious illness, loss of a job, and foreclosure of a mortgage or loan, rank significantly lower. This rating is true of both workers and non-workers.

Trying to start a career on top of this, along with major changes in role and financial status, is an enormous task. Employers are often very fearful of hiring such employees, at the same time that generating income quickly is often vital to the well-being of the woman and her family. Our studies and those of the U.S. Labor Department indicate that 40 to 50 percent of displaced homemakers in Nebraska fall immediately into poverty. According to the November, 1979 issue of Social Work Journal, less than half of those ordered in divorce court to pay child support (38 percent in a 1972 study), keep up the support payments for even one year and the percentage declines steadily with each succeeding year. A recent study in California, quoted in the same journal, found that average child support orders provided "significantly" less than one half of the actual costs of rearing a child.

By definition, displaced homemakers are over 40 years of age. This often means that because of their age they experience discrimination when attempting to enter the job market.

(2) Age: At an average age of 47 in Nebraska's Displaced Homemaker Programs, this group faces significant age barriers. They are still competing, often for entry level jobs, with a "baby boom" generation of young people, generally more highly educated than previous generations. Many find that young people with fewer family, home, and personal obligations are willing to work for less money than they can afford to accept. While more employers are recognizing the values of maturity, they worry about whether older workers will be flexible, and whether they will maintain attendance, unfamiliar with U.S. Labor Department findings that workers over 40 miss fewer work days. Some employers express reservations about higher pension and insurance costs. Mature workers are handicapped in seeking management or other jobs requiring long periods of training on the job because employers are unwilling to make the investment.

In assembly and other jobs in which performance is judged solely by speed, they are also handicapped because they learn and perform somewhat more slowly, though according to studies produce more accurately and consistently.

(3) Lack of recent experience and/or training: Many employers understandably prefer a "proven quantity" with recent experience; applicants who have proven themselves to other employers, are familiar with the latest technology or practice, and with work references they can check. The displaced homemaker lacks these entry tickets; often, her homemaking and volunteer experience are not recognized or counted. In fact, an Omaha, Nebraska, employer was quoted in the local paper last year as planning to interview a woman because she had the "guts" to claim homemaking as a work experience. Training, which can help bridge some of these gaps, is often impossible. Basic Educational Opportunity Grants are available, but who's going to be the breadwinner, homemaker, and possibly parent while the displaced homemaker carries a full school load? A quarter at a community college is often the most women can afford. CETA has very limited dollars to provide stipened training, and CETA regulations requiring that total family income for at least the past six months must be counted, disqualify many eligible persons from eligibility.

Rural displaced homemakers face other obstacles when trying to find employment. Lack of transportation, especially in these days of high gas prices, is doubly difficult in rural areas. Most rural areas do not have public transportation to help with this problem. And there's the old cycle of—you can't get a job without transportation, and you can't afford a car without a job. Small town morals and standards also have an effect on rural D-H'ers obtaining employment. These standards are usually more strictly attached to the woman than a man. These standards are another factor in making employment difficult to obtain.

The purpose of the Targeted Jobs Tax Credit is to provide an advantage to the labor market for those who have the most difficulty in finding employment. Work is a way for displaced homemakers to gain skills, training and experience needed to gain employment in the private sector.

Targeted Tax Credits seem an easy, inexpensive way to encourage employers to hire groups who historically have difficult finding employment. The paperwork is handled by existing systems—Job Services, CETA, Vocational Rehabilitation, and the Internal Revenue Service. Tax credits encourage on-the-job training, and move the hard to employ directly onto the tax-paying rolls. If an employee proves him or herself for one to two years, if is unlikely the employer will then release an employee; the credits are not so large as to encourage anyone to keep an unsatisfactory employee for the financial gain or marginal work production. Lastly, the program seems likely to be of the greatest help to small businesses, for which the credit would be more significant, thus enhancing other federal efforts.

The only drawback is that the bill will cover only CETA eligible displaced homemakers. While this is certainly a significant group, as noted, many displaced homemakers are artifically ineligible because of the six-month family income history. Sometimes a 12-month income history seems to apply. In considering this bill, we hope the committee may deal with this problem, either with a broader definition of the displaced homemaker or by looking into related CETA eligibility regulations which do not seem to take into account sudden changes in the marital status.

After thoughtful consideration of our remarks, we urge you to support S. 464 because we believe displaced homemakers should have equal access to the main stream of the job market and this Bill could provide greater opportunities for this to happen.

Submitted by: Nebraska Displaced Homemaker Centers, Grand Island, Omaha, Nebraska Commission on the Status of Women, Marge Hatheway, State Department of Education Liaison for Nebraska Displaced Homemaker Centers.

LINCOLN, NEBR., *March 5, 1980.*

MICHAEL STERN,
*Staff Director, Committee on Finance,*
*Washington, D.C.*

DEAR MR. STERN: I am a citizen who has been concerned about the welfare of fellow citizens for over 50 years. I am hoping you will become informed and concerned about Bill S. 464 concerning the Displaced Homemaker.

Because of your involment in Congressional legislation, you will find that support and helping the Displaced Homemaker a judicious economic decision. As a citizen, the bonus is the re-instatement of this Displaced Homemaker finding self-worth and again become a positive contributing member of society. This has been proven over and over by the volumes of testimony given at every level from grass roots to the halls of Congress. I trust that you will do your homework well and find the tremendous merits of this bill. I hope you will support it.

Sincerely yours,

MARIE KEHR.

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DELMARVA POULTRY INDUSTRY, INC.,
*Georgetown, Del., March 6, 1980.*

Re S. 2089.

Mr. MICHAEL STERN,
*Staff Director, Committee on Finance,*
*Washington, D.C.*

DEAR MR. STERN: Delmarva Poultry Industry, Inc. (DPI), Georgetown, Delaware is a non-profit organization whose primary function is to preserve, promote and encourage the progress of the poultry industry on the Delmarva Peninsula. Our membership consists of over 4,000 people and companies from all phases of the poultry industry and allied businesses, plus "main street" businessmen.

