# MISCELLANEOUS TAX BILLS VII

# HEARING

BEFORE THE

## SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

## COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-SIXTH CONGRESS

SECOND SESSION

ON

## S. 2484, S. 2486, S. 2500, S. 2503, S. 2548, H.R. 5043

MAY 30, 1980

Printed for the use of the Committee on Finance

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# MISCELLANEOUS TAX BILLS VII

FRIDAY, MAY 30, 1980

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

The committee met, pursuant to notice, at 9 a.m. in room 221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the subcommittee) presiding.

Present: Senators Byrd, Bradley, Packwood, and Dole.

[The press release announcing this hearing and the bills S. 2484, S. 2486, S. 2500, S. 2503, S. 2548, H.R. 5043 and description of these bills follow:]

P.R. #H-25

# PRESS RELEASE

FOR IMMEDIATE RELEASE
May 12,1980

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 a hearing on Friday, May, 30, 1980 on miscellaneous tax bills.

The hearing will begin at 9:00 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. Revenue estimates will be available at the time of the hearing.

S. 2484 -- Introduced by Senators Riegle and Levin. Would provide that certain foreign losses would not be subject to the loss recapture rules of the Tax Reform Act of 1976. A principal beneficiary of this bill is the Sealed Tower Company of Muskegon, Michigan.

S. 2486 -- Introduced by Senators Culver, McGovern and Baucus. Would exempt from taxation the interest earned on industrial development bonds if the proceeds are used to provide financing for railroad rehabilitation.

S. 2500 -- Introduced by Senators Moynihan, Javits, and Heinz. Would provide an investment tax credit for theatrical productions.

S. 2503 -- Introduced by Senator Kassebaum. Would provide for a refundable tax credit based on certain interest paid on loans for agricultural operations.

S. 2548 -- Introduced by Senator Stone. Would amend the substantial user rules for industrial development bonds if the proceeds are used for wharf improvements. A principal beneficiary of the bill is the Tampa Port Authority in Florida.

H.R. 5043 -- Bankruptcy Tax Bill of 1980. Provides Federal Income Tax Rules for bankruptcy with particular emphasis on bankruptcy reorganizations and bankrupt estates.

Witnesses who desire to testify at the hearing must submit a written request, including a mailing address and phone number, 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 May 21, 1980.

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

Witnesses scheduled to testify should comply with the following rules:

(1) A copy of the statement must be filed by noon 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, June 20, 1980.

P.R. #H-25

96TH CONGRESS
2D SESSION

# S. 2484

Providing that certain foreign losses which were economically incurred before December 31, 1975, will not be subject to the loss recapture rules of the Tax Reform Act of 1976.

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IN THE SENATE OF THE UNITED STATES

MARCH 27 (legislative day, JANUARY 3), 1980

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

---

# A BILL

Providing that certain foreign losses which were economically incurred before December 31, 1975, will not be subject to the loss recapture rules of the Tax Reform Act of 1976.

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 (3) of section 1032(c) of the Tax Reform
4 Act of 1976 (relating to effective dates for foreign loss recap-
5 ture provisions) is amended by adding at the end thereof the
6 following new sentence: "If substantially all of the employees
7 of a corporation in which the taxpayer owned at least 10
8 percent of the voting stock are discharged before April 15,

1 1977, then the preceding sentence shall be applied with re-
2 spect to losses incurred by the taxpayer from stock and in-
3 debtedness of such corporation by substituting 'January 1,
4 1979' for 'January 1, 1977'".
5 (b) The amendment made by subsection (a) shall take
6 effect on October 4, 1976.

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96TH CONGRESS
2D SESSION

# S. 2486

To amend the Internal Revenue Code of 1954 to exclude from taxation interest earned on obligations substantially all of the proceeds of which are used to provide financing for railroad rehabilitation.

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IN THE SENATE OF THE UNITED STATES

MARCH 27 (legislative day, JANUARY 3), 1980

Mr. CULVER (for himself, Mr. MCGOVERN, and Mr. BAUCUS) 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 from taxation interest earned on obligations substantially all of the proceeds of which are used to provide financing for railroad rehabilitation.

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 103 of the Internal Revenue
4 Code of 1954 (relating to industrial development bonds) is
5 amended by redesignating paragraph (9) as paragraph (10)
6 and by inserting after paragraph (8) the following new
7 paragraph:

1 "(9) RAILROAD REHABILITATION.—Paragraph
2 (1) shall not apply to any obligation which is part of an
3 issue substantially all of the proceeds of which are
4 used to provide financing for—
5 "(A) railroad rehabilitation, including the ac-
6 quisition, construction, reconstruction, or erection
7 of any roadbed, track, trestle, depot, switching
8 and signaling equipment, or any related equip-
9 ment, but not including rolling stock, or
10 "(B) acquisition of land or rights-of-way in
11 connection with railroad rehabilitation.".
12 (b) Paragraph (10) of section 103(b) of such Code (relat-
13 ing to exceptions), as redesignated by subsection (a), is
14 amended by striking out "and (7)" and inserting in lieu there-
15 of "(7), and (9)".
16 SEC. 2. The amendments made by the first section of
17 this Act shall apply to obligations issued after September 30,
18 1980.

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96TH CONGRESS
2D SESSION

# S. 2500

To amend the Internal Revenue Code of 1954 to provide for an investment tax credit for theatrical productions.

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IN THE SENATE OF THE UNITED STATES

MARCH 28 (legislative day, JANUARY 3), 1980

Mr. MOYNIHAN (for himself, Mr. JAVITS, and Mr. HEINZ) 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 for an investment tax credit for theatrical productions.

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.**
4 This Act may be cited as the "Theatrical Production
5 Investment Tax Credit Act of 1980".
6 **SEC. 2. INVESTMENT TAX CREDIT FOR THEATRICAL PRODUC-**
7 **TIONS.**
8 (a) THEATRICAL PRODUCTIONS TREATED AS "SEC-
9 TION 38 PROPERTY".—Section 48 of the Internal Revenue

1 Code of 1954 (relating to the definition of "section 38 prop-
2 erty") is amended by adding at the end of subsection (a) the
3 following new paragraph:
4 "(11) THEATRICAL PRODUCTIONS.—
5 "(A) IN GENERAL.—The term 'section 38
6 property' includes theatrical productions.
7 "(B) THEATRICAL PRODUCTION DEFINED.—
8 For purposes of this subpart, a 'theatrical produc-
9 tion' is a presentation of a dramatic work, like a
10 play, musical, opera, or ballet, in a commerical
11 theater before a live audience. It is not, however,
12 a presentation primarily for use on television or
13 radio, or in a night club or film.".
14 (b) SPECIAL RULES FOR THEATRICAL PRODUC-
15 TIONS.—Section 48 of such Code is amended by redesignat-
16 ing subsection (q) as subsection (r) and by inserting immedi-
17 ately after subsection (p) the following new subsection:
18 "(q) THEATRICAL PRODUCTIONS.—
19 "(1) ENTITLEMENT TO CREDIT.—
20 "(A) IN GENERAL.—A credit shall be al-
21 lowed under section 38 to a taxpayer for the costs
22 of a theatrical production, but only to the extent
23 that the taxpayer has an ownership interest in it.
24 "(B) OWNERSHIP INTEREST DEFINED.—A
25 taxpayer's 'ownership interest' shall be deter-

1 mined on the basis of his proportionate share of
2 any loss that may be incurred with respect to the
3 theatrical production.
4 "(2) PROPORTION OF INVESTMENT QUALIFYING
5 FOR THE CREDIT.—For purposes of theatrical produc-
6 tions, the term 'qualified investment' in section 46(a)(2)
7 means, for each theatrical production placed in service
8 by the taxpayer during the taxable year, an amount
9 equal to 66⅔ percent of the qualified United States
10 production costs.
11 "(3) PREDOMINANT USE TEST.—Section 48(a)(2)
12 shall not apply to theatrical productions.
13 "(4) QUALIFIED UNITED STATES PRODUCTION
14 COSTS.—
15 "(A) IN GENERAL.—For purposes of this
16 subsection, the term 'qualified United States pro-
17 duction costs' means with respect to any theatri-
18 cal production—
19 "(i) direct production costs allocable to
20 the United States, plus
21 "(ii) if 80 percent or more of the direct
22 production costs are allocable to the United
23 States, all other production costs other than
24 direct production costs allocable outside the
25 United States.

1 "(B) DIRECT PRODUCTION COSTS DE-
2 FINED.—'Direct production costs' are costs di-
3 rectly associated with the theatrical production,
4 like the cost of equipment and supplies, and com-
5 pensation (other than participations described in
6 (c)(iv) below) for services performed by actors,
7 production personnel, directors, and producers.
8 However, 'direct production costs' do not include
9 advertising and promotional expenses.
10 "(C) ALLOCATION OF DIRECT PRODUCTION
11 COSTS.—For purposes of this paragraph—
12 "(i) compensation for services performed
13 shall be allocated to the country in which the
14 services are performed, except that payments
15 to United States persons for services per-
16 formed outside the United States shall be al-
17 located to the United States. For purposes of
18 the preceding sentence, payments to an
19 electing small business corporation (within
20 the meaning of section 1371) or a partner-
21 ship shall be considered payments to a
22 United States person only to the extent that
23 such payments are included in the gross
24 income of a United States person other than

1 an electing small business corporation or
2 partnership.
3 "(ii) Amounts for equipment and sup-
4 plies shall be allocated to the country in
5 which, with respect to the theatrical produc-
6 tion, the predominant use occurs.
7 "(iii) All other items shall be allocated
8 under regulations prescribed by the Secre-
9 tary which are consistent with the allocation
10 principle set forth in clause (ii).
11 "(D) ALL OTHER PRODUCTION COSTS DE-
12 FINED.—For purposes of this paragraph, the term
13 'all other production costs' includes—
14 "(i) a reasonable allocation of general
15 overhead costs,
16 "(ii) the cost of the rights to present a
17 theatrical production (but not ancillary rights
18 such as rights for television, films, radio, or
19 night club presentations),
20 "(iii) residuals payable under contracts
21 with labor organizations, and
22 "(iv) participations payable as compen-
23 sation to actors, production personnel, direc-
24 tors, and producers.

1 But participations in all theatrical productions
2 produced by a taxpayer during a taxable year
3 shall be taken into account only to the extent of
4 the lesser of 25 percent of each such participation
5 or 12½ percent of the aggregate qualified United
6 States production costs (excluding costs described
7 in clauses (iii) and (iv) of this paragraph) for such
8 theatrical productions, taking into account, how-
9 ever, for both the 25-percent limit and the 12½-
10 percent limit no more than $1,000,000 in partici-
11 pations for any one individual for any one theatri-
12 cal production. For purposes of this paragraph
13 (other than clauses (iii) and (iv) and the preceding
14 sentence), costs shall be taken into account only if
15 they are capitalized.
16 "(5) UNITED STATES.—For purposes of this sub-
17 section, the term 'United States' includes possessions
18 of the United States.".

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96TH CONGRESS
2D SESSION

# S. 2503

To amend the Internal Revenue Code of 1954 to provide a refundable credit against income tax for certain interest on agricultural operating loans.

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IN THE SENATE OF THE UNITED STATES

APRIL 1 (legislative day, JANUARY 3), 1980

Mrs. KASSEBAUM 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 a refundable credit against income tax for certain interest on agricultural operating loans.

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) subpart A of part IV of subchapter A of chapter 1 of
4 the Internal Revenue Code of 1954 (relating to credits al-
5 lowed) is amended by inserting before section 45 the follow-
6 ing new section:

1 "SEC. 44F. QUALIFIED INTEREST ON AGRICULTURAL OPERAT-
2 ING LOANS.
3 "(a) IN GENERAL.—There shall be allowed as a credit
4 against the tax imposed by this chapter for the taxable year
5 an amount equal to the qualified interest paid or incurred by
6 the taxpayer during the taxable year on agricultural operat-
7 ing loans.
8 "(b) DEFINITION OF QUALIFIED INTEREST.—For pur-
9 poses of this section—
10 "(1) IN GENERAL.—The term 'qualified interest'
11 means the excess (if any) of—
12 "(A) the amount of interest paid or incurred
13 during the taxable year on an agricultural operat-
14 ing loan, over
15 "(B) the amount of such interest which
16 would have been paid or incurred if the annual
17 percentage rate of interest on such loan had been
18 equal to 12 percent.
19 "(2) LIMITATIONS ON INTEREST TAKEN INTO
20 ACCOUNT.—
21 "(A) AGGREGATE PRINCIPAL AMOUNT IN
22 EXCESS OF $25,000—If interest was paid or in-
23 curred by the taxpayer during the taxable year on
24 agricultural operating loans the aggregate original
25 principal amounts of which exceeded $25,000,
26 that portion of the interest attributable to such

3

1 excess, as determined under regulations prescribed
2 by the Secretary, shall not be taken into account
3 in determining the amount of the credit allowable
4 under subsection (a).

5 "(B) RATE OF INTEREST.—If the rate of in-
6 terest on an agricultural operating loan exceeds
7 the rate of interest which is 5 percent in excess of
8 the discount rate, including any surcharge there-
9 on, on 90-day commercial paper in effect at the
10 Federal Reserve bank in the Federal Reserve dis-
11 trict where the taxpayer resides, that portion of
12 the interest attributable to such excess rate shall
13 not be taken into account in determining the
14 amount of the credit allowable under subsection
15 (a).

16 "(C) INTEREST PAID TO RELATED
17 PERSON.—

18 "(i) IN GENERAL.—No credit shall be
19 allowable under subsection (a) in the case of
20 interest paid to a related person.

21 "(ii) RELATED PERSONS.—Persons
22 shall be treated as related to each other if
23 such persons would be treated as a single
24 employer under the regulations prescribed
25 under section 52(b).

1 "(c) OTHER DEFINITION AND SPECIAL RULES.—For
2 purposes of this section—
3 "(1) AGRICULTURAL OPERATING LOAN.—The
4 Term 'agricultural operating loan' means any loan—
5 "(A) The proceeds of which are to be used
6 for a purpose described in section 312 of the Con-
7 solidated Farm and Rural Development Act (7
8 U.S.C. 1942); and
9 "(B) the principal of which is required by the
10 terms of the loan to be repaid within 12 months.
11 "(2) CREDIT IN LIEU OF DEDUCTION.—No de-
12 duction shall be allowable under this chapter with re-
13 spect to any amount for which a credit is allowable
14 under subsection (a).
15 "(3) PASS THROUGH IN THE CASE OF SUB-
16 CHAPTER S CORPORATIONS, ETC.—Under regulations
17 prescribed by the Secretary, rules similar to the rules
18 of subsections (d) and (e) of section 52 shall apply.".
19 (b) Section 6401(b) of such Code (relating to amounts
20 treated as overpayment) is amended—
21 (1) by striking out "and 43 (relating to earned
22 income credit)," and inserting in lieu thereof "43 (re-
23 lating to qualified interest on agricultural operating
24 loan)," and

1 (2) by striking out "and 43" and inserting in lieu
2 thereof "43, and 44F".
3 (c) Subsection (e) of section 163 of such Code (relating
4 to interest deductions) is amended by adding at the end there-
5 of the following new paragraph:

**"(6) For disallowance of deduction for interest relating to agricultural operating loans, see section 44F(c)(2).**

6 (d) The table of sections for subpart A of part IV of
7 subchapter A of chapter 1 of such of such Code is amended
8 by inserting after the item relating to section 44E the follow-
9 ing new item:

"44F. Qualified interest on agricultural operating loans.".

10 (d) The amendments made by this section shall apply to
11 taxable years beginning after December 31, 1979.

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96TH CONGRESS
2D SESSION

# S. 2548

Relating to the application of section 103(b) of the Internal Revenue Code of 1954 to certain bonds for harbor improvements.

IN THE SENATE OF THE UNITED STATES

APRIL 3 (legislative day, JANUARY 3), 1980

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

# A BILL

Relating to the application of section 103(b) of the Internal Revenue Code of 1954 to certain bonds for harbor improvements.

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) for purposes of section 103(b) of the Internal Reve-
4 nue Code of 1954 (relating to industrial development bonds),
5 the use of the proceeds of any issue of obligations which meet
6 the requirements of subsection (b) to acquire and improve ex-
7 isting wharf facilities shall be treated as a use which meets
8 the requirements of paragraph (4)(D) of such section 103(b)

1 (without regard to whether the person from whom the facili-
2 ties were acquired, or a related person, is a substantial user
3 of such facilities before and after the issuance of such obliga-
4 tions).

5 (b) For purposes of subsection (a), an issue of obligations
6 meets the requirements of this subsection if—

7 (1) part of the proceeds of such issue are to be
8 used to make substantial improvements in the existing
9 wharf facilities to be acquired with such proceeds,

10 (2) there is reasonably expected to be more than
11 one substantial user of such existing wharf facilities
12 after the issuance of such obligations,

13 (3) at least one of the substantial users of such
14 existing wharf facilities after the issuance of such obli-
15 gations was not a substantial user of such facilities
16 before the issuance of such obligation (and was not a
17 related person to such a user),

18 (4) all facilities with respect to which financing is
19 provided from the proceeds of such issue are to be
20 owned by the issuer,

21 (5) the only interest in such facilities to be held by
22 any substantial user of such facilities (or related
23 person) is to be a lease executed after the issuance of
24 such obligations—

1 (A) which is for a period (including options to
2 renew) of not more than eighty years, and
3 (B) under which no lessee has an option to
4 purchase, and
5 (6) section 101 of Public Law 91–611 authorized
6 the initiation and partial accomplishment of a project
7 (described in House Document Numbered 91–401)
8 deepening the channel for the port in which such facili-
9 ties are located.
10 (c) For purposes of this section—
11 (1) The term "existing wharf facilities" means
12 any docks, wharves, or storage or training facilities di-
13 rectly related to any docks or wharves, the original use
14 of which began before the issuance of the obligations.
15 (2) The terms "substantial user" and "related
16 person" have the same meaning as when used in sec-
17 tion 103(b) of the Internal Revenue Code of 1954.

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96TH CONGRESS
2D SESSION

# H. R. 5043

IN THE SENATE OF THE UNITED STATES

MARCH 26 (legislative day, JANUARY 3), 1980
Read twice and referred to the Committee on Finance

# AN ACT

To amend the Internal Revenue Code of 1954 to provide for the tax treatment of bankruptcy, insolvency, and similar proceedings, 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; TABLE OF CONTENTS; AMENDMENT**
4 **OF 1954 CODE.**
5 (a) SHORT TITLE.—This Act may be cited as the
6 "Bankruptcy Tax Act of 1980".
7 (b) TABLE OF CONTENTS.—

Sec. 1. Short title; table of contents; amendment of 1954 Code.
Sec. 2. Tax treatment of discharge of indebtedness.
Sec. 3. Rules relating to title 11 cases for individuals.
Sec. 4. Corporate reorganization provisions.
Sec. 5. Miscellaneous corporate amendments.
Sec. 6. Changes in tax procedures.
Sec. 7. Effective dates.

8 (c) AMENDMENT OF 1954 CODE.—Except as otherwise
9 expressly provided, whenever in this Act an amendment or

1 repeal is expressed in terms of an amendment to, or repeal of,
2 a section or other provision, the reference shall be considered
3 to be made to a section or other provision of the Internal
4 Revenue Code of 1954.

5 **SEC. 2. TAX TREATMENT OF DISCHARGE OF INDEBTEDNESS.**

6 (a) AMENDMENT OF SECTION 108.—Section 108 (relat-
7 ing to discharge of indebtedness) is amended to read as
8 follows:

9 **"SEC. 108. INCOME FROM DISCHARGE OF INDEBTEDNESS.**

10 "(a) EXCLUSION FROM GROSS INCOME.—
11 "(1) IN GENERAL.—Gross income does not in-
12 clude any amount which (but for this subsection) would
13 be includible in gross income by reason of the dis-
14 charge (in whole or in part) of indebtedness of the tax-
15 payer if—
16 "(A) the discharge occurs in a title 11 case,
17 "(B) the discharge occurs when the taxpayer
18 is insolvent, or
19 "(C) the indebtedness discharged is qualified
20 business indebtedness.
21 "(2) COORDINATION OF EXCLUSIONS.—
22 "(A) TITLE 11 EXCLUSION TAKES PRECE-
23 DENCE.—Subparagraphs (B) and (C) of paragraph
24 (1) shall not apply to a discharge which occurs in
25 a title 11 case.
26 "(B) INSOLVENCY EXCLUSION TAKES PREC-

1 EDENCE OVER QUALIFIED BUSINESS EXCLU-
2 SION.—Subparagraph (C) of paragraph (1) shall
3 not apply to a discharge to the extent that the
4 taxpayer is insolvent.

5 "(3) INSOLVENCY EXCLUSION LIMITED TO
6 AMOUNT OF INSOLVENCY.—In the case of a discharge
7 to which paragraph (1)(B) applies, the amount excluded
8 under paragraph (1)(B) shall not exceed the amount by
9 which the taxpayer is insolvent.

10 "(b) REDUCTION OF TAX ATTRIBUTES IN TITLE 11
11 CASE OR INSOLVENCY.—

12 "(1) IN GENERAL.—The amount excluded from
13 gross income under subparagraph (A) or (B) of subsec-
14 tion (a)(1) shall be applied to reduce the tax attributes
15 of the taxpayer as provided in paragraph (2).

16 "(2) TAX ATTRIBUTES AFFECTED; ORDER OF
17 REDUCTION.—Except as provided in paragraph (5), the
18 reduction referred to in paragraph (1) shall be made in
19 the following tax attributes in the following order:

20 "(A) NOL.—Any net operating loss for the
21 taxable year of the discharge, and any net operat-
22 ing loss carryover to such taxable year.

23 "(B) CERTAIN CREDIT CARRYOVERS.—Any
24 carryover to or from the taxable year of the dis-
25 charge of an amount for purposes of determining
26 the amount of a credit allowable under—

1 "(i) section 38 (relating to investment in
2 certain depreciable property),
3 "(ii) section 40 (relating to expenses of
4 work incentive programs),
5 "(iii) section 44B (relating to credit for
6 employment of certain new employees), or
7 "(iv) section 44E (relating to alcohol
8 used as a fuel).
9 For purposes of clause (i), there shall not be taken
10 into account any portion of a carryover which is
11 attributable to the employee plan credit (within
12 the meaning of section 48(o)(3)).
13 "(C) CAPITAL LOSS CARRYOVERS.—Any
14 net capital loss for the taxable year of the dis-
15 charge, and any capital loss carryover to such
16 taxable year under section 1212.
17 "(D) BASIS REDUCTION.—
18 "(i) IN GENERAL.—The basis of the
19 property of the taxpayer.
20 "(ii) CROSS REFERENCE.—

**"For provisions for making the reduction described in clause (i), see section 1017.**

21 "(3) AMOUNT OF REDUCTION.—
22 "(A) IN GENERAL.—Except as provided in
23 subparagraph (B), the reductions described in

1 paragraph (2) shall be one dollar for each dollar
2 excluded by subsection (a).
3 "(B) CREDIT CARRYOVER REDUCTION.—The
4 reductions described in paragraph (2)(B) shall be
5 50 cents for each dollar excluded by subsection
6 (a).
7 "(4) ORDERING RULES.—
8 "(A) REDUCTIONS MADE AFTER DETERMI-
9 NATION OF TAX FOR YEAR.—The reductions de-
10 scribed in paragraph (2) shall be made after the
11 determination of the tax imposed by this chapter
12 for the taxable year of the discharge.
13 "(B) REDUCTIONS UNDER SUBPARAGRAPH
14 (A) OR (C) OF PARAGRAPH (2).—The reductions
15 described in subparagraph (A) or (C) of paragraph
16 (2) (as the case may be) shall be made first in the
17 loss for the taxable year of the discharge and then
18 in the carryovers to such taxable year in the
19 order of the taxable years from which each such
20 carryover arose.
21 "(C) REDUCTIONS UNDER SUBPARAGRAPH
22 (B) OF PARAGRAPH (2).—The reductions de-
23 scribed in subparagraph (B) of paragraph (2) shall
24 be made in the order in which carryovers are

1 taken into account under this chapter for the tax-
2 able year of the discharge.
3 "(5) ELECTION TO APPLY REDUCTION FIRST
4 AGAINST DEPRECIABLE PROPERTY.—
5 "(A) IN GENERAL.—The taxpayer may elect
6 to apply any portion of the reduction referred to
7 in paragraph (1) to the reduction under section
8 1017 of the basis of the depreciable property of
9 the taxpayer.
10 "(B) LIMITATION.—The amount to which an
11 election under subparagraph (A) applies shall not
12 exceed the aggregate adjusted bases of the depre-
13 ciable property held by the taxpayer as of the be-
14 ginning of the taxable year following the taxable
15 year in which the discharge occurs.
16 "(C) OTHER TAX ATTRIBUTES NOT RE-
17 DUCED.—Paragraph (2) shall not apply to any
18 amount to which an election under this paragraph
19 applies.
20 "(c) TAX TREATMENT OF DISCHARGE OF QUALIFIED
21 BUSINESS INDEBTEDNESS.—In the case of a discharge of
22 qualified business indebtedness—
23 "(1) BASIS REDUCTION.—
24 "(A) IN GENERAL.—The amount excluded
25 from gross income under subparagraph (C) of sub-

1 section (a)(1) shall be applied to reduce the basis
2 of depreciable property of the taxpayer.
3 "(B) CROSS REFERENCE.—

"For provisions for making the reduction described in subparagraph (A), see section 1017.

4 "(2) LIMITATION.—The amount excluded under
5 subparagraph (C) of subsection (a)(1) shall not exceed
6 the aggregate adjusted bases of the depreciable prop-
7 erty held by the taxpayer as of the beginning of the
8 taxable year following the taxable year in which the
9 discharge occurs (determined after any reductions
10 under subsection (b)).
11 "(d) MEANING OF TERMS; SPECIAL RULES RELATING
12 TO SUBSECTIONS (a), (b), AND (c).—
13 "(1) INDEBTEDNESS OF TAXPAYER.—For pur-
14 poses of this section, the term 'indebtedness of the tax-
15 payer' means any indebtedness—
16 "(A) for which the taxpayer is liable, or
17 "(B) subject to which the taxpayer holds
18 property.
19 "(2) TITLE 11 CASE.—For purposes of this sec-
20 tion, the term 'title 11 case' means a case under title
21 11 of the United States Code (relating to bankruptcy),
22 but only if the taxpayer is under the jurisdiction of the
23 court in such case and the discharge of indebtedness is

1 granted by the court or is pursuant to a plan approved
2 by the court.
3 "(3) INSOLVENT.—For purposes of this section,
4 the term 'insolvent' means the excess of liabilities over
5 the fair market value of assets. With respect to any
6 discharge, whether or not the taxpayer is insolvent,
7 and the amount by which the taxpayer is insolvent,
8 shall be determined on the basis of the taxpayer's
9 assets and liabilities immediately before the discharge.
10 "(4) QUALIFIED BUSINESS INDEBTEDNESS.—
11 Indebtedness of the taxpayer shall be treated as quali-
12 fied business indebtedness if (and only if)—
13 "(A) the indebtedness was incurred or
14 assumed—
15 "(i) by a corporation, or
16 "(ii) by an individual in connection with
17 property used in his trade or business, and
18 "(B) such taxpayer makes an election under
19 this paragraph with respect to such indebtedness.
20 "(5) SUBSECTIONS (a), (b), AND (c) TO BE AP-
21 PLIED AT PARTNER LEVEL.—In the case of a partner-
22 ship, subsections (a), (b), and (c) shall be applied at the
23 partner level.
24 "(6) REDUCTIONS OF TAX ATTRIBUTES IN TITLE
25 11 CASES OF INDIVIDUALS TO BE MADE BY

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1 ESTATE.—In any case under chapter 7 or 11 of title
2 11 of the United States Code to which section 1398
3 applies, for purposes of paragraphs (1) and (5) of sub-
4 section (b) the estate (and not the individual) shall be
5 treated as the taxpayer. The preceding sentence shall
6 not apply for purposes of applying section 1017 to
7 property transferred by the estate to the individual.
8 "(7) TIME FOR MAKING ELECTION, ETC.—
9 "(A) TIME.—An election under paragraph
10 (4) of this subsection or under paragraph (5) of
11 subsection (b) shall be made on the taxpayer's
12 return for the taxable year in which the discharge
13 occurs or at such other time as may be permitted
14 in regulations prescribed by the Secretary.
15 "(B) REVOCATION ONLY WITH CONSENT.—
16 An election referred to in subparagraph (A), once
17 made, may be revoked only with the consent of
18 the Secretary.
19 "(C) MANNER.—An election referred to in
20 subparagraph (A) shall be made in such manner
21 as the Secretary may by regulations prescribe.
22 "(8) CROSS REFERENCE.—

"For provision that no reduction is to be made in the basis of exempt property of an individual debtor, see section 1017(c)(1).

1 "(e) GENERAL RULES FOR DISCHARGE OF INDEBTED-
2 NESS (INCLUDING DISCHARGES NOT IN TITLE 11 CASES
3 OR INSOLVENCY).—For purposes of this title—
4 "(1) NO OTHER INSOLVENCY EXCEPTION.—
5 Except as otherwise provided in this section, there
6 shall be no insolvency exception from the general rule
7 that gross income includes income from the discharge
8 of indebtedness.
9 "(2) INCOME NOT REALIZED TO EXTENT OF
10 LOST DEDUCTIONS.—No income shall be realized from
11 the discharge of indebtedness to the extent that pay-
12 ment of the liability would have given rise to a
13 deduction.
14 "(3) ADJUSTMENTS FOR UNAMORTIZED PRE-
15 MIUM AND DISCOUNT.—The amount taken into ac-
16 count with respect to any discharge shall be properly
17 adjusted for unamortized premium and unamortized
18 discount with respect to the indebtedness discharged.
19 "(4) ACQUISITION OF INDEBTEDNESS BY PERSON
20 RELATED TO DEBTOR.—
21 "(A) TREATED AS ACQUISITION BY
22 DEBTOR.—For purposes of determining income of
23 the debtor from discharge of indebtedness, to the
24 extent provided in regulations prescribed by the

1 Secretary, the acquisition of outstanding indebted-
2 ness by a person bearing a relationship to the
3 debtor specified in section 267(b) or 707(b)(1)
4 from a person who does not bear such a relation-
5 ship to the debtor shall be treated as the acquisi-
6 tion of such indebtedness by the debtor.

7 "(B) MEMBERS OF FAMILY.—For purposes
8 of this paragraph, sections 267(b) and 707(b)(1)
9 shall be applied as if section 267(c)(4) provided
10 that the family of an individual consists of the in-
11 dividual's spouse, the individual's children, grand-
12 children, and parents, and any spouse of the indi-
13 vidual's children or grandchildren.

14 "(C) ENTITIES UNDER COMMON CONTROL
15 TREATED AS RELATED.—For purposes of this
16 paragraph, two entities which are treated as a
17 single employer under section 414(c) shall be
18 treated as bearing a relationship to each other
19 which is described in section 267(b).

20 "(5) PURCHASE-MONEY DEBT REDUCTION FOR
21 SOLVENT DEBTOR TREATED AS PRICE REDUCTION.—
22 If—

23 "(A) the debt of a purchaser of property to
24 the seller of such property which arose out of the
25 purchase of such property is reduced,

1 "(B) such reduction does not occur—
2 "(i) in a title 11 case, or
3 "(ii) when the purchaser is insolvent,
4 and
5 "(C) but for this paragraph, such reduction
6 would be treated as income to the purchaser from
7 the discharge of indebtedness,
8 then such reduction shall be treated as a purchase
9 price adjustment.
10 "(f) INDEBTEDNESS SATISFIED BY EQUITY INTER-
11 EST.—
12 "(1) CORPORATE RULE.—For purposes of deter-
13 mining income of the debtor from discharge of indebt-
14 edness—
15 "(A) STOCK-FOR-DEBT.—If a debtor corpo-
16 ration transfers its stock to a creditor in satisfac-
17 tion of its indebtedness, such corporation shall be
18 treated—
19 "(i) as not having transferred its stock,
20 but
21 "(ii) as having satisfied the indebtedness
22 with an amount of money equal to the fair
23 market value of the stock.
24 "(B) INDEBTEDNESS CONTRIBUTED TO CAP-
25 ITAL.—If a debtor corporation acquires its indebt-

1 edness from a shareholder as a contribution to
2 capital—
3 "(i) section 118 shall not apply, but
4 "(ii) such corporation shall be treated as
5 having satisfied the indebtedness with an
6 amount of money equal to the shareholder's
7 adjusted basis in the indebtedness.
8 "(C) EXCEPTION FOR CERTAIN SECURI-
9 TIES.—Subparagraph (A) shall not apply with re-
10 spect to an evidence of indebtedness—
11 "(i) which had interest coupons or was
12 in registered form on the later of—
13 "(I) the date on which issued in
14 connection with the incurring of the in-
15 debtedness, or
16 "(II) October 1, 1979, and
17 "(ii) which constitutes a security for
18 purposes of section 354.
19 The preceding sentence shall not apply to interest
20 which has accrued on the indebtedness.
21 "(D) STOCK OF PARENT CORPORATION.—
22 For purposes of this paragraph, stock of a corpo-
23 ration in control (within the meaning of section
24 368(c)) of the debtor corporation shall be treated
25 as stock of the debtor corporation.

1 "(E) TREATMENT OF SUCCESSOR CORPORA-
2 TION.—For purposes of this paragraph, the term
3 'debtor corporation' includes a successor
4 corporation.

5 "(2) PARTNERSHIP RULE.—Under regulations
6 prescribed by the Secretary, rules similar to subpara-
7 graphs (A), (B), (D), and (E) of paragraph (1) shall
8 apply with respect to the indebtedness of a
9 partnership."

10 (b) AMENDMENT OF SECTION 1017.—Section 1017 (re-
11 lating to discharge of indebtedness) is amended to read as
12 follows:

13 **"SEC. 1017. DISCHARGE OF INDEBTEDNESS.**

14 "(a) GENERAL RULE.—If—

15 "(1) an amount is excluded from gross income
16 under subsection (a) of section 108 (relating to dis-
17 charge of indebtedness), and

18 "(2) under subsection (b)(2)(D), (b)(5), or (c)(1)(A)
19 of section 108, any portion of such amount is to be ap-
20 plied to reduce basis,

21 then such portion shall be applied in reduction of the basis of
22 any property held by the taxpayer at the beginning of the
23 taxable year following the taxable year in which the dis-
24 charge occurs.

1 "(b) AMOUNT AND PROPERTIES DETERMINED UNDER
2 REGULATIONS.—
3 "(1) IN GENERAL.—The amount of reduction to
4 be applied under subsection (a) (not in excess of the
5 portion referred to in subsection (a)), and the particular
6 properties the bases of which are to be reduced, shall
7 be determined under regulations prescribed by the
8 Secretary.
9 "(2) LIMITATION IN TITLE 11 CASE OR INSOL-
10 VENCY.—In the case of a discharge to which subpara-
11 graph (A) or (B) of section 108(a)(1) applies, the reduc-
12 tion in basis under subsection (a) of this section shall
13 not exceed the excess of—
14 "(A) the aggregate of the bases of the prop-
15 erty held by the taxpayer immediately after the
16 discharge, over
17 "(B) the aggregate of the liabilities of the
18 taxpayer immediately after the discharge.
19 The preceding sentence shall not apply to any reduc-
20 tion in basis by reason of an election under section
21 108(b)(5).
22 "(3) CERTAIN REDUCTIONS MAY ONLY BE MADE
23 IN THE BASIS OF DEPRECIABLE PROPERTY.—
24 "(A) IN GENERAL.—Any amount which
25 under subsection (b)(5) or (c)(1)(A) of section 108

1 is to be applied to reduce basis shall be applied
2 only to reduce the basis of depreciable property
3 held by the taxpayer.
4 "(B) DEPRECIABLE PROPERTY.—For pur-
5 poses of this section, the term 'depreciable prop-
6 erty' means any property of a character subject to
7 the allowance for depreciation, but only if a basis
8 reduction under subsection (a) will reduce the
9 amount of depreciation or amortization which oth-
10 erwise would be allowable for the period immedi-
11 ately following such reduction.
12 "(C) SPECIAL RULE FOR PARTNERSHIP IN-
13 TERESTS.—Any interest of a partner in a part-
14 nership shall be treated as depreciable property to
15 the extent of such partner's proportionate interest
16 in the depreciable property held by such
17 partnership.
18 "(c) SPECIAL RULES.—
19 "(1) REDUCTION NOT TO BE MADE IN EXEMPT
20 PROPERTY.—In the case of an amount excluded from
21 gross income under section 108(a)(1)(A), no reduction
22 in basis shall be made under this section in the basis of
23 property which the debtor treats as exempt property
24 under section 522 of title 11 of the United States
25 Code.

1 "(2) ADJUSTMENT IN BASIS OF PARTNERSHIP
2 INTEREST MUST BE REFLECTED IN BASIS OF PART-
3 NERSHIP ASSETS.—Any reduction in the basis of a
4 partner's interest in a partnership under this section by
5 reason of the discharge of indebtedness of the partner-
6 ship shall be accompanied by a corresponding reduction
7 in the basis of the partnership property with respect to
8 such partner.
9 "(3) REDUCTIONS IN BASIS NOT TREATED AS
10 DISPOSITIONS.—For purposes of this title, a reduction
11 in basis under this section shall not be treated as a
12 disposition.
13 "(d) RECAPTURE OF REDUCTIONS.—
14 "(1) IN GENERAL.—For purposes of section 1245
15 and 1250—
16 "(A) any property the basis of which is re-
17 duced under this section shall be treated as sec-
18 tion 1245 property or section 1250 property
19 (whichever is appropriate), and
20 "(B) any reduction under this section shall be
21 treated as a deduction allowed for depreciation.
22 "(2) SPECIAL RULE FOR SECTION 1250.—For
23 purposes of section 1250(b), the determination of what
24 would have been the depreciation adjustments under

1 the straight line method shall be made as if there had
2 been no reduction under this section."

3 (c) AMENDMENT OF SECTION 111.—Section 111 (relat-
4 ing to recovery of bad debts, prior taxes, and delinquency
5 amounts) is amended by adding at the end thereof the follow-
6 ing new subsection:

7 "(d) INCREASE IN CARRYOVER TREATED AS YIELDING
8 TAX BENEFIT.—For purposes of paragraph (4) of subsection
9 (b), an increase in a carryover which has not expired shall be
10 treated as a reduction in tax."

11 (d) AMENDMENT OF SECTION 382.—Section 382 (re-
12 lating to special limitations on net operating loss carryover),
13 as in effect before its amendment by section 806 of the Tax
14 Reform Act of 1976, is amended by adding at the end thereof
15 the following new subsection:

16 "(d) CERTAIN STOCK RECEIVED FOR INDEBTED-
17 NESS.—

18 "(1) SUBSECTION (a).—For purposes of subsec-
19 tion (a), stock in the corporation which is acquired by a
20 security holder or creditor in exchange for the extin-
21 guishment or relinquishment (in whole or in part) of a
22 claim against the corporation in a title 11 or similar
23 case (within the meaning of section 368(a)(3)(A)) shall
24 be treated as not acquired by purchase, unless the

1 claim was acquired for the purpose of acquiring such
2 stock.
3 "(2) SUBSECTION (b).—For purposes of subsec-
4 tion (b), a creditor who receives stock in a reorganiza-
5 tion described in section 368(a)(1)(G) shall be treated
6 as a stockholder immediately before the reorganiza-
7 tion."
8 (e) TECHNICAL AMENDMENTS.—
9 (1) Subsection (b) of section 703 (relating to elec-
10 tions of the partnership) is amended to read as follows:
11 "(b) ELECTIONS OF THE PARTNERSHIP.—Any election
12 affecting the computation of taxable income derived from a
13 partnership shall be made by the partnership, except that any
14 election under—
15 "(1) section 57(c) (defining net lease),
16 "(2) subsection (b)(5) or (d)(4) of section 108 (re-
17 lating to income from discharge of indebtedness),
18 "(3) section 163(d) (relating to limitation of inter-
19 est on investment indebtedness),
20 "(4) section 617 (relating to deduction and recap-
21 ture of certain mining exploration expenditures), or
22 "(5) section 901 (relating to taxes of foreign coun-
23 tries and possessions of the United States),
24 shall be made by each partner separately."

1 (2) Subsection (c) of section 118 (relating to cross
2 reference) is amended to read as follows:
3 "(c) CROSS REFERENCES.—

**"(1) For basis of property acquired by a corporation through a contribution to its capital, see section 362.**
**"(2) For special rules in the case of contributions of indebtedness, see section 108(f)(1)(B)."**

4 (3) Subsection (b) of section 1032 (relating to
5 basis) is amended to read as follows:
6 "(b) CROSS REFERENCES.—

**"(1) For basis of property acquired by a corporation in certain exchanges for its stock, see section 362.**
**"(2) For special rules in the case of transfers of stock in satisfaction of indebtedness, see section 108(f)(1)(A)."**

7 **SEC. 3. RULES RELATING TO TITLE 11 CASES FOR INDIVID-**
8 **UALS.**
9 (a) IN GENERAL.—
10 (1) ADDITION OF RULES.—Chapter 1 (relating to
11 normal taxes and surtaxes) is amended by adding at
12 the end thereof the following new subchapter:
13 **"Subchapter V—Title 11 Cases**

"Sec. 1398. Rules relating to individuals' title 11 cases.
"Sec. 1399. No separate taxable entities for partnerships, corporations, etc.

14 **"SEC. 1398. RULES RELATING TO INDIVIDUALS' TITLE 11**
15 **CASES.**
16 "(a) CASES TO WHICH SECTION APPLIES.—Except as
17 provided in subsection (b), this section shall apply to any case
18 under chapter 7 (relating to liquidations) or chapter 11 (relat-

1 ing to reorganizations) of title 11 of the United States Code
2 in which the debtor is an individual.
3 "(b) EXCEPTIONS WHERE CASE IS DISMISSED,
4 ETC.—
5 "(1) SECTION DOES NOT APPLY WHERE CASE IS
6 DISMISSED.—This section shall not apply if the case
7 under chapter 7 or 11 of title 11 of the United States
8 Code is dismissed.
9 "(2) SECTION DOES NOT APPLY AT PARTNER-
10 SHIP LEVEL.—For purposes of subsection (a), a part-
11 nership shall not be treated as an individual, but the
12 interest in a partnership of a debtor who is an individu-
13 al shall be taken into account under this section in the
14 same manner as any other interest of the debtor.
15 "(c) COMPUTATION AND PAYMENT OF TAX; ZERO
16 BRACKET AMOUNT.—
17 "(1) COMPUTATION AND PAYMENT OF TAX.—
18 Except as otherwise provided in this section, the tax-
19 able income of the estate shall be computed in the
20 same manner as for an individual. The tax shall be
21 computed on such taxable income and shall be paid by
22 the trustee.
23 "(2) TAX RATES.—The tax on the taxable
24 income of the estate shall be determined under subsec-
25 tion (d) of section 1.

1 "(3) AMOUNT OF ZERO BRACKET AMOUNT.—The
2 amount of the estate's zero bracket amount for the tax-
3 able year shall be the same as for a married individual
4 filing a separate return for such year.
5 "(d) TAXABLE YEARS OF ESTATES AND DEBTORS.—
6 "(1) ESTATES.—The first taxable year of the
7 estate shall end on the same day as the taxable year of
8 the debtor which includes the commencement date.
9 "(2) GENERAL RULE FOR DEBTORS.—Except as
10 provided in paragraph (3), the taxable year of the
11 debtor shall be determined without regard to the case
12 under title 11 of the United States Code to which this
13 section applies.
14 "(3) ELECTION TO TERMINATE DEBTOR'S YEAR
15 WHEN CASE COMMENCES.—
16 "(A) IN GENERAL.—Notwithstanding section
17 442, the debtor may (without the approval of the
18 Secretary) elect to treat the debtor's taxable year
19 which includes the commencement date as 2 tax-
20 able years—
21 "(i) the first of which ends on the day
22 before the commencement date, and
23 "(ii) the second of which begins on the
24 commencement date.

1 "(B) SPOUSE MAY JOIN IN ELECTION.—In
2 the case of a married individual (within the mean-
3 ing of section 143), the spouse may elect to have
4 the debtor's election under subparagraph (A) also
5 apply to the spouse, but only if the debtor and the
6 spouse file a joint return for the taxable year re-
7 ferred to in subparagraph (A)(i).
8 "(C) NO ELECTION WHERE DEBTOR HAS NO
9 ASSETS.—No election may be made under sub-
10 paragraph (A) by a debtor who has no assets
11 other than property which the debtor may treat as
12 exempt property under section 522 of title 11 of
13 the United States Code.
14 "(D) TIME FOR MAKING ELECTION.—An
15 election under subparagraph (A) or (B) may be
16 made only on or before the due date for filing the
17 return for the taxable year referred to in subpara-
18 graph (A)(i). Any such election, once made, shall
19 be irrevocable.
20 "(E) RETURNS.—A return shall be made for
21 each of the taxable years specified in subpara-
22 graph (A).
23 "(F) ANNUALIZATION.—For purposes of
24 subsections (b), (c), and (d) of section 443, a
25 return filed for either of the taxable years referred

1 to in subparagraph (A) shall be treated as a
2 return made under paragraph (1) of subsection (a)
3 of section 443.
4 "(4) COMMENCEMENT DATE DEFINED.—For pur-
5 poses of this subsection, the term 'commencement date'
6 means the day on which the case under title 11 of the
7 United States Code to which this section applies
8 commences.
9 "(5) CROSS REFERENCES.—

"(A) For allowance of 1 change of accounting period by the estate without consent of Secretary, see subsection (j)(1).

"(B) For other rules relating to change of accounting period by the debtor or by the estate, see section 442.

10 "(e) TREATMENT OF INCOME, DEDUCTIONS, AND
11 CREDITS.—
12 "(1) ESTATE'S SHARE OF DEBTOR'S INCOME.—
13 The gross income of the estate for each taxable year
14 shall include the gross income of the debtor to which
15 the estate is entitled under title 11 of the United
16 States Code.
17 "(2) DEBTOR'S SHARE OF DEBTOR'S INCOME.—
18 The gross income of the debtor for any taxable year
19 shall not include any item to the extent that such item
20 is included in the gross income of the estate by reason
21 of paragraph (1).
22 "(3) DIVISION OF DEBTOR'S DEDUCTIONS AND
23 CREDITS.—Each item of deduction or credit of the

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1 debtor which is properly associated with gross income
2 to which paragraph (1) applies shall be treated as a de-
3 duction or credit of the estate.
4 "(4) RULE FOR MAKING DETERMINATIONS WITH
5 RESPECT TO DEDUCTIONS, CREDITS, AND EMPLOY-
6 MENT TAXES.—Except as otherwise provided in this
7 section, the determination of whether or not any
8 amount paid or incurred by the estate—
9 "(A) is allowable as a deduction or credit
10 under this chapter, or
11 "(B) is wages for purposes of subtitle C,
12 shall be made as if the amount were paid or incurred
13 by the debtor and as if the debtor were still engaged in
14 the trades and businesses, and in the activities, the
15 debtor was engaged in before the commencement of
16 the case.
17 "(f) TREATMENT OF TRANSFERS BETWEEN DEBTOR
18 AND ESTATE.—
19 "(1) TRANSFER TO ESTATE NOT TREATED AS
20 TRANSFER.—A transfer (other than by sale or ex-
21 change) of an asset from the debtor to the estate shall
22 not be treated as a transfer for purposes of any provi-
23 sion of this title assigning tax consequences to a trans-
24 fer, and the estate shall be treated as the debtor would
25 be treated with respect to such asset.

1 "(2) TRANSFER FROM ESTATE TO DEBTOR NOT
2 TREATED AS TRANSFER.—In the case of a termination
3 of the estate, a transfer (other than by sale or ex-
4 change) of an asset from the estate to the debtor shall
5 not be treated as a transfer for purposes of any provi-
6 sion of this title assigning tax consequences to a trans-
7 fer, and the debtor shall be treated as the estate would
8 be treated with respect to such asset.
9 "(g) ESTATE SUCCEEDS TO TAX ATTRIBUTES OF
10 DEBTOR.—The estate shall succeed to and take into account
11 the following items (determined as of the first day of the
12 debtor's taxable year in which the case commences) of the
13 debtor—
14 "(1) NET OPERATING LOSS CARRYOVERS.—The
15 net operating loss carryovers determined under section
16 172.
17 "(2) CHARITABLE CONTRIBUTIONS CARRY-
18 OVERS.—The carryover of excess charitable contribu-
19 tions determined under section 170(d)(1).
20 "(3) RECOVERY EXCLUSION.—Any recovery ex-
21 clusion under section 111 (relating to recovery of bad
22 debts, prior taxes, and delinquency amounts).
23 "(4) CREDIT CARRYOVERS, ETC.—The carryovers
24 of any credit, and all other items which, but for the
25 commencement of the case, would be required to be

1 taken into account by the debtor with respect to any
2 credit.
3 "(5) CAPITAL LOSS CARRYOVERS.—The capital
4 loss carryover determined under section 1212.
5 "(6) BASIS, HOLDING PERIOD, AND CHARACTER
6 OF ASSETS.—In the case of any asset acquired (other
7 than by sale or exchange) by the estate from the
8 debtor, the basis, holding period, and character it had
9 in the hands of the debtor.
10 "(7) METHOD OF ACCOUNTING.—The method of
11 accounting used by the debtor.
12 "(8) OTHER ATTRIBUTES.—Other tax attributes
13 of the debtor, to the extent provided in regulations pre-
14 scribed by the Secretary as necessary or appropriate to
15 carry out the purposes of this section.
16 "(h) ADMINISTRATION, LIQUIDATION, AND REORGANI-
17 ZATION EXPENSES; CARRYOVERS AND CARRYBACKS OF
18 CERTAIN EXCESS EXPENSES.—
19 "(1) ADMINISTRATION, LIQUIDATION, AND REOR-
20 GANIZATION EXPENSES.—Any administrative expense
21 allowed under section 503 of title 11 of the United
22 States Code, and any fee or charge assessed against
23 the estate under chapter 123 of title 28 of the United
24 States Code, to the extent not disallowed under any

1 other provision of this title, shall be allowed as a
2 deduction.
3 "(2) CARRYBACK AND CARRYOVER OF EXCESS
4 ADMINISTRATIVE COSTS, ETC., TO ESTATE TAXABLE
5 YEARS.—
6 "(A) DEDUCTION ALLOWED.—There shall
7 be allowed as a deduction for the taxable year an
8 amount equal to the aggregate of (i) the adminis-
9 trative expense carryovers to such year, plus (ii)
10 the administrative expense carrybacks to such
11 year.
12 "(B) ADMINISTRATIVE EXPENSE LOSS,
13 ETC.—If a net operating loss would be created or
14 increased for any estate taxable year if section
15 172(c) were applied without the modification con-
16 tained in paragraph (4) of section 172(d), then the
17 amount of the net operating loss so created (or
18 the amount of the increase in the net operating
19 loss) shall be an administrative expense loss for
20 such taxable year which shall be an administra-
21 tive expense carryback to each of the 3 preceding
22 taxable years and an administrative expense car-
23 ryover to each of the 7 succeeding taxable years.
24 "(C) DETERMINATION OF AMOUNT CARRIED
25 TO EACH TAXABLE YEAR.—The portion of any

1 administrative expense loss which may be carried
2 to any other taxable year shall be determined
3 under section 172(b)(2), except that for each tax-
4 able year the computation under section 172(b)(2)
5 with respect to the net operating loss shall be
6 made before the computation under this
7 paragraph.

8 "(D) ADMINISTRATIVE EXPENSE DEDUC-
9 TIONS ALLOWED ONLY TO ESTATE.—The deduc-
10 tions allowable under this chapter solely by
11 reason of paragraph (1), and the deduction pro-
12 vided by subparagraph (A) of this paragraph, shall
13 be allowable only to the estate.

14 "(i) DEBTOR SUCCEEDS TO TAX ATTRIBUTES OF
15 ESTATE.—In the case of a termination of an estate, the
16 debtor shall succeed to and take into account the items re-
17 ferred to in paragraphs (1), (2), (3), (4), (5), and (6) of subsec-
18 tion (g) in a manner similar to that provided in such para-
19 graphs (but taking into account that the transfer is from the
20 estate to the debtor instead of from the debtor to the estate).
21 In addition, the debtor shall succeed to and take into account
22 the other tax attributes of the estate, to the extent provided
23 in regulations prescribed by the Secretary as necessary or
24 appropriate to carry out the purposes of this section.

25 "(j) OTHER SPECIAL RULES.—

1 "(1) CHANGE OF ACCOUNTING PERIOD WITHOUT
2 APPROVAL.—Notwithstanding section 442, the estate
3 may change its annual accounting period one time
4 without the approval of the Secretary.
5 "(2) TREATMENT OF CERTAIN CARRYBACKS.—
6 "(A) CARRYBACKS FROM ESTATE.—If any
7 carryback year of the estate is a taxable year
8 before the estate's first taxable year, the carry-
9 back to such carryback year shall be taken into
10 account for the debtor's taxable year correspond-
11 ing to the carryback year.
12 "(B) CARRYBACKS FROM DEBTOR'S ACTIVI-
13 TIES.—The debtor may not carry back to a tax-
14 able year before the debtor's taxable year in
15 which the case commences any carryback from a
16 taxable year ending after the case commences.
17 "(C) CARRYBACK AND CARRYBACK YEAR
18 DEFINED.—For purposes of this paragraph—
19 "(i) CARRYBACK.—The term 'carry-
20 back' means a net operating loss carryback
21 under section 172 or a carryback of any
22 credit provided by part IV of subchapter A.
23 "(ii) CARRYBACK YEAR.—The term
24 'carryback year' means the taxable year to
25 which a carryback is carried.

1 "SEC. 1399. NO SEPARATE TAXABLE ENTITIES FOR PARTNER-
2 SHIPS, CORPORATIONS, ETC.

3 "Except in any case to which section 1398 applies, no
4 separate taxable entity shall result from the commencement
5 of a case under title 11 of the United States Code."

6 (2) CLERICAL AMENDMENT.—The table of sub-
7 chapters for chapter 1 is amended by adding at the end
8 thereof the following new item:

"SUBCHAPTER V. Title 11 cases."

9 (b) RETURN REQUIREMENTS.—

10 (1) Subsection (a) of section 6012 (relating to per-
11 sons required to make returns of income) is
12 amended by adding at the end thereof the following
13 new paragraph:

14 "(9) Every estate of an individual under chapter 7
15 or 11 of title 11 of the United States Code (relating to
16 bankruptcy) the gross income of which for the taxable
17 year is $2,700 or more."

18 (2) Paragraph (4) of section 6012(b) (relating to
19 returns of estates and trusts) is amended by striking
20 out "an estate or a trust" and inserting in lieu thereof
21 "an estate, a trust, or an estate of an individual under
22 chapter 7 or 11 of title 11 of the United States Code".

23 (c) DISCLOSURE OF RETURNS.—

24 (1) Subsection (e) of section 6103 (relating to con-
25 fidentiality and disclosure of returns and return infor-

1 mation) is amended by striking out paragraph (4), by
2 redesignating paragraphs (5) and (6) as paragraphs (6)
3 and (7), respectively, and by inserting after paragraph
4 (3) the following new paragraphs:

5 "(4) TITLE 11 CASES AND RECEIVERSHIP PRO-
6 CEEDINGS.—If—

7 "(A) there is a trustee in a title 11 case in
8 which the debtor is the person with respect to
9 whom the return is filed, or

10 "(B) substantially all of the property of the
11 person with respect to whom the return is filed is
12 in the hands of a receiver,

13 such return or returns for prior years of such person
14 shall, upon written request, be open to inspection by or
15 disclosure to such trustee or receiver, but only if the
16 Secretary finds that such trustee or receiver, in his fi-
17 duciary capacity, has a material interest which will be
18 affected by information contained therein.

19 "(5) INDIVIDUAL'S TITLE 11 CASE.—

20 "(A) IN GENERAL.—In any case to which
21 section 1398 applies (determined without regard
22 to section 1398(b)(1)), any return of the debtor for
23 the taxable year in which the case commenced or
24 any preceding taxable year shall, upon written re-

1 quest, be open to inspection by or disclosure to
2 the trustee in such case.
3 "(B) RETURN OF ESTATE AVAILABLE TO
4 DEBTOR.—Any return of an estate in a case to
5 which section 1398 applies shall, upon written re-
6 quest, be open to inspection by or disclosure to
7 the debtor in such case.
8 "(C) SPECIAL RULE FOR INVOLUNTARY
9 CASES.—In an involuntary case, no disclosure
10 shall be made under subparagraph (A) until the
11 order for relief has been entered by the court
12 having jurisdiction of such case unless such court
13 finds that such disclosure is appropriate for pur-
14 poses of determining whether an order for relief
15 should be entered."
16 (2) Paragraph (6) of section 6103(e) (as redesig-
17 nated by paragraph (1)) is amended by striking out "or
18 (4)" and inserting in lieu thereof "(4), or (5)".
19 (d) TECHNICAL AMENDMENT.—Subsection (e) of sec-
20 tion 443 (relating to cross references) is amended by adding
21 at the end thereof the following new sentence:

**"For returns for a period of less than 12 months in the case of a debtor's election to terminate a taxable year, see section 1398(d)(3)(E)."**

1 **SEC. 4. CORPORATE REORGANIZATION PROVISIONS.**

2 (a) CERTAIN TRANSFERS IN TITLE 11 OR SIMILAR
3 CASES TO BE INCLUDED IN DEFINITION OF REORGANIZA-
4 TION.—Paragraph (1) of section 368(a) (defining reorganiza-
5 tion) is amended by adding at the end thereof the following
6 new subparagraph:

7 "(G) a transfer by a corporation of all or part
8 of its assets to another corporation in a title 11 or
9 similar case; but only if, in pursuance of the plan,
10 stock or securities of the corporation to which the
11 assets are transferred are distributed in a transac-
12 tion which qualifies under section 354, 355, or
13 356."

14 (b) ADDITIONAL RULES FOR COORDINATING TITLE 11
15 AND SIMILAR CASES WITH THE GENERAL REORGANIZA-
16 TION RULES.—Section 368(a) is amended by adding at the
17 end thereof the following new paragraph:

18 "(3) ADDITIONAL RULES RELATING TO TITLE 11
19 AND SIMILAR CASES.—

20 "(A) TITLE 11 OR SIMILAR CASE DE-
21 FINED.—For purposes of this part, the term 'title
22 11 or similar case' means—

23 "(i) a case under title 11 of the United
24 States Code, or

1 "(ii) a receivership, foreclosure, or simi-
2 lar proceeding in a Federal or State court.
3 "(B) TRANSFER OF ASSETS IN A TITLE 11
4 OR SIMILAR CASE.—In applying paragraph
5 (1)(G), a transfer of the assets of a corporation
6 shall be treated as made in a title 11 or similar
7 case if and only if—
8 "(i) such corporation is under the juris-
9 diction of the court in such case, and
10 "(ii) the transfer is pursuant to a plan of
11 reorganization approved by the court.
12 "(C) REORGANIZATIONS QUALIFYING
13 UNDER PARAGRAPH (1)(G) AND ANOTHER PROVI-
14 SION.—If a transaction would (but for this sub-
15 paragraph) qualify both—
16 "(i) under subparagraph (G) of para-
17 graph (1), and
18 "(ii) under any other subparagraph of
19 paragraph (1) or under section 332 or 351,
20 then, for purposes of this subchapter (other than
21 section 357(c)(1)), such transaction shall be treat-
22 ed as qualifying only under subparagraph (G) of
23 paragraph (1).
24 "(D) AGENCY RECEIVERSHIP PROCEEDINGS
25 WHICH INVOLVE FINANCIAL INSTITUTIONS.—For

1 purposes of subparagraphs (A) and (B), in the
2 case of a receivership, foreclosure, or similar pro-
3 ceeding before a Federal or State agency involv-
4 ing a financial institution to which section 585 or
5 593 applies, the agency shall be treated as a
6 court.

7 "(E) APPLICATION OF PARAGRAPH
8 (2)(E)(ii).—In the case of a title 11 or similar case,
9 the requirement of clause (ii) of paragraph (2)(E)
10 shall be treated as met if—

11 "(i) no former shareholder of the surviv-
12 ing corporation received any consideration
13 for his stock, and

14 "(ii) the former creditors of the surviv-
15 ing corporation exchanged, for an amount of
16 voting stock of the controlling corporation,
17 debt of the surviving corporation which had
18 a fair market value equal to 80 percent or
19 more of the total fair market value of the
20 debt of the surviving corporation."

21 (c) TRANSFERS OF ASSETS TO SUBSIDIARIES.—Sub-
22 paragraph (C) of section 368(a)(2) (relating to transfers of
23 assets or stock to subsidiaries in certain paragraph (1)(A),
24 (1)(B), and (1)(C) cases) is amended to read as follows:

1 "(C) TRANSFERS OF ASSETS OR STOCK TO
2 SUBSIDIARIES IN CERTAIN PARAGRAPH (1)(A),
3 (1)(B), (1)(C), AND (1)(G) CASES.—A transaction
4 otherwise qualifying under paragraph (1)(A),
5 (1)(B), or (1)(C) shall not be disqualified by reason
6 of the fact that part or all of the assets or stock
7 which were acquired in the transaction are trans-
8 ferred to a corporation controlled by the corpora-
9 tion acquiring such assets or stock. A similar rule
10 shall apply to a transaction otherwise qualifying
11 under paragraph (1)(G) where the requirements of
12 subparagraphs (A) and (B) of section 354(b)(1) are
13 met with respect to the acquisition of the assets
14 or stock."

15 (d) USE OF STOCK OF CONTROLLING CORPORA-
16 TION.—Subparagraph (D) of section 368(a)(2) (relating to use
17 of stock of controlling corporation in paragraph (1)(A) cases)
18 is amended to read as follows:

19 "(D) USE OF STOCK OF CONTROLLING COR-
20 PORATION IN PARAGRAPH (1)(A) AND (1)(G)
21 CASES.—The acquisition by one corporation, in
22 exchange for stock of a corporation (referred to in
23 this subparagraph as 'controlling corporation')
24 which is in control of the acquiring corporation, of
25 substantially all of the properties of another cor-

1 poration shall not disqualify a transaction under
2 paragraph (1)(A) or (1)(G) if—
3 "(i) no stock of the acquiring corpora-
4 tion is used in the transaction, and
5 "(ii) in the case of a transaction under
6 paragraph (1)(A), such transaction would
7 have qualified under paragraph (1)(A) had
8 the merger been into the controlling
9 corporation."
10 (e) TREATMENT OF PROPERTY ATTRIBUTABLE TO AC-
11 CRUED INTEREST.—
12 (1) AMENDMENT OF SECTION 354.—Subsection
13 (a) of section 354 (relating to exchanges of stocks and
14 securities in certain reorganizations) is amended by
15 striking out paragraphs (2) and (3) and inserting in lieu
16 thereof the following:
17 "(2) LIMITATIONS.—
18 "(A) EXCESS PRINCIPAL AMOUNT.—Para-
19 graph (1) shall not apply if—
20 "(i) the principal amount of any such
21 securities received exceeds the principal
22 amount of any such securities surrendered,
23 or
24 "(ii) any such securities are received
25 and no such securities are surrendered.

1 "(B) PROPERTY ATTRIBUTABLE TO AC-
2 CRUED INTEREST.—Neither paragraph (1) nor so
3 much of section 356 as relates to paragraph (1)
4 shall apply to the extent that any stock, securi-
5 ties, or other property received is attributable to
6 interest which has accrued on securities on or
7 after the beginning of the holder's holding period.
8 "(3) CROSS REFERENCES.—

**"(A) For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered, but not including property to which paragraph (2)(B) applies), see section 356.**

**"(B) For treatment of accrued interest in the case of an exchange described in paragraph (2)(B), see section 61."**

9 (2) AMENDMENT OF SECTION 355.—Subsection
10 (a) of section 355 (relating to distribution of stock and
11 securities of a controlled corporation) is amended by
12 striking out paragraphs (3) and (4) and inserting in lieu
13 thereof the following:
14 "(3) LIMITATIONS.—
15 "(A) EXCESS PRINCIPAL AMOUNT.—Para-
16 graph (1) shall not apply if—
17 "(i) the principal amount of the securi-
18 ties in the controlled corporation which are
19 received exceeds the principal amount of the
20 securities which are surrendered in connec-
21 tion with such distribution, or

1 "(ii) securities in the controlled corpora-
2 tion are received and no securities are sur-
3 rendered in connection with such distribu-
4 tion.
5 "(B) STOCK ACQUIRED IN TAXABLE TRANS-
6 ACTIONS WITHIN 5 YEARS TREATED AS BOOT.—
7 For purposes of this section (other than paragraph
8 (1)(D) of this subsection) and so much of section
9 356 as relates to this section, stock of a con-
10 trolled corporation acquired by the distributing
11 corporation by reason of any transaction—
12 "(i) which occurs within 5 years of the
13 distribution of such stock, and
14 "(ii) in which gain or loss was recog-
15 nized in whole or in part,
16 shall not be treated as stock of such controlled
17 corporation, but as other property.
18 "(C) PROPERTY ATTRIBUTABLE TO AC-
19 CRUED INTEREST.—Neither paragraph (1) nor so
20 much of section 356 as relates to paragraph (1)
21 shall apply to the extent that any stock, securi-
22 ties, or other property received is attributable to
23 interest which has accrued on securities on or
24 after the beginning of the holder's holding period.
25 "(4) CROSS REFERENCES.—

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"(A) For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered, but not including property to which paragraph (3)(C) applies), see section 356.

"(B) For treatment of accrued interest in the case of an exchange described in paragraph (3)(C), see section 61."

1 (f) TERMINATION OF EXISTING PROVISIONS RELAT-
2 ING TO INSOLVENCY REORGANIZATIONS.—Part IV of sub-
3 chapter C of chapter 1 (relating to insolvency reorganiza-
4 tions) is amended by inserting before section 371 the follow-
5 ing new section:

6 "SEC. 370. TERMINATION OF PART.

7 "(a) GENERAL RULE.—Except as provided in subsec-
8 tion (b), this part shall not apply to any proceeding which is
9 begun after September 30, 1979.

10 "(b) EXCEPTIONS.—Subsection (a) shall not apply to
11 subsections (c) and (e) of section 374."

12 (g) CARRYOVER OF SECTION 381 ITEMS IN SECTION
13 368(a)(1)(G) REORGANIZATIONS.—Subsection (a) of section
14 381 (relating to carryovers in certain corporate acquisitions)
15 is amended—

16 (1) by striking out "subparagraph (A), (C), (D)
17 (but only if the requirements of subparagraphs (A) and
18 (B) of section 354(b)(1) are met), or (F) of section
19 368(a)(1)" in paragraph (2) and inserting in lieu thereof
20 "subparagraph (A), (C), (D), (F), or (G) of section
21 368(a)(1)", and

1 (2) by adding at the end thereof the following new
2 sentence: "For purposes of the preceding sentence, a
3 reorganization shall be treated as meeting the require-
4 ments of subparagraph (D) or (G) of section 368(a)(1)
5 only if the requirements of subparagraphs (A) and (B)
6 of section 354(b)(1) are met."
7 (h) TECHNICAL AND CONFORMING AMENDMENTS.—
8 (1) Paragraphs (1) and (2) of section 354(b) (relat-
9 ing to exception to general rule on exchanges of stock
10 and securities in certain reorganizations) are each
11 amended by striking out "section 368(a)(1)(D)" and in-
12 serting in lieu thereof "subparagraph (D) or (G) of sec-
13 tion 368(a)(1)".
14 (2) Paragraph (2) of section 357(c) (relating to
15 liabilities in excess of basis) is amended to read as
16 follows:
17 "(2) EXCEPTIONS.—Paragraph (1) shall not apply
18 to any exchange—
19 "(A) to which subsection (b)(1) of this section
20 applies,
21 "(B) to which section 371 or 374 applies, or
22 "(C) which is pursuant to a plan of reorgani-
23 zation within the meaning of section 368(a)(1)(G)
24 where no former shareholder of the transferor cor-
25 poration receives any consideration for his stock."

1 (3) Paragraph (1) of section 368(a) (defining reor-
2 ganization) is amended—
3 (A) by striking out "or" at the end of sub-
4 paragraph (E), and
5 (B) by striking out the period at the end of
6 subparagraph (F) and inserting in lieu thereof ";
7 or".
8 (4) Subsection (b) of section 368 (defining party to
9 reorganization) is amended—
10 (A) by striking out "or (1)(C)" in the third
11 sentence and inserting in lieu thereof "(1)(C), or
12 (1)(G)", and
13 (B) by striking out "paragraph (1)(A)" in the
14 fourth sentence and inserting in lieu thereof
15 "paragraph (1)(A) or (1)(G)".
16 (5) The table of sections for part IV of subchapter
17 C of chapter 1 is amended by inserting before the item
18 relating to section 371 the following new item:

"Sec. 370. Termination of part."

19 **SEC. 5. MISCELLANEOUS CORPORATE AMENDMENTS.**
20 (a) EXCEPTION FROM PERSONAL HOLDING COMPANY
21 TAX FOR CORPORATIONS IN TITLE 11 OR SIMILAR
22 CASES.—Subsection (c) of section 542 (relating to exceptions
23 from definition of personal holding company) is amended by
24 striking out the period at the end of paragraph (8) and insert-

1 ing in lieu thereof "; and" and by adding at the end thereof
2 the following new paragraph:
3 "(9) a corporation which is subject to the jurisdic-
4 tion of the court in a title 11 or similar case (within
5 the meaning of section 368(a)(3)(A)) unless a major
6 purpose of instituting or continuing such case is the
7 avoidance of the tax imposed by section 541."
8 (b) REDEMPTION OF STOCK ISSUED IN RAILROAD
9 REORGANIZATIONS.—
10 (1) IN GENERAL.—Subsection (b) of section 302
11 (relating to redemptions treated as exchanges) is
12 amended by striking out paragraph (4) and by redesig-
13 nating paragraph (5) as paragraph (4).
14 (2) CONFORMING AMENDMENTS.—
15 (A) Subsection (a) of section 302 is amended
16 by striking out "(2), (3), or (4)" and inserting in
17 lieu thereof "(2), or (3)".
18 (B) Paragraph (4) of section 302(b) (as redes-
19 ignated by paragraph (1)) is amended—
20 (i) by striking out "(2), (3), or (4)" and
21 inserting in lieu thereof "(2) or (3)", and
22 (ii) by striking out "(1), (2), or (4)" and
23 inserting in lieu thereof "(1) or (2)".
24 (c) SECTION 337 TO APPLY WHERE LIQUIDATING
25 CORPORATION IS INSOLVENT.—Section 337 (relating to

1 gain or loss on sales or exchanges in connection with certain
2 liquidations) is amended by adding at the end thereof the fol-
3 lowing new subsection:

4 "(g) TITLE 11 OR SIMILAR CASES.—

5 "(1) IN GENERAL.—If—

6 "(A) a corporation in a title 11 or similar
7 case (within the meaning of section 368(a)(3)(A))
8 adopts a plan of complete liquidation after the
9 commencement of such case,

10 "(B) all of the assets of the corporation are
11 transferred to creditors within the period begin-
12 ning on the date of the adoption of the plan and
13 ending on the date of the termination of the case,
14 and

15 "(C) no shareholder of the corporation re-
16 ceives any consideration for his stock,

17 then subsection (a) shall apply to sales and exchanges
18 by the corporation of property within the period de-
19 scribed in subparagraph (B).

20 "(2) NO NONRECOGNITION FOR PROPERTY AC-
21 QUIRED AFTER PLAN IS ADOPTED.—

22 "(A) IN GENERAL.—For purposes of para-
23 graph (1), the term 'property' does not include
24 any item acquired on or after the date of the
25 adoption of the plan of liquidation.

1 "(B) COORDINATION WITH SUBSECTION
2 (b)(2).—For purposes of paragraph (2) of subsec-
3 tion (b), if (but for this subparagraph) an item
4 would be treated as described both in subpara-
5 graph (A) of this paragraph and in subparagraph
6 (A) or (B) of subsection (b)(1), such item shall be
7 treated as described only in subparagraph (A) or
8 (B) of subsection (b)(1)."
9 (d) ESTATE OF INDIVIDUAL IN TITLE 11 CASE PER-
10 MITTED TO BE SHAREHOLDER OF SUBCHAPTER S CORPO-
11 RATION.—Section 1371 (defining small business corporation)
12 is amended by adding at the end thereof the following new
13 subsection:
14 "(f) ESTATE OF INDIVIDUAL IN TITLE 11 CASE MAY
15 BE SHAREHOLDER.—For purposes of subsection (a)(2), the
16 term 'estate' includes the estate of an individual in a case
17 under title 11 of the United States Code."
18 (e) AMENDMENTS OF SECTION 351.—
19 (1) Section 351 (relating to transfer to corporation
20 controlled by transferor) is amended by redesignating
21 subsection (e) as subsection (f) and by striking out sub-
22 section (d) and inserting in lieu thereof the following
23 new subsections:

1 "(d) SERVICES, CERTAIN INDEBTEDNESS, AND AC-
2 CRUED INTEREST NOT TREATED AS PROPERTY.—For
3 purposes of this section, stock or securities issued for—
4 "(1) services,
5 "(2) indebtedness of the transferee corporation
6 which is not evidenced by a security, or
7 "(3) interest on indebtedness of the transferee cor-
8 poration which accrued on or after the beginning of the
9 transferor's holding period for the debt,
10 shall not be considered as issued in return for property.
11 "(e) EXCEPTIONS.—This section shall not apply to—
12 "(1) TRANSFER OF PROPERTY TO AN INVEST-
13 MENT COMPANY.—A transfer of property to an invest-
14 ment company.
15 "(2) TITLE 11 OR SIMILAR CASE.—A transfer of
16 property of a debtor pursuant to a plan while the
17 debtor is under the jurisdiction of a court in a title 11
18 or similar case (within the meaning of section
19 368(a)(3)(A)), to the extent that the stock or securities
20 received in the exchange is used to satisfy the indebt-
21 edness of such debtor."
22 (2) Subsection (a) of section 351 is amended by
23 striking out the last sentence.

1 (f) EFFECTS ON EARNINGS AND PROFITS.—Section
2 312 (relating to effect on earnings and profits) is amended by
3 adding at the end thereof the following new subsection:
4 "(l) DISCHARGE OF INDEBTEDNESS INCOME.—The
5 earnings and profits of a corporation shall not include income
6 from the discharge of indebtedness to the extent of the
7 amount applied to reduce basis under section 1017."
8 **SEC. 6. CHANGES IN TAX PROCEDURES.**
9 (a) SUSPENSION OF RUNNING OF PERIOD OF LIMITA-
10 TIONS DURING TITLE 11 CASES.—Section 6503 (relating to
11 suspension of running of period of limitation) is amended by
12 redesignating subsection (i) as subsection (j) and by inserting
13 after subsection (h) the following new subsection:
14 "(i) CASES UNDER TITLE 11 OF THE UNITED STATES
15 CODE.—The running of the period of limitations provided in
16 section 6501 or 6502 on the making of assessments or collec-
17 tion shall, in a case under title 11 of the United States Code,
18 be suspended for the period during which the Secretary is
19 prohibited by reason of such case from making the assess-
20 ment or from collecting and—
21 "(1) for assessment, 60 days thereafter, and
22 "(2) for collection, 6 months thereafter."
23 (b) COORDINATION OF DEFICIENCY PROCEDURES
24 WITH TITLE 11 CASES.—Section 6213 (relating to restric-
25 tions applicable to deficiencies; petition to Tax Court) is

1 amended by redesignating subsections (f) and (g) as subsec-
2 tions (g) and (h), respectively, and by inserting after subsec-
3 tion (e) the following new subsection:

4 "(f) COORDINATION WITH TITLE 11.—

5 "(1) SUSPENSION OF RUNNING OF PERIOD FOR
6 FILING PETITION IN TITLE 11 CASES.—In any case
7 under title 11 of the United States Code, the running
8 of the time prescribed by subsection (a) for filing a pe-
9 tition in the Tax Court with respect to any deficiency
10 shall be suspended for the period during which the
11 debtor is prohibited by reason of such case from filing
12 a petition in the Tax Court with respect to such defi-
13 ciency, and for 60 days thereafter.

14 "(2) CERTAIN ACTION NOT TAKEN INTO AC-
15 COUNT.—For purposes of the second and third sen-
16 tences of subsection (a), the filing of a proof of claim or
17 request for payment (or the taking of any other action)
18 in a case under title 11 of the United States Code shall
19 not be treated as action prohibited by such second
20 sentence."

21 (c) TRUSTEE OF DEBTOR'S ESTATE MAY INTERVENE
22 IN TAX COURT PROCEEDING.—

23 (1) IN GENERAL.—Part II of subchapter C of
24 chapter 76 (relating to Tax Court procedure) is
25 amended by redesignating section 7464 as section

1 7465 and by inserting after section 7463 the following
2 new section:

3 "SEC. 7464. INTERVENTION BY TRUSTEE OF DEBTOR'S
4 ESTATE.

5 "The trustee of the debtor's estate in any case under
6 title 11 of the United States Code may intervene, on behalf
7 of the debtor's estate, in any proceeding before the Tax
8 Court to which the debtor is a party."

9 (2) CLERICAL AMENDMENT.—The table of sec-
10 tions for part II of subchapter C of chapter 76 is
11 amended by striking out the item relating to section
12 7464 and by inserting in lieu thereof the following:

"Sec. 7464. Intervention by trustee of debtor's estate.
"Sec. 7465. Provisions of special application to transferees."

13 (d) CROSS REFERENCES TO TAX DETERMINATIONS IN
14 TITLE 11 CASES.—

15 (1) AMENDMENT OF SECTION 7430.—Section
16 7430 (relating to cross references) is amended by strik-
17 ing out paragraphs (1), (2), (3), and (4) and inserting in
18 lieu thereof the following new paragraph:

**"(1) For determination of amount of any tax, additions to tax, etc., in title 11 cases, see section 505 of title 11 of the United States Code."**

19 (2) AMENDMENT OF SECTION 6212.—Paragraph
20 (2) of section 6212(c) (relating to cross references) is
21 amended by adding at the end thereof the following
22 new sentence:

"For provisions allowing determination of tax in title 11 cases, see section 505(a) of title 11 of the United States Code."

1 (3) AMENDMENT OF SECTION 6512.—Section
2 6512 (relating to limitations in case of petition to Tax
3 Court) is amended by adding at the end thereof the
4 following new subsection:
5 "(c) CROSS REFERENCE.—

"For provisions allowing determination of tax in title 11 cases, see section 505(a) of title 11 of the United States Code."

6 (4) AMENDMENT OF SECTION 6532.—Subsection
7 (a) of section 6532 (relating to periods of limitations on
8 suits) is amended by adding at the end thereof the
9 following new paragraph:
10 "(5) CROSS REFERENCE.—

"For substitution of 120-day period for the 6-month period contained in paragraph (1) in a title 11 case, see section 505(a)(2) of title 11 of the United States Code."

11 (e) RELIEF FROM CERTAIN PENALTIES IN TITLE 11
12 CASES.—
13 (1) IN GENERAL.—Subchapter A of chapter 68
14 (relating to additions to the tax and additional
15 amounts) is amended by inserting after section 6657
16 the following new section:
17 **"SEC. 6658. COORDINATION WITH TITLE 11.**
18 "(a) CERTAIN FAILURES TO PAY TAX.—No addition
19 to the tax shall be made under section 6651, 6654, or 6655
20 for failure to make timely payment of tax with respect to a

1 period during which a case is pending under title 11 of the
2 United States Code—
3 "(1) if such tax was incurred by the estate and
4 the failure occurred pursuant to an order of the court
5 finding probable insufficiency of funds of the estate to
6 pay administrative expenses, or
7 "(2) if—
8 "(A) such tax was incurred by the debtor
9 before the earlier of the order for relief or (in the
10 involuntary case) the appointment of a trustee,
11 and
12 "(B)(i) the petition was filed before the due
13 date prescribed by law (including extensions) for
14 filing a return of such tax, or
15 "(ii) the date for making the addition to the
16 tax occurs on or after the day on which the peti-
17 tion was filed.
18 "(b) EXCEPTION FOR COLLECTED TAXES.—Subsec-
19 tion (a) shall not apply to any liability for an addition to the
20 tax which arises from the failure to pay or deposit a tax
21 withheld or collected from others and required to be paid to
22 the United States."
23 (2) CLERICAL AMENDMENT.—The table of sec-
24 tions for subchapter A of chapter 68 is amended by in-

1 serting after the item relating to section 6657 the fol-
2 lowing:

"Sec. 6658. Coordination with title 11."

3 (f) CREDIT AGAINST FEDERAL UNEMPLOYMENT TAX
4 NOT REDUCED IN CERTAIN CASES.—Subsection (a) of sec-
5 tion 3302 (relating to credits against unemployment tax) is
6 amended by adding at the end thereof the following new
7 paragraph:

8 "(5) In the case of wages paid by the trustee of
9 an estate under title 11 of the United States Code, if
10 the failure to pay contributions on time was without
11 fault by the trustee, paragraph (3) shall be applied by
12 substituting '100 percent' for '90 percent'."

13 (g) REMOVAL OF PROVISION FOR IMMEDIATE ASSESS-
14 MENT IN CERTAIN TITLE 11 CASES.—

15 (1) IN GENERAL.—Section 6871 (relating to
16 claims for income, estate, and gift taxes in bankruptcy
17 and receivership proceedings) is amended to read as
18 follows:

19 "SEC. 6871. CLAIMS FOR INCOME, ESTATE, GIFT, AND CERTAIN
20 EXCISE TAXES IN RECEIVERSHIP PROCEED-
21 INGS, ETC.

22 "(a) IMMEDIATE ASSESSMENT IN RECEIVERSHIP PRO-
23 CEEDINGS.—On the appointment of a receiver for the tax-
24 payer in any receivership proceeding before any court of the

1 United States or of any State or of the District of Columbia,
2 any deficiency (together with all interest, additional amounts,
3 and additions to the tax provided by law) determined by the
4 Secretary in respect of a tax imposed by subtitle A or B or by
5 chapter 41, 42, 43, 44, or 45 on such taxpayer may, despite
6 the restrictions imposed by section 6213(a) on assessments,
7 be immediately assessed if such deficiency has not theretofore
8 been assessed in accordance with law.

9 "(b) IMMEDIATE ASSESSMENT WITH RESPECT TO
10 CERTAIN TITLE 11 CASES.—Any deficiency (together with
11 all interest, additional amounts, and additions to the tax pro-
12 vided by law) determined by the Secretary in respect of a tax
13 imposed by subtitle A or B or by chapter 41, 42, 43, 44,
14 or 45 on—

15 "(1) the debtor's estate in a case under title 11 of
16 the United States Code, or

17 "(2) the debtor, but only if liability for such tax
18 has become res judicata pursuant to a determination in
19 a case under title 11 of the United States Code,

20 may, despite the restrictions imposed by section 6213(a) on
21 assessments, be immediately assessed if such deficiency has
22 not theretofore been assessed in accordance with law.

23 "(c) CLAIM FILED DESPITE PENDENCY OF TAX
24 COURT PROCEEDINGS.—In the case of a tax imposed by
25 subtitle A or B or by chapter 41, 42, 43, 44, or 45—

1 "(1) claims for the deficiency and for interest, ad-
2 ditional amounts, and additions to the tax may be pre-
3 sented, for adjudication in accordance with law, to the
4 court before which the receivership proceeding (or the
5 case under title 11 of the United States Code) is pend-
6 ing, despite the pendency of proceedings for the rede-
7 termination of the deficiency pursuant to a petition to
8 the Tax Court; but
9 "(2) in the case of a receivership proceeding, no
10 petition for any such redetermination shall be filed with
11 the Tax Court after the appointment of the receiver."
12 (2) AMENDMENT OF SECTION 6873.—Subsection
13 (a) of section 6873 (relating to unpaid claims) is
14 amended by striking out "or any proceeding under the
15 Bankruptcy Act".
16 (3) CLERICAL AMENDMENTS.—
17 (A) The table of sections for subchapter B of
18 chapter 70 is amended by striking out the item
19 relating to section 6871 and inserting in lieu
20 thereof the following:

"Sec. 6871. Claims for income, estate, gift, and certain excise taxes in receivership proceedings, etc."

21 (B) The heading of subchapter B of chapter
22 70 is amended to read as follows:

1 **"Subchapter B—Receiverships, Etc."**

2 (C) The item relating to subchapter B in the
3 table of subchapters for chapter 70 is amended to
4 read as follows:

"SUBCHAPTER B. Receiverships, etc."

5 (D) The heading of chapter 70 is amended to
6 read as follows:

7 **"CHAPTER 70—JEOPARDY, RECEIVERSHIPS,**
8 **ETC."**

9 (E) The item relating to chapter 70 in the
10 table of chapters for subtitle F is amended to read
11 as follows:

"CHAPTER 70. Jeopardy, receiverships, etc."