Section 314(b) of Public Law 95-60 entitled The Revenue Act of 1978 added a new Section, 48(p), to Subtitle A of the Internal Revenue Code. This new provision specifically qualifies the cost of "single purpose agricultural structures" for the investment tax credit. Section 48(p) IRC was made effective for all taxable years ending after August 15, 1971 to correspond such credit allowance with the Senate Finance Committee's intention as expressed in their report on the Revenue Act of 1971. As written, Section 48(p) of Internal Revenue Code has failed to treat all taxpayers alike in allowance of the credit. This is because Section 6511(a) of the Internal Revenue Code, which allows a taxpayer only a three year period to file an amended return for any year, does not permit taxpayers who made investment in such single purpose agricultural structures in calendar years 1971, 1972, 1973, and 1974 to file amended returns for those years to correctly claim the investment tax credit.

At present our membership has an estimated total investment in broiler and breeder houses in excess of $160,000,000. Many of our members are farmers who earn 100 percent of their income from the combination of crop and poultry farming. Like small farmers everywhere in the Country, our growers have been squeezed between their high cost of equipment, fuel and other operating expenses and the market forces which have kept prices relatively low. The addition of Section 48(p) into the law in The Revenue Act of 1978, while providing a tremendous economic benefit to the farmers as a whole, for which we are very grateful, has "short changed" the farmer who made his poultry house investment in either of the years 1971 through 1974. Our estimates are that $540,000 of income taxes could be recovered by farmers on the Delmarva peninsula by amending their returns for these years. We believe that in view of Congress' obvious intention (as written in the provision) to make the credit available to all farmers from August 1971 forward, Section 314 of The Revenue Act of 1978 should be amended to accomplish this result. An amendment, S. 2089, to correct this inequity has been introduced by Senators Roth, Talmadge and Helms. On behalf of our entire DPI membership, we respectfully request that S. 2089 be passed into law.

We appreciate the opportunity to express our views to the Senate Finance Subcommittee on Taxation and Debt Management regarding this matter that is so vitally important to many of our grower members.

Sincerely,

PAUL V TWINING, Jr., *President.*

STATEMENT BY THE SOUTHERN FOREST PRODUCTS ASSOCIATION, NEW ORLEANS, LA., IN SUPPORT OF S. 1901

The Southern Forest Products Association is an organization of forest products manufacturers with operations in Alabama, Arkansas, Florida, Georgia, Louisiana, Mississippi, North and South Carolina, Oklahoma, Tennessee, Texas and Virginia. SFPA member companies produce more than 60 percent of the eight billion board feet of Southern Pine lumber produced annually. They also manufacure large quantities of softwood plywood and pulpwood.

Southern output of forest products has increased substantially during the last 20 years and further escalation is forecast. The Forest Service of the U.S. Department of Agriculture has predicted that by the year 2000 the region will become the main source of lumber, plywood and pulpwood for the nation as a whole.

For the South to be able to meet this responsibility, substantial increases in timber growth and inventory will be needed, primarily on nonindustrial private forestland ownerships which represent 140 million acres or 73 percent of the region's 192 million acres of commercial forestland.

While immense in aggregate, the nonindustrial private holdings are individually small, with 2½ million separate owners. Although they provide two-thirds of the timber for softwood lumber and plywood production in the South and three-fourths of the raw material for pulpwood production, the net annual rate of tree growth on these holdings is less than half of potential. In fact, one million acres of pine forestland are being lost annually in this region due to failure of the owners to reforest after harvests.

Unless this unfavorabvle trend is initially checked and ultimately reversed, the inevitable and costly results will be timber shortages and adverse effects on the future availability and prices of lumber and plywood for housing.

The costs and risks involved in long-term forestry investments plus the uncertain, deferred nature of returns are the main deterrents to the practice of wise forest management by the millions of small landowners. To reverse this situation, incentives must be created and disincentives removed. Taxation is one of the main areas where improvement is needed.

This Association has been one of the prime movers in the long campaign to repeal the carryover basis rule of estate taxation. SFPA also supports the enactment by the Congress of reform of estate taxation, in general, and creation of investment taxation plus fast writeoff to encourage reforestation by small landowners.

Beyond that, the Association wholeheartedly supports S. 1901 and congratulates its sponsor, Senator Heflin, for a constructive effort to mitigate the risk factor.

As a general rule, at least 25 years elapses from the time of planting until the landowner realizes any appreciable return from a forestry investment. And at any time during that long interim, he is exposed to financial ruination from natural disasters such as fire, wind, insect and disease infestation not covered by commercial insurors.

Without insurance, his only other recourse to partially offset his losses and gain the wherewithall to replant his destroyed timber stand would be casualty loss deductions from his income tax. But, under current tax law, such a deduction is limited to the amount of his adjusted basis in the property. This means that if he bought the land and timber for $5,000 many years before the loss occurred, and even though his property has increased in value to $50,000 by the time of the loss, he could not deduct more than $5,000 for the casualty loss.

Senator Heflin's bill is designed to correct this inequity and thereby remove one of the worst disincentives to reforestation. Under his bill, for purposes of determining casualty loss deductions, the basis would be considered to be at least equal to the fair market value of the timber at the time the casualty was suffered.

While there are a number of ways in which the casualty loss problem can be addressed, the Heflin approach would do a great deal to relieve the impact of such losses on timber owners. The Association supports the thrust of the legislation and urges its favorable consideration by the Congress.

RESOURCE MANAGEMENT SERVICE, INC.,
*Birmingham, Ala., March 6, 1980.*

Re Senate bill 1901 by Senator Heflin

Mr. MICHAEL STERN,
*Staff Member, Senate Finance Committee,*
*Washington, D.C.*

DEAR MR. STERN: Our firm is a forestry consulting company where major clients are the private non-industrial landowners.

We would strongly urge the Senate Finance Committee to support Senator Howell Heflin's Bill S. 1901 which would allow forest landowners to declare natural disasters, such as the epidemic infestation of the Southern pine beetle, as a casualty loss.