12 (h) REPEAL OF SECTION 1018.—
13 (1) IN GENERAL.—Section 1018 (relating to ad-
14 justment of capital structure before September 22,
15 1938) is hereby repealed.
16 (2) CLERICAL AMENDMENT.—The table of sec-
17 tions for part II of subchapter O of chapter 1 is
18 amended by striking out the item relating to section
19 1018.
20 (i) TECHNICAL AND CONFORMING AMENDMENTS.—
21 (1) Subsection (a) of section 128 (relating to cross
22 references) is amended by striking out paragraph (1)

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1 and by redesignating paragraphs (2) through (9) as
2 paragraphs (1) through (8), respectively.
3 (2) Subsection (c) of section 354 (relating to cer-
4 tain railroad reorganizations) is amended by striking
5 out "approved by the Interstate Commerce Commis-
6 sion under section 77 of the Bankruptcy Act, or" and
7 inserting in lieu thereof "confirmed under section 1173
8 of title 11 of the United States Code, or approved by
9 the Interstate Commerce Commission".
10 (3) Paragraph (5) of section 422(c) (relating to
11 certain transfers by insolvent individuals) is amended
12 by striking out "under the Bankruptcy Act" and in-
13 serting in lieu thereof "under title 11 of the United
14 States Code".
15 (4) Section 1023 (relating to cross references) is
16 amended by striking out paragraph (2) and by redes-
17 ignating paragraph (3) as paragraph (2).
18 (5) Paragraph (3) of section 6012(b) (relating to
19 receivers, trustees, and assignees for corporations) is
20 amended by striking out "trustee in bankruptcy" and
21 inserting in lieu thereof "trustee in a case under title
22 11 of the United States Code".
23 (6) Section 6036 (relating to notice of qualification
24 as executor or receiver) is amended by striking out
25 "trustee in bankruptcy" and inserting in lieu thereof

1 "trustee in a case under title 11 of the United States
2 Code".

3 (7) Paragraph (2) of section 6155(b) (relating to
4 cross references) is amended by striking out "bank-
5 ruptcy or".

6 (8) Subsection (c) of section 6161 (relating to
7 claims in bankruptcy or receivership proceedings) is
8 amended—

9 (A) by striking out "in bankruptcy or receiv-
10 ership proceedings" and inserting in lieu thereof
11 "in cases under title 11 of the United States Code
12 or in receivership proceedings", and

13 (B) by striking out "BANKRUPTCY OR RE-
14 CEIVERSHIP PROCEEDINGS" in the subsection
15 heading and inserting in lieu thereof "CASES
16 UNDER TITLE 11 OF THE UNITED STATES
17 CODE OR IN RECEIVERSHIP PROCEEDINGS".

18 (9) Paragraph (1) of section 6216 (relating to
19 cross references) is amended to read as follows:

**"(1) For procedures relating to receivership proceedings, see subchapter B of chapter 70."**

20 (10)(A) Section 6326 (relating to cross references)
21 is amended by striking out paragraphs (2), (3), (4), and
22 (5) and inserting in lieu thereof the following:

"(2) For exclusion of tax liability from discharge in cases under title 11 of the United States Code, see section 523 of such title 11.

"(3) For recognition of tax liens in cases under title 11 of the United States Code, see sections ~~554~~ *545* and 724 of such title 11.

"(4) For collection of taxes in connection with plans for individuals with regular income in cases under title 11 of the United States Code, see section 1328 of such title 11."

(B) Section 6326 is amended by redesignating paragraphs (6) and (7) as paragraphs (5) and (6), respectively.

(11) Paragraph (2) of section 6503(i) (relating to cross references) is amended to read as follows:

"(2) Receiverships, see subchapter B of chapter 70."

(12) Section 6872 (relating to suspension period on assessment) is amended by striking out "any proceeding under the Bankruptcy Act" and by inserting in lieu thereof "any case under title 11 of the United States Code".

(13) Section 7430 (as amended by this Act) is amended by inserting after paragraph (1) the following new paragraphs:

"(2) For exclusion of tax liability from discharge in cases under title 11 of the United States Code, see section 523 of such title 11.

"(3) For recognition of tax liens in cases under title 11 of the United States Code, see sections ~~554~~ *545* and 724 of such title 11.

"(4) For collection of taxes in connection with plans for individuals with regular income in cases under title 11 of the United States Code, see section 1328 of such title 11."

1 (14) Paragraph (1) of section 7508(d) is amended
2 by striking out "BANKRUPTCY AND RECEIVERSHIPS"
3 in the paragraph heading and inserting in lieu thereof
4 "CASES UNDER TITLE 11 OF THE UNITED STATES
5 CODE AND RECEIVERSHIPS".

6 **SEC. 7. EFFECTIVE DATES.**

7 (a) FOR SECTION 2 (RELATING TO TAX TREATMENT
8 OF DISCHARGE OF INDEBTEDNESS).—The amendments
9 made by section 2 shall apply—
10 (1) to all transactions in any bankruptcy case or
11 similar judicial proceeding commencing on or after Oc-
12 tober 1, 1979, and
13 (2) to any transaction not described in paragraph
14 (1) which occurs after December 31, 1980 (other than
15 in a proceeding under the Bankruptcy Act, or in a sim-
16 ilar judicial proceeding, commenced before October 1,
17 1979).
18 (b) FOR SECTION 3 (RELATING TO RULES RELATING
19 TO TITLE 11 CASES FOR INDIVIDUALS).—The amendments
20 made by section 3 shall apply to any bankruptcy case com-

1 mencing more than 90 days after the date of the enactment
2 of this Act.
3 (c) FOR SECTION 4 (RELATING TO CORPORATE REOR-
4 GANIZATION PROVISIONS).—
5 (1) IN GENERAL.—The amendments made by sec-
6 tion 4 shall apply to any bankruptcy case or similar ju-
7 dicial proceeding commencing on or after October 1,
8 1979.
9 (2) EXCHANGES OF PROPERTY FOR ACCRUED IN-
10 TEREST.—The amendments made by subsection (e) of
11 section 4 (relating to treatment of property attributable
12 to accrued interest) shall also apply to any exchange—
13 (A) which does not occur in a proceeding
14 under the Bankruptcy Act, or similar judicial pro-
15 ceeding, commenced before October 1, 1979, but
16 (B) which occurs after December 31, 1980.
17 (d) FOR SECTION 5 (RELATING TO MISCELLANEOUS
18 CORPORATE AMENDMENTS).—
19 (1) FOR SUBSECTION (a) (RELATING TO EXEMP-
20 TION FROM PERSONAL HOLDING COMPANY TAX).—
21 The amendments made by subsection (a) of section 5
22 shall apply to any bankruptcy case or similar judicial
23 proceeding commenced on or after October 1, 1979.

1 (2) FOR SUBSECTION (b) (RELATING TO REPEAL
2 OF SPECIAL TREATMENT FOR CERTAIN RAILROAD
3 REDEMPTIONS).—The amendments made by subsection
4 (b) of section 5 shall apply to stock which is issued
5 after September 30, 1979 (other than stock issued pur-
6 suant to a plan of reorganization approved on or before
7 that date).
8 (3) FOR SUBSECTION (c) (RELATING TO APPLICA-
9 TION OF 12-MONTH LIQUIDATION RULE).—The
10 amendment made by subsection (c) of section 5 shall
11 apply to any bankruptcy case or similar judicial pro-
12 ceeding commenced on or after October 1, 1979.
13 (4) FOR SUBSECTION (d) (RELATING TO PERMIT-
14 TING BANKRUPTCY ESTATE TO BE SUBCHAPTER S
15 SHAREHOLDER).—The amendment made by subsection
16 (d) of section 5 shall apply to any bankruptcy case
17 commenced on or after October 1, 1979.
18 (5) FOR SUBSECTION (e) (RELATING TO CERTAIN
19 TRANSFERS TO CONTROLLED CORPORATIONS).—The
20 amendments made by subsection (e) of section 5 shall
21 apply as provided in subsection (a) of this section.
22 (6) FOR SUBSECTION (f) (RELATING TO EFFECT
23 OF DEBT DISCHARGE ON EARNINGS AND PROFITS).—
24 The amendment made by subsection (f) of section 5
25 shall apply as provided in subsection (a) of this section.

1 (e) FOR SECTION 6 (RELATING TO CHANGES IN TAX
2 PROCEDURES).—The amendments made by section 6 shall
3 take effect on October 1, 1979, but shall not apply to any
4 proceeding under the Bankruptcy Act commenced before Oc-
5 tober 1, 1979.

6 (f) DEFINITIONS.—For purposes of this section—

7 (1) BANKRUPTCY CASE.—The term "bankruptcy
8 case" means any case under title 11 of the United
9 States Code (as recodified by Public Law 95-598).

10 (2) SIMILAR JUDICIAL PROCEEDING.—The term
11 "similar judicial proceeding" means a receivership,
12 foreclosure, or similar proceeding in a Federal or State
13 court (as modified by section 368(a)(3)(D) of the Inter-
14 nal Revenue Code of 1954).

Passed the House of Representatives March 24, 1980.

Attest: EDMUND L. HENSHAW, JR.,

*Clerk.*

By W. RAYMOND COLLEY,

*Deputy Clerk.*

# DESCRIPTION OF H.R. 5043

## (BANKRUPTCY TAX ACT OF 1980)

### As Passed the House

## INTRODUCTION

This pamphlet has been prepared by the staff of the Joint Committee on Taxation for the public hearing on H.R. 5043, the Bankruptcy Tax Act of 1980, scheduled for May 30, 1980, before the Senate Finance Subcommittee on Taxation and Debt Management Generally.

The pamphlet provides background information on the bill, a summary of the major provisions of the bill, a more detailed description of present law and the provisions of the bill, and the estimated revenue effect.

(A separate pamphlet describes five Senate bills—S. 2484, S. 2486, S. 2500, S. 2503, and S. 2548—which are also scheduled for the May 30 Subcommittee hearing.)

# I. BACKGROUND

H.R. 5043, the Bankruptcy Tax Act of 1980, concerns the Federal income tax aspects of bankruptcy, insolvency, and discharge of indebtedness. The bill passed the House of Representatives on March 24, 1980, by a vote of 324–0, after having been ordered favorably reported by the Ways and Means Committee on March 12, 1980 (House Report No. 96–833).

The bill was developed over the past several years on the basis of extensive hearings, studies, and suggestions as to appropriate tax rules for bankruptcy and related tax issues. This effort to review and modernize bankruptcy tax law began with Congressional establishment of the Commission on the Bankruptcy Laws of the United States and the report issued by that Commission in 1973.[1] That report recommended changes and clarifications in both substantive rules and tax rules of bankruptcy.

In 1978, the 95th Congress enacted legislation (Public Law 95–598) which significantly revised and modernized the substantive law of bankruptcy as well as bankruptcy court procedures. Public Law 95–598 repealed the Bankruptcy Act and substituted a new title 11 in the U.S. Code, completely replacing the former provisions.[2] The new law generally became effective for bankruptcy cases commencing on or after October 1, 1979. H.R. 5043 is intended to complete the process of revising and updating Federal bankruptcy laws by providing rules governing the tax aspects of bankruptcy and related tax issues.

Because of the October 1, 1979 effective date enacted in Public Law 95–598 for repeal of the Bankruptcy Act (including repeal of provisions governing Federal income tax treatment of debt discharge in bankruptcy), and for implementation of new bankruptcy court procedures, provisions of H.R. 5043 applicable with respect to bankruptcy

[1] The present-law Federal income tax rules relating to taxpayers in bankruptcy cases and the Commission's recommendations for legislative changes, together with alternative proposals, are discussed in detail in a series of articles by William T. Plumb, Jr., Esq., entitled "The Tax Recommendations of the Commission on the Bankruptcy Laws." These articles appear at 29 Tax Law Review 227 (1974) (tax effects of debt reduction; insolvency reorganizations); 72 Mich. L. Rev. 935 (1974) (income tax liabilities of the bankruptcy estate and the debtor); and 88 Harv. L. Rev. 1360 (1975) (tax procedures).

[2] The 1978 statute did not include a "short title" (although it has been designated by some commentators as the "Bankruptcy Reform Act of 1978"). This pamphlet refers to the 1978 bankruptcy statute as "P.L. 95–598." The substantive bankruptcy law which is superseded by P.L. 95–598 is referred to as the "Bankruptcy Act."

In this pamphlet, the provisions of title 11 of the U.S. Code which were enacted by P.L. 95–598 are cited as "new 11 U.S. Code sec.—" References to the "Code" are to the Internal Revenue Code of 1954, as amended.

In the bill (H.R. 5043), bankruptcy cases to which the substantive provisions of P.L. 95–598 apply—generally, cases commenced on or after October 1, 1979—are referred to as "title 11 cases."

cases would generally be effective for bankruptcy cases commencing on or after October 1, 1979. Present law would continue to apply for bankruptcy cases commenced under the Bankruptcy Act, i.e., prior to October 1, 1979, including Bankruptcy Act cases which are commenced before and continue after that date. Provisions of H.R. 5043 applicable to transactions outside bankruptcy cases (such as discharge of indebtedness of a solvent taxpayer outside bankruptcy) generally would be effective for such transactions occurring after December 31, 1980.

Hearings were held on H.R. 5043 before the Ways and Means Subcommittee on Select Revenue Measures on September 27, 1979.[3] Throughout the development of the bill over the past several years, comments as to the appropriate tax rules in bankruptcy cases and related tax issues have been received from various groups and individuals, including the American Bar Association, Tax Section, Ad Hoc Committee for Bankruptcy Revision; the American Institute of Certified Public Accountants, Bankruptcy Task Force; the Association of the Bar of the City of New York, Committee on Taxation; the New York State Bar, Tax Section, Committee on Bankruptcy and Insolvency; the National Bankruptcy Conference, Committee on Tax Matters; the State Bar of California, Tax Section, Bankruptcy Tax Revision Committee; the Departments of Treasury and Justice; and the Internal Revenue Service.

[3] In 1978, the Ways and Means Committee held hearings on H.R. 9973 (95th Congress), concerning Federal income tax aspects of bankruptcy and related issues.

## II. SUMMARY OF H.R. 5043

### A. Tax Treatment of Discharge of Indebtedness

In Public Law 95-598, Congress repealed provisions of the Bankruptcy Act governing Federal income tax treatment of a discharge of indebtedness in bankruptcy, effective for cases instituted on or after October 1, 1979. The bill would provide tax rules in the Internal Revenue Code applicable to debt discharge in the case of bankrupt or insolvent debtors, and would make related changes to existing Code provisions applicable to debt discharge in the case of solvent debtors outside bankruptcy.

#### *Bankruptcy or insolvency*

Under the bill, no amount would be included in income for Federal income tax purposes by reason of a discharge of indebtedness in a bankruptcy case, or outside bankruptcy if the debtor is insolvent. Instead, the amount of discharged debt which would be excluded from gross income by virtue of the bill's provisions (the "debt discharge amount") would be applied to reduce certain tax attributes.

Unless the taxpayer elects first to reduce basis in depreciable assets, the debt discharge amount would be applied to reduce the taxpayer's net operating losses and then certain tax credits and capital loss carryovers. Any excess of the debt discharge amount over the amount of reduction in these attributes would be applied to reduce asset basis (but not below the amount of the taxpayer's remaining undischarged liabilities). Any further remaining debt discharge amount would be disregarded, i.e., would not result in income or have other tax consequences.

The bill would provide that the taxpayer may elect to apply the debt discharge amount first to reduce basis in depreciable property, before applying any remaining amount to reduce net operating losses and then other tax attributes in the order stated in the bill. A debtor making this election could elect to reduce basis in depreciable property below the amount of remaining liabilities (i.e., where the debtor would rather so reduce asset basis than reduce carryovers). To the extent the debtor makes an election to reduce basis in depreciable assets, or reduces basis in assets after reduction in other tax attributes, it is anticipated that Treasury regulations prescribing the order of basis reduction among assets would generally accord with present Treasury regulations which apply in the case of basis reduction under section 270 of the (now repealed) Bankruptcy Act.

To insure that ordinary income treatment eventually would be given to the full amount of basis reduction in depreciable or nondepreciable assets, the bill provides that any gain on a subsequent disposition of reduced-basis assets would be subject to "recapture" under sections 1245 or 1250 of the Internal Revenue Code.

### *Outside bankruptcy—solvent taxpayers*

The bill would modify the existing Federal income tax election (secs. 108 and 1017 of the Code) under which a solvent taxpayer outside bankruptcy may elect to reduce basis of assets instead of recognizing current income from debt cancellation. Similar to the rules of the bill applicable to bankrupt or insolvent debtors, the bill provides that the election to reduce basis allowed to the solvent debtor outside bankruptcy would require reduction in basis of depreciable assets.

To the extent that the debtor makes an election to reduce basis, it is anticipated that Treasury regulations prescribing the order of basis reduction among the taxpayer's depreciable assets would generally accord with present Treasury regulations under section 1017 of the Code. As in the case of bankrupt or insolvent debtors, the bill provides that any gain on a subsequent disposition of reduced-basis assets would be subject to "recapture" under sections 1245 or 1250 of the Code.

The bill also provides that in the case of a solvent taxpayer outside bankruptcy, a reduction to the purchaser in the amount of a purchase-money debt, by the seller of the property, would be treated for Federal income tax purposes as a purchase price reduction and not as a discharge of indebtedness.

### *Equity-for-debt rules*

The bill also provides rules relating to discharge of indebtedness of corporate debtors (whether or not in a bankruptcy case) in order to better coordinate the treatment of discharged debt at the corporate level with treatment at the creditor level.

If a corporate debtor issues stock to its creditor for an outstanding security (such as a bond), there would be no debt discharge amount and no attribute reduction would be required. Thus, no tax consequences at the corporate level would occur with respect to a transaction which is treated generally as a nonrecognition of gain or loss transaction for the creditors.

If a corporate debtor issues stock for other debts (such as debt held by trade creditors or by a lender holding a short-term note), the corporation would be treated as having satisfied the debt with an amount of money equal to the stock's value. To the extent the stock's value is less than the debt discharged, the discharge of indebtedness rules summarized above would apply. This treatment would be consistent with the usual recognition treatment for the creditors (e.g., a bad debt deduction is allowed for trade creditors) and would reflect the fact that tax attributes generally arise as a result of incurring debt obligations or expending loan proceeds.

If a value is placed on the stock either (1) by the bankruptcy court in a proceeding in which the Internal Revenue Service had the right to intervene on the valuation issue (including notice of the court hearing on the valuation issue) or (2) in a bankruptcy or similar proceeding or in an out-of-court agreement in which the debtor and creditor had adverse interests in the tax consequences of the valuation, the Revenue Service as well as the debtor and creditor would be bound by the valuation for purposes of the debt discharge rules of the bill and the creditor's bad debt deduction.

In light of these stock-for-debt rules, the bill provides that the special limitations on net operating loss carryovers (sec. 382 of the Inter-

nal Revenue Code) generally would not apply to the extent creditors receive stock in exchange for their claims.

The bill also provides that the debt discharge rules would apply to the extent that the amount of debt transferred to a corporation as a contribution to capital exceeds the shareholder's basis in the debt.

### *Other rules concerning debt discharge*

In addition, other rules in the bill concerning debt discharge would relate to debt acquired by a related party, discharge of liabilities payment of which would have given rise to deductions, the tax benefit rule of section 111 of the Code, and discharge of a partnership debt. Also, the bill provides (overturning a contrary position of the Internal Revenue Service) that if the basis of investment credit property is reduced by a debt discharge amount, no investment credit recapture would occur by reason of the reduction.

### *Effective date*

The provisions of the bill relating to tax treatment of debt discharge would apply for bankruptcy cases (or receivership, foreclosure, or similar judicial proceedings) commenced on or after October 1, 1979. Present tax law would continue to apply for bankruptcy cases (or receivership, etc. proceedings) commenced prior to October 1, 1979.

In the case of discharge of indebtedness outside bankruptcy cases (or receivership, etc. proceedings), the debt discharge rules of the bill would apply to any discharge of indebtedness occurring after December 31, 1980.

## B. Bankruptcy Estate of an Individual

### *In general*

The bill would treat the bankruptcy estate of an individual in a liquidation or reorganization case under the new bankruptcy statute as a separate taxable entity for Federal income tax purposes. Also, the bill provides that no separate taxable entity would be created by commencement of a bankruptcy case in which the debtor is an individual in a case under chapter 13 of the new bankruptcy law (adjustment of debts of an individual with regular income), a partnership, or a corporation.

The Federal income tax rules set forth in the bill with respect to a bankruptcy estate of an individual which would be treated as a separate taxable entity would include rules for allocation of income and deductions between the debtor and the estate, computation of the estate's taxable income, accounting methods and periods of the estate, the treatment of the estate's administrative costs as deductible expenses, carryover of tax attributes between the debtor and the estate, and requirements for filing and disclosure of returns.

### *Debtor's election to close taxable year*

Also, the bill generally would give an individual debtor an election to close his or her taxable year as of the day the bankruptcy case commences. If the election were made, the debtor's Federal income tax liability for the "short" taxable year ending on commencement of the case would become an allowable claim against the bankruptcy estate. If the election were not made, the commencement of the bankruptcy case would not terminate the taxable year of an individual debtor.

***Effective date***

These provisions of the bill would apply to bankruptcy cases commencing more than 90 days after the date of enactment of the bill.

**C. Corporate Reorganizations in Bankruptcy**

***Expansion of reorganization provisions***

The bill would expand the categories of tax-free corporate reorganizations defined in section 368 of the Code to include a new category of "G" reorganizations. This category would include certain transfers of assets pursuant to a court-approved reorganization plan in a bankruptcy case (or in a receivership, foreclosure, or similar proceeding). Accordingly, the bill would terminate the applicability of special rules of current law relating to insolvency reorganizations (secs. 371–374 of the Code).

The bill would permit a "G" reorganization to take the form of a triangular reorganization, including a "reverse merger." Also, the bill would allow the acquiring corporation in a "G" reorganization to transfer the acquired assets to a controlled subsidiary. In light of the debt discharge rules of the bill, which would adjust tax attributes of a reorganized corporation to reflect changes in its debt structure, the statutory rule generally governing carryover of tax attributes in corporate reorganizations (sec. 381 of the Code) would apply in the case of a "G" reorganization.

Since "G" reorganizations would be subject to the rules governing the tax treatment of exchanging shareholders and security holders which apply generally to corporate reorganizations, a shareholder or security holder who receives securities in a "G" reorganization with a principal amount exceeding the principal amount of securities surrendered would be taxed on the excess. Also, money or other "boot" property received in a "G" reorganization would be subject to the dividend-equivalence tests which apply to the reorganizations generally.

***Property attributable to accrued interest***

Under the bill, a creditor exchanging securities in any corporate reorganization described in section 368 of the Code (including a "G" reorganization) would be treated as receiving interest income on the exchange to the extent the creditor receives new securities, stock, or other property attributable to accrued but unpaid interest on the securities surrendered.

***Effective date***

These provisions of the bill would apply to bankruptcy cases (or receivership, foreclosure, or similar judicial proceedings) commencing on or after October 1, 1979. In addition, the amendments relating to property attributable to accrued interest also would apply to transactions occurring after December 31, 1980 (other than transactions in a proceeding under the Bankruptcy Act or in a receivership, foreclosure, or similar judicial proceeding begun before October 1, 1979).

**D. Miscellaneous Corporate Amendments**

The bill would make a number of miscellaneous amendments to the Internal Revenue Code relating to corporate tax issues, including the following.

*1. PHC status.*—Under the bill, a corporate debtor generally would not be considered a personal holding company, subject to additional taxes on certain passive income, while in a bankruptcy case (or receivership, foreclosure, or similar proceeding) commencing on or after October 1, 1979.

*2. Liquidation rule.*—The corporate nonrecognition tax rules applicable to 12-month liquidations would be extended to cover sales by insolvent corporations of assets, other than assets acquired after commencement of the bankruptcy case, during the entire period from adoption (after commencement of the case) of the plan of liquidation through conclusion of the case. This provision would apply to bankruptcy cases (or receivership, etc. proceedings) commencing on or after October 1, 1979.

*3. Subchapter S shareholder.*—The bill provides that for bankruptcy cases commencing on or after October 1, 1979, the bankruptcy estate of an individual debtor could be an eligible shareholder in a subchapter S corporation.

*4. Section 351 applicability.*—Under the bill, transfers to a controlled corporation of indebtedness of the corporation which is not evidenced by a security, or of claims against the corporation for accrued but unpaid interest on indebtedness, would not be covered by the nonrecognition rule of section 351 of the Code. Also, the nonrecognition rule would not apply in the case of a transfer to a controlled corporation of the assets of a debtor in a bankruptcy or similar case to the extent the stock or securities received in exchange for the assets were used by the debtor to pay off his debts. The effective date for these provisions would be the same as for the provisions of the bill relating to tax treatment of discharge of indebtedness.

*5. Earnings and profits.*—The bill provides that to the extent the amount of discharged indebtedness is applied to reduce basis under section 1017 of the Code, such basis-reduction amount would not affect the debtor corporation's earnings and profits. The effective date for this provision would be the same as for the provisions of the bill relating to tax treatment of discharge of indebtedness.

**E. Changes in Tax Procedures**

The bill would coordinate certain provisions of the Internal Revenue Code with the bankruptcy court procedures enacted in P.L. 95-598. These procedures include the automatic stay on assessment or collection of certain tax claims against the debtor, the automatic stay on institution or continuation by the debtor of deficiency litigation in the U.S. Tax Court, and the authority of the bankruptcy court to lift the stay and permit the debtor's tax liability to be determined by the Tax Court.

# III. EXPLANATION OF H.R. 5043

## A. Tax Treatment of Discharge of Indebtedness (sec. 2 of the bill and secs. 108, 111, 382, and 1017 of the Code)

### *Present law*

#### *In general*

Under present law, income is realized when indebtedness is forgiven or in other ways cancelled (sec. 61(a)(12) of the Internal Revenue Code). For example, if a corporation has issued a $1,000 bond at par which it later repurchases for only $900, thereby increasing its net worth by $100, the corporation realizes $100 of income in the year of repurchase (*United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931)).

There are several exceptions to the general rule of income realization. Under a judicially developed "insolvency exception," no income arises from discharge of indebtedness if the debtor is insolvent both before and after the transaction; [1] and if the transaction leaves the debtor with assets whose value exceeds remaining liabilities, income is realized only to the extent of the excess.[2] Treasury regulations provide that the gratuitous cancellation of a corporation's indebtedness by a shareholder-creditor does not give rise to debt discharge income to the extent of the principal of the debt, since the cancellation amounts to a contribution to capital of the corporation.[3] Some courts have applied this exception even if the corporation had previously deducted the amount owed to the shareholder-creditor.[4] Under a related exception, no income arises from discharge of indebtedness if stock is issued to a creditor in satisfaction of the debt, even if the creditor was previously a shareholder, and even if the stock is worth less than the face amount of the obligation satisfied.[5] Further, cancellation of a previously accrued and deducted expense does not give rise to income if the deduction did not result in a reduction of tax (sec. 111). A debt cancellation which constitutes a gift or bequest is not treated as income to the donee debtor (sec. 102).

A debtor which would otherwise be required to report current income from debt cancellation under the preceding rules instead may elect to reduce the basis of its assets in accordance with Treasury regulations (secs. 108 and 1017 of the Code). This income exclusion is available if the discharged indebtedness was incurred by a corporation or by an individual in connection with property used in his trade or business. These provisions were intended to allow the tax on the

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[1] Treas. Regs. § 1.61-12(b)(1); *Dallas Transfer & Terminal Warehouse Co.* v. *Comm'r*, 70 F. 2d 95 (5th Cir. 1934).

[2] *Lakeland Grocery Co.*, 36 B.T.A. 289 (1937).

[3] Treas. Regs. § 1.61-12(a).

[4] *Putoma Corp.* v. *Comm'r*, 66 T.C. 652 (1976), *aff'd*, 601 F. 2d 734 (5th Cir. 1979).

[5] *Comm'r* v. *Motor Mart Trust*, 156 F. 2d 122 (1st Cir. 1946).



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debt discharge income to be deferred and collected through lower depreciation deductions for the reduced-basis assets, or greater taxable gains on sale of the assets.

The Internal Revenue Service takes the position that a reduction in the basis of qualified investment credit property resulting from an income-exclusion election under sections 108 and 1017 of the Code is *pro tanto* a disposition of the property the basis of which was reduced, resulting in partial recapture of the investment credit allowed upon its purchase (Rev. Rul. 74-184, 1974-1 C. B. 8).

***Bankruptcy proceedings***

The Bankruptcy Act contains certain rules relating to the Federal income tax treatment of discharge of indebtedness in bankruptcy proceedings. However, these rules have been repealed by P.L. 95-598 effective for bankruptcy cases instituted on or after October 1, 1979.

Under the Bankruptcy Act provisions, no income is recognized on cancellation of indebtedness in an insolvency reorganization (under chapter X).[6] The Act requires the debtor corporation to reduce the basis of its assets by the amount of indebtedness discharged, but not below the fair market value of such assets as of the date the bankruptcy court confirms the reorganization plan.[7] However, under section 372 of the Internal Revenue Code, no basis reduction is required if the corporation's property is transferred to a successor corporation as part of the bankruptcy reorganization.[8]

Similar rules apply in the case of an "arrangement" (under chapter XI), a "real property arrangement" (under chapter XII), and a wage earner's plan (under chapter XIII), except that no basis reduction is required under a wage earner's plan.[9] In addition, in the case of a Bankruptcy Act discharge other than under an insolvency reorganization or an arrangement described above, income is not realized to the extent the general "insolvency exception" applies.[10]

## *Explanation of provisions*

***Debt discharge in bankruptcy***

*In general*

Under the bill, no amount would be included in income for Federal income tax purposes by reason of a discharge of indebtedness in a bankruptcy case.[11] Instead, the amount of discharged debt which would be excluded from gross income by virtue of the bill's provisions (the "debt discharge amount") would be applied to reduce certain tax attributes.

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[6] Sec. 268 of the Bankruptcy Act.

[7] Sec. 270 of the Bankruptcy Act.

[8] While under present law no basis reduction is required if a successor corporation is used in the insolvency reorganization, the Code under present law does not permit the carryover of tax attributes, such as net operating losses, from the debtor to the successor corporation (except possibly in certain situations where the reorganization meets the requirements of secs. 368 and 381 of the Code, in which case net operating losses may be limited by section 382 of the Code).

[9] Secs. 395, 396, 520, 522, and 679 of the Bankruptcy Act.

[10] Treas. Regs. § 1.61-12(b). See text accompanying notes 1 and 2.

[11] For purposes of these rules, the term "bankruptcy case" (referred to in the bill as a "title 11 case") means a case under new title 11 of the U.S. Code, but only if the taxpayer is under the jurisdiction of the court in the case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.

Unless the taxpayer elects first to reduce basis of depreciable assets, the debt discharge amount would be applied to reduce the taxpayer's tax attributes in the following order:

(1) net operating losses and carryovers;

(2) carryovers of the investment tax credit (other than the ESOP credit), the WIN credit, the new jobs credit, and the credit for alcohol used as a fuel; [12]

(3) capital losses and carryovers; and

(4) the basis of the taxpayer's assets.

The reduction in each category of carryovers would be made in the order of taxable years in which the items would be used, with the order determined as if the debt discharge amount were not excluded from income.[13] For this purpose, any limitations on the use of credits that are based on the income of the taxpayer would be disregarded.

After reduction of the specified carryovers, any remaining debt discharge amount would be applied to reduce asset basis, but not below the amount of the taxpayer's remaining undischarged liabilities. (Thus, a sale of all the taxpayer's assets immediately after the discharge generally would not result in income tax liability except to the extent the sale proceeds and cash on hand exceed the amount needed to pay off the remaining liabilities.) Any amount of debt discharge which is left after attribute reduction under these rules would be disregarded, i.e., would not result in income or have other tax consequences.

*Election to reduce basis in depreciable property*

The bill provides that the taxpayer could elect, in accordance with Treasury regulations, to apply all or a portion of the debt discharge amount first to reduce basis (but not below zero) in depreciable property,[14] before applying any remaining amount to reduce net operating losses and other tax attributes in the order described above. A debtor making this election could elect to reduce basis (but not below zero) in depreciable property below the amount of remaining liabilities (i.e., where the debtor would rather so reduce asset basis than reduce carryovers).

An election first to reduce basis in depreciable property would be made on the taxpayer's return for the year in which the discharge occurs, or at such time as permitted by Treasury regulations. Once

[12] These credits would be reduced at the rate of 50 cents for each dollar of debt discharge amount. This flat-rate reduction would avoid the complexity of determining a tax on the debt discharge amount and determining how much of the amount would be used up by the credits for purposes of determining other reductions. Except for reductions in credit carryovers, the specified tax attributes would be reduced one dollar for each dollar of debt discharge amount.

[13] Thus in the case of net operating loss and capital loss, the debt discharge amount first would reduce the current year's loss and then would reduce the loss carryovers in the order in which they arose. The investment credit carryovers would be reduced on a FIFO basis, and the other credit carryovers also would be reduced in the order they would be used against taxable income. These reductions would be made after the computation of the current year's tax.

[14] For this purpose, the term "depreciable property" means any property of a character subject to the allowance for depreciation, but only if the basis reduction would reduce the amount of depreciation or amortization which otherwise would be allowable for the period immediately following such reduction. Thus, for example, a lessor could not reduce the basis of leased property where the lessee's obligation in respect of the property will restore to the lessor the loss due to depreciation during the term of the lease, since the lessor cannot take depreciation in respect of that property. See *Harry H. Kem, Jr.*, 51 T.C. 455 (1968), *aff'd*, 432 F.2d 961 (9th Cir. 1970).

made, an election could be revoked by the taxpayer only with the consent of the Internal Revenue Service.

*Recapture rule*

If the basis of property (whether depreciable or nondepreciable) were reduced pursuant to the rules in the bill, any gain on a subsequent disposition of the property would be subject to "recapture" under section 1245 of the Code or, in the case of realty, under section 1250. The computation of the amount of straight-line depreciation (under sec. 1250(b)) would be determined as if there had been no reduction of basis under section 1017.

*Basis reduction—general rules*

To the extent a debtor makes an election to reduce basis in depreciable property, or reduces basis in assets after reduction in other attributes, the particular properties the bases of which would be reduced would be determined pursuant to Treasury regulations. It would be anticipated that the order of reduction prescribed in such regulations would generally accord with present Treasury regulations which apply in the case of basis reduction under section 270 of the (now repealed) Bankruptcy Act (Treas. Regs. §§ 1.1016–7 and 1.1016–8).

In order to avoid interaction between basis reduction and reduction of other attributes, the bill provides that the basis reduction would take effect on the first day of the taxable year following the year in which the discharge took place. If basis reduction were required in respect of a discharge of indebtedness in the final year of a bankruptcy estate, the reduction would be made in the basis of assets acquired by the debtor from the estate at the time so acquired.

In a bankruptcy case involving an individual debtor to which new section 1398 of the Code (as added by the bill) would apply, any attribute reduction required under the bill would apply to the attributes of the bankruptcy estate (except for purposes of applying the basis-reduction rules of section 1017 to property transferred by the estate to the individual) and not to those attributes of the individual which arose after commencement of the case. Also, the bill provides that in a bankruptcy case involving an individual debtor, no reduction in basis would be made in the basis of property which the debtor treats as exempt property under new 11 U.S. Code section 522.

***Debt discharge outside bankruptcy—insolvent debtors***

The bill provides that if a discharge of indebtedness occurs when the taxpayer is insolvent (but is not in a bankruptcy case), the amount of debt discharge would be excluded from gross income up to the amount by which the taxpayer is insolvent,[15] and that the excluded amount would be applied to reduce tax attributes in the same manner as if the discharge had occurred in a bankruptcy case. Any balance of the debt discharged which would not be excluded from gross income

[15] The bill defines "insolvent" as the excess of liabilities over the fair market value of assets, determined with respect to the taxpayer's assets and liabilities immediately before the debt discharge. The bill provides that except pursuant to section 108(a)(1)(B) of the Code (as would be added by the bill), there is to be no insolvency exception from the general rule that gross income includes income from discharge of indebtedness.

(because it exceeds the insolvency amount) would be treated in the same manner as debt cancellation in the case of a wholly solvent taxpayer.

***Debt discharge outside bankruptcy—solvent debtors***

In the case of a solvent taxpayer outside bankruptcy, the bill would modify the present rule (secs. 108 and 1017 of the Code) permitting an election to reduce the basis of assets in lieu of reporting income from discharge of indebtedness. Under this modification, only the basis of depreciable property held by the taxpayer could be reduced.[16]

An election to reduce basis in depreciable property would be made on the taxpayer's return for the year in which the discharge occurs, or at such other time as permitted by Treasury regulations. Once made, an election could be revoked by the taxpayer only with the consent of the Internal Revenue Service.

If a taxpayer makes an election to reduce basis in depreciable property, the particular depreciable assets the bases of which are to be reduced (but not below zero) would be determined pursuant to Treasury regulations. It would be anticipated that the order of reduction among depreciable assets of the taxpayer would generally accord with present Treasury regulations (Treas. Regs. §§ 1.1017-1 and 1.1017-2). The bill provides that the basis reduction would take effect on the first day of the taxable year following the year in which the discharge takes place.

To the extent a solvent taxpayer outside bankruptcy does not make an election to reduce basis in depreciable property in lieu of reporting income from debt discharge, or to the extent the debt discharge amount exceeds the maximum reduction which can be made through an election, the excess constitutes income from discharge of indebtedness which, as under present law, constitutes gross income for Federal income tax purposes (sec. 61(a)(12) of the Code; Rev. Rul. 67-200, 1967-1 C.B. 15).

*Recapture rule*

To insure that ordinary income treatment eventually will be given to the full amount of basis reduction, the bill provides that any gain on a subsequent disposition of reduced-basis property would be subject to "recapture" under section 1245 of the Code or, in the case of realty, under section 1250. The computation of the amount of straight-line depreciation (under sec. 1250(b)) would be determined as if there had been no reduction of basis under section 1017.

*Certain reductions as purchase price adjustments*

The bill provides that if the seller of specific property reduces the debt of the purchaser which arose out of the purchase, and the reduction to the purchaser does not occur in a bankruptcy case or when the

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[16] The exclusion from gross income under section 108(a) of the Code (as would be amended by the bill) would apply, in the case of a discharge which does not occur in a title 11 case and which does not occur when the taxpayer is insolvent, where the indebtedness discharged is "qualified business indebtedness." The latter term means indebtedness of the taxpayer if both (1) the indebtedness was incurred or assumed by a corporation, or by an individual in connection with property used in his trade or business, and also (2) the taxpayer makes an election to reduce the basis of depreciable assets.

For this purpose, the term "depreciable property" would be defined the same way as in the case of the election by a bankrupt or insolvent taxpayer to reduce the basis of depreciable property (see note 14, *supra*).

purchaser is insolvent, then the reduction to the purchaser of the purchase-money debt would be treated (for both the seller and the buyer) as a purchase price adjustment on that property. This rule would apply only if but for this provision the amount of the reduction would be treated as income from discharge of indebtedness.

This provision would be intended to eliminate disagreements between the Internal Revenue Service and the debtor as to whether in a particular case to which the provision applies the debt reduction should be treated as discharge income or a true price adjustment. If the debt has been transferred by the seller to a third party (whether or not related to the seller), or if the property has been transferred by the buyer to a third party (whether or not related to the buyer), this provision would not apply to determine whether a reduction in the amount of purchase-money debt should be treated as discharge income or a true price adjustment; nor would it apply where the debt is reduced because of factors not involving direct agreements between the buyer and the seller, such as the running of the statute of limitations on enforcement of the obligation.

***Equity-for-debt rules***

The bill would provide rules relating to corporate indebtedness in order to better coordinate the treatment of discharged debt at the corporate level with treatment at the creditor level. These rules would apply whether the debtor is solvent or insolvent, and whether or not the debtor is in a bankruptcy case.

*Securities*

Under the bill, if a corporate debtor issues stock to its creditor for the principal amount of an outstanding security (such as a bond), there would be no debt discharge amount, and no attribute reduction would be required. Thus, no tax consequences at the corporate level would occur with respect to a transfer which is treated generally as a nonrecognition of gain or loss transaction for the creditor.

For purposes of this rule, the term "security" would mean an evidence of indebtedness which was issued by a corporate debtor with interest coupons or in registered form (within the meaning of sec. 165(g)(2)(C) of the Code) and which constitutes a security for purposes of section 354 of the Code.[17] Thus, the term "security" would be intended to mean those instruments with repect to which generally no reduction for partially worthless debts could have been allowed under section 166(a)(2) of the Code and with respect to which no loss could be recognized in an exchange under a plan of reorganization by reason of sections 354 or 356 of the Code.[18]

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[17] The bill provides that the stock-for-security exception would apply only if the debt for which the stock is issued constituted a "security" either on October 1, 1979, or if incurred after that date, then at all times after the debt was incurred. Accordingly, the exception in section 108(f)(1)(C) would not apply if non-security debt held by a creditor is transformed (after October 1, 1979) into security debt either directly (through an exchange of the non-security debt for debt in registered form, for example) or indirectly (through a "repayment" that is, as a practical matter, conditioned on reinstitution of the debt in the form of a security).

[18] However, if the creditor holding the security is a bank, the "securities rule" applies under the bill (i.e., there would be no tax consequences to the debtor) even though, unlike other taxpayers, banks are permitted under present law (sec. 582(a) of the Code) to claim a bad debt deduction for a partially worthless security.

The "securities rule" of the bill would not be intended to apply if only a *de minimis* amount of stock is issued for an outstanding security. Thus, the value of the stock received could not be very small when compared to the total amount of the creditor's claim, so that the debt forgiveness rules would not be circumvented by the issuance of token shares to a creditor with no real equity interest in the corporation.

If both stock and other property were issued for a debt evidenced by a security, the stock would be treated as issued for a proportion of the debt equal to its proportion of the value of the total consideration. For example. if $30 cash and $20 worth of stock are issued to cancel a $100 bond, the cash would be treated as satisfying $60 of the debt (resulting in a debt discharge amount of $30 to which the rules of the bill apply), and the stock would be treated as issued for the other $40 of the debt (with no income resulting or attribute reduction required).

*Debts other than securities*

If a corporate debtor issues stock for other debts (such as debts held by trade creditors or by a lender holding a short-term note), the corporation would be treated as having satisfied the debt with an amount of money equal to the stock's fair market value. To the extent the stock's value is less than the principal amount of the debt discharged, the discharge of indebtedness rules summarized above would apply.[19]

This treatment would be consistent with the usual recognition treatment for the creditors (e.g., a bad debt deduction is allowed for trade creditors) and reflects the fact that tax attributes generally arise as a result of incurring debt obligations or expending loan proceeds.

If a value is placed on the stock either (1) by the bankruptcy court in a proceeding in which the Internal Revenue Service had the right to intervene on the valuation issue (including notice of the court hearing on the valuation issue) or (2) in a bankruptcy or similar proceeding or in an out-of-court agreement in which the debtor and creditor had adverse interests in the tax consequences of the valuation, the Revenue Service as well as the debtor and creditor would be bound by the valuation for purposes of tax calculations, including the debt discharge rules of the bill and the creditor's bad debt deduction.

*Capital contributions*

The bill also provides that the discharge of indebtedness rules would apply to the extent that the amount of debt transferred to a

[19] For example, assume a corporate debtor borrows $1,000 on a short-term note and later issues $600 worth of stock in cancellation of the note. Under present law, the creditor recognizes a $400 loss, but the corporate debtor neither recognizes income nor must reduce tax attributes. Under the bill, the creditor would recognize a $400 loss (as under present law) and the corporation must account for a debt discharge amount of $400.

If the corporation is insolvent or in bankruptcy, it must apply the $400 debt discharge amount to reduce tax attributes pursuant to the rules discussed in the text above. If the debtor is a solvent corporation outside bankruptcy, it could elect to reduce basis of depreciable assets by $400 in lieu of recognizing $400 of income in the year of discharge.

corporation as a contribution to capital exceeds the shareholder's basis in the debt.[20] Thus, the discharge of indebtedness rules would apply when a cash-basis taxpayer contributes to the capital of an accrual-basis corporation a debt representing an accrued expense previously deducted by the corporation.[21]

*Application of rules*

For purposes of the equity-for-debt rules, the bill provides that the term "debtor corporation" would include a successor corporation, and that the stock of a corporation in control of the debtor corporation would be treated as stock of the debtor.[22]

*Partnership debt*

Similar rules would apply in the case of discharge of partnership indebtedness if an equity interest in the partnership is exchanged for a partnership debt, or if partnership debt is contributed by a partner as a contribution to capital.

***Other rules concerning debt discharge***

*No disposition on basis reduction.*—If the basis of qualified investment credit property would be reduced by a debt discharge amount under the rules of the bill, no investment credit recapture tax would be incurred, because the reduction would not be considered a disposition. This rule would overturn the position taken by the Internal Revenue Service in Rev. Rul. 74–184, *supra*, in the case of a solvent debtor making an election under sections 108 and 1017 of the Code (as

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[20] For example, assume a corporation accrues and deducts (but does not actually pay) a $1,000 liability to a shareholder-employee as salary, and the cash-basis employee does not include the $1,000 in income. In a later year, the shareholder-employee forgives the debt.

Under the bill, the corporation must account for a debt discharge amount of $1,000. If the corporation is insolvent or in bankruptcy, it must apply the $1,000 debt discharge amount to reduce tax attributes pursuant to the rules discussed in the text above. If the debtor is a solvent corporation outside bankruptcy, it could elect to reduce basis of depreciable assets by $1,000 in lieu of recognizing $1,000 of income in the year of discharge.

On the other hand, if the shareholder-employee were on the accrual basis, had included the salary in income, and his or her basis in the debt was still $1,000 at the time of the contribution, there would be no debt discharge amount, and no attribute reduction would be required.

[21] This contribution-to-capital rule would reverse the result reached in *Putoma Corp.* v. *Comm'r*, 66 T.C. 652 (1976), *aff'd*, 601 F.2d 734 (5th cir. 1979). Moreover, it would be intended that the result reached in *Putoma* could not alternatively be sustained on the ground that the shareholder has made a "gift" to the corporation, since it would be intended that there will not be any gift exception in a commercial context (such as a shareholder-corporation relationship) to the general rule that income is realized on discharge of indebtedness.

[22] Thus the stock-for-debt rules of the bill would apply for an exchange by a successor corporation (i.e., a corporation whose attributes carried over under section 381 of the Code, as amended by this bill) of its stock for debt of its predecessor, or an exchange by the debtor of the successor corporation's stock for the debt. Also, these rules would apply where stock of a corporation in control of the debtor corporation or the successor corporation is transferred in the exchange.

would be amended by the bill), and would preclude extension of that position to bankrupt or insolvent debtors.[23]

*Indebtedness of taxpayer.*—The debt discharge rules of the bill would apply with respect to discharge of any indebtedness for which the taxpayer is liable or subject to which the taxpayer holds property.

*Unamortized premium and discount.*—The bill provides that the amount taken into account with respect to any discharge of indebtedness would be properly adjusted for unamortized premium and unamortized discount with respect to the indebtedness discharged.[24]

*Debt acquired by related party.*—The bill provides that, for purposes of determining income of the debtor from discharge of indebtedness, an outstanding debt acquired from an unrelated party by a party related to the debtor would be treated as having been acquired by the debtor to the extent provided in regulations issued by the Treasury Department. For purposes of this rule, a person would be treated as related to the debtor if the person is (1) a member of a controlled group of corporations (as defined for purposes of sec. 414(b) of the Code) of which group the debtor is a member, (2) a trade or business treated as under common control with respect to the debtor (within the meaning of sec. 414(c) of the Code), (3) either a partner in a partnership treated as controlled by the debtor or a controlled partnership with respect to the debtor (within the meaning of sec. 707 (b)(1) of the Code), or (4) a member of the debtor's family or other person bearing a relationship to the debtor specified in section 267(b) of the Code. The definition of "family" for this purpose would also include a spouse of the debtor's child or grandchild. This rule would be intended to treat a debtor as having its debt discharged if a party related to the debtor purchases the debt at a discount (for example, where a parent corporation purchases at a discount debt issued by its subsidiary).[25]

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[23] No inference would be intended, by virtue of adoption of the no-disposition rule of the bill as described in the text above, as to whether the position taken by the Internal Revenue Service in Rev. Rul. 74-184, *supra*, represents a correct interpretation of Federal income tax law prior to the effective date of the bill's no-disposition rule.

A purchase price adjustment (whether or not described in new sec. 108(e)(5) of the Code, as would be added by this bill) would continue to constitute an adjustment for purposes of the investment credit rules of the Code.

[24] This provision of the bill would not be intended to be a change from the rules of current law as to adjustments for unamortized premium and discount.

[25] It would be intended that the Treasury Department has authority to and will issue regulations providing for the following income tax consequences on repayment or capital contribution of debt which had been acquired by a related party subject to the rule of the bill treating the debtor as having acquired the debt.

If the debtor subsequently pays the debt to the related party and the related party recognizes gain on the payment transaction, a deduction equal to the amount of such gain will be allowed to the debtor for the year in which such payment occurs. For example, assume a parent corporation purchases for $900 on the open market a $1,000 bond issued at par by its wholly owned subsidiary. Under the bill, the debtor (the subsidiary) must account for a debt discharge amount of $100 for its taxable year during which the debt was so acquired. In the following year when the debt matures, assume the subsidiary pays its parent the full principal amount ($1,000). The Treasury regulations would provide that the debtor will be allowed a $100 deduction in the year of such payment.

If a related party transfers to a corporation as a contribution to capital debt issued by the corporation and the debtor corporation thereby has a debt dis-

"*Lost*" *deductions*.—The bill provides that if the payment of a liability would have given rise to a deduction, the discharge of that liability would not give rise to income or require reduction of tax attributes. For example, assume a cash-basis taxpayer owes $1,000 to its cash-basis employee as salary and has not actually paid such amount. If later the employee forgives the debt (whether or not as a contribution to capital, then the discharge would not give rise to income or require any reduction of tax attributes.

*Section 382 exception*.—Because the bill would contain rules providing for attribute reduction in certain circumstances where a corporation's indebtedness is discharged upon the issuance of stock, no further reduction of attributes would be required under sections 382 and 383 of the Code if stock is issued in exchange for a creditor's claim against the corporation (unless the claim were acquired for the purpose of acquiring the stock).[26] The bill specifically provides that acquisition of stock for debt in a bankruptcy or similar case would not be treated as an acquisition by purchase in applying section 382(a) of the Code and that the creditors of the debtor corporation would be treated as shareholders in applying the continuity rules of section 382(b) to a reorganization under section 368(a)(1)(G) of the Code (as added by this bill).

It is expected that the Treasury regulations defining a consolidated return change of ownership would be amended to conform with the amendment made by this bill to section 382 of the Code.

*Tax benefit rule*.—The bill would clarify present law by providing that in applying the tax benefit rule of section 111 of the Code in order to determine if the recovery of an item is taxable, a deduction would be treated as having produced a reduction in tax if the deduction increased a carryover that had not expired at the end of the taxable year in which the recovery occurs. Thus, if an accrual-basis taxpayer incurs a deductible obligation to pay rent in 1980, and that obligation is forgiven in 1981, the rent deduction would be treated as having produced a reduction in tax even if it had entered into the calculation of a net operating loss that had not expired at the end of 1981 but had not been used as of that time.

### Partnerships

The bill would provide that the rules of exclusion from gross income and reduction of tax attributes in section 108 of the Code (as amended by the bill) are to be applied at the partner level and not at

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charge amount pursuant to the rules of the bill, a deduction equal to the debt discharge amount will be allowed to the debtor for the year in which the capital contribution is made. For example, assume a parent corporation purchases for $900 on the open market a $1,000 bond issued at par by its wholly owned subsidiary. Under the bill, the debtor (the subsidiary) must account for a debt discharge amount of $100 for its taxable year during which the debt was so acquired. In the following year, assume the parent transfers the debt to its subsidiary as a contribution to capital (i.e., forgives the debt). The Treasury regulations would provide that the amount treated as a debt discharge amount under the capital contribution rules of the bill ($100 in the example given) will be reduced by the debt discharge amount previously taken into account by the subsidiary ($100).

[26] For example, any claim purchased after it had become evident that the claim would have to be satisfied primarily with stock could be considered to have been acquired for the purpose of acquiring the stock.

the partnership level.[27] Accordingly, income from discharge of a partnership debt would not be excludable at the partnership level under amended section 108. Instead, such income would be treated as an item of income which is allocated separately to each partner pursuant to section 702(a) of the Code.

This allocation of an amount of debt discharge income to a partner results in that partner's basis in the partnership being increased by such amount (sec. 705). At the same time, the reduction in the partner's share of partnership liabilities caused by the debt discharge results in a deemed distribution (under sec. 752), in turn resulting in a reduction (under sec. 733) of the partner's basis in the partnership. The section 733 basis reduction, which offsets the section 705 basis increase, would be separate from any basis reduction pursuant to the attribute-reduction rules of the bill.

The tax treatment of the amount of discharged partnership debt which is allocated as an income item to a particular partner would depend on whether that partner is in a bankruptcy case, is insolvent (but not in a bankruptcy case), or is solvent (and not in a bankruptcy case). For example, if the particular partner were bankrupt or insolvent, the debt discharge amount would be excluded from gross income pursuant to amended section 108 and would be applied to reduce the partner's net operating losses and other tax attributes, unless the partner elects to apply the amount first to reduce basis in depreciable assets. If the particular partner were solvent (and not in a bankruptcy case), the amount allocated to that partner would be included in that partner's gross income except to the extent the partner elects to reduce basis of depreciable assets.

The bill would provide that, in connection with these attribute-reduction rules, a partner's interest in a partnership is to be treated as depreciable property to the extent of such partner's proportionate interest in the depreciable property held by the partnership. The bill also would provide that if a partner reduces his basis in the partnership under section 1017 of the Code by reason of the debt discharge rules of the bill, the partnership must make a corresponding reduction in the basis of the partnership property with respect to such partner (in a manner similar to that which would be required if the partnership had made an election under section 754 to adjust basis in the case of a transfer of a partnership interest).[28]

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[27] The effect of these provisions of the bill would be to overturn the decision in *Stackhouse* v. *U.S.*, 441 F.2d 465 (5th Cir. 1971).

[28] For example, assume that a partnership is the debtor in a bankruptcy case which began March 1, 1981, and that in the bankruptcy case a partnership liability in the amount of $30,000 is discharged. The partnership has three partners. The three partners have equal distributive shares of partnership income and loss items under section 702(a) of the Code. Partner A is the debtor in a bankruptcy case; partner B is insolvent (by more than $10,000), but is not a debtor in a bankruptcy case; and partner C is solvent, and is not a debtor in a bankruptcy case.

Under section 705 of the Code, each partner's basis in the partnership is increased by $10,000, i.e., his distributive share of the income of the partnership. (The $30,000 debt discharge amount constitutes income of the partnership for this purpose, inasmuch as the income exclusion rules of amended sec. 108 would not apply at the partnership level.) However, also by virtue of present law, each partner's basis in the partnership is decreased by the same amount secs. 752 and 753 of the Code). Thus, there is no net change in each partner's

***Technical amendments***

The bill would amend section 703(b) of the Code, relating to elections of a partnership, to provide that any election under sections 108(b)(5) or 108(d)(4) of the Code (as would be amended by the bill) with respect to income from discharge of indebtedness is to be made by each partner separately and not by the partnership. Section 118(c) of the Code, relating to cross references, would be amended to add a reference to the rules of the bill on capital contributions of indebtedness. Section 1032(b) of the Code, relating to basis, would be amended to add a cross reference to the stock-for-debt rules of the bill.

***Effective date***

The amendments to the Internal Revenue Code made by section 2 of the bill would apply to transactions in a bankruptcy case if the case commenced on or after October 1, 1979; to transactions in a receivership, foreclosure, or similar proceeding if the proceeding commenced on or after October 1, 1979; and to other transactions which occur after December 31, 1980 (except that the provisions of section 2 would not apply to any transactions in proceedings under the Bankruptcy Act or in a receivership, foreclosure, or similar proceeding which proceeding began before October 1, 1979, even if such transaction occurs after December 31, 1980).

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basis in the partnership resulting from discharge of the partnership indebtedness except by operation at the partner level of the rules of sections 108 and 1017 of the Code (as would be amended by the bill).

In the case of bankrupt partner A, the $10,000 debt discharge amount must be applied to reduce net operating losses and other tax attributes as would be specified in the bill, unless A elects first to reduce the basis of depreciable assets. The same tax treatment would apply in the case of insolvent partner B. In the case of solvent partner C, such partner could elect to reduce basis in depreciable assets in lieu of recognizing $10,000 of income from discharge of indebtedness.

If A, B, or C elects to reduce basis in depreciable assets, such partner could be permitted, under the Treasury regulations, to reduce his basis in his partnership interest (to the extent of his share of partnership depreciable property), because the bill would treat that interest as depreciable property. If a partner does so reduce basis in his interest in the partnership, the bill also would require that the partnership must make a corresponding reduction in the basis of the partnership property with respect to such partner (in a manner similar to that which would be required if the partnership had made an election under section 754 to adjust basis in the case of a transfer of a partnership interest).

## B. Rules Relating to Title 11 Cases for Individuals (sec. 3 of the bill; new secs. 1398 and 1399 and secs. 6012 and 6103 of the Code)

### *Effect of bankruptcy law*

Under bankruptcy law, the commencement of a liquidation or reorganization case involving an individual debtor creates an "estate" which consists of property formerly belonging to the debtor. The bankruptcy estate generally is administered by a trustee for the benefit of creditors, and it may derive its own income and incur expenditures. At the same time, the individual is given a "fresh start"—that is, wages earned by the individual after commencement of the case and after-acquired property do not become part of the bankruptcy estate, but belong to the individual, and certain property may be set aside as exempt.

### *Explanation of provisions*

#### *1. Debtor and bankruptcy estate as separate entities*

*Present law*

For Federal income tax purposes, the estate created on commencement of a bankruptcy proceeding with respect to an individual debtor is treated as a new taxable entity, separate from the individual (Rev. Rul. 72–387, 1972–2 C.B. 632). Accordingly, the trustee must file a tax return (Form 1041) for the bankruptcy estate if the gross income of the estate, for the period beginning with filing of the petition or for any subsequent taxable year, is $600 or more.

The taxable year of the individual debtor is not terminated on commencement of the bankruptcy proceeding. On the individual's return (Form 1040 or 1040A) for the year in which the bankruptcy proceeding commenced, the individual reports all income earned by him or her during the entire year (including income earned by the individual before commencement of the proceeding, even though any assets derived from such income pass to the bankruptcy estate), but does not report any income earned by the bankruptcy estate.

*General provisions of bill*

The bill, like present law, would treat the bankruptcy estate of an individual as a separate taxable entity for Federal income tax purposes. The separate entity rules under the bill (new Code sec. 1398) [1] would apply if a bankruptcy case involving an individual debtor is brought under chapter 7 (liquidation) or chapter 11 (reorganization) of title 11 of the U.S. Code, as amended by P.L. 95–598. No separate taxable entity would be created on commencement of a case under

[1] In this pamphlet, provisions of the Internal Revenue Code which would be added by section 3 of the bill are cited as "new Code sec. —".

chapter 13 of new 11 U.S. Code (adjustment of debts of an individual with regular income).[2]

*Exception*

If a bankruptcy case involving an individual is commenced but subsequently dismissed by the bankruptcy court, the estate would not be treated as a separate entity (new Code sec. 1398(b)(1)). In this situation, where the bankruptcy case does not run to completion, it would be appropriate to treat the debtor's tax status as if no proceeding had been brought.[3]

*Partnerships, corporations*

The bill provides that no taxable entity would result from commencement of a bankruptcy case involving a partnership or corporation. This rule (new Code sec. 1399) would reverse current Internal Revenue Service practice as to partnerships, under which the estate of a partnership in bankruptcy is treated as a taxable entity (Rev. Rul. 68-48, 1968-1 C.B. 301), but would be the same as present law with respect to commencement of a bankruptcy case involving a corporation (Treas. Reg. § 1.641(b)-2(b)).

Accordingly, the bankruptcy trustee of a partnership in a bankruptcy case would be required to file annual information returns (under section 6031 of the Code) for the partnership. Also, the bankruptcy trustee of a corporation in a bankruptcy case, as under present law, would be required to file annual income tax returns and pay corporate income tax for the corporation (sec. 6012 (b)(3) of the Code; Rev. Rul. 79-120, 1979-1 C.B. 382).

## 2. Debtor's election to close taxable year

*In general*

The bill would give an individual debtor an election to close his or her taxable year as of the day before the date on which the bankruptcy case commences (the "commencement date"). If the election were made, the debtor's taxable year which otherwise would include the commencement date would be divided into two "short" taxable years of less than 12 months. The first such year would end on the day

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[2] The rationale for generally treating the individual debtor and the bankruptcy estate as separate entities is that the individual may obtain new assets or earn wages after transfer of the pre-bankruptcy property to the trustee and thus derive income independent of that derived by the trustee from the transferred assets. In a chapter 13 case, however, both future earnings of the debtor and exempt property may be used to make payments to creditors, and hence the bankruptcy law does not create the same dichotomy between after-acquired assets of the individual debtor and assets of the bankruptcy estate as in chapter 7 or chapter 11 cases.

For purposes of the separate entity rules under new Code section 1398, a partnership would not be treated as an individual. The interest in a partnership of a debtor who is an individual would be taken into account under new Code section 1398 in the same manner as any other interest of the debtor (new Code sec. 1398(b)(2)).

[3] If the estate is not treated as a separate entity because the bankruptcy case was dismissed, the debtor would include on his or her return(s), for the year(s) the estate was in existence, any gross income, deductions, or credits which otherwise would be tax items of the estate. The estate, although temporarily in existence under bankruptcy law prior to dismissal of the case, would not constitute a taxable entity for Federal income tax purposes.

before the commencement date; the second such year would begin on the commencement date (new Code sec. 1398(d)(3)(A)). If the election were not made, the commencement of the bankruptcy case would not affect the taxable year of an individual debtor (new Code sec. 1398 (d)(2)).

As a result of the debtor's making the election, his or her Federal income tax liability for the first short taxable year would become (under bankruptcy law) an allowable claim against the bankruptcy estate as a claim arising before bankruptcy. Accordingly, any tax liability for that year would be collectible from the estate, depending on the availability of estate assets to pay debts of that priority. Inasmuch as any such tax liability for an electing debtor's first short taxable year would not be dischargeable, the individual debtor would remain liable for any amount not collected out of the bankruptcy estate (new 11 U.S. Code sec. 523(a)(1)). If the debtor does not make the election, no part of the debtor's tax liability from the year in which the bankruptcy case commences would be collectible from the estate, but would be collectible directly from the individual debtor.

If the election were made, the debtor would be required to annualize his or her taxable income for each short taxable year in the same manner as if a change of annual accounting period had been made (new Code sec. 1398(d)(3)(F)).

*Availability of election*

The election provided under the bill would be available in cases to which new section 1398 of the Code applies. Accordingly, the election would be available to an individual debtor in a bankruptcy case under chapter 7 (liquidation) or chapter 11 (reorganization) of title 11 of the U.S. Code, as amended by Public Law 95-598, except where such case is commenced but subsequently dismissed by the bankruptcy court. Also, the bill provides that the election would not be available to a debtor who has no assets other than property which he or she may treat as exempt property under new 11 U.S. Code section 522 (new Code sec. 1398 (d)(3)(C)). In the latter instance, since there would be no assets in the bankruptcy estate out of which the debtor's tax liability for the period prior to the commencement date could be collected, there is no reason to authorize termination of the taxable year.

*Due date, manner of election*

The election must be made on or before the 15th day of the fourth month following the commencement date—i.e., by the date on which a return would be due for the first short taxable year if the election were made, determined without regard to any extension for filing such return. For example, if the bankruptcy case commences on March 10, the election must be made by July 15 of that year. The election would be made in such manner as prescribed by Treasury regulations, but the election would not be conditioned on approval of the Internal Revenue Service, as under section 442 of the Code. The election, once made, would be irrevocable (new Code sec. 1398(d)(3)(D)).

*Spousal election*

If the debtor making the election was married on the date the bankruptcy case involving him or her commenced, the debtor's spouse could

join in the election to close the taxable year, but only if the debtor and the spouse file a joint return for the first short taxable year (new Code sec. 1398(d)(3)(B)). The filing of a joint return for the first short taxable year would not require the debtor and the spouse to file a joint return for the second short taxable year.

If during the same year a bankruptcy case involving the debtor's spouse were commenced, the spouse could elect to terminate his or her then taxable year as of the day before the commencement date, whether or not the spouse previously had joined in the debtor's election. If the spouse previously had joined in the debtor's election, or if the debtor had not made an election, the debtor could join in the spouse's election. But if the debtor had made an election and the spouse had not joined in the debtor's election, the debtor could not join in the spouse's election, inasmuch as the debtor and the spouse, having different taxable years, could not file a joint return for a year ending with the spouse's commencement date (sec. 6013 of the Code).

*Illustrative example*

The rules relating to spousal elections under the bill would be illustrated by the following example.

Assume that husband and wife are calendar-year taxpayers, that a bankruptcy case involving only the husband commences on March 1, 1982, and that a bankruptcy case involving only the wife commences on October 1, 1982.

If the husband does not make an election, his taxable year would not be affected; i.e., it does not terminate on February 28. If the husband does make an election, his first short taxable year would be January 1 through February 28; his second short taxable year would begin March 1. The wife could join in the husband's election, but only if they file a joint return for the taxable year January 1 through February 28.

The wife could elect to terminate her then taxable year on September 30. If the husband had not made an election, or if the wife had not joined in the husband's election, she would have (if she made the election) two taxable years in 1982—the first from January 1 through September 30, and the second from October 1 through December 31. If the husband had not made an election to terminate his taxable year on February 28, the husband could join in an election by his wife, but only if they file a joint return for the taxable year January 1 through September 30. If the husband had made an election but the wife had not joined in the husband's election, the husband could not join in an election by the wife to terminate her taxable year on September 30, since they could not file a joint return for such year.

If the husband had made the election and the wife had joined in it, she would have two additional taxable years with respect to her 1982 income and deductions (if she makes the election relating to her own bankruptcy case)—the second short taxable year would be March 1 through September 30, and the third short taxable year would be October 1 through December 31. The husband could join in the wife's election if they file a joint return for the second short taxable year. If the husband does so join in the wife's election, they could file joint returns for the short taxable year ending December 31, but would not be required to do so.

### *3. Computation of bankruptcy estate's tax liability*

*Gross income, deductions, credits*

Under the bill, the gross income of the bankruptcy estate of an individual would consist of (1) any gross income of the individual debtor realized after the commencement of the case which under bankruptcy law (new 11 U.S. Code) constitutes property of the bankruptcy estate, and (2) the gross income of the estate beginning on and after the date the case commenced (new Code sec. 1398(e)(1)). The deductions and credits of the bankruptcy estate would consist of (1) any item of deduction or credit of the debtor that is properly associated with gross income of the debtor which would be treated (under new Code sec. 1398(e)(1)) as gross income of the estate and (2) the deductions and credits of the estate (new Code sec. 1398(e)(3)).

*Taxable year*

The first taxable year of the estate would end on the same day as the taxable year of the debtor which includes the commencement date (new Code sec. 1398(d)(1)).

*Attribute carryover*

The estate would succeed to the following income tax attributes of the debtor (determined as of the first day of the debtor's taxable year in which the case commences):

(*a*) net operating loss carryovers;

(*b*) capital loss carryovers;

(*c*) credit carryovers;

(*d*) charitable contribution carryovers;

(*e*) recovery exclusions (under sec. 111 of the Code);

(*f*) the debtor's basis in and holding period for, and the character in the debtor's hands of, any asset acquired (other than by sale or exchange) from the debtor;

(*g*) the debtor's method of accounting; and

(*h*) other tax attributes, to the extent provided by Treasury regulations (new Code sec. 1398(g)). For example, the regulations could allow the estate the benefit of section 1341 of the Code if the estate repays income which the debtor received under claim of right.

*Character of expenditures*

Under present law, it is not clear whether certain expenses or debts paid by the trustee are deductible if the trustee does not actually operate the debtor's trade or business (and if such expenses are not incurred in a new trade or business of the estate.) To alleviate this problem, the bill would provide that an amount paid or incurred by the bankruptcy estate is deductible or creditable by the estate to the same extent as that item would be deductible or creditable by the debtor had the debtor remained in the same trades, businesses, or activities after the case commenced as before and had the debtor paid or incurred such amount. The same test would be applied to determine whether amounts paid by the estate constitute wages for purposes of Federal employment taxes (new Code sec. 1398(e)(4)).

*Administrative expenses*

Under present law, it is unclear in certain circumstances whether administrative and related expenses of the bankruptcy estate are de-

ductible by the estate (see Rev. Rul. 68-48, 1968-1 C.B. 301). The bill would provide (new Code sec. 1398(h)(1)) that the estate could deduct (a) any administrative expense allowed under new 11 U.S. Code sec. 503 and (b) any fee or charge assessed against the estate under 28 U.S. Code, ch. 123 (court fees and costs). Such deductions would be available whether or not considered trade or business expenses or investment expenses, but would be subject to disallowance under other provisions of the Internal Revenue Code, such as sections 263 (capital expenditures), 265 (expenses relating to tax-exempt interest), or 275 (certain taxes).

Under present law, any deduction otherwise available for administrative or related expenses may be lost, since no carryover deduction is permitted for expenses not incurred in a trade or business. The trustee often cannot pay administrative expenses until the end of the bankruptcy proceeding; unless considered trade or business expenses, the unused amount cannot be carried back and deducted against income of the bankruptcy estate received in earlier years.

To alleviate this problem, the bill would provide that any amount of the new deduction for administrative, etc. expenses not used in the current year could be carried back by the estate three years (but only to a taxable year of the estate) and forward seven years (new Code sec. 1398(h)(2)). These carryovers would be "stacked" after the net operating loss deductions (allowed by sec. 172 of the Code) for the particular year. An administrative, etc. expense which would be deductible solely under new Code sec. 1398(h)(1), or a carryover deduction for such expense, would be allowable only to the estate (new Code sec. 1398(h)(2)(D)).

*Carryback of estate's net operating losses*

If the bankruptcy estate itself incurs a net operating loss (apart from losses passing to the estate from the individual debtor), the bill provides that the bankruptcy estate could carry back its net operating losses not only to previous taxable years of the estate, but also to taxable years of the individual prior to the year in which the case commenced (new Code sec. 1398(j)(2)). Similarly, the bill would allow the bankruptcy estate to carry back excess credits, such as the investment tax credit, to pre-bankruptcy taxable years of the individual debtor.

*Tax rate schedule, etc.*

Except as otherwise provided in new Code section 1398, the taxable income of the bankruptcy estate would be computed in the same manner as in the case of an individual. The estate would be allowed a deduction of $1,000 under section 151 of the Code as its personal exemption. Under the bill, the zero bracket amount for the estate and the tax rate schedule applicable to the estate would be the same as for married individuals filing separate returns (new Code sec. 1398(c)). The estate would not be eligible for income averaging.

*Returns of estate*

Under the bill, the trustee would be required to file a Federal income tax return on behalf of the bankruptcy estate for any year in which the estate's gross income is $2,700 or more (sec. 3(b) of the bill and new sec. 6012(a)(9) of the Code), and to pay the estate's tax liability

due for that year (new Code sec. 1398(c)(1)). No return need be filed and no income tax would be due if gross income for the year is less than $2,700.

*Change of accounting period*

The estate would be permitted to change its annual accounting period (taxable year) one time without obtaining approval of the Internal Revenue Service as otherwise required under section 442 of the Code (new Code sec. 1398(j)(1)). This rule would permit the trustee to effect an early closing of the estate's taxable year prior to the expected termination of the estate, and then to submit a return for such "short year" for an expedited determination of tax liability pursuant to new 11 U.S. Code sec. 505.

*Disclosure of returns*

The bill would provide that the estate's Federal income tax return would be open (upon written request) to inspection by or disclosure to the individual debtor (sec. 3(c) of the bill and amended sec. 6103(e) of the Code). Such disclosure would be necessary so that the debtor could properly determine any amount of tax attributes to which the debtor would succeed on termination of the bankruptcy estate.

*No-disposition rule*

Under the bill, a transfer (other than by sale or exchange) of an asset from the bankruptcy estate to the individual debtor on termination of the estate would not be treated as a transfer giving rise to recognition of gain or loss, recapture of deductions or credits, or acceleration of income or deductions (new Code sec. 1398(f)(2)).

### *4. Computation of individual's tax liability*

*Gross income, deductions, credits*

If any item of gross income of the debtor realized after commencement of the bankruptcy case would be treated under new Code section 1398(e)(1) as gross income of the bankruptcy estate (because under bankruptcy law such income constitutes property of the estate), that item would not be included by the debtor as gross income on his or her return or a joint return with the debtor's spouse (new Code sec. 1398(e)(2)).

This provision of the bill, treating such income items as gross income of the estate rather than of the individual, would be intended to override otherwise applicable "assignment of income" principles of tax law. For example, if the estate were entitled under bankruptcy law to a salary payment earned by the debtor before the case commences but paid after that date, the amount of the payment would be included in the estate's gross income and is not to be included in the debtor's gross income.

If any item of deduction or credit of the debtor would be treated under new Code section 1398(e)(3) as a deduction or credit of the bankruptcy estate (because such item is properly associated with gross income of the debtor which would be treated as gross income of the estate), that item would not be allowable to the debtor as a deduction or credit on his or her return or a joint return with the debtor's spouse (new Code section 1398(e)(3)). This rule would insure that no particular item of deduction or credit can be allowable to both the debtor and the estate.

*No-disposition rule*

Under the bill, a transfer (other than by sale or exchange) of an asset from the individual debtor to the bankruptcy estate would not be treated as a transfer giving rise to recognition of gain or loss, recapture of deductions or credits, or acceleration of income or deductions (new Code sec. 1398(f)(1)). For example, such a transfer of an installment obligation would not be treated as a disposition giving rise to acceleration of gain under section 453(d) of the Code.

*Carryback of net operating loss*

The bill would provide that an individual debtor cannot carry back, to a year that preceded the year in which the case was commenced, any net operating loss or credit carryback from a taxable year ending after commencement of the bankruptcy case (new Code sec. 1398(j)(2)(B)). As noted above, the bill would permit the bankruptcy estate to carry back its net operating loss deduction to offset the pre-bankruptcy income of the individual debtor.

*Attribute carryover*

On termination of the bankruptcy estate, the debtor would succeed to the following tax attributes of the estate:

(*a*) net operating loss carryovers;

(*b*) capital loss carryovers;

(*c*) credit carryovers;

(*d*) charitable contribution carryovers;

(*e*) recovery exclusions (under sec. 111 of the Code);

(*f*) the estate's basis in and holding period for, and the character in the estate's hands of, any asset acquired (other than by sale or exchange) from the estate [4]; and

(*g*) other tax attributes, to the extent provided by Treasury regulations (new Code sec. 1398(i)).

*Disclosure of returns*

In a bankruptcy case to which new Code section 1398 would apply (determined without regard to whether the case is dismissed), the Federal income tax returns of the debtor for the taxable year in which the bankruptcy case commenced and preceding years would be open (upon written request) to inspection by or disclosure to the trustee of the bankruptcy estate. (This disclosure would be necessary so that the trustee properly may determine attribute carryovers to the estate and may carry back deductions to preceding years of the debtor.) In an involuntary case, however, no such disclosure to the trustee could be made prior to the time the bankruptcy court has entered an order for relief unless that court finds that such disclosure is appropriate for

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[4] In a bankruptcy case to which new Code sec. 1398 would apply, any attribute reduction under section 2 of the bill would apply to tax attributes of the bankruptcy estate (except for purposes of applying the basis-reduction rules of section 1017 to property transferred by the estate to the individual) and not to those attributes of the individual which arose after commencement of the case. Also, the bill would provide that in a bankruptcy case involving an individual debtor, no reduction in basis is to be made in the basis of property which the debtor treats as exempt property under new 11 U.S. Code section 522. The tax attributes to the estate, as so reduced, would carry over (to the extent unused on termination of the estate) to the individual debtor pursuant to new Code sec. 1398(i).

purposes of determining whether an order for relief should be entered (sec. 3(c) of the bill and amended sec. 6103(e) of the Code).

Also under the bill, prior year returns of the debtor in a bankruptcy case, or of a person whose property is in the hands of a receiver, would be open (upon written request) to inspection by or disclosure to the trustee or receiver, but only if the Internal Revenue Service finds that such trustee or receiver, in his fiduciary capacity, has a material interest which would be affected by information contained in the return.

### 5. *Technical amendment*

Section 443(c) of the Code, relating to cross references, would be amended by adding a cross reference to new Code section 1398(d)(3)(E), with respect to returns for a period of less than 12 months in the case of a debtor's election to terminate a taxable year.

### 6. *Effective date*

The amendments made by section 3 of the bill would apply to bankruptcy cases commencing more than 90 days after the date of enactment of the bill.

## C. Corporate Reorganization Provisions (sec. 4 of the bill and secs. 354, 355, 357, 368, and 381 of the Code)

### *Present law*

#### *Definition of reorganization*

A transfer of all or part of a corporation's assets, pursuant to a court order in a proceeding under chapter X of the Bankruptcy Act (or in a receivership, foreclosure, or similar proceeding), to another corporation organized or utilized to effectuate a court-approved plan may qualify for tax-free reorganization treatment under special rules relating to "insolvency reorganizations" (secs. 371–374 of the Internal Revenue Code).

These special rules for insolvency reorganizations generally allow less flexibility in structuring tax-free transactions than the rules applicable to corporate reorganizations as defined in section 368 of the Code. Also, the special rules for insolvency reorganizations do not permit carryover of tax attributes to the transferee corporation, and otherwise differ in important respects from the general reorganization rules.[1] While some reorganizations under chapter X of the Bankruptcy Act may be able to qualify for nonrecognition treatment under section 368, other chapter X reorganizations may be able to qualify only under the special rules of sections 371–374 and not under the general reorganization rules of section 368.

#### *Triangular reorganizations*

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of sections 371–374 of the Code, the stock or securities used to acquire the assets of the corporation in bankruptcy must be the acquiring corporation's own stock or securities. This limitation generally precludes corporations in bankruptcy from engaging in so-called triangular reorganizations, where the acquired corporation is acquired for stock of the parent of the acquiring corporation. By contrast, tax-free triangular reorganizations generally are permitted under the general rules of section 368.

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[1] Under present law, it is not clear to what extent creditors of an insolvent corporation who receive stock in exchange for their claims may be considered to have "stepped into the shoes" of former shareholders for purposes of satisfying the nonstatutory "continuity of interest" rule, under which the owners of the acquired corporation must continue to have a proprietary interest in the acquiring corporation. Generally, the courts have found the "continuity of interest" test satisfied if the creditors' interests were transformed into proprietary interests prior to the reorganization (e.g., *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942); Treas. Reg. § 1.371–1(a)(4)). It is unclear whether affirmative steps by the creditors are required or whether mere receipt of stock is sufficient.

***Transfer to controlled subsidiary***

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of sections 371–374 of the Code, it is not clear under present law whether and to what extent the acquiring corporation may transfer assets received into a controlled subsidiary. In the case of other corporate reorganizations, the statute expressly defines the situations where transfers to subsidiaries are permitted (sec. 368(a)(2)(C) of the Code).

***Carryover of tax attributes***

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of sections 371–374 of the Code, court cases have held that attributes (such as net operating losses) of the corporation in bankruptcy do not carry over to the new corporation. In the case of other corporate reorganizations, however, specific statutory rules permit carryover of tax attributes to the surviving corporation (sec. 381 of the Code).

***"Principal amount" rule; "boot" test***

In a corporate reorganization, generally the exchange of stock or securities of one corporation for those of another corporation is not tax-free to the extent the principal amount of the securities received exceeds the principal amount of the securities surrendered, or to the extent of the principal amount of the securities received if no securities are surrendered (secs. 354(a)(2)(B) and 356(d)(2) of the Code). Also, "boot" (money or property other than stock and securities permitted to be received without recognition of gain) received in a corporate reorganization is subject to the dividend-equivalence test of section 356 of the Code. These rules do not apply under present law to insolvency reorganizations qualifying only under sections 371–374 of the Code.

***Treatment of accrued interest***

Under present law, a claim for unpaid interest is treated as an integral part of the security to which it relates, so that the surrender of the security together with the claim for unpaid interest is treated only as the surrender of a security. Thus, the nonrecognition provisions apply to an exchange of a security with accrued but unpaid interest although the unpaid interest would have been taxable as ordinary income if paid separately.[3]

***Explanation of provisions***

Section 4 of the bill generally would conform the tax rules governing insolvency reorganizations with the existing rules applicable to other corporate reorganizations.

***Definition of reorganization***

*In general*

The bill would add a new category—"G" reorganizations—to the general Code definition of tax-free reorganizations (sec. 368(a)(1)).

[3] *Carman* v. *Comm'r*, 189 F. 2d 363 (2nd Cir. 1951); Rev. Rul. 59-98, 1959-1 C.B. 76.

The new category would include certain transfers of assets pursuant to a court-approved reorganization plan in a bankruptcy case under new title 11 of the U.S. Code, or in a receivership, foreclosure, or similar proceeding[3] in a Federal or State court.[4]

The special tax rules (secs. 371–374) now applicable to insolvency reorganizations would continue to apply only to bankruptcy proceedings commenced prior to October 1, 1979, except that the bill would not terminate the applicability of the rules in sections 374(c) and 374(e) of the Code governing tax-free exchanges under the final system plan for ConRail.

In order to facilitate the rehabilitation of corporate debtors in bankruptcy, etc., these provisions are designed to eliminate many requirements which have effectively precluded financially troubled companies from utilizing the generally applicable tax-free reorganization provisions of present law. To achieve this purpose, the new "G" reorganization provision would not require compliance with State merger laws (as in category "A" reorganizations), would not require that the financially distressed corporation receive solely stock of the acquiring corporation in exchange for its assets (category "C"), and would not require that the former shareholders of the financially distressed corporation control the corporation which receives the assets (category "D").

The "G" reorganization provision added by the bill would require the transfer of assets by a corporation in a bankruptcy or similar case, and the distribution (in pursuance of the court-approved reorganization plan) of stock or securities of the acquiring corporation in a transaction which qualifies under section 354, 355, or 356 of the Code. This distribution requirement is designed to assure that either substantially all of the assets of the financially troubled corporation, or assets which consist of an active business under the tests of section 355, are transferred to the acquiring corporation.

*"Substantially all" test*

The "substantially all" test in the "G" reorganization provision is to be interpreted in light of the underlying intent in adding the new "G" category, namely, to facilitate the reorganization of companies in bankruptcy or similar cases for rehabilitative purposes. Accordingly, it would be intended that facts and circumstances relevant to this intent, such as the insolvent corporation's need to pay off creditors or to sell assets or divisions to raise cash, are to be taken into account in determining whether a transaction qualifies as a "G" reorganization. For example, a transaction would not be precluded from satisfying the "substantially all" test for purposes of the new "G" category merely because, prior to a transfer to the acquiring corporation, pay-

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[3] For this purpose, the definition of a receivership, foreclosure, or similar proceeding would be the same as under present section 371 of the Code.

[4] Under the bill, asset transfers in a receivership, foreclosure, or similar proceeding involving a financial institution (to which section 585 or 593 of the Code applies) before a Federal or State agency would be treated in the same manner as transfers in such a proceeding before a court. Thus, for example, asset transfers in a receivership proceeding under 12 U.S.C. sec. 1729 involving a savings and loan association could qualify as a "G" reorganization.

ments to creditors and asset sales were made in order to leave the debtor with more manageable operating assets to continue in business.[5]

*Relation to other provisions*

A transaction which qualifies as a "G" reorganization would not be treated as also qualifying as a liquidation under section 332, an incorporation under section 351, or a reorganization under another category of section 368(a)(1) of the Code.[6]

A transaction in a bankruptcy or similar case which does not satisfy the requirements of new category "G" would not thereby be precluded from qualifying as a tax-free reorganization under one of the other categories of section 368(a)(1). For example, an acquisition of the stock of a company in bankruptcy, or a recapitalization of such a company, which transactions are not covered by the new "G" category, could qualify for nonrecognition treatment under sections 368(a)(1)(B) or (E), respectively.

*Continuity of interest rules*

The "continuity of interest" requirement which the courts and the Treasury have long imposed as a prerequisite for nonrecognition treatment for a corporate reorganization must be met in order to satisfy the requirements of new category "G". Only reorganizations—as distinguished from liquidations in bankruptcy and sales of property to either new or old interests supplying new capital and discharging the obligations of the debtor corporation—could qualify for tax-free treatment.

It is expected that the courts and the Treasury would apply to "G" reorganizations continuity-of-interest rules which take into account the modification by P.L. 95–598 of the "absolute priority" rule. As a result of that modification, shareholders or junior creditors, who might previously have been excluded, may now retain an interest in the reorganized corporation.

For example, if an insolvent corporation's assets are transferred to a second corporation in a bankruptcy case, the most senior class of creditor to receive stock, together with all equal and junior classes (including shareholders who receive any consideration for their stock), should generally be considered the proprietors of the insolvent corporation for "continuity" purposes. However, if the shareholders receive consideration other than stock of the acquiring corporation, the transaction should be examined to determine if it represents a purchase rather than a reorganization.

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[5] Because the stated intent for adding the new "G" category is not relevant to interpreting the "substantially all" test in the case of other reorganization categories, the comments in the text as to the appropriate interpretation of the "substantially all" test in the context of a "G" reorganization would not be intended to apply to, or in any way to affect interpretations under present law of, the "substantially all" test for other reorganization categories.

[6] However, if a transfer qualifying as a "G" reorganization also meets the requirements of section 351 or qualifies as a reorganization under section 368(a)(1)(D) of the Code, the "excess liability" rule of section 357(c) would apply if any former shareholder of the transferor corporation receives consideration for his stock, but would not apply if no former shareholder of the transferor corporation receives any consideration for his stock (i.e., if the corporation is insolvent). This rule would parallel present law, under which insolvency reorganizations under sections 371 or 374 are excluded from the application of section 357(c).

Thus, short-term creditors who receive stock for their claims may be counted toward satisfying the continuity of interest rule, although any gain or loss realized by such creditors will be recognized for income tax purposes.

### *Triangular reorganizations*

The bill would permit a corporation to acquire a debtor corporation in a "G" reorganization in exchange for stock of the parent of the acquiring corporation rather than for its own stock.

In addition, the bill would permit the acquisition in the form of a "reverse merger" of an insolvent corporation (i.e., where no former shareholder of the surviving corporation receives any consideration for his stock) in a bankruptcy or similar case if the former creditors of the surviving corporation exchange their claims for voting stock of the controlling corporation which has a value equal to at least 80 percent of the value of the debt of the surviving corporation.

### *Transfer to controlled subsidiary*

The bill would permit a corporation which acquires substantially all the assets of a debtor corporation in a "G" reorganization to transfer the acquired assets to a controlled subsidiary without endangering the tax-free status of the reorganization. This provision would place "G" reorganizations on a similar footing with other categories of reorganizations.

### *Carryover of tax attributes*

Under the bill, the statutory rule generally governing carryover of tax attributes in corporate reorganizations (sec. 381 of the Code) would also apply in the case of a "G" reorganization. This would eliminate the so-called "clean slate" doctrine and would reflect the fact that adjustments may be made to a reorganized corporation's tax attributes under the rules in section 2 of the bill.[7]

### *"Principal amount" rule; "boot" test*

Under the bill, "G" reorganizations would be subject to the rules governing the tax treatment of exchanging shareholders and security holders which apply to other corporate reorganizations. Accordingly, an exchanging shareholder or security holder of the debtor company who receives securities with a principal amount exceeding the principal amount of securities surrendered would be taxable on the excess, and an exchanging shareholder or security holder who surrenders no securities would be taxed on the principal amount of any securities received. Also, any "boot" received would be subject to the general dividend-equivalence test of section 356 of the Code.

### *Treatment of accrued interest*

Under the bill, a creditor exchanging securities in any corporate reorganization described in section 368 of the Code (including a "G"

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[7] Special rules relating to limitations on net operating loss carryovers under section 382 of the Code are discussed in section III-A of this pamphlet. It is anticipated that the amount carried over under section 381 of the Code would be adjusted to take into account any amount of debt discharge income which the corporation realized after the close of the taxable year by delaying the discharge of its debts.

reorganization) would be treated as receiving interest income on the exchange to the extent the security holder receives new securities, stock, or any other property attributable to accrued but unpaid interest (including accrued original issue discount) on the securities surrendered. This provision, which would reverse the so-called *Carman* rule,[8] would apply whether or not the exchanging security holder realizes gain on the exchange overall. Under this provision, a security holder which had previously accrued the interest (including original issue discount) as income could recognize a loss to the extent the interest is not paid in the exchange.

If the plan of reorganization allocates the value of the stock or other property received by the creditor between the principal amount of the creditor's security and the accrued interest, both the corporate debtor and the creditor would be required to utilize that allocation for Federal income tax purposes.[9] However, if the value of the stock or other property received by the creditor exceeds the principal amount of the security, the amount allocated to the security could not exceed such principal amount until an amount has been allocated to interest equal to the full amount of the accrued interest.

***Example***

The reorganization provisions of the bill may be illustrated in part by the following example.

Assume that Corporation A is in a bankruptcy case commenced after October 1, 1979. Immediately prior to a transfer under a plan of reorganization, A's assets have an adjusted basis of $75,000 and a fair market value of $100.000. A has a net operating loss carryover of $200,000. A has outstanding bonds of $100,000 (on which there is no accrued but unpaid interest) and trade debts of $100,000.

Under the plan of reorganization, A is to transfer all its assets to Corporation B in exchange for $100,000 of B stock. Corporation A will

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[8] See note 2, *supra*.

[9] For example, assume that a corporation, pursuant to a plan of reorganization, transfers stock with a value of $55 to its creditor in exchange for the creditor's $100 security with $10 accrued interest. Also assume that, under the terms of the plan, the $55 stock is exchanged for the principal of the debt and no portion of the stock is transferred for the interest claim. In this situation, (1) the security holder would not have any interest income on the exchange (or could deduct $10 if that amount previously had been accrued by the creditor as interest income), and (2) the corporation would have a debt discharge amount of $10, with the tax consequences as determined in section 2 of the bill (except that there would be no debt-discharge amount if either the corporation had not previously deducted the accrued interest or else the prior deduction had not resulted in a "tax benefit" under sec. 111 of the Code).

On the other hand, if the reorganization plan first allocates the stock to accrued interest and the remainder to principal, then (1) the security holder would have $10 of interest income (unless that amount had previously been accrued by the creditor as income) and (2) the corporation would not have any debt discharge amount (since the stock was exchanged for a security).

If the stock is allocated proportionately to principal and accrued interest, then (1) the security holder would have $5 of interest income (unless that amount had previously been accrued by the creditor as income), and (2) the corporation's debt discharge amount would be $5, with the tax consequences as determined in section 2 of the bill (except that there would be no debt discharge amount if either the corporation had not previously deducted the accrued interest or else the prior deduction had not resulted in a "tax benefit" under section 111 of the Code).

distribute the stock, in exchange for their claims against A, one-half to the security holders and one-half to the trade creditors. A's shareholders will receive nothing.

The transaction would qualify as a reorganization under new section 368(a)(1)(G) of the Code, since all the creditors are here treated as proprietors for continuity of interest purposes. Thus, A would recognize no gain or loss on the transfer of its assets to B (sec. 361). B's basis in the assets would be $75,000 (sec. 362), and B would succeed to A's net operating loss carryover (sec. 381).

Under the bill, the distribution of B stock to A's security holders would not result in income from discharge of indebtedness or require attribute reduction. On the distribution of B stock to A's trade creditors, A would exclude from gross income the debt discharge amount of $50,000—i.e., the difference between the $100,000 debt held by nonsecurity creditors and the $50,000 worth of stock given for such debt. A could elect to reduce the basis of its depreciable assets transferred to B by all or part of the $50,000 debt discharge amount; to the extent the election were not made, the debt discharge amount would reduce A's net operating loss carryover by the remainder of the debt discharge amount. Assuming that A's creditors did not acquire their claims for purposes of acquiring stock, there would be no reduction of A's net operating loss carryover under section 382.

Assume the same facts as above except that B also transfers $10,000 in cash, which is distributed by A to its creditors. Although A would otherwise recognize gain on the receipt of boot in an exchange involving appreciated property, the distribution by A of the $10,000 cash to those creditors having a proprietary interest in the corporation's assets for continuity of interest purposes would prevent A from recognizing any gain (sec. 361(b)(1)(A)).[10]

***Technical and conforming amendments***

Section 4(h) of the bill would make technical and conforming amendments to the Internal Revenue Code.

*1. Amendment of section 354(b).*—Paragraphs (1) and (2) of section 354(b) of the Code, relating to exception to general rule on exchanges of stock and securities in certain reorganizations, would be amended by adding references to new subparagraph "G" of section 368(a)(1).

*2. Amendment of section 357(c)(2).*—Section 357(c)(2) of the Code, providing exceptions to the general rule with respect to liabilities in excess of basis on transfers to controlled corporations, would be amended to add an exception for any exchange pursuant to a plan of reorganization under new category "G" of section 368(a)(1) if no former shareholder of the transferor corporation receives any consideration for his stock.[11]

*3. Amendment of section 368(a)(1).*—A conforming amendment would be made to section 368(a)(1) of the Code to take into account the addition of new category "G" reorganizations.

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[10] See sec. 371(a)(2)(A) of the Code and Treas. Reg. § 1.371-1(b) for a similar rule relating to distribution of boot to creditors in an insolvency reorganization under present law.

[11] See note 6, *supra*.

*4. Amendment of section 368(b).*—Section 368(b) of the Code, defining "party to a reorganization", would be amended to include references to new category "G" reorganizations.

*5. Technical change.*—A change would be made in the table of sections for part IV of subchapter C of chapter 1 of the Code.

***Effective date***

The amendments made by section 4 of the bill would apply to bankruptcy cases commencing on or after October 1, 1979, and to receivership, foreclosure, or similar judicial proceedings begun on or after that date.

In addition, the amendments made by section 4(e) of the bill, relating to exchanges of property for accrued interest, also would apply to transactions occurring after December 31, 1980, other than transactions in a proceeding under the Bankruptcy Act or in a receivership, foreclosure, or similar judicial proceeding begun before October 1, 1979.

## D. Miscellaneous Corporate Amendments (sec. 5 of the bill)

### 1. Exception from personal holding company status (sec. 5(a) of the bill and sec. 542 of the Code)

*Present law*

Under present law, a corporation in a bankruptcy or insolvency proceeding may become subject to the personal holding company tax on certain passive income (sec. 541 of the Internal Revenue Code) if its assets are converted to investments which produce passive income before the corporation is liquidated.

*Explanation of provision*

Under this provision, a corporation subject to court jurisdiction in a bankruptcy or similar case [1] would not be considered a personal holding company. This exception would not be available, however, if a major purpose in commencing or continuing the proceeding is avoidance of the personal holding company tax.

*Effective date*

The amendment made by this provision would apply to bankruptcy cases commenced on or after October 1, 1979 and to similar cases commenced on or after that date.

### 2. Repeal of special treatment for certain railroad stock redemptions (sec. 5(b) of the bill and sec. 302 of the Code)

*Present law*

Present law provides that any distribution in redemption of stock issued by a railroad corporation pursuant to a reorganization plan under section 77 of the Bankruptcy Act gives rise to capital gain, even if under the general redemption distribution tests the stockholder would realize ordinary income (sec. 302(b)(4) of the Code).

*Explanation of provision*

This provision would repeal the special rule giving automatic capital gain treatment in the case of redemptions of certain stock issued by railroad corporations in bankruptcy.

*Effective date*

The amendment made by this provision would apply to a redemption of stock issued after September 30, 1979 (other than stock issued pursuant to a plan of reorganization approved on or before that date).

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[1] The terms "bankruptcy case" and "similar case" refer, respectively, to (1) cases under new 11 U.S. Code (i.e., bankruptcy cases commenced on or after October 1, 1979) and (2) receivership, foreclosure, or similar proceedings in a Federal or State court (or, in the case of a financial institution, a Federal or State agency).

### 3. Application of section 337 liquidation rule to insolvent corporations (sec. 5(c) of the bill and sec. 337 of the Code)

***Present law***

Under present law, a corporation which adopts a plan of liquidation and within 12 months thereafter liquidates in a distribution to shareholders generally does not recognize gain or loss on sales within that period (sec. 337 of the Code). The Internal Revenue Service has ruled that this provision does not apply if, as in the case of an insolvency proceeding, the assets are transferred on liquidation to creditors rather than to shareholders (Rev. Rul. 56-387, 1956-2 C.B. 189).

***Explanation of provision***

This provision would allow an insolvent corporation (i.e., where no shareholder of the corporation receives any consideration for his stock) in a bankruptcy or similar case [2] to sell certain of its assets tax-free where the corporation, after the case commences, adopts a plan of complete liquidation and, upon the liquidation, all of the corporation's assets are transferred to its creditors within the nonrecognition period.[3] The period for nonrecognition would begin on the date of adoption (after commencement of the case) of a plan of liquidation and ends on the date the case terminates. This provision would not apply to assets acquired on or after the date of adopting the liquidation plan, other than to inventory sold in bulk.

***Effective date***

This provision would apply to bankruptcy cases commencing on or after October 1, 1979 and to similar cases commencing on or after that date.

### 4. Estate of individual in bankruptcy as subchapter S shareholder (sec. 5(d) of the bill and sec. 1371 of the Code)

***Present law***

Under present law, only individuals, estates, and certain trusts are permitted to be shareholders of subchapter S corporations (sec. 1371 of the Code). Failure to satisfy this rule disqualifies the election of the corporation under subchapter S.

The Internal Revenue Service has ruled that an "estate" for subchapter S purposes includes only the estate of a decedent and not the estate of an individual in bankruptcy (Rev. Rul. 66-266, 1966-2 C.B. 356). Accordingly, the Revenue Service also has ruled that the filing of a voluntary petition in bankruptcy by a shareholder terminates the subchapter S election as of the beginning of the taxable year in which the petition is filed (Rev. Rul. 74-9, 1974-1 C.B. 241). However, the U.S. Tax Court has held that the filing of a petition seeking financial rehabilitation of a debtor under the debt arrangement provisions of the Bankruptcy Act does not create a new entity apart from the debtor and does not cause the termination of a subchapter Selection.[4]

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[2] See note 1, *supra*.

[3] A liquidating solvent corporation in a bankruptcy or similar case could make tax-free sales during the 12-month nonrecognition period of present law (sec. 337).

[4] *OHM Company*, 68 T.C. 31 (1977).

*Explanation of provision*

Under the bill, the bankruptcy estate of an individual would be allowed as an eligible shareholder in a subchapter S corporation. Thus, a corporation's subchapter S election would not be terminated because of commencement of a bankruptcy case involving an individual who is a shareholder in the corporation. In addition, the bankruptcy estate of an individual which owns stock in a corporation could consent to an election under subchapter S made by the corporation after commencement of the bankruptcy case.

*Effective date*

The amendment made by this provision would apply to bankruptcy cases commenced on or after October 1, 1979.

**5. Certain transfers to controlled corporations (sec. 5(e) of the bill and sec. 351 of the Code)**

*Present law*

Under present law, if property is transferred to a corporation controlled by the transferor, no gain or loss is recognized on the transfer (sec. 351 of the Code). For this purpose, property includes (1) indebtedness of the transferee corporation not evidenced by a security [5] and (2) a claim for accrued interest on indebtedness of the transferee corporation.[6]

*Explanation of provision*

Under the provision, transfers to a controlled corporation of indebtedness of the corporation which is not evidenced by a security, or of claims against the corporation for accrued but unpaid interest on indebtedness, would not be covered by the nonrecognition rule of section 351 of the Code.

Also, the nonrecognition rule would not apply in the case of a transfer to a controlled corporation of the assets of a debtor in a bankruptcy or simliar case [7] to the extent the stock or securities received in exchange for the assets are used by the debtor to pay off his debts. Accordingly, gain or loss would be recognized to the debtor upon the debtor's transfer of assets to the controlled corporation if the stock is then transferred to creditors pursuant to a plan approved in a bankruptcy or similar case. (If less than all the stock is transferred to creditors, a proportionate share of gain or loss would be recognized.) Since the basis of the stock received is adjusted for any gain or loss recognized, the amount recognized on the transfer of the stock to the creditors would reflect any amount recognized on the incorporation transfer.

Thus, the sum total of income or loss to the debtor in the two transfers would be the same as if the assets had been transferred directly to the creditors. However, the basis of the assets in the hands of the corporation also would be adjusted by any gain or loss recognized on the

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[5] *Alexander F. Duncan*, 9 T.C. 468 (1947), acq. 1948-2 C.B., 2; Rev. Rul. 77-81, 1977-1 C.B. 97.

[6] See *Carman* v. *Comm'r*, 189 F.2d 363 (2d Cir. 1951).

[7] See note 1, *supra*.

transfer to the corporation, thus reducing any "built-in" loss on assets which had depreciated in value.[8]

*Effective date*

The effective date for this provision would be the same as for section 2 of the bill, relating to income from discharge of indebtedness.

### 6. Effect of discharge of indebtedness on earnings and profits (sec. 5(f) of the bill and sec. 312 of the Code)

*Present law*

Under present law, the effect of discharge of indebtedness upon the earnings and profits of a corporation in a bankruptcy proceeding is unclear.[9]

*Explanation of provision*

The bill would provide that to the extent that income from discharge of indebtedness (including an amount excluded from gross income pursuant to section 108 of the Code, as amended by this bill) is applied to reduce basis under section 1017 of the Code, such basis-reduction amount does not affect the debtor corporation's earnings and profits (although reduced depreciation deductions or increased gains on sales of reduced-basis assets would affect earnings and profits in the years such deductions are taken or sales made). Otherwise, discharge of indebtedness income, including amounts excluded from gross income (pursuant to section 108 of the Code, as would be amended by this bill), increases the earnings and profits of the corporation (or reduces a deficit).

*Effective date*

The effective date for this provision would be the same as for section 2 of the bill, relating to income from discharge of indebtedness.

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[8] This rule does not apply to a transfer under a plan of reorganization, since no gain or loss is recognized by reason of section 361 of the Code.

[9] In the case of *Meyer* v. *Comm'r*, 383 F.2d 883 (8th Cir. 1967), the Eighth Circuit held that earnings and profits did not arise where indebtedness was discharged under the Bankruptcy Act. The Internal Revenue Service has announced that it will not follow the *Meyer* decision to the extent that the amount of debt discharged exceeds the reduction in basis of the taxpayer's assets (Rev. Rul. 75-515, 1975-2 C.B. 117).

## E. Changes in Tax Procedures (sec. 6 of the bill)

### 1. Coordination with bankruptcy court procedures (secs. 6(a), (b), (c), (d), and (g) of the bill and secs. 6213, 6503, 6871, and 7464 of the Code)

#### *Procedures under Bankruptcy Act*

*Bankruptcy court jurisdiction*

In the case of an individual debtor, the commencement of a bankruptcy proceeding creates an estate, which is under control of the bankruptcy court. This estate consists of all assets of the individual other than exempt property and certain assets acquired after the proceeding begins. The assets of the bankruptcy estate are not subject to levy by the Internal Revenue Service for the debtor's prepetition income tax liabilities, and generally can be reached only through the Service's filing of a proof of claim in the bankruptcy court.

The bankruptcy court has jurisdiction to determine the debtor's liability for any unpaid tax, whether or not assessed, unless the liability was adjudicated prior to bankruptcy by a court of competent jurisdiction (sec. 2a(2A) of the Bankruptcy Act). In proceedings under the Bankruptcy Act [1] a determination by the bankruptcy court of a prepetition tax liability of an individual debtor is binding on the Internal Revenue Service and on the trustee of the bankruptcy estate, but might not settle the personal liability of an individual debtor for the amount, if any, of prepetition nondischargeable tax claims which are not satisfied out of the assets of the bankruptcy estate. Accordingly, if the bankruptcy court rules in favor of the Revenue Service with respect to a nondischargeable tax claim, the debtor may be able to force the Service to relitigate the issue if the claim cannot be fully paid out of estate assets.

*Effect on Tax Court jurisdiction*

Under present Federal income tax law (sec. 6871 of the Code) as applicable to Bankruptcy Act proceedings, the Internal Revenue Service is authorized, on institution of a bankruptcy proceeding, immediately to assess any income tax liabilities against the debtor. The Service is not required to follow the normal procedure under which a deficiency notice is issued to the taxpayer and the taxpayer may challenge an asserted income tax liability in the U.S. Tax Court without payment of the tax.

Even if a statutory deficiency notice had been issued and the time for filing a Tax Court petition had not expired before commencement of the bankruptcy proceeding, the debtor still is barred from contesting the asserted liability in the Tax Court (i.e., from litigating without first paying the disputed amount) if the Revenue Service exercises its immediate assessment authority. Present income tax law likewise

[1] The Bankruptcy Act was repealed by P.L. 95–598, effective for bankruptcy cases commencing on or after October 1, 1979, but remains in effect for bankruptcy proceedings commenced prior to that date.

provides that any portion of a claim for nondischargeable taxes allowed in a bankruptcy proceeding but not satisfied out of assets in the estate shall be paid by the taxpayer after termination of the bankruptcy proceeding (sec. 6873 of the Code).

Under the law applicable to Bankruptcy Act proceedings, the U.S. Tax Court thus loses jurisdiction to determine the debtor's personal liability for prepetition taxes unless a Tax Court case had been filed prior to the bankruptcy proceeding. Accordingly, unless the debtor can invoke the jurisdiction of the bankruptcy court and that court makes a determination, the debtor is precluded from prepayment review of an asserted income tax liability. The debtor's only recourse is to pay the tax and then contest the issue through the refund claim procedure of the Internal Revenue Service and subsequent refund litigation in the U.S. District Court or U.S. Court of Claims.

If a notice of deficiency had been issued and a Tax Court case filed prior to institution of the bankruptcy proceeding, but the Tax Court had not reached a decision as to the debtor's income tax liability, both the bankruptcy court and the Tax Court have jurisdiction to determine the tax liability issue. A decision by the Tax Court would not necessarily bind the estate of the bankrupt, unless the trustee had intervened in the Tax Court litigation. A decision by the bankruptcy court might not necessarily bind the individual debtor, unless the debtor individually had invoked the bankruptcy court's jurisdiction.

Thus, under the law applicable to Bankruptcy Act proceedings, in certain circumstances there may be duplicative litigation concerning the debtor's tax liability. In other circumstances, the debtor may be precluded from obtaining prepayment review of prepetition tax liabilities.

### *New bankruptcy statute (P.L. 95-598)*

New 11 U.S. Code section 505(a) continues the jurisdiction of the bankruptcy court to determine liability for a tax deficiency, regardless of whether it has been assessed, unless it has been adjudicated by a court of competent jurisdiction prior to filing of the bankruptcy petition.[2] The new law, effective for bankruptcy cases commenced on or after October 1, 1979, also seeks to resolve the problems mentioned above by giving the bankruptcy court, in effect, the authority to determine whether the tax liability issue should be decided in the bankruptcy court or in the U.S. Tax Court.

Under new 11 U.S. Code section 362(a)(8), commencement of a bankruptcy case triggers an automatic stay of institution or continuation of any U.S. Tax Court proceedings to challenge an asserted tax de-

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[2] Under the law applicable to Bankruptcy Act proceedings, the trustee of a bankruptcy estate must proceed in courts other than the bankruptcy court to seek a refund of Federal taxes paid by the debtor. While the trustee succeeds to any right to refund for tax overpayments, the bankruptcy court has jurisdiction only to allow claims against the bankruptcy estate, and not to enforce claims against third parties.

New 11 U.S. Code sec. 505(a) expands the jurisdiction of the bankruptcy court to include determination of refund claims. To invoke the bankruptcy court's jurisdiction, the trustee must file an administrative claim for refund with the Internal Revenue Service (if the debtor had not done so prior to commencement of the bankruptcy case). If a claim filed by the trustee is denied or if 120 days elapse without action by the Internal Revenue Service, the court has jurisdiction to determine the refund issue.

ficiency of the debtor. Also under the new law, assessment or collection of a prepetition tax claim against the debtor is automatically stayed by commencement of the bankruptcy case (sec. 362(a)(6)).[3] Unless the stay is lifted by the bankruptcy court, or a discharge is granted or denied, the stay continues until termination of the bankruptcy case (sec. 362(c)).

The new statute authorizes the bankruptcy judge to lift the stay and permit the debtor to institute a Tax Court case (if a notice of deficiency has been issued and the period for filing such case has not expired) or to continue a pending Tax Court case involving the debtor's tax liability (new 11 U.S. Code sec. 362(d)). The bankruptcy court, for example, could lift the stay if the debtor seeks to litigate in the Tax Court and the trustee wishes to intervene in that proceeding. In such a case, the merits of the tax controversy will be determined by the Tax Court, and the Tax Court's decision will bind both the individual debtor as to any taxes which are nondischargeable and the intervenor trustee as to the tax claim against the estate.

However, if the bankruptcy court does not lift the automatic stay, but instead itself decides the tax issue and (at the request of the Revenue Service or of the debtor) determines the debtor's personal liability for a nondischargeable tax, then the bankruptcy court's decision will bind both the individual debtor and the estate as well as the government.

### *Explanation of provisions*

Sections 6(a), 6(b), 6(c), 6(d), and 6(g) of the bill would coordinate certain provisions of the Internal Revenue Code with the bankruptcy court procedures enacted in P.L. 95-598, as described above. These procedures include the automatic stay on assessment or collection of certain tax claims against the debtor, the automatic stay on institution or continuation by the debtor of deficiency litigation in the U.S. Tax Court, and the authority of the bankruptcy court to lift the stay and permit the debtor's tax liability to be determined by the Tax Court.

## *Immediate assessment*

### *General rule*

Section 6(g) of the bill generally would repeal the present rule (in sec. 6871(a) of the Code) authorizing the Internal Revenue Service to assess certain prepetition tax deficiencies of the debtor immediately

[3] The stay does not preclude the Internal Revenue Service from issuing a deficiency notice during the bankruptcy case (new 11 U.S. Code sec. 362(b)(8)).
government.[4]

[4] 124 Cong. Rec. H-11,111 (daily ed. Sept. 28, 1978) (remarks of Mr. Edwards); 124 Cong. Rec.. S-17,427 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini). In the case of a corporate debtor, the commencement of a bankruptcy proceeding does not create a separate taxable entity, and (unlike in the case of an individual debtor) the debtor corporation is considered to be personally before the bankruptcy court. Accordingly, a decision by the bankruptcy court as to the corporate debtor's prepetition income tax liability is binding on the corporation, which cannot thereafter institute a Tax Court case to relitigate the issue. However, under P.L. 95-598, the bankruptcy judge is authorized to lift the automatic stay under new 11 U.S. Code sec. 362 and permit the tax issue to be determined in the U.S. Tax Court (if a case involving the issue is already pending in that Court, or if a deficiency notice has been issued and the period for filing such case has not expired).

on institution of bankruptcy proceedings. Accordingly, if the bankruptcy court lifts the automatic stay under new 11 U.S. Code section 362(a)(8), the debtor would not be precluded from filing a petition (if timely) in the Tax Court to challenge an asserted prebankruptcy tax deficiency.

*Exceptions*

The bill would authorize the Revenue Service to make an immediate assessment (1) of tax imposed on the bankruptcy estate of an individual debtor, or (2) of tax imposed on a debtor if liability for such tax has become res judicata against the debtor pursuant to a bankruptcy court determination.

These two exceptions reflect bankruptcy situations in which there is no need to require the Revenue Service to follow the normal deficiency notice procedure. In the case of taxes imposed on the bankruptcy estate of an individual (i.e., where the estate is treated as a separate taxable entity), the estate's own tax liability is determined by the bankruptcy court and cannot be litigated in the Tax Court. In the case where an individual debtor's personal liability for nondischargeable tax claims has been litigated in the bankruptcy court, and under the doctrine of res judicata the debtor would be precluded from relitigating the issue in any court, no purpose would be served by requiring issuance of a deficiency notice prior to assessment. For the same reason, the bill would permit immediate assessment of a corporate debtor's tax liabilities once the bankruptcy court has made a determination which is res judicata.

*Conforming rules*

The bill also would amend section 6871 of the Code to delete the prohibition in current law on filing a Tax Court petition after commencement of a bankruptcy proceeding. This change likewise would conform to the provisions of P.L. 95-598 which stay the debtor, on commencement of a bankruptcy case, from instituting a Tax Court proceeding to challenge an asserted tax deficiency, but authorize the bankruptcy judge to lift the stay and permit the debtor to institute a Tax Court case (if a notice of deficiency has been issued and the period for filing such case has not expired). Also, the bill would restate the rule of present law that claims for certain tax deficiencies, etc. may be presented for adjudication before the bankruptcy court, notwithstanding the pendency of any Tax Court proceedings for redetermination of the deficiency.

*Receiverships*

The bill would not modify the present law rules in section 6871 of the Code relating to receivership proceedings. To the extent immediate assessment authority is retained for receivership proceedings, and for the two bankruptcy situations described above, the bill would expand the category of taxes which could be so assessed to include taxes under Internal Revenue Code chapters 41 (public charities), 42 (private foundations and black lung benefit trusts), 43 (qualified pension, etc., plans), and 44 (real estate investment trusts).

*Collection*

Section 6(g) of the bill also would amend section 6873(a) of the Code to delete the rule that any portion of a claim for nondischarge-

able taxes allowed in a bankruptcy case but not satisfied out of assets in the estate must be paid by the taxpayer upon notice and demand by the Internal Revenue Service after termination of the bankruptcy case. (No change would be made in section 6873 with respect to payment of claims for taxes allowed in a receivership proceeding.) As described above, if the bankruptcy court has made a determination of the debtor's tax liability which (under the doctrine of res judicata) precludes the debtor from relitigating the issue in any other court, the Revenue Service could make an immediate assessment of such liability without issuing a deficiency notice. Thereafter, the provisions of the Code relating to collection of assessed taxes would apply.

*Tax Court petition*

Section 6(b) of the bill would provide that if the stay under new 11 U.S. Code section 362(a)(8) precludes a debtor from filing a petition in the U.S. Tax Court after receipt of a deficiency notice, the running of the normal 90-day period for filing the petition is suspended during the stay and for 60 days thereafter. Also, the bill would clarify that the filing of a proof of claim, the filing of request for payment, or other action taken by the Internal Revenue Service in the bankruptcy case (such as a request that the court determine the personal liability of an individual debtor for a nondischargeable tax) is not to be treated as prohibited under section 6213(a) of the Code (relating to certain restrictions generally applicable to assessment of a tax deficiency).

*Tax Court intervention*

Section 6(c) of the bill would provide that the trustee of the bankruptcy estate of a debtor may intervene, as a matter of right, on behalf of the estate in any proceeding before the U.S. Tax Court to which the debtor is a party. This provision would apply where the bankruptcy judge lifts the automatic stay under new 11 U.S. Code section 362 so that the debtor's prepetition tax liability can be determined in the Tax Court.

*Assessment and collection limitations*

Section 6(a) of the bill would provide that if the automatic stay under new 11 U.S. Code section 362(a)(6) precludes the Internal Revenue Service from assessment or collection of tax, the running of the period of limitations is suspended, for assessment, for the duration of the stay and for 60 days thereafter; and for collection, during the period of the stay and for six months thereafter.

*Cross references*

Section 6(d) of the bill would add cross references in sections 6212, 6512, 6532, and 7430 of the Code to new 11 U.S. Code section 505 (relating to jurisdiction of the bankruptcy court).

**2. Relief from certain failures to pay tax when due (sec. 6(e) of the bill and new sec. 6658 of the Code.)**

*Present law*

The Internal Revenue Code (secs. 6651, 6654, and 6655) imposes penalties for failure timely to pay certain taxes, unless the taxpayer can establish that the failure was due to reasonable cause and not due

to willful neglect. Under bankruptcy rules, a debtor or the trustee of a bankruptcy estate may be precluded from timely paying certain taxes after commencement of the bankruptcy proceedings.

*Explanation of provision*

Section 6(e) of the bill would relieve the debtor or the trustee from penalties which otherwise might be applicable under sections 6651, 6654, or 6655 of the Code for failure timely to pay certain taxes, with respect to a period during which a bankruptcy case is pending, to the extent that the bankruptcy case precludes payment of such taxes when due.[5]

In the case of a tax incurred by the estate, the relief would be granted if the failure occurs pursuant to a court order finding probable insufficiency of funds to pay such taxes. In the case of a tax incurred by the debtor before commencement of the bankruptcy case, the relief provision of the bill would apply if either the bankruptcy petition is filed before the tax return due date, or the date for imposing the penalty occurs after commencement of the bankruptcy case.

These relief rules would not, however, apply with respect to liability for penalties for failure timely to pay or deposit any employment tax required to be withheld by the debtor or trustee.

**3. Preservation of FUTA credit (sec. 6(f) of the bill and sec. 3302 of the Code)**

*Present law*

Present law provides a credit against the Federal unemployment tax imposed on an employer for amounts paid by the employer into a State unemployment compensation fund (sec. 3302 of the Internal Revenue Code). A reduction in the otherwise allowable credit is required in the case of late contributions to a State fund (sec. 3302(a)(3) of the Code).

*Explanation of provision*

Section 6(f) of the bill would amend section 3302(a) of the Code to provide that there is no reduction in the credit against the FUTA tax if the failure to make timely contributions to a State unemployment compensation fund, with respect to wages paid by the trustee of a bankruptcy estate, is without fault of the trustee on account of the bankruptcy case.

**4. Repeal of deadwood provision (sec. 6(h) of the bill and sec. 1018 of the Code)**

*Present law*

Section 1018 of the Internal Revenue Code provides certain basis adjustment rules which apply if, in a bankruptcy proceeding under section 77B of the Bankruptcy Act which concluded before September 22, 1938, indebtedness was cancelled in pursuance of a plan of reorganization consummated by adjustment of the capital or debt structure of the insolvent corporation.

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[5] No inference would be intended, by virtue of adoption of the rules in section 6(e) of the bill, that under present law such penalties should be imposed where a debtor or the trustee of a bankruptcy estate is precluded from timely paying such taxes by virtue of bankruptcy proceedings.

***Explanation of provision***

Section 6(h) of the bill would repeal section 1018 of the Internal Revenue Code.

**5. Technical and conforming amendments (sec. 6(i) of the bill)**

Section 6(i) of the bill would make technical and conforming amendments to the Internal Revenue Code, principally to substitute references to bankruptcy cases under new title 11 of the U.S. Code for references to bankruptcy proceedings under the now-repealed Bankruptcy Act.

*1. Amendment of section 128(a).*—In section 128(a) of the Code, relating to cross references to other Acts, the reference to the Bankruptcy Act would be deleted.

*2. Amendment of section 354(c).*—Section 354(c) of the Code, relating to exchanges of stock and securities in certain railroad reorganizations, would be amended to substitute a reference to plans of reorganization confirmed under new 11 U.S. Code section 1173, for a reference to plans approved by the Interstate Commerce Commission under section 77 of the Bankruptcy Act.

*3. Amendment of section 422(c).*—Section 422(c)(5) of the Code relating to certain transfers by insolvent individuals of stock acquired pursuant to exercise of a qualified stock option, would be amended by substituting a reference to new 11 U.S. Code for a reference to the Bankruptcy Act.

*4. Amendment of section 1023.*—Section 1023 of the Code, relating to cross references, would be amended by deleting a cross reference to the Bankruptcy Act.

*5. Amendment of section 6012(b).*—Section 6012(b)(3) of the Code, relating to returns made by receivers, trustees, and assignees for corporations, would be amended by substituting a reference to a trustee in a bankruptcy case under new 11 U.S. Code for a reference to a trustee in a bankruptcy proceeding (under the Bankruptcy Act).

*6. Amendment of section 6036.*—Section 6036 of the Code, relating to notice of qualification as executor or receiver, would be amended by substituting a reference to a trustee in a bankruptcy case under new 11 U.S. Code for a reference to a trustee in a bankruptcy proceeding (under the Bankruptcy Act).

*7. Amendment of section 6155(b).*—Section 6155(b)(2) of the Code, relating to cross references, would be amended by deleting the reference to section 6873 of the Code with respect to bankruptcy proceedings (under the Bankruptcy Act).

*8. Amendment of section 6161(c).*—Section 6161(c) of the Code, relating to extension of time for payment of tax claims in bankruptcy or receivership proceedings, would be amended by substituting references to bankruptcy cases under new 11 U.S. Code for references to bankruptcy proceedings (under the Bankruptcy Act).

*9. Amendment of section 6216(1).*—Section 6216(1), relating to cross references, would be amended by deleting a reference to subchapter B of chapter 70 of the Code with respect to bankruptcy procedures.

*10. Amendment of section 6326.*—Section 6326 of the Code, relating to cross references, would be amended by deleting references to the Bankruptcy Act and adding references to new 11 U.S. Code.

*11. Amendment of section 6503(i).*—Section 6503(i)(2), relating to cross references, would be amended by deleting a reference to subchapter C of chapter 70 of the Code with respect to suspension of running of period of limitation in a bankruptcy proceeding (under the Bankruptcy Act).

*12. Amendment of section 6872.*—Section 6872 of the Code, relating to suspension of period on assessment, would be amended by substituting a reference to a bankruptcy case under new 11 U.S. Code for a reference to a bankruptcy proceeding under the Bankruptcy Act.

*13. Amendment of section 7430.*—Section 7430 of the Code, relating to cross references, would be amended by deleting references to the Bankruptcy Act and adding references to new 11 U.S. Code.

*14. Amendment of section 7508(d).*—Section 7508(d)(1) of the Code, relating to time for performing certain acts postponed by reason of service in combat zone, would be amended by substituting a reference to bankruptcy cases under new 11 U.S. Code for a reference to bankruptcy proceedings (under the Bankruptcy Act).

**6. Effective date for provisions of section 6 of the bill**

The provisions of section 6 of the bill (relating to changes in tax procedures) would be effective October 1, 1979, except that such provisions would not apply to any Bankruptcy Act proceeding commenced before October 1, 1979.

## F. Revenue Effect

The revenue effect of the provisions of the bill, other than of those provisions of section 2 (tax treatment of discharge of indebtedness) which apply to solvent taxpayers outside bankruptcy, cannot be estimated with precision. However, it is estimated that the provisions of section 2 other than those applicable to solvent taxpayers outside bankruptcy would result in some revenue gain; that the provisions of section 3 (rules relating to title 11 cases for individuals) and of section 6 (changes in tax procedures) would have a negligible revenue effect; and that the provisions of section 4 and 5 (corporate reorganization provisions and miscellaneous corporate amendments) would result in some revenue loss.

It is not expected that these revenue effects would be significant during the next few fiscal years. This is because the provisions of the bill generally would apply only to bankruptcy cases or similar court proceedings beginning on or after October 1, 1979, to transactions occurring more than 90 days after the date of enactment, or to transactions occurring after December 31, 1980; because it can take considerable time for completion of bankruptcy cases or similar proceedings and of corporate insolvency reorganizations; and because the debt discharge rules of the bill generally would affect revenues in years subsequent to the year in which the debt discharge occurs.

It is estimated that those provisions of section 2 of the bill which apply to solvent taxpayers outside bankruptcy, and which would modify the election under sections 108 and 1017 of the Code to reduce basis of assets in lieu of recognizing income from discharge of indebtedness, would increase tax revenues by less than $5 million annually.

# DESCRIPTION OF MISCELLANEOUS TAX BILLS

## INTRODUCTION

The bills described in this pamphlet have been scheduled for a hearing on May 30, 1980, by the Senate Finance Subcommittee on Taxation and Debt Management Generally. There are 6 Senate bills described in the pamphlet (S. 2484, S. 2486, S. 2500, S. 2503, S. 2526 and S. 2548).

The first part of the pamphlet is a summary of the bills presented in bill numerical order. 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.

(A separate pamphlet describes the House-passed Bankruptcy Tax Act of 1980, H.R. 5043, which is also scheduled for the May 30 Subcommittee hearing.)

# I. SUMMARY

## 1. S. 2484—Senators Riegle and Levin

### Recapture of Foreign Losses

The bill would expand the application of an exception to the general effective date of the foreign loss recapture provisions of the Tax Reform Act of 1976. Under the 1976 Act, the foreign loss recapture provisions generally apply to losses sustained after 1975. Certain exceptions to the effective date were made for losses attributable to investments in foreign subsidiaries which were substantially worth less on the effective date. Under one of these exceptions, where a loss was sustained in 1976 with respect to such a substantially worthless subsidiary, the full amount of the loss was exempt from recapture. Under a second, more limited exception, losses on such substantially worthless subsidiaries sustained after 1976 but before 1979 were exempt from recapture to the extent of the deficit in the earnings and profits of the subsidiary as of the general December 31, 1975, effective date. The bill would expand these exceptions so that the full amount of such losses sustained in the period after 1976 but before 1979 would be exempt from recapture if substantially all the employees of the foreign subsidiary were discharged before April 15, 1977.

## 2. S. 2486—Senators Culver, McGovern, and Baucus

### Tax Exemption for Industrial Development Bonds for Railroad Rehabilitation

Under present law, tax-exempt industrial development bonds may be used to provide certain transportation facilities (e.g., airports, docks, wharves, mass commuting facilities, and public parking facilities). The bill would allow the use of tax-exempt industrial development bonds for the financing of railroad rehabilitation and the acquisition of land and rights-of-way in conjunction with railroad rehabilitation.

## 3. S. 2500—Senators Moynihan, Javits, and Heinz

### Theatrical Production Investment Tax Credit Act of 1980

Under present law, taxpayers are entitled to receive an investment credit for certain tangible personal property that is placed in service by the taxpayer. The presentation of a dramatic work, such as a play or opera, before a live audience is not tangible personal property, and no investment credit is allowed for an investment in a theatrical production. The bill would allow an investment credit for qualified investments in certain theatrical productions.

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### 4. S. 2503—Senator Kassebaum

**Refundable Tax Credit for Certain Interest on Agricultural Loans**

The bill would allow a tax credit equal to the amount of interest paid on certain agricultural operating loans on a principal amount not exceeding $25,000 to the extent that the interest is attributable to a rate that exceeds 12 percent and does not exceed the 90-day commercial paper rate by more than 5 percentage points.

### 5. S. 2526—Senator Baucus

**Tax Exemption for Industrial Development Bonds for Facilities Used To Furnish Railroad Transportation**

Under present law, tax-exempt industrial development bonds may be used to provide certain transportation facilities (e.g., airports, docks, wharves, mass commuting facilities, and public parking facilities). The bill would allow tax-exempt industrial development bonds to be used to provide facilities, including rolling stock, for railroad transportation.

### 6. S. 2548—Senator Stone

**Tax Exemption for Industrial Development Bonds Used To Refinance Certain Docks and Wharves**

Under present law, tax-exempt industrial development bonds may be used to provide docks and wharves. However, such obligations will not be tax-exempt where they are used to refinance existing docks and wharves which were not originally financed with tax-exempt bonds. The bill would allow the use of tax-exempt industrial development bonds for the refinancing of existing docks and wharves in Tampa, Florida, which were not originally financed with tax-exempt bonds.

# II. DESCRIPTION OF BILLS

## 1. S. 2484—Senators Riegle and Levin

## Recapture of Foreign Losses

### *Present law*

Where a taxpayer's foreign operations result in a net overall foreign loss for a particular taxable year, that net foreign loss will reduce the taxpayer's U.S. tax on its U.S. source income for that year by decreasing the worldwide taxable income on which the U.S. tax was based. In addition, prior to the Tax Reform Act of 1976, if the taxpayer earned net income from foreign sources in future years, no reduction in the taxpayer's foreign tax credit limitation was made to recapture the prior benefits from foreign losses (except in the case of foreign oil related losses, which were subject to recapture pursuant to amendments made by the Tax Reduction Act of 1975). Thus, in such situations, the taxpayer reduced its U.S. tax on its U.S. income as the result of the foreign loss while not paying U.S. tax on its foreign operations when they generated net income because of the foreign tax credit.

To reduce these advantages, the 1976 Act extended the recapture provisions to all foreign losses. The recapture rules are intended to ensure that the foreign tax credit cannot be used against U.S. source income. The Act requires that, in cases where a loss from foreign operations reduces U.S. tax on U.S. source income, the loss is to be recaptured by the United States if the company subsequently derives income from abroad. In general, the recapture is accomplished by treating a portion of foreign income which is subsequently derived as income from domestic sources.

The loss recapture provisions generally apply to losses sustained in taxable years beginning after December 31, 1975. An exception to the general effective date was provided for cases where a loss sustained in 1976 is from a direct investment in a foreign subsidiary which was substantially worthless prior to the effective date and the taxpayer terminated all operations of the corporation before January 1, 1977, through a sale, liquidation or other disposition of the corporation or its assets. This exception applied where a corporation suffered an operating loss in three out of the five years preceding the year in which the loss was sustained, and the corporation sustained an overall loss for those five years.

A second, limited exception was provided for taxpayers who satisfied the other requirements of the first exception but failed to qualify because the operations of the foreign subsidiary were not terminated in 1976. If the operations were continued after 1976 but were terminated before 1979, the loss would nevertheless not be subject to recapture, to the extent of the deficit in the subsidiary's earnings and profits on the general effective date of the recapture provisions (December 31, 1975).

*Issue*

The issue is whether the second exception to the December 31, 1975, effective date of the foreign loss recapture provisions (applicable to investments terminated after 1976 but before 1979 as described above) should be expanded to exempt from recapture the full amount of the loss, rather than just the loss realized by the subsidiary before 1976, where substantially all of the foreign corporation's employees were discharged before April 15, 1977.

*Explanation of the bill*

Under the bill, a loss on the termination of an investment in a foreign subsidiary after 1976 but before 1979 which qualifies for the limited second exception to the December 31, 1975, effective date (but not the first) would be exempt in full recapture (rather than just to the extent of the deficit in earnings and profits as of the general effective date) if substantially all of the employees of the terminated corporation are discharged before April 15, 1977.

The principal beneficiary of the bill would be the Sealed Power Corporation.

*Effective date*

The bill would be effective as of October 4, 1976, the date of enactment of the 1976 Act.

*Revenue effect*

According to preliminary estimates, this provision will reduce budget receipts by less than $10 million annually for the next several years.

## 2. S. 2486—Senators Culver, McGovern, and Baucus

### Tax Exemption for Industrial Development Bonds for Railroad Rehabilitation

*Present law*

Under present law, interest on State and local government obligations is generally exempt from Federal income tax. However, since 1968, tax exemption has been denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

An exception to the denial of tax exemption for IDBs applies in the case of such obligations which are used to provide exempt activity facilities, including certain types of transportation facilities, e.g., airports, docks, wharves, mass commuting facilities, and public parking facilities (Code sec. 103(b)(4)(D)). No exception is provided under present law for IDBs used to provide financing for railroad rehabilitation.

The exception for IDBs for exempt activity facilities applies where the proceeds of an IDB are to be used to finance the construction of a new facility or to finance the acquisition of an existing facility from an unrelated person. However, under the IRS regulations, the exception does not apply where the proceeds of an IDB are to be used to refinance an existing facility which was not originally financed with tax-exempt bonds (e.g., it was conventionally financed). Under these IRS regulations, the exception will apply to the financing of an existing facility only where the person who was a substantial user of the facilities before issuance of the obligations and who receives the proceeds of the obligation will not be a substantial user of the facilities following the issuance of the obligations (Treas. Reg. sec. 1.103-8(a)(5)(iv)). In general, a substantial user of a facility includes any nonexempt person who regularly uses a part of such facility in his trade or business where (1) the gross revenue derived by such user with respect to such facility is more than 5 percent of the total revenue derived by all users of such facility or (2) the amount of area of the facility occupied by such user is more than 5 percent of the entire usable area of the facility (Treas. Reg. sec. 1.103-11(b)). For example, an IDB would not be tax exempt in the case where the proceeds of the obligation are used by a governmental entity to purchase an exempt activity facility which is then, in turn, leased back to the prior owner for a period equal to the useful life of the facility.

### *Issue*

The principal issue is whether tax-exempt IDBs should be allowed to be used to provide financing for railroad rehabilitation. A subsidiary issue is whether tax-exempt IDBs should be allowed to be used to refinance existing conventionally financed railroad systems.

### *Explanation of the bill*

The bill provides that interest on an industrial development bond would be exempt from Federal income taxation where substantially all the proceeds of the bond are used to provide financing for railroad rehabilitation or the acquisition of land or rights-of-way in connection with railroad rehabilitation. Under the bill, railroad rehabilitation includes the acquisition, construction, reconstruction, or erection of any roadbed, track, trestle, depot, switching and signal equipment, or any related equipment, but not rolling stock.

Finally, under the bill, it is unclear whether tax-exempt IDBs may be used for the refinancing of existing conventionally financed railroad systems.

### *Effective date*

The bill would apply to obligations issued after September 30, 1980.

### *Revenue effect*

It is estimated that this bill would reduce budget receipts by $1 million in fiscal year 1980, $30 million in 1981, $80 million in 1982, $180 million in 1983, $300 million in 1984 and $460 million in 1985. (For these estimates, it is assumed that tax-exempt refinancing of existing facilities would not be allowed.)

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## 3. S. 2500—Senators Moynihan, Javits, and Heinz

## Theatrical Production Investment Tax Credit Act of 1980

### *Present law*

Under present law, taxpayers are entitled to receive an investment tax credit for qualified tangible personal property which is placed in service by the taxpayer (Code sec. 38). In order to receive the full credit, the property placed in service by the taxpayer must have a useful life of at least 7 years. If the property has a useful life of at least 5 years (but less than 7 years) the taxpayer is entitled to two-thirds of the full credit. If the property has a useful life of at least 3 years (but less than 5 years) the taxpayer is entitled to one-third of the full credit. In addition, the property will cease to quality as section 38 property if, during any taxable year, there is any predominant foreign use of the property.

The Tax Reform Act of 1976 provided rules that clarified and modified the application of the investment tax credit to movies and television films. Under these rules, all of the direct production costs and certain indirect costs of movies or films qualify for the investment tax credit. The taxpayer may use the actual useful life of the movie or film to determine the amount of the investment credit or, at his election, the taxpayer may receive an investment tax credit for two thirds (66⅔ percent) of the full investment tax credit regardless of the useful life of the movie or film. The Act also contains detailed rules to insure that the investment tax credit applies to production costs generally incurred in the United States regardless of where the movie or film is shown. In addition, a taxpayer is entitled to the investment tax credit only if he has an ownership interest in the movie or film.

No investment tax credit is allowed for the costs of producing a dramatic work before a live audience, such as a play or opera, because a play, opera, or other live presentation is not considered tangible personal property.

### *Issue*

The issue is whether taxpayers should be allowed an investment tax credit for qualified investments in certain theatrical productions.

### *Explanation of the bill*

The bill would allow an investment credit for qualified investments in "theatrical productions". The credit allowed under Code section 38 would be based on two-thirds (66⅔ percent) of the qualified United States production costs. The bill contains detailed rules, similar to those contained in the Tax Reform Act of 1976 for movies and television films, to exclude foreign production costs from being eligible for the investment tax credit. A credit would be allowed only to the extent the taxpayer has an ownership interest in the theatrical production.

The bill defines "theatrical production" as the presentation of a dramatic work in a commercial theater before a live audience. The definition includes plays, musicals, operas, and ballets. A presentation primarily for use in a film or nightclub or on radio or television, however, would not qualify for an investment tax credit under the bill.

### *Effective date*

The effective date of the provisions is not specified in the bill.

### *Revenue effect*

This bill is estimated to reduce budget receipts by less than $5 million annually.

## 4. S. 2503—Senator Kassebaum

## Refundable Tax Credit for Certain Interest on Agricultural Loans

### *Present law*

*Tax credit*

Under present law, no income tax credit is allowed a taxpayer for interest paid or incurred with respect to any debt.

*Deduction for interest expense*

In general, interest expense is allowed as a deduction in the taxable year paid or incurred, depending upon the taxpayer's method of accounting (Code sec. 163). If a taxpayer uses the cash receipts and disbursements method of accounting to compute taxable income, interest which is properly allocable to any later taxable year must be charged to the capital account and treated as paid in the periods in which (and to the extent that) the interest represents a charge for the use or forbearance of borrowed money during each such taxable year (Code sec. 461(g)).

In the case of a taxpayer other than a corporation which is not a subchapter S corporation or a personal holding company, real property construction period interest is to be capitalized in the year in which paid or accrued and amortized over a 10-year period after a transitional period. A portion of the amount capitalized may be deducted for the taxable year in which paid or accrued. The balance must be amortized over the remaining years in the amortization period beginning with the year in which the property is ready to be placed in service or is ready to be held for sale (Code sec. 189).

With respect to interest on investment indebtedness, present law limits the deduction to $10,000 per year increased by the amount of the taxpayer's net investment income (Code sec. 163(d)). However, except for construction period interest, there is no limitation on the amount of interest allowed as a deduction that is incurred in connection with a trade or business.

### *Issue*

The principal issue is whether a refundable tax credit for certain interest paid or incurred on agricultural loans should be provided. Subsidiary issues include whether the credit should be available with respect to loans between related persons and, if not, what definition of related persons should be prescribed.

### *Explanation of the bill*

The bill would provide a refundable[1] tax credit for certain interest

[1] Appropriations acts may be required for the Internal Revenue Service to make payments of the portion of the credit which exceeds the taxpayer's tax liability. See section 303 of Public Law 95–355 (92 Stat. 563–4).

paid or incurred by the taxpaper on agricultural operating loans. In general, the amount of the credit is equal to the excess of the interest paid or incurred on agricultural operating loans over the interest which would have been paid had the annual percentage rate of interest on the loan been 12 percent. The interest to be taken into account for purposes of computing the credit may not exceed the discount rate, including any surcharge, on 90-day commercial paper in effect at the Federal Reserve bank in the Federal Reserve district where the taxpayer resides, increased by 5 percentage points. Additionally, only interest paid or incurred on $25,000 of original principal amount may be taken into account. To the extent a taxpayer claims a credit for the interest on agricultural operating loans, no deduction for such amount would be allowed. Also, no credit would be allowed for interest paid to a related person (as determined pursuant to the regulations under Code sec. 52(b)). In the case of subchapter S corporations, estates and trusts (and presumably partnerships), under regulations prescribed by the Secretary of the Treasury, the credit is to pass through to the shareholders and beneficiaries, respectively (and the partners).

Under the bill, the term "agricultural operating loan" means a loan with a maturity not to exceed 12 months, the proceeds of which are to be used for a purpose described in section 312 of the Consolidated Farm and Rural Development Act (7 U.S.C. 1942). This section generally provides that:

> "(a) Loans may be made under this subchapter for (1) paying costs incident to reorganizing the farming system for more profitable operation, (2) purchasing livestock, poultry, and farm equipment, (3) purchasing feed, seed, fertilizer, insecticides, and farm supplies and to meet other essential farm operating expenses including cash rent, (4) financing land and water development, use, and conservation, (5) without regard to the requirements of section 1941(a)(2) and (3) of this title, to individual farmers or ranchers to finance outdoor recreational enterprises or to convert to recreational uses their farming or ranching operations, including those heretofore financed under this chapter, (6) enterprises needed to supplement farm income, (7) refinancing existing indebtedness, (8) other farm and home needs including but not limited to family subsistence, (9) loan closing costs, and (10) for assisting farmers or ranchers in effecting additions to or alterations in the equipment, facilities, or methods of operation of their farms or ranches in order to comply with the applicable standards promulgated pursuant to section 655 of Title 29 or standards adopted by a State pursuant to a plan approved under section 667 of Title 29, if the Secretary determines that any such farmer or rancher is likely to suffer substantial economic injury due to such compliance without assistance under this paragraph.
>
> "(b) Loans may also be made under this subchapter to residents of rural areas without regard to the requirements of clauses (2) and (3) of section 1941(a) of this title to operate in rural areas small business enterprises to provide such residents with essential income."
>
> "(c) Loans may also be made to eligible applicants under this subchapter for pollution abatement and control projects in rural areas.

*Effective date*

The provisions of the bill would be effective with respect to taxable years beginning after December 31, 1979.

*Revenue effect*

It is estimated that the bill would decrease Federal budget receipts by $16 million in fiscal year 1980, $182 million in 1981, $85 million in 1982, and $49 million in 1983.

## 5. S. 2526—Senator Baucus

### Tax Exemption for Industrial Development Bonds for Facilities Used To Furnish Railroad Transportation

***Present law***

Under present law, interest on State and local government obligations is generally exempt from Federal income tax. However, since 1968, tax exemption has been denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

An exception to the denial of tax exemption for IDBs applies in the case of such obligations which are used to provide "exempt activity" facilities, including certain types of transportation facilities (e.g., airports, docks, wharves, mass commuting facilities and public parking facilities) (Code sec. 103(b)(4)(D)). No exception is provided under present law for IDBs used to provide facilities, including rolling stock, for the furnishing of railroad transportation.

***Issue***

The issue is whether tax-exempt IDBs should be allowed to be used to provide facilities, including rolling stock, for the furnishing of railroad transportation.

***Explanation of the bill***

The bill provides that interest on an industrial development bond would be exempt from Federal income taxation where substantially all the proceeds of the bond are to be used to provide facilities, including rolling stock, for the furnishing of railroad transportation. It is unclear whether the bill would apply only to rolling stock and other facilities which are owned by or leased to regulated railroad systems or whether it would also apply to rolling stock and other facilities owned by or leased to industries (e.g., a tank car owned by or leased to a chemical company).

***Effective date***

The bill would apply to obligations issued on or after the date of enactment.

***Revenue effect***

If the bill does not apply to companies that lease equipment to railroads, budget receipts would be reduced by $2 million in fiscal year 1980, $40 million in 1981, $130 million in 1982, $280 million in 1983, $480 million in 1984, and $720 million in 1985. However, if equipment leasing companies are eligible for tax-exempt financing under the provision of the bill, preliminary estimates indicate that budget receipts would be reduced by approximately $0.1 billion in fiscal year 1981, $0.2 billion in 1982, $0.5 billion in 1983, $0.8 billion in 1984, and $1.3 billion in 1985.

## 6. S. 2548—Senator Stone

### Tax Exemption for Industrial Development Bonds Used to Refinance Certain Docks and Wharves

***Present law***

Under present law, interest on State and local government obligations is generally exempt from Federal income tax. However, since 1968, tax exemption has been denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

An exception to the denial of tax exemption for IDBs applies in the case of such obligations which are used to provide exempt activity facilities, including docks and wharves (Code sec. 103(b)(4)(D)). This exception applies where the proceeds of an IDB are to be used to finance the construction of a new facility or to finance the acquisition of an existing facility from an unrelated person. However, under the IRS regulations, the exception does not apply where the proceeds of an IDB are to be used to refinance an existing facility which was not originally financed with tax-exempt bonds (e.g., it was conventionally financed). Under these IRS regulations, the exception will apply to the financing of an existing facility only where the person who was a substantial user of the facilities before issuance of the obligations and who receives the proceeds of the obligation will not be a substantial user of the facilities following the issuance of the obligations (Treas. Reg. sec. 1.103–8(a)(5)(iv)). In general, a substantial user of a facility includes any nonexempt person who regularly uses a part of such facility in his trade or business where (1) the gross revenue derived by such user with respect to such facility is more than 5 percent of the total revenue derived by all users of such facility or (2) the amount of area of the facility occupied by such user is more than 5 percent of the entire usable area of the facility (Treas. Reg. sec. 1.103–11(b)). For example, an IDB would not be tax exempt in the case where the proceeds of the obligation are used by a governmental entity to purchase docks and wharves which are then, in turn, leased back to the prior owner for a period equal to the useful life of the docks and wharves.

***Issue***

The issue is whether tax-exempt IDBs should be allowed to be used to refinance certain existing conventionally financed docks and wharves located in Tampa, Florida.

*Explanation of the bill*

The bill provides that interest on certain IDBs used to refinance existing conventionally financed docks and wharves in Tampa, Florida, would be exempt from Federal income taxation. In order to qualify under this provision, six requirements must be satisfied. First, part of the proceeds of the obligations must be used to make substantial improvements in the existing wharf facilities acquired with the obligations. Second, it must reasonably be expected that there will be more than one person who is a substantial user of the facilities after the issuance of the obligations. Third, at least one of the substantial users of the existing wharf facility after the issuance of the obligations must not have been a substantial user before the issuance of the obligation. Fourth, all facilities with respect to which financing is provided must be owned by the issuing governmental unit. Fifth, the only interest in such facilities to be held by a substantial user must be a lease executed after issuance of the obligations for a period (including options) of not more than 80 years and under which no lessee has an option to purchase the facilities. Finally, the facilities must be located in a port with respect to which section 101 of Public Law 91-611 authorized the initiation and partial accomplishment of a project as described in House Document No. 91-401.[1]

The principal beneficiary of this bill would be the Agrico Chemical Company.

*Effective date*

The bill would be effective for obligations issued after the date of enactment.

*Revenue effect*

It is estimated that this bill would reduce budget receipts by $1 million in fiscal year 1981, $2 million in 1982, and $3 million in 1983, 1984 and 1985.

[1] This document describes only the Port of Tampa, Fla.

Senator BYRD. Now, 9 o'clock having arrived, the committee will come to order.

The subcommittee today will consider six miscellaneous tax bills and H.R. 5043, the Bankruptcy Tax Act of 1980. Two pamphlets prepared by the Joint Tax Committee describing this legislation in greater detail will be made a part of the hearing record.

In looking at the miscellaneous tax bills before the subcommittee, I find that three of the six bills involve an expansion of the rules governing the issuance of tax-exempt industrial development bonds. While I approach this legislation with an open mind, I should note that I am concerned about the growing trend to expand the scope of tax-exempt financing through industrial development bonds.

The Bankruptcy Tax Act of 1980 deserves close and careful attention. It is important for both businesses and individuals, and clarifies many bankruptcy tax issues which today are confused and uncertain. A major part of the bill, the tax consequences of discharge of indebtedness, is the subject of differing views, and represents a conflict between bankruptcy and tax policy.

The focus of bankruptcy policy is to provide a forgiveness of debts for the bankrupt and assist the bankrupt in a fresh start. Under this view, tax liabilities under normal circumstances should be forgiven. However, a tax policy perspective would focus upon a deferral of tax liability to a time when the debtor has an income on which to repay the deferred tax liability.

I look forward to the comments of the witnesses about a proper balance between the differing tax and bankruptcy policy considerations.

Before proceeding further, Senator Packwood, do you have any comments?

Senator PACKWOOD. No statement, Mr. Chairman.

Senator BYRD. The Chair recognizes the distinguished Senator from New Jersey, Mr. Bradley.

Senator BRADLEY. Thank you very much, Mr. Chairman.

I would like to introduce to the committee today Mr. Robert Schaeberle, the chairman and chief executive officer of Nabisco. Nabisco is a very good corporate citizen, both in my State of New Jersey, where it employs over 3,000 people, and in many other States. Nabisco plays a very important role in our national economy and in the international economy.

It is therefore a pleasure for me to introduce Mr. Schaeberle to the committee. He brings before the committee a problem that we should give full and sensitive hearing to. I personally am very concerned about this problem and feel that there are some real questions here that we should address. It is my pleasure to welcome him to the committee, and to thank you, Mr. Chairman, for holding the hearing.

Senator BYRD. Thank you, Senator Bradley.

Mr. Schaeberle, you are traveling with good credentials when you get such high comment from Senator Bradley. We are pleased to have you, and pleased to have Chairman Mills, whom the committee knows so well, and all of the Congress and the American people know so well.

Gentlemen, welcome.

The first piece of legislation will be S. 2484, Recapture of Foreign Losses. Besides Mr. Schaeberle, who has already been introduced by Senator Bradley, Mr. Edward Schalon of Sealed Power Co., and Mr. Leonard L. Silverstein, Washington, D.C., for Champion International Corp., will be a panel of three, and each witness will have 5 minutes.

Mr. Schaeberle, do you wish to proceed first?

STATEMENT OF ROBERT M. SCHAEBERLE, NABISCO, INC., ACCOMPANIED BY HON. WILBUR D. MILLS, WASHINGTON, D.C.

Mr. SCHAEBERLE. Thank you very much, Senator. Thank you for the introduction, Senator Bradley.

I really appreciate the opportunity to appear before you today in support of S. 2484, which, if amended and enacted, will provide Nabisco equitable treatment in the closing down of an unprofitable foreign operation.

Briefly stated, we seek an extension of what we consider to be an inadequate transition period with in which to close down our German business in an orderly manner. I will merely summarize the prepared minutes that I have already submitted to you, and I would like those included in the record today.

Senator BYRD. They will be included in the record.

Mr. SCHAEBERLE. Thank you.

We ask that the April 15, 1977, date in S. 2484 be changed to December 31, 1977, so that Nabisco will be able to receive the equitable relief from foreign loss recapture that we believe Congress intended in the 1976 Tax Reform Act. Allow me to briefly outline our situation.

Nabisco acquired a biscuit business in West Germany in 1964, and operated it as a foreign subsidiary through its lifetime. Although it was our desire to see this company reach a profitable posture in a reasonable timespan, unfortunately, in July of 1977, we had to close down the operation, and as a result, sustained a worthless stock loss.

We want to emphasize that since this was operated as a foreign subsidiary, those German losses were not taken for U.S. tax purposes during its operations. This loss exceeded the foreign source income that Nabisco earned in 1977, and was classified as an overall foreign loss, in accordance with the then newly enacted section 904(f)(2) of the Code.

This section provides that an overall foreign loss must be recaptured in future years by the mechanism of converting foreign source income into U.S. source income. This reduces the usage of available foreign tax credits. However, sections 1032(c) (3) and (4) of the Tax Reform Act of 1976 provided some relief for the onerous provisions of section 904(f) if a taxpayer met the requirements set forth therein.

Basically, section 1032(c)(3) provided full relief from the foreign tax recapture where a taxpayer, one, owned at least 10 percent of voting stock of the corporation; second, the latter had sustained losses in 3 out of the last 5 tax years beginning before January 1, 1976; and also had sustained an overall loss in the prior 5-year period.

However, the relief did not apply unless the taxpayer terminated its investment before January 1, 1977.

Nabisco met these tests except for the investment termination requirement.

In 1976, Congress recognized the difficulties of closing down a large foreign operation, and provided a limited transition period. The Tax Act of 1976, which created this recapture concept, was enacted into law on October 4, 1976, and it was virtually impossible to close down and dispose of a multimillion-dollar operation between only October 4 and December 31 of that year.

This transition period was inadequate and could not be used by Nabisco.

Section 1032(c)(4) of the Tax Reform Act provided for a more liberal transition period, and Nabisco was able to secure some relief under this provision. However, even under this section, Nabisco finds itself in a position where approximately $19 million of foreign source income is subject to recapture, despite the fact that the funds involved to support this portion of our loss were invested in Germany prior to December 31, 1975.

We estimate the net revenue loss to the Treasury in this case would approximate $2 million.

Senator BYRD. Excuse me. You are talking about your particular case——

Mr. SCHAEBERLE. Yes, sir.

Senator BYRD [continuing]. Or the bill itself?

Mr. SCHAEBERLE. Yes, Senator, our case.

Senator BYRD. Not the bill itself, but in your particular case?

Mr. SCHAEBERLE. No, sir.

A substantial portion of Nabisco's investment in West Germany was in bricks and mortar. On a going concern basis, these assets were properly reflected at book value. However, on a forced sale because of liquidation we realized substantial losses on the disposition of these assets. None of these losses could have been reflected in the deficit in earnings and profits as at the end of 1975, because the sale took place at a later date. Similar substantial losses would have been realized as at the end of 1975 if the forced sale had taken place prior to that date.

S. 2484, with a December 31, 1977, date, would provide exemption from the foreign loss recapture rules if substantially all of the employees of a foreign subsidiary were discharged before that date.

As a result, the transition rules set forth in S. 2484, with our amendment, is more equitable than the present law.

In summary, by providing for transitional periods in 1976, Congress recognized that a major change in the tax law could create problems for taxpayers. We are asking that this earlier congressional recognition be implemented by a more realistic transition period that would be provided by S. 2484 with our proposed amendment.

Thank you for the opportunity to be before you this morning, and we would be pleased to answer any questions.

Senator BYRD. Thank you, Mr. Schaeberle.

Mr. Schalon?

STATEMENT OF EDWARD I. SCHALON, SEALED POWER CO.

Mr. SCHALON. Mr. Chairman, I am Edward I. Schalon, the chief executive officer of Sealed Power Co. Sealed Power is a publicly owned company headquartered in Muskegon, Mich., which manufactures and sells piston rings and other parts for automotive and industrial engines.

We appreciate the subcommittee holding these hearings, and we are grateful for the opportunity to testify in support of S. 2484. May I ask leave to file a copy of our testimony for the record, and briefly summarize our position for the subcommittee this morning?

The purpose of S. 2484 is to correct an inequity in the foreign loss recapture provisions enacted as part of the Tax Reform Act of 1976, which became law October 4, 1976. Prior to enactment of section 1022 of that act, losses incurred from the failure of foreign subsidiaries did not adversely affect computation of foreign tax credits in future years. However, section 1032(c) provided that where a taxpayer claims a foreign loss and thus reduces its U.S. source income, the amount of the reduction must be recaptured in future years to the extent the taxpayer has foreign source income.

This is done by reducing foreign tax credits on foreign source income in those future years. In early versions of the legislation, this new provision was made effective as of December 31, 1975. The Senate Finance Committee recognized the unfairness of applying this new provision to transitional situations where losses had been economically incurred by companies prior to the effective date of the act, but the loss could not be recognized for tax purposes.

This statutory recognition took the form of transitional provisions or exceptions which extended the effective date of the new law in certain limited circumstances.

Specifically, the loss recapture provisions do not apply to losses incurred with respect to the stock or indebtedness of foreign subsidiaries which were substantially worthless before enactment of the provisions on October 4, 1976, provided that the taxpayer has terminated or will terminate all operations of the subsidiary before January 1, 1977.

In the case of Sealed Power, the 88-day time period between encactment of the statute and the January 1, 1977, cutoff date was unrealistic in light of the complex situation involving Belgian laws which applied to the termination of operations of corporations.

It would have been virtually impossible for Sealed Power or other taxyapers similarly situated who owned worthless foreign subsidiaries on October 4, 1976, to dispose of those subsidiaries or their assets prior to January 1, 1977. The cutoff date in the 1976 act benefits taxpayers who happen to be in a position to make a quick sale of substantially worthless foreign subsidiaries, but denies relief to other taxpayers with identical equities.

S. 2484 would eliminate unfairness by adding additional conditions under which relief from the loss recapture provisions would be granted. Under S. 2484, the discharge of substantially all employees of the subsidiary satisfies the act's requirement that the operations of the foreign subsidiary be terminated for purposes of the bill. The cutoff date for termination of operations of January 1, 1977, is extended to April 15, 1977, and the time within which such

losses may be realized is extended to January 1, 1979, to allow for an orderly disposition of assets.

Mr. Chairman, not the least of the adverse effects of section 1032 of the 1976 act is that it constitutes a deterrent to the repatriation of foreign earnings. Sealed Power currently is facing a dilemma with respect to foreign earnings which would be relieved by passage of this bill.

We urge you to favorably consider and act upon this legislation.

Thank you for your consideration, and we will be happy to respond to any questions the committee may have.

Senator BYRD. Thank you.

Mr. Silverstein?

STATEMENT OF LEONARD L. SILVERSTEIN, WASHINGTON, D.C., FOR CHAMPION INTERNATIONAL CORP., ACCOMPANIED BY THOMAS F. VOLPE, DIRECTOR, TAX AFFAIRS

Mr. SILVERSTEIN. Good morning, Mr. Chairman, Senator Packwood, my name is Leonard L. Silverstein. I am a member of the law firm here of Silverstein and Mullins, and appear here today on behalf of Champion International Corp.

Champion is a company engaged primarily in the manufacture and sale of wood base building materials, paper, paper packaging, and related products in the United States and elsewhere in the world. Its headquarters are in Stamford, Conn., and it employs worldwide more than 40,000 persons. We welcome this opportunity to comment on S. 2484 as it relates to Champion.

First, some general observations about the statute; I might add that we have just had opportunity, within minutes, to observe what I regard as a rather contentious Treasury statement about the policy of the statute. We believe it to be complex, and in its present form, we believe that it fails to satisfy the tax policy objectives at which it is aimed or properly should be aimed.

Since its enactment in 1976, this, section 904(f) has in fact proven to be a deterrent, and in the case of Champion, certainly so, to prudent management of its worldwide business operations. In the case of Champion and other companies which may be similarly situated, section 904(f) in fact operates not to cause double dipping, as is stated in the Treasury statement, but in fact to cause economic double taxation of foreign earnings.

On a previous occasion in 1977, Champion expressed its concern to the Congress in connection with this section in circumstances somewhat but not entirely similar to those stated by the other companies that appear here today. In addition, Champion is today faced with another situation in which the operation of section 904(f) causes in economic effect double taxation of foreign earnings.

This situation relates to a loss which Champion anticipates will occur on the termination of its interest in United Kingdom carpet manufacturing business. This business was acquired on January 3, 1974, as a wholly owned affiliate of Champion. That affiliate purchased all of the shares of a corporation then actively and profitably engaged in manufacturing synthetic carpeting in the United Kingdom. This acquisition was made as part of a then planned product diversification. As part of the acquisition transaction,

funds were advanced or made available to the wholly owned affiliate in the form of capital contributions, loans, and guarantees.

At the time of the commitment, there wasn't any realistic anticipation that future foreign tax credits would be forfeited if, contrary to management expectations, the United Kingdom business didn't prove successful, and Champion was required to dispose of its investment at a loss. As a result of section 904(f)'s enactment, precisely that harsh result will occur if and when Champion repatriates its foreign earnings from other, totally unrelated operations for normal business reasons.

While section 904 permits Champion to reduce U.S. income tax currently by the amount of the loss when it is realized in the United States, it then requires that the tax benefits be recaptured through the tax credit forfeiture provisions.

When Congress adopted 904(f), it recognized that undue hardship could occur for numerous types of business investments which were then in progress in reliance on existing law; as a result, the various series of transitional rules to which reference has been made today were adopted. Even these in 1977 were later changed because of difficulties of their application.

We believe that section 904(f) should be further amended because of the anomalies of its application with respect to investments, such as those made by Champion, in reliance on the then existing law.

Senator Byrd, I would suggest that you, who are so interested in the carryover basis provisions—there is a great similarity here, because even in their original form, full credit was given for what was called a fresh start, or the commitments that were then made at the date of the cutoff. That does not occur in the case of Champion. It had its investment in place. It was not possible to dispose of it immediately, as is suggested in the Treasury statements. You can't simply dispose of large businesses that way.

What we suggest, therefore, is that a more proper effect would be a 10-year transitional rule from the date of the original statute, from 1976 until 1986, to permit taxpayers who had investments in place, commitments in place at the cutoff date, to give them a chance, then, to account for the new and abrupt change in present law. That is our proposal.

Now, we tell you that in the statute, contrary to the double-dipping reference that is referred to in the Treasury statement, there are situations, if double dipping exists, that are permitted in the statute, and that occurs in cases such as shipwreck, theft, or other allegedly external losses. When Champion made its investment in the United Kingdom, it could not have possibly taken into account the unplanned losses that occurred. This arose as a result, in fact, of the oil embargo which made the company unexpectedly uncompetitive.

We suggest that that is very similar to the unplanned type of loss which occurs in the case of shipwreck, theft, or other events exonerated by statute. For that reason, we urge that companies who had made foreign investments before 1976 should be permitted to terminate these investments by the end of 1985 without forfeiture of a foreign tax credit.

Now, we request permission to submit the full statement for the record.

Senator BYRD. The full statement will be published in the record.

Mr. SILVERSTEIN. With the draft amendment. Thank you.

Senator BYRD. To put it in perspective, it has been mentioned several times that the transition period is inadequate. What is the transition period under the present law?

Mr. SILVERSTEIN. Well, there are a number of transition periods, but I guess the basic one is, if a company whose investment was totally economically worthless by the end of 1975 could dispose of the business within 1 year, you would be out from under this statute.

That, of course, fails to take into account the fact that businesses, as the other panelists today have indicated, simply can't be disposed of at the drop of a hat.

Senator BYRD. Well, Mr. Schaeberle mentioned, I believe twice, that the transition period is inadequate.

Mr. SCHAEBERLE. Yes, sir.

Senator BYRD. Now, that is the 1-year transition period you are speaking of?

Mr. SCHAEBERLE. Well, the legislation was signed by the President in October of 1976, and that required that we be out of business by the end of 1976, some 3 or 4 months; it was completely impractical for us to take a very large overseas subsidiary and close it down that quickly.

We are asking that the date be extended until the end of 1977.

Senator BYRD. You are asking for an additional year?

Mr. SCHAEBERLE. Yes, sir.

Senator BYRD. Mr. Silverstein is asking for 10 years.

Mr. SILVERSTEIN. Well, that is one way of looking at it. The other way is to say that the present statute is retroactive in effect, because it applies to companies that were fully committed and had no way of realizing losses immediately. Our suggestion is that if there is going to be cutoff, it ought to exonerate, as it does in the case of shipwreck or theft or other external losses, those persons whose investments were in place at the time of the cutoff and could not have been removed.

Senator BYRD. Well, now, if the transition rules are changed, doesn't that open up the possibility for continually changing the transition rules? Does anyone want to comment on that?

Mr. SILVERSTEIN. No suggestion has been made, Senators, with respect to any investments newly made after the public was on notice that there would be recapture of foreign tax credit. We are only talking about investments made in reliance upon law than in place.

Senator BYRD. In regard to Nabisco and Sealed Power, is it correct that the statute already provides substantial relief for losses sustained economically prior to 1976 but recognized after 1975, and haven't these two companies already obtained relief pursuant to these provisions?

Mr. SCHALON. Mr. Chairman, in our case, that is not true, because the books do not reflect the losses which were incurred in sale of the building and some of the other assets subsequent to 1976.

Mr. SCHAEBERLE. Senator, in our case, there was a partial recovery by that legislation. However, we still feel from an equitable point that we should be allowed to recover all of the loss that we sustained, because it was absolutely impossible for myself to go to our board of directors in a 3-month period and suggest that we close out an installation that we had an $85 million investment in a 3-month period.

So, we are asking that—and we did it as quickly as we could during the following year, and that is why we are asking for the extension to the end of 1977, to let us recoup an equitable recovery in total.

Senator BYRD. You have testified that the legislation would mean $2 million?

Mr. SCHAEBERLE. Approximately $2 million is the best estimate that we can make today, sir.

Senator BYRD. How much relief has been optioned prior to this time?

Mr. SCHAEBERLE. It was about $55 million, sir, the cumulative losses and the deficit that—versus the $19 million that has not been recovered so far. I mentioned the $19 million that has not been recovered, which would translate into a bottom line estimated revenue loss for the Treasury of $2 million.

Senator BYRD. What is the bottom line on the $55 million figure?

Mr. SCHAEBERLE. About $27 million, sir.

Senator BYRD. Now, what would the effect of this legislation be dollarwise on Sealed Power?

Mr. SCHALON. Approximately $4 million, Mr. Chairman.

Senator BYRD. And how about on Champion?

Mr. SILVERSTEIN. Well, our loss hasn't been taken yet with respect to the investment made at the cutoff date. We don't know. The initial investment approximates $100 million. How much will actually be subject to recapture depends upon the amount of repatriated earnings that are made in the next ongoing years. Approximately $2 million per year for a period could be subject to recapture, if I have stated that right. Thomas F. Volpe, the director of tax affairs of Champion is here and can amplify on that.

Mr. VOLPE. The recapture penalty, or the loss of revenue that we are referring to would approximate about $2 million over an extended period of time.

Senator BYRD. $2 million per year?

Mr. VOLPE. Per year.

Senator BYRD. Senator Packwood?

Senator PACKWOOD. No questions, Mr. Chairman.

Mr. SCHALON. Mr. Chairman?

Senator BYRD. Yes?

Mr. SCHALON. As an example of the inequity which we feel that the present law holds for us, only about $3 million of the total $13 million which we incurred in losses represents a number which is protected under the present statutory language.

Senator BYRD. Thank you, gentlemen.

Mr. MILLS. Mr. Chairman?

Senator BYRD. Mr. Mills?

Mr. MILLS. May I ask unanimous consent on the part of the panelists to have permission to add additional information in the

light of the Treasury report? There are some comments we would like to file with the committee in response to that.

Senator BYRD. Yes, that would be satisfactory.

[The material referred to follows:]

Supplemental Statement Submitted
on Behalf of Nabisco, Inc.
Relating to S.2484

Following the written and oral testimony presented by representatives of the Treasury Department to the Subcommittee in connection with the public hearing on S.2484, we believe it necessary to respond and correct misimpressions or misconceptions created by that testimony.

Purpose of Recapture Rules

Initially, we would take issue with the characterization of an exemption from the "recapture rule" of Section 904 (f) I.R.C., as "double dipping." The foreign tax credit became law because of the concern that domestic corporations with foreign operations would be doubly taxed. A review of the history of the recapture provision will show that it was originally proposed for a very, very limited purpose. That purpose was to prevent the taxpayer from deducting "start-up" losses incident to the commencement of a foreign business, and then taking a credit for foreign taxes paid on income received in subsequent years from that foreign business. This limited purpose of the recapture rule was then expanded to cover cases in which losses from ongoing foreign operations reduced U.S. tax on U.S. source income, and in later years foreign income was derived *from* other foreign operations. However, to apply this very limited purpose rule to a situation where there has been a termination of a foreign business, completely distorts the original intent of the provision.

According to the testimony submitted by the representatives of the Treasury to this Subcommittee, they "reject" any argument that the recapture rule was technical in nature and that a liberal exemption policy for the termination of foreign operations was necessary to carry out the intent of Congress. Nevertheless, we stand by the legislative history of this provision and the statement by the Honorable William E. Simon, Secretary of the Treasury, submitted to the Senate Finance Committee on March 17, 1976, in which he said:

> "We view this [i.e., the recapture rule] as a technical change to eliminate an unintended benefit. Under present law, a U.S. taxpayer can use foreign startup losses to reduce U.S. tax and then pay no U.S. tax on subsequent foreign gains because of the foreign tax credit. In such cases, it is only fair for the U.S. to recapture the tax lost by the startup period."

It should also be pointed out that prior to the liquidation in 1977, Nabisco never claimed any losses from this operation because it was always operated as a foreign subsidiary.

Extension of Transition Rules Not Unusual

Termination losses are not comparable to startup losses and they should not be subject to the recapture rule. However, we are not asking for such a change in the law. Present law provides an exemption from the recapture rule for a corporation whose subsidiary has sustained losses in three out of the last five taxable years beginning prior to 1976, and also had sustained an overall loss for the five-year period, provided the corporation terminated its investment before January 1, 1977. We are asking that the date by which a corporation must terminate its investment be extended from January 1, 1977 to December 31, 1977.

To extend this type of equitable relief is not unusual for the Finance Committee. In fact, just such relief was granted last year and characterized as merely a technical change.*

Original Three Month Transition Period

Senator Byrd specifically asked the Treasury Department the length of time Nabisco had in the form of a transition period. Treasury responded "It had from October of 1976 to December 31, 1978." This was not accurate. In order for Nabisco to have been completely exempt from the recapture rule it would have had to terminate its investment in the foreign subsidiary by the end of 1976. This gave Nabisco less than three months to completely liquidate an $85 million foreign investment, which included substantial plant and equipment. It was physically impossible to terminate a foreign investment of that size in that period of time.

Alternative Limited Transition Period

The 1976 Act also included a second, limited exception for taxpayers who satisfied the other requirements of sustained losses over a five-year period but failed to qualify because the operations of the foreign subsidiary were not terminated in 1976. If the operation was terminated before 1979, the loss would not be subject to recapture, but only to the extent of the deficit in the subsidiary's "earnings and profits" as of December 31, 1975. Nabisco's German subsidiary had such losses reflected in its earnings and

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* The Revenue Act of 1978 provided a transitional period to the end of 1978, which permitted participants in a qualified retirement plan to roll-over their investment tax-free into an I.R.A. Because the bill did not become law until late in the year, the transition period was less than 60 days. The Congress realized this was not enough time and in the Technical Corrections Act of 1979 extended the transitional period for another year.

profits as of December 31, 1975 and these amounts have not been subjected to recapture. However, the losses reflected on the earnings and profits statements did not begin to accurately reflect the total liquidation of a subsidiary. This was because the losses, as reflected on the earnings and profits statement, were operational losses. They did not and could not accurately reflect the substantial losses that would only be incurred when the plant, equipment and machinery were sold at forced liquidation values. In response to Senator Byrd's questions concerning the extent to which Nabisco had been able to avail itself of this second existing transitional rule, corporation records reflect that there has been a savings of $26.6 million in taxes. However, corporate records also reflect that an additional $19 million of foreign source income remained subject to the recapture rules.