As you are perhaps aware, the Southern pine beetle has reached epidemic proportions across the South resulting in huge losses of timber. As of date there are no available preventive measures from this loss.

Many of our landowners who have invested in the forest management and improvement of their lands over a couple of decades, now find the trees they have grown, and were ready for harvest, now dead. When they can sell the dead trees, they get less than 10 percent of its value before they died. Many times less than 5 percent of their original capital investment in planting and/or management.

As an example, a landowner in 1969 site prepared and planted 20 acres at a capital cost of $90 per acre, or a total investment of $1,800. The trees in 1980 would have grown to a value of $320 per acre, or a total of $6,400 for the 20 acres. The pine beetle "hit" and the only stumpage return he was able to get for the dead trees was less than $600.

Most certainly our government needs to provide for a landowner to be permitted to take a casualty loss from such a disastrous affect; to do otherwise will not only discourage private non-industrial landowners from stewardship of a basic national need of providing wood, but encourage them to sell their lands, and thereby lessening private non-industrial ownership. A situation unacceptable to our national interests.

Appreciating your consideration.

Very truly yours,

HARRY E. MURPHY, *Vice President.*

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CALIFORNIA GRAPE AND TREE FRUIT LEAGUE,
*Fresno, Calif., March 12, 1980.*

Senator ROBERT BYRD,
*Chairman, Subcommittee on Taxation and Debt Management Generally*
*Washington, D.C.*

DEAR SENATOR BYRD: The California Grape and Tree Fruit League is in support of the concept of providing tax relief to growers who suffer damage to orchards as a result of natural disasters. The League represents approximately 80% of the growers and shippers of fresh grapes and deciduous tree fruits grown in California and Arizona.

As has been noted in hearings on S. 1900, consideration of replacement costs of orchards is clearly warranted in addition to reimbursement for the value of the crop on the trees.

It is the position of the League that an amendment to Senator Heflin's bill is necessary, however. This tax relief consideration should be extended to growers of all perennial crops—particularly including vineyards in addition to orchards.

The capital inputs for establishing a vineyard are unique and costly. For example, consider the materials required for setting up the vineyard's trellis system, including stakes, end posts, wire, cross arms, braces, and staples. The cost of these materials, coupled with other needed inputs, over the three year period it takes before a vineyard comes into production amounts to $3,215 per acre, according to University of California statistics.

In those cases in which an already established vineyard is devastated by natural disaster which requires removal of the vine, the grower also faces the loss of income from those vines over the three year start-up period. Based upon an average Thompson Seedless vineyard which produces 522 lugs (one lug=23 lbs.) of fresh grapes per acre, the loss in grower returns minus variable input costs is $2,939.22 per acre each year. (University of California figures, based on an average price of $6.60 per lug.)

Only two years ago, in December of 1977, a natural disaster in the form of a violent windstorm, slashed through the vineyards of the southern San Joaquin Valley of California. The winds whipped up the soil around the vines—in effect sandblasting many vineyards. The result was that numerous vines were rendered unproductive and had to be replaced by growers. Growers then faced a three-year wait before the vineyards would begin to produce a crop. Clearly the provision S. 1900 would have been helpful to those growers.

With the incorporation of this amendment, the California Grape & Tree Fruit League strongly supports S. 1900. We urge passage of this key measure.

Sincerely,

THOMAS J. HALE,
*Executive Vice-President.*

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## STATEMENT OF THE AMERICAN BANKERS ASSOCIATION

The American Bankers Association, a trade association composed of over 13,000 banks, 4,000 of which have fiduciary powers, is pleased to have the opportunity to submit this statement in connection with the hearings held on March 4, 1980. We would like to offer our comments on two issues under consideration by the subcommittee, the use of crop share leases as a basis for valuing farm estates and simplification of private foundation reporting requirements.

### S. 2201 AND S. 1859 USE OF CROP SHARE RENTALS TO VALUE FARMLAND

The American Bankers Association (ABA) supports S. 1859 and S. 2201, both of which would amend Section 2032A to specifically authorize the use of the average net share rentals derived from comparable land and determining the average gross cash rentals for use in the so-called farm valuation formula under Section 2032A(e)(7).

On September 10, 1979, the Internal Revenue Service amended its proposed regulations issues on July 19, 1978, to disallow the conversion of crop share leases into cash rentals in order to qualify for the farm valuation formula. While the Service may be technically correct in its interpretation of Section 2032A(e)(7), we are persuaded that the provisions may just as easily be given the opposite interpretation particularly when you consider that the IRS view is clearly contrary to the intent of Congress. The legislative history (General Explanation of the Tax Reform Act of 1976, Public Law 94-455, page 537) states that the purpose in enacting Section 2032A was not only to exclude valuation of real property based on the highest and best use, but also to eliminate speculative valuation of real property which do not bear a reasonable relation to its capacity.

Should the section not be amended as proposed by the bills you are now considering and the proposed IRS regulations become final and are subsequently upheld by the courts, then, in our view, the majority of farm valuation formula which basically eliminates the speculation aspects of farm valuations. The result will be the return to the usual method of valuing farm land under prior law which is based on comparable sales. Comparable sales valuations will generally include the speculative excesses which Congress intended to eliminate.

It might be asked why then do not the farm owners convert their leases from crop share arrangements to cash rent leases. The answer is very simple. Only leased land which is leased for crop shares will meet the business use test under Section 2032A(b)(2) of the law, which is essential in order to qualify for the special use valuation law in the first place. As a result, some farm owners are actually converting from cash rent leases to crop share leases and this will leave little land available which may be used to qualify for the farm valuation formula should the IRS position prevail. We therefore support enactment of S. 1859 or S. 2201 which amends section 2032A(e)(7) so as to correct the proposed interpretation by the IRS.

### H.R. 4746 SIMPLIFICATION OF PRIVATE FOUNDATION REPORTING REQUIREMENTS

Section 1 of H.R. 4746 amend Section 6033 relating to returns filed by exempt organizations. We support the efforts to simplify reporting requirements of private foundations, particularly the proposed combining of the Return of Private Foundation Exempt from Income Tax (Form 990-PF) and the Annual Report of Private Foundations (Form 990-AR) into a single return containing information currently requred on the separate forms. However, the extension of the requirement to file a Return of Organization Exempt from Income Tax (Form 990) to nonexempt charitable 4947(a)(1) trusts deemed to be public charities would be contrary to the basic

purpose of this Congressional review of simplifying reporting requirements. Nonexempt charitable trusts classified as public charities are currently only required to file a U.S. Fiduciary Income Tax Return (Form 1041) and to attach to the return a copy of the IRS determination letter stating that the trust is not a private foundation or that it qualified as a public charity. To impose a Fo-.i 990 reporting requirement on these trusts would greatly increase the reporting burden on fiduciaries. In order to carry out the purpose of the bill of greater public disclosure we recommend that the Form 1041 filing requirement be retained but that a fiduciary be required to attach to it a listing of the trust's assets and their market values as of the beginning and/or end of the trust's taxable year and that this information be made available to the public or to state officials.

Sine Section 1 of H.R. 4746 deals with simplifying the reporting requirements of charitable trusts, we would like to suggest that reporting simplification would be in order for Section 664 charitable remainder trusts. Today charitable remainder annuity trusts and charitable remainder unitrusts are required to file a Form 101-B, a Form 5227, and a Form 10410A. A review of the information in these three forms would show that the necessary reporting could best be achieved by combining Form 1041-A. A review of the information in these three forms would show that the necessary reporting could best be achieved by combining Form 1041-B and Form 5227 into a single return incorporating the information of the two separate forms, and by eliminating Form 1041-A since the information requested is either duplicative or not relevant.

We thank the Subcommittee for the opportunity to comment on these proposals which are currently under consideration.

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STATEMENT OF JOHN J. STEPHENS, VICE PRESIDENT AND GROUP EXECUTIVE, WOOD PRODUCTS & RESOURCES GROUP, INTERNATIONAL PAPER CO.

International Paper Company strongly supports S. 1901 introduced by Senator Howell Heflin (D-Alabama), to change the tax code to adequately relieve the adverse financial impact of casualty losses to timber owners. The Company also endorses the statement of G. Robin Swift, Jr., who testified in support of this bill on behalf of the Forest Industries Committee on Timber Valuation and Taxation.

If our nation is to meet future softwood fiber demands, it is absolutely essential that current productivity levels on private forestlands be doubled. Today, we are nowhere close to reaching this goal—in fact, we are rapidly losing ground, since about fifty percent of the small forest tracts currently harvested are not being regenerated. And when a devastating hurricane destroys large portions of timberlands, the problem becomes even more acute.

For many years International Paper Company, through its Landowner Assistant Program, has worked closely with private non-industrial woodlands owners to encourage and assist them in managing their lands to meet their wood fiber productivity potential. In this activity, we have become acutely aware of the many disincentives facing all private landowners as they manage this long-term forest resource. Of all the risks facing the timber investment the most serious is the possibility the resource will be destroyed by hurricanes, fires, and ice storms. This risk is compounded by the fact commercial insurance on timber is not available. Hurricane Frederic, which devastated forests in Alabama and Mississippi, most of which were of prime, mature quality, carefully nurtured over many years, is only the most recent testimonial of this very serious concern. Federal tax policy provisions for such casualty losses are unrealistic and grossly inadequate. Under current law, casualty loss deductions for timber owners are generally limited to the adjusted basis of the property, which usually represents costs incurred in past years and which are much less than the true value of the resource to the owner. Under Senator Heflin's bill, the basis would be at least equal to the fair market value of the timber before the casualty loss. Thus his bill would allow a much more realistic tax deduction based on the true value of the resource.

A good example of the need for S. 1901 is seen from the losses sustained by International Paper Company because of Huricane Frederic.

International Paper sustained timber losses from the hurricane in excess of $28 million, based on the fair market value of the standing timber when the hurricane struck the Gulf Coast on September 12, 1980. The devastating winds did extensive damage to IP timber stands in Mississippi and Alabama. Only about 10 percent of the damaged timber was salvageable, with losses measured in excess of 700,000 cords.

Fair market value for the timber at the time of the hurricane was $40.00 a cord, for a total loss of about $28 million. Under present rules, tax write-offs for the

timber losses are based on the actual cost of the timber stands, and average of about $1.25 a cord or about $875,000 total.

Obviously, the difference is significant IP, and this example shows how current tax provisions are totally inadequate to cover these losses. Unfortunately, our experience can be seen again and again in the plight of hundreds of forestland owners who also had much of their timber investment destroyed.

For these reasons, International Paper urges the Congress to approve S. 1901.

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STATEMENT OF THE AGRICULTURAL COUNCIL OF CALIFORNIA

The Agricultural Council of California is a trade association representing 70 agricultural cooperatives consisting of 30,000 individual farmer members in California.

We strongly support the efforts of Senator Heflin in providing an equitable basis for casualty losses by nut and fruit farmers. Further, the Agricultural Council recommends the amendments to S. 1900 suggested by the California Grape and Tree Fruit League

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TESTIMONY OF THE NATIONAL BOARD, YWCA

The National Board of the YWCA appreciates the opportunity to present testimony to the Senate Finance Committee considering Senator Inouye's bill to add displaced homemakers to the list of groups targeted for employee credit under the Internal Revenue Code.

Our testimony is based upon the experiences of sixteen of our member associations from every part of the country, who operate successful programs of job counseling, skills training in non-traditional and traditional jobs, jobs referral and placement programs, and a variety of support services, including child care and crisis centers. These programs are either specifically for displaced homemakers or include sizeable numbers of displaced homemakers.

Some general comments made by many of the directors of these programs document the special needs of women in this category.

"Such women face three crises: the sense of grief and loss, the change of status and role, and sudden poverty."