Revenue Loss

It appeared in 1977 that if the transition rule was extended, exemption from the recapture of $19 million of foreign source income would result in a revenue loss to the Treasury of approximately $8 million. However, by proper planning, Nabisco believes this revenue loss will be cut to only $2 million. In order to accomplish this result, Nabisco has had to adopt policies which alter its financial planning and have an adverse impact on the U.S. balance of payments. Nabisco has deferred the repatriation of earnings in the form of dividends from its subsidiaries located in high tax rate countries. This policy is designed to avoid the generation of excess foreign tax credits at a time when foreign source income is subject to recapture.

In addition, Nabisco is now directing its foreign subsidiaries to forego borrowing from local banks and to borrow instead from the parent corporation. This enables Nabisco to derive additional foreign source income, but also leads to an outflow of funds from the U. S.

The effect of these policies is to increase Nabisco's foreign exchange exposure and has required us to enter into additional costly forward exchange contracts to hedge the increased exposure.

Relief Requested

Mr. Chairman and members of the Subcommittee, the issue can be reduced to these simple terms. In 1976, the rules governing this area were changed and made far more restrictive. As enacted into law it was more restrictive than even the Treasury had originally proposed. Several corporations attempting to compete overseas were trapped by the expanded coverage of the recapture rules and were given a transition period of less than ninety days to liquidate a foreign holding in order to avoid the new rules. Alternatively, at the urging of the companies which realized that foreign subsidiaries could not be liquidated that quickly, a limited exemption was enacted, but this, too, proved inadequate.

In 1976, Congress realized that an equitable transition rule was required to protect certain cases. This transition rule has proven to be inadequate, but that does not change the equities that Congress recognized and tried to protect. The solution is quite simple. We are asking only that the remedies originally proposed in 1976 be made adequate to protect those equities as Congress intended.

SUPPLEMENTARY STATEMENT ON S.2484
BY EDWARD I. SCHALON
IN BEHALF OF SEALED POWER CORPORATION
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE FINANCE COMMITTEE
May 30, 1980

(Submitted on June 18, 1980 by leave of the Subcommittee)

International Tax Counsel, Department of the Treasury, has presented testimony in opposition to S.2484. Invoking the pejorative term "double-dipping", they argue that a change in the current law is not sound policy, that the existing law was carefully drafted and is reasonable, and that, in any case, S.2484 is "special legislation." Their response mischaracterizes the thrust of S.2484, and incorrectly states the effect of the change in the law.

The Treasury position with respect to "double-dipping" is inappropriate. This is illustrated as follows:

A U.S. taxpayer who received foreign income (and has no foreign losses) generally must include the foreign income in his gross income for U.S. tax purposes and is entitled to a credit against U.S. taxes for foreign income taxes paid to the extent of the lesser of the effective foreign tax rate or the U.S. tax rate. Under those circumstances the United

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States receives tax revenues equal to 46% of the taxpayer's domestic income. The taxpayer's U.S. and foreign income taxes are equal to at least 46% of his aggregate worldwide income.

Section 904(f) applies to a U.S. taxpayer who receives foreign income and also incurs a foreign loss. The Treasury Department states that Section 904(f) is designed to prevent a taxpayer from "double dipping", which it defines as "claiming the benefit of (a foreign loss) as a reduction of U.S. source income in one year and claiming a second benefit--the foreign tax credit--to shelter foreign income from U.S. taxation in a subsequent year."

The implication is that by claiming the foreign tax credit after taking a foreign loss, the U.S. taxpayer is taking a second free ride or "double dip" which gives him an advantage over other taxpayers. As a practical matter, this simply is not the case.

Under the law prior to the enactment of Section 904(f), the effect of the taxpayer's ability to reduce his worldwide income by the amount of foreign income taxes paid was to maintain the taxpayer's aggregate U.S. and foreign income taxes at approximately 46% of his aggregate U.S. and foreign

income. The taxpayer's total U.S. and foreign income taxes expressed as a percentage of his total income could never be less than the 46% rate paid by a U.S. taxpayer with solely domestic operations.

For example, if over a period of years the taxpayer received $200 of U.S. income and $200 of foreign income (on which he paid foreign income taxes at 46% of $200, or $92), and incurred a foreign loss of $100, his aggregate U.S. and foreign income would have been $200 plus $200 less $100, or $300. The taxpayer could have claimed the foreign loss as a deduction against his U.S. income, thereby reducing his U.S. income taxes from $92 to $46. His total U.S. and foreign income taxes of $138 would have been equal to 46% of his total income of $300. The Treasury would have received less revenue, however, then had all the income been earned in the U.S.

With the enactment of Section 904(f), the taxpayer in the above example can no longer apply the foreign loss to reduce his U.S. taxes. He therefore incurs an additional $46 of U.S. tax on his total income of $300. The sum of his U.S. taxes of $92 plus his foreign income taxes of of $92 is equal to 61.3% of his aggregate foreign and U.S. income. A U.S. taxpayer ordinarily cannot use foreign losses incurred in one country to offset foreign income in another country,

so that Section 904(f) prevents the taxpayer from utilizing foreign losses to reduce his U.S. income taxes. As a result, the taxpayer is subjected to double taxation since he must pay both U.S. income taxes and foreign losses taxes on a portion of his foreign income.

Contrary to the Treasury Department's implication, Section 904(f) did not eliminate an advantage enjoyed by U.S. taxpayers with foreign operations relative to other taxpayers with solely domestic operations. On the contrary, Section 904(f) imposed a disadvantage for taxpayers with foreign operations relative to other taxpayers with solely domestic operations, since a taxpayer with foreign operations now may be subjected to U.S. and foreign income taxes on his total worldwide income, and in excess of the 46% U.S. tax rate.

Without debating the merits and rationale underlying Section 904(f), the point is that since Section 904(f) is a section which results in the imposition of additional U.S. and foreign taxes (rather than eliminating a "double dipping of benefits,") to permit the section to apply retroactively is unfair and inconsistent with Congressional intent.

The Treasury asserts that the transitional period was adequate, and that taxpayers participated in its consideration by the Congress. This assertion is incorrect on both counts. Sealed Power did not appear before the subcommittee in 1976, since it was unaware of the proceedings. An elaboration of our position with respect to the transitional period is in order here.

The Tax Reform Act of 1976 as passed by the House in December, 1975, contained no transition rules for the effective dates for Section 904(f). Under the House bill, Section 904(f) would have applied to losses incurred upon the disposition or worthlessness of stock of a foreign subsidiary after December 31, 1975.

A taxpayer who owned a "substantially worthless" foreign subsidiary on January 1, 1976 could have reasonably anticipated, on the basis of the House version of the Tax Reform Act, that either no change would be made in the effective date for Section 904(f) or that the Section would be extended on a uniform basis to permit all taxpayers with built-in losses in substantially worthless foreign subsidiaries a reasonable time either to dispose of the stock of the subsidiary or establish that the stock had become worthless within the meaning of Section 165(f).

Section 1032(c)(3) was added to the Senate version of the Tax Reform Act in the late Summer of 1976, apparently at the suggestion of one taxpayer. A taxpayer certainly had a right to be surprised that Section 1032(c)(3) provided relief for the taxpayer who actually disposed of stock of a foreign subsidiary during 1976 while denying relief to a taxpayer who owned stock of a foreign subsidiary which had become worthless during 1976.

A taxpayer who read Section 1032(c)(3) on the earliest possible moment that it was released to the general public in proposed form would have had a maximum of three or four months prior to January 1, 1977 in order to comply with the conditions of the section by making a disposition of the stock or assets of a foreign subsidiary. For most taxpayers, it would have been practically impossible in the Autumn of 1976 to arrange for a disposition of the stock or assets of a troubled foreign subsidiary by January 1, 1977, as our testimony makes clear. For those taxpayers, there was indeed an "element of surprise" in Section 1032(c)(3), and an inequity created that warrants correction now.

The Treasury makes a curious argument that since taxpayers have received some "benefit" from one transitional rule, there is no need to give additional "benefits"

by addressing possible inequities in transitional rules addressed to other situations. The Treasury compounds this faulty reasoning by arguing that the "privilege" of the extended transitional period under the other transitional rule (Section 1032(c)(4)) somehow cures the inadequate period of 88 days (three months) under the transitional rule (Section 1032(c)(3)) which results in the inequity to Sealed Power. The answer to Senator Byrd's question to the Treasury about the adequacy of the transition time addressed in S.2484 should have indicated that only approximately three months elapsed following enactment of the bill to the cutoff date in the bill; and only approximately six months elapsed following consideration of the transitional rules to the cutoff date in Section 1032(c)(3). This is a far cry from the two years stated by the Treasury in reply to the question.

As indicated in Senate Report No. 94-938--Part 2 at page 64, Section 1032(c)(4) is intended to apply to the case in which "a corporation may want to continue an investment beyond 1976 in an attempt to try to make investment profitable. . ." If the investment in a foreign subsidiary is terminated before January 1, 1979, a taxpayer obtains relief from Section 904(f), but only for that portion of his loss which represents pre-1976 operating losses of the subsidiary. He does not obtain any relief for that portion of his loss representing a decline in value in the subsidiary's business

and assets. The extent to which Section 1032(c)(4) provides relief will vary from taxpayer to taxpayer, depending on the nature of the taxpayer's loss. In Sealed Power's case, the larger part of its $13,000,000 loss on its investment was attributable to a decline in the value of the subsidiary's business and assets rather than to pre-1976 operating losses. Consequently, Sealed Power obtained little relief from Section 1032(c)(4).

As our testimony states at pages 5 through 7, Section 1032(c)(3) did not even address the Section 165(g) type of disposition of a failed foreign subsidiary that Sealed Power was forced to implement. We are asking that the equity intended to be done by the enactment of Section 1032(c)(3) be made to apply fairly to all taxpayers.

Finally, the Treasury dismisses S.2484 as "special interest" legislation. Whatever effect they may intend from such a gloss, it is inappropriate here.

As indicated in the first section of this response, the effect of Section 904(f) is not to remove a "benefit" that certain taxpayers enjoyed relative to other U.S. taxpayers, but rather to impose on these taxpayers both U.S. income taxes and foreign income taxes to the extent they receive foreign income matching foreign losses.

Section 1032(c)(3) extended the effective date of Section 904(f) for those taxpayers able to comply with its terms. Sealed Power believes that the time period for complying with the terms of Section 1032(c)(3) was so unrealistically short that the section in practical effect would have to be classified by the Treasury as "special interest legislation" for the benefit of a few taxpayers. S.2484 would extend the effective date of Section 904(f) for substantially all remaining taxpayers who were in the process of closing down "substantially worthless" foreign subsidiaries. S.2484 broadens Section 1032(c)(3) from its present protection of a few taxpayers into general legislation for the benefit of substantially all taxpayers similarly situated.

Senator BYRD. Thank you, gentlemen.

[The prepared statement of the preceding panel follow:]

STATEMENT
ON BEHALF OF
NABISCO, INC.
BY
ROBERT M. SCHAEBERLE

Before the
Senate Committee on Finance
Subcommittee on Taxation and Debt Management

on
S. 2484

May 30, 1980

Good morning!

I am Robert M. Schaeberle, Chairman and Chief Executive Officer of Nabisco, Inc. Nabisco is a publicly held New Jersey corporation principally engaged in the manufacturing, processing and sale of a variety of consumer products. We have a business presence in all 50 of the United States and over 100 foreign markets.

I appreciate this opportunity to appear before you today in support of S.2484 which if amended and enacted will provide Nabisco, Inc. equitable treatment in the closing down of an unprofitable foreign operation. Briefly stated, we seek an extension of what we considered to be an inadequate transition period within which to close down our German business in an orderly manner. (1)

We ask that the April 15, 1977 date in S.2484 be changed to December 31, 1977 so that Nabisco will be able to receive the equitable relief from "foreign loss recapture" that we believe Congress intended in the 1976 Tax Reform Act. This is consistent

with the December 31, 1977 date found in H.R.6117 now pending before the Committee on Ways and Means, Subcommittee on Select Revenue Measures.(2)

Perhaps a brief glimpse at our circumstances will provide you with the necessary background to better understand our need for legislative action.

Nabisco had a biscuit subsidiary in West Germany that was operating in a loss position. Certainly our desire and efforts were to see this company reach a profitable position within a reasonable time span. These losses in Germany were not taken for U.S. tax purposes during the period of operations, since it operated as a foreign subsidiary from the date of our acquisition in 1964. While reluctant to close an operation in Europe due to employee, customer and business responsibilities, it became evident that a profitable return to our shareholders was too remote and too costly for the continued efforts of our management team. In reality, a decision had to be made to "fish or cut bait".

In July 1977, Nabisco, Inc. closed down its biscuit operations in West Germany, and as a result sustained a worthless stock loss within the meaning of section 165(g)(3) of the Internal Revenue Code of 1954. This loss exceeded the foreign source income that Nabisco earned in 1977, and thereby was classified as an "overall foreign loss" in accordance with the then newly enacted section 904(f)(2) of the Code. Section 904(f) provides that an "overall foreign loss" must be recaptured in future years by the mechanism of converting foreign source income into

U.S. source income. This reduces the usage of available foreign tax credits.

However, sections 1032(c)(3) and (4) of the Tax Reform Act of 1976 provided some relief from the onerous provisions of section 904(f) if a taxpayer met the requirements set forth therein. Basically, section 1032(c)(3) provided full relief from foreign loss recapture where a taxpayer owned at least 10% of the voting stock of a corporation, the latter had sustained losses in three out of the last five taxable years beginning before January 1, 1976, and also had sustained an overall loss for the aforesaid five year period. However, the relief did not apply unless the taxpayer terminated its investment before January 1, 1977.

Nabisco met these tests except for the investment termination requirement. In 1976 Congress recognized the difficulties of closing down a large foreign operation and provided a limited transition period. The Tax Reform Act of 1976, which created this recapture concept, was enacted into law on October 4, 1976, and it was virtually impossible to close down and dispose of a multi million dollar operation between October 4 and December 31, 1976. This transition period could not be used by Nabisco. In fact, it took Nabisco approximately 19 months after the decision was made to completely dispose of its West German biscuit business.

Section 1032(c)(4) of the Tax Reform Act provided for a more liberal transition period, and Nabisco was able to secure some relief under this provision. This paragraph sets forth the

same requirements as in section 1032(c)(3) except that the loss can be sustained in a taxable year beginning before January 1, 1979, and relief from foreign loss recapture is provided to the extent of the foreign corporation's deficit in "earnings and profits" as of December 31, 1975. However, even under section 1032(c)(4), Nabisco finds itself today in a position where approximately $19 million of foreign source income is subject to recapture despite the fact that the funds involved to support this portion of our loss were invested in Germany prior to December 31, 1975. We estimate the net revenue loss to the Treasury in this case would approximate $2 million.

"Earnings and profits" is a federal tax concept which reflects net income or loss computed in accordance with a taxpayer's method of accounting and adjusted to reflect tax accounting rules. A substantial portion of Nabisco's investment in West Germany was in "bricks and mortar". On a going concern basis these assets were properly reflected at book value. However, on a forced sale because of liquidation, we realized substantial losses on the disposition of these assets. None of these losses could have been reflected in the deficit in "earnings and profits" as of December 31, 1975 because the sales took place at a later date. Similar substantial losses would have been realized as of December 31, 1975 if the forced sales had taken place prior to that date.

S.2484, with a December 31, 1977 date, would provide exemption from the foreign loss recapture rules if substantially

all of the employees of the foreign subsidiary were discharged before December 31, 1977. If S.2484 is adopted with our proposed amendment, Nabisco will not be subject to foreign source loss recapture with respect to the loss from its West German biscuit subsidiary since substantially all of its employees were discharged before December 31, 1977.

The transition rule set forth in S.2484, with our amendment, is more equitable than the present law as contained in section 1032(c)(3) of the Tax Reform Act of 1976. It would allow a United States parent corporation approximately 15 months from the date of enactment of the new "recapture" rules to have its foreign subsidiary dismiss its work force. In this connection, the months of intensive negotiations involved in closing down a business under West German labor law should not be overlooked.

In summary, by providing for transitional periods in 1976, Congress recognized that a major change in the tax law could create problems for taxpayers. We are asking that this earlier Congressional recognition be implemented by the more realistic transition period that would be provided by S.2484 with our proposed amendment.

I thank you for the opportunity to be here today and will be pleased to try to answer any questions you may have with respect to my testimony.

STATEMENT OF S.2484
BY EDWARD I. SCHALON
ON BEHALF OF SEALED POWER CORPORATION
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE FINANCE COMMITTEE

May 30, 1980

I am Edward I. Schalon, the Chief Executive Officer of Sealed Power Corporation. Sealed Power is a publicly-owned company headquartered in Muskegon, Michigan, which manufactures and sells piston rings and other parts for automotive and industrial engines. We appreciate the Subcommittee holding this hearing and we are grateful for the opportunity to testify in support of S.2484. May I ask leave to file a copy of our testimony for the record, and briefly summarize our position for the Subcommittee this morning.

The purpose of S.2484 is to correct an inequity in the foreign loss recapture provisions enacted as part of the Tax Reform Act of 1976 which became law October 4, 1976. Prior to enactment of § 1032 of that Act, losses incurred from the failure of foreign subsidiaries did not adversely affect computation of foreign tax credits in future years.

However, Section 1032(c) provided that where a taxpayer claims a foreign loss and thus reduces its U.S. source income, the amount of the reduction must be recaptured in future years to the extent the taxpayer has foreign source income. This is done by reducing foreign tax credits on foreign source income in those future years.

In early versions of the legislation, this new provision was made effective as of December 31, 1975. The Senate Finance Committee recognized the unfairness of

applying this new provision to transitional situations where losses had been economically incurred by companies prior to the effective date of the Act, but the loss could not be recognized for tax purposes. This statutory recognition took the form of transitional provisions or exceptions which extended the effective date of the new law in certain limited circumstances.

Specifically, the loss recapture provisions do not apply to losses incurred with respect to the stock or indebtedness of foreign subsidiaries which were "substantially worthless" before enactment of the provisions on October 4, 1976, provided that the taxpayer has terminated or will terminate all operations" of the subsidiary before January 1, 1977.

In the case of Sealed Power, the 88-day time period between enactment of the statute and the January 1, 1977 cut-off date was unrealistic in the light of the complex situation involving Belgian laws which applied to the termination of operations of corporations. It would have been virtually impossible for Sealed Power or other taxpayers similarly situated who owned worthless foreign subsidiaries on October 4, 1976 to dispose of those subsidiaries or their assets prior to January 1, 1977. The cut-off date in the 1976 Act benefits taxpayers who happen to be in a position to make a quick sale of "substantially worthless" foreign subsidiaries, but denies relief to other taxpayers with identical equities.

S.2484 would eliminate unfairness by adding additional conditions under which relief from the loss recapture provisions would be granted. Under S.2484, the discharge of substantially all employees of the subsidiary satisfies the

Act's requirement that the operations of the foreign subsidiary be terminated, for purposes of the bill. The cut-off date for termination of operations of January 1, 1977 is extended to April 15, 1977, and the time within which such losses may be realized is extended to January 1, 1979 to allow for orderly disposition of assets.

Mr. Chairman, not the least of the adverse effects of Section 1032 the 1976 Act is that it constitutes a deterrent to the repatriation of foreign earnings. Sealed Power currently is facing a dilemma with respect to foreign earnings which would be relieved by passage of this bill. We would urge you to favorably consider and act upon this legislation.

Thank you for your consideration. We will be happy to respond to any questions the Committee may have.

STATEMENT ON S.2484
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SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE FINANCE COMMITTEE

May 30, 1980
(Filed on June 18, 1980 by leave of the Subcommittee)

SUMMARY

(1) Sealed Power believes that the loss recapture provisions of Section 904(f) apply unfairly to taxpayers owning worthless securities of foreign subsidiaries.

(2) The inequity arises because complete relief from Section 904(f) is accorded only to losses arising out of a disposition of securities of a subsidiary before January 1, 1977. No relief is accorded for losses under Section 165(g) arising out of the worthlessness, rather than the disposition, of securities. In addition, for many taxpayers owning worthless securities of subsidiaries, January 1, 1977, which is 88 days after enactment of the section, is not a reasonable or fair cut-off date for the disposition of those subsidiaries.

(3) Sealed Power recommends the enactment of S.2484 which would eliminate unfairness by increasing the transitional period within which relief from the losses accrued under Section 904(f) would be granted.

STATEMENT

Mr. Chairman, I am Edward I. Schalon, Chairman of the Board of Sealed Power Corporation. I am appearing in support of S.2484, which would correct an inequity in the foreign loss recapture provisions enacted as part of the Tax Reform Act of 1976 ("the Act") on October 4, 1976.

Sealed Power Corporation is a publicly-owned company headquartered in Muskegon, Michigan, which manufactures and sells piston rings and other parts for automotive and industrial engines. The company employs approximately 4,400 people in operations in the United States. It also has subsidiaries in Canada and Mexico. 1979 sales and net income were approximately $280 million and $21 million, respectively.

Sealed Power's Failed Foreign Subsidiary

In 1973, Sealed Power organized a Belgian subsidiary and advanced funds to the subsidiary in the form of capital contributions, loans and guarantees. The subsidiary, which constructed a plant in Belgium specifically designed for the manufacture of piston rings, incurred substantial unplanned losses in each year of its existence. By 1976 Sealed Power's investment in the subsidiary was wholly worthless. Sealed Power claimed a worthless security loss on its 1976 tax return under Section 165(g)(3) and in March 1977 caused the subsidiary to terminate

its labor force and put its plant on the market. Sealed Power's total loss on the termination of its Belgian subsidiary, including payment in 1977 and 1978 in discharge of guaranty obligations under the subsidiary's loan agreements with Belgian banks, was approximately $13 million.

## Tax Reform Act of 1976

Under the law as it existed prior to enactment of the Act on October 4, 1976, Sealed Power would have been entitled to claim the losses incurred as deductions for U.S. tax purposes without adversely affecting the computation of foreign tax credits in future years. The Act, however, changed the law regarding the future computation of the foreign tax credit.

Section 904(f) added by the Act provides in general that any taxpayer who sustains an overall foreign source loss which reduces the taxpayer's U.S. tax for any taxable year after December 31, 1975 is required to repay this tax benefit over future years by reducing its use of future available foreign tax credits. In effect, a taxpayer is required to match foreign source losses incurred in one year against foreign source income incurred in a future year. As a consequence, the foreign source income is subject to both U.S. and foreign income taxes, while the taxpayer receives no tax effect from his foreign loss.

In hearings before the Senate Finance Committee considering

Section 904(f), testimony by a small number of affected taxpayers raised the question of the proposed effective date of Section 904(f), i.e., which foreign source losses should be matched against future foreign source income. These taxpayers pointed out that when a taxpayer has operated abroad through a foreign subsidiary, losses incurred by the foreign subsidiary would create "built-in" losses in the taxpayer's investment in the subsidiary on the date of enactment of Section 904(f), even though they would not become deductible losses for U.S. tax purposes until the taxpayer's investment in the subsidiary was disposed of or became worthless.

In recognition of the fact that it would be unfair to permit Section 904(f) to apply to economic losses already built into investments in foreign subsidiaries on the date the section became law, two transitional exclusion provisions, Sections 1032(c)(3) and (4) of the Act, were added through action initiated in the Senate Finance Committee.

S.2484 is concerned with the first of these exclusionary provisions, Section 1032(c)(3). Section 1032(c)(3), entitled "Substantial Worthlessness Before Enactment", provides protection from Section 904(f) for losses incurred on stock or indebtedness of a foreign corporation in which the taxpayer owns at least ten percent of the voting stock where the foreign corporation sustained losses in three out of the last five taxable

years, beginning before January 1, 1976, as well as an overall loss for those five years. However, the protection is not afforded unless there is a termination of operations "by reason of sale, liquidation, or other disposition before January 1, 1977 of such corporation or its assets."

While Sealed Power met the other requirements of Section 1032(c)(3), it could not dispose of all of the stock or all of the assets of its Belgium subsidiary before January 1, 1977. Consequently, it is not entitled to the protection from Section 904(f) written into the law by Section 1032(c)(3) of the Act.

Inequities of the Current Law

A U.S. taxpayer recognizes a loss on an investment in a "substantially worthless" foreign subsidiary in one of two ways: he may either dispose of the stock of the foreign subsidiary or he may establish, pursuant to Section 165(g) of the Internal Revenue Code, that the stock has become worthless and could not be disposed of to anyone for more than a nominal consideration. The major defect of Section 1032(c)(3) is that it addresses only the first of these two ways in which losses on securities are recognized. It provides protection from Section 904(f) when the taxpayer incurs a loss through the disposition of stock in a foreign subsidiary prior to January 1, 1977, but it does not provide protection from Section 904(f) when a taxpayer incurs a loss by establishing that stock of a foreign subsidiary has

become wholly worthless prior to January 1, 1977.

As a practical matter, if a wholly worthless foreign subsidiary cannot be sold or disposed of as a going concern, the "termination of operations" must be effected by discharging the employees and liquidating inventories and other assets on a piecemeal basis. In most instances in foreign countries, it would be unrealistic to expect that the liquidation of all of the subsidiary's assets and the "disposition" of its stock through the dissolution of the subsidiary could be completed in less than one year. Consequently, in the normal course of events, the taxpayer can be expected to incur a worthless security loss under Section 165(g) with respect to the stock of a subsidiary in one year even though the ultimate dissolution of the subsidiary and the disposition of its stock does not occur until a subsequent year. See, e.g., Steadman v. Commissioner, 424 F.2d 1 (6th Cir. 1970), aff'g 50 T.C. 369.

As a result, the condition in Section 1032(c)(3) that a taxpayer "terminate the operations" of its foreign subsidiary by disposing of all of the subsidiary's stock or all of its assets by January 1, 1977 is a completely unrealistic requirement for a taxpayer owning a wholly worthless stock in a foreign subsidiary.

The January 1, 1977 cut-off date is also unrealistic in cases where the operations of a "substantially worthless" foreign subsidiary are integrated with domestic operations of a taxpayer. If the operations of the subsidiary represent a foreign extension of the taxpayer's domestic business, it would be unrealistic to

expect that the foreign operations could be sold in the three-month period from the enactment of the section to January 1, 1977 even if they retained some value. As a practical matter, the operations of a foreign subsidiary conducting a business integrated with its parent's business must be terminated by the discharge of employees and the cessation of business, rather than through a sale of its assets or stock to a third party who continues the business.

To repeat, Section 1032(c)(3) provides protection from Section 904(f) for a taxpayer who owned a foreign subsidiary which (a) still had some value, and (b) conducted operations unrelated to the taxpayer's domestic operations and therefore happened to be in a position to make a quick sale of the subsidiary before January 1, 1977, 88 days after the section became law. But Section 1032(c)(3) provides no protection from Section 904(f) for a taxpayer who incurred a worthless security loss on stock in a foreign subsidiary in 1976, but could not realistically dispose of the assets or stock of the subsidiary before January 1, 1977, either because the subsidiary had no value or because its operations were tied to the taxpayer's domestic operations. There is no equitable reason to distinguish between these two types of losses, the loss on disposition and the worthless security loss. We are certain that this result could not have been intended by Congress, and S.2484 is designed to cure the resulting inequity.

Application of Section 1032(c)(3) to Sealed Power

Sealed Power's experience in terminating the operations of its Belgian subsidiary is illustrative of the need for an amendment to Section 1032(c)(3). As explained above, the stock of the Belgian subsidiary was worthless as of December 31, 1976 and Sealed Power claimed a worthless security loss under Section 165(g)(3) for its entire equity investment in the subsidiary. However, even though the stock of its Belgian subsidiary became worthless in 1976, by reasons of conditions in Belgium and Belgian laws Sealed Power was not able to dispose of all of the assets or all of the stock of its subsidiary before January 1, 1977. Sealed Power therefore cannot obtain the protection from Section 904(f) offered by Section 1032(c)(3).

The decision by Sealed Power's board to terminate operations in Belgium was made in March of 1977. However, even if it had been made in 1976, because of numerous business and legal problems in Belgium there was no way to meet the statutory requirement of selling, liquidating or otherwise disposing of the stock or all of the assets of the Belgian subsidiary prior to January 1, 1977. Selling or otherwise disposing of the stock of the Belgian subsidiary was not possible because the stock had no value. Selling the assets of the Belgian subsidiary as a going concern to a third party who would then compete with Sealed Power in the manufacture of piston rings was not a practical or conceivable possibility.

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Therefore, the manufacturing inventories of the Belgian subsidiary could not be sold or disposed of to a third party (other than sales in fulfillment of customer purchase orders in the ordinary course of business). Special-purpose machinery and equipment could not be sold or disposed of to any third party except a competing manufacturer of piston rings. Consequently, inventories and special-purpose machinery and equipment of the Belgian subsidiary had to be acquired by Sealed Power itself.

The major remaining asset of the subsidiary was its plant. Although the plant was immediately placed on the market, there was a glut of manufacturing-type buildings being offered at the time and the plant was not sold until February, 1978. The plant's sale price of $1,500,000 represented less than thirty percent of its original cost. The proceeds collected from the liquidation of all of the assets of the Belgian subsidiary represented a shortfall from the subsidiary's bank indebtedness and other liabilities of approximately $6,000,000, which Sealed Power paid as guarantor of the subsidiary's bank indebtedness.

S.2484 Will Correct the Inequity of the Current Law

Under the Internal Revenue Code, losses incurred at the foreign subsidiary level cannot be deducted by its U.S. parent until some time in the future when the U.S. parent either disposes of the stock of the foreign subsidiary or the stock becomes worthless. The rationale underlying Section 1032(c)(3) is that

unless some transitional accommodation is made for this time gap between the year losses are incurred at the subsidiary level and the year losses are recognized for U.S. tax purposes at the parent level, Section 904(f) would have an unfair retroactive effect. It is Sealed Power's position that the conditions under which protection under Section 1032(c)(3) is granted should be realistic, so that substantially all taxpayers similarly situated with built-in losses in worthless foreign subsidiaries have a reasonable opportunity to avail themselves of that protection.

S.2484 would amend Section 1032(c)(3) so that the section applies not only to losses incurred by taxpayers who are able to sell the assets or stock of a foreign subsidiary, but also to losses (primarily worthless security losses) incurred by taxpayers who must pursue the more lengthy alternative process of closing down the operations of a foreign subsidiary and discharging its employees. S.2484 accomplishes this by providing that the discharge of substantially all employees of the subsidiary satisfies the Act's requirement that the operations of the foreign subsidiary be terminated. S.2484 includes recognition that the cessation of business requires more time, as a practical matter, than the sale of the assets or stock of a foreign subsidiary as a going business. Consequently, the cut-off date of January 1, 1977 for termination of operations is extended to April 15, 1977. Further, the period in which such losses may be realized is extended to January 1, 1979, to allow for orderly disposition of assets, a period recognized by the Congress in Section 1032(c)(4).

S.2484 can hardly be considered special interest legislation in the sense that it would grant extraordinary benefit to only one or two taxpayers. On the contrary, S.2484 assures that the protection accorded by Section 1032(c)(3) applies uniformly to substantially all taxpayers holding worthless foreign subsidiaries, rather than to that limited number of taxpayers who happened to be in a position to make a quick sale during 1976 of a "substantially worthless" foreign subsidiary. S.2484 would remove a penalty which has been inadvertently imposed on taxpayers such as Sealed Power who could not reasonably have disposed of their "substantially worthless" foreign subsidiaries during 1976.

As indicated previously, a second transitional exclusionary provision to Section 904(f) is Section 1032(c)(4) of the Act. This section sets forth the same requirements as Section 1032(c)(3), except that the loss can be sustained in a taxable year beginning before January 1, 1979 and relief from foreign loss recapture is provided to the extent of the foreign corporation's deficit in earnings and profits as of December 31, 1975. Section 1032(c)(4) provides partial relief to Sealed Power to the extent of the Belgian subsidiary's deficit in earnings and profits of approximately $4.5 million. However, that section provides no relief for the remainder of Sealed Power's loss reflecting the decline in the value of the subsidiary's business and assets, even though that loss was economically built-in prior to the enactment of Section 904(f).

Conclusion

The hardship faced by Sealed Power because of the fact that it does not come within the technical exceptions aimed at preventing retroactive effect can be illustrated as follows: Sealed Power sustained an approximate $13,000,000 foreign loss as the result of the closing of its Belgian subsidiary. At least $8,425,000 of this loss was not covered by one of the exceptions presently contained in the statute. Thus, if Sealed Power receives $16,850,000 of foreign source income in future years, half of that amount will be treated as though it were U.S. source income and will therefore be subject to both foreign income taxes and full U.S. income taxes. (The other half will be subject to foreign income taxes, the payment of which will be a credit against U.S. income taxes.)

Sealed Power's major potential for foreign-source income in future years is dividends which could be paid by Sealed Power's Mexican subsidiaries. Sealed Power must choose whether to cause its Mexican subsidiaries to transfer funds to the United States through the payment of dividends or to reinvest those funds outside the United States. Sealed Power believes that its investment opportunities are greater within the United States. However, under the present statute, the "cost" of bringing the funds back to the United States rather than leaving them abroad is an additional U.S. income tax of approximately $4 million to $4.5 million. As indicated in the conclusion of the attached

exhibit, the composite U.S. and Mexican income tax rate on Mexican income distributed as a dividend to Sealed Power would be approximately 70%. It is not clear that the advantages of investing in the United States rather than abroad can justify the additional cost of bringing funds home.

Mr. Chairman, we sincerely appreciate your convening this hearing on S.2484. We are anxious to respond to any questions you may have with respect to the merits of our situation or the merits of the bill.

EFFECT OF $2,000,000 DIVIDEND FROM MEXICAN SUBSIDIARIES

| | With Recapture | | | Without Recapture | |
|---|---|---|---|---|---|
| | Without Dividend | With Grossed-Up Dividend | With Dividend Not Grossed-Up | Without Dividend | With Grossed-Up Dividend |
| U.S. source income | 15,000,000 | 15,000,000 | 15,000,000 | 15,000,000 | 15,000,000 |
| Dividend (Grossed up = 2,000,000 ÷ 58)* | - | 3,448,000 | 2,000,000 | - | 3,448,000 |
| Taxable Income | 15,000,000 | 18,448,000 | 17,000,000 | 15,000,000 | 18,448,000 |
| U.S. tax at 48% minus 13,500 | 7,186,500 | 8,841,540 | 8,146,500 | 7,186.500 | 8,841.540 |
| Foreign Taxes Paid: | | | | | |
| Taxes withheld on dividend | - | 420,000 | 420,000 | - | 420,000 |
| Taxes deemed to have been paid | - | 1,448,000 | - | - | 1,448,000 |
| Total | - | 1,868,000 | 420,000 | - | 1,868,000 |
| Foreign tax credit limitation: | | | | | |
| Gross foreign source income | - | 3,448,000 | 2,000,000 | - | 3,448,000 |
| Recapture of loss carry-forward | - | 1,724,000 | 1,000,000 | - | - |
| Net foreign source income | - | 1,724,000 | 1,000,000 | - | 3,448,000 |
| Dividend by total taxable income | 15,000,000 | 18,448,000 | 17,000,000 | 15,000,000 | 18,448,000 |
| Limitation percent | 0% | 9.345% | 5.882% | 0% | 18.69% |
| U.S. tax | 7,186,500 | 8,841,500 | 8,146,500 | 7,186,500 | 8,841,500 |
| Limitation amount | 0 | 826,000 | 420,000** | 0 | 1,652,500 |
| Net U.S. tax | 7,186,500 | 8,015,500 | 7,726,500 | 7,186,500 | 7,189,000 |
| U.S. tax without dividend | | 7,186,500 | 7,186,500 | | 7,186,500 |
| U.S. tax on dividend | | 829,000 | 540,000 | | 2,500 |
| Foreign tax withheld on dividend | | 420,000 | 420,000 | | 420,000 |
| Total tax on dividend | | 1,249,000 | 960,000 | | 422,500 |
| Tax rate on dividend | | 62.45% | 48.00% | | 21.13% |
| Effective tax rate - .42 Mexican tax + (.58 x tax rate on dividend) | | 78.22% | 69.84% | | 54.25% |

*The income tax rate in Mexico is 42%

**Limited to tax paid.

Note: The effect of the allocations required under Section 861 have been omitted for simplification. The effect of these allocations is to reduce the foreign tax credit and increase the U.S. tax.

Conclusion: Without using the Gross-up election, it will require $16,850,000 in dividends to completely offset the $8,425,00 loss recapture. At a dividend rate of $2,000,000 per year this will take 8.425 years and a total additional U.S. inome tax cost of $4,528,000. If we elect the gross-up procedure it will require $9,775,000 in dividends over the 4.887 years to eliminate the $8,425,000 loss at an additional U.S. income tax cost of $4,039,000.

SUMMARY OF STATEMENT
OF
LEONARD L. SILVERSTEIN, ESQ.
ON BEHALF OF
CHAMPION INTERNATIONAL CORPORATION

Under section 904(f) of the Internal Revenue Code (added by section 1032 of the Tax Reform Act of 1976), if in a taxable year beginning after 1975 a corporation has an "overall foreign loss" (that is, an excess of foreign losses over foreign income), then, in future years, this loss is applied (on a one to one basis) to convert at least 50 percent of the corporation's net foreign income to domestic income, until an amount equal to all the loss is used up. This, of course, reduces the ceiling for the maximum foreign tax credit permissible by 50 percent for such future years.

This rather harsh treatment applies even to losses realized on a corporation's termination of its interest in a 50 percent controlled foreign corporation, which it acquired before 1976, without any plan or intent to save income taxes. Since it seems inappropriate to increase taxes because of a loss on a foreign business commitment made in good faith before the enactment of the 1976 Act, an amendment to the effective date is proposed. Under this amendment, there will not be any forfeiture of foreign tax credits on a termination loss with respect to stock and debt of a foreign 50 percent controlled subsidiary paid for before January 1, 1976 or guarantees of debts made before that date. For the exception to apply, the subsidiary would have to have been 50 percent owned and engaged in the active conduct of a trade or business on January 1, 1976. The exception will apply only to losses recognized before January 1, 1986.

A copy of the draft bill submitted with the statement is attached to this summary.

Amendment to Effective Date
of Section 904(f)
Champion International Corporation

Be it enacted . . .
That (a) Section 1032(c) of the Tax Reform Act of 1976 (relating to effective dates for foreign loss recapture provisions) (Public Law 94-455, as amended by Public Law 95-600) is amended by:

(1) Striking the words in paragraph (1) thereof "except as provided in paragraph (2), (3) and (5)" and substituting the words "except as provided in paragraphs (2), (3), (5) and (7)," and

(2) Adding at the end thereof a new paragraph (7) as follows:

"(7) LOSS ON TERMINATION OF PRE-1976 INVESTMENT. -- The amendments made by subsection (a) shall not apply to losses incurred before January 1, 1986, attributable to the termination of all of the taxpayer's interest in a corporation, to the extent such losses do not exceed the amount of the taxpayer's pre-1976 investment, if, on January 1, 1976, the corporation was engaged in the active conduct of a trade or business, and the taxpayer owned (within the meaning of section 958 of the Internal Revenue Code of 1954) more than 50 percent of the voting stock of such corporation. The term "pre-1976 investment" includes payments made for stock and indebtedness (whether or not later capitalized) of the corporation before 1976, and payments (whenever made) in satisfaction of guarantees of debts of the corporation (whether by contribution to capital of the corporation or otherwise), to the extent of money borrowed under such guarantees before 1976.

(b) EFFECTIVE DATE. The amendments made by (a) above shall apply to all taxable years with respect to which the filing of a claim for refund is not barred by any law or rule of law on a date thirty days after the date of enactment.

STATEMENT OF LEONARD L. SILVERSTEIN

ATTORNEY, WASHINGTON, D.C.

ON BEHALF OF

CHAMPION INTERNATIONAL CORPORATION

May 30, 1980

Mr. Chairman and members of the Subcommittee.

My name is Leonard L. Silverstein. I am a member of the law firm of Silverstein and Mullens and appear here today on behalf of Champion International Corporation.

Champion is a company engaged primarily in the manufacture and sale of wood based building materials, paper, paper packaging and related products in the United States and abroad. Champion's headquarters are in Stamford, Connecticut.

We welcome this opportunity to comment on S. 2484, dealing with the operation of Section 904(f), and to make specific recommendations for corrective legislation in relation to Champion (and other taxpayers similarly situated).

First, some pertinent general observations. Section 904(f) is a complex statute which fails to satisfy the tax policy objectives at which it is aimed, or properly should be aimed. Since its enactment in 1976, Section 904(f) has proven in many cases to be a deterrent to prudent management of worldwide business operations, including normal continuing repatriation of earnings from foreign affiliates. In the case of Champion and other companies in like circumstances, Section 904(f) operates to generate double taxation of their foreign earnings.

On a previous occasion in 1977, Champion expressed its concern to the Congress in connection with the impact of Section 904(f) upon unplanned losses suffered with respect to a Belgian subsidiary which was disposed of a few months subsequent to an arbitrarily chosen transitional effective date. Other companies appearing here today also are confronted with this problem and have proposed an extended cut-off date to deal with it.

In addition to the foregoing, Champion is faced with another situation in which the operation of Section 904(f) causes, in economic effect, double taxation of its foreign earnings. The situation referred to relates to a loss which Champion anticipates will occur on the termination of its interest in a United Kingdom carpet manufacturing business. On January 3, 1974 (as a result of a binding commitment made on November 7, 1973), a wholly-owned affiliate of Champion purchased all of the shares of a corporation actively and profitably engaged in manufacturing synthetic carpeting in the United Kingdom. This acquisition was made as part of a then planned product diversification of Champion. As part of the acquisition transaction, funds were advanced to the wholly owned affiliate in the form of capital contributions, loans and guarantees.[1/]

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[1/]On November 30, 1974 the carpet company was liquidated into the wholly-owned affiliate of Champion in a nontaxable transaction.

At the time of such commitments, there was no realistic anticipation that future foreign tax credits would be forfeited if, contrary to management expectations, the U.K. business did not prove successful and Champion disposed of its investment at a loss. As a result of the subsequent enactment in 1976 of Section 904(f), however, precisely this harsh result will occur if and when Champion repatriates its foreign earnings (from other operations) for normal ongoing business reasons. While that section permits Champion to reduce U.S. income by the amount of the loss, it requires that the tax benefits of the loss be recaptured by causing Champion to forfeit future foreign tax credits from other foreign operations. When it adopted Section 904(f), however, Congress recognized that undue hardship would occur for numerous types of business investments which were then in progress in reliance on existing law. As a result, Congress adopted a series of transitional rules to the general effective date of January 1, 1976. These transitional rules allowed leeway in the impact of Section 904(f) in order to phase in the new rules in an equitable manner. However, in the heat of battle

in 1976, the transitional rules did not fully carry out the philosophy of exempting losses arising from investments irrevocably committed before the general effective date.

In light of the above, we believe that Section 904(f) should be amended with respect to prior investments made in reliance on then existing law. To this end, Champion proposes a 10 year transitional rule which would exempt from the recapture provision any loss recognized before January 1, 1986, resulting from investments made by the taxpayer before the general effective date of Section 904(f), namely January 1, 1976. We have prepared a draft amendment carrying out this proposal.

Before describing the details of this amendment, Mr. Chairman, I would like to point out that unplanned termination losses such as those confronting Champion are not comparable to the start-up losses or other planned losses at which section 904(f) was aimed. The existing transitional

rules contained in section 1032 of the 1976 Act reflect a Congressional intention to ameliorate the effect of Section 904(f) where the business cycle straddles the cut-off date. Particularly pertinent is a transitional rule already in the statute exonerating losses realized on the disposition of debt instruments issued by a foreign government as payment for foreign property or stock. Irrespective of the year in which the debt instrument is sold, Section 904(f) does not apply. In addition, the statute excepts from its reach unplanned losses such as those sustained from fire, storm, shipwreck, casualty or theft.

When Champion made its investment in the United Kingdom, management could not have been expected to take into account the possibility that if the investment in the United Kingdom suffered unplanned losses, such losses could cause the company to forfeit the benefit of the foreign tax credit. In fact, the loss suffered by Champion occurred essentially because of the sudden oil embargo which caused a sudden increase in the cost of petrochemical supplies for the principal product of the new

business. The oil embargo also caused a sudden downward change in the British economy, thereby making the U.K. synthetic carpet business noncompetitive. To compound these unforeseen economic costs with the tax burdens of Section 904(f) is a result much too unfair to be tolerated by the Congress. This is particularly so when the circumstances of Champion (and other companies similarly situated) are compared with those of a company sustaining losses as a result of expropriation, fire, storm, shipwreck, theft or other unanticipated casualty. In Champion's case, as in the case of the events excepted in the statute, the losses were just as unplanned and unpredictable in nature and beyond the control of prudent businessmen as the theft, fire and other excepted losses. In all of these situations the unplanned losses were a result of external events beyond the control of the taxpayer and thus differ entirely from programmable costs such as start-up expenses to which Section 904(f) is essentially directed.

Accordingly, Champion urges that companies committed to foreign investments before 1976 should be permitted to terminate these investments by the end of 1985 without forfeiture of the foreign tax credit.

The attached draft bill amends the effective date provision of the Tax Reform Act of 1976 to specify that there shall not be any forfeiture of foreign tax credits on the recognition of a termination loss with respect to stock or debt of a foreign subsidiary paid for before January 1, 1976 or guarantees of such subsidiary's debts made before such date. The change would apply only if:

(A) the subsidiary was a 50 percent controlled foreign corporation on December 31, 1975,

(B) the subsidiary was engaged in the active conduct of a trade or business, and

(C) the loss is recognized by the end of 1985.

I thank you for this opportunity to testify and will be glad to answer any questions the Subcommittee may wish to ask.

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Amendment to Effective Date
of Section 904(f)
Champion International Corporation

Be it enacted . . .
That (a) Section 1032(c) of the Tax Reform Act of 1976 (relating to effective dates for foreign loss recapture provisions) (Public Law 94-455, as amended by Public Law 95-600) is amended by:

(1) Striking the words in paragraph (1) thereof "except as provided in paragraph (2), (3) and (5)" and substituting the words "except as provided in paragraphs (2), (3), (5) and (7)," and

(2) Adding at the end thereof a new paragraph (7) as follows:

"(7) LOSS ON TERMINATION OF PRE-1976 INVESTMENT. -- The amendments made by subsection (a) shall not apply to losses incurred before January 1, 1986, attributable to the termination of all of the taxpayer's interest in a corporation, to the extent such losses do not exceed the amount of the taxpayer's pre-1976 investment, if, on January 1, 1976, the corporation was engaged in the active conduct of a trade or business, and the taxpayer owned (within the meaning of section 958 of the Internal Revenue Code of 1954) more than 50 percent of the voting stock of such corporation. The term "pre-1976 investment" includes payments made for stock and indebtedness (whether or not later capitalized) of the corporation before 1976, and payments (whenever made) in satisfaction of guarantees of debts of the corporation (whether by contribution to capital of the corporation or otherwise), to the extent of money borrowed under such guarantees before 1976.

(b) EFFECTIVE DATE. The amendments made by (a) above shall apply to all taxable years with respect to which the filing of a claim for refund is not barred by any law or rule of law on a date thirty days after the date of enactment.

# SUPPLEMENTAL STATEMENT ON BEHALF OF CHAMPION INTERNATIONAL CORPORATION

Contents

A. Objectives of Section 904(f).

B. Practical Business Difficulties in Adjusting to Section 904(f).

C. Compatibility of Champion's Proposal with the Transitional Rules Enacted in 1976.

D. Nonretroactivity of Champion's Proposal

E. Conclusion

At the Subcommittee hearing held on May 30, 1980, the Treasury made several statements critical of S. 2484 and of the proposed amendment offered on behalf of Champion International Corporation ("Champion").

In its oral and written testimony, the Treasury contended that (1) the foreign tax credit

amendments adopted in 1976[1] were designed to prevent "double dipping"; (2) the existing transitional rules were "carefully" and "precisely" considered in 1976; and that (3) both S. 2484 and Champion's proposal constitute retroactive "special interest" legislation.[2] Thus, according to Treasury, Champion's proposal involves at least "partial repeal" of section 904(f).[3] We believe that these statements require a response.

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[1] P.L. 94-455, Tax Reform Act of 1976, §1031. Unless otherwise indicated, all references to the "Code" or to sections thereof refer to the Internal Revenue Code of 1954, as amended.

[2] Prepared Statement of H. David Rosenbloom, International Tax Counsel, Department of the Treasury, before the Senate Finance Subcommittee on Taxation and Debt Management, May 30, 1980.

[3] Treasury asked rhetorically whether, if Champion is to receive the tax consequences in effect when its U.K. investment was made, it should also be taxed at the 48 percent corporate tax rate, also then in effect. Traditionally, taxpayers have no right to rely on existing rates of tax. These rates, and changes thereto, are usually determined by economic

[footnote continued]

A. Objectives of Section 904(f).

The Tax Reform Act of 1976 made major structural changes in the foreign tax credit provisions of the Code. The opportunity for "double dipping" to which the Treasury refers was intended to be curbed by a combination of repeal of the per-country limitation and by enactment of section 904(f).[4/] This major structural revamping mandated, in effect, aggregation of a corporation's worldwide foreign losses and profits regardless of national boundaries or of the span of time over which they occur. The latter effect was produced by a *de facto* repeal (through enactment of section 904(f)) of the annual accounting period rule. In other areas of

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[footnote 3/ continued]

conditions and budget needs from time to time. By contrast, however, Congress has recognized the right of taxpayers to rely on existing tax law with respect to legislative changes in basic or longstanding substantive provisions of the Code.

4/The per-country limitation made foreign tax credits from one country available without diminution in the same year that foreign losses were sustained in a different country. See Section 904(a), prior to repeal by the Tax Reform Act of 1976, §1031.

the tax law, however, the annual accounting concept has been deeply imbedded in the Code and in tax jurisprudence.

Thus, the nature of the changes made in the foreign tax credit provisions in 1976 were, from a structural standpoint, fundamental and sweeping.

When section 904(f) was initially proposed to the Congress in 1975-1976, Treasury Secretary William Simon indicated that the proposal primarily aimed at "start-up" losses. In testimony before the Senate Finance Committee on March 17, 1976, Secretary Simon stated:

> "We view this (i.e., the proposed recapture rule) as a technical change to eliminate an unintended benefit. Under present law, a U.S. taxpayer can use foreign start-up losses to reduce U.S. tax and then pay no U.S. tax on subsequent foreign gain because of the foreign tax credit. In such a case, it is only fair for the U.S. to recapture the tax lost during the start-up period."[5]

This same targeted approach focusing on losses and subsequent profits derived from the same business was

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[5] Statement of William E. Simon, Secretary of Treasury, before the Senate Finance Committee, March 17, 1976.

described in the Treasury Department's original tax proposals in this area in 1973.[6/]

As enacted, however, section 904(f) was not limited to losses and profits from the same business or even from the same country. The reason that section 904(f) was not so limited lay in the simultaneous repeal of the per-country limitation. Section 904(f) thus required a major upheaval in foreign investment planning in light of the entire complex of new law adopted in 1976.

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[6/] The Treasury's written proposal stated, in part:

> "Under the proposal [the Treasury study stated], certain losses incurred by United States taxpayers operating abroad and deducted against domestic income would reduce foreign tax credits in later years <u>when the taxpayer earns profits on these operations</u>. * * * When <u>the foreign operations in the country of loss</u> become profitable, taxes are often paid to such country without taking into account the prior losses." (Emphasis added.)

Although the Treasury refers to "double dipping" under pre-1976 law, it is important to emphasize that even under prior law, U.S. taxpayers paid taxes on foreign profits, although to a foreign jurisdiction. No double benefit, in the sense of a double deduction for the same expense, occurred, and no complete escape from taxes on income occurred. While proponents of section 904(f) argue that this provision is necessary in order to eliminate the possibility for "double dipping," it is important to recognize that the phrase "double dipping" is not being used in its customary sense. Used in its customary sense, the phrase "double dipping" connotes tax avoidance or evasion, in situations where, for example, a taxpayer receives a double deduction for the same item of expense. In the context of section 904(f), however "double dipping" refers to a situation where a U.S. taxpayer incurs a real economic loss on a foreign investment, which loss currently reduces its U.S. income tax, and in subsequent years, is then entitled to foreign tax credits on its foreign source income without regard

to the prior impact of the loss. Even in such a situation, it is important to recognize that the taxpayer, in fact, paid a tax on the foreign income which section 904(f) recharacterizes, even though the tax is paid to a foreign jurisdiction. Without section 904(f), what mechanically occurs is that the foreign income is subject to both a foreign tax and U.S. tax but a credit is allowed for the foreign tax paid. Under section 904(f), both the foreign tax and U.S. tax are paid on the same income but no foreign tax credit is allowed against U.S. tax so that a U.S. tax is also paid on the foreign income.

Thus, contrary to the customary meaning of "double dipping," section 904(f) does not deal with a situation where income escapes tax.

The true policy question to be addressed here concerns the propriety, after 1976, of imposing two taxes, rather than one, on foreign source income. This double tax burden results, under section 904(f), from denial of a foreign tax credit with respect to certain foreign profits. As a

result, the U.S. taxpayer pays one tax to the foreign country and a second tax on the same income to the U.S. Treasury. The wisdom of imposing such a double tax is raised by enactment of section 904(f).[7]

The combined effects of the 1976 foreign tax credit changes required profound reformulation of plans for existing, bona fide foreign investments because the recapture rules significantly and adversely increased the net worldwide economic risk involved in terminating a foreign operation. A

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[7]Responsible commentators have pointed out several defects in the mechanism of section 904(f). Recapture occurs under section 904(f), for example, even though the foreign loss did not produce a tax benefit in the U.S. because U.S. operations produced a net loss. Section 904(f) also may apply even when, under applicable foreign law, the loss is in fact carried forward against income in a future year. In this situation there is, in fact, no foreign tax credit to "double dip." Mentz, "The Effect of Net Operating Losses on the Foreign Tax Credit," 30 Tax Lawyer 309, at 317-318, 320-322 (1977); Dale, "The Reformed Foreign Tax Credit: A Path Through the Maze," 33 Tax L. Rev. 175, 212-217 (1978). Other policy issues require review, including the

[footnote continued]

taxpayer must now add the section 904(f) tax cost (denial of future foreign tax credits) to other hard costs occasioned by termination of a foreign affiliate. Section 904(f) clearly operates in areas beyond deliberate tax avoidance techniques or "double dipping" to which the Treasury pejoratively refers.

B. Practical Business Difficulties in Adjusting to Section 904(f).

In its May 30 testimony the Treasury stated:

> "A U.S. taxpayer that chose to continue the operations of a foreign subsidiary after 1975 was on notice with respect to the possible effect of section 904(f) recapture with respect to its investment in that subsidiary."

Thus, according to the Treasury, on the effective date of the new scheme a taxpayer was on notice to "fish or cut bait." Such a philosophy gives no effect to the demands of prudent business

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[footnote 7/ continued]

interaction of section 904(f) with the net operating loss rules set forth in the Court of Claims decision in Motors Insurance Co. v. U.S., 530 F.2d 864 (Ct. Cl. 1976).

practice. In determining whether to continue or terminate a business enterprise, business management must concern itself not only with the effects of termination on other business operations, but also with the economic effects on employees and on the local community. In Champion's case, termination of its U.K. investment is planned to occur in a manner which will result in the least possible hardship to all the various interests affected.

At the time it considered transition rules in 1976, Congress recognized the very practical business problems which a company such as Champion now faces. The guiding policy principle for the transition rules was stated as follows:

> In some cases, a corporation may want to continue an investment beyond 1976 in an attempt to try to make the investment profitable although it may ultimately fail in that endeavor."8/

This policy principle recognizes the practical business decision problems in connection with planning for an existing investment. Congress

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8/ S. Rept. 94-938 (Part 2), 94th Cong. 2nd Sess. 64 (1976), 1976-3 C.B. (Vol. 3) at 706.

exhibited tolerance toward the practical problems involved for businesses to adjust investments already in place to new legislative rules. The stated policy principle describes Champion's present problem and the reason for its current proposal. Despite the 1974 oil embargo, which seriously threatened the U.K. carpet business (depending, as it does, on petrochemical materials), Champion tried to make its investment profitable. Ultimately, it failed in that endeavor. This situation is precisely the rationale set forth by the Senate Finance Committee in 1976 for the transition rules.[9/] Champion's efforts with regard to its U.K. subsidiary is fully within this policy.

C. Compatibility of Champion's Proposal with the Transitional Rules Enacted in 1976.

The Treasury asserts that the 1976 transitional rules were "precise" and "carefully drafted," as well as "deliberately" considered.

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[9/] The same rationale was reiterated in the Joint Tax Committee Explanation of the Tax Reform Act of 1976 as representing the intent of Congress with respect to the law as finally enacted. General Explanation of the Tax Reform Act of 1976, prepared by the Staff of the Joint Committee on Taxation, December 29, 1976, 1976-3 C.B. (Vol. 2) 1, 254.

Notwithstanding this assertion, none of the transition rules eventually adopted had been considered by the House in its bill as initially reported.[10/] Although the bill reported by the Senate Finance Committee contained two transitional rules,[11/] these rules were further liberalized when the Finance Committee, in an unusual action in 1976, held further hearings on the bill, leading *inter alia* to additional transitional rules under section 904(f). This activity occurred in a chaotic atmosphere surrounding the additional hearings which took place after the bill had already been ordered reported by the Finance Committee. Thereafter, the Committee issued a "supplemental" committee report adding 37 amendments to the bill, including several new transition rules affecting section 904(f).[12/]

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[10/] See H. Rept. 94-658, 94th Cong. 1st Sess., 225, 229 (1976), 1976-3 C.B. (Vol. 2) 695, 921.

[11/] See S. Rept. 94-938, 94th Cong. 2d Sess. 236, 240 (1976), 1976-3 C.B. (Vol. 3) 49, 278.

[12/] See S. Rept. 94-938 (Part 2), *supra* footnote 8. The transition rules under section 904(f) are

[footnote continued]

We submit that the atmosphere for "precise, carefully drafted" transition rules did not in fact exist during this period. Indeed, "perfecting" amendments to the 1976 transitional rules were made in the Revenue Act of 1978 and further underscore the general lack of precision in the consideration given to the transition rules to date.13/

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[footnote 12/ continued]

contained in §1032(c) of the Tax Reform Act of 1976. Champion is aware that American Can Company provided written testimony in 1976 suggesting that a fair application of section 904(f) would exempt from recapture any termination loss resulting from investments made before the effective date of the new provision. See Summary of Testimony of American Can Co., in Hearings Before the Senate Finance Committee on Certain Committee Amendments to H.R. 10612, 94th Cong. 2nd Sess. 370, 372 (July 20-22, 1976). It is evident that this point, contained in a written submission, was not specifically considered by the Senators and Congressmen, however.

13/See P.L. 95-600, Revenue Act of 1978, §701(u). These 1978 amendments modified an existing transition rule contained in 1976 Act §1032(c)(4), relating to loss corporations having a deficit in earnings and profits on December 31, 1975. The amendment made in 1978 grandfathered, in effect, earnings and profits of the corporations (from which the loss arose) in taxable years beginning before

[footnote continued]

A guiding policy principle for the transition rules was established in 1976. This principle has been quoted earlier.[14] This policy reveals an intent to allow leeway with regard to investments in place before 1976, although continued "beyond 1976." In the hectic atmosphere in which the actual transition rules were adopted at the time, this policy principle was not fully carried out. Only a few limited applications of the basic principle were written into the law at the time,

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[footnote 13 continued]

December 31, 1962. Revenue Act of 1978, §701(u)(7)(A).

The 1978 Act added several new transition rules under section 904(f). The first relates to possessions source income (including Puerto Rico) for taxpayers still entitled to use the per country limitation. Revenue Act of 1978, §701(u)(7)(B), adding new §1032(c)(6) to the transition rules.

The second transition rule added in 1978 related to certain mining companies allowed by the 1976 Act to use the per-country limitation through 1978. Revenue Act of 1978, §701(u)(6), amending 1976 Act §1031(c)(2).

[14] See text at footnote 8, <u>supra</u>.

evidently reflecting those taxpayers able to contact their Congressmen and Senators in time. As a result, some of the transition rules allow relief only for losses which were "built in" but not yet recognized before 1976.

Such transition rules are not in fact the only illustrations of the business situation described in the policy principle; Champion's proposal encompasses another situation equally deserving of relief under the same policy.

Champion submits that transition relief from the radical change made through section 904(f) should not depend on the fortuity of whether a loss had been realized "on paper" before 1976, particularly since the timing of a business decline is primarily an economic matter and ought not to result in different tax consequences. Like Champion, those taxpayers who obtained relief in 1976 had not recognized their losses before 1976. Both they and Champion will have recognized their losses after 1975 on pre-1976 investments. The only difference lies in the rapidity of the actual economic suffering of the loss. Champion submits that its fact situation is

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totally within the transition policy adopted by Congress in 1976 under section 904(f).

D. <u>Nonretroactivity of Champion's Proposal</u>

The question is how section 904(f) should be applied to corporations which had made large foreign business commitments abroad before 1976 in reliance on then-existing law. As explained in Appendix A, Congress has made it a practice to "grandfather" existing tax law as to taxpayers who relied on existing law nearly every time a basic structural change in the tax law has been made. There is no reason Congress should now depart from this practice in a matter of this economic importance. The question of how to treat those who had <u>already</u> invested abroad before 1976 has received no in-depth consideration up to the present time (except as to those who had already suffered an economic loss). It is therefore time to consider the broader question.

Champion proposes that pre-1976 law remain applicable to losses recognized on termination of an investment in a foreign subsidiary after 1976, to the extent that such losses are attributable to <u>pre-1976</u>

investment -- that is, money advanced and liabilities incurred before the effective date of the 1976 Act.

Although the Treasury labels the relief sought by Champion (and other companies under S. 2484) "retroactive" legislation, this observation ignores the fact that the event which gives rise to Champion's proposal -- loss of Champion's pre-1976 business investment in the U.K. -- had not been realized by the close of 1975. Champion's proposal would insulate from the penalties of section 904(f) a loss realized after the general effective date but only with respect to an investment commitment made before such date.

Contrary to the Treasury's statement, the relief proposed by Champion cannot be expanded indefinitely. The amount of pre-1976 investment cannot now be increased, and relief is sought only for "termination" losses and not for losses from operations. Thus, no "next cases" can or should arise.

As noted earlier, the thrust of the already enacted transition rules under section 904(f) suggests that Congress has basically accepted a

"grandfathering" principle. In addition, by excepting from section 904(f) losses arising after 1975 from fire, storm, theft or other casualty -- in reality, "termination losses" -- Congress has expressly exonerated forms of termination losses sustained after 1975.[15/]

Special mention should be made of some of the significant precedents for Champion's proposal to except pre-1976 investments. The effective date of section 1248 (relating to gains from sales or exchanges of stock of certain foreign corporations) excepts earnings and profits accumulated before December 31, 1962. The "fresh start" adjustment allowed in 1976, when the longstanding stepped-up basis rules for transfers at death were changed, also exempted property values as of December 31, 1976.[16/] The pending proposed "legislative" regulations under Code section 385 (relating to

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15/ See Section 904(f)(2)(B).

16/ See Code §1023(h).

classification of interests in corporations as debt or equity) would apply only to instruments issued after December 31, 1980. This approach in effect "grandfathers" any debt obligation issued before the defined effective date.

E. Conclusion

In light of the fundamental changes in the tax law made in 1976, Champion's proposal is fully consistent with longstanding "grandfathering" concepts and with the specific policy for transition rules under section 904(f). Since the proposal is limited to pre-1976 investments and to termination losses, Champion submits that its proposal does not "repeal" section 904(f) to any extent.

Respectfully submitted,

Leonard L. Silverstein

# APPENDIX: PRECEDENTS FOR "GRANDFATHERING" EXISTING INVESTMENTS

## 1. Carryover Basis

The Tax Reform Act of 1976 repealed the "stepped-up" basis rule of Code section 1014(a) (relating to property acquired from a decedent) and generally required an heir to use as his basis in the inherited property the decedent's basis in the property.[1/]

As originally proposed, the carryover basis rule would have applied to property acquired from a decedent who dies after December 31, 1976, and the basis to be carried over was the decedent's basis in the property.[2/] As enacted, however, section 1023 provided a "fresh-start" to all property acquired from a decedent after 1976 by deeming its basis to be the fair market value (if greater than its basis) of the property on December 31, 1976.

This fresh start rule effectively "grandfathered" existing investments at their value on December 31, 1976. The rationale for such treatment was expressed as follows:

> "A multitude of taxpayers will have relied on existing law to their detriment if the carryover basis is enacted. Thousands of investors have already made investment decisions and have relinquished certain financial advantages in reliance on present law. Thus [without a fresh start rule] the carryover basis provision will of necessity be retroactive in its effect and as such is unquestionably unfair."[3/]

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[1/] Pub. L. 94-455, §2005 (1976). The carryover basis provisions were repealed in 1980 without ever having taken effect. Pub. L. 96-223, §401 (1980).

[2/] H.R. 14844, 94th Cong., 2d Sess. §6(a)(2) (1976).

[3/] H. Rept 94-1380, 94th Cong., 2d Sess. 179 (1976) (Supplemental Views of Representatives Burleson, Waggonner, Pickle, Martin and Ketchum).

2. Gain from Certain Sales or Exchanges of Stock in Certain Foreign Corporations

Section 1248 provides that when a U.S. shareholder of a controlled foreign corporation (CFC) sells or exchanges the stock of the CFC, or receives a redemption or liquidating distribution, he must treat as ordinary income the gain recognized on the sale or exchange to the extent of the earnings and profits of the foreign corporation accumulated in taxable years beginning after December 31, 1962.

As originally proposed, gain would have been recognized to the extent of earnings and profits accumulated since February 28, 1913.[4] However, in comments on this proposal, several witnesses, including the New York Bar Association, argued that this was potentially discriminatory and that under the proposal, gains would be taxed as ordinary income "to the extent of earnings and profits accumulated during the entire forty-nine years that the Federal income tax law has been in effect."[5]

As a result of this and other similar arguments, Congress limited the operation of section 1248 as enacted to earnings and profits of the foreign corporation accumulated after December 31, 1962. This rule effectively "grandfathered" earnings and profits from investments before 1963.

3. Transitional rules for recapture of foreign losses.

In determining the effective date for the foreign loss recapture provisions, section 1032(c)(4) of the Tax Reform Act of 1976 provided that, with

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[4]H.R. 10650, 87th Cong., 2d Sess. §16 (1962).

[5]Hearings on H.R. 10650 Before the Committee on Finance, U.S. Senate, 87th Cong., 2d Sess. 3806 (1976) (Statement of the New York Bar Association).

respect to certain losses from stock or indebtedness, a loss sustained on such stock or indebtedness after December 31, 1976, and in a taxable year beginning before January 1, 1979, need not be recaptured to the extent that there was on December 31, 1975, a deficit in earnings and profits in the corporation from which the loss arose. As originally enacted, the existence of a deficit was determined with reference to all taxable years of the corporation.

This provision was amended in the Revenue Act of 1978[6] to provide that the deficit in earnings and profits was to be calculated only with respect to earnings and profits accumulated in taxable years of the corporation beginning after December 31, 1962. Thus, the effect of the amendment is to "grandfather" all earnings and profits accumulated in taxable years prior to January 1, 1963.

4. Section 385 regulations.

Section 385 of the Code provides that the Treasury Department is authorized to prescribe "legislative" regulations classifying interests in a corporation as debt or as equity.

On March 24, 1980, Treasury published proposed regulations under section 385.[7] The application of the regulations is to be prospective only. The regulations will apply only to corporate instruments issued after December 31, 1980.[8] Thus, corporate instruments created before January 1, 1981, will not be affected by the regulations.

5. Dividends.

Dividends are defined in Code section 316(a) to include distributions by a corporation out of its

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[6] Pub. L. 95-600 §701(u)(7)(A), (1978).

[7] 45 Fed. Reg. 18957 (March 24, 1980).

[8] *Id.* at 18963, proposed §1.385-1(a).

earnings and profits accumulated after February 28, 1913.

This cut-off date corresponds with the effective date of the first general income tax law. The provision "grandfathers" earnings and profits accumulated prior to March 1, 1913, whenever such earnings and profits are distributed.

6. Foreign trusts with U.S. beneficiary.

Section 679 of the Code provides that U.S. persons who transfer money or other property to foreign trusts are taxed on the annual income of the trust if there is a U.S. beneficiary of the trust.

This section was added by the Tax Reform Act of 1976 and applies to all foreign trusts created after May 21, 1974.[9/] The effect of this provision is that trusts created before May 21, 1974, in reliance on tax provisions of the prior law are not affected by the legislative changes made in 1976.

7. Powers of Appointment

Code section 2041 provides that the value of a gross estate for Federal estate tax purposes includes the value of property with respect to which the decedent has a power of appointment. The Code provides that the value of property subject to a power created on or before October 21, 1942, is included in the value of the decedent's gross estate only if the decedent actually exercised the power.[10/] However, the value of property subject to a power created after October 21, 1942, is included in the decedent's estate whether or not the decedent exercised the power.[11/]

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9/Pub. L. 94-455, §1013 (1976).

10/§2041(a)(1).

11/§2041(a)(2).

In rationalizing this "grandfather" treatment of powers created on or before October 21, 1942, the Congressional committee reports stated:

> "The prior law, taxing only the exercise of general powers, had been in force for nearly 25 years. In 1942 there were in existence a great many powers which had been created years before, in reliance on the law as it then existed."12/

8. Bad Debts

Section 166 of the Code was amended in 1976 to provide that a payment in discharge of an obligation as a guarantor of a noncorporate debt could no longer be deductible as a business loss against ordinary income, but must be treated as a nonbusiness loss deductible as a short-term capital loss.13/

This amendment was effective for taxable years beginning after 1975 "in connection with guaranties made after that date."14/ Thus, guaranties made before December 31, 1975, were not affected by the amended law.

9. Basis of Property Acquired by Gift

The basis of property acquired by gift prior to January 1, 1921, is the fair market value of the property at the time of acquisition.15/ The basis of property acquired by gift after December 31,

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12/H. Rept. No. 327, 82d Cong., 1st Sess. 3 (1951); see also S. Rept. 382, 82d Cong. 1st Sess. 2 (1951).

13/Pub. L. 94-455, §605 (1976).

14/*Id.* at §605(c).

15/§1015(c).

1921, is the basis of the property in the hands of the donor.[16]

The effect of these two rules is to "grandfather" the basis of gifts made prior to the Revenue Act of 1921, when the carryover basis provision was adopted.[17]

10. Transfers with Retained Life Interest

Section 2036 of the Code provides that the value of a decedent's gross estate for Federal estate tax purposes includes the value of property which the decedent has transferred at any time prior to his death, if he had retained an interest in the property for his life.

This section does not apply to transfers made before March 4, 1931. The effect of this provision is to "grandfather" transfers made before the amended law[18] in reliance on the existing law.

11. Revocable Transfers

Section 2038 of the Code provides that the value of a decedent's gross estate for Federal estate tax purposes includes the value of property transferred by the decedent if the decedent possessed at the time of his death the power to alter, amend, or terminate the transferee's enjoyment of the property.

The value of property transferred after June 22, 1936, must be included in the value of a decedent's gross estate if the decedent possessed the requisite power, regardless of when or from what

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16/§1015(a).

17/Pub. L. 98, §202(a) (1921).

18/Joint Resolution 131, 71st Cong., 1st Sess. (1931) (approved March 3, 1931).

source this power was acquired.[19] Transfers made on or before June 22, 1936, are included only if the power was reserved at the time of the transfer.[20] The effect of the two provisions is that transfers made before the effective date of the charge in law[21] in reliance on the tax provisions of the old law continue to be subject to the provisions of the former law.

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[19]/§2038(a)(1).

[20]/Regs. §20.2038-1(c)

[21]/Pub. L. 740, §805 (1936).

Senator BYRD. The committee would like to get the views of the Treasury Department on this legislation.

Who will be speaking for Treasury on this?

## STATEMENT OF H. DAVID ROSENBLOOM, INTERNATIONAL TAX COUNSEL, DEPARTMENT OF TREASURY, ACCOMPANIED BY STEVEN HANNES, THE ASSOCIATE INTERNATIONAL TAX COUNSEL

Mr. ROSENBLOOM. I will, Mr. Chairman.

I am H. David Rosenbloom, the International Tax Counsel with the Treasury Department, and on my left is Steven Hannes, the Associate International Tax Counsel. On this bill, we will be speaking for the Treasury Department.

Senator BYRD. You may proceed.

Mr. ROSENBLOOM. Thank you very much, Mr. Chairman.

I have a prepared statement which I would request permission to submit for the record.

Senator BYRD. It will be placed in the record.

Mr. ROSENBLOOM. Thank you, Mr. Chairman.

I would like to summarize as briefly as possible our position toward S. 2484, which we oppose. The issue presented is somewhat technical, but it can be viewed as follows: U.S. tax laws establish a fundamental difference between U.S. source income and foreign source income. The difference is that foreign source income is susceptible of being shielded from U.S. taxation by the foreign tax credit.

The differentiation between U.S. source income and foreign source income breaks down by reason of another principle in our law, which is the annual accounting concept. At the end of given annual accounting period, it is possible to have losses from foreign sources which under our rules would reduce U.S. source income, and then in a subsequent year to have foreign income which is completely shielded from U.S. taxation by the foreign tax credit.

It is in this sense that section 904 is aimed at a problem of double dipping. The taxpayer in year 1 has the benefit of a foreign loss offsetting U.S. source income, and in a second year, when

foreign source income is earned, there is no U.S. tax revenue because that income is offset by the foreign tax credit.

Section 904(f), which was enacted in 1976, responds to this problem by, in effect, restoring the losses that were taken against U.S. source income to their proper place on the foreign side of the ledger. It does this by recapturing the foreign source loss in a subsequent year when foreign income is earned. That foreign income is recharacterized as U.S. income to make up for the fact that in the prior year a foreign loss shielded U.S. income from taxation.

In short, section 904(f) is a sound policy statement by the Congress which was taken with all deliberate action in 1976. It is particularly sound in light of other action that was taken in 1976, when Congress considered what the appropriate limitation should be with respect to the foreign tax credit.

In that year, Congress repealed the per country limitation on the foreign tax credit and provided an overall limitation for all taxpayers. Under the overall limitation, all income, losses, and taxes having to do with foreign source operations are lumped together. In effect, our law takes the position that the world is divided into the United States on the one hand and the rest of the world en masse on the other.

Thus, under the overall limitation, foreign taxes from one country can offset U.S. tax liability with respect to income earned in another country, and similarly, foreign losses in one country can offset income earned in another country. In effect, once you have the overall limitation in the law, section 904(f) becomes more important than ever, because, as the cases being considered today illustrate, there are many circumstances in which a termination loss can be encountered in a particular country while foreign income continues to be earned in other countries.

Given the theory of the overall limitation, that the rest of the world is lumped together, the fact that a company has terminated operations in one particular country is, in effect, irrelevant.

As I said, Congress repealed the overall limitation in 1976.

Now, the issue before us today really goes, in the case of two of the taxpayers, Nabisco and Sealed Power, to moving the effective date with respct to the 901(f) rule established in 1976. With respect to Champion, which is asking for a 10-year ongoing transitional period, I think we are confronted with the issue of whether section 904(f) should be repealed, because I think the Champion position would have that effect for a substantial number of people and for a substantial period of time.

I also think that the revenue cost of these measures is quite substantial. My statement takes the position that it is over $10 million. Rough calculations based on statements made in this committee today would suggest that doubling that figure would probably be on the conservative side.

So, substantively, we have a problem with the relief that is being requested in S. 2484. Moreover, this relief is retroactive legislation, changing an effective date that was deliberately considered by Congress in 1976, in which consideration these taxpayers participated. There is specific relief in the law now in favor of these

taxpayers, and we are being asked 4 years later to come back and undo the specific relief that was put in the law in 1976.

This position has been considered by Congress in 1978 and was rejected by Congress in 1978. Furthermore, the relief that is being requested is unfair to the next case, and there will be next cases. There will be cases just beyond the dates that are sought in this bill.

Congress made a decision in 1976, Mr. Chairman. It considered the trasitional period deliberately. It provided rules which were carefully thought out and from which all of these taxpayers have benefited substantially, and we think that it is not appropriate or necessary to extend the statute, or, for that matter, to effect its pro tanto repeal.

Thank you, Mr. Chairman. That concludes my summary of our position. I would be happy to answer any questions you may have.

Senator BYRD. Mr. Rosenbloom, in regard to the reasonableness of the trasition period, I don't believe you have commented on that.

Mr. ROSENBLOOM. Yes, Mr. Chairman. One point that I think was not clearly stated in the discussion of the panel is that there were two relevant transition periods provided in 1976. One went through 1976 for termination. The other, however, went through 1978, and pursuant to the second provision, which was specifically requested by one of the taxpayers here, and which was specifically provided for its case, that taxpayer has reaped very substantial transition benefits.

I think we heard today that the transition benefits were on the order of $30 million already pocketed, in effect, and we are talking about, according to that taxpayer, a lesser amount today.

I might add parenthetically, Mr. Chairman, that our own computations of the amount at issue with respect to that taxpayer would suggest that the amount involved here is somewhat more than $2 million, but I obviously do not have access to the full figures on that.

Senator BYRD. The taxpayer has already benefited to the extent of $30 million?

Mr. ROSENBLOOM. Yes, sir. I think that is what they said. My statement doesn't say that, but that is what I understood them to say.

Senator BYRD. That is correct. That is my understanding.

Well, I think Nabisco said that it was given only 6 months,

Mr. ROSENBLOOM. No. Mr. Chairman, the second effective date, which is regularly forgotten in the discussion, extended through 1978, and it is pursuant to that second transitional rule that Nabisco has already reaped $30 million in benefits.

Senator BYRD. Well, it has had what period of time in the form of a transition period?

Mr. ROSENBLOOM. It had from October 1976 to December 31, 1978. And it has used that privilege. It has taken advantage of it.

Senator BYRD. It had a little over a year, then.

Mr. ROSENBLOOM. No, I think a little over 2 years.

Senator BYRD. Yes, 2 years. You are right.

Senator Packwood?

Senator PACKWOOD. No questions, Mr. Chairman.

Senator BYRD. Thank you, gentlemen.

Mr. ROSENBLOOM. Thank you very much.

[The prepared statement of Mr. Rosenbloom follows:]

FOR RELEASE UPON DELIVERY
9:00 a.m. DST
May 30, 1980

STATEMENT OF H. DAVID ROSENBLOOM
INTERNATIONAL TAX COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE SENATE FINANCE SUBCOMMITTEE
ON TAXATION AND DEBT MANAGEMENT

Mr. Chairmen and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on S. 2484.

S. 2484 is special interest legislation designed to change retroactively the effective date rules governing an important provision in the Tax Reform Act of 1976. The Treasury opposes this bill.

In the 1976 legislation Congress addressed the question of "double dipping" in regard to foreign losses: claiming the benefit of such losses as a reduction of U.S. source income in one year and claiming a second benefit--the foreign tax credit--to shelter foreign income from U.S. taxation in a subsequent year. Congress added a provision to the Internal Revenue Code (section 904(f)) which requires that when a foreign loss reduces U.S. tax on U.S. source income, the loss is recaptured when the taxpayer subsequently derives income abroad. This recapture rule is designed to prevent "double dipping."

The recapture rule operates in the context of the overall limitation on the foreign tax credit which was also considered by Congress in 1976. Under that limitation, losses and gains and foreign income taxes from all foreign countries are grouped together in computing the allowable credit. In 1976, Congress repealed the election to use a per-country limitation.

The recapture provision generally applies to losses sustained in taxable years beginning after December 31, 1975. Thus, a loss sustained in a foreign operation in 1975 would not be subject to recapture, whereas the same loss sustained in 1976 would be. An exception to the general effective date was provided where a U.S. 10 percent shareholder of a

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foreign corporation sells or otherwise disposes of the stock of such corporation prior to 1977 and the stock was substantially worthless because of a loss sustained in the five taxable years beginning prior to 1976. A second exception to the general effective date was provided if the shareholder's loss on its investment was sustained after 1976 but prior to 1979; this exception, however, allows the shareholder to avoid the recapture provisions only to the extent of the subsidiary's pre-1976 losses (i.e., its pre-1976 deficit in earnings and profits). We understand that the second exception was added to the 1976 legislation at the urging of the Nabisco Corporation.

That same taxpayer now argues that the relief given it in 1976 is not adequate. The Nabisco foreign subsidiary continued to operate and additional deficits in earnings and profits were sustained by it in 1976, 1977 and 1978. Another taxpayer, Sealed Power Corporation, requests that the exception to the effective date be delayed so that it too can obtain additional benefits. A third taxpayer, Champion International Corporation, apparently seeks a ten-year transitional rule.

S. 2484 and H.R. 6117, the bill introduced on behalf of Nabisco, are intended to provide additional relief from the effective date of section 904(f). The bills do not, however, amend the special effective date exception originally enacted on behalf of Nabisco. Rather, the bills would amend the first special effective date rule, carrying the already delayed effective date of section 904(f) from January 1, 1977 to January 1, 1979. This additional delay would apply only if "substantially all of the employees" of the foreign subsidiary are discharged prior to April 15, 1977 (S. 2484) or December 31, 1977 (H.R. 6117).

These bills are objectionable. The special effective date provisions already in the statute provide substantial relief for losses sustained economically prior to 1976 but recognized after 1975. And Nabisco and Sealed Power have already obtained relief pursuant to these provisions.

Moreover, S. 2484 fundamentally alters the original purpose of the effective date provisions. S. 2484 does not merely extend the period of time for disposition of a subsidiary without a recapture of pre-1976 losses. S. 2484 would allow losses recognized in 1976, 1977, or 1978 to be shielded from the recapture rule. In so doing S. 2484 effectively resurrects, at least for these particular taxpayers, the per-country limitation which Congress repealed in 1976.

We have heard arguments that this legislation is technical in nature and necessary to carry out the intention of Congress in 1976. These claims were made and rejected in the past in connection with the Technical Corrections Act of 1978. We believe such claims should be rejected again. The Tax Reform Act of 1976 has precise, carefully drafted transition rules for section 904(f). These rules were not accidental or haphazard; they operate as intended and excuse the recapture of losses only if losses were sustained by a foreign subsidiary by 1975 and where the subsidiary is disposed of by 1976 or, in certain cases, by 1979. There can be no element of surprise or misunderstanding about these provisions. A U.S. taxpayer that chose to continue the operations of a foreign subsidiary after 1975 was on notice with respect to the possible effect of section 904(f) recapture with respect to its investment in that subsidiary.

As mentioned earlier one taxpayer goes so far as to request that the effective date of section 904(f) be delayed until 1986, apparently on the theory that it is entitled to the tax consequences of U.S. law as in effect at the time of its foreign investment. We wonder whether this taxpayer would also request that it should bear U.S. tax at the then prevailing rate of 48 percent.

In 1976 Congress did not intend to provide a benefit for losses sustained after 1975 or to "grandfather" indefinitely all existing investments. We do not now believe that it is either necessary or advisable to change retroactively the thrust of the precise effective date provisions of section 904(f) for the benefit of a few taxpayers.

We estimate that S. 2484 will decrease government revenues by over $10 million, with a benefit of from $5 to $10 million going to one taxpayer.

Senator BYRD. Mr. Samuels and Mr. Shakow, do you want to comment on this legislation?

Mr. SAMUELS. No, Mr. Chairman.

Senator BYRD. What do you want to comment on?

Mr. SAMUELS. I would like to comment on five of the bills that are to be considered today, and Mr. Shakow will comment on the bankruptcy legislation.

Senator BYRD. Very well. Proceed.

## STATEMENT OF JOHN M. SAMUELS, TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. SAMUELS. Thank you, Mr. Chairman.

I am John M. Samuels, Tax Legislative Counsel of the Treasury Department.

I have a prepared statement on five of the bills that I would ask be submitted in full for the record.

Senator BYRD. It will be placed in the record.

Mr. SAMUELS. In view of the limited time and number of witnesses scheduled to testify this morning, I would like to address orally today only the two bills that would permit tax-exempt financing for railroads, and then I would be delighted to try to answer any questions you might have about any of the other bills.

Senator BYRD. Now, that is S. 2486 and S. 2526. Is that correct?

Mr. SAMUELS. Yes, Mr. Chairman.

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S. 2486 would allow the issuance of tax-exempt industrial development bonds to finance railroad rehabilitation and the acquisition of railroad rights-of-way, and S. 2526 would permit tax-exempt industrial development bond financing for all railroad equipment, including railroad rolling stock.

I am sure it will be no surprise to you, Mr. Chairman, to learn that the Treasury Department is strongly opposed to both of these bills.

Senator BYRD. I assume the same would apply to S. 2548, Industrial Development Bonds for Refinancing Certain Docks and Wharves?

Mr. SAMUELS. We are opposed to that bill in its present form. However, we believe that bill raises a policy question in our regulations that we feel——

Senator BYRD. You will comment on that separately?

Mr. SAMUELS. Yes, I will. As you know, Mr. Chairman, and Senator Packwood, since the adoption of the Federal income tax in 1913, interest on State and local governmental obligations has generally been exempt from Federal income tax. This exemption represents a recognition of the independent sovereignty of States and their instrumentalities under our Federal system, as well as the desire to enhance the strength of State and local governments, the entities closest to the people, in solving local problems.

The rationale for this tax exemption applies to all State and local government borrowings for public purposes. However, it does not apply to the kind of industrial development railroad bonds that would be issued under either of these bills, because these bonds would be obligations of State and local governments only in the most purely formalistic sense.

In substance, they would be obligations issued by the railroads themselves. For example, these bills would permit a municipality to issue bonds and then turn the bond proceeds over to a railroad. The railroad would agree to repay the municipality the precise amount of money necessary to make the interest and principal payments on the bond.

The municipality would assume no obligation, either direct or indirect, for the payment of principal or interest on these bonds, and the bond purchasers therefore would look solely to the credit of the railroad for payment. Indeed, in frank recognition of the economic reality of these transactions, State courts would generally not treat these bonds as obligations of the issuing government for purposes of constitutional debt limits or other similar state restrictions on municipal borrowing.

Because these bonds would in no meaningful sense be obligations to state and local governments, but rather would be railroad obligations, the only reason for extending tax exemption to them is to provide a subsidy to the railroads in the form of a lower tax-exempt interest rate.

In addition to opening up the tax-exempt market to increased private borrowing, we believe the use of these tax-exempt bonds to provide further subsidies to the railroads would be wasteful, inefficient, and excessively expensive. They would be expensive because the lower interest rates that would be passed on to the railroads

would be possible only because the interest on the bonds in the hands of the bondholders is exempt from tax.

Therefore, the full benefit that would be derived by the railroads is achieved only at the expense of the loss of Federal revenues, and this loss of revenues would be quite substantial. We estimate that the revenue loss attributable to S. 2486, the bill that would permit tax-exempt financing for railroad rehabilitation, would be $562 million for the period from 1981 through 1985, and in the longer run, would be $1 billion every year. The revenue loss from S. 2526, the bill that would permit tax-exempt financing of all rail transportation equipment, would be approximately $4 billion for the same 5-year period, and in the long run, would be $2.7 billion every year.

These losses would be in addition to the substantial direct Federal outlays for railroads, which amounted to $2.3 billion in fiscal year 1980. These losses would be completely outside the budget process. They would require no authorizations, no appropriations. In short, they would be open ended and uncontrollable.

In this time of inflation, when we face an absolute necessity to reduce budget deficits, uncontrollable losses of this magnitude are simply unacceptable.

In addition to being expensive, these bonds are inefficient and uneconomic. The cost to the Federal Government in lost tax revenues would substantially exceed the financial benefits that the railroads would realize. We estimate that the Treasury would lose at least $1.33 of revenue for every dollar of benefit provided to the railroad.

These railroad bonds would also compete in the municipal market with bonds issued by State and local governments for traditional governmental purposes, such as the construction of schools, firehouses, city halls, and other essential governmental projects.

Senator BYRD. Have such bonds been issued in the past?

Mr. SAMUELS. Railroad bonds have not been issued in the past, but before 1968, a number of industrial revenue bonds were issued, and in 1968, for the reasons I have outlined today, Congress recognized that industrial development bond financing is a fundamentally unsound way to provide a subsidy. Nothing has changed since 1968. They still represent a wasteful, inefficient——

Senator BYRD. I understand that, but that is not my question. My question is, have other railroad industrial development bonds been issued?

Mr. SAMUELS. No, Senator, not to our knowledge, or if they have, they would be taxable.

None of what I have said this morning or anything that is contained in the written statement should be interpreted to mean that the administration is not aware of and being responsive to the rail situation in the Midwest that has spawned these two proposals. We believe that the Federal Government and State governments both have an important role to play in the restructuring of the bankrupt Milwaukee and Rock Island Railroads. However, we do not believe that this Federal assistance should be provided through the use of tax-exempt industrial development bonds.

As I mentioned earlier, in no sense can these bonds be deemed to be State aid to the railroads. The States are not liable, and the States are not spending any money.

Senator BYRD. Now, at this time, do you want to comment on 2584, or do you want to do that later?

Mr. SAMUELS. As you wish, Mr. Chairman.

Senator BYRD. All right. Go ahead.

Mr. SAMUELS. We do oppose 2528, as well, in its present form. It is a special interest bill for the Tampa Port Authority. I think it is important to understand the transaction to understand the problem. It is rather technical.

Basically, the current law permits tax-exempt industrial development bonds to be issued to provide certain kinds of facilities; for example, docks and wharves, but only to provide those facilities. However, the current Treasury regulations do not allow an owner of dock or wharf to refinance that facility that with industrial development bonds.

For example, if there is already an existing dock or wharf, the current Treasury regulations don't permit the owner of that dock or wharf to go out, if he can talk a port authority into it, and borrow $50 million at tax-exempt rates and then use that money for a purpose other than providing a dock or wharf.

However, the restriction in the regulations that prevents such refinancings has two rather anomalous effects. It prevents a substantial rehabilitation of a dock or wharf. Now, in one sense, a substantial rehabilitation of an already exempt facility could be considered to be the providing of a new facility, or, at least very close, to providing a new facility; perhaps tax-exempt bonds should be issued in these cases if it is a truly substantial rehabilitation.

On the other hand, the current regulations would permit the owner of that dock or wharf to sell it to a third party in a sale financed with tax-exempt bonds, even when there is no new construction so that no new dock or wharf is being provided.

Senator BYRD. That is the part you object to, I assume.

Mr. SAMUELS. No—well, that is the part of our regulations we are reexamining.

Senator BYRD. Well, that is not involved in the bill, then.

Mr. SAMUELS. We have met with the proponents of the bill, and do not yet know enough of the facts about the acquisition of the existing facility and the renovation. Now, if the renovation of the facility that is being acquired is sufficiently substantial, I think that perhaps it would be appropriate for us to reexamine our regulations, which we are currently doing, and that reexamination perhaps, depending on the facts, would permit that renovation to be financed with tax-exempt bonds.

On the other hand, if it is a mere acquisition of an existing facility, we see no policy reason for allowing tax-exempt bonds to——

Senator BYRD. Well, does the legislation get into that aspect of it?

Mr. SAMUELS. No, it doesn't. The legislation really was a—what we at the Treasury sometimes refer to as describing a particular hippopotamus. It describes just the particular case, and says tax-exempt bonds can be issued——

Senator BYRD. Well, I am having a difficult time understanding whether you favor it or oppose it.

Mr. SAMUELS. We oppose it in its current form. However, depending on the facts we think that working with our regulations and with the proponents of the bill, we may be able to accomplish their objectives. However, we do oppose the enactment of this legislation, frankly, because we would be unable to hold—it would continue to permit, as you pointed out——

Senator BYRD. That is your own regulation that you are talking about.

Mr. SAMUELS. Well, we are examining——

Senator BYRD. You disagree with your regulation. Is that it?

Mr. SAMUELS. Yes, we do. Or at least we are re-examining it. I might point out the regulation was drafted well before this Treasury arrived in Washington.

Senator BYRD. I might say at this point that Senator Stone and Senator Chiles are very much interested in this legislation. They have discussed it with me, and Senator Stone had planned to be here today, until the development of the death of a very close associate prevented him from being here, and Senator Chiles is in the same situation, or else both of them would have been here in regard to this legislation.

Thank you very much.

Now, Mr. Shakow?

## STATEMENT OF DAVID SHAKOW, ASSOCIATE TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. SHAKOW. Yes, Mr. Chairman. I am David Shakow, Associate Tax Legislative Counsel for the Treasury. I am appearing to present the Treasury's views on H.R. 5043, which is the Bankruptcy Tax Act.

With your permission, I would like my whole prepared statement to be included in the record.

Senator BYRD. Yes; it will be.

Mr. SHAKOW. I will try to summarize briefly here.

Senator BYRD. Good.

Mr. SHAKOW. H.R. 5043 revises the provisions of Federal income tax law dealing with taxpayers in bankruptcy to make them consistent with the rules of the new bankruptcy law which went into effect on October 1 of last year.

This bill has been developed over the course of a number of years, during which it was subject to substantial comment from outside practitioners as well as the Treasury and the Justice Department and the Internal Revenue Service, and it has been before Congress in various forms for more than 2 years.

Like any document that must take into account different and sometimes conflicting considerations because both bankruptcy policy and tax policy must be accommodated in its provisions, H.R. 5043 will not completely satisfy everyone. The Treasury, for example, would have liked to see the rules in the bill made more consistent with tax policy.

However, we believe it is very important to have the bill passed expeditiously, so that taxpayers in bankruptcy and practitioners who advise them can plan their transactions with knowledge of what the consequences of those transactions will be.

Accordingly, my prepared statement does not suggest any changes in the bill, because we think that treating it expeditiously is the most important thing to be done at this time.

Senator BYRD. Do you support the bill as it is?

Mr. SHAKOW. Yes, we do.

The bill covers a number of significant areas, and I would like to review in summary fashion a few of the more significant changes that are made by the bill.

The bill attempts to remedy some of the anomalies under present law in the treatment of forgiveness of indebtedness income, without accepting across the board the view that is the Supreme Court's position, which is that forgiveness of indebtedness is always income like any other income.

Thus, even for a taxspayer outside bankruptcy, the bill will generally continue the rule of current law that allows taxpayers to reduce the basis of its assets rather than recognize income. However, the basis reduction that will be permitted under the bill will now be restricted to depreciable property, so that no reduction will be allowed where reducing the basis of an asset can have the practical effect of no tax being paid on forgiveness income.

In other words, if a corporation owed $100, and because interest rates had gone up, it was allowed to pay off the debt with $80, it would have received the $100, paid out $80, and it would have $20 of income. The current law would say you can reduce the basis of any of your assets as a means of somehow spreading forward that $20 of income, but in a substantial number of cases the corporation would be permitted, for example, to reduce the basis of the land on which its plant is located.

Now, the land is not depreciable property, so that even if its basis is lower, there is no depreciation to be taken, so it has no effect on income, and the corporation has no intention of selling the land on which its plant is located. The net effect of applying that rule is that the $20 of income never gets taxed. The present bill says you must reduce the basis of depreciable assets, so that your depreciation deductions in the future will be lower, and therefore your income ultimately will reflect that $20 of forgiveness.

Now, in the case of a taxpayer in bankruptcy, or an insolvent taxpayer, the bill provides an even more lenient rule. Such a taxpayer is never required to recognize income when debt is forgiven. Instead, the taxpayer is required to reduce any of its favorable tax attributes. If it had a tax credit which it hadn't been able to use, or a loss, or a capital loss, or the basis of its assets, it can reduce those, and a floor is placed on that below which the attrributes can't be reduced.

Any additional forgiveness is totally forgotten for tax purposes. This essentially will permit the taxpayer to compete fairly thereafter with other taxpayers who have not gone through bankruptcy without saddling the bankrupt business with potential tax liabilities that will make it difficult for it to rehabilitate itself economically in the future.

Now, one other significant aspect of the Bankruptcy Tax Act involves the treatment of stock that is issued in exchange for a corporation's debt. Under current law, a corporation generally recognizes no foregiveness income when stock is used to satisfy a debt.

Let's take the case I used before. The corporation had $100 of debt, and if it, let's say, issued stock for $80, and took the $80 and paid off the debt, there is no question that there would be $20 of income. If instead it took stock worth $80 and gave it to the creditor, current law would say, no taxable income at all.

On the creditor's side, though, there is no question, if the creditor was owed $100, and it received $80 for that $100 debt, whether it was $80 of cash or $80 of stock, a normal trade creditor would have a loss in that case. So, the bill says, in general, in the cases where a creditor has a loss, the corporation should have a matching gain. In other cases where the creditor, for example, owns a bond—like a trade bond, where, when it receives stock in exchange for the bond, the tax law says no income at all, in that case, the corporation also will not have income.

So, the bill just tries to match the consequences to the creditor with the consequences to the debtor in that situation.

The bill also clarifies a large number of issues involving the treatment of individuals in bankruptcy, and my statement covers merely some of the particular provisions that are treated in the bill.

Basically, for most individual taxpayers, it tries to provide rules that will allow those taxpayers to disregard any special tax rules in bankruptcy, so that the taxpayer can just continue to file its tax returns without having to worry about what the niceties of tax law are as they apply in bankruptcy.

An individual who has a complicated business picture is given the flexibility to arrange his affairs under the law in a way that when he goes into bankruptcy, he really puts a stop to anything that has happened before. Everying before that is a concern of his bankruptcy estate, and he starts again with his fresh start thereafter. The bill also has a number of provisions dealing with corporate reorganizations, and basically just tries to adapt bankruptcy reorganization rules to the general flexible reorganization rules that are provided in the code, and there are a number of other corporate provisions and provisions dealing with tax procedure that are covered in the bill, which is rather long and in most cases simply technical and conforming, and I think generally helpful for taxpayers who will be going into bankruptcy courts trying to decide issues in this area.

Neither my written testimony nor my oral testimony has covered nearly all the provisions of the bill. Many of these, as I say, are rather technical, but I would like to stress again the importance of dealing with the bill swiftly and favorably.

Taxpayers going into bankruptcy should know what the tax consequences of their subsequent actions will be.

I would be pleased to answer any questions you may have.

Senator BYRD. Thank you. I have just one question. You mentioned two examples of $100 and $80. Now, the first example that you mentioned, mentioning the $80, you have mentioned an increase in interest rates. Now, I didn't catch the connection.

Mr. SHAKOW. I am sorry. I was simply trying to suggest one of the reasons that you would have forgiveness of indebtedness. In other words, when a corporation issues a bond at 6 percent and then interest rates go to 12, if the bond is a long-term bond, it is

going to trade in the marketplace at well below the $100 it was issued for. I was saying, for example, it might trade at $80.

Now, the Supreme Court case that is the basic case in this area said if the corporation goes out and buys this bond back for $80, having received $100 and having paid back $80, it has $20 of income. I was merely suggesting that as an example of a case where you would have forgiveness of indebtedness.

It may seem as if forgiveness of indebtedness only applies to taxpayers who are in financial difficulty, but in fact, particularly because of circumstances like this, there can be perfectly solvent corporations that will have what is considered under the tax law forgiveness of indebtedness, and that is one of the major——

Senator BYRD. Well, they had a loss, is what happened, isn't it?

Mr. SHAKOW. Well, the corporation had a gain. In other words, it had received $100 for issuing its debt, and then it paid back only $80 of that $100 in buying back the debt for $80, so it stayed with $20.

Now, the creditor has had a loss, and the creditor's loss is always recognized, and this bill doesn't deal with the creditors. And as I say, current law, just as an example, current law does recognize that if $80 of cash is used to satisfy that $100 debt, the corporation will have $20 of income. It is just a question of how it will be treated.

Senator BYRD. Thank you.

Senator Packwood?

Senator PACKWOOD. No questions, Mr. Chairman.

Senator BYRD. Thank you, gentlemen.

[The prepared statements of Messrs. Samuels and Shakow follow:]

For Release Upon Delivery
Expected at 9:00 a.m.

STATEMENT OF
JOHN M. SAMUELS
TAX LEGISLATIVE COUNSEL
BEFORE THE
SENATE FINANCE SUBCOMMITTEE
ON TAXATION AND DEBT MANAGEMENT

May 30, 1980

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on the following five bills: S. 2486, allowing tax exempt financing for railroad rehabilitation; S. 2526, allowing tax exempt financing for all railroad facilities; S. 2500, providing a tax credit for theatrical productions; S. 2503, providing a refundable credit for interest on certain agricultural loans, and S. 2548, permitting tax exempt financing for certain harbor improvements. These bills raise a number of significant issues of tax policy and we commend the Subcommittee for providing the opportunity to discuss these issues.

M-511

After setting out a summary of the position of the Treasury Department with respect to each bill, I will discuss each proposal in detail.

## Summary

S. 2486 would allow the issuance of tax exempt industrial development bonds to provide financing for railroad rehabilitation or the acquisition of land or rights-of-way in connection with such rehabilitation. The Treasury Department is opposed to S. 2486.

S. 2526 would permit the issuance of tax exempt industrial development bonds to provide all facilities, including rolling stock, for the furnishing of rail transportation. The Treasury Department is also opposed to S. 2526.

S. 2500 would allow a tax credit for the costs of certain theatrical productions. The Treasury Department opposes S. 2500.

S. 2503 would provide a refundable credit for interest in excess of 12 percent per annum on certain agricultural loans. The Treasury Department opposes S. 2503.

S. 2548 would permit tax exempt financing for the acquisition and rehabilitation of certain harbor improvements. The Treasury Department is opposed to S. 2548 in its present form.

## S. 2486 and S. 2526
## Tax Exempt Bonds for Railroads

S. 2486 would permit the issuance of tax exempt industrial development bonds to provide financing for railroad rehabilitation or the acquisition of land or rights-of-way in connection with such rehabilitation. For this purpose, the term "railroad rehabilitation" is broadly defined to include the acquisition, construction, reconstruction, or erection of any roadbed, track, trestle, depot, switching and signaling equipment, or any related equipment. Rolling stock, however, is expressly excluded.

S. 2526 would permit the issuance of tax exempt industrial development bonds to provide all facilities, including rolling stock, for the furnishing of rail transportation.

The Administration is aware of and has been responsive to the rail situation in the Midwest which has spawned these proposals. Both the federal government and the states have roles to play in the restructuring of the bankrupt Milwaukee and Rock Island railroads, but we believe the Congress and the states should focus on more direct and efficient means of accomplishing this objective than the use of tax exempt industrial revenue bonds.

The Fiscal Year 1980 supplemental appropriation currently pending in the House contains a rescission of $75 million in rail restructuring funds which would severely compromise the ability to maintain and improve rail service in the Midwest. These funds could be restored.

Moreover, the states have a number of available mechanisms for providing true state assistance to railroads. For example, states can and do make direct appropriations, either from general revenue or from dedicated taxes, to assist in the acquisition and rehabilitation and operation of rail lines. States also have available the Department of Transportation's State Assistance Program, in which shippers and local communities often provide matching funds from surcharges on the rail cars they use or from other sources. At least one state has issued general obligation bonds in part to provide grants to continue rail service. In those states which have constitutional blocks to state funding of rail facilities, the Department of Transportation has supported creation of port authorities for the purpose of receiving and spending public funds

The Treasury does not dispute the legitimacy of the need to provide public assistance for rail restructuring or preservation of rail service. However, it does oppose using tax exempt financing to provide this assistance and thus opposes both S. 2486 and S. 2526. These bills would open the tax exempt market to increased private borrowing. Further, the bills are wasteful, inefficient and overly expensive.

Background

An industrial development bond is a debt obligation issued under the name of a state or local government for the benefit of a private industrial corporation. A typical industrial development bond financing involves a municipality which issues bonds and uses the proceeds to construct a facility; the facility is then "leased" to a corporation for a rental set at the precise amount needed to make the interest and principal payments on the bonds. Characteristically, the bonds are revenue bonds payable only out of the rent; the municipality assumes no obligation, direct or indirect, for their payment. Thus, such bonds really represent obligations of a private corporation, but because the municipality places its name on the bonds, it claims and passes on the federal tax exemption.

In recognition of the economic reality of these transactions, state courts generally agree that these revenue bonds are not debts of the issuing governmental unit for purposes of applying state or local debt ceilings or similar restrictions on municipal borrowing. In some less prevalent situations a governmental unit will issue its general obligation bonds secured by the lease revenues, so that the municipality assumes a subordinate role as a guarantor of the corporate obligation. However, the lease revenues are regarded as the principal security behind the bonds and the use of general obligation bonds does not materially alter the abuses that flow from the transaction.

Prior to 1968, interest on industrial development bonds issued by state and local governments had been exempt from federal income taxation. The use of these bonds had been growing in importance as a mechanism by which state and local governments sought to attract plants to their communities. Through their use, these governments had been able to extend the tax exemption afforded to interest on their securities issued for public investment to interest on bonds issued for essentially private purposes. Of course, as many states and localities came to utilize this method, the competitive advantage was lost and the increased volume of tax exempt financing affected the interest cost of public issues. These

factors, and fear of increasing federal revenue losses as use of this method of financing long-term private debt expanded, led to the limits on industrial development bond financing included in the Revenue and Expenditure Control Act of 1968.

In the past few years, the volume of tax exempt bonds issued for non-governmental purposes -- principally for private residences, private hospitals, pollution control facilities, and various commercial and industrial purposes -- has increased sharply as a share of the tax exempt market. There are indications that this trend is likely to increase and with it the potential for abuse.

A study being conducted by the Congressional Budget Office shows the extent and degree of abuse. It appears that more than $7 billion of industrial development bonds were sold in 1979 to finance such projects as shopping centers, fast-food restaurants, pizza parlors, doctor's offices and even a massage parlor. In many cases, the industrial development bonds are nothing more than a conventional bank loan, rubber-stamped by a local authority. In fact, the borrowing arrangement is almost identical to a commercial loan, except for the official sanction of the industrial development authority. Often, the requisite approval is granted as a matter of routine. Under those circumstances, the authority cannot be said to exercise any independent judgment that the borrowing serves a public purpose.

Industrial Development Bonds are an Inefficient Method of Providing a Subsidy

In all cases the exemption from tax of interest on industrial development bonds is simply a federal subsidy to private corporations. The lower interest rates -- which are passed on to the private corporations in the form of lower rental charges -- are only possible because the interest in the hands of the bondholders is tax exempt. Therefore, the full benefit derived by private industry is achieved only at the expense of a loss of federal tax revenues. Thus, such obligations are in no real sense a vehicle for state aid. Instead, they represent a forced federal subsidy. The amount of the subsidy, the beneficiary of the subsidy, and the use to which the borrowed funds are put are not considered in any way by the federal government. The sole decision as to whether or not to benefit a private corporation rests with the various state and local governments, and since industrial revenue bond financing imposes no direct costs on the issuing

governmental units, there is no agency that has any effective interest in assessing the merits of extending federal tax benefits to any particular private corporate beneficiary.

In addition, industrial development bond financing represents a most inefficient and uneconomic means of subsidizing private industry. The cost to the federal government in lost tax revenues substantially exceeds the financial benefits that corporations realize through their ability to borrow funds at lower interest rates. This inefficiency is best illustrated by an example. When the yield on taxable securities is approximately 10 percent, the yield on tax exempt bonds of similar quality will be approximately 7 percent. This means that a borrower who has access to tax exempt financing is able to save thirty cents on each dollar of interest that would normally be paid. On the other hand, the average marginal tax bracket for holders of tax exempt securities is approximately 40 percent and, if the interest were not exempt, taxes would have been payable at that rate. This means that Treasury loses about forty cents for each dollar of interest paid on these bonds. In other words, the Treasury loses about $1.33 of revenue for each dollar of incentive provided by tax exempt borrowing. Moreover, the cost to the federal government will constantly increase as the volume of tax exempt bonds grows larger and interest rates for all tax exempt obligations rise in order to elicit more demand, particularly from relatively lower bracket taxpayers.

Cost to Federal, State, and Local Governments

Treasury estimates the revenue loss attributable to S. 2486 at $562 million for the period 1981-1985 and the revenue loss attributable to S. 2526 at $3.94 billion for the same period. In the longer run, we would stand to lose as much as $1 billion every year from S. 2486 and $2.7 billion every year from S. 2526 (expressed in 1985 dollars).

Revenue Loss Assuming
Passage of Either
S. 2486 or S. 2526

| Bill | FY 1981: | FY 1982: | FY 1983: | FY 1984: | FY 1985: |
|---|---|---|---|---|---|
| | ($millions) | | | | |
| S. 2486 | 34 | 64 | 107 | 154 | 203 |
| S. 2526 | 298 | 493 | 759 | 1043 | 1347 |

These revenue losses, also known as tax expenditures, are one type of indirect federal subsidy for railroads. To this must be added direct federal outlays for railroads which, for fiscal year 1980 alone amounted to $2.3 billion.1/ In this time of inflation, when we face an absolute necessity to reduce budget deficits, increasing federal subsidies in either form to railroads must be closely examined.

The Treasury also estimates that S. 2486 would bring $7.2 billion of obligations onto the tax exempt market during the period 1981-1985 and that S. 2526 would bring $39 billion of such bonds to the market in the same period. This additional volume of bonds would raise borrowing costs for all state and local governments and could squeeze some out of the market entirely.

Considerations of Tax Equity

Tax exempt bonds also raise serious questions of tax equity. The dollar loss in foregone revenues to the Treasury, as described above, is a dollar benefit to the wealthy investors who buy tax exempt bonds. If the ordinary working man has to pay taxes on his entire paycheck, it is hard to justify an incentive program which provides billions of dollars of tax free interest for the very wealthy.

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1/ The Budget of the United States, Fiscal Year 1981, 196

New Incentives For Rolling Stock Are Unnecessary

As indicated previously, S. 2526 permits tax exempt financing of railroad rolling stock. This rule rests on a belief that the current incentives for investment in such equipment are inadequate. The opposite appears to be true, however. Equipment leasing tax shelters involving railroad rolling stock are, according to reports, a very popular variety of investment.1/ In addition, there are some small rail lines whose principal business is the leasing of rolling stock at favorable rates.2/ Thus, the incentives provided under current law both through the tax system and otherwise seem to be quite adequate.

In any case, if the supply of rolling stock were inadequate and existing incentives were insufficient to supply a sufficient stock, the whole policy toward railroad rolling stock would have to be evaluated. To do otherwise would be to impose a patchwork of incentives, some through tax expenditures and some otherwise, that were totally unfocused. In particular, the efficacy of providing subsidies for railroads through the tax system would have to be carefully examined.

Distinctions Between Public and Private Borrowing

Since the adoption of the federal income tax in 1913, interest on state and local government obligations generally has been exempt from federal income tax. This exemption represents a recognition of the independent sovereignty of states and their instrumentalities under our federal system as well as the desire to enhance the strength of state and local governments, the entities closest to the people, in solving local problems.

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1/ Wall Street Journal, August 21, 1979, 6

2/ Wall Street Journal, August 6, 1979, 19

This rationale applies to all state and local governmental borrowings for public purposes. It does not apply to industrial development bonds, however, because they are merely obligations nominally issued by a state or local government to raise funds for private development.

The only reason for making industrial development bonds tax exempt is to provide a subsidy or incentive. This reason, which is the one underlying S. 2486 and S. 2526, is, for the reasons we have stated, fundamentally unsound. Tax exempt bonds such as those provided for in S. 2486 and S. 2526 have considerable drawbacks as a method of providing a subsidy or incentive. They are demonstrably inefficient and inequitable, and they damage the market for tax exempt bonds as a whole.

## S. 2500
## Tax Credits for Theatrical Productions

S. 2500 would allow a tax credit equal to 6 2/3 percent of the production costs incurred in the United States for the presentation of a dramatic work, such as a play, opera, or ballet, before a live audience. Production costs eligible for the credit would include the cost of equipment and supplies, and compensation for services performed by actors, directors, producers and other production personnel. Certain indirect production costs would also be eligible for the credit if at least 80 percent of the direct production costs were allocable to the United States. The proposed theatrical credit appears to be modeled after a similar credit allowed for the production costs of motion pictures.

The Treasury Department is opposed to S. 2500. We do not believe that a tax credit is an appropriate method for providing additional public subsidies to stage productions. Instead, in this time of special concern for control of the federal budget, we believe that any additional public support for the theatre should be provided directly through the regular appropriations process, so that the theatre would have to compete directly for funds with other programs of encouragement to the arts. Indeed, such direct aid is particularly appropriate in view of the existence of

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established, directly funded programs of public support to the theatre and other arts, with oversight by agencies and Congressional committees charged with the responsibility for fostering the arts.

For example, during the most recently completed fiscal year the National Endowment for the Arts expended approximately $20.2 million in support of stage productions, including theatre, opera and dance, and approximately $22.05 million is budgeted for these programs in the current fiscal year, a sum that does not take into account assistance provided by state and local agencies. Any additional assistance to such productions should be provided through an expansion of these existing programs.

While S. 2500 is couched in terms of an extension to theatrical productions of the investment credit now allowed for machinery and equipment, we believe such a characterization of the proposed theatrical credit is inapposite. The investment credit was enacted in 1962 for the express purpose of stimulating capital investment and the modernization and expansion of our industrial capacity. To achieve this goal, the investment credit was limited to durable equipment used in production processes. Then Secretary of the Treasury Douglas Dillon explained the reasons for limiting the credit to machinery and equipment in his testimony before the Senate Finance Committee:

> "Machinery and equipment expenditures -- the type of business capital expenditure which is basic to the creation of new products and which also makes the most direct contribution to cost-cutting, productivity and efficiency -- constitute a smaller percentage of the gross national product in the United States than in any major industrial nation in the world. In recent years we have devoted less than 6 percent of our GNP (less than 5 percent in 1961) to this type of vital capital outlay, only one-half the portion devoted to this purpose by West Germany, only three-fourths of that of the United Kingdom, and only about 60 percent as much as the combined average of the European members of the OECD. Even more significant is the fact that in the United States this percentage has recently been declining steadily, whereas it has been increasing in these other nations. . .

> "[T]he credit should be viewed primarily as a means of encouraging the modernization of industrial, mining, agricultural and other equipment, increasing the productivity of the American economy by adding to the quantity and quality of capital available per worker, and increasing the relative attractiveness of investment at home compared with investment abroad."

Thus, the investment credit today applies to trucks, office equipment, cash registers, power plants, stamping machinery, and other such durable capital equipment. However, it does not apply to many other kinds of assets that may also be regarded as productive, such as inventories, the development of new products and processes, works of art, and buildings, to name but a few. By targeting the investment credit on a limited class of productive assets, Congress has evidenced a special concern for expanding and modernizing the stock of producers' durable equipment as a means of improving the productivity and growth of the Nation's economy. Whatever the merits of providing additional subsidies to the theatre, doing so cannot be justified by likening theatrical productions to durable equipment.

To be sure, the proposed tax credit for theatrical productions would help to stimulate economic activity in the theatre industry. This could mean additional jobs in the theatre, additional demand for related goods and services, and additional entertainment for patrons of the arts. However, these effects are by no means unique to the theatre. Similar benefits to other industries would result from other measures of economic stimulus, whether narrowly targeted or broadly applied. In the final analysis, the issue boils down to how much, either in direct expenditures or foregone revenues, the federal government can afford at this time, and to what purposes those funds should be applied. We believe this to be a particularly inopportune time to make an open-ended commitment of budgetary resources in the form of tax credits to the theatre industry or, for that matter, to any specific sector of the economy.

The proponents of S. 2500 may contend that the proposed credit merely provides treatment for theatrical productions that is equivalent to that now accorded motion pictures. The same argument, however, can be made on behalf of any number of specific economic activities for which tax credits are not now provided; theatre productions have no special claim to such treatment.

Finally, in many cases credits for the cost of theatrical productions would offset the tax liability of so-called "angels," wealthy individuals who finance theatrical productions by investing in tax shelter partnerships. The opportunity afforded by present law to utilize the losses incurred in these ventures to offset income from other sources already provides these investors with substantial tax benefits. Availability of the investment credit would make theatrical investments an even more attractive tax shelter.

Indeed, for the very purpose of preventing wealthy individuals from using the investment credit to escape their tax liability, that credit is not available to passive investors with respect to machinery and equipment that is leased by them to third parties in transactions that are in substance tax shelters. It would surely be anomalous to deny the investment credit to passive investors in machinery and equipment -- the very property whose production was intended to be stimulated by the investment credit -- while at the same time permitting these investors to avoid tax by claiming a credit for investments in theatrical productions.

## S. 2503
## Tax Credits for Agricultural Loans

S. 2503 would provide a refundable credit against income tax for interest in excess of a specified amount on "agricultural operating loans." Specifically, subject to certain limitations, interest charges on such loans exceeding a 12 percent annual rate (but subject to a maximum described below) could be credited against the borrower's income tax liability instead of being deducted. If the credit exceeded the borrower's tax liability, the borrower would be entitled to a refund in an amount equal to the credit.

An agricultural operating loan is defined as a loan that will be repaid within 12 months and whose proceeds are used for a purpose described in section 312 of the Consolidated Farm and Rural Development Act. That section describes the following 10 categories of loans:

(1) paying costs for reorganizing the farming system for more profitable operation;

(2) purchasing livestock, poultry and farm equipment (including equipment which utilizes solar energy);

(3) purchasing feed, seed, etc., and to meet other essential farm operating expenses including cash rent;

(4) financing land and water development use and conservation;

(5) financing outdoor recreational enterprises or conversion of farm or ranch operations to recreational uses;

(6) enterprises needed to supplement farm income;

(7) refinancing existing indebtedness;

(8) other farm and home needs, including family subsistence;

(9) loan closing costs, and

(10) assisting farmers in effecting additions to, or alterations in, their equipment, etc., in order to comply with other state or federal statutory standards.

The bill would allow a credit for interest payments in excess of an annual rate of 12 percent on the first $25,000 of qualified indebtedness. The creditable interest is limited to interest paid at a rate which is no more than five percent greater than the discount rate (including surcharges) on 90-day commercial paper in effect at the Federal Reserve bank in the Federal Reserve district where the taxpayer resides. No credit would be allowed for interest paid to a "related person," which is defined by reference to the regulations under section 52(b), relating to the jobs credit. Finally, as drafted, the credit would apply to all taxable years beginning after December 31, 1979. However, we understand that the bill's sponsor anticipates that the credit would expire in 24 months.

Although we share Senator Kassebaum's concern with the problems high interest rates pose for the agricultural community, we do not believe S. 2503 is an appropriate response to these problems and, therefore, the Treasury Department opposes the bill.

High interest rates affect all citizens and are a particular burden on businesses where credit is essential for operations. However, the agricultural sector is not the only segment of our economy faced with the problem of high interest rates. A sustained and disciplined program to control inflation is of paramount importance to all segments of the economy at this time. It would frustrate well-considered monetary policies designed to bring inflation under control by gradually cooling off the economy to provide special tax subsidies that would have the effect of insulating the targeted groups from these policies.

It is important that all government subsidies be examined closely and compared with the many other competing demands on the limited financial resources of the federal government. During this period of fiscal austerity, we believe it is particularly inappropriate to avoid this examination process by providing subsidies through the tax system.

This is especially true in the case of agricultural operating loans since current law already provides the Secretary of Agriculture with the authority both to make funds available at less than the market rate of interest and to guarantee "operating loans" that are identical to the loans for which S. 2503 would provide a tax subsidy. These subsidized loans and guarantees are available only if the applicants are unable to obtain sufficient credit elsewhere to finance their needs, a standard we believe to be appropriate for providing government assistance. The borrower is charged not more than the interest rate on federally insured loans, except that low-income, limited resource borrowers may be charged an interest rate of six percent per year.

Current information indicates that about 38,000 loans, with a total loan balance in excess of $897 million, were outstanding in fiscal year 1979. Slightly fewer loans are expected for fiscal years 1980 and 1981.

We estimate that the revenue loss attributable to S. 2503 would be $22.5 million for fiscal 1980, $263 million for fiscal 1981 and $175 million for fiscal 1982, assuming the credit expires at the end of 24 months.

We also question whether it is appropriate to include as eligible for the proposed credit interest on loans for the conversion of farms or ranch land to recreational purposes, or interest on loans to supplement farm income. Both of these categories of loans qualify as operating loans in the Consolidated Farm and Rural Development Act and thus would be eligible for the credit. While it would seem appropriate -- and indeed likely -- that the Secretary of Agriculture would exercise discretion on a case-by-case basis in determining whether loans for these purposes should be directly subsidized, such an exercise of discretion is not possible under the proposed tax credit.

In addition to our general concerns with using the tax system to provide subsidies outside of the appropriations process, we are also concerned with the bill's provision that the interest credit will be refundable if it exceeds the farmer's or rancher's income tax liability.

Refundable credits raise important questions of tax policy. First, in many cases, the persons who would benefit from a refundable credit are those who pay no income tax because, as a result of investing in ventures that are hopeless losers, they have no profits. A refundable credit would permit these improvident investors to continue to receive unchecked government assistance in the form of refundable credits. Second, and perhaps more importantly, once the principle of allowing tax credits to be refundable is established, any government spending program can be cleared through the tax system, thereby avoiding the safeguards and controls that can be built into a direct grant program. Moreover, although a refundable credit would serve the same function as a direct grant program, it would be perceived as an integral part of the income tax system. These refundable credits would further erode the belief that the tax system is fair since the beneficiaries of these credits would, in many cases, be paying what is in effect a negative income tax.

Finally, we believe the proposal would be extremely difficult to administer. The calculation to be made in arriving at the credit (particularly where the ceiling based on the local Federal Reserve discount rate applies) and the determination of whether a loan qualifies for the credit would be extremely difficult both for taxpayers and the Internal Revenue Service. We also have technical and administrative problems with the definition of the interest

ceiling and, if the bill is adopted, recommend that the ceiling be restated as a specified percentage, such as 18 percent (the current Federal Reserve discount rate plus five percent).

S. 2548
Tax Exempt Financing for
the Acquisition and Rehabilitation
of Harbor Improvements

S. 2548 would provide for a special application of section 103(b) of the Code where the proceeds of an issue of industrial development bonds are used to acquire and improve an existing wharf facility. Regardless of who used the facilities before and after the issuance of such obligations, the interest on the bonds would be tax exempt. We understand S. 2548 is intended to benefit the Tampa Port Authority by enabling it to acquire and expand the Agrico Chemical Company's Big Bend phosphate terminal at Tampa and lease it back to a joint venture in which Agrico will own a substantial interest.

The Treasury is opposed to S. 2548 in its current form. If S. 2548 were enacted, issuers would be quick to point out the inconsistency which would permit the issuance of tax exempt industrial development bonds to rehabilitate a wharf (or similar exempt facility) but not a sports stadium (or other similar facility). The bill does raise, however, a broader issue which we feel merits discussion -- the extent to which tax exempt industrial development bonds should be available to finance the renovation and rehabilitation of exempt facilities.

Current Treasury regulations provide that if the original use of a facility which is permitted to be financed by tax exempt industrial development bonds (in this case, the wharf) commences prior to the date of issuance of the bonds, there are certain restrictions relating to the subsequent use of the facility that must be met. A person who was a "substantial user" of the facility at any time during the five-year period preceding the date of issuance of the obligations and who received, directly or indirectly, 5 percent of the face value of the industrial development bonds for his interest in the facility generally may not be a "substantial user" of the facility at any time during the five years following issuance without the interest on the bonds losing their tax exemption. (Because Agrico is now a "substantial user" of the facility, would remain so after

the proposed transaction, and would receive the largest share of the bond proceeds for its interest in the terminal, the current regulations bar the use of tax exempt financing.)

The purpose for the restrictions in the regulations is plain. Tax exempt borrowing was permitted for industrial development bonds to provide facilities, and not to permit persons to borrow against existing facilities or refinance taxable indebtedness with tax exempt bonds. If a facility is already in use, the regulations provide that tax exempt borrowing is available unless the facility will continue to be used substantially for the benefit of those persons already using it (and such persons receive 5 percent or more of the face amount of the obligation in payment for their interest). Thus, the regulations appropriately bar refinancing with tax exempt industrial development bonds. However, the current regulations also prevent a continuing owner from financing substantial rehabilitation with tax exempt bonds, but yet permit the issuance of tax exempt bonds to finance the acquisition of an existing property even though no new facility or construction is provided.

We believe that the distinction drawn by the current regulations with regard to the use of tax exempt borrowing to finance the acquisition and rehabilitation of facilities already in use should be reexamined, and we are currently considering the extent to which such borrowing, with appropriate safeguards, should be available to finance the acquisition, renovation and rehabilitation of all types of exempt facilities.

We believe a rational approach to the use of tax exempt borrowing for rehabilitation must strike a balance between the goal of preventing the use of such financing to borrow against existing facilities or to refinance, directly or indirectly, existing taxable debt and the goal of allowing certain rehabilitation of existing facilities even though there is no change in the persons who use them. In accomplishing this latter goal, it must be acknowledged that some bond proceeds will likely be expended to pay off existing debt.

We are currently considering an approach that would bar the issuance of tax exempt obligations for the mere acquisition (with no significant renovation or reconstruction) of a facility which is already in use. That is a clear case in which tax exempt industrial development

bonds are used merely to supplant private borrowing. No new facilities are provided for public use. There has only been a change in ownership. There seems little reason to allow tax exempt industrial development bonds to finance such a transaction.

On the other hand, it may be appropriate to permit tax exempt industrial development bonds to be issued for the substantial renovation or rehabilitation of an exempt facility. In the case of a substantial reconstruction or rehabilitation, a facility with a changed or expanded use which benefits the public is provided. In some sense, it can be said to be a "new" facility. Such a change would eliminate the rule of the current regulations which restricts the identity of the persons who can make substantial use of an existing, renovated facility after issuance of the bonds. The new standard might be drawn to require that any issuance of tax exempt obligations to substantially rehabilitate or reconstruct a facility would require that the amount of bond proceeds spent for the rehabilitation equal or exceed some percentage of the facility's adjusted basis or fair market value immediately prior to the rehabilitation or reconstruction. If this percentage were set high enough, substantial renovations could be undertaken without a risk that the obligations would be used principally to refinance an existing taxable indebtedness.

Of course, an extension of tax exempt industrial development bonds to finance rehabilitation without a change in users would require appropriate safeguards. The quantitative standard by which a qualifying rehabilitation might be measured is one such safeguard. Another would be the period of time that must intervene between a qualified rehabilitation and the time the property is first placed in service. Any proposal creating incentives to rehabilitate property will, to some extent, encourage the deferral of routine maintenance and repair until it could be financed as part of a qualifying rehabilitation. Such expenses are usually paid out of working capital, and deferral of these expenses may indirectly allow tax exempt borrowing to finance working capital.

We believe that the use of tax exempt borrowing for the rehabilitation of exempt facilities, accompanied by appropriate safeguards, may well be justified in certain cases. Policy in this regard should certainly be reexamined and clarified. We stand ready to work with this Committee, and all interested persons, in examining and clarifying the rules in this area.

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For Release Upon Delivery
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May 30, 1980

STATEMENT OF DAVID J. SHAKOW
ASSOCIATE TAX LEGISLATIVE COUNSEL
BEFORE THE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

Mr. Chairman and members of the Subcommittee:

I am pleased to appear before you today to present the Treasury's position on H.R. 5043, the Bankruptcy Tax Act of 1980.

H.R. 5043 systematically revises the provisions of the Federal income tax law dealing with taxpayers in bankruptcy and makes them consistent with the rules of the new bankruptcy law which went into effect on October 1, 1979. The bill has been developed over the course of a number of years during which it was subject to substantial comment from outside practitioners, and it has been before Congress in various forms for more than two years. Like any document that must take into account different and sometimes conflicting considerations--both bankruptcy policy and tax policy must be accommodated in its provisions--H.R. 5043 will not completely satisfy everyone. The Treasury, for example, would have preferred a bill that was more consistent with overall tax policy. However, we believe it is very important to have the bill passed expeditiously so that taxpayers in bankruptcy and practitioners who advise them can plan their transactions with knowledge of what the consequences will be.

The bill covers a number of significant areas. It provides a general treatment of discharge of indebtedness, an important aspect of any bankruptcy proceeding. It develops a coherent structure for the tax treatment of individuals in bankruptcy so that they can deal easily with the tax consequences of their bankruptcy. It coordinates the provisions of corporate reorganizations in bankruptcy with the general corporate reorganization provisions, so that the flexibility generally provided for all tax-free

reorganizations will apply equally to bankruptcy reorganizations. It also adopts a number of miscellaneous changes in the corporate tax law and in tax procedures that will allow for clearer treatment of taxpayers in bankruptcy. I would like to review in summary fashion a few of the more significant changes that are made by this bill.

I. Tax Treatment of Discharge of Indebtedness

As a general rule, when a business borrows money, it can be expected that the money will be used either to pay the business's day-to-day expenses or to purchase assets used by the business. Accordingly, one would generally expect the borrowed funds to be reflected in the calculation of the business's taxable income, either through an immediate reduction of taxable income because the funds were used to pay for an item that can be deducted, or else through a future reduction of taxable income because the amounts are reflected in the basis of the assets of the taxpayer.

If the taxpayer thereafter is not required to repay the loan, it might seem plausible to trace the borrowed dollars to their final resting place and reverse whatever tax consequences resulted from the borrowed funds. However, the Supreme Court (and subsequently Congress, in drafting the Internal Revenue Code itself) has ruled that forgiveness of indebtedness is, except in unusual circumstances, income like any other income, without regard to the use of the loan proceeds.

However, because taxpayers who have their debts forgiven are often (although not always) in financial difficulty, both the courts and Congress have developed rules that moderate the consequences of the rule that forgiveness leads to income. For example, the courts have ruled that a taxpayer who is insolvent before and after a debt was forgiven does not have any income because the forgiveness of the debt has not freed up any assets that the taxpayer could use for its own purposes. This rule has been adopted by the courts even though no similar rule is applied to exclude any other kind of income recognized by an insolvent taxpayer. Congress, for its part, has adopted the provisions of sections 108 and 1017 of the Code, which allow taxpayers to reduce the basis of property rather than recognizing income when debt is forgiven. When the basis of property is reduced, a taxpayer may expect his income in the future to be increased as the basis is taken into account in calculating taxable income. However, it should be noted that the basis reduction rules of current law will apply even when the basis reduction will

have no significance in calculating taxable income of the taxpayer in the foreseeable future, for example, when the taxpayer reduces the basis of the stock of a subsidiary or of the land on which the taxpayer's plant is located. In those cases, a taxpayer may, in practice, recognize no income when its debts are forgiven.

The bill attempts to remedy some of the anomalies under present law in the treatment of forgiveness of indebtedness income without accepting across the board the Supreme Court's view that forgiveness of debts is always income. Thus, even for a taxpayer outside bankruptcy, the bill will continue to allow a taxpayer to reduce the basis of its assets rather than recognize income. However, the basis reduction will now be restricted to depreciable property, so no reduction will be allowed where reducing the basis of an asset can have the practical effect of no tax being paid on forgiveness income. In the case of a taxpayer in bankruptcy or an insolvent taxpayer, an even more lenient rule is provided. Such a taxpayer will never be required to recognize income when debt is forgiven. Instead, the taxpayer will reduce its favorable tax attributes to reflect the debt forgiven. Moreover, a limit is placed on the amount of attributes that a taxpayer may be required to reduce. Accordingly, the taxpayer's basis in its assets may not be reduced below the amount of any liabilities that remain when it emerges from bankruptcy. To the extent any debt is forgiven after this limit is reached, the forgiveness is disregarded for tax purposes. This will permit the taxpayer to move ahead in reasonable competition with other taxpayers who have not gone through bankruptcy without saddling the bankrupt business with potential tax liabilities that will make it impossible for it to rehabilitate itself economically.

One significant aspect of H.R. 5043 involves the treatment of stock that is issued in exchange for a corporation's debt. Under current law, a corporation generally recognizes no forgiveness income when stock is used to satisfy a debt. Under the bill, if a corporation issues $40 of stock in exchange for a debt of $100, it may have $60 of income from forgiveness of indebtedness just as if it had issued $40 of cash for that $100 of debt. This provision makes the treatment of a corporation that issues stock for debt consistent with the treatment of the creditor who receives stock in exchange for debt. Accordingly, where the debt cancelled would be considered a security for tax purposes, and thus an exchange of stock for such debt would

not normally be taxed to the holder of the debt, the corporation will not be deemed to have forgiveness of indebtedness income. On the other hand, if the debt is of the type that will allow the creditor to claim a deduction on the exchange (or beforehand, through a bad debt deduction), the corporation must also recognize forgiveness of indebtedness income on the exchange.

II. Tax Treatment of Individuals in Bankruptcy

The bill clarifies a number of issues involving the treatment of individuals and their estates in bankruptcy. In general, the bill provides that the estate of an individual in bankruptcy is treated as separate from the individual, the same general rule as current law. The bill provides a coherent set of rules that indicate what tax attributes are accounted for by the taxpayer and what attributes belong to the estate in bankruptcy. The bill provides that a taxpayer may reflect on his or her individual tax return all pre-bankruptcy income and deductions in the calendar year in which he or she has declared bankruptcy. This rule will make it easier for individuals who are not faced with a complicated tax picture to continue to file their tax returns with relative ease and without bothering to distinguish fine points of tax law. On the other hand, an individual with a complicated tax picture is permitted to terminate his tax year at the time the bankruptcy proceeding is commenced, so that all the pre-bankruptcy income and deductions will be associated with the estate in bankruptcy, inasmuch as the estate in bankruptcy will get the benefits (and will be saddled with the burdens) of any of those income and deduction items. The bill also indicates when the tax attributes of the debtor can be used thereafter by the estate, and provides rules that will make it easier for an estate in bankruptcy to use deductions incurred in the administration of the individual's estate.

III. Corporate Reorganization Provisions

The bill attempts to give corporate taxpayers in bankruptcy the benefits of the flexible rules for corporate reorganizations that have been included in the Code generally for corporations outside bankruptcy. In general, this is done by adding the definition of a bankruptcy reorganization to the list of tax-free corporate reorganizations. As a result of this change and various conforming amendments, most of the rules that apply to corporate reorganizations at present, and that may be extended to corporate reorganizations in the future, will apply automatically to bankruptcy reorganizations.

A difficult problem in this area relates to the ambiguous position played by shareholders and creditors of a bankrupt corporation. As a corporation moves toward bankruptcy, the shareholders of the corporation will often lose their equity interest in the bankrupt corporation and, ultimately, their control over the corporation. Normally, in deciding whether a reorganization is tax-free, it is necessary to determine whether the transaction satisfies the judicial test of "continuity of interest," which attempts to distinguish a true reorganization of a corporation from a taxable purchase of the corporation by new interests. When creditors take over a corporation, it may be difficult to determine whether what they are giving up in exchange for stock is the equivalent of an old investment or new money. We believe that, in applying the provisions of this bill to the new bankruptcy law, it will be possible to distinguish between true reorganizations and purchases. We will monitor closely the application of these provisions and will be prepared to offer suggestions for legislation if needed.

IV. <u>Other Corporate Amendments</u>

The bill amends a number of other provisions involving the taxation of corporations in bankruptcy. For example, although a corporation in bankruptcy may become a personal holding company under the Code, it would normally not be appropriate to subject the corporation to the special tax on personal holding companies. Accordingly, such corporations are generally excluded from the definition of personal holding companies. Similarly, the rules for corporate liquidations are modified to extend beyond one year the period over which a tax-free liquidation may take place. When properly restricted to avoid abuse, this rule takes account of the fact that a corporation under court supervision may not have the flexibility to act quickly that other corporations normally have. Also, a rule is provided under the general provisions involving incorporation of a business so that there will be no technical distinction between incorporating a sole proprietorship for the benefit of creditors and selling the assets of a sole proprietorship for the creditors' accounts. In either case, the transaction will be treated as a sale.

It should be noted that these provisions generally provide flexibility for corporations and allow them to operate without some of the constraints of the tax law in order to accommodate the concerns of bankruptcy policy.

V. Changes in Tax Procedure

A number of technical changes are made in the Internal Revenue Code to coordinate the Code with the rules of the new bankruptcy law and to carry out certain policy decisions that were made when the new bankruptcy law went into effect. Included are rules involving the statute of limitations and the authority of the Bankruptcy Court to permit the debtor's tax liability to be determined by the Tax Court.

My testimony has not covered all the provisions that are included in H.R. 5043. It must be recognized that many of these provisions are highly technical, and involve fairly difficult areas of law where bankruptcy policy and tax policy must be meshed. I would like to stress again the importance of dealing with the bill swiftly and favorably. Taxpayers going into bankruptcy should know what the tax consequences of their subsequent actions will be.

Senator BYRD. The next panel will deal with H.R. 5043, the Bankruptcy Tax Act of 1980. Mr. Charles M. Walker, chairman, tax section, American Bar Association, accompanied by Edward N. Delaney, Esq., Washington, D.C.; George F. Crawford, Esq., Kansas City, Mo.; Robert H. Lipsey, Federal Tax Division, American Institute of Certified Public Accountants.

Welcome, gentlemen. We are glad to have you.

## STATEMENT OF CHARLES M. WALKER, CHAIRMAN, TAX SECTION, AMERICAN BAR ASSOCIATION, ACCOMPANIED BY EDWARD N. DELANEY, WASHINGTON, D.C.

Mr. WALKER. Thank you, Mr. Chairman, Senator Packwood.

My name is Charles M. Walker. I am from Los Angeles. I appear today as chairman of the section on taxation of the American Bar Association.

Senator BYRD. We are glad to have you, sir.

Mr. WALKER. Thank you, Mr. Chairman.

We have prepared a written statement, which I ask be included in the record, and I will give an oral summary, if I may.

Senator BYRD. Yes; it will be published in the record.

Mr. WALKER. We reflect only the position of the tax section, and are not to be considered as speaking also for the entire association.

We support H.R. 5043, and urge that it be passed. We share the Treasury's comment that it should be passed promptly. Most of the bill is noncontroversial, and much of it is essential. For example, the bill conforms the Internal Revenue Code's tax assessment and collection procedure to the new bankruptcy law.

Also, it enacts for the first time a comprehensive set of rules dealing with the tax responsibilities of bankruptcy trustees and the computation of taxable income of bankruptcy estates. These have been almost universally lauded as a major advance. The bill also rationalizes many corporate income and reorganization procedures as they impact on bankruptcy.

There are three provisions of the bill I would like to mention in my oral statement. The tax section supports one of them, opposes another, and takes no position on the third.

The first provision, which we support, deals with the so-called attribute reductions. Under the present law, it may be possible to structure a bankruptcy reorganization under which the debtor compromises its debts without realizing taxable income—a point with which we wholeheartedly agree—but it also emerges from bankruptcy with its net operating loss carryovers and the basis of its assets intact. This gives it a tax break that other taxpayers don't enjoy. Every bankruptcy tax proposal, beginning with the Bankruptcy Commission's draft statute, has contained some provision for reducing net operating loss carryovers in bankruptcy when the debtor enjoys the nonrecognition of income from the discharge of indebtedness.

After hearing all the arguments from all the interested groups, the House now has agreed on a compromise which would allow the debtor to reduce the basis of his depreciable assets before charging net operating loss carryovers. This is a sensible result, in that it preserves the principle of attribute reduction, while allowing some tax relief to companies emerging from bankruptcy.

In the end, both the Government and the taxpayer will have their due.

The second provision, which we oppose, deals with the stock for debt rule.

Senator BYRD. The what?

Mr. WALKER. The stock for debt rule. The Treaury has given you some comment on that. It has long been established, both inside and outside of bankruptcy, that the substitution of stock for debt does not represent income to the debtor nor does it affect net operating losses and other tax attributes.

The courts reached this result on the theoretical basis that the substitution of stock for debt did not finally discharge the debtor's liability. It merely changed the form of the creditor's interest in the company. It has been argued that this notion is theoretically unsound. The Treasury steadfastly has pushed to abolish the rule, and the bill has gone a long way in doing so. We believe it has gone too far, and we urge you to allow the preexisting rule to continue. It is a salutary rule, since it gives tax relief to a company which reorganizes by giving stock to its creditors, who can continue the company, saving jobs and revitalizing it as a taxpayer.

But if the House version of the bill is enacted, creditors will have no incentive not to demand cash, and possibly force a liquidation of the company, or at least make its post confirmation life precarious.

If the present stock-for-debt rule is to be retained, which we urge we would like to repeat a suggestion we made to the Ways and Means Committee. In some situations, the stock for debt rule has been availed of where the stock issued has important characteristics of debt, such as liquidation preference and short-term maturity date.

Since that doesn't carry out the intent of the rule, the committee could address that narrow issue but leave the existing rule otherwise intact. This would accomplish a reasonable goal without frustrating any competing bankruptcy policies. We urge you to consider this alternative.

This third provision deals with the elective nonrecognition of income by financially distressed taxpayers who are neither insol-

vent nor who are in bankruptcy. We take no position on the merits of this provision, because it is not clear to us that the subject has been sufficiently explored to assure such taxpayers that the bill provides them adequate relief.

Individual members of the tax section, however, have analyzed the bill from this standpoint, and tend to support it, but find some trouble with it.

I have not taken time to mention some technical changes which we have included in the statement and other statements that have been made to the staff, and they are working with some of these technical changes.

Finally, Mr. Chairman, I repeat that the tax section supports the bill as a whole. It is an important piece of legislation, while we urge this amendment I have mentioned about the stock for debt, we hope consideration of that recommendation will not delay enactment of the bill, which we think is important.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, Mr. Walker.

Before calling on the next witness, Senator Dole, do you have any questions?

Senator DOLE. No questions, Mr. Chairman, but I would like to have my opening statement made a part of the record.

[The opening statement of Senator Dole follows:]

OPENING STATEMENT OF SENATOR DOLE

Mr. Chairman, once again you have provided us with an opportunity to explore the feasibility of several innovative tax incentives. Given the deteriorating economic condition, it is particularly important to give substantial attention to incentives which may help this nation to become more productive. This Senator has long been an advocate of providing incentives to spur productivity and is most interested in the reaction of the witnesses we shall hear to the specific proposals at issue today.

Among the bills subject to discussion are three concerning a tax-exemption for industrial development bonds. This area has been a sensitive subject for several years and the concerns which led Congress to deny a tax-exemption for interest on these bonds are understandable. However, the need for reliable and efficient transportation systems in an era of escalating fuel costs certainly mandates a re-examination of the advisability of taxing interest on industrial development bonds issued to rehabilitate our railroads. Similarly, there may be merit in re-examining the rules relating to the financing of wharves and docks. This Senator hopes to learn much from the testimony today on these issues.

Similarly, there is little question that inflation and the high cost of credit causes severe hardship to farmers. Serious consideration must be given to comments on S. 2503 indroduced by Senator Kassenbaum.

Finally, this Senator, for one, is pleased to have an opportunity to receive comments on the Bankruptcy Tax Act of 1980. Much work has gone into this legislation over a period of years to provide new rules governing the tax aspects of bankruptcy. This legislation would complete the revision of the Federal laws relating to bankruptcy and is much needed. However, the specific rules are very technical. We must, of necessity, look to practitioners and experts in this area to determine whether this bill satisfies the reasonable needs of the concerned parties. Mr. Chairman, a hearing on this bill should be of unique usefulness to this subcommittee and the Committee on Finance as a whole.

Senator BYRD. Senator Packwood?

Mr. WALKER. Mr. Chairman, may I just say, there are additional technical amendments that we have been discussing with the staff—I believe yesterday there was a meeting about this—and we have prepared a memorandum which we would like to submit in addition to the written statement.

Senator BYRD. It will be received.

Mr. WALKER. Thank you.
Senator BYRD. Mr. Crawford

STATEMENT OF GEORGE F. CRAWFORD, KANSAS CITY, MO.

Mr. CRAWFORD. Mr. Chairman, Senator Packwood, Senator Dole, my name if George Crawford. I am appearing as an individual. I reside in Overland Park, Kans., and practice law in Kansas City, Mo.

I have submitted a written statement which I would request permission to have included in the record.

Senator BYRD. Your statement will be included in the record.

Mr. CRAWFORD. My statement is directed to essentially one point relating to the consequences of discharge of indebtedness under section 2 of the bill. The bulk of my written statement was prepared at a time when the House bill contemplated a complete repeal of the so-called section 108 election in regard to solvent taxpayers. This would have effected a return to previously existing law which had proved unworkable in application, in that is involved extreme factual uncertainties as to the existence or nonexistence of insolvency, and would have, at least in my opinion, provided a very direct incentive to bankruptcy.

I believe both the joint-committee staff report and the testimony of Mr. Halperin on behalf of the Treasury in earlier stages in the development of this bill have acknowledged the importance of avoiding any incentive or disincentive to bankruptcy.

The bill has undergone evolution to the extent of eliminating the total repeal of the 108 election in relation to solvent taxpayers, and to that extent could be supported relatively.

However, there are still differences in the tax consequences of indebtedness discharge as between bankrupt taxpayers and insolvent taxpayers on one hand and solvent taxpayers on the other hand. In other words, as the spokesman for the Treasury has stated, a bankrupt or insolvent taxpayer may have the election to have certain tax attributes reduced or in the alternative, to elect a reduction in the basis of depreciable assets, and then have attributes reduced, and if any portion of the discharged amount is not exhausted by that process, there are no tax consequences whatsoever.

On the other hand, a solvent taxpayer is limited to reduction of the basis of directly depreciable assets. As stated before, with respect to a financially distressed taxpayer, it can be an intensely factual question whether or not the taxpayer is insolvent under the statutory "balance sheet" test, which is phrased in terms of excess of liabilities over fair market value of assets.

This is a much more stringent test of insolvency than the bankruptcy test, and I submit that is these discrepancies are retained, there will still remain albeit to a lesser degree than under total repeal of the 108 election for solvent taxpayers, a direct incentive for taxpayers in certain instances to take bankruptcy in order to obtain the relatively more favorable consequences available to them in that environment and to avoid the uncertainties of litigating the issue of insolvency.

The bill in its original form provided a condition to reduction in the basis of a nondepreciable asset consisting of stock of a subsidi-

ary. The condition was to obtain the consent of the controlled subsidiary to a reduction in the basis of its depeciable assets.

I would respectfully urge that consideration be given to reinstating this alternative for solvent taxpayers and in like manner requiring insolvent and bankrupt taxpayers to obtain such consent from a controlled subsidiary as a condition to reducing basis in the stock of the subsidiary.

Finally, I would suggest that this issue is of sufficient importance that, if it cannot be resolved to the mutual satisfaction of all interested parties, perhaps consideration should be given to moving the legislation forward with treatment of the 108 and 1017 issues at a later time.

Senator BYRD. Thank you, Mr. Crawford.

Mr. Lipsey?

## STATEMENT OF ROBERT H. LIPSEY, FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. LIPSEY. Good morning, Mr. Chairman and Senators Packwood and Dole.

We have submitted a written statement to be introduced into the record.

Senator BYRD. It will be placed in the record.

Mr. LIPSEY. Thank you very much.

I am Robert Lipsey, a member of the Bankruptcy Task Force of the Federal Tax Division, American Institute of Certified Public Accountants. I appreciate the opportunity to appear here today on behalf of the AICPA.

I would like to emphasize our agreement with the other speakers as to the necessity for a prompt solution to this complex problem of bankruptcy tax law, to provide guidance for taxpayers who currently have no clear indication as to the tax law application to them.

In general, we support the adoption of H.R. 5043, although we are still in disagreement with some of its provisions as currently drafted. I will touch briefly on those aspects of the bill and our suggestions for their improvement in the time which has been allotted to me.

First, however, I would like to point out that we are very pleased with the thoughtful way in which this legislation has been developed to the present. Throughout the process, our Institute has worked closely with the staff, and they have been receptive to our suggestions. We feel that a good piece of tax legislation is being developed, and that it can be made somewhat better.

We are particularly pleased with the elimination of the tracing concept for debt cancellation, and the change in the effective dates applicable to taxpayers outside of bankruptcy.

Let me now address the two areas of the bill where we most strongly urge that changes be made to result in what we believe will be the best tax law. The major thrust of the bill is to provide debt-ridden companies with a fresh start and to eliminate the head start that sometimes occurs under existing law when debts are reduced or canceled.

We believe that financially distressed companies who are able to renegotiate and reduce their debts in order to continue in business

should be treated the same with respect to their tax attributes whether or not they are solvent.

As accountants, we are frequently faced with the task of trying to determine the fair market value of a company's assets in order to decide the extent, if any, of its solvency, and thus its taxable income from debt cancellation. Frequently, highly skilled appraisers have wide disagreements as to the fair market value of particular assets, and most distressed companies don't have funds available to pay any appraisers, highly skilled or not.

Only a sale of assets will indicate their true fair market value, and even then, if the seller is under duress, the sales price may not reflect that value.

H.R. 5043 presently requires insolvent or bankrupt companies to reduce their tax attributes by the full amount of debt cancellation income. Solvent companies may reduce the tax basis of only depreciable assets, with the remaining portion of the debt cancellation treated as immediately taxed income. A debtor that does not have significant depreciable assets, and the fair market value of whose assets is not readily determinable, might be pushed by the bill into bankruptcy in order to avoid enormous tax liabilities upon reduction of debts.

We do not believe this is an appropriate result. In light of the need for a workable solution to the issue of attribute reduction, the Tax Division has proposed in its written submission a comprehensive alternative solution which would allow all debtors—solvent, insolvent, or bankrupt—to either reduce current attributes, including the basis of depreciable property only, or take cancellation income directly into gross income over a future period of time.

Even if the committee finds this alternative unacceptable, we still urge that it give careful consideration to our basic position that, in this area, the same tax law should be applicable to all taxpayers—solvent, insolvent, or bankrupt.

From an accounting point of view, it is extremely difficult to determine with any accuracy whether or not a taxpayer is insolvent. Many different methods can be used to value assets, in the absence of an actual sale; and depending upon the method of valuation, different evaluations as to the taxpayer's solvency or insolvency can be reached. It is not appropriate that two different methods of valuing assets could result in a choice of two different tax laws being applicable to the same taxpayer.

We also ask the committee to reconsider those provisions of the bill that would cause a debtor to realize taxable income upon issuance of its stock to a creditor. The bill would apply such a rule only where the debt involved was short-term debt, not considered a security under the law.

We are unable to see why a debtor's income tax liability should be so much affected by whether or not its debt was originally long term or short term. Indeed, many companies with short-term debts become unable to meet such obligations for many years and yet, even in that situation, the determination of taxable income would be based on the original terms of the instrument, not its actual facts.

Additionally, substantial taxable income can result from a determination of the fair market value of the debtor's stock. While the

committee report now provides for a negotiated setting of values for this purposes, we do not feel such negotiations can be meaningful in view of the debtor's lack of bargaining power. The determination of value of stock, which is usually not marketable, of a distressed company is sometimes impossible absent a sale, and such a subjective concept should not be added to the tax law.

We recongize the committee's concern with the debtor not recognizing income on the exchange, while the creditor benefits from any bad debt deductions he may have previously taken, or takes currently, as a result of the bankruptcy proceeding.

To this end, the committee might consider legislation which would require the creditor to recapture, as ordinary income, this bad debt deduction upon ultimate sale of the stock received. Additionally, corporate debt contributed to capital by shareholders should not result in income being recognized by the corporate obligor. Differing shareholder basis will result in distortion of the corporate debtor's tax attributes.

The Tax Division suggests that the committee may wish to consider legislation which would require that where a noncontrolling creditor-shareholder makes a capital contribution of unpaid expenses, such as salary and interest, which have been accrued by the debtor but not yet included in the income of the creditor-shareholder, due to his accounting method, the creditor-shareholder would recognize such amounts as ordinary income upon the ultimate disposition of the debot's stock.

We covered these issues and several other technical points in our detailed submission. I want to thank you again on behalf of the AICPA for this opportunity to present our position. I would be happy to answer any questions.

Senator BYRD. Thank you.

Senator Packwood?

Senator PACKWOOD. No questions, Mr. Chairman.

Senator BYRD. Senator Dole?

Senator DOLE. No questions, Mr. Chairman.

Senator BYRD. Thank you, gentlemen.

[The prepared statements of the preceding panel follow:]

SUMMARY OF STATEMENT
OF
CHARLES M. WALKER
CHAIRMAN

SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

May 30, 1980

COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
UNITED STATES SENATE

H.R. 5043, "The Bankruptcy Act of 1980"

The Section of Taxation has previously submitted written statements and presented oral testimony relative to the tax rules to be applied in bankruptcy situations. Representatives of the Section have been in frequent contact with the staff of the Joint Committee on Taxation to assist in the development of the legislation which is the subject matter of these hearings.

The development and enactment of legislation governing the tax aspects of bankruptcy is critically important. While the present bill includes provisions with which the Section does not fully concur, we believe it is nevertheless of paramount importance that this bill be enacted promptly.

We do believe in the wisdom of a stock for debt exception to income realization from a discharge of indebtedness. We urge the retention of such an exception for exchanges of common stock, but not for exchanges where preferred stock having the characteristics of debt is used.

Additionally, we urge that a series of technical amendments, detailed in our written statement, modifying H.R. 5043 be enacted. Such amendments are necessary to avoid uncertainty and possible future litigation over the meaning and intent of several provisions of the bill.

Although the Section urges prompt enactment, with amendments, of H.R. 5043, it refrains from taking a position on the provisions

of the bill dealing with elective nonrecognition outside of bankruptcy.

It is not clear to us that the subject has been sufficiently explored to assure financially distressed taxpayers not in bankruptcy that H.R. 5043 provides adequate relief.

SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

Statement of
CHARLES M. WALKER
Before the

COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
UNITED STATES SENATE

May 30, 1980

H.R. 5043, "The Bankruptcy Tax Act of 1980"

As chairman of the American Bar Association's Section of Taxation, I welcome this opportunity to present the Section's current views on H.R. 5043, "The Bankruptcy Tax Act of 1980." My testimony reflects only the position of the Section of Taxation of the American Bar Association, and should not be construed as a position adopted by the American Bar Association.

The development of legislation governing the tax aspects of bankruptcy is a critically important subject in which the Section of Taxation has taken an interest and a participatory role from the outset of the legislative process. The Section has previously presented oral testimony and written statements to subcommittees of the Senate Finance Committee and the House Ways and Means Committee. In addition, representatives of the Section have been in frequent contact with the staff of the Joint Committee on Taxation to assist the staff in the development of the legislation now before the Finance Committee.

The current views of the Section on Taxation may be summarized quite briefly. First, while the bill includes provisions with which the Section does not fully concur, we believe it is nevertheless of paramount importance that the bill be enacted

promptly. Second, for reasons explained in part II of this statement, the Section does not take a position regarding the provisions of the House bill which apply to the discharge of indebtedness outside of bankruptcy. Third, there are a series of technical amendments which the Section believes should be made to the House bill.

## I.

## The Need For Prompt Legislative Action

The passage of this legislation at the earliest possible date is, in the Section's judgment, a matter of critical importance. The new Bankruptcy Act has been in effect since October 1, 1979, and the repeal of the old Bankruptcy Act eliminated fundamental provisions dealing with the taxation of certain transactions occurring in bankruptcy proceedings. As a result, there now exists a gap in the tax law which H.R. 5043 is designed to correct. Although H.R. 5043 will be made retroactive to October 1, 1979 in these important respects, retroactivity is not a totally acceptable solution since the controversy that has surrounded certain aspects of the bill has led some to doubt whether the proposed legislative solutions would ultimately be adopted. Due to this controversy, debtors, creditors and their advisors have been unable to consummate transactions while the tax rules remain uncertain.

These considerations have prompted the Section consistently to urge that the legislative process move forward. We have taken this position even when we disagreed with one or more specific proposals. This continues to be our view.

It is, we believe, vitally important that H.R. 5043 be enacted this year.

We hold this view with full appreciation that some provisions of the bill have been and remain controversial. While the bill was passed by a unanimous vote in the House, it is nevertheless a compromise measure whose history reflects a strong divergence of views both among members of Congress and private parties having an interest in the ultimate shape of the legislation. Consistent with the need for prompt enactment of bankruptcy tax legislation, and in recognition of the need for compromise to achieve this paramount objective, the Section of Taxation has concluded that the bankruptcy provisions of the bill should be considered as acceptable to the Section in their present form.

The principal aspects of the bankruptcy portions of the bill with which the Section does not fully concur involve the questions of attribute reduction and the stock for debt rule.

In its previous testimony and statements with respect to H.R. 5043 and its predecessors, the Section has consistently supported the concept of attribute reduction in connection with a discharge of indebtedness in a bankruptcy proceeding when the discharge is not taxed. We adopted this position on the theory that non-recognition of income in such discharge situations is merely a deferral device and not a tax forgiveness.

In other sections of the Internal Revenue Code where tax deferral is required or permitted, there is usually some form of tax basis carryover to preserve the deferred income for taxation when the taxpayer has funds with which to pay the tax. Accordingly, it has been the Section's view that, where indebtedness is discharged in a bankruptcy proceeding, net operating loss carryovers should be reduced before other tax attributes are reduced so that the tax properly due will be paid out of the earliest income realized.

The Section has also consistently supported the retention in this legislation of the rule of present law which provides that income subject to tax is not realized when shares of stock are issued in satisfaction of a debt. This view may be challenged by some on conceptual grounds. The Section has always believed, however, that a rule that encouraged creditors to take stock in lieu of cash would encourage reorganizations rather than liquidations, and this is we believe a fundamental purpose of the bankruptcy laws.

After the receipt of additional written comments on the questions of attribute reduction and the issuance of stock for debt, the Subcommittee on Select Revenue Measures of the House Ways and Means Committee fashioned a compromise which was sufficient to assure approval of the bill by the full

Ways and Means Committee and the House of Representatives. While we are prepared to support the compromise, we continue to believe in the wisdom of the stock for debt exception to income from discharge of indebtedness, except for preferred stock having the characteristics of debt, and urge retention of the exception.

In connection with need for prompt legislation, the Section believes it is important to note that the new Bankruptcy Act, as effective on October 1, 1979, set forth general principles of taxation for state and local taxes. Legislation will be necessary to conform those principles with the Federal tax rules included in H.R. 5043. Although such conformity cannot be achieved in connection with H.R. 5043, we stress that it is necessary for this subject to be addressed at the earliest possible time by the appropriate Congressional committees upon enactment of H.R. 5043.

II.

Non-Bankruptcy Tax Provisions

Although the Section of Taxation urges prompt enactment of H.R. 5043, it nevertheless refrains from taking a position on the merits of the provision of the bill relating to elective nonrecognition outside of bankruptcy.

Under present law, a solvent taxpayer not in bankruptcy is not always required to recognize discharge of indebtedness income. If the taxpayer is a corporation, or if the indebtedness is incurred or assumed in connection with property used in a trade or business, the taxpayer may elect not to recognize the income. If such an election is made, the taxpayer would reduce the tax basis of assets in a manner prescribed by the current regulations. Although these regulations in most cases require that the basis of depreciable property be reduced before the basis of nondepreciable property is reduced, it nevertheless may be possible for a taxpayer to achieve a more or less permanent tax savings by making the election where the ability exists to reduce the basis of corporate stock or other nondepreciable, especially intangible, property.

The possible repeal of this election as part of a bankruptcy tax bill was first raised by the Treasury Department in its testimony before the House Subcommittee on Select Revenue Measures on H.R. 5043. In its testimony, the Treasury Department took the position that the election was in practice a method by which large corporations could refinance their public debt without adverse tax consequences, and not merely a relief provision benefiting financially distressed taxpayers. In subsequent written statements to the Subcommittee, some advanced the argument

that repeal of the election would pose major hardships on certain taxpayers, and that the election should therefore be retained.

It is not clear to us that the subject has been sufficiently explored to assure financially distressed taxpayers, not in bankruptcy, that the bill provides them adequate relief. For that reason the Tax Section refrains from taking a position on this aspect of the bill.

Some members of the Section however, have analyzed the proposal and as individuals support it. One of these members is present and can testify to this effect if the Subcommittee desires to hear him.

In any case, this provision is not a critical part of H.R. 5043 and if the hearings do not point to a sound and equitable solution I urge that the provision be dropped from the bill so that it can be enacted without further delay. The matter of elective nonrecognition outside of bankruptcy can then be approached with greater deliberation at a later time.

## III.

## Technical Changes

Finally, the Section of Taxation recommends that a series of technical amendments to H.R. 5043 (as described below) be adopted. The Section believes these amendments are

necessary to avoid uncertainty and possible future litigation over the meaning of several provisions of the bill.

1. H. Rep. 96-833, 96th Cong. 2d. Sess. states at p. 15, "If a value is placed on the stock [issued in satisfaction of debt] either (1) by the bankruptcy court in a proceeding in which the Internal Revenue Service had the right to intervene on the valuation issue (including notice of the court hearing on the valuation issue) or (2) in a bankruptcy or similar proceeding or in an out-of-court agreement in which the debtor and creditor had adverse interests in the tax consequences of the valuation, the Internal Revenue Service as well as the debtor and creditor are to be bound by the valuation for purposes of tax calculations, including the debt discharge rules of the bill and the creditor's bad debt deduction."

This proposition may not be accepted by the courts, though it seems central to the "compromise." It is respectfully urged that if this is the intent of Congress it be included directly in the bill.

2. The list of credits to be reduced in the case of nonrecognized debt discharge income in bankruptcy does not include foreign tax credits. This is probably because the draftsmen felt that a taxpayer should not be permitted to reduce foreign tax credits rather than the basis of assets in a case where the taxpayer might realize no foreign income after bankruptcy. On the other hand, as the bill is drafted, a taxpayer without loss carryovers and basis in excess of liabilities sufficient to absorb all of the nonrecognized income could emerge from bankruptcy with foreign tax credit carryovers which would be usable against subsequently realized foreign income. This does violence to the spirit of the bill. The appropriate response would appear to be to add a new subparagraph (E) to proposed §108 (b)(2) to read, "(E) FOREIGN TAX CREDIT CARRYOVERS - Any foreign tax credit carryover to or from the taxable year of the discharge."

3. A new paragraph should be added to IRC §702(a) to include "income from the discharge of indebtedness." This would implement proposed IRC §108(d)(5).



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4. A cross reference to proposed IRC §1398 is required in IRC §§1245 and 1250, 1252 and 1254, which apply "notwithstanding any other provision of this subtitle."

5. Proposed IRC §1399 should be amended to include any taxpayer in a federal or state receivership, foreclosure or similar proceeding.

6. The tracking of the language "qualifies under section 354, 355 or 356" from the (D) reorganization is inappropriate in proposed IRC §368 (a)(1)(G). Suppose that a Title 11 reorganization plan contemplates transfer of assets to a corporation in exchange for stock and distribution of such stock to creditors, none of whom hold "securities." There would be no transaction qualifying under IRC §354, since nobody would be entitled to non-recognition. Words to the following effect should be added to proposed IRC §368(a)(1)(G): "or the corporation is liquidated and all of the stock or securities received in exchange for such assets are distributed to creditors of the transferor corporation."

7. Proposed IRC §368(a)(3)(E) should be clarified either by amendment or statement in the committee report that its application is limited to cases where no former shareholders receive stock, but if they do, present IRC §368(a)(2)(E) could apply if its requirements are otherwise satisfied.

8. The Senate has passed, and there is now pending before the House of Representatives, S. 658, proposing "technical" amendments to the bankruptcy laws. §108 of that bill would provide that the period of limitations on assessment of tax would not expire before 90 days following the earlier of the termination of any stay under 11 U.S.C. §362 and the date on which such assessment is permitted. The 60 day period provided by this bill would be in conflict.

9. No income should be realized by a debtor corporation upon the contribution by a creditor to its capital of a debt evidenced by a security, except for the portion of such debt attributable to accrued but unpaid interest. This would make the treatment of contributions to capital closer to stock for debt exchanges.

STATEMENT OF
GEORGE F. CRAWFORD

BEFORE THE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
UNITED STATES SENATE

May 30, 1980

H.R. 5043
THE BANKRUPTCY TAX ACT OF 1980

This statement relates to H.R. 5043, the Bankruptcy Tax Act. Exhibit A to this statement consists of a Memorandum dated February 1, 1980, at which time H.R. 5043, in its then amended form, would have effectively repealed the section 108 election now available to solvent taxpayers. The Memorandum reflects the views of the writer that such repeal would have represented an unwise return to former law which proved unsatisfactory in application, with attendant uncertainties, tax litigation and direct incentive to elect bankruptcy in borderline cases.

H.R. 5043 in its presently proposed form, preserves the section 108 election in somewhat restricted form, and thus would substantially mitigate the principal objection to which the attached Memorandum is addressed.

However, there remain certain differences in the treatment of bankrupt and insolvent taxpayers on the one hand, and solvent taxpayers on the other hand. As a result, the discussion contained in the attached Memorandum is of continuing relevance, at least in the view of the writer.

Under section 2 of the Bill, bankrupt and insolvent taxpayers may apply the amount of discharged indebtedness in reduction of certain tax attributes (net operating loss carryovers, certain tax credits, and capital loss carryovers) and finally in reduction of the basis of assets, including non-depreciable assets; in the alternative, such taxpayers may first apply the amount of discharged indebtedness to reduce the basis of depreciable property and then to reduce the other tax attributes. Any amount remaining after this process is disregarded, and does not result in the recognition of income or other tax consequences to the bankrupt or insolvent taxpayer.

A solvent taxpayer, on the other hand, may utilize the section 108 election only to the extent of reducing basis in depreciable property. Under the Bill in present form, there will thus continue to exist in certain cases, although to a lesser degree than under the previous amendment of the Bill, an incentive to engage in tax litigation over the issue of insolvency or to elect formal bankruptcy to avoid such tax litigation.

As noted in the attached Memorandum, a major objective of the Bill in its original form was to avoid any incentive or disincentive to bankruptcy. In furtherance of this basic objective, it is respectfully suggested that consideration be given to bringing all taxpayers into closer parity of treatment.

More specifically, it is submitted that a solvent taxpayer should have the right, as contemplated by the Bill in its original form, to apply discharge amounts in reduction of its basis in the stock of an affiliated (within the meaning of section 1504)

subsidiary to the extent that the subsidiary consents to an accompanying reduction of its basis in depreciable assets. As a corollary, a bankrupt or solvent taxpayer having such a subsidiary should be required to obtain a similar consent as a condition to its exclusion of amounts applied in reduction of its basis in the stock of such a subsidiary.

Respectfully submitted,

George F. Crawford

May 30, 1980

EXHIBIT A

MEMORANDUM

Re: Bankruptcy Tax Act of 1979 (H.R. 5043); Comments regarding proposed repeal of I.R.C. sections 108 and 1017 as applied to solvent taxpayers.

INTRODUCTORY

H.R. 5043 is described as a bill to "amend the Internal Revenue Code of 1954 to provide for the tax treatment of bankruptcy, insolvency, and similar proceedings, and for other purposes", and is entitled "Bankruptcy Tax Act of 1979". It has been developed as an accompaniment to the Bankruptcy Reform Act of 1978.

The repeal by P.L. 95598 (The Bankruptcy Reform Act of 1978) of the income tax provisions formerly contained in the Bankruptcy Act created an accompanying need to incorporate provisions in the Internal Revenue Code regarding the tax treatment of situations involving bankruptcy or insolvency. Fulfillment of this need is the immediate objective of H.R. 5043 (the "Bill"). It has also served as an occasion, as noted in a pamphlet prepared by the staff of the Joint Committee on Taxation ("JCT Pamphlet"), "to update and clarify federal income tax rules relating to discharge or cancellation of indebtedness, the tax treatment of the bankruptcy estate of an individual debtor, the tax treatment of corporate insolvency reorganizations, and procedural rules relating to assessment and collection of tax liability of the debtor and of the bankruptcy estate." See citation, *infra*.

The Bill consists of sev , sections, in implementation of the objectives stated above. The provisions of those sections other than section 2, regarding discharge of indebtedness, are wholly related to and affect matters involving bankruptcy or similar situations.

Section 2 of the Bill, regarding the tax treatment of discharge of indebtedness, does relate to bankrupt and insolvent debtors. Moreover, it does more than to "update and clarify" rules relating to such taxpayers; it significantly modifies the tax effect which a discharge of indebtedness will have upon a bankrupt or insolvent taxpayer. Even more significantly, section 2, in its most recently proposed form, would completely repeal the existing substantive law as to other taxpayers; if enacted in this form, it will undoubtedly have broad and material impact in terms of the tax consequences which will result to such taxpayers from the discharge of indebtedness.

Comments have been requested regarding the changes referred to above, including the proposed repeal of Code sections 108 and 1017 with respect to solvent taxpayers. This Memorandum is directed to the furnishing of comments on the specific change last described.

Before undertaking to comment on the proposed legislative changes contemplated by the Bill, it seems appropriate to review the development of tax law regarding discharge of indebtedness down to its present state, as particularly reflect by sections 108 and 1017 of the Internal Revenue Code. A good summary of the present law, as well as the changes contemplated by the Bill, in the form in which it was initially introduced on August 1, 1979, is contained

in a pamphlet ("JCT Pamphlet") prepared by the Joint Committee on Taxation for consideration at the hearing held by the House Ways and Means Subcommittee on Select Revenue Measures held September 27, 1979. This pamphlet is reproduced in BNA Daily Tax Report No. 182, dated September 18, 1979, and the discussion on discharge of indebtedness appears at pages J 1-3; a copy of that part of the discussion accompanies this Memorandum as Exhibit B.

The general rule under present law is that the discharge of indebtedness through forgiveness or cancellation constitutes a realization of income. This general rule is embodied in section 61(a)(12) of the Internal Revenue Code, which represents a codification of the Supreme Court decision in United States v. Kirby Lumber Co., 284 U.S. 1 (1931). There are a number of judicially developed exceptions to the general rule; these exceptions relate to situations of insolvency, shareholder contributions to capital, issuance of stock for debt, cancellation of liability for accrued expenses which did not give rise to tax benefit, and amounts discharged by gift or bequest. Apart from the judicially developed exceptions, section 108 of the Internal Revenue Code now provides that any debtor who would otherwise be required to report income from debt cancellation under the general rule may elect to exclude the income, if the indebtedness was incurred by a corporation or by an individual in connection with his trade or business, by electing to reduce the basis of the debtor's assets in accordance with regulations under section 1017 of the Code.