"Though they need six months to begin to adjust and make a new life for themselves, they have maybe ten days to find a job."

"Age limits in on-the-job training really hurt these women."

"They come to the YWCA because they have no resources."

"Younger women can work for less money—employers don't realize that though an older woman may take longer to learn a skill, in the end she is more accurate and more likely to remain on the job longer."

"The rural displaced homemaker lacks transportation. If she has no car she can't get a job and because she has no job she can't get a car."

"Salaries here are very low for women; they're employed at the minimum wage. But displaced homemakers often have children and can't support them on the minimum wage."

"It's actually easier to place women with fewer skills than women with professional training—they're told they're overqualified."

"Employers need help in translating homemakers' skills into marketable skills. Homemakers need help in resume writing and role-playing for job interviews."

"Their lack of recent experience and work recommendations make it hard for employers to see how they can use displaced homemakers."

"Counselors in the public employment agency are not sensitive to the needs or skills of displaced homemakers."

"When part of the settlement is the house, that provides no income. But the house settlement may mean the woman isn't eligible for CETA training."

Where job markets are tight and unemployment is high, displaced homemakers are at an even greater disadvantage. This was emphasized especially by our Associations in Hartford, Conn., Missoula, Mont., Dallas, Tex., and Nampa, Idaho.

One strong concern of the YWCA is for women of color. Where racial and ethnic breakdowns were available, we sought to ascertain whether our programs were serving women of diverse backgrounds. In Hartford, where racial breakdowns are not yet completed, 10 percent are Hispanic. In Nashville, Tenn., out of 137 women, 44 are Black and one is American Indian. In Waterloo, Iowa, out of 34 women, one is Black, one American Indian, one Hawaiian, and 31 white. In Missoula, Mont., of 500 women served, 10 percent are American Indian. In Billings, Mont., of 175

women served, 11 percent are minority women; Chicano, American Indian, and Black. The Billings Association also has an outreach program to two reservations in the area. In Boston, out of 67 women, 4 are Black. In Dallas, of 1000 women served in 18 months, 5 percent have been Chicano and American Indian and 35–40 percent Black. In Oahu, Hawaii, in the last group of 19 women, 7 were white, one Black, one American Indian, 2 Japanese, one Samoan, 3 Filipino, and 4 Hawaiian.

The opinions of the directors of these programs on the probable advantage of a tax credit to employers of displaced homemakers were very favorable. They felt that displaced homemakers were seen as such an employment risk that this credit would help them. All seemed to feel it would give the plight of these women visibility and help employers begin to be sensitive to their needs and alert to the advantages of hiring them. One said, "It would be such a help to be able to say to employers, 'Here's another benefit.' "

The Director of the Hartford YWCA program, New Jobs for Women, felt that if the credit were substantial enough it would make a very real difference. Hartford's experience has been that it is better to place women in larger industries because these can subsidize the needed job training. Hartford feels it is very important for displaced homemakers to get into entry-level machinist jobs since these pay from $5 to $7 per hour.

The Director of the Nashville YWCA Displaced Homemakers Program was particularly strongly in favor of such tax credits. The Nashville program tries to get women placed in smaller companies because they feel such companies maximize the skills and utilize the abilities of individuals more flexibly. Tax credits may be more appreciated, she feels, by smaller firms.

The Director of the Displaced Homemakers Program at the YWCA of Waterloo, Iowa, felt that tax credits might encourage on-the-job training, a special need for displaced homemakers. The goal of the Waterloo program is to establish a job bank.

The Coordinator of the Displaced Homemakers Program at the YWCA of Omaha stated her belief that the least costly way to make employers aware of displaced homemakers in a variety of job areas would be by offering them tax credits. The Omaha and Grand Island, Nebraska, YWCAs are cooperating with the Nebraska Commission on the Status of Women and the Nebraska Department of Education in presenting testimony on behalf of this bill.

The Director of Women in Transition Programs under Title IIB for Classroom Training at the YWCA in Glendale, California, and the Director of the YWCA-sponsored Women's Center in Billings, Montana, believe that tax credits would be an inducement to employers and would give needed publicity to the plight of displaced homemakers. The Executive Director of the YWCA at Ft. Smith, Arkansas, says that in that low income area tax credits would help to get displaced homemakers into jobs paying more than the minimum wage.

The Coordinator of the Displaced Homemakers Program at the YWCA of Grand Island, Nebraska, believes that the tax credit would be an easy, inexpensive way for small businesses to open the door to displaced homemakers. She pointed out that no additional government employees would be needed to apply the credits, since these would be applied on forms already being used by employers and processed by the government.

A tax credit would be a bargaining point to use in getting displaced homemakers into jobs, in the opinion of the Coordinator of Second Wind, the Boston YWCA's program for Displaced Homemakers. She had attended a meeting at which several personnel directors indicated they are taking existing tax credits.

A staff member at the YWCA Women's Resource Center in Dallas explains that the YWCA tries to place several displaced homemakers at a time with a given employer. One woman alone may feel an almost overwhelming sense that it is up to her to see that the employer has a positive experience with displaced homemakers. In their approach to employers, the YWCA could stress the availability of tax credits to advantage, she believes.

Statistics given by the Director of the new CETA-funded Displaced Homemakers Program at the YWCA of Nampa, Idaho, should bring home to us all how many women are affected. Thirteen thousand marriage licenses were issued in Idaho in 1978. There were 6000 divorces in Idaho that year. By conservative estimates, there are 10,000 displaced homemakers in Idaho alone, of whom 8000 are over forty. The National Board of the YWCA and its member Associations are acutely aware of the needs of these women, their numbers many times mulitplied across the country. We hope that Senator Inouye's bill will be passed in this Congress.

The National Board of the YWCA thanks you for this opportunity to recount a few of the experiences of some of our many Associations who are working hard to

meet those needs programmatically and by serving as advocates for displaced homemakers in the formation of public policy.