Before the adoption of P.L. 95-598 (The Bankruptcy Reform Act of 1978), the Bankruptcy Act contained provisions

governing federal income tax treatment of debt discharge in bankruptcy. P.L. 95-598 repealed those provisions for bankruptcy cases commencing on or after October 1, 1979, which is the effective date of P.L. 95-598 for general purposes. The tax effect of debt cancellation in bankruptcy under the former provisions of the Bankruptcy Act is reviewed in a following portion of this Memorandum.

"ATTRIBUTE REDUCTION" CONCEPT

As noted above, Section 108 of the Internal Revenue Code now provides that any taxpayer, as to indebtedness incurred by a corporation or by an individual engaged in trade or business, may elect to exclude from gross income any amount otherwise includible by reason of the discharge of such indebtedness, by consenting to a reduction in the basis of the taxpayer's assets under section 1017. Under the now-repealed provision of the Bankruptcy Act, no income was recognized on debt cancellation in a bankruptcy; in some instances there was an accompanying requirement to reduce basis; and in other instances there was no such requirement. Under existing case law, a similar exclusion, with no requirement to reduce basis, occurs to the extent of insolvency of a non-bankrupt debtor.

The principal thrust of the Bill in its original form, was to substitute the concept of "attribute reduction" for that of decrease in basis, as the price for excluding income under section 108; moreover, the consequences of "attribute reduction" were made applicable to bankrupt and insolvent debtors, as well

as to other taxpayers. In regard to bankrupt and insolvent taxpayers, the concept of "attribute r ..uction" is implemented by amending section 108 to provide for, in lieu of basis reduction alone, the reduction of multiple tax attributes in the following order:

(1) net operating losses and carryovers;

(2) carryovers of investment tax credit (other than ESOP credit), WIN credit and new jobs credit;

(3) capital losses and carryovers; and

(4) basis of taxpayer's assets (not below an amount equal to remaining undischarged liabilities).

The immediate motivation for injecting the "attribute reduction" concept in section 108 may well have been to correlate the treatment of debt cancellation for federal income tax purposes with bankruptcy law and state and local taxation; the Bankruptcy Act now mandates use of the "attribute reduction" concept for state and local tax purposes. However, the underlying policy motivation appears to have been dissatisfaction on the part of the Treasury with respect to the operation of the basis reduction concept presently embodied in section 1017. As noted in the JCT Pamphlet, sections 108 and 1017 "were intended to allow the tax on the debt-discharge income to be deferred and collected through lower depreciation deductions for the reduced-basis assets, or greater taxable gains on sale of the assets." It is believed by the Treasury that the recognition of income deferred under the present rules has been unduly delayed and sometimes indefinitely postponed. In fact, the Bill contains provisions which are specifically designed to prevent a planning

technique, described in the JCT Pamphlet, whereby a parent corporation (often a holding company) will borrow funds which it then contributes to an active subsidiary; if the debt is later repurchased at a discount, the parent company makes an election to reduce the basis of its stock in the subsidiary under section 1017 and reports no income. If the subsidiary later is liquidated, the basis of the assets in the hands of the parent carries over from their basis in the hands of the subsidiary under section 334(b)(1); thus the debt-discharge income completely and permanently escapes taxation.

Such an avoidance technique is obviously a legitimate object of corrective legislation, if necessary. Indeed, the proposed Bill handles the problem very well, by providing that a taxpayer may elect to reduce the basis of an investment in stock in a member of a controlled group (under section 1504) of corporations only if the controlled corporation also elects to reduce the basis of its assets. However, this could be accomplished by adding to section 1017 in its present form, the six-line special rule provided by subsection 1017(c)(2) in the Bill as originally proposed. It even seems possible that regulations to prevent such an abuse could lawfully be promulgated under section 1017 in its present form.

PROPOSED REPEAL OF SECTION 108 AND SECTION 1017 AS TO SOLVENT TAXPAYERS

As noted in the foregoing discussion, H.R. 5043 introduced the concept of "attribute reduction" in place of basis reduction as the price for exclusion of debt-discharge income from taxation under section 108; it should be noted further that the

application of section 108, as amended, would not be elective with the bankrupt or insolvent taxpayer.

In its original form the Bill made section 108 applicable to bankruptcy (Title II) cases and insolvency cases. It also preserved the application of section 108 to other (solvent) taxpayers, by providing for an elective exclusion from a debtor's income of amounts representing discharge of "qualified business indebtedness." The Bill also provided, in effect, for application of the "attribute reduction" concept to solvent taxpayers by including in the gross income of such taxpayers those amounts of discharge income which were offset by net operating losses, including carryovers, and such amounts as served to increase tax credits. "Qualified business indebtedness" was defined in the terms now found in section 108, i.e., as indebtedness incurred or assumed by a corporation, or by an individual in connection with property used in his trade or business.

The JCT Pamphlet regarding the Bill in its original form, described the Bill as "accomodating tax policy to bankruptcy policy." After summarizing the basic consequences of debt-discharge in bankruptcy under the Bill, it went on to say that "[I]n addition, the Bill would provide generally similar discharge of indebtedness rules for taxpayers whose debts are cancelled outside bankruptcy, so that the debt-discharge rules will not operate as an incentive or disincentive to commencement of bankruptcy cases."

As previously noted, the Halperin Statement submitted with regard to the Bill in its original form on September 27,

1979, expressed Treasury approval of the proposed application and amendment of section 108 with respect to debt-discharge in bankruptcy. The expressed grounds for such approval were that the exclusion of income from discharge, coupled with "attribute reduction", represented an acceptable "middle ground" between present law and the recognition of taxable income to the extent of indebtedness discharged in such situations.

The Halperin Statement also indicated Treasury agreement with the application of section 108, as amended by the Bill, to indebtedness discharged where the debtor is insolvent, to the extent of such insolvency. He observed that the same equitable considerations were present in insolvency as exist in bankruptcy and went on to state, as a ground for such agreement, the following reason:

> "If a different rule were applied outside bankruptcy, a debtor contemplating bankruptcy would have to take careful account of the effect of any decision on the tax treatment of forgiveness of indebtedness. We believe such a result would be very unfortunate -- tax consequences should not significantly influence a debtor's decision to go into bankruptcy."

It seems important to note that the statement quoted above refers to situations "outside bankruptcy" -- not just to situations which involve insolvency. The statement in its literal, unqualified form, appears to be sound.

Notwithstanding such statement, however, the Halperin Statement went on to urge repeal of sections 108 and 1017 as applied to solvent taxpayers. As the basis for such recommendation, the following statement was made:

> "Different considerations apply, however, if a taxpayer outside of bankruptcy is solvent. Under current law, such a taxpayer can elect not to be taxed on debt forgiveness.

> Instead, the taxpayer can choose to have the basis of assets reduced to the extent of the forgiveness, pursuant to section 1017. The bill before you changes these rules by requiring taxpayers to reduce net operating losses and credits before basis is reduced. In our view, to create a coherent structure, it is necessary to make further changes affecting taxpayers outside bankruptcy. Otherwise, the application of these amendments to solvent taxpayers would provide unintended benefits. Most solvent taxpayers have debts forgiven only when they repay their low-interest loans at a discount. Even after the changes in the bill are taken into account, solvent taxpayers with forgiveness income, who have fully used each year their deductions and credits, will be permitted to reduce the basis of some of their assets. While basis reduction may result in income recognition, the effects can be long delayed, and in some circumstances may be avoided completely. We believe the bill before you deals properly with the taxpayer in financial difficulty, but our studies of current law convince us that solvent taxpayers are obtaining, for no good reason, the benefits of tax deferral in an amount which we estimate equals about $500 million a year. Now is the time to end this unjustified tax subsidy to solvent taxpayers."

The Halperin Statement went on to report the results of Treasury research and investigation of how the section 108 election operates in practice. This report was as follows:

> "In summary, we find no evidence that these provisions are being used for the benefit of taxpayers in financial difficulty. Instead our figures show that the election is being made in most cases by the very largest corporations, generally when they purchase low interest obligations at a discount. We estimate that about 250 of the 2,500 largest corporations use the election each year to defer about $300 million of income. On the other hand, if we exclude the largest one percent of all corporations, there may be fewer than 250 corporations each year utilizing the election, and collectively they defer less than $10 million. Very few, if any, of this small group of corporations are in financial distress."

By way of conclusion, Mr. Halperin acknowledged the need for an exception from his proposed general rule of recognition for solvent taxpayers. Purchase money indebtedness, he said, should be excepted because of the administrative difficulty

of separating foregiveness income from adjustment of purchase price.

The Halperin Statement in support of the Treasury's recommendation to repeal the section 108 election for solvent taxpayers was apparently very persuasive. On November 7, 1979, a revised form of the Bill was reported by the House Subcommittee on Select Revenue Measures; the revised Bill contains no provision for exclusion of income resulting from the discharge of indebtedness other than discharges occurring in Title 11 (bankruptcy) cases and discharges occurring when the taxpayer is insolvent. The revised Bill also contains a special new set of rules whereby a reduction of purchase money debt will be treated as a price adjustment rather than debt cancellation, for solvent taxpayers only.

The comments which follow are directed to a consideration of whether the proposed revision of the Bill as to solvent taxpayers is sound from a policy standpoint and workable from a practical standpoint, apart from other virtues or deficiencies the Bill may have.

At first blush, it seems very unlikely that there could be a tenable basis to question the policy underlying a revision which would preclude the use of section 108 by large, affluent corporations to defer the recognition of income realized by them when they apply large amounts of excess cash to retire outstanding low-interest debt at a discount. Yet some basis to question the total economic soundness of the proposed revision of the Bill may be furnished by the very fact that such funds are not being otherwise used by the disbursing corporations in conducting operations or for investment in modernization or expansion of

production facilities, and are thus available to retire outstanding indebtedness. There are many businesses, small as well as large, which are in dire need of funds in order to continue in business or to grow. It may indeed be doubtful wisdom to implement a tax policy which could have the effect of "locking in" the excess funds of corporations which have no current productive use for them, and thereby preventing such funds from being used by other taxpayers to create jobs, purchase equipment, acquire or expand plant facilities, and otherwise generate new taxable income. The fiscal soundness of such a policy seems particularly questionable when viewed in the context of a lagging economy, tight money, and a broadly recognized need to encourage capital formation.

If it is difficult to challenge the proposed revision from a policy standpoint, the Bill as revised seems much less invulnerable from the standpoint of practical workability. As previously observed, both the JCT Pamphlet and the Halperin Statement recognized the importance of continuing to have the section 108 exclusion applicable to non-bankruptcy situations, in order to avoid confusion on the part of taxpayers as to their position and to avoid having section 108 provide an incentive or disincentive to the institution of formal bankruptcy proceedings. However, there is implicit in the Treasury's suggested repeal of sections 108 and 1017 with respect to solvent taxpayers, and in the revised Bill which adopts such suggestion, an assumption that such problems are avoided by having those sections apply to discharges effected where a debtor-taxpayer is insolvent, although

not in bankruptcy. Such an assumption appears to be a serious error..

For purposes of H.R. 5043, "insolvency" is defined as an "excess of liabilities over the fair market value of assets" immediately before the discharge. This concept is completely subjective and involves factual determinations which will be a source, not only of uncertainty and confusion, but of extensive litigation if the "qualified business indebtedness" alternative is eliminated. Moreover, it is understood that "insolvency", for purposes of the Bankruptcy Act, is not based on a balance sheet test, but upon the inability (or declared liability) of a debtor to pay his creditors as their claims mature. In many cases, particularly in times of tight credit, a business could be clearly "solvent" from the standpoint of balance sheet net worth, while "insolvent" for bankruptcy purposes because of cash shortages. Under the Bill as revised, there would seem to be a defin incentive for a taxpayer in such circumstances to cause or permit the institution of bankruptcy proceedings in connection with any effort to obtain a significant cancellation of indebtedness. This uncertainty and incentive for bankruptcy would be eliminated by restoring the Bill to its original form.

In his statement on September 27, Mr. Halperin made the following observation regarding the history of section 108:

> "The election to reduce basis rather than paying tax on forgiven debt was intended to aid corporations in financial distress that wished to reduce their yearly interest payments by repurchasing their debt on the open market. Indeed, the original version of the section as passed in 1939 required the taxpayer to be 'in an unsound financial condition' in order to obtain any special benefits."

He also stated as follows:

> "Only because of administrative difficulties in identifying such corporations was that requirement dropped thereafter."

Both observations are correct. Section 22(b)(9) of the Internal Revenue Code of 1939 did require, as a condition to the exclusion of income attributable to discharge of indebtedness, a showing of evidence satisfactory to the Commissioner or by certification from a federal loan or regulatory agency "that at the time of such discharge the taxpayer was in an unsound financial condition."

The requirement of financial unsoundness was eliminated from Code section 22(b)(9) by section 114(a) of the Revenue Act of 1942. The Senate Finance Committee Report contains the following comment:

> "In the case of a corporation, the existing law excludes from gross income amounts of income attributable to the discharge of the taxpayer's indebtedness, if at the time of such discharge the taxpayer was in an unsound condition.
>
> "Your committee believes these restrictions unnecessarily strict and that they deny the benefits of this section in many meritorious cases. Consequently, the committee bill removes the necessity that the taxpayer be in an unsound financial condition at the time." Senate Report 1631, 77th Congress, 2nd Session.

The history of section 108 and its predecessor thus reflects past experience which confirms the impracticality of legislative provisions, the application of which depends entirely on the alternatives of formal bankruptcy or resolution of such complex factual issues as "insolvency" or "unsound financial condition". In view of such considerations as to workability, coupled with the admittedly tremendous fiscal impact which will result from the repeal of section 108 in relation to solvent taxpayers, it is urged that any such repeal be deferred for such

more thorough future consideration. For purposes of further consideration for current adoption, H.R. 5043 should be restored to the form in which it was initially introduced.

George F. Crawford

February 1, 1980

STATEMENT OF ROBERT H. LIPSEY

ON BEHALF OF

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

SUBMITTED TO THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

SENATE COMMITTEE ON FINANCE

HOLDING HEARINGS ON

H.R. 5043

BANKRUPTCY TAX BILL OF 1980

MAY 30, 1980

GOOD MORNING. I AM ROBERT LIPSEY, A MEMBER OF THE BANKRUPTCY TASK FORCE OF THE FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS.

I APPRECIATE THE OPPORTUNITY TO APPEAR HERE TODAY ON BEHALF OF THE AICPA. I WOULD LIKE TO EMPHASIZE OUR AGREEMENT WITH THE NECESSITY FOR A PROMPT SOLUTION T- THE COMPLEX PROBLEM OF BANKRUPTCY TAX LAW TO PROVIDE GUIDANCE FOR TAXPAYERS, WHO CURRENTLY HAVE NO CLEAR INDICATION AS TO THE TAX LAW APPLICABLE TO THEM. IN GENERAL, THE AICPA SUPPORTS THE ADOPTION OF HR 5043, ALTHOUGH WE ARE STILL IN DISAGREEMENT WITH SOME OF THE PROVISIONS OF THE BILL AS CURRENTLY DRAFTED. I WILL TOUCH BRIEFLY ON THOSE ASPECTS OF THE BILL, AND OUR SUGGESTIONS FOR THEIR IMPROVEMENT, IN THE TIME WHICH HAS BEEN ALLOTTED TO ME.

FIRST, HOWEVER, I WOULD LIKE TO POINT OUT THAT WE ARE VERY PLEASED WITH THE THOUGHTFUL WAY IN WHICH THIS LEGISLATION HAS BEEN DEVELOPED UP TO THE PRESENT. THROUGHOUT THE PROCESS, WE HAVE WORKED CLOSELY WITH THE STAFF, AND THEY HAVE BEEN RECEPTIVE TO OUR SUGGESTIONS. WE FEEL THAT A GOOD PIECE OF TAX LEGISLATION IS BEING DEVELOPED, AND THAT IT CAN BE MADE BETTER. WE ARE PARTICULARLY PLEASED WITH THE ELIMINATION OF THE TRACING CONCEPT FOR DEBT CANCELLATION AND THE CHANGE IN THE EFFECTIVE DATES APPLICABLE TO TAXPAYERS OUTSIDE OF BANKRUPTCY.

LET ME NOW ADDRESS THE TWO AREAS OF THE BILL WHERE THE AICPA MOST STRONGLY URGES THAT CHANGES BE MADE TO RESULT IN WHAT WE BELIEVE WILL BE THE BEST TAX LAW. THE MAJOR THRUST OF THE BILL IS TO PROVIDE DEBT-RIDDEN COMPANIES WITH A "FRESH START" AND TO ELIMINATE THE "HEAD START," THAT SOMETIMES RESULTS UNDER EXISTING LAW, WHEN THEIR DEBTS ARE REDUCED OR CANCELLED. WE BELIEVE THAT FINANCIALLY DISTRESSED COMPANIES WHO ARE ABLE TO RENEGOTIATE AND REDUCE THEIR DEBTS IN ORDER TO CONTINUE IN BUSINESS SHOULD BE TREATED THE SAME WITH RESPECT TO THEIR TAX ATTRIBUTES WHETHER OR NOT THEY ARE SOLVENT.

As accountants, we are frequently faced with the task of trying to determine the fair market value of a company's assets in order to decide the extent, if any, of its solvency, and thus, its taxable income from debt cancellation. Highly skilled professional appraisers often have wide disagreements as to the fair market value of particular assets, and there is usually no money available to a distressed company for appraisers of any sort. Only a sale of assets will indicate their true "fair market value" and even then, if the seller is under duress, the sales price may not reflect that true value.

HR 5043 presently requires "insolvent" or bankrupt companies to reduce their tax attributes by the full amount of debt cancellation income. Solvent companies may reduce the tax basis of depreciable assets only, with the remaining portion of the debt cancellation treated immediately as taxable income. A debtor that does not have significant depreciable assets, and the fair market value of whose assets is not readily determinable, might be pushed by the Bill to bankruptcy in order to avoid enormous tax liabilities upon reduction of debts. We do not believe this is an appropriate result. In light of the need for a workable solution to the issue of attribute reduction, the Tax Division has proposed in its written submission a comprehensive alternative solution which would allow all debtors (solvent, insolvent, or bankrupt) to either reduce current attributes, including the basis of depreciable property only, or take cancellation income directly into gross income over a future period of time.

Even if the Committee finds this alternative unacceptable, we still urge that it give careful consideration to our basic position that, in this area, the same tax law should be applicable to all classes of taxpayers - solvent, insolvent, or bankrupt. From an accounting point of view, it is extremely difficult to determine with any accuracy whether or not a taxpayer is insolvent. Many different methods can be used to value assets, in the absence of an actual sale; and depending upon the method of

VALUATION, DIFFERENT EVALUATIONS AS TO THE TAXPAYER'S SOLVENCY OR INSOLVENCY CAN BE REACHED. IT IS NOT APPROPRIATE THAT TWO DIFFERENT METHODS OF VALUING ASSETS COULD RESULT IN A CHOICE OF TWO DIFFERENT TAX LAWS BEING APPLICABLE TO THE SAME TAXPAYER.

WE ALSO ASK THE COMMITTEE TO RECONSIDER THOSE PROVISIONS OF THE BILL THAT WOULD CAUSE A DEBTOR TO REALIZE TAXABLE INCOME UPON ISSUANCE OF ITS STOCK TO A CREDITOR. THE BILL WOULD APPLY SUCH A RULE ONLY WHERE THE DEBT INVOLVED WAS SHORT-TERM DEBT, NOT CONSIDERED A "SECURITY" UNDER THE LAW. WE ARE UNABLE TO SEE WHY A DEBTOR'S INCOME TAX LIABILITY SHOULD BE SO MUCH AFFECTED BY WHETHER OR NOT ITS DEBT WAS ORIGINALLY LONG-TERM OR SHORT-TERM. INDEED MANY COMPANIES WITH "SHORT-TERM" DEBTS BECOME UNABLE TO MEET SUCH OBLIGATIONS FOR MANY YEARS AND YET, EVEN IN THAT SITUATION, THE DETERMINATION WOULD BE BASED ON THE ORIGINAL TERMS OF THE INSTRUMENT, NOT ITS ACTUAL FACTS.

ADDITIONALLY, SUBSTANTIAL TAXABLE INCOME CAN RESULT FROM A DETERMINATION OF THE FAIR MARKET VALUE OF THE DEBTOR'S STOCK. WHILE THE COMMITTEE REPORT NOW PROVIDES FOR NEGOTIATED SETTING OF VALUES FOR THIS PURPOSE, WE DO NOT FEEL SUCH NEGOTATIONS CAN BE MEANINGFUL IN VIEW OF THE DEBTOR'S LACK OF BARGAINING POWER. THE DETERMINATION OF VALUE OF STOCK (USUALLY NOT MARKETABLE) OF A DISTRESSED COMPANY IS SOMETIMES IMPOSSIBLE ABSENT A SALE AND SUCH A SUBJECTIVE CONCEPT SHOULD NOT BE ADDED TO THE TAX LAW.

WE RECOGNIZE THE COMMITTEE'S CONCERN WITH THE DEBTOR NOT RECOGNIZING INCOME ON THE EXCHANGE WHILE THE CREDITOR BENEFITS FROM ANY BAD DEBT DEDUCTIONS HE MAY HAVE PREVIOUSLY TAKEN, OR TAKES CURRENTLY, AS A RESULT OF THE BANKRUPTCY PROCEEDING. TO THIS END, THE COMMITTEE MAY CONSIDER LEGISLATION WHICH WOULD REQUIRE THE CREDITOR TO RECAPTURE, AS ORDINARY INCOME, THIS BAD DEBT DEDUCTION UPON ULTIMATE SALE OF THE STOCK RECEIVED.

ADDITIONALLY, CORPORATE DEBT CONTRIBUTED TO CAPITAL BY SHAREHOLDERS SHOULD NOT RESULT IN INCOME BEING RECOGNIZED BY THE CORPORATE OBLIGOR. DIFFERING SHAREHOLDER

BASIS WILL RESULT IN DISTORTION OF THE CORPORATE DEBTOR'S TAX ATTRIBUTES. THE TAX DIVISION SUGGESTS THAT THE COMMITTEE MAY WISH TO CONSIDER LEGISLATION WHICH WOULD REQUIRE THAT WHERE A NON-CONTROLLING CREDITOR-SHAREHOLDER MAKES A CAPITAL CONTRIBUTION OF UNPAID EXPENSES, SUCH AS SALARY AND INTEREST, WHICH HAVE BEEN ACCRUED BY THE DEBTOR BUT NOT YET INCLUDED IN THE INCOME OF THE CREDITOR-SHAREHOLDER (DUE TO HIS METHOD OF ACCOUNTING), THE CREDITOR-SHAREHOLDER WOULD RECOGNIZE SUCH AMOUNTS AS ORDINARY INCOME UPON THE ULTIMATE DISPOSITION OF THE DEBTOR'S STOCK.

WE ARE SUBMITTING FOR THE RECORD, A MORE DETAILED TECHNICAL DISCUSSION OF THESE ISSUES, AS WELL AS OUR COMMENTS ON SEVERAL OTHER ASPECTS OF THE BILL.

I WANT TO THANK YOU AGAIN ON BEHALF OF THE AICPA FOR THE OPPORTUNITY TO PRESENT OUR POSITION.

IF YOU HAVE ANY QUESTIONS, I WILL BE HAPPY TO TRY TO ANSWER THEM.

# Detailed Explanation of the AICPA Federal Tax Division's Position and Recommendations Covering H.R. 5043

## Income from the Discharge of Indebtedness

### 1. Introduction: The Effects of Cancellation Income

The key issue in this area lies in resolving what results should flow from cancellation income. Traditionally, where a solvent debtor realizes income from the cancellation of indebtedness, some method is available to the debtor to defer the recognition of such cancellation income. Where insolvent or bankrupt debtors are involved, the focus has centered on the debtor's poor financial condition resulting in non-reduction in tax attributes. Thus, insolvent debtors do not impact their net operating loss to the extent debt forgiveness does not exceed the zero solvency level. To the extent solvency is created, deferral under §§108 and 1017 is available. Where formal bankruptcy proceedings are in process, the Chandler Act of 1938 called for the reduction of basis of assets, but not below the asset's fair market value. However, due to the effects of inflation, such markdowns are usually limited.

As is clear from our prior discussion, the Task Force has concluded that the focus of cancellation income should be what consideration is received by the creditor, rather than the current test of the debtor's financial condition. Accordingly, we agree that where the creditor does not continue as an equity risk-taker by taking stock in the debtor, cancellation of indebtedness income results. Thus, where the creditor is either completely terminated as an obligee of the debtor or remains solely as a creditor with a reduction in the amount due him, the forgiven liabilities should result in cancellation income. However, we feel that the underlying rehabilitation policy involved in this area

does not necessarily mandate immediate income recognition. Rather, the Task Force is of the opinion that where such income is realized, whether the debtor is solvent, insolvent or bankrupt, recognition should be spread over a number of years consistent with the underlying policy of current §§108 and 1017.

To this end, the Task Force feels that a number of acceptable methods exist for protecting the integrity of a deferral concept allowing the debtor to avoid current reduction of cash flow and tax attributes. Thus, it would seem acceptable to continue application of current §§108-1017 to solvent debtors if those areas of abuse which have existed under these sections are foreclosed. Accordingly, the preference of the Task Force is for the continuation of §§108 and 1017 in a manner substantially similar to their present form with uniform treatment of attribute reduction between bankrupt, insolvent and solvent taxpayers. However, the Task Force recognizes the need for bankruptcy tax legislation, which has essentially not existed since October 1, 1979, and for a workable solution acceptable to all parties in interest to the multitude of issues surrounding the attribute reduction debate. In light of these conditions, the Task Force would deem acceptable as an alternative to the substantial continuation of §§108 and 1017, a comprehensive solution which is discussed in detail below.

In summary, the Task Force feels that continued deferral should be permitted for solvent, insolvent or bankrupt taxpayers. Allowing such debtors to spread the effects of such income over a future period of time, rather than force a single adjustment of various debtor attributes, is consistent with both appropriate tax policy, debtor rehabilitation, and the Administration's efforts for further capital formation.

## 2. Equivalent Tax Treatment for All Debtors

H.R. 5043 presently requires "insolvent" or bankrupt companies to reduce their tax attributes by the full amount of debt cancellation income while only allowing solvent companies to reduce the tax basis of depreciable assets, with the remaining portion of the debt cancellation treated immediately as taxable income. This results in a more favorable tax position for adjudicated bankrupt debtors and thus encourages financially marginal taxpayers to reject debt compromise until they qualify for this more favorable tax result. Thus, obligors who have cancellation of indebtedness income under a bankruptcy proceeding are permitted to exclude such income in its entirety from their computation of taxable income, albeit with the reduction of various attributes. A debtor who is not bankrupt or insolvent might be required to report the entire amount as taxable income causing a cash drain out of the very transaction which was meant to conserve corporate cash flow.

We feel that in this area, the same tax law should be applicable to all classes of taxpayers - solvent, insolvent, or bankrupt. From an accounting point of view, it is extremely difficult to determine with any accuracy whether or not a taxpayer is insolvent. Many different methods can be used to value assets, in the absence of an actual sale; and depending upon the method of valuation, different evaluations as to the taxpayer's solvency or insolvency can be reached. It is not appropriate that two different methods of valuing assets could result in a choice of two different tax laws being applicable to the same taxpayer.

3. Proposed Alternative for Tax Attribute Reduction

Under the proposed Bill, tax attributes of the insolvent or bankrupt debtor would be decreased in a prescribed order for each dollar of cancellation income realized. This contrasts sharply with the basis markdown provisions of previous law under which no income from the cancellation of indebtedness occurred when a debtor was insolvent or bankrupt. While such attribute reduction is understandable in light of the fact that the debtor has not paid for these deductions, we must reiterate that such attribute reduction would occur only where the creditor did not receive stock, and thus does not maintain a continuing interest in the debtor as a result of the reorganization. Under our proposal, where a creditor does receive stock, no income would be realized and no attribute reduction would be required. We feel this policy is consistent with the fact that where such stock is received, the debtor has in fact "paid" for any deduction and thus the transaction should not result in income or attribute reduction. Any abuses by the creditor should be dealt with at the creditor level. However, in light of the need for a workable solution which should be acceptable to all parties involved, the Task Force wishes to propose the following comprehensive solution to the issues of attribute reduction.

The debtor would be allowed an election to reduce all of its tax attributes, including the basis of assets, in any order it chooses, providing that the basis of assets to be reduced is to be limited to depreciable or amortizable assets. However, this proviso, that only depreciable or amortizable assets be written down, will be acceptable only if the alternative election is included in the Bill permitting the debtor, in lieu of current attribute reduction, the ability to include the cancellation income, as determined below, ratably over a future period of either twenty years, or ten years commencing five years from the date of cancellation.

In no event shall the total amount of cancellation income for which the debtor must account exceed the debtor's tax attributes at the date of cancellation. Tax attributes shall be equal to the total of the debtor's NOL, credit and capital loss carryforwards (as described in H.R. 5043), plus the excess of his total assets over liabilities after the cancellation. If the debtor elects to reduce attributes currently, only depreciable assets plus his other tax carryforward attributes may be reduced. If after reducing the defined attributes, there still remains an amount of cancellation income to be accounted for, such remaining amount will be included in income ratably over the time period mentioned above.

> <u>Example</u>: Assume a taxpayer has $110 in liabilities and the following carryforwards; $40 net operating loss; $10 investment tax credits; $10 capital loss carryforward. In addition, the tax basis of its assets at the date of cancellation is $20, $15 of which is in non-depreciable assets. As a result of a debt cancellation of $100, its remaining liabilities at the date of cancellation equal $10. The total amount of cancellation income

for which the debtor will be required to account is $80, determined as follows:

| | |
|---|---|
| $40 | (N.O.L.) |
| $20 | (I.T.C. carryover applied at 50 cents of credit to each dollar of cancellation income.) |
| $10 | (Capital loss carryover) |
| $10 | (Tax basis of total assets in excess of remaining liabilities at the date of cancellation.) |

If the debtor chooses to reduce attributes currently, it would eliminate its $70 of carryovers and be limited to an additional $5 basis reduction attributable solely to the depreciable assets. The remaining $5 balance must be included in income over a future period of time. The balance of the $100 cancellation income less the $80 accounted for would simply be disregarded.

The Task Force feels this proposal would combine the needed flexibility required to accomodate and equalize the treatment of solvent, insolvent and bankrupt debtors within one overall consistent concept.

As a less preferable proposal, it would be possible for the Bill to again provide for the uniform treatment of insolvent, solvent and bankrupt debtors by requiring that attributes be reduced in lieu of cancellation income in the same order as provided in H.R. 5043. This would allow for the markdown of property other than property with a depreciable or amortizable basis. However, this provision should be subject to the same time spread, discussed above, for direct inclusion in income of any amounts not applied to attributes and which exceed remaining liabilities at the date of cancellation. Such an election would be final once made.

The Task Force feels that its first proposal is preferable in that reduction of asset basis would be limited to depreciable or amortizable property, subject to the time spread inclusion option. This would avoid the problems created by the Bill's initial draft requiring that in the case of a holding company, both the basis of the investment account in the holding company and the subsidiary's assets be reduced. As discussed immediately hereafter, we feel that such a double reduction is both onerous and uncalled for.

Various modifications can easily co-exist with our proposal. For example, it may be possible to allow any cancellation income to be spread over the remaining life of the outstanding obligation or over the life of any newly-issued debt which was used to repay the first issue. This would be analagous to debt discount.

Further, writedowns of depreciable property might be required to reflect the average life of the debtor's depreciable assets. See, for example, Rev. Proc. 78-16, 1978-2 CB 489. We must note however, that a policy limiting writedowns to depreciable or amortizable property only is detremental from a taxpayer point of view. For example, current law allows no amortization of certain capital assets, such as purchased goodwill or land, until disposition of the related assets. These results clearly contrast with a Bill that limited writedowns to depreciable property only. Yet, it is the Task Force's opinion, that in light of the necessity for a legislative resolution of this issue, an acceptable solution would call for restriction of amortization of debt cancellation income to depreciable property, providing an alternative election to include such income over a future period of time were available.

Where depreciable property is not available, administrative ease may call for the amortization of any cancellation income over a stated period of years. Thus, any cancellation income should be taken into income over the same minimum time periods discussed above. This would give the debtor a period in which to reestablish financial security, and better allow his cash flow to respond to his business needs.

Recognition of Income From Issuance of Stock to Retire Debt

Introduction: The Measurement of Income Issue

Perhaps the most important issue addressed by H.R. 5043 relates to the issuance of stock for outstanding obligations. The Task Force believes that such transactions should not be viewed as taxable events since such exchanges are totally consistent with the underlying rehabilitation policy of a bankruptcy proceeding, and would not be in violation of any overriding principle of taxation. Thus, we reject the analysis which views the stock issuance as a closing transaction to the outstanding indebtedness. Such an analysis is both detrimental to rehabilitation efforts and inconsistent with the debtor's attempt to strengthen his capital structure. Rather, the Task Force believes that the issuance of stock should be viewed as an ongoing obligation of the debtor, albeit, in an equity form.

In addition, we feel that excessive litigation would result from any administrative effort calling for a determination of the fair market value of the stock issued. Pivotal questions which remain unsolved, such as those with respect to §385, would surely add to the confusion and litigation which will ensue from such taxable events.

We feel that our proposed "recapture" concept, as discussed below, with respect to the eventual disposition by the former creditor of the stock received in the reorganization is sufficient to insure the integrity of the entire transaction. As a result of such recapture, a greater potential exists for the equal treatment of both security and non-security holders.

Measurement of Income

1. Stock Issued for Outstanding Obligations

Under §2(a) of the Bill, where debt not qualifying as a "security" is satisfied by the issuance of equity, the corporate debtor or its successor would be treated (1) as not having transferred its stock but (2) as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock. This represents a significant change in long standing current law. The courts have long rejected the view that, where stock is issued for debt, the debtor should be seen as first having issued its stock for cash, with the cash then being used by the corporation to satisfy its obligations at a discount. Tower Building Corp., 6 TC 125 (1945). Traditionally, where the face amount of the debt is greater than the par value of the stock, the excess is seen as a premium or subscription paid for the debtor's stock by the creditor. Comm. v. Capento Securities Corp., 140 F.2d 382 (1st Cir. 1944). With respect to the stock of a financially troubled debtor, problems will obviously be created by the determination of "fair market value." The effect of this new standard would be to tax the debtor on the amount by which the fair market value of the stock issued was less than the face of the debt cancelled. The difficulty with this proposed approach is that it fails to recognize that the equity is in reality a continuation of the old debt obligation in a new form and thus not an appropriate point for the debtor to recognize gain or loss. Tower Building Corporation, supra. Further,

the wording of the section is unique. It directs that the debtor "corporation shall be treated . . . as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock". This raises two immediate questions: (1) in determining fair market value, will the stock be valued as though it were issued before or after the debt was removed from the debtor's balance sheet — the very act of debt removal increases the debtor's net worth; (2) will all stock (voting, non-voting, preferred or redeemable stock) qualify? The inability to refinance debt via stock issuance on a tax-free basis will, in many instances, limit rehabilitation since many reorganizations and debt restructuring are currently formulated in this manner. Once creditors accept stock to safeguard their position, they become true equity risk-takers and have in reality continued their prior investment in a less secure position.

It is interesting to note that the issuance of stock for debt is often the result of mismatched financing by the debtor. Thus, where a debtor does not have access to capital markets with respect to the placement of debt with long maturities, it may often turn to short term sources of credits such as the local bank. As a result, assets with a payback over a long period of time are in reality financed by short-term notes. Such short-term debt, when added to the short-term credit granted by suppliers, will often result in a liquidity crisis. Many such problems were

handled in Chapter 11 arrangements with creditors. Often, creditors would realize the true needs of the debtor and thus accept stock in consideration for their debt. Clearly, in such instances, no taxable event as prescribed in the proposed Bill should be deemed to have occurred. At most, the acceptance of stock is no more than the continuation of the debt in an altered form.

As this entire section applies only to debt which is not a "security", it discriminates against heavy users of short-term credit, as well as smaller companies which are foreclosed from issuing debt which will qualify as securities due to their size and the relative cost of issuing such obligations. Where creditors take stock, continuity should be viewed as to the ongoing investment. Tax results should not differ based on the type and tenor of debt surrendered. It would be unfair to determine the tax consequence to the corporate debtor based on the nature and form of the debt surrendered by the creditors. Such differentiation will only add to those complications already inherent in negotiating the interests of security verses non-security lenders and may potentially lead to an extreme pro-liquidation bias on the part of such non-security holders.

2. Contribution to Capital

Under §2(d) of the Bill, where indebtedness is acquired from a shareholder as a contribution to capital, the Bill provides that §118 will not apply. Rather, the transaction would be treated as being in satisfaction of the debt for an amount of money equal to the shareholder's adjusted basis in the contributed indebtedness, resulting in

the corporate debtor including as income any difference between the shareholder's basis in the debt and the obligation's face value. The intent of the Bill is to require certain corporate debtors to restore to income the deductions taken for accrued but unpaid expenses which have not been recognized as income by the creditor-shareholder due to the creditor-shareholder's method of accounting.

Thus, if the creditor-shareholder has written-down his debt from the corporation, the corporation would recognize income equal to the excess of the face value of the debt over the adjusted basis of the debt in the hands of the creditor. This provision of the Bill causes the corporate debtor to recognize income based upon the creditor's taking a bad-debt deduction, which is contrary to the Supreme Court decision in Moline Properties Inc. v. U.S., 319 US 436 (1943), which held that a corporation is clearly a separate entity distinct unto itself for tax purposes. In addition, the Bill is inequitable in that it forces the corporation to subsidize the writedown of large bad debt deductions by some creditor-shareholders against the smaller bad debt deductions of other creditor-shareholders.

The debtor should not be viewed as having had a taxable event, when its stock is substituted for its outstanding obligations. Alteration of tax results of the debtor based upon the nature of the creditor's investment is an inappropriate measurement. Further complications would occur in terms of administration, supervision, and compliance as few debtors are aware of the basis of any particular debt in the hands of their creditor. For instance, what is the adjusted

basis of an account receivable to a creditor who is on the reserve method? Under these circumstances, it would seem appropriate not to alter current provisions with respect to contributions to capital.

Further, where intercompany indebtedness exists between a parent corporation and its subsidiary, tax treatment of the cancellation will differ depending on whether the parent simply directs the debt to be applied as an additional contribution to the capital of the subsidiary or accepts additional stock as consideration for its actions. Particularly in the case of a wholly-owned subsidiary, the issue of whether additional stock is or is not received should not alter the underlying tax consequences. In both cases, the debt is simply replaced by an equity obligation, and thus, is not a taxable event warranting realization and recognition of gain or loss. Where potential abuses exist, Congress should consider foreclosing such unwarranted benefits at the shareholder level rather than at the corporate level.

We further wish to note that the tax treatment of convertible debt is less than clear due to the sweeping language of the Bill. Clearly, it would not be proper to have the exercise of a conversion privilege cause taxable income to the corporate debtor. The Bill and legislative reports should clearly reject any such conclusion.

3. Short-Term Creditors and Section 351

Under §5(e) of the Bill, a corporation would not be able to transfer its stock for its outstanding short-term indebtedness tax free under §351 of the Code as such short-term debt would no longer be considered property. This position has been considered by the Courts on numerous occasions and has been stoutly rejected. As already discussed, the issuance of stock has not in the past been viewed as an appropriate time to measure gain or loss to a debtor. Further, in Rev. Rul. 77-81, 1977-1 CB 97, the Service accepted the determination made by the Court that a debtor's short-term obligations were acceptable as property in a §351 exchange for the debtor's stock. The courts have also accepted the use of stock issuance under §351 for outstanding indebtedness in Cement Investors, 316 U.S. 527 (1942), and Alexander E. Duncan, 9 T.C. 468, acq. 1948-2 CB 2.

We feel that the issuance of stock under §351 for short-term indebtedness is totally consistent with bankruptcy policy. Further, this is often a technique used to resolve debtors' financial difficulties, and is most useful in aiding the capital formation efforts of debtors. Foreclosure of this avenue will result in a severe strain on rehabilitation efforts and may result in a clear preference by creditors to liquidate debtors. Clearly, the imposition of a taxable event on both creditors and debtors, and the resulting negative cash flow implication of such transaction, will cause creditors to accept the receipt of fewer current dollars due to their potentially higher present value.

One other important point should be made with respect to the measurement of income. Under current law, the Dallas Transfer & Terminal Warehouse Co., 70 F.2d 95 (CA-5, 1934), case stands for the proposition that when a debtor transfers appreciated property to its creditors when it is insolvent, no gain or loss is to be recognized on such transfer. Thus, the excess of the appreciated value over the basis of the property will not be taxed to the debtor upon transfer of this property to the creditor. Regulations proposed under §1.1001-2 may be interpreted as implying that such results would no longer be true. As a result of such interpretation, while the proposed Bill would exempt an insolvent debtor from realizing and recognizing income on the discharge of indebtedness, it is possible that the Internal Revenue Service could argue that income is realized and recognized due to a sale or exchange taking place upon the debtor's transfer of property to his creditors. We feel that if it is the intent of Congress to change this result, specific language to this effect should be added to the Bill. If this is not the intent, then administrative regulation should not be permitted to override judicial interpretations which have existed for over forty-five years.

4. Recognition of Income by Creditors

The Task Force recognizes the Committee's concern with the debtor's not recognizing income upon the receipt of stock in exchange for debt and the creditor benefitting from any bad debt deductions he may have previously taken, or takes currently as a result of the bankruptcy proceeding. To this end, the Committee may consider legislation which

would require the creditor to recapture this bad debt deduction upon ultimate sale of the shares received in order to insure that the character of any income derived is properly matched with its origin. This would necessitate the reversal of many current precedents to the contrary. See, Allen v. Trust Co. of Georgia, 50-1 USTC ¶9214, 180 F.2d 409 (CA-5, 1950); Rev. Rul. 66-320, 1966-2 CB 37; Continental Illinois National Bank and Trust Co. of Chicago, 69 TC 357 (1977).

With respect to contributions to capital by creditor-shareholders, the Task Force suggests that where a non-controlling creditor-shareholder (i.e., those not encompassed by present §267 of the Code), makes a capital contribution of unpaid expenses, such as salary and interest, accrued by such debtor but not yet included in the income of such creditor-shareholder, due to the creditor-shareholder's method of accounting, the Committee may wish to consider legislation which would require the creditor-shareholder to recognize such amounts upon the ultimate disposition of the debtor's stock. Consistent with our position on bad debt deductions previously taken by creditors, the Task Force suggests that the solution to this problem be sought at the creditor-shareholder level rather than crossing the entity line to the corporate level. This goal could be accomplished by either a recapture or a basis reduction concept.

Other Recommendations With Respect to Attribute Reduction

1. Expired Net Operating Losses

In determining the debtor's net operating loss attribute, we feel that consideration should be given to allowing the debtor to reactivate net operating losses which have gone unused for the three years prior to the date of plan confirmation. This is in line with legislative intent in other areas of the Code such as §374(e), and would be consistent with the rehabilitative tax policy advocated here.

2. Order of Net Operating Loss Absorption

The Task Force further believes that the Bill should make clear that attribute reduction is to take place as of the first day of the year following the forgiveness. If this is not specifically spelled out, it is conceivable that debtors will have income at a most inopportune time. For instance, assume a debtor has a $5,000 NOL, $5,000 of debt forgiven in year 1981 and $1,000 of taxable income from operations in 1981. Under our interpretation, the $1,000 net operating income is first offset against the $5,000 NOL with the balance of $4,000 being removed through application of the debt cancellation in 1981. If not, the $5,000 debt forgiven will offset the $5,000 NOL, and the taxpayer will have a tax liability on the $1,000 of operating income. We feel this result would be both harsh and non-rehabilitative.

In addition, the Bill's mandating attribute reduction in an order other than one which would cause the oldest attributes to be absorbed first is unduly harsh. Because of the limited time an NOL and capital

loss can be carried forward, and due to the typically long periods involved in both debt cancellation by creditors and bankruptcy procedures, it would be more consistent with bankruptcy rehabilitation philosophy to allow the losses that are oldest to expire first via their prior application to the forgiven debt. Likewise, where a taxpayer has incurred NOL's or capital losses which have already expired, he may be penalized if he must reduce his current NOL for the cancelled amount. From a simplistic point of view this could occur where the expiring NOL arose from cancelled liabilities with the taxpayer not having received any benefit from the NOL. Due to the length of time the NOL may be carried forward under current law and the impractical possibilities of determining whether liabilities being forgiven represent "losses" which have expired, there is no other acceptable alternative to the aging problem other than to, at a minimum, allow the application of NOL's on a first in-first out (FIFO) basis.

3. Sections 108 and 1017: Markdown of Investment Accounts

Under the Bill addressed at the September hearings, Internal Revenue Code section 1017(c)(2) would be amended so that where qualified business indebtedness is cancelled, the basis in the stock of a subsidiary could be reduced only if the subsidiary agreed to reduce the basis of its assets by a corresponding amount. To qualify, the subsidiary must be a member of an affiliated group (as defined in §1504). The reduction rule was not applicable if the debt discharge is due to a Title 11 proceeding or the insolvency of the debtor. Presumably the rule is designed to prevent a subsequent tax-free liquidation of the subsidiary wherein a pure carryover basis of the subsidiary's assets under §334(b)(1) would be enjoyed

by the parent, thus negating the effect of any prior write-down of its stock holdings. Accordingly, this double write-down is justifiable only if there had been an abuse by the taxpayer. Thus, the markdown should take place upon the taxpayer's §332 liquidation of the subsidiary resulting in lower asset basis in the hands of the parent. Further, if the investment account has been written down, that portion of the reduced basis attributable to the markdown should result in ordinary income upon sale of the subsidiary to an entity outside its consolidated group. Note, under our recommended senario, this adjustment would not be required due to the limitation to depreciable or amortizable property only. Rather, mandated inclusion over our recommended period of time would be required.

4. The Carman Rule

With respect to the proposed rejection of the Carman decision, we respectfully suggest that additional securities received for accrued but unpaid interest should be treated as though it were §306 stock. Critically, such status would not be dependent on any accumulated earnings or profits but rather upon a proportionate part of the stock received being considered ordinary in character upon ultimate disposition of the consideration received. This is consistent with the well established Corn Products doctrine, and would defer immediate tax liabilities upon receipt of additional non-liquid consideration.

The Task Force further believes that under no circumstances should a taxpayer be in receipt of accrued interest if, as a result of the entire transaction, the creditor is not in receipt of an economic gain. Thus, as the Bill is unclear as to the amount "attributable to accrued interest", it would be unfair to argue for any accrued interest when the fair value of the consideration received is less than the tax basis of the securities exchanged. Without clear indication of how interest is to be measured when consideration is received, difficult administrative problems may result.

## Introduction: The Proposed "G" Reorganization

As a result of the often poor interaction between §§371 and 372 and the balance of the Subchapter C provisions, the Bill proposes a new "G" reorganization permitting a transfer of the debtor's assets to a new corporation. While a complex continuity of interest principle has been removed from the pre-Holland version of the Bill, difficult questions continue to exist with respect to exact operation of the new "G" reorganization.

### 1. Continuity of Interest

The Bill provides little guidance with respect to the continuity of interest to creditors who, after the transfer, have effective control of the new corporation. Under current law, such creditors are typically viewed as satisfying the broad concept of continuity of interest. However, continued problems have existed with respect to the application of §381 as §§371 and 372 do not currently authorize §381 application. If a §371 transfer does not currently also satisfy some other §368 definitional test, §381 may not apply. Further support for this conclusion is drawn directly from the Supreme Court's opinion in Southwest Consolidated Corp., 315 US 194 (1942), wherein the Court stated that having satisfied continuity of interest under Alabama Asphaltic Limestone Co, 315 US 179 (1942), is not the same as to have actually have been a shareholder for application of the net operating loss limitations under §382.

While the Bill does provide that §368(a)(1)(G) will be subject to §381, such application will be subject to the "substantially all" test of §354(b). As will be discussed in our second point, the "substantially all" test may make the "G" reorganizations criteria difficult to meet. Section 2(d) of the proposed Bill provides that stock received by a creditor shall not be viewed as received by "purchase" for §382(a). Further, for purposes of §382(b), creditors receiving stock in a reorganization described in §368(a)(1)(G) "shall be treated as stockholders immediately before the reorganization". Where an alternative route to reorganization is chosen, the statute should make clear that the prohibitive implication of Southwest Consolidated shall not limit loss carryover under §382(b). Such a policy would be excessively restrictive and be inconsistent with the Subcommittee adoption of our prior suggestion that the "G" reorganization not be the exclusive provision available to bankrupt debtors.

2. The "Substantially All" Test

Substantial problems exist with the proposed §368(a)(1)(G) reorganization. Thus, the new reorganization would need to qualify under either §354 or §355. For §354 to apply, "substantially all" of the debtor's assets must be transferred. "Substantially all" under Internal Revenue Service guidelines for advance rulings (Rev. Proc. 77-37, 77-2 CB 568), is 90% of the net assets and 70% of the gross assets of the transferor. However, various cases provide alternate criteria for measurement of "substantially all". Smothers,

79-1 USTC ¶9216. Statutory guidance must be given as to what items are to be included in determining "substantially all". Further, guidance as to the point in time when such a determination is to be made is critical. For example, if the determination of what constitutes "substantially-all" is to be made immediately prior to the effectuation of a "G" reorganization, what treatment would be accorded cash payments made to creditors who retain no continuing interest in the reorganized debtor? The "substantially all" test should be measured at the time of the Court's approval of a plan and all dispositions and sales of assets ordered by the Court for the benefit of creditors should be excluded from the determination of whether the "substantially all" test is met. Failure to define the appropriate point of time at which the "substantially all" test is to be measured may make the "G" reorganization unworkable.

Senator BYRD. There will be a panel of two on the same piece of legislation, William J. Rochelle, Jr., National Bankruptcy Conference, and Mr. Robert E. Phelan of Dallas, Tex.

Welcome, gentlemen. You may proceed.

## STATEMENT OF WILLIAM J. ROCHELLE, JR., NATIONAL BANKRUPTCY CONFERENCE

Mr. ROCHELLE. On behalf of the National Bankruptcy Conference, we would like to express appreciation for this opportunity to be heard.

I have prepared a short written statement. I would ask that it be included in the record.

Senator BYRD. It will be included in the record.

Mr. ROCHELLE. The chairman of the Committee on Taxation of the Conference is unable to be present. He will submit a more elaborate written statement at a later date.

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

[The material referred to follows:]

STATEMENT OF MYRON M. SHEINFELD,
SHEINFELD, MALEY & KAY, HOUSTON, TEXAS
IN CONNECTION WITH H. R. 5043 -
BANKRUPTCY TAX ACT OF 1980

## Background of Witness

My name is Myron M. Sheinfeld, I am a partner in the law firm of Sheinfeld, Maley & Kay of Houston, Texas. I am Chairman of the Committee on Tax Matters of the National Bankruptcy Conference. I have written and lectured extensively in the field of bankruptcy and taxation and presently I am a Lecturer in Law at the University of Texas School of Law. I have testified before the Ways and Means Subcommittee on Select Revenue Measures. I have previously submitted statements in connection with the Bankruptcy Code and the income tax aspects of Bankruptcy and Business Reorganization.

## Introduction

I submit this written statement in connection with the consideration of H. R. 5043, The Bankruptcy Tax Act of 1980 ("BTA") presently being considered by the Subcommittee on Taxation and Debt Management of the Committee on Finance proposes sweeping and substantial changes in the area of debt reorganization and the taxable effect of certain transactions in and out of bankruptcy. The BTA does more than revise and update the tax aspects of bankruptcy proceedings. The BTA affects Bankruptcy Court proceedings and out-of-court

reorganizations and is designed to be applicable whether or not a debtor is solvent or insolvent. The effect of the application of the BTA is long lasting and consequential even after the completion of a substantive reorganization. The provisions of the BTA will affect the debtor's future tax obligations. Many of the provisions of the BTA have been criticized; many have been supported; and many provisions remain controversial and can be improved. My statement is intended to be directed to those provisions of the BTA which can and should be improved. My statement is also intended to supplement the testimony of William J. Rochelle, Jr. in behalf of the National Bankruptcy Conference.

## Tax Treatment of Discharge of Indebtedness

### A. The BTA Structure.

It is crucial to "step back" and observe the BTA treatment of discharge of indebtedness first from afar. It is necessary to "walk a maze" before the full effect of the BTA provisions can be determined in dealing with the treatment of income realized from discharge of indebtedness. The tax treatment of income realized from discharge of indebtedness is dependent on whether the debtor is solvent or insolvent, whether the discharge of indebtedness is accomplished in a bankruptcy case in court or in a non-bankruptcy context out of Bankruptcy Court, whether the debtor is a corporation or another entity, and whether the discharge of indebtedness is



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accomplished by exchange of stock for debt or compromise by composition or even some combination of stock and percentage payment. All of these questions must be considered before the full impact of BTA provisions on discharge of indebtedness is apparent. In addition, the action or treatment by the debtor through voluntary election may affect the tax treatment of income recognized and will create tax liability that will survive a reorganization.

B. The Treatment of Income from Discharge of Indebtedness.

For many years there had been well-articulated exceptions to the recognition of income from discharge of indebtedness. These exceptions were developed judicially and legislatively. Exceptions were carried forward in the writing of tax regulations. In both arrangements and reorganizations under the Bankruptcy Act (as it existed prior to October 1, 1979) there had been a well-recognized exception to the treatment of income from discharge of indebtedness--simply stated, income was not recognized and the debtor was merely required to reduce basis of assets by the amount of debt that had been discharged. However, asset basis was not reduced below fair market value on the date the Bankruptcy Court approved the arrangement or reorganization plan. If the arrangement or reorganization plan called for a transfer of the debtor's assets to a successor corporation, there was no requirement of any reduction in asset basis. In retrospect, the treatment

of recognition of income from discharge of indebtedness under the old Bankruptcy Act was intelligent and encouraged successor corporations to take over and continue the debtor's business and assume all or a portion of its indebtedness. This special treatment was not abused. The debtor's creditors generally benefited. Most, if not all, of the bankruptcy and reorganization practitioners would have preferred the same tax treatment under the Bankruptcy Code (for cases filed after October 1, 1979) as occurred under the Bankruptcy Act. This is not the case under the BTA.

C. A Critique and a Suggested Solution.

Any income recognized from discharge of indebtedness ("the debt discharge amount") is postponed to be applied to reduce tax attributes. The reduction of tax attributes is meaningful if the debtor has any tax attributes to reduce. Certainly we do not want the debtor to lose the benefit of net operating loss carry-overs. Since they cannot be transferred, sold or traded, utilizing the debt discharge amount as a reduction against that particular tax attribute is sensible, commendable, and beneficial. Likewise, the reduction of tax attributes in the basis of depreciable assets, investment tax credit, and capital losses and carry-overs are viewed with similar favor. Why, however, would the BTA allow reduction in basis of depreciable assets below fair market value? This can occur under the existing

provisions of the BTA. The BTA insures that if depreciable assets are sold, tax liability will result. Recapture is applicable so that if the depreciable asset is subsequently sold, a tax liability is immediately imposed on the debtor. In a way, the whole scenario is designed, on the surface, to aid the debtor, after recognizing income from the discharge of indebtedness, but, it does not go far enough and may not be all the help it purports! We recommend and urge that the debtor's income realized from discharge of indebtedness, if it be taxed, and apparently this is the case, should be taxed <u>at the debtor's election</u> over a period years after successful reorganization has been finalized and accomplished. Postponement of income realization and the ultimate tax liability encourages the debtor to utilize reorganization as a rehabilitative device to continue the business rather than as a device to terminate it. Postponement of tax liability appeals to third parties who may be the successor to the debtor and who, in that capacity, assume the debtor's obligations and attempt to reorganize, reconceive and rehabilitate the existing business. Thus, some form of postponement of income realization over a period of years is consistent with the bankruptcy philosophy of "fresh start." Postponement of income realized from discharge of indebtedness is consistent with the philosophy of the BTA. How should the postponement of income realization operate? It should

be the objective in common of Treasury, the debtor and its creditors to preserve the on-going nature of the reorganized business and revitalize its management, continue and add to its labor force, with the ultimate goal of profitability. Profit generates tax, provides funds for expansion, is the source for increased wages, and is the goal of the equity participants. Any reorganized debtor, whether in or out of Bankruptcy Court, needs time to become profitable. That time can be given in the form of concessions to the reorganized debtor. The first concession was recognized in the BTA when income from the discharge of indebtedness can be utilized as a credit against net operating loss carry-overs. This concession falls short unless it is coupled with a deferral of income reporting. If the debtor has no net operating loss carry-over, then income recognized from the discharge of indebtedness is immediately realized. Now, for the second concession, and the clarification of our postponement of income recognition theory. A debtor in reorganization, whether in or out of Bankruptcy Court, should be granted an <u>option</u> to elect to report the income realized from discharge of indebtedness over the next ten (10) years. We would suggest that this concept be called the <u>deferred income election</u>. A debtor electing deferred income treatment may do so before crediting income from discharge of indebtedness against net operating loss carry-over, or, may elect to credit such income against net

operating loss carry-over and defer any income remaining. The deferred income election would operate over a period of ten (10) years beginning with the first full tax year after reorganization. The first two (2) years of the deferred income period, the debtor would have no mandatory requirement to include income recognized from discharge of indebtedness in gross income reported, however, could do so if it desired. Years three (3) through ten (10) would be different. A minimum of one-eighth (1/8) of the deferred income recognized from discharged indebtedness <u>must</u> be included in the debtor's gross income. Failure to include the minimum one-eighth (1/8) in each year three (3) through ten (10) would trigger the entire deferred income being included in gross income and subject the debtor to interest and penalty on the entire amount of the deferred income omitted. We suggest that the only tax attribute affected would be the net operating loss carry-over, and only if the debtor elected voluntarily to credit income from discharge of indebtedness against it before optioning to defer income over the next ten (10) years. All other tax attributes would remain intact and would be preserved. Our suggestion is simple, recognizes income from discharged indebtedness, grants reorganized debtors ample time to "retrench," refinance, and revive, does not impact unfavorably the collection of taxes but encourages tax reporting and payment, is consistent with the

bankruptcy concept of "fresh start," and is easily administered from the debtor and collection viewpoint.

## Tax Rules Relating to Individuals, Partnerships and Corporations

A. The BTA Concept.

We endorse the treatment of individuals, partnerships and corporations as to the creation or non-creation of separate taxable entities. For quite some time much confusion has existed as to the creation or non-creation of separate taxable entities. Individuals can elect numerous remedies under the Bankruptcy Code (Title 11). For quite some time we have advocated the creation of a separate taxable entity when a liquidation (Chapter 7) or a reorganization (Chapter 11) is commenced by an individual. We felt that it was only through this means that pre-petition and post-petition income, assets, expenses and rights, could be cleanly and logically separated. On the other hand, when an individual seeks relief by proposing to make payments through a plan providing periodic distributions to creditors from regular income (Chapter 13), no logical reason is required to separate pre-petition and post-petition income and assets. Thus, in reality, the individual in Chapter 13 never liquidates, does not reorganize, but merely uses assets and income from pre-petition and post-petition sources as the basis for payments to creditors under a plan. Once payments have been

made, the individual in Chapter 13 is discharged. There is no logical hiatus for an individual once a Chapter 13 is filed. There is no reason for creating a separate taxable entity. We are pleased that the partnership and corporation in liquidation (Chapter 7) or reorganization (Chapter 11) does not trigger creation of a separate taxable entity. Confusion over treatment of partnerships has been present in the past and has caused needless disputes between partnership trustees and the Internal Revenue Service.

B. Recommended Modification.

Provisions have been written into the BTA for the disclosure and accessibility of tax returns by the debtor to the trustee, and by the trustee to the debtor. We view the disclosure of tax returns to be a necessity for any trustee (or other functionary) in the administration of a voluntary or involuntary liquidation or reorganization. Prior tax returns are as important as current returns. Any restriction on the accessibility of prior or current tax returns which may be dependent on the obligation of Internal Revenue Service to make a finding that the information sought is material and should or should not be disclosed is opposed. Such a "veto right" appears to be written into the BTA (§ 1398). It is improper to permit the Internal Revenue Service to have such a right when the parties involved all have access to the Bankruptcy Court and

that Court has absolute and pervasive jurisdiction over the debtor and its property. If a dispute were to arise over accessibility of tax returns, the adverse parties would have a justiciable issue which should be litigated before the court. Why go through the administrative process of written request, determination by Internal Revenue Service, appeal through Internal Revenue Service hierarchy, and then to court when the Bankruptcy Court is initially involved and can readily rule on the dispute. We would thus recommend that the Internal Revenue Service right to determine access to prior year tax returns of the debtor be eliminated.

Mr. ROCHELLE. The National Bankruptcy Conference is a group of practitioners, law professors, and bankruptcy judges. It has been in existence since 1936, and the purpose of the Conference is to be of help and assistance to the Congress in the improvement of bankruptcy legislation and bankruptcy procedure.

We appear today to support the historical position on the concept of cancellation of indebtedness as it is related to income, and to oppose the concept of taxability arising from discharge of indebtedness as that concept is incorporated in H.R. 5043.

The historical concept is reflected in section 268 and section 270 of the old Bankruptcy Act. That is still the law, I think. These sections provide that the only effect of cancellation of indebteness will be to reduce basis only to the point that that basis equals fair market value. This has worked well. To my knowledge, it has not caused a loss of income to the Treasury for one very simple reason, and that is that to the extent that an emerging debtor from a reorganization proceeding is able to make use of the increased operating cash resulting from net operating loss carry forward, it is better able to repay prepetition debt and therefore the prepetition creditors have less of a tax writeoff than they would have had had the corporation gone down the tube and been unable to pay its prepetition debt, or to pay the new debt instruments which issued out of the reorganization proceeding.

The Conference supports this historical principle, and sees no reason why it should not continue to be the law, but if in its wisdom the Congress believes that there should be further treatment of the cancellation of indebtedness by way of calling it taxable, then we would urge that the debtor have the option, first, to decrease basis, and then, only then, should the debtor be required to reduce its net operating loss carry forward; and then, and if there is final tax consequence, this should be paid over an extended period of time. We suggest a 10-year period, and perhaps the first 2 years to be in a moratorium status.

If I may simply make brief reference to some remarks which have been made this morning, one gentleman has indicated that

emerging debtors should compete fairly. This is another way of saying, well, we may recognize the principle of the fresh start, which is inherent in our Bankruptcy Reform Act, but we don't think an emerging debtor should have a headstart.

I suggest that this has no basis in reality. I have represented debtors all the way from the Mom and Pop corner grocery to Commonwealth Oil Refining Co., a billion dollar corporation now in chapter XI, and it takes years after emergence before they are even able to come back to a competitive position.

Also, the statement is made that there might be some incentive, if the present law is retained, for debtors to take bankruptcy. In my experience of over 30 years, I have not seen a single instance where a person voluntarily went into the bankruptcy court to take advantage of the tax laws that were incident to the bankrutpcy law. The fact is that debtors are forced into the bankruptcy court to get under the umbrella, to protect them from the rain of garnishments, lawsuits, and receivership.

It is in no sense a voluntary undertaking, and the preservation of the current law in my opinion would not create any such incentive.

Mr. Phelan, who will next speak, is also a practicing lawyer laboring in these vineyards, and he will be followed by a gentleman from Kuhn Loeb, from Lehman Bros., Goldman Sachs, who will be able to give the committee the benefit of the practical experience of the real world of corporate finance for troubled debtors.

Thank you.

## STATEMENT OF ROBIN E. PHELAN, DALLAS, TEX.

Mr. PHELAN. Good morning, Mr. Chairman, Senator Packwood, Senator Dole.

I am Robin Phelan, from Dallas, Tex. I appear today as an individual, but with the substantially unanimous concurrence of the members of the Business Bankruptcy Committee of the section on corporation banking and business law of the American Bar Association, the Bankruptcy and Reorganization Committee of the State bar of Texas, and the bankruptcy and commercial law section of the Dallas Bar Association.

I am chairman of the tax subcommittee of each of those groups.

I will summarize my statement, but request that the full statement be included in the record.

Senator BYRD. Your statement will be published in the record.

Mr. PHELAN. What this bill does is to take money out of creditors' pockets and temporarily give it to the Internal Revenue Service. There has been much said today about giving a debtor a fresh start but not a headstart, with the implication that the utilization of a tax loss carryforward gives the debtor a headstart.

Look at that for a minute in the context of practical realities. The ability of a debtor in a rehabilitation to pay its prepetition debts is directly dependent upon its cash flow. Eliminating a tax loss carry forward and other tax attributes reduces that cash flow. That reduced cash flow does not allow the debtor to pay its prepetition creditors as much as it otherwise would be able to do. Consequently, by reducing the carryover and other tax attributes, you are not just hurting the debtor. What you are doing is taking

money out of the creditor's pockets, and you end up in a circular catch 22 situation.

Reduced cash flow means you can't pay your prepetition creditors as much, which means they have to write off more of their debt, which means you've got more debt reduction, which further reduces your carryover, which further reduces your cash flow, until you get down to that minimal level that you can afford to pay.

If H.R. 5043 is enacted in its present form, the Treasury really won't benefit, as Mr. Rochelle indicated, because additional collections from the debtor resulting from the elimination of the tax loss carryover will be offset dollar for dollar by greater bad debt losses taken by the prepetition creditors, and more than offset by losses from debtors who now will not be able to rehabilitate at all.

This bill is going to kill a lot of debtors that would otherwise be able to rehabilitate because the postpetition cash flow won't justify reorganization.

Rehabilitated debtors pay taxes. Their employees pay taxes. Their suppliers make profits and pay taxes on those profits. H.R. 5043 ignores these facts, and takes a short-sighted approach to revenue collection.

The Treasury maintains that this bill brings the state of the law into compliance with and indicates a consistent posture with present tax policy, and conforms the law to the tax law. Well, I submit that is not justification for passage of a bill. The tax law is wrong and tax policy is wrong as it applies to an insolvency, bankruptcy situation.

In addition, the complexities of H.R. 5043 will doom many small business reorganizations to failure, because small business reorganizations cannot afford high-priced tax lawyers and tax accountants, which H.R. 5043 will require. I generally don't handle billion dollar corporations. I handle the small- and medium-sized types of cases, and they can't afford these high-priced tax lawyers and tax accountants.

The alternative of a 10-year spread forward proposal does not make the bankruptcy tax bill acceptable, but it does help a little. This subcommittee should consider the 10-year spread forward proposal as an alternative.

The subcommittee has a simple decision to make. If the bankruptcy tax bill is passed in its current form, four things happen. First, many small- and medium-sized businesses will not be able to reorganize at all. Second, creditors will receive less in the cases which are reorganized. Third, the cost of rehabilitation will increase, due to increased legal and accounting costs for tax planning. Fourth, the IRS will receive less revenues in the long run.

In short, nobody wins, everybody loses. You can vote against the carryover reduction of H.R. 5043, encourage rehabilitation of small financially troubled businesses, and maximize long-term revenues for the Treasury, or you can vote for H.R. 5043 in its current form.

Thank you very much.

Senator BYRD. What each of you are saying, if I understand you correctly, is that H.R. 5043 changes the fundamental concept of the bankruptcy laws?

Mr. ROCHELLE. It changes the historical concept as now reflected in section 268 and 270 of the old Bankruptcy Act, yes.

Mr. PHELAN. And is diametrically opposed, diametrically opposed to the philosophy of chapter 11, bankruptcy reorganizations, under the new code.

Senator BYRD. And both of you are opposed to the legislation in its present form?

Mr. PHELAN. Absolutely.

Mr. ROCHELLE. This aspect of it. Yes, sir.

Senator BYRD. Senator Packwood?

Senator PACKWOOD. No questions, Mr. Chairman.

Senator BYRD. Thank you.

[The prepared statements of the preceding panel follow:]

STATEMENT OF
WILLIAM J. ROCHELLE, JR., ATTORNEY
OF ROCHELLE, KING & BALZERSEN
DALLAS, TEXAS

ON

H.R. 5043

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

MAY 30, 1980

* * * * * * *

Summary of Principal Points

1. Historically, discharge of indebtedness resulting from bankruptcy proceedings resulted only in reduction of basis.

2. H.R. 5043 would first require reduction from net operating loss carry-forward with remainder to be applied to reduction of basis.

3. Such treatment would have an extremely adverse effect on the efficacy of reorganization under the Bankruptcy Reform Act of 1978.

4. The National Bankruptcy Conference recommends that the debtor should be given the option first to reduce basis and then to reduce loss carry-forward, with any remainder to be spread over a ten-year period.

STATEMENT OF
WILLIAM J. ROCHELLE, JR.
ON
H.R. 5043
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
MAY 30, 1980

My name is William J. Rochelle, Jr. This statement is submitted on behalf of the National Bankruptcy Conference (NBC) and in support, generally, of its position with respect to the concept of "forgiveness of indebtedness" as income, and the treatment of such income as contemplated in H.R. 5043.

NBC is a private organization composed of practicing attorneys, bankruptcy judges, and professors of law, all of whom specialize in the area of bankruptcy law. Its purpose is to improve the administration of bankruptcy law and practice under the Bankruptcy Act through the process of legislative amendment. The Conference is vitally concerned with the present pending legislation since it, if enacted, would have an extremely adverse effect on the administration of the reorganization provisions of the Bankruptcy Reform Act of 1978.

I am a partner in the firm of Rochelle, King & Balzersen in Dallas, Texas, where I have specialized in the field of bankruptcy and corporate reorganization for over thirty years. I have represented individual and corporate debtors under the Reform Act and under the old Bankruptcy Act in straight bankruptcy, corporate reorganization under

Chapter X and arrangements under Chapter XI. I have also served as trustee in Chapter X reorganizations, as receiver in arrangement proceedings, and as attorney for receivers and trustees in all type proceedings. I frequently represent creditors, both secured and unsecured, as well as creditors' committees.

I have served as adjunct professor at Southern Methodist University Law School in Dallas and the University of Texas Law School in Austin, teaching seminars in corporate reorganization. I have lectured on bankruptcy law at many institutes for continuing legal education.

I am a contributing editor to Collier on Bankruptcy, Volume 13, and have contributed articles to numerous law reviews and bar journals. I am a member of the American Bar Association and the Commercial Bankruptcy Committee of its Corporation, Banking and Business Law Section. I am a former Chairman of the Corporation, Banking, and Business Law Section of the State Bar of Texas, and was the first Chairman of its Bankruptcy and Reorganization Committee. I am a Research Fellow of the Southwestern Legal Foundation and a Fellow of the Texas Bar Foundation.

I am a member of the National Bankruptcy Conference, former Chairman of its Committee on Taxes, and a member of its Committee on Reorganization.

## Historical Treatment of Debt - Forgiveness as Income

Historically (e.g., Section 268, Bankruptcy Act), cancellation of indebtedness resulting from a reorganization proceeding under the Bankruptcy Act did not result in taxable income or a reduction of net operating loss carry-forward. Its only effect was to reduce basis of depreciable assets to an amount not less than their fair market value (Section 270).

This was a Congressional recognition of the realities of the situation, in that discharged indebtedness of a bankrupt resulted in no real increase in the estate of the debtor with which taxes could be paid. It was a further recognition of the fact that forgiveness connotes a voluntary act by a creditor, which voluntarism is entirely absent in the atmosphere of a bankruptcy reorganization.

It further recognized the "fresh start" philosophy which permeates the reorganization concept, and the pragmatics of the repayment of debt, post-petition, with earnings which may be enlarged by the pre-petition loss carry-forward.

The NBC has always supported and still supports this historical approach.

## Treatment of Discharged Debt by H.R. 5043

H.R. 5043 would require a debtor first to reduce net operating losses by any debt forgiveness, and then to apply any remainder to basis reduction of depreciable assets.

NBC Recommendations

If the unrealistic concept of discharge as income must be retained, then at the very least the debtor should be given the option first to reduce basis and then to reduce loss carry-forward. As to any so-called income which may remain after such attribute reduction, the debtor should be permitted to elect the reporting of such income over an extended period of time. Ten years is suggested, with a moratorium in the first two years.

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## Summary of Principal Points

## STATEMENT OF ROBIN E. PHELAN

## ATTORNEY, DALLAS, TEXAS

## REGARDING BANKRUPTCY TAX ACT OF 1980

1. While the current bill is a substantial improvement over earlier versions, in my opinion the current provisions seriously limit the effectiveness of the reorganization provisions of the new Bankruptcy Code and are inconsistent with the basic purposes of a bankruptcy reorganization proceeding.

2. The thrust of the tax law has been to impede and to frustrate the rehabilitation purpose of a bankruptcy reorganization. The Internal Revenue Service adopts a short-sighted viewpoint that it must collect its pre-petition taxes in full, without regard to the destruction of a viable ongoing concern, even though a reorganized debtor would result in increased taxes in future taxable years.

3. Since the purpose of the tax loss carryover provisions is to mitigate the adverse effect of the annual accounting period concept, to require the debtor to pay additional taxes on post-petition income prior to the payment of trade and other creditors is inconsistent with the tax loss carry-

over provisions. In a circuitous manner, less funds would be available for payment to creditors which in turn would require further forgiveness of debt which would further reduce the tax loss carryover and cash flow of the debtor.

4. Elimination of tax attributes under HR 5043 will not only render many reorganizations impossible by depriving the potentially rehabilitated debtor of working capital necessary to carry on its operations, but will also entail significantly greater expense for professional services.

5. Forgiveness of debt in any reorganization under Chapter 11 of the Bankruptcy Code should not result in reduction of the debtor's tax attributes. Successful rehabilitation of debtors will result in additional tax revenues from the elimination of bad debt losses by creditors, taxes paid by parties employed by the rehabilitated debtor, and additional income taxes paid in the future by the rehabilitated debtor.

6. Alternatively, the compromise proposal which provides for the alternative of attribute reduction or the spreading forward of income resulting from the forgiveness of debt over a ten-year period is clearly preferable to the current wording of HR 5043.

7. The current version of HR 5043, which provides that the satisfaction with stock of a debt not evidenced

by a security results in the computation of a debt discharge amount and the reduction of tax attributes, is clearly inconsistent with the exemption conferred to debt evidenced by a security. In addition, the current version of HR 5043 to tax an exchanging bondholder with respect to unpaid interest or original issue discount as interest income is contrary to a long line of judicial authority and accordingly should be reconsidered. The exclusion of a parent-debtor subsidiary cancellation transaction from Section 351 also seems unwarranted.

STATEMENT OF ROBIN E. PHELAN,

ATTORNEY, DALLAS, TEXAS

REGARDING BANKRUPTCY TAX ACT OF 1980

Mr. Chairman, Members of the Subcommittee, and Members of the Subcommittee Staff, my name is Robin Phelan, and I am a member of the law firm of Haynes and Boone, of Dallas, Texas. I am a graduate of The Ohio State University, with a double major in accounting and finance and a graduate of The Ohio State University Law School. My practice consists entirely of bankruptcy and insolvency matters and I have been actively involved in all facets of representation in connection with insolvency and bankruptcy proceedings. I have been a receiver and trustee in both liquidation and reorganization proceedings, and have represented debtors, trustees, receivers, secured creditors, unsecured creditors, committees of various interest holders and indenture trustees.

I am chairman of the Tax Subcommittee of the Business Bankruptcy Committee of the Corporation Banking and Business Law Section of the American Bar Association, a member of the Creditors Rights Committee of the Litigation Section of the American Bar Association, Chairman of The Tax Subcommittee of the Bankruptcy and Reorganization Committee of the Corporation Banking and Business Law Section of the State Bar of

Texas, and a member and former chairman of the Dallas Bar Association's Section on Bankruptcy and Commercial Law. I have taught creditor's rights and bankruptcy law at Southern Methodist University School of Law and have authored several articles regarding bankruptcy and insolvency law. I am currently assisting in the revision of a multi-volume treatise on bankruptcy law. The positions expressed today are expressed solely as an individual and not as the representative of any of the above-mentioned organizations. I can represent to this Subcommittee, however, that I have received almost unanimous concurrence in the positions which I will express today from the members of the various committees referred to above.

The current version of the Bankruptcy Tax Act of 1980 provides for the computation of an amount which would otherwise be included as income for federal income tax purposes by reason of the discharge of indebtedness in a bankruptcy case. This "debt discharge amount" is applied to reduce certain tax attributes, including the basis of depreciable property and any tax loss carryovers. Although the current bill is a substantial improvement over earlier versions of the bill, and incorporates many changes which were previously advocated by the bankruptcy bar, its provisions regarding reduction of tax attributes, in my opinion, seriously limit the effectiveness of the reorganization provisions of the

new Bankruptcy Code and are inconsistent with the basic purposes of a bankruptcy reorganization proceeding.

A bankruptcy is a disaster. It often means that people will lose their jobs, that creditors will go unpaid, that suppliers of the bankrupt entity may find themselves in financial difficulties. The financial problems of a bankrupt business entity extend far beyond the debtor itself. Consequently, the new Bankruptcy Code provides for two types of bankruptcy proceedings for the business debtor. The first alternative is a Chapter 7 proceeding where the assets of the debtor are liquidated by a trustee and distributed to the creditors of the debtor. The second alternative is a reorganization proceeding under Chapter 11 of the Bankruptcy Code. In a reorganization proceeding, the debtor is encouraged to rehabilitate by formulating a plan of reorganization to provide for the payment of all or part of the obligations owing to the creditors of the debtor. Often, creditors are paid a percentage of their claims or issued stock or other securities in exchange for all or a portion of the their claims. In addition to the amounts received by creditors in connection with reorganization proceedings, the Chapter 11 affords creditors and other interested parties an opportunity to supply additional goods and services to the rehabilitated debtor. It offers employees of the debtor an opportunity to retain their jobs. Finally, it affords the Internal

Revenue Service, and other taxing authorities, a viable economic entity that will hopefully make profits in the future and pay taxes upon those profits. In short, the purpose of a Chapter 11 Reorganization Proceeding under the Bankruptcy Code is to provide the debtor with a fresh start, to provide creditors with an opportunity to recoup their claims, to provide suppliers with an ongoing entity which will purchase goods and services, to provide employees with continued employment, to provide the community with a viable economic entity and to provide taxing authorities with a rehabilitated debtor, capable of earning profits and paying taxes.

A rehabilitated debtor provides a ripple effect and generates significant positive contributions to the community and to the economy in general. I am a bankruptcy lawyer, not a tax attorney, but I do understand a little about economics and finance and it appears to me that the Bankruptcy Tax Act of 1980 contains provisions which are short-sighted and inconsistent with these basic purposes of a bankruptcy rehabilitation.

Notwithstanding the basic purpose of a reorganization proceeding to rehabilitate the debtor to the mutual benefit of all parties concerned, it has been my experience that the thrust of the tax law, and particularly the Internal Revenue Service application of the tax law, has been to impede and

to frustrate, whenever possible the rehabilitation process. The Internal Revenue Service has fought so tenaciously for the special favors granted to them in connection with bankruptcy proceedings that I have been told by bankruptcy practitioners far more knowledgeable than myself that it is foolish and impossible to attempt to convince Congress that the Internal Revenue Service should not have priority in a bankruptcy proceeding, should be treated as any other creditor, and that tax debts should be discharged in the same fashion as are other obligations. Now, I have never understood why the tax collector should receive priority in a rehabilitation case where the debtor often needs what little cash is available for future working capital purposes, and where a successful rehabilitation would often result in the generation of substantially greater tax revenues than the small sums which would be collected in connection with a liquidation of the debtor. I have never understood why tax obligations could not be discharged in the same fashion as other obligations of the debtor. I may be like Don Quixote, tilting the windwill, but I do understand that someone must inform this Subcommittee of the additional special privileges which are contained in HR 5043 which are contrary to the purposes of the Bankruptcy Code, and which benefit the Federal Treasury only momentarily at the sacrifice of a rehabilitated debtor and greater revenues in the future for all concerned.

An example of the short-range attitude of the Internal Revenue Service is a situation which I have encountered more than once, where a corporate debtor conducted fraudulent operations. In one instance, the corporate debtor was engaged in the business of discounting mobile home purchase contracts. In addition to the legitimate purchase contracts which the debtor sold, it also sold counterfeit, fraudulent purchase contracts. Through its fraudulent operations, the debtor managed to steal upwards of $500,000 from lending institutions. A reorganization proceeding was commenced and the dishonest management ousted. Since the debtor had legitimate contracts in its portfolio it might have been able to reorganize the debtor and pay back the defrauded creditors a significant percentage of their claims. However, the Internal Revenue Service took the position that the available funds of the debtor should be utilized to pay taxes on the stolen money, rather than utilized to return stolen funds to the creditors. Unfortunately, this appears to be the current state of the law.

In a reorganization proceeding, creditors of the debtor will often take a percentage of their claim in order to preserve the debtor as an ongoing entity. The creditors realize that the preservation of their customer will allow them to obtain profits from dealings with the debtor in the future. The taxing authority, on the other hand, has always

maintained the short-sighted viewpoint that it must collect its pre-petition taxes in full, even if the collection of such taxes destroys the viability of the enterprise and prevents a reorganization. This is true, notwithstanding the fact that a reorganized debtor would result in the collection of taxes in the future, many times the amount to be collected in connection with a liquidation of the debtor.

The purpose of the tax loss carryover provisions is to prevent the taxpayer from being penalized for the timing of its income. The carryover provisions also recognize that losses in a particular taxable year should be recovered before the debtor is required to pay taxes on income which offsets such losses. In a bankruptcy reorganization context, such losses have often resulted in the inability of the debtor to pay its creditors. To require the debtor to pay additional taxes on post-petition income until such creditors are paid would be inconsistent with the purposes of the tax loss carryover provisions, since the debtor has not yet achieved a break-even position. Consequently, less funds would be available for payment to creditors which would require further forgiveness of debt which, in turn, would further reduce the carryover and cash flow .

It frustrates the purpose of Chapter 11 to require that a consolidation of the debtor's pre-petition liabilities to rehabilite the debtor and return some dollars to its creditors

will result in the creation of additional potential liabilities to the taxing authorities which frustrate the reorganization and will, in many instances, prevent rehabilitation altogether.

The prior Bankruptcy Act contained a simple, workable formula. No gain was recognized from the forgiveness of debt in a bankruptcy rehabilitation. The old act was simple and consistent with the purposes of reorganization. Elimination of tax attributes under HR 5043 will not only render many reorganizations impossible, since the potentially rehabilitated debtor is deprived of working capital necessary to carry on its operations, but will entail significantly greater expense for attorneys, accountants, and other professional persons due to the complexity of determining the appropriate tax treatment of a reorganization. Rehabilitation of the small business debtor in a Chapter 11 proceeding is already expensive enough, and in many instances cannot carry the additional costs of tax counsel and tax accountants which will be required under HR 5043.

The concept of tax revenue now, rather than rehabilitation, contained in HR 5043, although arguably consistent with overall taxation theory, is both short-sighted from a revenue production standpoint and in direct conflict with the purposes of the new Bankruptcy Code. Bankruptcy tax

must be viewed in the context of the priority and non-dischargeability advantages already available to the Internal Revenue Service. In a bankruptcy reorganization, creditors and other interested parties agree to take less than the immediate full payment of their debt with the understanding that reorganization of the debtor will ultimately result in greater return for all concerned. In HR 5043, however, the Internal Revenue Service, with its priority position and non-dischargeability advantage, takes the position that the priority advantage is not enough, that the non-dischargeability advantage is not enough, that rehabilitation should not be encouraged and that the debtor, and its creditors, should be deprived of the utilization of the very tax losses which resulted in the inability of the debtor to pay its creditors. What this Subcommittee must realize is that each dollar of tax loss carryforward which is denied deprives the debtor of badly needed working capital and reduces the cash flow available to pay the creditors which are the victims of those losses. The net effect of the current position of HR 5043 is a vicious circle which takes dollars out of the creditors pockets and increases the amount of debt which must be forgiven. I find it somewhat inconsistent for the current bill to say that the utilization of a Bankruptcy Code designed to allow creditors to recoup their claims will

result in the creation of additional obstacles to the payment of those very creditors. Utilization of the Bankruptcy Code should enhance, not impede, a debtor's ability to pay its creditors.

It is my position that forgiveness of debt in any reorganization under Chapter 11 of the Bankruptcy Code should not result in income to the debtor and should not result in reduction of the debtor's tax attributes. A non-recognition policy will have minimal negative impact on tax revenue and will be of significant benefit to reorganized debtors and their creditors. I believe the successful rehabilitation of debtors will result in additional tax revenues from the elimination of bad debt losses by creditors, taxes paid by parties employed by the rehabilitated debtor, and additional income taxes paid in the future by the rehabilitated debtor. The current position of HR 5043 is short-sighted since the successful rehabilitation of debtors will result in additional tax revenues. At a minimum, there should be no reduction in basis below fair market value, and the debtor should be allowed to choose which tax attributes to reduce.

Proponents of the elimination of the tax attributes may argue that HR 5043 is consistent with overall tax policy. Such an argument might carry some weight standing isolated by itself, however, such an analysis rings hollow when

viewed in the context of the priority and non-dischargeability advantages currently enjoyed by the tax collector, which are grounded in a "king can do no wrong" anachronistic mentality, fly in the face of the purpose of Chapter 11 of The Bankruptcy Code and do not comport with modern tax philosophy.

It is my understanding that the House considered, but rejected, a modification which would provide an alternative to the reorganized debtor to either reduce attributes such as the net operating loss carryforward or spread the income resulting from forgiveness of indebtedness over a ten-year period. I understand that the proposal provided that no income would be recognized for the first two taxable years following the end of the taxable year in which the business reorganization was completed. Thereafter, income would be recognized in equal amounts during the third through the tenth year. No interest would be charged on the deferred income. Such a proposal would allow the debtor greater flexibility in its reorganization, and enhance the chances of a successful rehabilitation as a competitive and viable enterprise. Although my position remains that no income should result from forgiveness of indebtedness in a reorganization proceeding and that no attribute reduction should take place, the compromise proposal which provides for the alternative of attribute reduction or the spreading forward of the income resulting from forgiveness of debt over a

ten-year period is preferable to the current wording of HR 5043.

Hopefully, this Subcommittee will adopt the position that successful rehabilitation of debtors should be encouraged, that no income should result from the forgiveness of debt, and that tax attributes should not be reduced. Such a position is consistent with long range maximization of tax revenues, and will provide substantial benefit to the economy of this country. In the alternative, I suggest that the compromise proposal be considered, which would allow a choice between the reduction of tax attributes and spreading the income resulting from forgiveness of debt over a ten-year period.

The current version of HR 5043 provides that no debt discharge amount is calculated if stock is issued to a creditor in exchange for a security, but that satisfaction with stock of a debt not evidenced by a security results in a computation of a debt discharge amount and the reduction of tax attributes which we discussed earlier. The exchange of stock for debt is a frequent reorganization device, and will become more meaningful under the Bankruptcy Code because of the expanded effect of Chapter 11. I find it inconsistent to reduce tax attributes if the claim is not evidenced by a security, but to ignore such attribute reduction when the claim is evidenced by a security. It is my opinion that

this provision discriminates unfairly against trade creditors (as opposed to holders of debt which qualifies as a "security") and will result in a situation where defrauded equity security holders may be placed in an advantageous bargaining position in a rehabilitation proceeding in contravention of the spirit of Section 510(b) of the Bankruptcy Code, since such "security holders" could argue that their position in the rehabilitation allows the greater utilization of tax attributes by the debtor. I suggest that the issuance of stock for trade debt in a reorganization proceeding not result in a reduction of any tax attributes. Also, the current version of HR 5043 provides that the reciept of stock which does not constitute a security by a debt holder pursuant to a tax-free reorganization, to the extent the stock is "attributable to accrued interest" on the debt (which according to the Committee Report includes original issue discount), will be considered by such holder as the receipt of interest income. This provision will apply notwithstanding the debt holder's failure to receive cash in respect of the unpaid interest element. Under current law, such holder is not required to immediately report the unpaid interest element as ordinary income but instead the gain attributable to the unpaid interest is deferred by reason of the substituted basis taken in the issued stock. In addition,



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such stock, the character of gain recognized--even that portion attributable to the unpaid interest element--would be capital rather than ordinary.

The current bill also provides that the cancellation of debt of a subsidiary corporation to its parent will result in the reduction of tax attributes, and that Section 351 of the Internal Revenue Code would not be applicable to such a situation. I see no good reason to exempt such a transaction from Section 351 and to treat such a contribution to capital by the parent corporation any differently than such a transaction would be treated absent the Chapter 11 proceeding.

The purpose of the Bankruptcy Code is to maximize the long range return to creditors and other interested parties, including the tax collector. Viewed in the context of the priority and non-dischargeability advantages currently available to the Internal Revenue Service which require no compromise by the tax collector and require payment in full of all taxes due, it is inconsistent with the purposes of the Bankruptcy Code to allow the Catch 22 situation provided by the current version of HR 5043 which provides that the utilization of the rehabilitation provisions of the Bankruptcy Code will result in an inability to utilize the losses which have been incurred and which resulted in the non-payment of creditors of the debtor and will restrict the cash flow available for the payment of those very creditors. Such a

short-sighted position is not only inconsistent with the purposes of the Bankrtupcy Code, but will result in reduced revenue collection by the taxing authorities. Rehabilitated debtors pay taxes. Employed people pay taxes. Creditors who receive a greater percentage of their claims because cash flow is available for such payments pay taxes on such income and do not take bad debt losses. It is my position that implementation of the suggestions which we have discussed will result in a positive revenue impact for the Treasury and be consistent with the Bankruptcy Code.

**SUPPLEMENTARY STATEMENT OF**
**ROBIN E. PHELAN, ATTORNEY, DALLAS, TEXAS**
**REGARDING BANKRUPTCY TAX ACT OF 1980**

(HR 5043)

The provisions of HR 5043 which reduce loss carryover and other tax attributes are directly contrary to the purposes of the reorganization provisions of the Bankruptcy Code and constitute a serious impediment to bankruptcy reorganizations. In a bankruptcy reorganization, creditors agree to reduce their claims in order to preserve the debtor as a going concern and eventually receive more than would be received through liquidation. The amount that can be paid to the creditors is directly dependent upon the post confirmation earnings and cash flow of the debtor.

Proponents of the tax attribute reduction provisions of HR 5043 argue that such provisions are consistent with overall tax policy and that the debtor will be able to unfairly compete with its competitors if it has available to it loss carryovers but is not required to pay its pre-petition creditors. The flaw in such logic is that the increased cash flow which results from utilization of a loss carryover will not be retained by the debtor but instead will be used by the debtor to pay the pre-petition creditors. Reduction in loss carryover simply reduces the amount of funds available to pay such

creditors and increases the amount of debt which must be forgiven. For every dollar which the Treasury receives by reducing a loss carryover, the Treasury loses a dollar by the increase in bad debt write-off which must be taken by pre-petition creditors of the debtor. The Treasury suffers a loss where the creditor's tax bracket is greater than the debtor's. In short, HR 5043 harms creditors but does not increase the amount of net revenue available for the Treasury.

In addition, revenues to the Treasury will be lost since many debtors will be unable to reorganize. In such cases, the Treasury will generally receive nothing. Rehabilitated debtors pay taxes in the future. Their employees pay taxes. Their suppliers make profits and pay taxes on those profits. HR 5043 ignores these facts and takes a short sighted approach to revenue collections. Reduction of tax attributes will likely result in decreased tax revenues in the long run.

The complexity of HR 5043 will doom many small business reorganizations to failure because small business reorganizations cannot afford the high price lawyers and tax accountants which HR 5043 will require.

One proponent of carryover reduction stated that there is no policy in the Bankruptcy Code which favors reorganization over liquidation. Although this is a debatable point it is undisputed that the Bankruptcy Code

does have a policy in favor of maximum return to creditors. Reduction of tax loss carryover and other tax attributes reduces the funds available for payment of creditors and is directly contrary to the Bankrutpcy Code. In addition, such reduction does not benefit the Treasury.

It is my position that forgiveness of debt should not result in reduction of loss carryover and other tax attributes, that such non-recognition will result in positive revenue impact for the Treasury, generate greater returns to creditors and will be consistent with the purposes of the Bankruptcy Code.

Senator BYRD. The next panel, Mr. Francis H. Musselman, New York, Mr. John C. Jamison, Goldman Sachs & Co., New York, and Mr. Steven R. Fenster, Lehman Bros., Kuhn Loeb, New York.

Welcome, gentlemen. Proceed as you wish.

## STATEMENT OF FRANCIS H. MUSSELMAN, NEW YORK, N.Y.

Mr. MUSSELMAN. Mr. Chairman, Senator Packwood, my name is Francis H. Musselman. I am appearing in opposition to the provisions of the Bankruptcy Tax Act of 1980, which would cause a reduction of a debtor's net operating loss on forgiveness or discharge of debt.

For more than 25 years, I have been practicing as a corporate lawyer, not a tax specialist, in the bankruptcy and corporate reorganization field. As we know, the old Bankruptcy Act has been replaced by the new bankruptcy code. The old Bankruptcy Act has been repealed, including the tax provisions of the old Bankruptcy Act, and the new bankruptcy tax law is intended to cover the tax aspects of bankruptcy as well as tax aspects of out of court reorganizations and insolvencies.

There is a policy difference between the bankruptcy law and the Internal Revenue Code. The bankruptcy law policy basically is to give a debtor a fresh start. Contrary to the present law, contrary to the present tax laws in this instance, the proposed act has an underlying policy of deferring but ultimately collecting ordinary income taxes on ordinary income felt to arise from the forgiveness of indebtedness, the Supreme Court cases holding that taxable income results from forgiveness of indebtedness.

This is not a bankruptcy case. It is outside of the bankruptcy scope entirely. And while there were exceptions, like the investment tax credit, the Internal Revenue Code does not countenance two bites of the apple. Implicit in the policy of the bankruptcy law is that there shall be two bites of the apple, and it is the serious responsibility of the Congress to resolve this inconsistency.

I suggest it should be, in bankruptcy cases, resolved in favor of the bankruptcy policy, two bites of the apple.

One of the most important aspects of the bankruptcy policy, the bankruptcy law as it has existed for a century, or for 150 years, is that the net operating loss is an asset, an important asset, which debtors and creditors can look to for the cure of the sickness.

In almost every troubled case of which I have knowledge, in court and out, the NOL, the net operating loss, was most significant, and sometimes the most significant element in making a sick company better.

It does constitute a change in prior law. The prior law has worked. It has worked well. Businesses producing income, employing people, earning taxable income, were rejuvenated and preserved. To paraphrase Will Rogers, if it isn't broken, don't fix it.

A higher authority has long ago admonished us to ask forgiveness of our debts as we forgive our debtors. The Treasury would tax adherence to this admonishment, even as to distressed debtors.

I urge you to stay with the law as it was under the old Bankruptcy Act.

Thank you.

Senator BYRD. Mr. Fenster?

## STATEMENT OF STEVEN R. FENSTER, LEHMAN BROS., KUHN LOEB

Mr. FENSTER. Thank you, Mr. Chairman, Senator Packwood.

My name is Steven R. Fenster. I am appearing in my capacity as a managing director of Lehman Bros., Kuhn Loeb. We are pleased to be able to present our views concerning the proposed Bankruptcy Tax act. In particular, I will focus on the provisions of that Act that would cause a reduction of a debtor's net operating loss consequent upon forgiveness by creditors of indebtedness of a debtor.

In summary, we would recommend the provisions of the proposed act resulting in reduction of the net operating loss on forgiveness of debt be eliminated, principally because of the adverse economic consequences we see of this proposed change.

The proposed act would make it more difficult for companies in bankruptcy to seek successfully the accord of their creditors to rehabilitate, and if permitted to rehabilitate, it would reduce their chances for economic growth and survival.

The perspective that we have applied is that of an investment banker who has acted in a variety of situations concerning troubled companies, some of whom have gone through formal bankruptcy, whereas others have worked out arrangements outside of the Bankruptcy Act.

Elegant arguments can be made from a theoretical tax point of view concerning the proposals in the act concerning debt forgiveness. I would propose leaving these arguments to the tax practitioners and others. The focus that we bring to this statement would be the effect in the real world, the real business effect on companies of the proposed tax change, as well as the effect on the U.S. Treasury and the larger national benefits of the successful rehabilitation of bankrupt companies.

Our conclusion relies on the fact that one of the most significant issues in forming a judgment as to whether a company can be rehabilitated or must be liquidated concerns the future cash flow that might be available. Typically, one does this analysis following

a determination that the company would probably earn money in a reorganized framework, since otherwise the proposed rehabilitation has little basis.

In that situation, the use of prior net operating losses results in a higher cash flow, inasmuch as future tax payments are reduced. The need for an adequate cash flow is in a sense self-evident, but I think it might be nevertheless useful to note the areas where it is most critical.

First is the maintenance of adequate working capital. Clearly, in a situation following bankruptcy, trade credit and other credit is reduced to a company that is seeking to survive.

Second, they need adequate cash flow to finance their capital expenditures. Again in a situation like this, external financing is not normally available, and indeed the company may have gone into bankruptcy because of inadequate and outdated plant and equipment.

Third, adequate cash flow is critical to demonstrate to the lenders that there is a meaningful prospect of repayment of debt that is recognized in a post-insolvency setting. This is important in two senses. First, the creditors must feel that the value of their debts in a reorganized business exceeds what they would get in liquidation. Second, the larger amount of debt that the creditors are willing to keep in the business consistent with prudent leverage, the more it is likely that the entity can achieve the front-end payments that are necessary to get out of bankruptcy.

There are also, we think, some important considerations from a national point of view. One can view rehabilitation, aided by the prospect of foregoing certain income taxes, as a benefit conferred by Congress to prospective reorganized companies in the sense of a tax expenditure.

This tax expenditure should help prevent a dispersal of assets both in terms of people and physical assets. More importantly, it only becomes an expenditure to the extent the reorganized company succeeds, which is a circumstance we would all welcome. If the company fails, no tax expenditure would have been made. Therefore, it should be noted that the current tax provisions do not subsidize companies who will fail, and thus we do not believe the provisions of the proposed act are necessary.

I am not aware of an economic study that weighs the value of these tax expenditures. It would appear to me that rehabilitation as compared to liquidation confers certain immediate benefits. The first is quantitative, savings of unemployment taxes, welfare, continuation of income tax payments by individuals. The second benefit is social and political: Lack of disturbances of families; no necessity to seek a new career.

These benefits, which seem to me to be quite real, would presumably be measured against the discounted future tax payments that the proposed bill might create, and my impression from some of the staff reports is that this amount of money would probably be minimal.

Accordingly, we think that this matter should be viewed more in an economic context, and as seen in that context, the value of encouraging rehabilitation clearly appears to augment—to be

greater than the need to possibly raise additional revenue in the manner this bill suggests.

Thank you.

Senator BYRD. Thank you.

STATEMENT OF JOHN C. JAMISON, GOLDMAN, SACHS & CO.

Mr. JAMISON. Senator Byrd. Senator Packwood, I am John Jamison, a partner in Goldman, Sachs.

I very much support Mr. Musselman's statement, and second Mr. Fenster's statement. I have been involved in many situations involving the restructing of debt of financially troubled companies, with the aim of avoiding bankruptcy proceedings, if possible. In each instance, the alternative of such a proceeding as a rehabilitative vehicle has to be given serious consideration.

In this regard, I am specifically opposed to the proposal in sections 108 and 1017 of the code, which permit presently a markdown of basis in the assets of a solvent debtor, because doing this outside of a proceeding, you are going to create some solvent and some net worth, we hope, and trying to preserve, even in those circumstances, an NOL, to the extent practicable, is a significantly important rehabilitative aspect of the exercise.

Preservation under existing tax laws of the debtor's net operating loss and carry forward as an aid to the financial rehabilitation of the debtor has been a critical consideration in determining whether recoveries for creditors and ultimately shareholders might be greater in maintaining the creditor as a going concern or in liquidating the business.

The treatment of NOL's proposed in H.R. 5043, in my judgment, would result in a greater bias for liquidation and consequent loss of employment and significant disruption of personal lives. Such a result is totally inconsistent with the objective of the new Bankruptcy Code.

Thank you.

Senator BYRD. Thank you, gentlemen.

Senator Packwood?

Senator PACKWOOD. No questions.

Senator BYRD. Thank you.

[The prepared statements of the preceding panel follow:]

FINANCE COMMITTEE OF THE SENATE
Hearing on the Bankruptcy Tax Act of 1980
(H.R. 5043)
May 30, 1980

Statement by Francis H. Musselman
Partner
Milbank, Tweed, Hadley & McCloy
One Chase Manhattan Plaza
New York, N. Y. 10005

Summary of Points Covered

The provisions of the new act resulting in reduction of the net operating loss (NOL) upon forgiveness of debt should be eliminated because:

A. Policy conflict between bankruptcy law and tax law should be resolved in favor of bankruptcy law.

B. NOL helps sick companies recover.

C. Represents a change from prior law which worked.

D. NOL encourages creditors to assist in rejuvenating businesses.

FINANCE COMMITTEE OF THE SENATE
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May 30, 1980

Statement by Francis H. Musselman
Partner
Milbank, Tweed, Hadley & McCloy
One Chase Manhattan Plaza
New York, N. Y. 10005

My name is Francis H. Musselman. I am appearing in opposition to the provisions of the Bankruptcy Tax Act which would cause a reduction of a debtor's net operating loss consequent upon forgiveness by creditors of indebtedness of a debtor.

For more than twenty-five years, I have specialized as a corporate lawyer (not a tax specialist) in bankruptcy, corporate reorganizations, proceedings for the arrangment of unsecured debt and out-of-court work outs of the problems of distressed debtors.

The old Bankruptcy Act has been replaced by the new Bankruptcy Code. The Bankruptcy Tax Act is intended to replace the tax provisions of the replaced Bankruptcy Act. It is also intended to accommodate bankruptcy policy and tax policy.

The underlying policy of the Bankruptcy Law is to give a distressed debtor a "fresh start". Contrary to present law, underlying policy of the proposed law in the context of formal and informal proceedings involving debtors is to defer but ultimately to collect tax on ordinary income felt to result from from debt discharged or forgiven.

While there are exceptions like investment tax credits, the Internal Revenue Code does not countenance "two bites of the apple". Implicit in the policy of the constitutionally based Bankruptcy Law is that there shall be "two bites of the apple". It is the serious responsibility of the Congress to resolve this conflict in promulgating legislation.

The old Bankruptcy Act, including the tax provisions therein, as interpreted by the courts, preserved in most cases for a distressted debtor a very important asset, the net operating loss (the NOL). Under Chapters X and XI of the old Act, no income was realized on cancellation of indebtedness although some basis reduction was required in certain circumstances. However, what was preserved in most cases was the NOL. In many, many cases, the preservation of the NOL persuaded creditors to grant forbearance and to assist in the rehabilitation of a debtor.

The NOL was an asset. Creditors were reluctant to see assets destroyed.

In almost every trouble case of which I have knowledge, in court and out of court, the NOL was most significant and in some cases the most significant element enabling a sick company to be granted the chance of recovery.

The Bankruptcy Tax Act of 1980 constitutes a change from the prior law. The prior law worked. It worked very well to the ultimate benefit of the Federal, State and local tax collectors. Businesses producing taxable income, employing people earning taxable incomes, were rejuvenated and preserved. To paraphrase Will Rogers, "If it isn't broken, don't fix it."

The forgiveness of indebtedness by creditors is absolutely necessary in very many cases in proceedings under the Bankruptcy Law or in out-of-court arrangements calculated to keep businesses out of the Bankruptcy Court. Creditors should be encouraged to forgive part of their claims and extend the balance. They are not going to be encouraged so to do if there is commensurate damage done to the entity they are trying to save.

A Higher Authority has long ago admonished us to ask forgiveness of our debts "as we forgive our debtors". The Treasury would tax adherence to this admonishment, even as to distressed debtors.

I urge you to stay with the law as it was under the old Bankruptcy Act at least insofar as the NOL is concerned.

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Committee on Finance
U. S. Senate

Subcommittee on Taxation and Debt Management

Hearing on the Bankruptcy Tax Act of 1980
(H.R. 5043)

May 30, 1980

Statement by

Steven R. Fenster, Managing Director
Lehman Brothers Kuhn Loeb
Incorporated

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Committee on Finance
U. S. Senate

Subcommittee on Taxation and Debt Management.

Hearing on the Bankruptcy Tax Act of 1980
(H.R. 5043)

May 30, 1980

Statement by
Steven R. Fenster, Managing Director
Lehman Brothers Kuhn Loeb
Incorporated

My name is Steven R. Fenster. I am appearing in my capacity as a Managing Director of Lehman Brothers Kuhn Loeb Incorporated, an Investment Banking firm. I am pleased to be able to set forth our views concerning the proposed Bankruptcy Tax Act of 1980. In particular, I will focus on the provisions of that Act that would cause a reduction of a debtor's net operating loss consequent upon forgiveness by creditors of indebtedness of a debtor.

In summary, we would recommend that the provisions of the proposed Act resulting in reduction of the net operating loss upon forgiveness of debt should be eliminated principally because of the adverse economic effect of this proposed change. The proposed Act would make it more difficult for companies in bankruptcy to seek successfully the accord of their creditors to rehabilitate and, if permitted to rehabilitate, would reduce their chances for economic survival and growth.

The perspective that we have applied to this statement is that of an investment banker. Acting in that capacity, we have advised in many "troublesome" financial situations, some of which have gone through formal bankruptcy proceedings, whereas others have worked out arrangements outside of the Bankruptcy Act. In my capacity as a Partner of the Firm, I have been among those active in this field.

Elegant arguments can probably be made from a theoretical tax point of view concerning the proposals of the Act with respect to the treatment of debt forgiveness. However, I would propose leaving this argumentation to tax practitioners and others.

The focus that I would bring to this statement would be the effect in the "real world", i.e., the real business effect on companies of the proposed tax changes of the Act, as well as the effect on the U. S. Treasury and the larger national benefits of the successful rehabilitation of bankrupt companies.

Our conclusion relies on the fact that one of the most significant issues in forming a judgment as to whether a company can be rehabilitated or must be liquidated concerns the future cash flow that might be available. Typically, one does this analysis following a determination that the company would probably earn money in a reorganized framework since otherwise the proposed rehabilitation has little basis. In that situation, the use of prior net operating losses results in a higher cash flow inasmuch as tax payments are reduced.

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The need for an adequate cash flow is, in a sense, self-evident, but I think it might be nevertheless useful to note the areas where it is most critical.

(i) It is important that there be enough working capital to conduct the company's business, particularly in a situation where trade credit and other credit might be somewhat restricted subsequent to the bankruptcy, at least for a period of time.

(ii) Adequate cash flow is necessary to finance capital expenditures since external financing is generally not available, at least in the early years and typically one of the reasons that a company may have gone bankrupt is that its plant and equipment had needed modernization.

(iii) Adequate cash flow is critical to demonstrate to lenders that there is a meaningful prospect of repayment of the debt that is recognized in a post-insolvency setting.

This is important in two senses. First, clearly the creditors have to feel that the prospect of getting their debts repaid in a reorganized business exceed what they would get in liquidation. Second, the larger amount of debt that the creditors are willing to keep in the business consistent with prudent leverage of the reorganized company, the more it is likely that the entity can achieve the "front end" payments that may be needed to achieve a settlement.

In many of the reorganizations, the additional cash flow that may be made available by the ability not to have to pay income taxes owing to the debtor's net operating loss is an important factor in analyzing the sufficiency of the prospective cash flow, i.e., whether there is enough prospective cash flow in the years following a bankruptcy to render desirable rehabilitation vs. liquidation.

From a national policy point of view, one could view rehabilitation, in part, aided by the prospect of foregoing certain income taxes as a benefit conferred by Congress to prospective reorganized companies in the sense of a "tax expenditure". This tax expenditure should help to prevent a dispersal of assets, both in terms of people and physical assets. Most importantly, it only becomes an expenditure to the extent the reorganized company succeeds, which is a circumstance we would all welcome. If the company fails, no tax expenditure would have been made. Therefore, it should be noted that the current tax provisions do not subsidize companies who will fail.

I am not aware of a study that weighs the value of these tax expenditures. It would appear to me that rehabilitation as compared to liquidation confers certain immediate benefits. The first is quantitative and is measured by avoided expenditures on unemployment insurance and welfare, as well as continued receipt of income taxes from the indi-

viduals who keep working. The second is a political and social benefit in that individuals and families are spared the difficult experience of seeking new positions and perhaps a new career, if their company can, in effect, succeed a "second time". These benefits would presumably be measured against the discounted future tax payments that this proposed Act might create or the possibly higher tax payments that might be received from corporations who put to productive use the assets arising out of a liquidation.

It would seem perhaps appropriate to suggest that such an economic study might well be accomplished prior to considering the proposed tax changes of this Act.

Accordingly, therefore, I believe the issue of the treatment of debt forgiveness of bankrupt companies should not be primarily or exclusively viewed as a technical tax matter, but rather should be studied in the context of a cost/benefit analysis of the value and cost to the nation of possibly providing an additional opportunity for a company to succeed.

In that setting, it would be our judgment that the tax provisions with respect to debt forgiveness that prevail in the existing statutes concerning bankrupt companies should be maintained.

Thank you.

SUMMARY STATEMENT OF JOHN C. JAMISON, PARTNER OF GOLDMAN, SACHS & CO.
TO SENATE FINANCE COMMITTEE HEARING, MAY 30, 1980

I have for the past five years specialized on behalf of my firm in situations involving restructuring the debt of financially troubled companies with the aim of avoiding bankruptcy proceedings. In each instance, the alternative of such a proceeding as a rehabilitative vehicle for these companies has received serious consideration.

Preservation under existing tax laws of the debtor's net operating loss and carryover (NOL) as an aid to the financial rehabilitation of the debtor has been a critical consideration in determining whether recoveries for creditors and ultimately shareholders might be greater in maintaining the creditor as a going concern or in liquidating the business.

The treatment of NOL's proposed in H.R. 5043 in my judgment would result in a greater bias toward liquidations and a consequent loss of employment and significant disruption of personal lives. Such a result is totally inconsistent with the objective of the new Bankruptcy Code which is to rehabilitate debtors.

Senator BYRD. The next panel, Mr. Robert A. Bergquist, New York, Mr. Richard L. Bacon, of Washington, D.C.

## STATEMENT OF ROBERT A. BERGQUIST, NEW YORK, N.Y., ACCOMPANIED BY ALFRED GROFF

Mr. BERGQUIST. Mr. Chairman and members of the subcommittee, my name is Robert Bergquist. I am with the New York law firm of Shearman & Sterling. Joining me today is Alfred Groff of my firm, who has helped prepare my statement and who shares the views that I will express.

My law firm represents numerous creditors and debtors in bankruptcy reorganizations. I am not here today, however, to express the opinions of any particular client. Instead, I am here to express my views as an interested tax practitioner who works on a great many bankruptcy reorganizations.

The overall effect of the bill in its present form will be to subvert the fundamental policy of the new Bankruptcy Code as well as the old Bankruptcy Act, which is to encourage financially troubled companies to reorganize and to stay in existence rather than to liquidate. To the contrary, the bill in its present form will definitely encourage the liquidation of companies, the piecemeal sale of their assets, the dismissal of their employees, and the termination of their businesses.

Without question, the main feature of the bill which will produce this unwelcome result is the provision calling for a scale-down of tax attributes such as the net operating lose carryover.

Under the long-standing existing practice in the bankruptcy area, it is clear that creditors view these tax attributes as highly important assets of a bankrupt company. You can take the simple example of a bankrupt company which has, let's say, a $10 million net operating loss. Heretofore, such a company would go through bankruptcy with that net operating loss intent, and thereafter available to shelter the earnings it is expected to have once the bankruptcy reorganization is completed.

On the other hand, if this bill in its present form is passed, that $10 million net operating loss will be greatly reduced or eliminated in its entirety. This is very important because, as the investment bankers, who are in the practice of advising creditors whether they should go along with the bankruptcy reorganization as opposed to calling for the immediate liquidation of the company, testified earlier today, it is crucial to the future working capital needs and the cash flow needs of the company at least not to have that company paying dollars to the U.S. Treasury in the first few years after it emerges from bankruptcy.

I strongly urge this subcommittee to eliminate in their entirey the provisions of the bill that call for the scale-down of the net operating loss carryover and other tax attributes. On the other hand, if this subcommittee has come to a point where it simply cannot eliminate these provisions, and I don't believe this has occurred, at least this subcommittee should make some other changes to the bill that will diminish the complete upheaval that otherwise is going to occur by virtue of this legislation.

What should those changes be? Well, first, there should be no recognition of forgiveness of indebtedness income for at least the first 3 years after the company emerges from the bankruptcy. It would be devastating to require a company coming out of bankruptcy to pay a significant amount of tax to the Treasury within this initial 3-year period.

Second, the stock-for-debt rule that several people have mentioned today should be retained as it exists under prevailing law. Under that rule, there is no forgiveness of indebtedness income if a company satisfies its debt by issuing its stock. That is a very sensible rule in the bankruptcy area, because it encourages creditors to convert their debt to stock. It reduces the debt, which is what has gotten the bankrupt company into its greatest difficulty in the first place.

Finally, the effective date of the bill for bankrupt companies, as well as nonbankrupt companies, should be pushed forward in time to December 31, 1980. The bill in its present form is effective with respect to nonbankrupt companies only as to transactions occurring on or after December 31, 1980. On the other hand, for companies which went into bankruptcy on or after last October 1, it is effective as to any transaction whether such transaction occurred before or after the date on which the bill is enacted. There are a lot of companies today which fall into this latter category, and many of them have taken irrevocable and irreversible actions over the past several months. To apply these new harsh rules to the bankruptcy companies would be totally unwarranted and unfair.

I have just one final comment, and that is that I have looked at the committee reports, I have talked to the Joint Committee on Taxation, and it appears absolutely clear that the revenue gained from this legislatiion will be only negligible.

I cannot fathom the reasons why the Senate should bring about an upheaval of the basic tax rules which have worked so well for so many years in bankruptcy reorganizations when there is no showing that any appreciable revenue gain will result.

Thank you.

Senator BYRD. Thank you, sir.

Mr. Bacon?

## STATEMENT OF RICHARD L. BACON, WASHINGTON, D.C.

Mr. BACON. Mr. Chairman, my name is Richard Bacon. I am an ttorney in private practice in Washington.

In bringing up the rear on testimony on this bill, let me give you ny perspective on it. I am a former member of the staff of the Joint Committee on Taxation. I have worked on this tax bill, and I also worked on developing some of the tax concepts in the basic bankruptcy reform law of 1978.

Many of the arguments that we have heard today from various representatives of creditors and banks and the bankruptcy bar are arguments that were carefully considered in developing this bill. Many of the arguments were taken into account in developing the provisions of the bill.

I support the bill and I think you should, too. I think the bill does balance the interest of creditors, the debtor, and other businesses operating in the community that have to compete with a company that comes out of bankruptcy.

In developing the concepts in the basic 1978 law, and in developing the concepts of the bill before you today, we tried to balance the interests of tax policy and bankruptcy policy. H.R. 5043 does this in a number of ways to carryout what is perceived as the real bankruptcy policy. I would like to address today what I think real bankruptcy policy is, and what tax policy is in regard to some of the arguments you have heard today.

The bill does not destroy the net operating loss of a company that comes out of bankruptcy. It tries to adjust it and scale it down to reflect the fact that that carryover was financed by debts that were canceled and no longer have to be paid. The theory is that it is unfair to keep a loss carryover when you finance that carryover with debts that have been cancelled and no longer have to be paid.

If a constituent approached you as a competitor of a company that came out of bankruptcy with all of its carryovers intact, that constituent might legitimately feel upset about the fact that that constituent, who may have had some losses in the past, but is chugging along in a tough market, has to pay his debts that gave rise to his losses. He might regard it as unfair that his competitor comes out of bankruptcy with loss carryovers totally intact, even though the money that financed them, the debts that financed them, do not have to be paid any further.

Now, in scaling down carryovers, the bill today reflects the fact that over the years, the tax law has never been very clear on these issues. There was some theory in some courts that loss carryovers were wiped out entirely. The bill does not do that. The bill strikes a balance in between, and tries to scale the losses down. In general, unless the company has an exorbitant amount of loss carryovers, H.R. 5043 tries to allow the company a dollar of carryover for every dollar of basis that the creditor has left in his claim against the company.

The other point I want to make is that legitimate bankruptcy policy does not call for necessarily rehabilitating a company as opposed to liquidating it. If you take a close look at bankruptcy policy, it is basically neutral with regard to whether the company

liquidates or whether it survives and reorganizes. The debate recently held in Congress over whether Chrysler Corp., should receive subsidies reflects the fact that we have no clear policy on whether a company should survive or whether it should liquidate. The tax bill does not take any position on this, and it does nothing to try to encourage a company to reorganize or to liquidate. It lets the creditors make that decision on the basis of real economic values, not on the basis of an artificial incentive in the form of a tax subsidy or a tax shelter.

The tax policy in the bill tries to carry out this neutral bankruptcy policy by removing obstacles to a company that has financial trouble, but without granting it artificial tax subsidies. In this respect, I think the bill is fair to the debtor, to the creditors, and to businesses that have to compete with the debtor.

Thank you.

Senator BYRD. Thank you, Mr. Bacon.

I have only one question. Mr. Bergquist brought out the effective date for bankruptcy cases. The effective date would commence on or after October 1, 1979.

Mr. BERGQUIST. The new bill would be applicable———

Senator BYRD. To those cases.

Mr. BERGQUIST [continuing]. To any actions occurring with respect to a company which went into bankruptcy on or after last October 1.

Senator BYRD. Well, my question is directed to Treasury. Why should this bill in effect be made retroactive?

Mr. SHAKOW. Mr. Chairman, when the new bankruptcy law came into effect on October 1, the effect was that there were no special rules that applied to entities in bankruptcy, and the reason we have in the past and are now urging that this bill be passed quickly is that some rules are needed.

If we were to change the effective date, which is something that we would not favor because we believe that—and I will explain the reasons in a moment, but if we were to change the effective date, there would be a need to provide something for the interim period in any event, which would not in our view be a simple task.

The reason we don't feel that it is necessary or advisable to change the effective date, besides the fact that we need to make provision for the interim period is that most of the provisions, I would imagine, that would be of significance would involve complicated corporate bankruptcies.

Now, those, to the extent they commenced after October 1, 1979, are not likely to be in a position that final decisions have yet been made on giving stock for debt or anything of that nature.

Senator BYRD. It might well have been. October 1, 1979, was quite along time ago.

Mr. SHAKOW. I appreciate that in some cases they would have been. To the extent that they would have been, we would imagine that practitioners, having nothing to guide them, would have looked to the bill that had been considered by at least one House, that to a significant degree followed the provisions that have been in the various versions of the bankruptcy tax law over the past few years, and if their clients needed advice at that point, could have advised them accordingly.

Otherwise, as I say, they would be in the position that there was no law specifically applying to corporations in bankruptcy, and if they had to advise under current law, they would have had to advise that there were no special provisions dealing with those corporations in bankruptcy.

Mr. BERGQUIST. May I say that I know of several cases where many actions have been taken with the tax practitioners, the tax advisers; namely, myself and others like me, not knowing what the law will be, that there were significant changes made in the House from the original bill that was introduced there last fall, and may I say further that this is one more example, Mr. Shakow's testimony, of how the Joint Committee on Taxation in this matter does not know what is going on in the real world of bankruptcy reorganizations. They don't have the slightest idea of the practical considerations in working out a bankruptcy reorganization.

Senator BYRD. I might say to Treasury that I don't think the practitioner needs to assume that the Senate is going to pass precisely what the House passed. It doesn't always work that way.

Mr. SHAKOW. I was not by any means suggesting that.

Senator BYRD. Thank you, gentlemen.

Senator Packwood?

Senator PACKWOOD. No questions, Mr. Chairman.

[The prepared statements of the preceding panel follow:]

Summary of Statement of Robert A. Bergquist, Attorney, New York, New York

The provisions of the Bill requiring a scale-down of tax attributes to the extent of forgiveness of indebtedness income should be eliminated in their entirety. If this is not done, then, at the very minimum, the Bill should be amended as follows:

1. The stock-for-debt rule in H.R. 5043 (proposed Code § 108(f)(1)(A)) should be modified to incorporate existing law except where creditors receive an insignificant amount of the debtor's stock in satisfaction of their claims.

2. No forgiveness of indebtedness income should, if the debtor elects, be recognized until the third year following the year in which the forgiveness occurs.

3. A provision similar to proposed Code § 382 (d)(1) (treating pre-existing creditors as shareholders) should be incorporated into the change-in-control test in Code § 269(a).

4. The Bill should specifically provide that no "continuity of interest" is required for a "G" reorganization. The objective tests contained in sections 382 and 383 of the Internal Revenue Code will offer sufficient protection against the trafficking in favorable tax attributes of insolvent companies.

5. The effective date of the Bill, for bankrupt as well as non-bankrupt debtors, should be postponed to the date which is 90 days after the date on which the Bill is enacted.

Statement of Robert A. Bergquist, Attorney, New York, New York

Mr. Chairman and members of the subcommittee, my name is Robert Bergquist. I am a member of the law firm of Shearman & Sterling. Joining me today is Alfred Groff, who works with me in my law firm and who has participated in the preparation of my statement and shares the views I will express. My law firm represents numerous debtors and creditors in bankruptcy reorganizations. I am not here today, however, to express the opinions of any particular client. Instead, I am here to express our views as interested tax practitioners.

The overall effect of the Bill, in its present form, will be to subvert the fundamental policy of the new Bankruptcy Code, as well as the old Bankruptcy Act, which is to encourage financially troubled companies to reorganize and to stay in existence as viable economic entities. To the contrary, the Bill, in its present form, will encourage the liquidation of such companies, the piece-meal sale of their assets, the dismissal of their employees and the termination of their businesses.

Without question, the main feature of the Bill which would produce this unwelcome result is the provision calling for a scale-down of the tax attributes of a debtor to the extent to which there is cancellation of indebtedness income. These tax attributes are the net operating loss carryforward, the capital loss carryforward, the investment

tax credit carryforward, the tax basis of assets for depreciation purposes and some other attributes which are of less importance.

Under the existing practice in the bankruptcy and insolvency area, it is clear that creditors view these tax attributes as highly important assets of the debtor and, specifically, as having a heavy impact on future cash flow and future working capital needs. If the debtor's tax attributes are eliminated or greatly reduced (as surely will occur under the Bill) creditors will be far more reluctant to consent to a reorganization rather than recovering whatever they can by means of an immediate liquidation.

Moreover, there is no evidence that reducing the debtor's tax attributes will result in any significant increase in the Federal government's tax revenues either in the short or the long term. As I have noted, with the reduction in favorable tax attributes resulting under the Bill, fewer companies will be reorganized. If fewer companies are reorganized, creditors will be entitled to greater loss deductions because the going concern value of the debtor will not be taken into account in calculating such deductions. Moreover, potential tax revenues on wages paid to the debtor's employees and the debtor's future income (after net operating loss carryovers have been used or expired) will be lost if the debtor cannot be reorganized.

I strongly urge this subcommittee to eliminate the provisions of the Bill which call for a scale-down of these valuable tax attributes. I realize that this is a rather complicated tax issue and I suggest, therefore, that if this subcommittee is not prepared to do a surgeon's job of excision the responsible course of action would be for this subcommittee to reject the Bill in its entirety. The potential benefits that other portions of the Bill have are far outweighed by the damaging effect of the provisions calling for a scale-down of tax attributes. If, however, this subcommittee ultimately concludes that a Bill of some sort must be enacted, then I implore you to at least reduce the size of the resulting catastrophe by making the following changes:

1. <u>Stock-for-Debt Exception</u>

Under existing tax law, a corporate debtor is not required to recognize cancellation of indebtedness income to the extent that such indebtedness is satisfied in exchange for the debtor's stock. Proposed section 108(f)(1)(A) of the Internal Revenue Code would eliminate the stock-for-debt exception under existing law where the debt is not a security except to the extent that the debtor's stock has demonstrable value. Since the stock of a financially distressed company rarely has more than speculative value, the exception will be largely eliminated in bankruptcy and insolvency situations.

In essence, the concept behind the proposed change is one of symmetry, that is, a deduction to a creditor theoretically should be balanced by an inclusion in income via the reduction in tax attributes of the debtor. Accordingly, since the creditor can claim a loss deduction equal to the difference between the creditor's basis in the debt claim surrendered and the value of the stock received, the Bill's revisions require the debtor to reduce its tax attributes by the difference between the amount of debt cancelled and the value of the stock transferred. In addition, the revised rule is intended to thwart the abuse which currently can arise where a minimal amount of stock is issued by a debtor in order to avoid cancellation of indebtedness income.

I believe, however, that this blind devotion to symmetry is misplaced. There are numerous situations in the tax law where a deduction on one side of a transaction is not reflected by an inclusion on the other side, and *vice versa*. For example, many fringe benefits are deductible by employers but are not required to be included in the income of employees. On the other hand, dividend payments are includable by shareholders in their income but are normally not deductible by the distributing corporation.

Practical reasons exist for asymmetrical treatment of such items, of course and I submit that equally strong practical reasons exist for continuing the stock-for-debt exception under existing law. First, the stock-for-debt rule under existing law encourages a shift in the capitalization of the debtor from debt to equity. Such a shift is often critical to the ultimate success of the reorganized debtor. If the debtor is loaded down with debt when it emerges from a bankruptcy reorganization or non-bankruptcy recapitalization, the chances are that the debtor will again fail and that the reorganization will have proven to be futile. Second, one can easily anticipate that many debtors will use subordinated debt and other "funny" debt to satisfy claims instead of stock in order to avoid the reduction in tax attributes mandated by the Bill's provisions. The practical consequence will be a spate tax litigation to determine whether the instruments issued by the debtor should be treated as debt or equity for tax purposes. Third, the stock-for-debt rule under existing law avoids valuation problems.

I offer one further point on the stock-for-debt issue. Although existing law should generally be continued, the issuance by a debtor of a minimal amount of stock in order to avoid cancellation of indebtedness income admittedly may be abusive and should be eliminated. To remedy this, I

suggest that the exception be allowed only in cases where the creditor receives an amount of stock which is reasonable in proportion to his claim against a debtor and only where such stock is issued in connection with an equity based rearrangement of the debtor's capitalization -- *i.e.*, in situations where a significant proportion of the debt claims against the debtor are converted into stock. One way of achieving such protection from abusive use of the rule would be to adopt a provision similar to the one contained in attachment A to this statement.

2. Deferral

In the context of bankruptcy and non-bankruptcy workouts of financially distressed debtors, immediate cash considerations are often critical to the consummation of the transaction. Accordingly, I suggest that the debtor be given the election to defer recognition of cancellation of indebtedness income (or reduction of favorable tax attributes) until the third year following the year in which cancellation occurs.

3. Code Section 269(a)

Code Section 269(a) authorizes disallowance of a debtor corporation's favorable tax attributes where any person or persons acquire a 50% or greater stock interest in the debtor and the principal purpose for such acquisition is

"evasion or avoidance of Federal income tax by securing the benefit" of such tax attributes. The possible application of this section is a hindrance to the successful consummation of a bankruptcy reorganization and is difficult to justify because, under the new Bankrtupcy Code, the Internal Revenue Service is entitled to oppose a plan of arrangement where the proscribed tax avoidance purpose exists. Accordingly, I suggest that a provision similar to the proposed section 382(d)(1) of the Internal Revenue Code (treating pre-existing creditors as shareholders) be incorporated into the change-in-control test in section 269(a) of the Internal Revenue Code.

4. Continuity of Interest

Under existing tax law the acquisition of the assets or stock of a corporation by another corporation will not qualify as a tax-free reorganization unless the acquired company's shareholders retain a sufficient "continuity of interest" in the stock equity of the surviving company. This requirement was devised by courts in the context of solvent companies. It simply cannot be adapted to the context of insolvent companies because of the difficulty in determining the relevant "shareholder" group. Therefore, I suggest that the Bill specifically provide that no continuity of interest is required for a "G" reorganization. The objective tests contained in sections 382 and 383 of the Internal Revenue Code will offer sufficient protection against the trafficking in the debtor's favorable tax attributes.

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5. Effective Date

The Bill, in its present form, would have retroactive effect in cases heretofore commenced under the new Bankruptcy Code. Since the changes wrought will be significant and in many situations extremely adverse to bankrupt companies, I urge that the effective date in bankruptcy as well as non-bankruptcy situations be postponed to a date which is 90 days after the date on which the Bill is signed into law.

Attachment A

INDEBTEDNESS SATISFIED BY EQUITY INTEREST.-

(1) CORPORATE RULE.-For purposes of determining income of the debtor from discharge of indebtedness-.

(A) STOCK FOR DEBT.-

(i) If a debtor corporation transfers its stock to a creditor in satisfaction of its indebtedness, then, unless such creditor receives a qualifying percentage (as defined below) of stock issued by such corporation in an equity-based workout (as defined below), such corporation shall be treated-

(1) as not having transferred its stock, but

(2) as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock.

(ii) For purposes of this subparagraph-

(1) The term "qualifying percentage" shall mean (A), in the case of a secured creditor, at least 50 percent multiplied by a fraction the numerator of which is the amount of indebtedness owed to such secured creditor which is discharged in an equity-based workout and the denominator of which is the total amount of indebtedness owed to all secured creditors discharged in such equity-based workout and (B), in the case of an unsecured creditor, at least 50 percent multiplied by a fraction the numerator of which is the amount of

indebtedness owed to such unsecured creditor which is discharged in an equity-based workout and the denominator of which is the total amount of indebtedness owed to all unsecured creditors discharged in such equity-based workout. For purposes of the foregoing, a creditor shall be treated as a secured creditor to the extent of the fair market value of the security for the indebtedness owed to such creditor and as an unsecured creditor if the indebtedness owed to such creditor is unsecured or, if partial security exists for such indebtedness, to the extent such indebtedness exceeds the fair market value of such security.

(2) The term "equity-based workout" shall mean any transaction or series of related transactions in which-

(a) at least 30 percent of the indebtedness of a debtor corporation is satisfied in consideration for the transfer of such corporation's stock, or

(b) at least 30 percent of the total value of all classes of such corporation's stock is transferred to creditors of such corporation in consideration for the satisfaction of indebtedness owed by such corporation.

May 30, 1980

STATEMENT OF RICHARD L. BACON
ATTORNEY, WASHINGTON, D.C.
ON
H.R. 5043
SENATE FINANCE SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT

Summary

1. No bankruptcy or tax policy supports preservation of loss carryovers (and other similar tax attributes) in full to a business emerging from a bankruptcy reorganization. Creditors do not need - or deserve - to benefit from loss carryovers financed by debts which no longer have to be paid.

2. The bill, H.R. 5043, properly adjusts loss carryovers (and other tax attributes) following a reorganization to reflect cancelled debts. It scales down carryovers to the amount appropriate to the creditors who remain with the company. The bill will effectively require creditors to focus on the real economic value of the business and not to be falsely induced to prolong an enterprise that is better off liquidating. The bill will also prevent potential abuses which give creditors of a bankrupt business an unfair advantage over business competitors of the debtor company.

3. In other respects, H.R. 5043 is sound and well conceived, although the effective dates should be advanced to reflect the passage of time toward enactment.

Statement

Mr. Chairman and members of the Subcommittee:

My name is Richard L. Bacon. I am a tax lawyer engaged in private practice in Washington, D.C. I am appearing here today on my own behalf and not on behalf of any special interest or group. Until March of last year, I was a member of the staff of the Joint Committee on Taxation and have spent considerable time studying the interaction of our tax laws and bankruptcy laws. I have a continuing interest in this subject.

This Subcommittee participated in the milestone project which, in 1978, resulted in the first major reform of federal bankruptcy law in 80 years. This Subcommittee held hearings on the tax provisions of that legislation on referral from the Senate Judiciary Committee, and reported a series of amendments to the bill which eventually became part of the public law (P.L. 95-598). For this effort, this Subcommittee can take deserved credit.

Today's bill is moved by the same philosophy of reform: to reexamine old concepts rigorously and to change old rules, where appropriate, in light of new thinking and updated tax concepts. The 1978 law did this in its nontax provisions, and modernized bankruptcy law in light of new commercial developments, newly-developed rights of debtors and creditors, and new court procedures. The tax bill before you today challenges us to keep moving in the same direction. I support this bill. I would like to help make sure that you are not misled by "buzz words" referring to loss of jobs or massive shutdowns of local businesses which are intended to frighten you into an emotional, unthinking reaction. I would like to close this public testimony by trying to make clear what our present tax policy is; more importantly, what bankruptcy policy is, and is not; and what effect this bill today will really have.

There are technical changes to the bill which are desirable, and I have submitted my list of these items to the Subcommittee staff for inclusion in the record.

SCALING DOWN CARRYOVERS TO REFLECT CANCELLED DEBTS

As you have heard, the core concept of the bill deals with the tax treatment of cancellation of debts for businesses in bankruptcy. The bill continues a generous measure of relief in not imposing tax on the income arising from a cancellation of debts for a corporation or for an individual undergoing bankruptcy. This is generous relief; it departs from the long established tax rule that a taxpayer who has a debt forgiven realizes income to the extent of the funds he borrowed which he no longer has to repay.

The chief areas of controversy are whether the bill is sound in changing present law to require that a bankrupt business should receive additional relief by being able to retain all of its net operating loss carryovers for use against future income -- even though these past losses were financed partly by debt obligations which have been discharged and no longer have to be paid. Second, should a corporation which gives stock to its creditors be required to reduce its loss carryovers as if it had paid them cash?

We have heard arguments threatening dire consequences for jobs, for bankrupt companies, and for our economy in general, if companies emerging from a bankruptcy reorganization

do not keep their loss carryovers totally intact in the name of "cash flow."

First, let me point out that there is no bankruptcy policy supporting the claim that companies are to be encouraged to reorganize rather than liquidate, or that tax benefits ought to be made available as an incentive to creditors to agree to reorganize the company. The main purpose of bankruptcy is an orderly processing of the debtor's affairs, to keep some creditors from trampling others in the rush to be paid, to arrange for either liquidation or reorganization as the parties prefer, but not necessarily to favor survival rather than a straight cash payoff to all creditors and orderly termination.

In 1973 the Bankruptcy Commission of the United States itself proposed that loss carryovers should be scaled down to reflect cancelled debts (although the Commission would not have applied this rule where stock is issued for debt). The Commission made clear that there is no bankruptcy reason for creditors who remain with the company to benefit from carryovers arising from debts to creditors who are not now still around.

Consider this matter, too, from the standpoint of competitors of a company emerging from a reorganization in bankruptcy. What would be your reaction, Mr. Chairman, if your constituent operated a moderately successful business, having some net operating loss carryovers available from prior years, but still getting by in a tough competitive market. Your constituent then finds that one of his competitors has just emerged from a reorganization in bankruptcy with not only a clean slate of debts, but also with an extra benefit of all of his loss carryovers, including those financed with debts that were cancelled in the bankruptcy Your constituent, however, would still have to pay <u>his</u> debts that have financed <u>his</u> loss carryovers. I am sure that your constituent would perceive this situation as intolerably unfair and excessive relief to the debtor, who can now operate with tax-sheltered earnings.

Fortunately, there is in fact no bankruptcy policy favoring reorganization over liquidation or which requires turning the reorganized business into a tax shelter for the benefit of big banks or other creditors. Real bankruptcy policy is neutral on these issues beyond granting the debtor a discharge of his debts. This neutrality gives

relief to the debtor without harming his competitors. This is the meaning of the statement, frequently made, that the purpose of bankruptcy is to give the debtor a "fresh start" rather than a "head start."

Frequently, the debtor companies to which many big banks have loaned money are large multi-business enterprises; they go into a bankruptcy reorganization, sell off unprofitable divisions or assets, and emerge with the creditors owning only the profitable assets such as a hotel, a shopping center or, in the case of the Penn Central railroad, valuable real estate in Manhattan and elsewhere. In these situations, preserving loss carryovers for the benefit of creditors is least of all a needed rehabilitative cushion; it is, rather, a pure tax shelter. If the carryovers were financed by debts that no longer have to be paid, this result is pure gravy for the creditors and is also unfair competition to businesses trying to compete with the reborne debtor.

There is also no tax policy favoring the full preservation of loss carryovers after a bankruptcy, and the bill today makes this clear for the future. Creditors argue that the name of the game in bankruptcy reorganizations is

"cash flow." This is just another way of saying that creditors want to be repaid out of future profits <u>before tax</u>. This will occur if the company's future earnings can be sheltered by loss carryovers financed by creditors who are no longer there, or by debts that no longer have to be paid. Ordinarily, however, a business's payments to creditors are not deductible expenses and are paid out of <u>after-tax</u> earnings. If you buy the creditors' arguments, I suggest that you perform radical surgery on the tax law generally. But you are under no mandate to do so by either bankruptcy or tax policy.

The desire of creditors to preserve loss carryovers also has been known to reflect clever tax planning. Many large creditors are willing to accept stock in a debtor company if large loss carryovers can be kept in place to shelter the company's future profits. These earnings could then also be withdrawn almost totally tax free to the creditor/stockholder by reason of the 85 percent intercorporate dividends received deduction (allowable under Section 243 of the tax Code). The availability of the loss carryovers also makes it easier to sell off the stock to investors interested in a tax shelter. This process of

"stripping" the debtor company explains many creditors' real motives - rather than a social conscience to rehabilitate fallen members of the business community.

I must tell you also that the allowance of carry-overs to a debtor after bankruptcy is shrouded in uncertainty under present tax law. Do not think that a 100 percent preservation of loss carrryovers has somehow been clearly sanctioned by Congress or deeply rooted in court precedents. The tax committees of Congress have never, during the last 80 years, participated in the development of tax policy for bankruptcy with respect to whether loss carryovers should be adjusted to reflect cancelled debts. Some court decisions have in fact ruled that a corporation emerging from bankruptcy takes no carryovers at all with it, on the theory that its slate has been "wiped clean" of both debts and tax benefits. These court decisions stood unchallenged until 1977. Yet bankruptcy reorganizations went ahead during this period, and creditors allowed companies to reorganize, despite the possible loss of carryovers under the Clean Slate Doctrine. I think this suggests that creditors' decisions turn on more basic economic considerations than tax benefits.

H.R. 5043 does not adopt a Draconian "clean slate" rule. It strikes a middle course; it allows the company to keep $1 of loss carryovers for each $1 of basis remaining in the claims of creditors who stay with the company unless the amount of cancelled debt greatly exceeds the unused balance of the carryovers. But remember even then: a small remaining balance of loss carryovers means that the company has already benefitted in the past by using its carryovers; the bill will not disturb this past benefit in any way.

STOCK ISSUED FOR DEBT

We have also heard a challenge today to the bill's rules where a debtor company issues stock to its creditors in exchange for part or all of their claims. The bill strikes a compromise in reducing carryovers where stock is issued to trade creditors or other short-term lenders, but not where stock is issued to holders of senior debt instruments. It is simply false to conjure up a spectacle of creditors refusing to agree to reorganize a company and to accept stock for their claims if the company's loss carryovers are to be scaled down. The rule has long been accepted that if creditors accept a new debt instrument in a lesser amount than their

existing claim, the company realizes income from cancellation of debt. H.R. 5043 provides a parallel rule for the issuance of stock to creditors, except, of course, that no positive income is actually imposed on the company; its loss carryovers and other carryovers, if any, are scaled down.

Why are creditors willing to take stock in a reorganizing company? If profitable aspects of the company can be turned around and stock can be sold off for even a dollar more (by present value) than the amount for which the creditor could sell his claim, the creditor comes out better than if he had liquidated the company. Stock can also be sold in many cases more easily than the creditor could sell his claim as such. Neither of these reasons for taking stock depends on preserving loss carryovers in full.

SUBSIDY POLICY

I acknowledge that loss carryovers are sometimes taken into account today in valuing a business in bankruptcy, at least where the parties believe the company can retain

carryovers under the court decisions. But these are unearned tax benefits which are being valued. If these unearned tax benefits were taken away or reduced, a different kind of reorganization plan would be negotiated under different rules of the road, where less tax shelter would be available. Mr. William T. Plumb, Jr., the leading expert on bankruptcy tax policy, has aptly pointed out that without a tax subsidy, "the same products would be saleable in the same markets, if the company is viable at all...Only the capital structure would be changed, to reflect different tax assumptions." Indeed, I predict that without undeserved tax subsidies, creditors will not delude themselves into reorganizing companies which lack real economic value, which will only bring grief to new creditors and maybe new employees, and which are better off liquidating now.

Why, indeed, should the Federal Treasury be more inclined to spare creditors from loss than to rescue the stockholders' investment as well? The logic of some of the arguments you have heard extends to reimbursing stockholders for their losses. Of course, stockholders invest "risk"

capital while creditors take fixed obligations. But the Federal Government does not guarantee private debts any more than private stockholders' investments.

If you should want to subsidize creditors or stockholders, however, you might follow the Chrysler example across the board for all business. In that event, I suggest that you could do a more efficient job by extending Federal loan guarantees or direct Federal payments to all bankrupts as a general rule rather than as a rare exception. You might also consider keying a Federal subsidy to the number of jobs at stake in the company, rather than to the accidental amount of loss carryovers left.

One serious possibility which you might consider, however, is to extend the "Conrail rule" to all bankruptcies. Since companies emerging from bankruptcy are not assured of instant profits, you might consider allowing a company to "freeze" whatever carryovers (as reduced) it has at that point and to use those carryovers against such profits as it may generate over, say, a five-year period. There is precedent for such a "springing use" of loss carryovers, in a similar rule which Congress adopted for the Conrail Railroad reorganization (see section 374(e) of the Code).

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EFFECTIVE DATES

Bankruptcy cases. We are moving sufficiently far away from October 1, 1979, the general effective date of the bankruptcy code of 1978, so that certainly would not be furthered by making H.R. 5043 retroactive to cases begun last year. I propose advancing the effective date of the bankruptcy provisions of H.R. 5043 to petitions filed or similar proceedings commenced more than 90 days after the date of enactment of H.R. 5043.

Outside formal bankruptcy. Section 7(a)(2) of the bill makes the rules for cancellation of indebtedness outside bankruptcy effective for "transactions" which occur after December 31, 1980. The quoted term is ambiguous, because it leaves unclear whether "transaction" covers debt cancellations after December 31, 1980, pursuant to negotiations begun in 1980. I propose advancing the effective date of the rules for cancellation of indebtedness outside bankruptcy to cancellations of debt occurring after June 30, 1981. This proposal keys on the date of discharge or cancellation, but the delay is probably sufficient, in most cases, to cover only cancellations pursuant to negotiations begun after the likely date of enactment of the bill.

CONCLUSION

This tax bill already compromises many major items of controversy. These compromises were arrived at after taking into account the legitimate concerns of the debtor and of creditors, including such matters as the effect on the basic decision whether to reorganize or liquidate the company. The bill carefully balances bankruptcy policy with the bona fide concerns of business competitors of the debtor. The bill gives essential relief in preventing the tax law from creating unnecessary obstacles to a reorganization. But it firmly stays away from creating new and unprecedented tax incentives just for businesses going through a bankruptcy. This is not, and never has been a legitimate objective of bankruptcy reorganizations.

After you consider the technical changes which have been suggested to the staff, I urge you to stand fast and approve this bill. You can do so with a firm belief that you are "doing right" by debtors, creditors, and the rest of the business community.

June 6, 1980
Richard L. Bacon

TECHNICAL COMMENTS

I. CANCELLATION OF INDEBTEDNESS

A. Basic Inclusion in Income

1. Amend existing I.R.C.§61(a)(12). The House bill fails to correct an existing defect in the Code, which does not assert statutory control over the basic inclusion in income of cancellation of indebtedness. Currently, I.R.C. §61(a)(12) requires inclusion only of "income" from discharge of indebtedness. This unusual formulation in effect leaves it to the courts to determine when "income" arises; under this loophole, courts have fashioned exceptions and definitions (including the insolvency test), some of which tests are inconsistent among different circuits.

I propose amending §61(a)(12) to read as follows:

"(12) indebtedness forgiven or discharged."

2. Express inclusion in income. If the solvency-insolvency distinction for debtors outside bankruptcy is retained (but see my alternative proposal below):

a. The bill should amend the Code expressly, or at least the Senate committee report should state, that debt cancellation amounts not applied to reduce depreciable basis must be included in income under §61(a)(12). This point is not completely clear under present law and is not clarified in the House Committee report (although the point is explicitly stated in the staff pamphlet prepared for the Senate subcommittee hearing on the bill on May 30, 1980. See staff pamphlet, p. 14).

b. The bill's intent is that an insolvent debtor who is made solvent by a cancellation of debt must report income under §61(a)(12) _to the extent_ he is solvent _after_ the cancellation or forgiveness of his debts. _First_, this point is not made clear in the committee report but ought to be. _Second_, the committee report should also call attention to the fact that by keying the test on the debtor's degree of insolvency _before_ the discharge (rather than on the extent of his solvency _after_ the discharge), this approach means that no express measurement of solvency will be made. Hence, new money invested by outsiders in

the debtor will not be taken into account in determining how much §61(a)(12) income is realized by reason of the forgiveness of debts.

B. Cancellation of Debt Outside Bankruptcy

I believe that the bill's measurement of a debtor's solvency or insolvency as a basic criterion outside formal bankruptcy will be too difficult to apply in practice. Such a test requires a precise valuation of assets; this is particulary hard where the debtor is in the midst of financial difficulty; it also involves policy questions whether a solvent taxpayer's payment of tax on debt cancellation income will cause him to become insolvent.

I propose:

(1) deleting the solvency-insolvency distinction, and

(2) substituting a rule that, outside bankruptcy, a debtor who realizes income from debt cancellation can elect to reduce carryovers and/or his basis in depreciable assets (down to the basis solvency floor), and that any balance of the discharged

debt not so absorbed would be current income or, at the debtor's election, tax thereon could be paid in equal installments over 5 years (unless IRS agrees to different or longer terms).1/

This rule would apply without regard to the debtor's solvency or insolvency at any point. He would not be allowed to reduce his basis in non-depreciable assets.

C. Interrelation of Related Party, Contribution to Capital, and Stock for Debt Rules

1. Add a statutory rule that if the related party rule is triggered, the related party will take a basis in the claim equal to the unpaid principal amount of the claim (rather than cost to the related party or the transferor creditor's basis). This basis rule would apply, however, only for purposes of gain or loss on dispositions of the claim outside the affiliated group and (as described below) would not apply to transactions between the related party and the debtor with respect to the debt.

This basis rule will prevent the debtor from realizing income a second time if the related party contributes the debt to the capital of a corporate debtor.

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1/ The debtor would be entitled to seek collection relief from the Service or to use income averaging, if the facts permit.

The proposed basis rule would also block devices by which a shareholder could effectively withdraw earnings from his corporation at capital gain rates.

> Example: Subsidiary owes outside creditor $100. Parent Corp. purchases this debt for $70. Subsidiary realizes $30 ordinary income. Subsidiary later pays $100 to Parent Corp. If Parent's basis in the debt were its cost, i.e., $70, Parent would realize $30 capital gain via §1232. The House Committee Report would allow Subsidiary a $30 deduction (p. 16, fn. 25). In effect, Parent has extracted $30 from Subsidiary at capital gain rates.

The proposed basis rule would prevent the related party from realizing capital gain. As a counterbalance to this favorable result for the related party, however, the Senate committee report or the statute should state that the debtor will not get any deduction if he pays the debt. (Otherwise, the related party rule could operate to let shareholders withdraw corporate earnings completely taxfree without any adverse income tax effects at the corporate debtor's level).

In the above Example, if Subsidiary pays Parent $70, and if Parent is required to take a $100 basis in the Subsidiary's debt, the Parent should also not be entitled to any capital loss.

2. Where creditors of a controlled subsidiary transfer their claims to the parent company in exchange for stock of the parent, this will not be a good section 351 transaction if the transferors are short-term creditors. The transfer may qualify under §351 if the transferors are security holders of the subsidiary, however, unless proposed I.R.C. §108(f)(1)(D) applies for purposes of §351 (which it apparently does not). The Committee Report should clarify this point. In my view, the transfer by the creditors should be tested under §351, but the related party rule should operate in all events, so that the related party (the parent corporation) would take a basis in the acquired claim as proposed in 1. above. Thus, the related party rule would operate in all cases to trigger debt cancellation income to the subsidiary. It is necessary to override the normal carryover basis rule under §351, however, where the special related party basis rule would operate.

3. If a parent company (P) contributes its own stock to controlled sub (S) which S uses to pay its creditors, the Committee Report should indicate that S realizes gain or loss under the general rules governing use of appreciated property to pay debts. (The zero basis problem is raised, of course, in determining S' basis in the P stock).

D. Miscellaneous

1. Stock for debt rule.

a. In valuing stock, for purposes of the stock for debt rule, clarify in the statute or committee report whether the valuation is to reflect elimination of the very short-term debt with respect to which the stock is being issued. (If so, this will presumably produce a higher valuation and less reduction in attributes).

b. Consider indicating in the committee report whether the stock for debt rule in the bill will be triggered where a new debt instrument issued for existing debt is reclassified as stock under existing I.R.C. §385.

c. The committee report should make explicit that the stock for debt rule can be triggered where convertible debt is actually "converted" to stock. The act of conversion is essentially an exchange of a debt instrument for stock of the same company.

d. Binding valuation procedures: For bankruptcy cases, an attempt should be made to insert provisions dealing with this subject in the new bankruptcy code itself (11 U.S.C. 101 et seq.). For agreements outside bankruptcy, specific provisions should be added to the Internal Revenue Code.

2. <u>"Lost deductions" (prop. I.R.C. §108(e)(2)</u>. This provision is intended to avoid hardship to cash method debtors who never deducted the forgiven item. Since the debtor has not "lost" any deduction, I propose changing the title of §108(e)(2) to: <u>"Special Rule for Cash Method Taxpayers</u>."

3. Make clear in the committee report that the elective basis reduction outside bankruptcy is not available with respect to inventory.

4. Proposed I.R.C. §108(e)(5) (purchase-money debt reduction): Simplify and restate as a flat rule. Concern for gift situations can be resolved by an express exception or by a cross reference to the overriding rules of present I.R.C. §108.

5. Proposed I.R.C. §1017(c)(3) -- change "dispositions" to disposition (singular).

6. Amendment to I.R.C. §111 (tax benefit rule): add to proposed §111(d) after "expired":

"at the end of the taxable year".

7. Partnership provision overruling Stackhouse): Prop. I.R.C. §108(d)(5) should be revised as an amendment to I.R.C. §702(a) to fit better within the separately-stated item format. E.g., add new §702(a)(8)(A). The basic technical defect in the existing bill is that proposed §108(d)(5) merely says that proposed §108(a) is to be applied at the partner level. However, subsection (a) operates only with respect to amounts which would be includible in gross income apart from §108 itself ("but for this subsection"). This language preserves the court's opportunity to determine

at the threshold (as it did in Stackhouse) that debt cancellation income is included at the partnership level and the partner is governed by existing §§752 and 731. Nothing in H.R. 5043 changes this holding in Stackhouse.

II. REORGANIZATIONS

A. Definition of G Reorganization

1. Sections 354-356 should be clarified to reflect the apparent policy not to allow a qualifying G reorganization if the debtor company has only short term creditors and no security holders or shareholders who receive stock.

2. Sections 354-356 should also be clarified to indicate which rules apply on an assumption that creditors will be deemed to be stockhodlers, and which rules apply to creditors treated as creditors (such as the excess principal amount rule of present §354(a)(2)).

a. Following a "G" transfer of assets of Debtor Co. for stock of the transferee corporation, Debtor Co. distributes the stock to its creditors. Does Debtor recognize gain by treating the creditors as creditors (per Rev. Rul. 70-271, 1970-1 C.B. 166), or are the creditors to be viewed as shareholders so that no gain is recognized at the corporate level?

3. Should stock for stock acquisitions be included under a related rule, i.e., 80% stock for cash, 20% boot OK?

4. Continuity of interest

a. Some kind of anti-"token" stock rule seems desirable in the statute as a hook for regulations.

b. Consider some discussion of continuity of interest in the committee report. This discussion could deal with acquisitions of insolvent companies generally, including the issue whether an insolvent company not in bankruptcy can qualify for an (A) through (F) reorganization in §368(a)(1). See Norman Scott, Inc., 48 T.C. 598 (1967).

5. Prop. I.R.C. §368(a)(3)(B)(ii) -- change "approved" to "confirmed."

6. Make clear in the Committee Report that the G reorganizations is available both to a creditors' takeover of control through a transferee corporation and to an acquisition by an unrelated outside corporation. (The language of existing §371 leaves it unclear whether §371 literally includes the latter acquisition).

B. Divisions

1. Allow corporate divisions ("spinoffs") to qualify under §355 without requiring the debtor to satisfy the 5-year active business history requirement (and possibly other technical rules of §355). Add a safeguard clause denying the availability of §355 if a major purpose for instituting the bankruptcy case is to qualify for this relaxation of the requirements of §355.

(Present section 371 allows transfers of "part" of a debtor's assets. H.R. 5043 tightens present law in requiring a transfer of "substantially all" the debtor's assets under the G reorganization).

2. Give the Treasury authority to issue regulations dealing with apportionment of tax attributes (in addition to earnings and profits, via §312(h)) in a §355 division.

C. Receivership, Foreclosure or Similar Proceeding in a Federal or State Court

1. Allow arbitration proceedings to qualify, even though conducted outside a court. See Alexander Duncan, 9 T.C. 468 (1947) (arbitration proceeding in context of §351 transaction).

2. In order to limit the proceedings to those under U.S. law, delete "in a Federal or State court" and substitute:

> "a foreclosure, arbitration, receivership, or similar proceeding, under United States law."

3. Indicate in the Committee Report that voluntary settlement agreements, including "workouts" and agreements settling private litigation between a debtor and creditors, are not covered by the G reorganization.

D. Section 382

1. Recapitalization. The committee report should clarify the following points regarding the application of §382 (limiting loss carryovers) in light of various amendments made by the bill. Under present law, §382 generally does not apply to restrict loss carryovers where creditors exchange claims directly for stock of Debtor Co., because the exchange is either a recapitalization under §368(a)(1)(E) as to security holders or a taxfree §351 transaction if the creditors

hold short-term interests. Existing §382 does not apply to (E) recapitalizations or to §351 transactions. The proposed creditor exception to §382, contained in H.R. 5043, will not affect, or change, these tax results. Even if an exchange by short-term creditors for stock of Debtor Co. fails to qualify for non-recognition treatment under §351 (per proposed I.R.C. §351(d)(2)) and is thus considered a "purchase" of stock by the short-termers, the company's loss carryovers will be saved by the proposed creditor exception to §382.

2. Make clear in the Committee Report that the §382(b) amendment does not apply to:

a. B reorganizations (inside or outside bankruptcy) since B reorganizations are not covered by §382 at all; or

b. Reorganizations outside bankruptcy, under (A) through (F) but not also under (G).

3. Add the "acquired for the purpose" clause to the §382(b) amendment.

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III. <u>MISCELLANEOUS CORPORATE</u>

A. <u>Earnings and Profits</u>

1. Amend proposed I.R.C. §312(1) to specify affirmatively that "E&P are <u>increased</u> by income from discharge of indebtedness, <u>except</u> to the extent of amounts applied to reduce basis under §1017."

a. Clarify whether E&P are increased by amounts of debt discharge (in bankruptcy) applied directly to reduce carryovers and other attributes.

2. Restore the provision of H.R. 9973 requiring reduction in a deficit E&P by the capital attributable to eliminated shareholders. But do not go further to create positive E&P; let the deficit be "increased" to zero. Treasury will define "capital account" by regulation. Proposed draft:

"§312

* * *

"(1) <u>Effect of Termination of Shareholder Interests</u>. -- If the interest of shareholders of a corporation are terminated under section 1141(d)(1)(B) of title 11 of the United States Code (relating to

bankruptcy), or the interests of shareholders are otherwise extinguished by reason of insolvency, any deficit in earnings and profits of the corporation (or its successor) shall be reduced by the amount of the capital account attributable to the interests of shareholders so terminated or extinguished, but positive earnings and profits shall not be increased or created thereby.

B. Section 337

1. Does reference to adoption of a plan contemplate allowing "straddling" to recognize losses?

2. Rewrite prop. I.R.C. §337(g)(2)(B) to make this provision understandable.

3. Conform the definition of "property" in present §337(b), which now applies only for purpose of subsection (a), to proposed new subsection (g).

Allow assets to be retained to meet claims.

IV. SECTIONS 1398-1399

A. Estate's inheritance of debtor's tax attributes.

1. Make clear in proposed I.R.C. §1398(g) whether the estate starts a new time cycle for the

carryovers it inherits from the debtor (3 years back and 7 years forward) or whether the estate inherits only the number of years remaining on the carryover at the start of the bankrptcy case. Neither the statute nor the House committee report deals with this important detail. It is a statutory point, however, and should be specified in the language of §1398(g).

2. Elections -- Does the estate inherit tax elections of various kinds (e.g., five-year amortizations) which the debtor may have made before the petition was filed?

Similarly, after the close of the case, is the debtor to be bound by any election which the estate made?

B. Return of tax attributes to individual debtor after close of case.

1. Specify in proposed I.R.C. §1398(i) that the carryovers and other attributes returned to the debtor come back after reduction under proposed I.R.C.

§§108 and 1017. The present language of §1398(i) says that the debtor will inherit "the items referred to in . . . subsection (g)" In fact, these are the tax attributes which the estate originally inherited from the debtor before reduction for cancellation of debt in the bankruptcy proceeding.

I do not believe the statement of intent in the House committee report (page 26, footnote 4) makes up for the statutory inadequacy on this point.

2. Specify in proposed §1398(i), or at least delegate to the Treasury authority to specify, how the debtor may treat the tax attributes he inherits. Even the House committee report is silent on this important subject. For example, can the debtor use carryovers returned from the estate only as carryovers to his own future years? Can he apply the amounts as carrybacks to his own prior taxable years -- and if so, can he go back to his own prepetition taxable years? What time limits govern the debtor's use of carryovers (and/or carrybacks, if allowed)? Does he get fresh 3 years back and 7 years forward, or does he get only the time remaining on the carryovers at the point they leave the estate?

C. Exempt Assets

Prop. §1398(d)(3)(C) refers to property which the debtor "may treat as exempt property" under 11 U.S.C. §522. The debtor may have a choice of Federal or state-law exemptions. The Code provision should refer to property, if any, which the debtor treats as exempt property, etc. See Prop. I.R.C. §1017(c)(1).

D. Rules If Debtor Does Not Make Election

The Senate committee report should fill a serious gap left by the House committee report and explain what rules apply if the debtor does not elect to close his taxable year when the bankruptcy case commences. I understand that "present law" will operate, but the basic rules should be described: What income does the estate report? When does the estate's taxable year begin? What income does the debtor report? For what period must the debtor file a return?

Possibly also discuss the factors involved in making the election or not.

E. Involuntary Cases

The committee report should indicate, if such is the policy, that the taxable year rules of proposed

I.R.C. §1398 apply equally to involuntary cases commenced under 11 U.S.C. §303, where the debtor is permitted to stay in possession of his business assets and continue to conduct his business until an order for relief is entered by the court or until a trustee is appointed. A trustee in such situations would have to get (and rely on ) information supplied by the debtor for the time period since the petition was originally filed.

V. MISCELLANEOUS

A. Terminology in General

1. I strongly advocate changing the bill's repeated references to a "title 11 case" to "bankruptcy case."

The frequent references to "title 11" in the Internal Revenue Code is not likely to be understood by tax practitioners who are not concerned with bankruptcy issues but who, seeing a reference to "title 11" of the U.S. Code, may believe that this title deals with matters of relevance to tax issues generally. In addition, the former Bankruptcy Act was also contained in

title 11 of the U.S. Code, so that reference to title 11 does not reflect a totally new creature of the 1978 law.

The bill already contains an excellent usage of the term "bankruptcy case or similar judicial proceeding" in section 7 (relating to effective dates). This usage should be adopted generally throughout the substantive Code provisions, except that the word "judicial" should be deleted.2/

2. Reference to "similar judicial proceeding" in bill section 7(f)(2). To reflect my proposal above that this category include arbitrations, which normally are conducted outside a court, this phrase should be amended to refer simply to "similar proceeding."

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2/ An alternative reference could be to the bankruptcy code of 1978. This would parallel the common references to the Internal Revenue Code of 1954, rather than to "Title 26" where the I.R.C. technically appears in the U.S. Code.

Senator BYRD. The next piece of legislation, S. 2486 and S. 2526, "Industrial Development Bonds for Railroad Rehabilitation and Railroad Rolling Stock." The committee is delighted to have the distinguished Senator from Iowa, Mr. Culver.

Welcome, Senator Culver.

## STATEMENT OF HON. JOHN C. CULVER, A U.S. SENATOR FROM THE STATE OF IOWA

Senator CULVER. Thank you, Mr. Chairman, Senator Packwood. I am delighted to have the opportunity to appear today on behalf of this legislation. I wish to thank the subcommittee.

This measure, Mr. Chairman, permits State and local units of government to issue fully tax-exempt industrial development bonds for repairing, rehabilitating, and acquiring essential rail lines. The bankruptcies of the Rock Island and Milwaukee Railroads have been the focus, as the committee is well aware, of emergency legislation by the Congress during the past 12 months.

Congress has authorized over $250 million to deal with these bankruptcies and the resulting service disruptions during the 96th Congress. The problems confronting these railroads are, however, unfortunately, symptomatic of a more general crisis and decline of midwestern railroad service.

This decline has resulted from a glaring lack of investment capital to meet the deferred maintenance problems of the industry. It has produced a steadily worsening spiral of bad service, lost revenues, abandonments, bankruptcies, and ultimately poorer service, and I know the committee is in agreement that this trend must be reversed.

The Department of Transportation, Mr. Chairman, estimates the industry shortfall to approach $10 billion. Obviously, the Federal Government cannot be expected to make up this difference by itself. This would be neither feasible nor desirable at a time when Congress is attempting at this very moment to balance the budget as part of the fight against inflation.

State and local governments, of course, must undertake a greater responsibility and commitment to provide some of the substantial revenues that will be needed to rehabilitate the freight rail system, but given the massive restructuring effort facing the midwestern railroads at this time, it is clearly unlikely that States can raise anywhere near the necessary revenues through general appropriations alone.

Several States, including Iowa, Kansas, Colorado, and Nebraska, are now in the process of creating State authorities to issue industrial development bonds to be used to rehabilitate or acquire rail line. Iowa, for example, may use up to $100 million in bonds to expand its successful branch line rehabilitation program, among other purposes.

States are permitted to issue IDB's under section 103 of the U.S. Internal Revenue Code. Normally, however, the interest earned on such bonds is subject to Federal taxation. This can, of course, limit their utility as a revenue raising mechanism, especially during periods of high interest rates. Certain IDB's which are issued for the construction of facilities with a public purpose, such as air-

ports, docks, and mass commuting facilities, have been granted a tax-exempt status.

This legislation, Mr. Chairman, S. 2486, amends section 103(b)(4) of the code, by adding bonds issued for the rehabilitation of railroads to the fully tax-exempt category. Eligible projects would include the construction, acquisition, or reconstruction of roadbeds, track, switching yards, depots, or grade crossings.

This change in the code will provide States with a needed mechanism for raising revenue which can be used to preserve their most important rail lines.

Mr. Chairman, I understand the Treasury Department's concern over the expansion of the tax-exempt bond category. If used uncritically, certainly such bonds can prove to be an unwarranted drain on the public treasury. However, given the magnitude of the railroad problem in the country, particularly the acuteness of the situation in the Midwest today, and the revenues needed to revive the industry, tax exempt bonds serve as one of the more feasible mechanisms available to States to help undertake the task.

It is possible to build additional safeguards into the legislation, I feel, to assure that the bonds will be issued only for productive rail rehabilitation or acquisition projects, and while the Joint Tax Committee estimates that enactment of this legislation would have a revenue impact on the Treasury of slightly more than $1 billion, the estimate fails, I think, to consider several possible criteria that could reduce the public revenue loss resulting from tax exempt bonds.

Mr. Chairman, the total dollar amount of bonds that can be issued by individual States could be limited. The State of Iowa has enacted legislation which limits the total bonding level which can be issued by a State rail authority to $100 million. Other States might also be limited to similar dollar ceilings, and other criteria include perhaps linking the issuance of bonds to specific rehabilitation or acquisition priorities outlined in State rail plans, or by limiting eligible projects to those related to railroads undergoing reorganization.

By incorporating one or more of these features into the legislation, I would hope it would be possible both to reduce the Federal revenue loss and assure that tax-exempt bonds be issued only for viable rail projects or facilities that improve the long-term health of the rail system.

Mr. Chairman, I also note that the Treasury Department estimates on revenue loss are considerably less than those projected by the Joint Tax Committee. The Treasury estimates the loss at $562 million the next 5 years, and considerably more after 1985, but I wish to point out, Mr. Chairman, that it seems to me that limiting the life of this particular legislation to 5 years would certainly be useful and helpful, and I see no real need to expand the authority beyond that period.

I look forward to working with the committee in every appropriate way, to assist wherever possible in developing final legislation that revitalizes the vital rail transportation sector while assuring that there is no unwarranted loss of public revenue.

Finally, Mr. Chairman, I believe that the critical condition of the rail industry and its importance to the economy of the Midwest

and the Nation warrant this change in the U.S. Tax Code. In Iowa alone, the loss of the Rock Island and Milwaukee Railroads may result in a $300 million loss to the State economy, including the elimination of over 5,200 jobs.

In addition, as we know, agricultural exports are the most critical element currently in our whole balance of trade position, and they, too, are seriously threatened when one of the Nation's leading agricultural States is now in a situation where 43 percent of the railroads carrying this crucial commodity are in a state of bankruptcy.

The potential revenue loss to the Treasury, therefore, will be more than offset by the benefits to be derived from well maintained and efficient rail networks. The Railroad Rehabilitation Bonding Act, I think, is a prudent measure which will help States solve this most serious long-term problem, and I respectfully urge the members of the subcommittee and the full committee to give it their careful sympathetic consideration.

Senator BYRD. Thank you, Senator Culver.

Senator Packwood?

Senator PACKWOOD. No questions, Mr. Chairman.

Senator BYRD. Senator Dole?

Senator DOLE. I would like to explain that I have been attending two hearings. That is why I have been running back and forth here.

I am not certain whether Senator Culver would suggest that we put a ceiling on this provision. I think that might be helpful if we provided a ceiling of, perhaps, $100 million and also specified that the exemption apply only to industrial revenue bonds issued to rehabilitate railroads under reorganization. This would pin it down to the Rock Island and Milwaukee only.

You may have commented on these two.

Senator CULVER. I did, Senator Dole. I certainly concur in your suggestion of a limit. In our own State of Iowa, we have a $100 million limit, for example, and I think we ought to—I have also agreed that we should try to give as much specificity as possible to the list of eligible beneficaries of such a fund, in terms of the particular nature of the activities that will be eligible for funding. It may also be desirable to have any of those priorities be part of a State rail plan, for example, to guard against the careless application of these revenues.

Senator DOLE. There is considerable interest in this legislation in Kansas also. It seems to me that we should be able to satisfy Treasury objections. Maybe by limiting the scope and limiting the dollar amount, we might be able to work out something.

Senator CULVER. I know that your State, Senator Dole, of course—and I know you are very much directly involved in it—is in the process, as our State is, in creating these State authorities, and I also pointed out that while the joint committee estimates a $1 billion loss, the Treasury comes in at about $562 million over the next 5 years. Admittedly, there would be an estimated considerably greater loss beyond that period.

I also pointed out that it is my understanding that 5 years for such an authority would be adequate for us to make a very substantial attack on the problem, and I think that even a sunset

provision of that nature would also further limit and constrain the likelihood of waste and loss in terms of the scope of this provision.

Senator DOLE. Thank you, Mr. Chairman.

Senator BYRD. Thank you, Senator Culver.

Senator CULVER. Thank you very much, Mr. Chairman.

[The prepared statement of Senator Culver follows:]

STATEMENT OF SENATOR JOHN C. CULVER

Mr. Chairman, I thank the Subcommittee on Taxation and Debt Management for the opportunity to testify in support of S. 2486, "The Railroad Rehabilitation Bonding Act." This measure permits state and local units of government to issue fully tax exempt industrial development bonds (IDB's) for repairing, rehabilitating, and acquiring essential rail lines.

The bankruptcies of the Rock Island Railroad and Milwaukee Railroads have been the focus of emergency legislation by the Congress during the past 12 months. Congress has authorized over $250 million to deal with these bankruptcies and the resulting service disruptions during the 96th Congress. The problems confronting these railroads are, however, symptomatic of a more general crisis and decline of midwestern railroads. This decline has resulted from a glaring lack of investment capital to meet the "deferred maintenance" problems of the industry. It has produced a steadily worsening spiral of bad service, lost revenues, abandonments, bankruptcies and, ultimately, poorer service. This trend must be reversed.