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OMAHA CHURCH WOMEN UNITED,
*Omaha, Nebr., March 11, 1980.*

MICHAEL STERN,
*Staff Director, Committee on Finance,*
*Washington, D.C.*

DEAR SIR: The Executive Committee of Omaha Church Women United, speaking for the organization (since no general meeting will be held before the deadline date for your committee records), endorses S.464 to amend existing tax credit legislation to include displaced homemakers.

Omaha Church Women United is an organization representing 92 churches of various denominations (Protestant, Roman Catholic and Orthodox) and was instrumental in helping to get displaced homemaker legislation extended in Nebraska recently.

We trust that our action will merit your consideration.

Yours very truly,

ELEANOR M. KELLOGG, *Secretary.*

NATIONAL TIRE DEALERS & RETREADERS ASSOCIATION, INC.
1343 L Street N.W. Washington, D.C. 20005 Area Code (202) 638-6650

April 18, 1980

The Honorable Harry F. Byrd, Jr.
Chairman
Subcommittee on Taxation and Debt Management Generally
Committee on Finance
United States Senate
Washington, D. C. 20510

Dear Senator Byrd and Subcommittee members:

The National Tire Dealers and Retreaders Association, Inc. ("NTDRA") submits the following comments in support of section 9 of H.R. 5505, currently pending in the Subcommittee on Taxation and Debt Management Generally, intended to correct what we believe to be inequities inadvertently imposed on retreaders by the Highway Revenue Act of 1956. The NTDRA is a national nonprofit trade association representing nearly 5,000 independent tire dealers and retreaders located in 50 states who are engaged in the wholesale and retail distribution of automobile and truck tires, the retreading of tires, and the sale of related products and services.

This legislation addresses the several instances under current law where a manufacturers' excise tax is imposed on tread rubber when, in a similar situation, the manufacturers' excise tax is not imposed (or a credit or refund of the tax is allowed) for the tax on new tires. It provides for tax credits or refunds of the manufacturers' excise tax on tread rubber where tax-paid tread rubber is wasted in the retreading process, used in the retreading of tires which are exported, sold to state or local governments, sold to nonprofit educational institutions, or sold as supplies for vessels or aircraft. It also modifies the statute of limitations so that a credit or refund of the tread rubber can be obtained for a period of one year after the warranty or

guarantee adjustment is made.

NTDRA has long sought the passage of legislation to correct the inequities currently imposed on retreaders. There has been prior congressional action on similar legislation, but repeatedly last minute scheduling problems or unrelated amendments have prevented final adoption. During the 95th Congress the Committee on Ways and Means reported a bill, H.R. 5103, with similar provision (House Report 95-916). By a voice vote the House of Representatives passed this bill on March 14, 1978. Provisions of the bill were included in H.R. 3050, which the Senate Finance Committee reported to the Senate on October 5, 1978 (Senate Report 95-1278). The full Senate never acted upon these provisions of H.R. 3050. During the 94th Congress the Committee on Ways and Means reported a bill, H.R. 2474, with similar provisions (House Report 94-1334) By voice vote, the House of Representatives passed this bill on August 24, 1976. The Senate Finance Committee Reported the bill to the Senate on September 29, 1976 (Senate Report 94-1348), but the Senate did not act on it. On October 30, 1979, the House passed H.R. 4726, containing similar provisions. These provisions have been included in the Subcommittee on Taxation and Debt Management of the Senate Finance Committee. There have been to date no congressional debates or testimony in opposition to the provisions. In fact, the Treasury Department endorses section 9 of H.R. 5505.

The inequities in the treatment of tread rubber are due to the fact that the tax of 5 cents a pound is on the raw materials rather than on the finished product as it is in the case of new tires. The Internal Revenue Service has on numerous occasions ruled that losses due to waste in the retreading process can not be designated for refunds unless the law is changed. Rubber wasted in manufacturing new tires is not subject to tax because the tax is imposed when the tire is sold and only on the materials contained in the completed tire. The tax on tread rubber, however, is imposed before the recapping or retreading of a used tire. Thus the wastage of tread

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rubber in that process occurs after the tread rubber tax liability has been determined, and no refund or credit is permitted. A provision of the pending bill allows a credit or refund of the tread rubber tax when rubber is destroyed, scrapped, wasted, or rendered useless in the recapping or retreading process.

If the sale price of a retreaded tire is adjusted by reason of warranty or guarantee, there is at present no method for securing a credit or refund on the tax. While the consumer gets his tax back on a pro-rated basis applied to the replacement tire, the retreader gets no refund of the tax. A new tire returned for adjustment or guarantee yields refunds to the consumer, the dealer, and the manufacturer. Section 9 of H.R. 5505 stipulates that the overpayment would be the same proportion of the tax paid as the adjustment in the sales price of the retreaded tire to the immediate vendee by the tire retreader.

When a retreaded tire is now exported, sold to state and local governments, sold to nonprofit educational organizations, or used or sold as supplies for vessels or aircraft, there is no method for getting a credit or refund. Provisions of the pending legislation would give the manufacturer one year after the adjustment is made within which to file a claim for credit or refund of the relevant tax.

Under existing regulations, if a used tire which has been taxed in the United States is exported and retreaded (other than from bead to bead) abroad and the tire then shipped back into the United States it is subject of neither a tax on the imported retreaded tire nor on the tread rubber used in the retreading. Section 9 of H.R. 5505 would levy a tax on the tread rubber used on used tires which are exported from the United States, retreaded abroad, and then imported into the United States.

In the past few years there have been a significant number of cases where the Internal Revenue Service has investigated retreaders who have failed to pay tax on rubber which had been wasted in the retreading process, or who had taken a credit for the rubber used in tires sold to local governments or for retreaded tires adjusted

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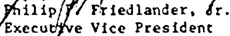
under a warranty or guarantee. In each case the Internal Revenue Service ruled against the retreader, placing the retreader in a financial bind. Some retreaders face a tax liability of as much as $25,000.00.

NTDRA supports the pending legislation which would correct all of these inequities and would make the application of the tread rubber tax more nearly equivalent to the application of the new tire tax. Also, NTDRA believes that the tax law should not created a competitive advantage for tires which are exported for retreading and then imported for sales in the United States. Existing inequities are due to the language of the original law. There was never an intent by Congress to penalize the retreader as far as this tax was concerned.

NTDRA has no objections to the Treasury's claim that Section 9 of H.R. 5505 contains one techincal error in that the statute of limitations for filing a refund claim ends one day less than one year after the warranty adjustment. The statute should be corrected to run for one year. NTDRA would support this correction.

Problems relative to the tread rubber tax have been ongoing for many years and have caused great difficulties and economic hardships for these small business people. NTDRA hopes that this Congress will understand their plight and finally move to correct these inequities. Attached for your information and inclusion in the official record of the hearings on H.R. 5505 is a copy of my statement on our legislative proposal submitted to the Ways and Means Committee on July 27, 1979.

Sincerely,



Philip F. Friedlander, Jr.
Executive Vice President

STATEMENT OF NATIONAL TIRE DEALERS AND RETREADERS ASSOCIATION

Before

HOUSE OF REPRESENTATIVES OF THE UNITED STATES

WAYS AND MEANS COMMITTEE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

on

H.R. 4726

July 27, 1979

My name is Philip P. Friedlander, Jr. Executive Vice President of the National Tire Dealers and Retreaders Association. NTDRA is a national nonprofit trade association representing nearly 5,000 independent tire dealers and retreaders located in fifty states who are engaged in the wholesale and retail distribution of automobile and truck tires, the retreading of tires and the sale of related products and services.

We appear here this morning to explain the need of H.R. 4726 for our retreading members.

This legislation deals with the several instances under current law where a manufacturers' excise tax is imposed on tread rubber, when in a similar situation the manufacturers' excise tax is not imposed (or a credit or refund of the tax is allowed) for the tax on new tires.

H.R. 4726 provides for credits or refunds of the manufacturers' excise tax on tread rubber where tax-paid tread rubber is (1) wasted in the retreading process, (2) used in the retreading of tires the sales of which are later adjusted under a warranty or guarantee, or (3) used in the retreading of tires which are exported, sold to state or local governments, sold to nonprofit educational institutions or sold as

supplies for vessels or aircraft. The bill also modifies the statute o limitations so that a credit or refund of the tread rubber can be obtained for a period of one year after the warranty or guarantee adjustment is made.

This Association has long sought the passage of legislation which would correct inequities we believe have been inadvertently imposed on retreaders by the Highway Revenue Act of 1956. In the past similar legislation to provide the relief from these inequities on the Tread Rubber Tax have passed the House and the Senate. Unfortunately, unrelated last minute amendments have prevented the final legislation from being adopted.

The inequities, according to the Internal Revenue Service, in the treadment of tread rubber have been caused by the fact that the tax of 5¢ a pound is on the raw material rather than on the finished product as it is in the case of new tires. The Internal Revenue Service states that there is nothing they can do to solve this problem without a chang in the law. IRS has ruled on numerous occasions that losses due to waste in the retreading process could not be designated for refunds. In the case of new tires, if a new tire is lost in production, the new tire is not subject to the Highway Excise Tax. However, if something happens to the tread rubber during processing where the retreaded tire can not be used, there is no method for recovering this loss. The tax liability on tread rubber is already created and no refund or credit is permitted.

Also in the case of tread rubber used in the retreading of tires, the sale of which is later adjusted under a guarantee or warranty, there is no method for securing a credit or refund on the tax. The consumer

gets his tax back on a pro-rated basis applied to the replacement tire but the retreader gets no refund on this tax. In the case of new tires, a tire returned for adjustment results in a refund being given to the consumer, the dealer, and the manufacturer. The inequity for the retreader is clear.

Third, when a retreaded tire is sold to state and local governments, there is no method of getting a credit or refund. If a new tire is sold to a state or local government an exemption is available. Since tread rubber is a raw material, and the taxed item, IRS says that the finished retreaded tire is neither taxable or exempt. Therefore, the retreader pays the manufacturer the excise tax on tread rubber but can not recover it from the state government nor can he get an exemption such as in the case of the new tire.

In the past few years, there have been a significant number of cases where the IRS has come in where the retreader unfortunately has been paying tax on rubber which has been wasted, has taken a reduction on the tax on returned, adjusted retreaded tires or has made some adjustment on his records for a tax credit relative to tires sold to a state. In every case, the IRS has disallowed this and the retreader has found himself in a financial bind. We have retreaders who have had a tax liability of as much as $25,000.

This legislation would correct all of these inequities. These inequities occurred because of the language of the original law, although there was never an intent by Congress to penalize the retreader as far as this tax was concerned.

The problems relative to the tread rubber tax have been going on for a number of years, and have caused great difficulty for these small business people. We hope this Congress will understand their plight and finally move to correct these inequities.

APPENDIX

Answers to Five Questions Submitted to Mr. Gutman and Mr. Jordan by Senator Gravel

OFFICE OF THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

MAY 19 1980

Dear Senator Gravel:

This is in response to your letter to Senator Byrd transmitting questions for the record relating to my March 4 testimony on S. 1194, a bill that would exempt certain crew members of fishing vessels from coverage under the Federal Unemployment Tax Act (FUTA). Following are the five questions you submitted and our responses. Since your questions concern the operation of the federal and state unemployment programs, we have consulted with the Department of Labor in preparing our responses.

1. Question. If employers are not required to make FUTA contributions on fishermen under the provisions of S. 1194, would these fishermen be precluded from collecting unemployment in the off season?

Answer. Probably. Under the employment insurance program, benefits are payable only if an individual works in employment covered by a State unemployment compensation law. If the FUTA is amended to exclude from coverage services performed by these individuals, and if the States amend their laws in a comparable fashion, which is most likely, then these crew members would be precluded from collecting unemployment benefits based on their service.

2. Question. If non-covered employee fishermen are ineligible for unemployment compensation, what will they do for basic income in the off season?

Answer. Presumably, these crew members would have to obtain other work during the off season, save during the season to last during the off season or find some other source of public funds to fill the gap between seasons.

3. Question. Under this bill would employers have the option of paying FUTA on their employees if they so desired?

Answer. No. Employers cannot elect to pay Federal unemployment tax on wages of workers in employment excluded from coverage. However, the critical issue to crew

members is not whether their employers are covered under the Federal law, but whether their services remain covered under the State unemployment compensation law. When FUTA coverage of certain employment is removed, the usual reaction of the States is to amend the State statutes to exclude State coverage of such employment. Even if a State does amend its law to exclude the services of the crew members, the employer may voluntarily elect coverage of those services under the State's unemployment insurance law, with the approval of the State employment security agency. In previous situations involving exclusion of employment from unemployment insurance coverage, however, the typical experience has been that employers do not voluntarily elect to obtain coverage for excluded employment.

4. Question. Is there any way in which employees could commit to pay their own FUTA (as they do estimated tax payments) if the boat owner chooses not to pay FUTA?

Answer. No. The Federal and State statutory provisions under which the Federal-State unemployment compensation program operates permit unemployment tax payments only by employers.

5. Question: If Congress enacts this bill, how could we best ensure that fishermen whose employers choose not to pay FUTA are covered in the event of their unemployment?

Answer. If this bill is enacted and excludes from the FUTA services performed by crew members of certain fishing vessels, it cannot be ensured that services performed by those crew members will be covered in the event of their unemployment.

The only possible method for ensuring that such crew members' services are covered would entail excluding such employment from the Federal unemployment tax while mandating coverage of such employment under State unemployment compensation laws. This has been done before, but only in certain special situations. Under the FUTA, organizations that are charitable or educational in nature and exempt from tax under section 501(c)(3) of the Internal Revenue Code and State and local governments are excluded from the Federal unemployment tax, but their employees are required to be covered by State unemployment compensation laws.

Congress chose to adopt this method of coverage of State and local government employees and employees of some tax-exempt organizations in order to leave intact the tax-exempt status of these entities and at the same time ensure protection for their employees against wage loss resulting from unemployment. These reasons could not be used to justify such coverage of crew members employed by owners of fishing vessels engaged in profitmaking businesses.

Please let me know if you have any further questions.

Sincerely yours,

(S) Harry L. Gutman

Harry L. Gutman
Deputy Tax Legislative Counsel

The Honorable
Mike Gravel
United States Senate
Washington, D.C. 20510

cc: The Honorable
Harry F. Byrd, Jr.
Chairman
Subcommittee on Taxation and Debt
Management Generally.

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March 17, 1980

Honorable Harry F. Byrd, Jr.
Chairman
Subcommittee on Taxation and Debt Management Generally
Committee on Finance
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

I testified recently on behalf of Senate Bill S.1194, introduced by Senator Heflin of Alabama. I was requested by an aide on your Committee to respond to five questions presented to you by Senator Mike Gravel. I am enclosing a copy of this letter for your reference.

Question 1. Under S.1194, self-employed fishermen would be precluded from collecting unemployment in the off season, as would any other self-employed individual be prohibited from collecting unemployment benefits.

Question 2. Under S.1194 crew members would become self-employed fishermen. In our area, crew members work primarily the entire year. There is very little off season, except for a certain period of January, February and March. The individuals, however, during the nine to ten months for which they have worked full time, earn between $20,000 and $35,000. These are basically unskilled individuals who most likely would not be capable of earning one-half that much in some other occupation. Therefore, the earnings for this period of active work should be adequate to accomodate them during the somewhat limited off season.

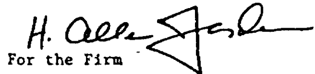
Question 3. Under S.1194, as it is presently written, employers would not have the option of paying FUTA on behalf of their self-employed workers.

Question 4. Under S.1194, as it is presently written, self-employed individuals would not have the option of paying their own FUTA. No other self-employed individuals at present have this option either.

Question 5. If Congress enacts this Bill, crew members would become self-employed individuals. They are working for themselves and not for any employer. In the event of their unemployment, they should not come under any FUTA requirements and are not eligible to receive any unemployment benefits. Boat owners should not be required to pay employment taxes on behalf of self-employed individuals.

I trust I have satisfactorily answered Senator Gravel's questions. It was certainly a pleasure to have appeared before your Committee. If I can be of any further assistance in regard to this matter, please do not hesitate to contact me.

Sincerely,



For the Firm

HAJ:mh
Enclosure:
As Noted

cc: Senator Howell Heflin
Congressman Jack Edwards

United States Senate
COMMITTEE ON FINANCE
WASHINGTON, D.C. 20510

March 4, 1980

Honorable Harry F. Byrd, Jr.
Chairman
Subcommittee on Taxation and Debt Management Generally
Committee on Finance
United States Senate
Washington, D.C.

Dear Mr. Chairman:

The fishing industry is a very significant part of the economy of Alaska. As a form of employment that is generally part-time in nature, I am curious as to the effect that S.1194 might have on crew members who often work as fishermen during the season and draw FUTA benefits in the off months. I would appreciate it if you would submit the follwoing questions to the Treasury Dept. and the proponents of S.1194 in order that they might be answered in writing for the record.

1. If employers are not required to make FUTA contributions on fishermen under the provisions of S.1194, would these fishermen be precluded from collecting unemployment in the off season?

2. If non-covered employee fishermen are ineligible for unemployment compensation what will they do for basic income in the off season?

3. Under this bill would employers have the option of paying FUTA on their employees if they so desired?

4. Is there any way in which employees could commit to pay their own FUTA (as they do estimated tax payments) if the boat owner chooses not to pay FUTA?

5. If Congress enacts this bill how could we best ensure that fishermen whose employers choose not to pay FUTA are covered in the event of their unemployment?

Thank you very much for your consideration in this matter.

Sincerely yours,

Mike Gravel