The Department of Transportation (DOT) estimates the industry shortfall to approach $10 billion. Obviously, the federal government cannot be expected to make up this difference by itself. This would be neither feasible nor desirable at a time when Congress is attempting to balance the budget as part of the fight against inflation. State and local governments must undertake a greater commitment to provide some of the substantial revenues needed to rehabilitate the freight rail system. But given the massive restructuring effort facing the midwestern railroads at this time, it is unlikely that states can raise the necessary revenues through general appropriations alone.

Several states, including Iowa, Kansas, Colorado, and Nebraska, are in the process of creating state authorities to issue industrial development bonds (IDBs) to be used to rehabilitate or acquire rail lines. Iowa, for example, may use up to $100 million in bonds to expand its successful branch line rehabilitation program, among other purposes. States are permitted to issue IDB's under section 103(b)(4) of the U.S. Internal Revenue Code. Normally, however, the interest earned on such bonds is subject to federal taxation. This can limit their utility as a revenue raising mechanism, especially during periods of high interest rates.

Certain IDB's which are issued for the construction of facilities with a public purpose—such as airports, docks, and mass commuting facilities—have been granted a tax exempt status. S. 2486 amends section 103 of the Code by adding bonds issued for the rehabilitation of railroads to the fully tax-exempt category. Eligible projects would include the construction, acquisition or reconstruction of roadbeds, tracks, switching yards, depots, or grade crossings. This change in the Code will provide states with the needed mechanism for raising revenue which can be used to preserve their most important rail lines.

Mr. Chairman, I understand the Treasury Department's concern over the expansion of the tax exempt bond category. If used uncritically, such bonds can prove to be an unwarranted drain on the public Treasury. However, given the magnitude of the rail problem and the revenues needed to revive the industry, tax exempt bonds serve as one of the few feasible mechanisms available to states to undertake the task.

It is possible to build additional safeguards into the legislation to assure that the bonds will be issued only for productive rail rehabilitation or acquisition projects. While the Joint Tax Committee estimates that enactment of S. 2486 would have a revenue impact on the Treasury of slightly more than $1 billion, the estimate fails to consider several possible criteria that could reduce the public revenue loss resulting from tax exempt bonds.

For example, the total dollar amount of bonds that can be issued by individual states can be limited. The state of Iowa has enacted legislation which limits the total bonding level which can be issued by a state rail authority to $100 million. Other states might also be limited to a similar dollar ceiling. Other criteria include linking the issuance of bonds to specific rehabilitation or acquisition priorities outlined in state rail plans, or by limiting eligible projects to those related to railroads undergoing reorganization. By incorporating one or more of these features

into the legislation, it is possible both to reduce the federal revenue loss and assure that tax exempt bonds be issued only for viable rail projects or facilities that improve the long term health of the rail system. I look forward to working with the Committee in developing final legislation that revitalizes the vital rail transportation sector while assuring that there is no unwarranted loss of public revenues.

Mr. Chairman, I believe that the critical condition of the rail industry and its importance to the economy of the midwest and the nation warrant this change in the U.S. Tax Code. In Iowa alone, the loss of the Rock Island and Milwaukee Railroads may result in a $300 million loss to the state economy, including the elimination of over 5,200 jobs. The potential revenue loss to the Treasury will be more than offset by the benefits to be derived from well-maintained and efficient rail networks. "The Railroad Rehabilitation Bonding Act" is a prudent measure which will help states solve this most serious long term problem. I urge the members of the Subcommittee and the full committee to approve it.

Thank you, Mr. Chairman.

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UNITED STATES CONFERENCE OF MAYORS,
*Washington, D.C., May 23, 1980.*

Hon. JOHN CULVER,
*Russell Senate Office Building,*
*U.S. Senate, Washington, D.C.*

DEAR SENATOR CULVER: I am writing to express the support of the U.S. Conference of Mayors for the concept of an exemption for railroad financing from current revenue bond limitations. S. 2486 contains this concept and can serve as the basis for major new capital investments in railroads and cities.

We have favored the revenue bond device as an important development tool. Our extensive involvement with railroads, including a series of conferences on urban rail concerns we cosponsored with the Association of American Railroads, has led us to conclude that important public benefits can be derived through tax exempt finance of certain rail facilities.

Specifically:

(1) Modernization and construction of rail facilities to provide better freight service to shippers and promote industrial development;

(2) Consolidation of older or obsolete facilities into more modern operations to free underutilized property for urban redevelopment;

(3) To help cities and railroads finance grade separations and other improvements to offset the negative effects of coal unit train or hazardous substances movements;

(4) To help cities, states and rail companies preserve decent rail service to major employers in light of the Midwest or potential Conrail reorganizations; and

(5) To help the public sector finance passenger rail operations.

In most cases these revenue bonds will have to be used in conjunction with general obligation and tax increment debt, federal aid and conventional financing to achieve a final financing package, however, the revenue bond tool is an essential but often unavailable element under existing law.

We feel interest subsidies will help encourage railroads to invest in their urban facilities which literally constitute the hubs of the national system, and in making them more efficient will improve service and open redevelopment possibilities.

For the past three years we have helped cities and railroads undertake job-creating redevelopment projects on railroad land. This Railroad Land Revitalization Program is sponsored by the Departments of Commerce and Transportation. Working closely and cooperatively with the rail industry and the states, the program has become directly involved in more than a hundred projects across the nation. This program presently retains counsel to show cities and railroads how to use existing exemptions as part of its technical assistance effort. The projects we are helping range from restoring historic train stations to providing increased rail service to ports to increasing intermodal freight service to consolidating facilities for subsequent industrial or commerical development to major restructuring of urban rail gateway facilities.

We feel the tax exempt incentive can spark many of these projects which might otherwise be dormant. Treasury revenues would thus be increased from resultant new construction and development, rather than decreased. Our studies suggest a potential for $2 billion in new issuances per year under this new exemption as an upper range estimate.

Our own efforts to use existing exemptions in urban development projects are being hampered by the $10 million (or $20 million UDAG) limitation because the railroad industries enormous capital investment programs, particularly over a span of years, dwarf these figures.

We also have learned through our efforts that the diversity of rail projects found in different regions and localities is tremendous. No categorical funding effort could address this diversity, making the tax exemption the most flexible and cost effective approach, particularly without creating a significant bureaucracy or red tape.

I look forward to working with you, the Administration, the states, the rail industry and other key groups to translate this urgently needed concept into final legislation.

Sincerely,

JOHN J. GUNTHER,
*Executive Director.*

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GREATER DES MOINES CHAMBER OF COMMERCE FEDERATION,
*Des Moines, Iowa, May 29, 1980.*

Hon. RUSSELL B. LONG,
*Chairman, Senate Finance Committee,*
*Dirksen Senate Office Building, Washington, D.C.*

DEAR SENATOR LONG: The Greater Des Moines Chamber of Commerce Federation urges your support of Senator John Culver's bill S. 2486, "The Railroad Rehabilitation Bonding Act" to exclude from taxation interest earned on obligations used for railroad track acquisition or rehabilitation.

The Iowa Legislature has created an Iowa Railway Finance Authority and has authorized the Authority to issue up to $100,000,000 in revenue bonds. Such bonds are exempt from state taxation and we strongly feel that they must also be exempt from Federal taxation. The sale of such bonds is imperative if this state is to preserve needed portions of the bankrupt Rock Island and Milwaukee Railroads. Only by the acquisition and rehabilitation of these segments can Iowa be assured of a competitive and efficient railroad system.

The Federal tax exemption as provided in Senator Culver's bill is comparable to the exemption now provided for financing used for airport, seaport, and mass transit improvements under S. 103(b)(4) of the Internal Revenue Code.

The Chamber urges your support for S. 2486.

Sincerely,

FRED W. WEITZ, *President.*

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NEWTON CHAMBER OF COMMERCE,
*Newton, Iowa, May 23, 1980.*

Hon. RUSSELL LONG,
*Senate Office Building,*
*Washington, D.C.*

DEAR SENATOR LONG: I am writing on behalf of the membership of the Greater Newton Area Chamber of the Commerce to urge the Senate Finance Committee to recommend exemption from taxation for state and local government bond issues for the rehabilitation of railroads.

In the interest of energy conservation, both now and in the future, we feel that any incentives to encourage railroad rehabilitation are in order. The membership of the Newton, Iowa Chamber of Commerce has gone on record, and is vitally interested in, the promotion of rail usage in our state.

Please consider this legislation, which we feel is a step toward putting the rail industry on an equitable basis with other transportation industries now receiving generous subsidies from government.

Sincerely,

MYRT LEVIN,
*Executive Manager.*

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IOWA CITY CHAMBER OF COMMERCE,
*Iowa City, Iowa, May 23, 1980.*

Senator RUSSELL LONG,
*Senate Finance Committee,*
*Washington, D.C.*

DEAR SENATOR LONG: The Iowa City Chamber of Commerce along with many communities in Iowa has been working diligently on the matter concerned with the demise of the Rock Island and Milwaukee Railroads. We are in the process of coming up with a plan to interest a major carrier in serving the North-South and

East-West areas of our state. Our State Legislature, along with Governor Ray, has made possible the issuance of 100 million dollars in bonds to aid in the rehabilitation of the tracks and roadbed, to make our area more attractive to a potential carrier. One of the items vitally necessary in getting the bonds sold has to do with providing a tax exempt to these bonds.

Because of the fact that we presently have minimal or no service, this is obviously an urgent matter from our standpoint. We therefore would appreciate you help and leadership in support of Senate File 2846, which in affect will provide tax exempt status for the issuance of our bonds.

Thanks very much for your consideration.

Cordially,

KEITH KAFER,
*Executive Vice President.*

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QUAD-CITY DEVELOPMENT GROUP,
*Quad-Cities, Ill., May 29, 1980.*

Hon. RUSSELL E. LONG,
*Chairman, Senate Finance Committee.*

DEAR SENATOR LONG; The Quad-City Development Group is a not-for-profit corporation financed through the private contributions of nearly 100 Quad-City companies including the area's leaders in industry, finance, retail and media. Formed in 1961, our primary purpose is to promote the economic health and well-being of the Quad-City Metropolitan Area.

An issue that the Development Group has become intimately involved in during the past several months, and one which we have been monitoring over the past several years, is the impact on the Quad-City economy brought about by the bankruptcies of two of the Railroads serving our area—the Rock Island and the Milwaukee Railroads. We can not understate the importance of the availability of rail transportation to the Quad-City economy, the economy of the States of Iowa and Illinois and the entire Midwestern United States. In keeping with our purpose we have worked very closely with rail shippers in this area to insure adequate and continued rail service as well as served as a focal point for a unified voice on rail-related matters as they may affect the Quad-City industrial community and their ability to do business at a Quad-City location.

It has recently been brought to our attention that the Senate Finance Committee is about to conduct hearings concerning legislation which would exempt from Federal Income tax the interest income from state-issued revenue bonds for railroad acquisition and development.

As you may be aware, the State of the Iowa has enacted legislation authorizing the issuance of up to $100 million of revenue bonds to serve as a source of financing to successors of the Rock Island and portions of the Milwaukee Railroads throughout the State. Obviously this legislation is extremey important to the Quad-City area and the State of Iowa as a whole.

It is appropriate and perhaps most cost effective for the Federal Government to exempt Income Tax on the Interest earned from these bonds rather than the several other alternatives which are available and which would result in much greater direct participation by the Government in solving the Midwest rail crises brought about by the bankruptcies of these two railroads.

We support the exemption from Federal Income Tax legislation now pending before your Committee and would hope a timely passage of this legislation would be a first step in preventing history from repeating itself in the form of a "Midwestern Conrail".

We appreciate the opportunity to comment on this issue and thank you in advance for any assistance you may provide in support of our position.

Sincerely,

RICHARD R. WEEKS, *President.*

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TESTIMONY BY IOWA DEPARTMENT OF TRANSPORTATION

The Iowa Department of Transportation thanks the Committee for the opportunity to provide written testimony on S. 2485 "Railroad Rehabilitation Bonding Act," a proposal to extend federal tax exempt status to industrial revenue bonds issued for rail transportation purposes by public bodies.

Iowa today sits at the crossroads of the midwest's rail concern—by virtue of its reliance on rail services being provided by two rail carriers of less than desirable financial health and two in federal bankruptcy reorganization, one in actual Court-

ordered liquidation. The Milwaukee and Rock Island Railroads today represent over 3,000 miles of rail service in Iowa.

To place Iowa's concerns for the future of its rail service, the long-term impacts of loss of this rail service should be noted:

[Dollars in millions]

| | Per year |
|---|---|
| Additional transportation costs | $157 |
| Personal income losses | 105 |
| Additional highway construction and maintenance costs | 42 |
| Total | $304 |
| Railroad jobs lost | 1,950 |
| Primary jobs lost | 1,950 |
| Secondary jobs lost | 2,400 |
| Total jobs lost | 6,300 |
| Trucking jobs created | 1,050 |
| Net Jobs Lost | 5,250 |

The Iowa DOT has an interest in the proposed legislation as a major element in the State's program to insure the provision of stable and reliable rail service for the future. The emphasis and priority of the State's program is to seek a long term solution based upon an economically viable private sector solution, in cooperation with the rail industry and the U.S. Department of Transportation. To assist in formulating this solution, the Iowa Legislature recently created the Iowa Rail Finance Authority and authorized it to issue up to $100,000,000 in revenue bonds.

Through this Authority the State proposes to assist in the necessary acquisition and rehabilitation of essential rail segments to insure continued rail services. In view of the low rate of return on private investment in rail services and the high cost and limited availability of federal funds, such State assistance will likely be necessary. This type of self-help program is what federal agencies have urged the states to develop to aid in meeting their own needs. However, to be effective with this state program the state must have the opportunity to qualify for tax exempt status for its proposed revenue bond issue. The current limit of $10,000,000, if applied to this bond issue, will handicap the state's ability to aid in insuring future rail services.

Further information on the Iowa Authority's program will help place this program in perspective. The intent of state legislation is to insure self-supporting revenue bonds related to specific projects—establishing a strong test of economic viability behind each project insuring that only essential projects, not subsidized projects, will be undertaken. In addition, the Authority's program and project selection must be consistent with the Iowa DOT's policy and state rail plan. This insures coordination with the State's branchline assistance program and with federal aid programs. The accomplishments of the State's self-help branchline assistance program underline how state policy will be implemented. Accomplishments thus far include $35,000,000 invested in over 830 miles of track and major repayment made by the railroads on this investment to both shippers and the state.

As the Iowa DOT views the importance of rail services to maintain our nation's flow of agricultural product to the world's market and the contribution these export earnings make to our balance of trade, the central role of transportation in our economy becomes very apparent. Yet, the distribution of benefits from federal rail assistance programs throughout the nation has been greatly weighted away from the midwest thus far. There has been a failure to respond to the emerging and midwest rail problem—particularly with program initiatives to maintain a viable private sector rail system. The Federal Railroad Administration's programs of loan assistance have been the major effort thus far. But that effort has been greatly under-funded compared to grants and subsidy to Conrail thus far.

Although tax exempt status can lead to minor losses of tax revenue to the Treasury, it will provide the public benefit of transportation services. It will also provide a low-cost alternative and back-up to existing federal assistance programs—without replacing the need for redirection in these programs ultimately. Some limitations on the purpose and scope of qualifying bonds, to insure consistency with national needs, will likely be required. Limiting use of such bonds to projects in conjunction with the reorganization of bankrupt railroads and to economically

viable projects will guide such bonding programs appropriately—to insure the continued provision of essential rail services.

In conclusion. Iowa and Iowa shippers need your support of this proposal—to provide tax exempt status to rail revenue bonds issued by public authorities. This will provide the states with one of the essential tools they must have to effectively cope with the issues they face today. The approach recommended by the Iowa DOT will allow the federal costs for this and other rail programs to be minimized and confined to true national priorities and interests. There is an imperative need to adopt tax exempt status now. The Iowa DOT urges your prompt consideration and action.

Senator BYRD. There are two additional witnesses, although I understand one may not be here, Mr. Raymond Kassel, Iowa Department of Transportation——

Senator CULVER. We have his statement, Mr. Chairman. Unfortunately, he had an airline problem that prevents him being here today, but we do have his statement, and we would like to have it be made part of the record.

Senator BYRD. His statement will be made a part of the record, Senator Culver.[1]

Senator CULVER. Thank you, Mr. Chairman.

Senator BYRD. Mr. George Dunham, the Family Lines System.

## STATEMENT OF GEORGE K. DUNHAM, THE FAMILY LINES SYSTEM

Mr. DUNHAM. Mr. Chairman, members of the committee, my name is George K. Dunham, and I am tax counsel for the Family Lines System of railroads.

Family Lines consists of the Seaboard Coastline Railroad, the Louisville & Nashville Railroad, Clinchfield Railroad, and the Georgia Railroad. These railroads operate approximately 16,000 miles of track and touch some 16 States in the midwestern and the southeastern part of the country.

I am here to testify in support of 2526, bill 2526, which would allow the use of tax-exempt bonds to finance railroad facilities and rolling stock. As you know, the railroad industry is extremely capital-intensive, and it requires large infusions of capital just to maintain and upkeep its track structure and its rolling stock. We believe that in the future, in view of the inherent efficiency of the railroad industry as a method of transportation, that there will be increased usage of the railroad facilities. In addition, as a major carrier of coal, we feel that future expansion of coalfields to meet our energy needs will bring new and greater requirements for new capital to the railroads.

Now, traditionally, the industry has financed its track improvements out of retained earnings, and in some cases bonds. The railroad bond market, however, is extremely thin, and is petering out as a source of funds for the needed improvements. While there is a market for equipment securities, equipment trusts, and while some equipment is acquired through leasing transactions, even this market is relatively limited.

We support this proposal to amend section 103, because we feel it will make available to the railroad industry a new source, a new market for the needed funds that we are going to have in the future. In addition, we believe, and it is acknowledged, that tax-

[1] See p. 443 for statement.

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exempt bonds are a less expensive form of financing, and that this will increase our cash flows and liquidity of the railroads.

S. 2526 would add to the list of items now qualifying for tax-exempt financing facilities including rolling stock for furnishing railroad transportation. Assuming that the term "facilities" is used in its broadest sense, we feel that the proposal will help the industry in this crucial area of financing its needs.

As a technical matter we believe that the legislation should make it clear that facilities include the track structure, including additions, betterments, and replacements, so that not only new facilities will be covered, but also operating and rehabilitation of existing lines.

Family Lines believes that S. 2526 would be an excellent tool that we can use in the future to meet the needs of transportation, and while I speak only for the Family Lines, I have talked with a number of other railroads. The Chessie System supports this legislation, as does ConRail, and a number of other roads are sympathetic with this approach.

Thank you for giving me the opportunity to speak to you.

Senator BYRD. Thank you, Mr. Dunham.

Senator Packwood?

Senator PACKWOOD. No questions, Mr. Chairman.

Senator BYRD. Senator Dole?

Senator DOLE. I have no questions. I made a comment when Senator Culver testified about limiting the scope of this proposal. It does not include some of the railroads you mentioned. Without a limitation, I doubt it would pass.

Senator BYRD. Thank you, Mr. Dunham.

[The prepared statement of Mr. Dunham follows:]

STATEMENT OF FAMILY LINES
SYSTEM IN SUPPORT OF S. 2526
TAX EXEMPT BONDS FOR RAILROAD
FACILITIES AND ROLLING

My name is George K. Dunham and I am Assistant Vice President-Taxation and Tax Counsel for the Family Lines System of railroads. The Family Lines consists of the Seaboard Coast Line Railroad, The Louisville and Nashville Railroad, The Clinchfield Railroad and the Georgia Railroad. These railroads operate approximately 16,000 miles of track touching some 16 states in the midwestern and southern states.

I am here to testify in support of S. 2526 which would allow the use of tax exempt bonds to finance railroad facilities and rolling stock. The Family Lines are vitally interested in any action on the part of Congress which enhances their ability to finance needed capital improvements. While the industry looks forward to the challenges of the future, thrust upon it as the most fuel efficient mode of freight transportation and as the major means of moving coal, a major alternative to dependence upon foreign oil, it is concerned about the availability of the financial resources necessary to make the capital expenditures necessary to meet that role. The railroad industry is capital intensive and requires large infusions of capital to maintain its car fleets and track structure. The increased demands resulting from increased utilization, and particularly the increased tonnages of coal, which will be required to meet the energy needs of the country will further aggravate demands for capital.

Traditionally, the industry has financed equipment acquisitions using equipment trusts, conditional sales agreements and leveraged leases. Track structure needs have been financed in large part out of retained earnings and secondarily with bonded indebtedness. This latter method of financing is limited because a lack of a market of institutional investors to invest in railroad securities. Such bond issues, where the market exists bear with them mandatory sinking fund requirements that frequently begin with the issue of the securities, with the result that the railroad's liquidity and working capital is adversely affected. Also such securities are relatively short term requiring the railroads to go to the market more frequently thereby complicating their financial flexibility. Even the market for securities secured by the equipment itself are finite and are reaching the saturation point.

The proposed amendment to Section 103 of the Code, would make available a new and much needed source of funds - the tax exempt bond market - for the needed future expansion and renewal. The industry makes use of the current exemptions afforded by Section 103 in a relatively limited way. Needed pollution control facilities are frequently financed by tax exempt bonds. In some cases port facilities have been financed by this type of financing as well as track and related facilities in industrial parks. Finally, in some isolated instances small projects have been financed by tax exempt bonds under the small issue exemptions. Overall, however, Section 103 has been of relatively small use to the railroad industry because of the existing limitations.

In addition to giving the railroads access to a new market to finance needed capital improvements, the legislation will lower the expense of such borrowings and thereby enhance the overall liquidity of the industry.

S. 2526, introduced by Senator Baucus, would add to the list of items qualifying for tax exempt financing, facilities, including rolling stock, for the furnishings of railroad transportion. Assuming that "facilities" is used in its broadest sense, we feel that the proposal will help the industry in the crucial area of financing its needs. As a technical matter we believe that the legislation should make it clear that "facilities" include the track structure including additions, betterments and replacement so that not only new facilities will be covered but also the upgrading and rehabilitation of existing lines will also qualify.

The Family Lines believes that S. 2526 will make available new sources of financing needed for railroad improvements a reasonable cost to the railroads and because of this with little or no loss of revenue to the Treasury. Further, the industry believes that S. 2526 is in keeping with the traditional approach of Congress to limit the exemptions to items of national or public interest which will not put the states or their instrumentalities in competition with private sector financial sources.

Senator BYRD. Representative Gibbons from the State of Florida is en route from the House of Representatives. Until he gets here, we will temporarily hold up S. 2548 and to go S. 2503 and S.2500, "Tax Credits for Certain Interest on Agricultural Loans and for Theatrical Productions".

At this time, so that we might save the time of the committee, I will call on Mr. Gerald Schoenfeld, League of New York Theaters and Producers, and when Senator Kassebaum gets here, I will call on Ms. Mildred Van Nahmen, American Agricultural Movement. But first I ask that the prepared statement of Senator Heinz be inserted in the record.

[The prepared statement of Senator Heinz follows:]

# STATEMENT OF SENATOR JOHN HEINZ

## FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
## S.2500, INVESTMENT TAX CREDITS FOR THEATRICAL PRODUCTIONS
## MAY 30, 1980

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I AM PLEASED TO HAVE THE OPPORTUNITY TO SUBMIT A FEW BRIEF REMARKS ON S. 2500, INVESTMENT TAX CREDITS FOR THEATRICAL PRODUCTIONS. AS AN ORIGINAL CO-SPONSOR OF THIS LEGISLATION, I WOULD LIKE TO SHARE WITH THE COMMITTEE SOME OF MY CONSIDERATIONS REGARDING THE NEED FOR FAVORABLE TAX TREATMENT OF THEATRICAL PRODUCTIONS.

-- THE PERFORMING ARTS NOT ONLY PROVIDE WORTHWHILE ENTERTAINMENT FOR THE AMERICAN PUBLIC, BUT ARE VITAL TO THE ECONOMIC LIVES OF THE DOWNTOWN AREAS OF MANY OF OUR LARGE CITIES.

-- THEATRES ARE NOT CURRENTLY AFFORDED THE TAX BENEFITS AVAILABLE TO THEIR PRINCIPLE COMPETITORS, MOTION PICTURES AND TELEVISION SERIES, WHICH PLACES THEM AT A COMPETITIVE DISADVANTAGE.

-- AS PRODUCTION COSTS ESCALATE DUE TO INFLATION AND LACK OF SUFFICIENT FINANCIAL BACKING, PRODUCERS ARE FORCED TO RAISE TICKET PRICES, WHEREAS TELEVISION AND MOTION PICTURE PRODUCERS

CAN OFFSET RISING COSTS BY INCREASING ADVERTISEMENT AND CIRCULATION CHARGES AND VOLUME.

TODAY, MANY OF OUR MAJOR CITIES FIND THEMSELVES IN ECONOMIC CRISES. THE INDIRECT INCOME BROUGHT TO THESE CITIES BY THEATREGOERS--FROM TAXI-CABS, RESTAURANTS, PARKING LOTS, HOTELS--REPRESENTS A CRITICAL SHOT-IN-THE-ARM FOR URBAN AREAS.

IN MY OWN HOME STATE OF PENNSYLVANIA, FOR EXAMPLE, IT HAS BEEN ESTIMATED THAT, FOR THE 1978-1979 THEATRICAL SEASON, THE ECONOMIC IMPACT OF THEATRE EXPENDITURES TOTALED $35 MILLION. IN THE FINANCIALLY TROUBLED CITY OF PHILADELPHIA ALONE, THEATRE-RELATED EXPENDITURES FOR LAST YEAR AMOUNTED TO APPROXIMATELY $15.3 MILLION.

THESE NUMBERS REPRESENT JOBS, REPRESENT INCOME, REPRESENT LIFE FOR AMERICA'S AILING URBAN AREAS, AND THIS BILL MARKS A SIGNIFICANT STEP TOWARDS INSURING THE CONTINUATION OF THE CRUCIAL CONTRIBUTIONS MADE BY PERFORMING ARTS TO OUR CITIES.

THIS LEGISLATION WOULD, FOR THE FIRST TIME IN HISTORY, PROVIDE LEGITIMATE THEATRES WITH A TAX BENEFIT SIMILAR TO THAT ENJOYED BY AMERICAN BUSINESS IN GENERAL AND THE MOTION PICTURE AND TELEVISION INDUSTRIES IN PARTICULAR.

IN 1976, CONGRESS DECIDED THAT MOTION PICTURES AND TELEVISION SERIES WERE ELIGIBLE FOR INVESTMENT TAX CREDIT. ALTHOUGH THESE OUTLETS ALSO PROVIDE WORTHWHILE ENTERTAINMENT, THEY CAN BE VIEWED ALMOST ANYWHERE, AND CONSEQUENTLY DO NOT BRING ADDITIONAL BENEFITS OF THE SAME MAGNITUDE TO OUR CITIES AS DOES THE THEATRICAL INDUSTRY. THEREFORE, I BELIEVE IT IS ONLY FITTING THAT THIS CONGRESS AFFORD TO THE LIVE PERFORMING ARTS THE SAME KIND OF FAVORABLE TAX TREATMENT FOR PRODUCTION AS IS CURRENTLY ENJOYED BY THE COMPETING ENTERTAINMENT INDUSTRIES. THE 10 PERCENT INVESTMENT TAX CREDIT FOR AN AMOUNT EQUAL TO TWO-THIRDS OF THE UNITED STATES' PRODUCTION COSTS, AS PROVIDED IN THIS BILL, IS A SIGNIFICANT MEASURE TOWARDS EQUITABLE TREATMENT OF THEATRICAL PRODUCTIONS.

THE THIRD CONSIDERATION THAT CONVINCES ME OF THE NEED FOR THIS LEGISLATION IS THE PARTICULAR HARDSHIP THAT INFLATION HAS WORKED UPON THE LIVE PERFORMING ARTS. THE THEATRE IS A HIGH-RISK BUSINESS, AND IN THIS TIME OF SPIRALLING INFLATION, THERE ARE A FEW PEOPLE WHO ARE ABLE TO RISK LARGE INVESTMENTS IN THIS INDUSTRY. FINANCIAL BACKERS HAVE THEREFORE BEEN DISCOURAGED FROM SUPPORT OF THEATRICAL PRODUCTIONS.

WE KNOW THAT TELEVISION AND MOTION PICTURES CAN GENERATE REVENUES TO SERVE AS A BUFFER FOR SIMILAR INFLATIONARY EFFECTS BY STEPPING UP ADVERTISEMENTS AND THE CIRCULATION OF FILMS. IN CONTRAST, THESE OPTIONS ARE NOT AVAILABLE TO THE LIVE PERFORMING ARTS. THEIR SOLE RESOURCE IS TO RAISE TICKET PRICES, WHICH IN TURN, CREATES AN EVEN GREATER ADVERSE ECONOMIC EFFECT BY DISCOURAGING SALES.

IT IS WITH THESE CONCERNS IN MIND THAT I HAVE CO-SPONSORED S.2500, INVESTMENT TAX CREDITS FOR THEATRICAL PRODUCTIONS. IT IS MY HOPE THAT IT WILL BE ADOPTED BY THE 96TH CONGRESS.

Senator BYRD. Mr. Schoenfeld.

## STATEMENT OF GERALD SCHOENFELD, LEAGUE OF NEW YORK THEATERS AND PRODUCERS

Mr. SCHOENFELD. Senator Byrd, Senator Dole.

Senator BYRD. Welcome.

Mr. SCHOENFELD. My name is Gerald Schoenfeld. I am here on behalf of the League of New York Theaters and Producers, which is a trade association representing what I would call the taxpaying theater of the United States.

The taxpaying theater is located throughout this country, in all of its major cities. Its shows, such as "South Pacific," "Oklahoma," "My Fair Lady," "Fiddler on the Roof"—I am sure you know them as well as I do—have played before the people of this country, and this taxpaying theater has given to this country such playwrights as Eugene O'Neill, Tennessee Williams, Arthur Miller, and other great playwrights of our history.

The taxpaying theater is that sole aspect of the performing arts constituency of this country which has never received any benefit of any kind from the U.S. Government. It receives no benefits from the National Endowment, and indeed, it is dependent upon its own ability to survive. Its survival, I am sure, as you know by the term "the fabulous invalid," has been a rather precarious one. If a business could be called cyclical, I guess you could call the taxpaying theater in this country a cyclical business.

We are here today asking for your support of Senate bill 2500, which would afford an investment tax credit to theatrical productions. Although by your own estimate the amount involved insofar as the budgetary impact would be less than $5 million, based on my own experience in this business, I would say that the budgetary impact would be closer to $1 million.

You have seen fit in the past to grant an investment tax credit to motion pictures, both for showing motion picture theaters as well as on television. All that we are really asking here is that this taxpaying theater in this country, which has survived all these years, be placed in a position of parity of equality with the motion picture industry, so that we would be able to engender support from people who are willing to invest their money in theatrical productions.

Our business is one that is dependent upon public financing. The number of shows that emanate in the taxpaying theater each year are between 40 and 60, down, I would say, substantially from the 250 a number of years ago.

This bill, with its nominal impact on the Treasury of this country, would be a measure of support, if you would, for this aspect of the performing arts which has received no support of any kind, nor has it indeed ever asked for any support of any kind. None of the provisions of the National Endowment Act apply to the taxpaying theater, and indeed, by its very provisions, it is limited to the nonprofit theater constituency of this country.

So, basically, by allowing this kind of an investment tax credit, which I believe would stimulate investments in theatrical productions, you would really be creating a revenue producing device, because the shows that would be financed would play in all of the

cities of this country, and indeed engender a tax benefit rather than a tax detriment.

So, simply, I ask for your support of this bill, and in a sense, a sense of recognition for the contribution made by the theater of this country.

Senator BYRD. Thank you, sir.

At the moment, I am noncommittal on the piece of legislation, but I am not noncommittal on those three shows that you mentioned.

Mr. SCHOENFELD. I could add to the list, Senator, if you wanted me to.

Senator BYRD. They are great shows.

Mr. SCHOENFELD. Thank you.

Senator BYRD. Senator Dole?

Senator DOLE. Does the Treasury support this bill?

Mr. SCHOENFELD. I do not believe the Treasury supports the bill, but I have been advised that the National Endowment for the Arts does support the bill, which is really a manifestation of the degree of the relationship between the taxpaying and the nontaxpaying constituency of the American theater, and I am pleased to receive that support.

Senator DOLE. Who benefits?

Mr. SCHOENFELD. Who benefits? The investors who would be investing in the theatrical productions would benefit by an investment tax credit of 6⅔ percent.

Senator DOLE. It only costs $1 million?

Mr. SCHOENFELD. That is all that I believe it would cost. By your own staff's estimates, the impact would be less than $5 million.

Senator DOLE. How many investors are you talking about?

Mr. SCHOENFELD. I would say you are talking about several thousand investors.

Senator DOLE. It is hardly worth it, is it?

Mr. SCHOENFELD. It is worth it to us, because we manage to create in this small part of the American theater these 50 or 60 shows a year, which form part of the great American national theater heritage, if you will, and in order to basically support this small amount of investment capital, we need all the help that we can get.

I don't think that you can put a price on such shows as Oklahoma or South Pacific or Chorus Line or Annie.

Senator DOLE. We are not talking about those shows.

Mr. SCHOENFELD. Well, we are talking about the means of financing those shows.

Senator DOLE. Do you get any public subsidies now?

Mr. SCHOENFELD. We get none.

Senator DOLE. So you would extend the investment credit?

Mr. SCHOENFELD. I would extend it, and I would say I am merely equalizing it with that which you have seen fit to give to motion pictures. The only distinction that we have with respect to motion pictures is that we are deemed to be an intangible asset, and they are deemed to be a tangible asset, but in reality, the only tangible asset that they have is about $5 worth of film, but all the ingredients that went into that motion picture are subject to the investment tax credit.

Senator DOLE. I am trying to scan the Treasury's objections. We appreciate your comments. Thank you.

Mr. SCHOENFELD. Thank you, Senator.

Senator BYRD. Let me ask you this. How would the investment tax credit be utilized? Would it be for tangible items, or would it be for the total cost of the production?

Mr. SCHOENFELD. It would be the total cost of the production, in the same way as the motion picture——

Senator BYRD. The investment tax credit for a business, if a business buys a piece of machinery, then that is——

Mr. SCHOENFELD. That is so, but you have seen fit with respect to the motion picture industry to allow the investment tax credit for the total cost of all of the ingredients that go into the making of that motion picture. That motion picture, I would say parenthetically, would probably cost upwards of $5 million and as much as $30 million. The most that a broadway show now costs to finance is about $400,000 to $500,000 for a straight play, and about $1.5 million to $2 million for a musical, and that musical, of course, or that play, travels, as does a motion picture, throughout the length and breadth of this land.

Senator BYRD. Well, are the stage props and all of that subject to investment tax credit now?

Mr. SCHOENFELD. Yes. Is it now? No, we get no benefit of any kind. None.

Senator BYRD. Your proposal is to have the tax credit, investment tax credit applied to the total cost of the production.

Mr. SCHOENFELD. That is correct, and the total cost of these productions is somewhere in the neighborhood of $20 million a year. So, applying the investment tax credit of 6⅔ percent, you would get slightly over $1 million.

Senator BYRD. I am thinking more of the principle involved than I am the money.

Mr. SCHOENFELD. I understand. The basic principle is, should we in the theater be given the same parity or equality as you have seen fit to give the motion picture business with an investment tax credit. and they have derived the benefits of that credit all of these years, which has sustained their business.

Senator BYRD. At this point, perhaps we should ask the Treasury for its comment. Mr. Samuels?

## STATEMENT OF JOHN M. SAMUELS, TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. SAMUELS. Thank you, Mr. Chairman, Senator Dole.

We do oppose this legislation for a number of reasons. I think—I don't want to go through them all. They all are set forth in the testimony. I think the first point I should address, though, is the distinction between motion pictures and the theater, and as the gentleman testifying pointed out, there really is only one distinction in our view, and that is that the motion picture industry does have a piece of celluloid, therefore, it has tangible property.

The Treasury Department and the Justice Department argued in court that motion picture films should not be entitled to the investment credit, because the real values was not in the celluloid but were intangibles. We lost that argument in the *Walt Disney* case.

Congress then enacted a provision that extended the investment credit to films. However, I really don't think we believe that is a legitmate extension of the investment credit. The investment credit, when you go back to 1962, was intended to apply to producer durables. There was substantial testimony by then Secretary of the Treasury Douglas Dillon as to why the investment credit was limited to essentially machinery and equipment.

Senator DOLE. Maybe instead of extending it we ought to repeal part of it.

Mr. SAMUELS. Well, we are not here to ask you to repeal the investment credit for films; but we are not sure that a credit for films is sound tax policy.

In response to your question, Senator Dole, as to who will get this credit, I think the answer is very clear. It will be the investors in the broadway plays, or angels, as they are referred to, who are high-income taxpayers. They do get a benefit, in the sense that most plays, I think, are failures, and therefore the losses incurred are ordinary losses and can be offset against income from other sources. More importantly, with respect to the investment credit for machinery and equipment, we do not allow passive individual investors to lease that equipment to third parties and claim the investment credit.

Congress has decided that the investment credit should not be used to shelter the income of wealthy individuals with respect to machinery and equipment, and we don't see any reason why a credit for theatrical productions, including—and I understand the credit would apply, Senator Byrd, to the compensation paid to actors, producers, directors, and all production personnel and other intangibles—we don't see any reason why a credit of that nature should be allowed to offset income of these wealthy individuals.

Senator BYRD. Is that the case with motion pictures?

Mr. SAMUELS. It is the case with motion pictures.

Senator BYRD. How did that happen? I don't recall that motion picture matter. And it resulted from a court case, you say?

Mr. SAMUELS. Well, there was a court case which the taxpayer won, Walt Disney, but I think the Government would have continued to contest the availability of the investment credit for films. The Government's position was that the real value was not in the tangible property or the piece of celluloid, but really in the intangible or the copyright, if you will, that prevented another party from copying the film, and it lost that case in court. And rather than allow it continue to litigate, Congress said that films should be eligible for the investment credit.

Senator BYRD. If a film costs, say, $40 million, then they would get a 10-percent investment credit?

Mr. SAMUELS. I think they have an election depending on the useful life of the film. If the useful life of the film is less than 3 years, I think they get a 6⅔ percent, although I am not sure, and they may get up to a 10 percent.

Senator BYRD. Well, that is a distortion of the original concept of investment tax credit, as I understand it.

Mr. SAMUELS. It clearly is if you go back to the legislative history of what you did in 1962, when you enacted the credit. I mean, you decided to target it to producer durables.

Senator BYRD. Thank you.

Senator DOLE. Do they get tax credit for props and costumes?

Mr. SAMUELS. They should qualify as tangible property, except the problem, I think, is, the useful life is less than 3 years.

Senator DOLE. We are talking about the investment tax credit.

Mr. SAMUELS. But those are tangible assets, and they would be eligible. They probably expense most of those, or write them off over a period of less than 3 years.

Mr. SCHOENFELD. Just one more observation, if I may. Motion pictures have also been benefitted by depreciation allowances, which we have not derived any benefit of. As I say, in view of the relatively insignificant amount of money that is involved here and the significant amount of benefit that would be conferred to, as I say, this essential part of the American cultural life, I thought it was appropriate that we do come here and support this bill.

Mr. SAMUELS. Mr. Chairman, I might point out that we at the Treasury enjoy the theater as well, but I think the plays that the gentleman enumerated were produced without any tax credit, and we are not sure that they would not continue to be produced without any tax credit.

Mr. SCHOENFELD. That is true of every piece of property produced in this country before the investment tax credit was enacted, so I would just like to be similarly circumstanced.

Senator DOLE. I think you have made a good case. I just don't think you have the votes.

Mr. SCHOENFELD. Well, I hope that after I leave here, I will have gotten a few more. [General laughter.]

Thank you very much.

Senator BYRD. Thank you, gentlemen.

[The prepared statement of Mr. Schoenfeld follow:]

**SUMMARY OF PRINCIPAL POINTS INCLUDED IN THE STATEMENT OF GERALD SCHOENFELD BEFORE THE COMMITTEE ON FINANCE, UNITED STATES SENATE, SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT, ON BEHALF OF THE LEAGUE OF NEW YORK THEATRES AND PRODUCERS, INC. IN SUPPORT OF S.2500**

1. Purposes of S. 2500
   a. To grant an investment tax credit for the costs incurred in creating a theatrical production and thereby stimulate investment in the commercial theater.
   b. To extend the benefits of live theater to more and more communities throughout the United States.

2. Revenue impact.

The direct revenue loss of the proposed legislation has been estimated by The Joint Committee Staff to be less than $5 million annually, and may even be close to $1 million. The revenue loss from a reduction in theatrical activity, both on the national and local levels, would be far in excess of such amount.

3. Economic considerations affecting the theatre industry.
   a. Rising costs of productions and operations make it increasingly difficult for commercial theatre to operate profitably.
   b. The theatre industry is a high risk labor intensive industry, leaving little opportunity for production efficiencies to reduce costs.

c. High rates of return for equity capital in other industries make it difficult for the theatre industry to compete for traditional investment funds.

d. A total absence of tax benefits or grants for commercial theatrical investments, as compared to other areas of the arts and to other industries, makes theatrical investments increasingly less attractive as an investment vehicle in an inflationary climate.

4. National policy considerations.

a. Live theatre in America is a basic cornerstone of our national culture. Congress has consistently recognized the need to support our cultural institutions. In this respect, Congress has appropriated substantial funds for nonprofit organizations (principally through the National Endowment for the Arts) and has previously extended the investment credit to film productions.

b. The theatre industry serves many national economic objectives:

i. It has a direct economic impact on many related industries such as transportation, hotels, restaurants, and retailing.

ii. It has a major impact on the economies of urban communities.



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iii. It is a significant minority employer.

iv. Live theatre tends to preserve the desirability of urban life by making cities more desirable places in which to live and promoting safety in areas in which the theatres operate.

5. Considerations of tax equity.

a. There are virtually no tax benefits available for investments in theatrical productions.

b. Although the underlying purposes of the investment tax credit applies to investments in theatrical productions, the investment tax credit has not been available to investments in theatrical productions by reason of technical considerations.

c. When Congress adopted special investment tax credit provisions for film production, it confirmed that the credit should not be denied on technical grounds.

d. The failure to provide the investment tax credit for theatrical productions unfairly discriminates against the theatre industry. The granting of the credit would place investments in theatrical productions on a more equal footing with investments in films.

STATEMENT OF GERALD SCHOENFELD BEFORE THE COMMITTEE ON FINANCE, UNITED STATES SENATE, SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT, ON BEHALF OF THE LEAGUE OF NEW YORK THEATRES AND PRODUCERS, INC., IN SUPPORT OF S.2500

Mr. Chairman, my name is Gerald Schoenfeld. I am a Vice President of The League of New York Theatres and Producers, Inc. and Chairman of the Governmental Relations Committee of the League.

The League is a professional trade association of producers and theatre managements functioning not only on Broadway but throughout the country through touring productions and member theatres.

S.2500 will amend the Internal Revenue Code (the "Code") to grant an investment tax credit for the costs incurred in creating a theatrical production. The Joint Committee on Taxation staff has estimated that the reduction in budgetary receipts which will occur if the bill is adopted will be "less than $5 million" (letter dated April 21, 1980 from Bernard M. Shapiro to Senator Moynihan). We believe that the budgetary impact will be closer to $1 million. Hence, national budgetary considerations should not be a significant element in evaluating the merits of this bill. Moreover, as shown below, the loss of revenue directly and indirectly contributed by theatrical activity, would have a much greater effect on the national budget.

Theatre in this country is divided into two distinct segments: the nonprofit theatre which is supported by private contributions and government grants, and the commercial theatre which is sustained by our system of free enterprise. As shown below the commercial theatre is a substantial contributor to the economic and cultural well being of the country and there is substantial justification for providing it with some beneficial support, particularly when such support can be provided with virtually no impact on the national budget. Congress has already provided an investment tax credit for the film industry. There is every legitimate basis for granting similar benefits to the commercial theatre.

The commercial theatre in recent times has experienced an impressive audience response. The imposing attendance figures, however, have tended to mask the fundamental weakness of the economic structure of the industry. The industry is not as strong as it appears to be and not as strong as it must be in order to weather bad times. Steadily rising production and operating costs substantially reduce the ability to operate profitably.

The average capitalization of a large musical, for example, increased from $620,000 in the 1976-77 season to $1,050,000 in the 1978-79 season. For a small musical the corresponding figures were $327,000 in 1976-77 and $537,000

in 1978-79. For a straight play, the figures were $229,500 in 1976-77 and $325,000 in 1978-79.

The business is highly volatile and cyclical. Indeed, the commercial theatre was almost eliminated during the last cyclical downturn during the 1970's.

Insofar as our tax laws are concerned, the commercial theatre is a stepchild and an undernourished one at that. Because of the unique characteristics of the business, none of the incentives to spur capital formation and investment that are available to industry generally are available to the commercial theatre. As a result, the investment base of the commercial theatre is grossly inadequate for its present needs and its reasonably-anticipated future needs. Its investors have been reduced to a small group who frequently look upon investments as contributions to the arts rather than business-oriented investments.

In order for commercial theatre to establish a sound underpinning, it must be able to attract greater numbers of investors, and in particular, small investors, who will make their investment decisions on the basis of valid investment considerations. S.2500 is viewed as a small step toward this goal.

The commercial theatre is a high risk labor intensive industry; there is little opportunity to reduce costs through

production efficiencies. The shortage of investment capital will significantly curtail theatrical productions unless remedial steps are taken. In deciding where to invest funds, investors traditionally evaluate alternatives in terms of comparative risks and relative rewards. Rewards must be measured in terms of (a) cash return, (b) the tax benefits with respect to the cash return, which determine the after tax yield to the investor, and (c) current tax benefits which decrease the after tax cost of the investment.

In a study entitled The Condition and Needs of the Live Professional Theatre in America prepared for the National Endowment for the Arts by MATHTECH, Inc., Princeton, New Jersey dated March 14, 1978, page III-55, a calculation of the probability of success for Broadway plays and musicals for the period 1965-66 through 1976-77 showed a 25% probability of success for straight plays and a 37% probability of success for musicals. For this purpose, a show is treated as being successful if it merely pays back its investment. If success were determined on the basis of a reasonable return on capital, the probability of success would be even smaller.

The income generated from theatrical investments, generally, is ordinary income taxable at rates up to 70%. Industry, on the other hand, has many opportunities for favorable tax treatment. For example, sales of depreciable

property used in business are subject to ordinary loss or long-term capital gain upon sale under section 1231 of the Code, and business property may be exchanged tax free under section 1031 of the Code.

With respect to the after tax cost of the investment dollar, the theatre industry compares unfavorably with industry in general, even if we disregard those industries which have been afforded special tax incentives, such as oil and gas, government housing, and farming. Industry generally has available to it depreciation based upon leverage obtained through debt financing and the investment tax credit for investment in the equipment will generate income. Thus, if a piece of industrial equipment with a 7 year life were purchased with 75% financing for $100,000, the investment capital required, taking into account a 10% investment credit of $10,000 would be $15,000. Since the commercial theatre is generally unable to obtain any debt financing whatsoever, and has no investment credit available, the same $100,000 cost would require equity capital of $100,000.

In terms of the "hard dollar" cost of investments and the tax treatment of benefits to be derived, the theatre again compares unfavorably to industry at large. As the competition for the investment dollar continues to grow, these conditions will cause a continual erosion in the proportion of investment dollars available for the commercial theatre.

Congress has consistently recognized the need to support our cultural institutions and toward this end has appropriated substantial funds for nonprofit organizations, principally through the National Endowment for the Arts. Indeed, Congressional grants to the National Endowment for the Arts have increased from over $3 million in the fiscal year ending June 30, 1966 to over $150 million in the fiscal year ending September 30, 1980. The National Endowment for the Arts is concerned with cultural, not economic considerations. The commercial theatre, since it is not tax exempt, does not qualify for support from the National Endowment. (It should be noted that nonprofit theatre is also nurtured by the commercial theatre. Approximately 65% of all nonprofit theatrical productions are derived from productions in the commercial theatre.)

The Department of Commerce has recognized the importance of theatre (as well as other cultural institutions) to our national economy. The economic significance of our cultural institutions has been well documented in a special study for The White House Conference on Balanced National Growth and Economic Development, a copy of which is attached hereto as Exhibit A and is made a part of this statement.

The theatre provides direct employment to those involved in productions: actors, singers, dancers, set designers, electricians, carpenters, painters, etc. It

creates indirect employment for many more people in such service areas as hotels, restaurants, and transportation. Theatrical audiences provide an overall economic stimulus for cities since they frequently use a city-going occasion as an opportunity for shopping.

A study entitled The Impact of the Broadway Theatre on the Economy of New York City, prepared in 1977 under the direction of economist William Baumol, offered statistical confirmation of the theatre's economic importance. The commercial theatre in New York was the subject of this particular study. The study provides a methodology for computing theatregoers' expenditures on related activities as well as the economic consequences of the direct expenditures.

The commercial theatre's gross revenues from ticket sales amounted to $146 million in the 1979-80 season. Using the methodology of the study, theatregoers' expenditures as a result of their attendance on such ancillary businesses as transportation, restaurants, and hotels amounted to $159 million. Applying the "multiplier effect" of macroeconomic analysis, these outlays stimulated further expenditures totalling $183 million in the New York metropolitan area and an additional $274 million across the country -- or a national total of $762 million. Moreover, the commercial theatre industry paid substantial taxes and generated further

tax payments from the affected industries. Direct tax payments to New York City alone in 1977-78 were estimated at $10.2 million. Although the study did not attempt to analyze federal and state payments, these undoubtedly exceeded the taxes paid to New York City. It should be noted that in the 1977-1978 season, at least $18 million in federal payroll taxes (including FICA and unemployment insurance) were withheld from union employees of all Broadway theatres.

During the 1979-80 theatre season, theatregoers spent approximately $115 million on restaurants, $26.4 million on taxis, and $11.0 million for parking. Bus tours brought in 218,000 people to attend the theatre, and organized theatre tours brought in a minimum of 37,000 visitors who often stayed the better part of the week. These visitors spent an estimated $6 million on hotels, shopping, etc. One could go on, but the import of these statistics is clear: the combined monetary outlays associated with the commercial theatre industry in New York City alone stimulate the urban economy to the extent of $.5 billion and with its national touring companies, the national economy to the extent of over $1.7 billion. The Impact of the Broadway Theatre on the Economy of New York City, supra, page 2; 1979-80 Industry Statistics of The League of New York Theatres and Producers.

The importance of the theatre as both an economic and cultural institution has been studied in places other

than New York; projects have been completed in Baltimore, Boston, Philadelphia, Washington and Connecticut. These reports have all concluded that the theatre industry is integrally related to other economic sectors of society and that, in general, each dollar spent directly on the theatre is associated eventually with total spending of four to six dollars throughout the nation. The Washington study, for example, revealed that the operating budgets of arts organizations in that area were approximately $12 million in 1974, and it was estimated that attendance at arts events generated an additional $20 million in related expenditures (e.g., restaurants, transportation, hotels, etc.). The Baltimore study demonstrated that operating budgets totalling $9.4 million for eight institutions generated an estimated total of $29.6 million in additional income in the Baltimore area.*

The conclusions that emerge from the foregoing studies are remarkably uniform: dollars spent in a vibrant theatre bring vast rewards throughout the economy. It has been estimated that at the present time the total contribution of the theatre in America to the gross national product is $2.1 billion. The theatre, in short, is not simply a cultural amenity; it is a significant economic force.

* League of New York Theatres and Producers, Our Perceptions of the Theatre in America Today: Appendix (1978).

In addition, it is significant that the economic impact of the theatre is greatest in geographic areas which are experiencing severe economic problems and with respect to segments of our population which are the most economically deprived. Urban communities directly are affected by economic fortunes of the theatre. Within such communities, minority unemployment is a major problem. The theatre and the related restaurant, hotel, and transportation industries, provide major employment opportunities for minority groups.

It is also noteworthy that the presence of an active theatre community and the night life that surrounds it creates safe cities and an aura of well-being for urban residents.

These facts and statistics clearly demonstrate the importance of the commercial theatre to the economy, culture and well being of our nation. For these reasons, it should be clear that any proposal that would stimulate investment in the theatre, without substantially reducing tax revenues, is both desirable and necessary.

Finally, the grant of an investment tax credit for the qualified costs of commercial theatrical productions would be consistent with underlying philosophy of the investment tax credit provisions.

Generally speaking, the investment tax credit has only been available to investments in "tangible" assets. This philosophy was, in effect, disregarded when the investment credit was made applicable to films. Prior to the legislation with respect to films, there had been substantial litigation in which the thrust of the government's approach was that the asset in a film was the "intangible" property right to show the film and not the piece of celluloid itself. The legislation allowing the credit for films was adopted despite strong opposition by the Treasury that the allowance of the film credit was at variance with the philosophy underlying the investment credit provisions. The allowance of such a credit for movie productions makes it clear that a similar credit should be allowed for commercial theatre productions. The similarities between the movie industry and the commercial theatre are obvious. While the differences are not as obvious, they do demonstrate that the allowance of a credit to the movie industry without a similar allowance to the commercial theatre is inequitable and unjust. In this connection, it should be noted that film productions have frequently been structured as tax shelters, many of which have been characterized as "abusive tax shelters". Commercial theatre productions, on the other hand, are not and have not been structured as tax shelters.

The fundamental purpose of the investment tax credit is to stimulate investment in income producing assets. The same principle applies to theatrical productions as applies to a rolling mill in a steel factory, a piece of equipment for an airplane production line or to the production of a movie film. The only real difference is that the rolling mill, the airline production equipment or the movie film can be financed so that the actual out-of-pocket expenditure when the investment tax credit is taken into account is nominal whereas in the theatre industry, given the best of circumstances, the out-of-pocket investment for each $100 of investment would have to be $93.33 after taking into account the proposed 6-2/3% credit.

Denial of the investment tax credit to the theatre industry results in unfair discrimination against an industry which contributes significantly toward a multitude of congressionally recognized and supported objectives. We are not seeking special tax benefits for that industry. What we are seeking is tax equality, recognition that the commercial theatre is an industry and that it should be accorded treatment under the tax laws equivalent to the treatment accorded industry at large.

We are hopeful that the adoption of S.2500 will make available more investment funds so that the benefits of live theatre may extend to more and more communities throughout the United States.

# PERSPECTIVES ON THE ECONOMIC DEVELOPMENT POTENTIAL OF CULTURAL RESOURCES

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FOR

THE WHITE HOUSE CONFERENCE ON
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## PERSPECTIVES ON THE ECONOMIC DEVELOPMENT POTENTIAL OF CULTURAL RESOURCES

Western concepts of cultural activities have been entrapped for centuries by notions about patronage based on the Medici model. The enduring misperception is that the arts survive on largesse alone, and that a loss in cultural activity implies a reduction in expenditures with little, if any, additional economic impact.

An alternate assessment suggests that a cultural industry with demonstrable economic interdependencies and advantages has evolved - officially overlooked by most policymakers. This industry encompasses profit and non-profit components of the arts, humanities, and historic preservation, and provides significant support to ancillary businesses and local tax structures.[1]

To substitute the economic value of the arts for their creative and spiritual value would be a severe distortion. However, to ignore their economic importance, and especially their usefulness in promoting balanced economic growth, would also be a serious mistake.

This paper examines the economic muscle of cultural resources and probes how that muscle has been and can be flexed. Because the observations are drawn primarily from a compilation and interpretation of recent economic impact studies on the arts, the emphasis is on professional non-profit arts activities.[2]

- Cultural resources function as "people magnets" introducing a vitality which attracts other businesses, tourists, and other consumers.
- Cultural resources are labor intensive. They have a capacity to absorb the full range of skill levels. Highly skilled labor represents only the most visible

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[1] Profit components include but are not limited to recording, publishing, filmmaking, advertising, and the full range of design.

[2] Community cultural activities are often a natural outgrowth of professional activities, and share many of the same properties. Moreover, although the connection is difficult to demonstrate rigorously, they seem to galvanize a neighborhood cohesion and spirit which contributes to an atmosphere in which business can thrive.

element. Essential support services encompass many semi-skill and low skill jobs.

- Cultural resources contribute to the well-being of a variety of businesses through purchase of goods and services.

- Cultural resources are ecologically and environmentally sound. The essential raw material is creativity. The absorption of irreplaceable physical resources is extremely limited.

These advantages characterize high quality professional activities whether they operate within a profit or non-profit structure.

CULTURAL RESOURCES AS A PEOPLE MAGNET

The economic consequences of the "people magnet" property are the stimulation of tourism, expanded demand for restaurants and transportation facilities, and an enrichment of locale for both residents and businesses which contributes to strengthening the tax base.

The immediate relevance of cultural activity to tourism is demonstrated by the development of airline tour packages in conjunction with major cultural offerings. Airline packages to Chicago and New Orleans for the Tutankhamen exhibition, to Charleston, South Carolina for the Spoleto Festival, and to Seattle, Washington for the Wagnerian Ring Cycle in the past year suggest an emerging pattern.[3] Many New York City hotels successfully promote weekend tour packages which combine theatre tickets with hotel and food accomodations and coordinate with airline and rail weekend fare rates. The Smithsonian Institution's recent experiment with a weekend tour package to Washington achieved immediate sell-out and waiting list capacity.[4]

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[3]Airlines involved include American, Braniff, Delta, TWA, and United. Several tours are coordinated with Greyline Bus.

[4]A study is currently underway by the University of Washington and the Washington State Department of Commerce and Economic Development to test the hypothesis that cultural tourists to the Wagnerian Ring Cycle spend more than the average visitor or conventioneer to the State, because the total performance time occupies only 20 hours of a six day period.

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To propose that the arts provide the sole reason for increased travel, particularly to major metropolitan areas, may be simplistic. Yet, increasingly, experience suggests that cultural programming is a significant factor in conversion of potential tourist to actual tourist.

The impact of cultural activity on tourism is more striking in remote than cosmopolitan settings. In 1969, on an investment of approximately one million dollars, Ashland, Oregon was able to expand its Shakespearean Festival facilities from seasonal to year round potential. In 1970, the theatre attracted 64,000 additional attendees, 59,000 of whom came from outside the Rogue River Valley. By conservative estimates, $667,000 new tourist dollars were directly attributable to audience expenditures. The expanded demand for hotel, motel, stores, record stores, craft shops, and the theatre itself, generated rapid job development in the area.[5] In the intervening seven years the theatre has expanded two more times. It consistently operates at a minimum of 97 per cent of capacity, and provides a significant feeder system to the tourism in the region.[6]

William Baumol's 1975 evaluation of the economic impact of the theatre strike in New York City highlights the relationship between theatre activities and ancillary services. The strike closed nine musical productions on Broadway for four weeks. Minimal estimates of the economic toll include:

- Loss of revenue to taxi drivers, $117,000 per week
- Loss of revenue to parking lot operators, $50,000
- Loss of revenue to restaurants, $510,000 per week[7]

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[5]Evaluation of the Oregon Shakespearean Expansion, Office of Administration and Program Analysis, Economic Development Administration, U.S. Department of Commerce, April, 1972.

[6]A September, 1977, press release from the Oregon Shakespearean Festival indicate a 1977 annual attendance rate of 98.8% of seating capacity. (232,453 attendees)

[7]The Effect of Theatre on the Economy of New York City, prepared by Mathmatica Inc., Princeton, N.J., 1976. (unpublished) Loss of revenue to the Broadway theatre was $855,000 per week.

The magnitude of loss to ancillary services resulted from the diminution of approximately 65 per cent of only one component of the city's total cultural life. (Lincoln Center, Carnegie Hall, the various museums; the off-Broadway and off-off-Broadway activities continued in full force.)

Eighty-eight per cent of the total Broadway box office is derived from national touring companies.[8] Furthermore, the 1975-76 Theatre Communications Group fiscal survey identifies 49 professional non-profit theatres in 40 cities which operate on annual budgets in excess of $250,000, and constitute an industry of 40.3 million dollars.[9] Although the absolute numbers vary, the Broadway figures describe a relationship between the performing arts and ancillary services which is demonstrated consistently across the country.

Cultural activities provide a focus, attracting large numbers of people to defined areas, thus improving the climate of those places not only for tourism, but also for expanded housing, offices, and small businesses. Perhaps the best example of this phenomenon is Lincoln Center for the Performing Arts in New York City. The site, which represented an econonically modest neighborhood when selected, is now considered prime property. New construction in Lincoln Center area exceeded one billion dollars between 1956 and 1973.[10] The resulting new and renovated apartment and office buildings, restaurants and small shops have netted the city a four hundred per cent increase in tax revenues since the 1962 opening of Lincoln Center (a jump from $10 million annually to $40 million annually based on tax figures from 1962 to 1973).[11]

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[8]Research paper, The Broadway Theatre: A Key to the Redevelopment of Times Square, the League of New York Theatres and Producers, December, 1977, unpublished.

[9]Theatre Communications Group, Annual Fiscal Survey, New York, 1975-1976. These figures represent one element of theatre activity. Professional non-profit theatre in their survey operating on less than $250,000 annually represents an additional $33 million.

[10]Report of the Mayor's Committee on Cultural Policy, New York City, 1974.

[11]The basic resource for Lincoln Center is, The Influence and Effect of the Lincoln Center Complex on Manhattan Real Property Values, Brown, Harris, Stevens, Inc., New York, 1967. Several updates including an unpublished study by John Carl Warneke & Co. for the American Broadcasting Company in 1974 yield the tax figures.

The key to Lincoln Center's success is the strength of the activities it houses. Successful duplication of the "Lincoln Center effect" depends on distinguishing between cultural activities and the buildings which enclose them. The experience of Atlanta's Memorial Arts Center is a case in point. The concepts of the centers were similar. The strength of their activities were not. From its inception, Lincoln Center housed activities of national and international reputation.[12] Atlanta's center housed, at its inception, growing, but only modestly accomplished cultural activities.

The site selection and concept of Colony Square, a multi-purpose complex across the street from the Atlanta Memorial Arts Center, drew heavily from the Lincoln Center model. The decision to build Colony Square was based in part on a projected increase in demand for housing, office space, shops, and restaurants perceived to be attendant to cultural centers. For many reasons, among them the reasons suggested above, this projection proved to be inaccurate. Atlanta's growing pains are a stark reminder that the activity, not the enclosure, provides the people magnet.[13]

On a less dramatic scale than the Lincoln or Memorial Arts Center undertakings, cultural activities can be a nucleus for efforts to deal with local economic problems. Cleveland's experience with the Playhouse Square coupled the magnetism of cultural activity with the draw of a bargain to produce the first substantial reversal of that city's 5 o'clock exodus to the suburbs. Subsidized, (at first free, now low-cost) quality theatre translated after-dark desolation to crowds of 18,000 theatre-goers per week.[14] Theatre patrons

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[12]The one exception, the Vivian Beaumont Theatre, drains the center financially, but does not interfere with the impact of the center as a whole.

[13]Colony Square's financial problems reflect many influences. This paper discusses only the relevance of the relationship to the cultural center. Colony Square banked on residual effects the Memorial Arts Center's activities were not able to provide. It should be noted, however, that the professionalism, strength, and reputation of Atlanta's Memorial Arts Center have grown dramatically. As they mature and generate larger audiences, they should contribute proportionally to the economic vitality of the surrounding district.

[14]The Wall Street Journal, April 13, 1977, pg. 48. "Low Price Tickets Enliven Cleveland, Raising Hopes for Awakening Other Downtowns."

became restaurant patrons generating waiting lines at once empty cafes. The nighttime activity has yet to effect daytime retail activity or demand for office space substantially, but a significant reversal of attitude has occurred.

An obvious but noteworthy strength of cultural resources as an economic stimulant is its ability to expand and enrich the hours of street vitality. This is currently recognized primarily as a property of performing arts. However, museums and galleries, libraries and book stores have demonstrated similar capacity when they remain open at night or on weekends.

The ability to hold and attract business and residents is crucial to every area. The competition among cities to attract major industries is intense. Corporate location decisions increasingly involve quality of life issues including the availability of cultural activities. Unless an industry is directly arts related, and there are many, the existence of a stimulating cultural life is not likely to be the primary consideration. However, the absence of cultural vitality may be decisive in the evaluation of otherwise balanced alternatives.

This is not to suggest that there is some magical formula for injecting adequate cultural activity to attract corporations To the contrary, the strength of the magnetism of cultural activities depends on their ability to reflect local priorities, creativity and identity, not a duplication of someplace else.

The influence of architecture on cultural identity and urban development should be recognized. The revitalization of dormant or decaying districts of older cities has been remarkable where preservation efforts have been linked with an infusion of arts activities. Seattle's Pioneer Square, Boston's Quincy Market, or Soho in lower Manhattan coupled the vitality and creativity of the arts with physical rehabilitation.

Historic preservation is itself a cultural activity. It applies training in the arts and humanities to the construction industry. Moreover, it is not only more labor intensive than new construction, it is aesthetically pleasing, and particularly attractive to other cultural activities. The effective combination of arts and architecture have been a significant revitalizing influence in Baltimore, Minneapolis, Louisville, St. Louis, San Antonio and many other cities. The Philadelphia

Planning Commission indicates that the Society Hill restoration under urban renewal produced a 444 percent revenue increase at completion over precondemnation revenues. Savannah, Georgia's restoration of 18th century squares and wards generated a 350 percent increase in the "tax digest" or assessment base.[15] Preservation efforts, as well as distinctive modern architecture and good landscape design, promote environments conducive to good business. Furthermore, they support a new leisure genre cropping up across the country - the walking tour. And the walks are taking place in areas of the city once thought unsafe.[16]

Cultural activities are not created to be economic development tools. Yet at a certain point they can and do become economic energizers of surprising magnitude. Precise determination of the level of activity adequate to translate cultural resources into an economic development tool remains elusive. In seeking that level some cities are taking their cues from the shopping center concept and creating cultural districts specializing in visual or performing arts. Yet physical juxtaposition is only one element. Clearly the quality and reputation of the activity are fundamental.

To achieve economic development through cultural resources requires an assessment and exploitation of indigenous strengths. It is the enrichment of identity and individuality that creates a stimulating and attractive environment and triggers the "people magnet" property.

CULTURE AS EMPLOYER

Cultural activity is essentially a service industry. Its effective function relies on creativity and people. According to a Ford Foundation study, fees and salaries constitute more than 66 percent of total budgets in the performing arts.[17] The performing artist is only the most visible element of this labor intensity. Less apparent is that a substantial percent

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[15] "Neighborhood Change and City Policy" by Lawrence O. Houstoun, Jr., Urban Land, July/August, 1976.

[16] Many cities and states now produce walking tour manuals through their arts councils. The recent announcement of walking tour manuals in California, part of a national promotional effort by Kinney Shoes, generated 20,000 written requests with $1 postage and handling charge enclosed, in three days.

[17] The Finances of the Performing Arts, Vol. 1, the Ford Foundation, New York, 1974.

of fees and salaries go to support services ranging from construction of sets and creation of costumes to box office personnel and ushers.

Further examination of supports system employment opportunities not only in the performing arts, but also in museums, zoos and other cultural institutions suggests that these are untapped resources for job development through CETA and other government programs, as well as through private sector development. Opportunities exist minimally in light construction, packing, shipping and crating, physical supervision and maintenance. For example, the Bronx Zoo reports that 40 percent of its fees and salaries go to blue collar workers.

Current job development programs, when and if applied to cultural resources, tend to address the professional needs of the institution only. It may be that by targetting at the operational level, rather than the service level, the impact of the job development would stimulate job opportunities for professionals and those in ancillary services as well.

Most economic development materials currently available relate to the performing arts. However, the growth of visual arts, particularly in crafts and design are potentially very significant.

Crafts generally propose self employment opportunities. However, Vermont, New Mexico and segments of Appalachia are finding crafts development, as well as wholesale and retail crafts distribution outlets, a reliable avenue for economic development. General interest in crafts and handmade goods is accelerating.[18]

An intriguing experiment has been proposed in Springfield Massachusetts, a city hard hit by industrial relocation. Establishment of a wholesale and retail crafts distribution center would seek to tie rural strength in crafts and the need for outlets, to urban labor availability and transportation facilities. The creative matching of the resources and needs of the rural and urban communities would open new avenues of employment opportunity for both constituencies. It would not duplicate the quantity of jobs created by a factory, but it could provide a reasonable, inexpensive and satisfying place to begin decreasing unemployment.

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[18] Crafts and other cottage industries are by definition highly skilled. That skill, however, is not dependent on extensive schooling, but rather on extensive discipline and creativity. The distinction between requirements of schooling and ability may be significant in evaluating its applicability to unemployment. Its potential relevance is virtually untested.

CULTURAL RESOURCES AS PURCHASER

The economic relevance of cultural activities in the community at large is generally evaluated in terms of audience expenditures. However, cultural institutions, like all other enterprises, generate a cash flow in proportion to their own financial magnitude.

An evaluation of the annual Bronx Zoo's operating budget (13.7 million dollars annually) reveals:

- It is the largest employer in the South Bronx.
- Its purchases provide substantial support to more than 80 local businesses.
- Its purchases in grain and feed provide substantial support to agricultural interests of Upper New York State.[19]

The most comprehensive evaluation of the production expenditures of cultural activities to date is documented in the recent Connecticut Economic Impact Study on the Arts.[20] The 81 organizations surveyed represent small to moderate sized institutions, most with annual operating budgets of $15,000 to $200,000. Only twelve institutions surveyed operate on a budget in excess of $200,000. Thus the findings are typical of a broad range of arts activities scattered throughout the country. The following are highlights of some of their findings:

- The non-profit arts industry of Connecticut (theatres, museums, dance companies symphony orchestras, community arts programs) spend $28.8 million dollars within the State on goods, services, and salaries.
- Connecticut's non-profit institutions generate a total of 5,962 jobs in the State, of which 2,399 are outside the arts, resulting from spending the originals in the arts industry.

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[19] Economic Impact Statement of the New York Zoological Society, May 1977. Unpublished.

[20] The Impact of the Arts on Connecticut's Economy, by John J. Sullivan and Gregory Wassal, University of Hartford, March, 1977.

- The direct and indirect spending effects of Connecticut's non-profit art's institution is $70 million.

- Some of the areas of greatest secondary impact include:

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| Retail trade | $13.1 million |
| Business Services | $12.4 million |
| Other Services | $ 7 million |
| Construction | $ 6.6 million |
| Communication and Utilities | $ 5 million |
| Printing | $ 3.7 million |
| Transportation | $ 2.3 million |

The Connecticut Study is a landmark in recognizing the significance of cultural institutions as business enterprises. Clearly cultural resources make a larger contribution to the economic well-being of the community than has been generally appreciated.

CULTURAL RESOURCES AND THE ENVIRONMENT

Robert Heilbroner, in An Inquiry into the Human Prospect, concentrates on the economic and social consequences of our economy's reliance on physical resources.[21] In his pessimistic, but provocative treatise, he briefly alludes to more optimistic alternatives through increased economic reliance on cultural and intellectual resources. He mentions "the arts and entertainment" as possible avenues of exploration. Arts and entertainment are indeed ecologically and environmentally sound. They rely on creativity and the human spirit both as raw material and end product. In fact, the possibilities are far broader.

The implications multiply when one recognizes that non-profit arts and humanities serve as the research and development arm of many profit making industries - recording, publishing, filmmaking, broadcasting, advertising and design to name only the most obvious. Thus for example, conversion of plays - like "Annie" or "The Wiz" from non-profit theatre to Broadway theatre to movie and record generates jobs and income, not to mention pleasure, for many. The influence of art exhibitions like the "Tut" show on the fashion and fabric industry are substantial. Creativity explored and tested in non-profit visual arts translates into new design concepts applied from packaging to automobile manufacture. Furthermore, the production of

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21 Robert Heilbroner, Prospects on the Human Dilemma, An Inquiry into the Human Prospect, W.W. Norton and Co., Inc., N.Y. 1974.

the material for artistic activity itself - instrument, sheet music, paints, canvas, etc. also contribute to overall economic vitality.

There has been no comprehensive assessment of the contributions of the cultural industry to the gross national product. However, Porat's research on the information industry provides some indirect indication of the magnitude, since the two industries share some components (e.g. broadcasting, advertising, publishing, etc.)[22] Both industries address ecologically sound ways to simultaneously expand intellectually and economically.

The growing public priority for an improved quality of life enhances the development potential of cultural resources. The Washington Post summarized the findings of a recent Harris Poll with the following excerpts:[23]

- By 76 to 17 per cent, a sizeable majority opts for "learning to get our pleasure out of non-material experiences" rather than on "satisfying our needs for more goods and services."
- By 59 to 33 per cent, a majority would stress "putting real effort into avoiding those things that cause pollution over finding ways to clean up the environment as the economy expands."
- By 77 to 15 percent, the public comes down for "spending more time getting to know each other better as human beings on a person to person basis" instead of "improving and speeding our ability to communicate through better technology."
- By 63 to 29 percent, a majority feels that the country would be better served if emphasis were put on "learning to appreciate human values more than material values" rather than on "finding ways to create more jobs for producing more goods."

There is an increased public demand for a variety of balanced growth rarely discussed - a balance between technological and scientific advancement and maintenance of humanistic tradition. Cultural resources are uniquely able to address the demand for a humanized environment and to promote economic health in the process.

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[22] Marc Uri Porat, Ph.D., The Information Economy: Definition and Measurement, Office of Telecommunications, U.S. Department of Commerce, May, 1977.

[23] Washington Post, June 23, 1977, "The Harris Survey: Deep Skepticism is Expressed About Unlimited Economic Growth."

SUPPLEMENTAL STATEMENT OF GERALD SCHOENFELD ON BEHALF OF THE LEAGUE OF NEW YORK THEATRES AND PRODUCERS, INC. TO THE COMMITTEE ON FINANCE, UNITED STATES SENATE, SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT, IN SUPPORT OF S.2500

This supplemental statement by Gerald Schoenfeld, Vice President of The League of New York Theatres and Producers, Inc. and Chairman of the Governmental Relations Committee of the League is submitted in response to certain points raised in the Statement of John M. Samuels, Tax Legislative Counsel, before the Senate Finance Subcommittee on Taxation and Debt Management on May 30, 1980. Mr. Samuels' statement sets forth the Treasury's opposition to S.2500.

I. The failure to recognize the significance of the differences between the commercial theatre and the tax exempt theatre.

Mr. Samuels' statement indicates that there is a complete lack of understanding on the part of the Treasury Department of the difference between commercial theatre and the tax exempt theatre. Mr. Samuels stated:

> "We do not believe that a tax credit is an appropriate method for providing additional public subsidies to stage productions. Instead, in this time of special concern for control of the federal budget, we believe that any additional public support for the theatre should be provided directly through the regular appropriations process, so that the theatre would have to compete directly for funds with other programs of encouragement to the arts. Indeed, such direct aid is particularly appropriate in view of the existence of established, directly funded programs of public support to the theatre and other arts, with oversight by agencies and Congressional committees charged with the responsibility for fostering the arts."

There are no "public subsidies" for the commercial theatre. There is no "regular appropriations process" by which public funds can be provi ed for the commercial theatre. The "direct aid" which Mr. Samuels calls "particularly appropriate" for the theatre is available for the tax exempt theatre only and does not exist for the commercial theatre.

Mr. Samuels stated:

> "For example, during the most recently complete fiscal year the National Endowment for the Arts expended approximately $20.2 million in support of stage productions, including theatre, opera and dance, and approximately $22.05 million is budgeted for these programs in the current fiscal year, a sum that does not take into account assistance provided by state and local agencies. Any additional assistance to such productions should be provided through an expansion of these existing programs."

The funds expended by the National Endowment for the Arts are expended on the tax exempt theatre, not the commercial theatre. Similarly, the funds provided by "state and local agencies" are for the tax exempt theatre, not the commercial theatre.

The tax exempt theatre pays no federal, state or city taxes and receives public funds. The commercial theatre, by contrast, pays federal, state and city taxes and does not seek public funds. What we are seeking to achieve by supporting S.2500 is recognition that the commercial theatre is competing in the commercial world with other industrial enterprises and deserves the opportunity to compete on equal footing with other commercial enterprises.

II. The incorrect characterization of investments in theatrical productions as "tax shelters."

Mr. Samuels stated:

> "...in many cases credits for the cost of theatrical productions would offset the tax liability of so-called 'angels', wealthy individuals who finance theatrical productions by investing in tax shelter partnerships. The opportunity afforded by present law to utilize the losses incurred in these ventures to offset income from other sources already provides these investors with substantial tax benefits. Availability of the investment credit would make theatrical investments an even more attractive tax shelter."

THEATRICAL VENTURES ARE NOT TAX SHELTERS! S.2500 WILL NOT MAKE THEM TAX SHELTERS!

Tax shelters traditionally provide either tax losses in excess of cash invested or favorable tax treatment of income generated. Theatrical ventures provide neither. The income from theatrical ventures is subject to tax at the highest brackets and losses are available only if sustained as an economic matter. Debt financing is generally not available so that there is no basis for generating losses in excess of the cash invested. A taxpayer in the 70% bracket who invests $10,000 in a theatrical production would have no tax loss if the venture is a financial success and would lose up to $3,000 after taxes if the venture were unsuccessful. If adopted, S.2500 would reduce the after tax loss to $2,333. There is no basis whatsoever to characterize investments in theatrical productions as tax shelters.

III. The beneficiaries of S.2500.

Mr. Samuels suggests that only the wealthy will benefit from S.2500. This statement completely distorts reality. Our whole nation benefits from the commercial theatre. Under our present tax structure only the wealthy can afford to support the commercial theatre since only the wealthy can afford to sustain real economic loss which commercial theatrical investments so frequently produce.

It is our hope that S.2500 will cause theatrical productions to attract the more traditional investment dollar. The commercial theatre needs an investment base not only from "angels" but from hard headed business men and women as well.

IV. The purpose of the Investment Tax Credit.

Finally, Mr. Samuels stated:

> "the investment credit was enacted in 1962 for the express purpose of stimulating capital investment and the modernization and expansion of our industrial capacity."

In addition, he suggests that it would be inappropriate to extend the investment tax credit to theatrical productions, since

> "doing so cannot be justified by likening theatrical productions to durable equipment."

There have been a number of statutory modifications to the investment tax credit since 1962. The legislative history of the investment tax credit since 1962 indicates that the creation of jobs has also been a major objective of the credit. For example, in extending the investment tax credit to certain

costs of motion picture productions, as part of the Tax Reform Act of 1976, the Senate Finance Committee stated:

> "Since the primary purpose of the investment credit is to create jobs, the committee amendment is designed to encourage the production of films in the United States. Thus, the credit base for motion picture films includes the direct costs which are allocable to production of the film in the United States (including its commonwealths and possessions) and, in addition, if at least 80 percent of the direct production costs are allocable to United States production, the credit base also includes certain indirect 'production costs'." S. Rept. No. 94-938, Part I, at 189 (1976). (underscoring added)

In extending the credit to the qualified costs of motion picture productions, the credit was expanded beyond "durable" capital equipment to "intangibles." Costs, for the most part, are essentially for the same elements, such as artistic property and creative talent. In the case of films, however, the work product is ultimately embodied in a piece of inexpensive celluloid through which the creative result is reproduced whereas in the case of a theatrical production, the creative result is reproduced in live performances. We submit that presence or absence of a piece of celluloid should not be the basis upon which the investment tax credit is granted or denied.

Senator BYRD. We have one more witness on S. 2503 and S. 2500, but we will go now to S. 2548, "Industrial Development Bonds for Refinancing Certain Docks and Wharves." The committee is pleased to have today Representative Sam Gibbons of the State of Florida.

We are glad to have you, Congressman Gibbons. Maybe you can bring us up to date as to what is happening in the House.

## STATEMENT OF HON. SAM M. GIBBONS, A U.S. REPRESENTATIVE FROM THE STATE OF FLORIDA

Mr. GIBBONS. Well, we are just having a little harassment over there today. As you know, we are having a lot of trouble with the budget. This is more trouble on the FTC legislation, and they are calling me back.

Let me be very brief, Senator Byrd and Senator Dole. I thank you for allowing me to come here and come out of order, and I thank you for having a hearing on this bill. We expect to have a hearing like this on the bill in the House. We are having a little more trouble getting to our business than we would want to.

Mr. Chairman, this is essentially the port authority for my port in Tampa. To get Tampa firmly fixed in your mind, that is where the bridge fell down the other day, and we had that terrible tragedy. The Port of Tampa is the third largest export port in the United States. Is is a very valuable U.S. asset. It helps us in our balance of trade.

These people here are the people that make it work. It ranks right behind your Port of Norfolk in volume and tonnage of goods that move out of this country. Its essential product that moves out is phosphate, some of which goes up to your area, Senator Dole, on all those fine farms that you've got up there, and some of it comes up here, Senator Byrd, and some of it goes all around the world, for the farmers and to help people around the world.

This is a very narrow, technical question dealing with tax-free bonds. The port authority wants to issue some bonds to help improve the port facilities there and help expand them. Of all the bonds that they want to issue, only $18 million worth of them are in question here, as to whether they would meet the test of the statute. As I say, it is a very narrow question as to whether the bonds do now meet the statute.

Their bond counsel has told them that it doesn't, and they want to be very safe, because these are very fine, conservative businessmen.

Mr. DeLaVergne, here, sitting on my right, is a banker. He serves on the port authority at no compensaion, and he does it as a public service. None of the members of the port authority are compensated. They all serve as a public trust.

Mr. Sessums, sitting here on my left, is a distinguished lawyer in our community, the former speaker of the Florida House of Representatives, and he is their counsel. I am going to let them present the details of this. As I say, I hope that you can find that this meets the test, and that this little adjustment in the bond legislation will allow them to go ahead and make this improvement.

I don't know which one of you gentlemen is going to speak first. Mr. DeLaVergne? I will excuse myself and go back over there and see if I can't get this thing straightened out in the House of Representatives.

Senator DOLE. That is—so you can get out of here. [General laughter.]

Mr. GIBBONS. I wanted to comment on that last witness, but I will do it with you privately. I will tell you why we passed that. We passed that legislation in order to get people to produce pictures in this country rather than in Italy and other places, and that is the reason why you find that law.

Senator BYRD. We are delighted to have you, Congressman Gibbons.

Mr. GIBBONS. Well, I feel like I have spent the better part of the winter with you two gentlemen, and I want to say it was a distinct pleasure. I, of course, have known Senator Dole for quite some time, and I want to say, Bob, your humor is improving all the time. [General laughter.]

I am sure your public service is, too, but I enjoyed those remarks that you had to make in that very fine conference that we had, and yours, too, Senator Byrd. Thank you.

Senator BYRD. I might say that the Tampa area is very ably represented in Congressman Gibbons.

Mr. GIBBONS. Well, this is—36,000 jobs in my community are directly related to the port, Senator Byrd, and this is a little amount of money, and it is very important to the commerce of not only of my area but the United States.

Senator BYRD. Thank you, sir.

## STATEMENT OF TED DeLaVERGNE, JR., TAMPA PORT AUTHORITY, ACCOMPANIED BY EMMETT LEE, PORT DIRECTOR, AND T. TERRELL SESSUMS, GENERAL COUNSEL, TAMPA PORT AUTHORITY

Mr. DELAVERGNE. Thank you, Congressman Gibbons.

Mr. Chairman, members of the committee, my name is Ted DeLaVergne, Jr. Currently I am serving as chairman of the Tampa Port Authority. I am testifying today on behalf of the authority in support of S. 2548. As you can tell, a'ong with me are several other gentlemen. One is Mr. Emmett Lee, to my left, who is currently the port director, and to his right is Mr. T. Terrell Sessums, who is the general counsel of the Tampa Port Authority.

S. 2548 amends the law to permit the issuance of tax exempt revenue bonds for the acquisition of existing port facilities even though the prior owner remains the substantial user. This amendment would permit the port authority to expand the Port on an economic basis and make it more efficient.

In particular, it allows the authority to purchase the existing Big Bend phosphate terminal, which is owned by Agrico Chemical Co., and to undertake an expansion of those facilities, leasing them back to a joint venture group that includes Agrico and at least one new substantial corporate user.

The proposed transaction benefits the Port of Tampa by giving it title to the existing Agrico facilities and approximately 100 acres of adjacent deepwater property. In addition to amortizing bonds issued by the authority to acquire the existing facilities, rental and wharfage payment will also increase the authority's annual revenues by approximately half a million dollars.

These revenues will amortize or help to amortize $3 million of additional revenue bonds issued to acquire the previously mentioned 100 acres of adjacent deepwater property suitable for future expansion, with net revenues remaining that can be used by the authority for other purposes.

In this manner, the authority will be able to improve the efficiency of the port and reduce the demurrage problem that is seriously impeding both domestic and foreign ship traffic today in the port.

The authority whould also be in a position to assure optimum future development of our port, which is currently the seventh largest operating seaport in the Nation. As was detailed in our written statement, both the State of Florida and the Federal Treasuries would immediately derive increased revenues from this transaction. The State would receive increased revenues from sales taxes on expansion and improvement of the facilities and from severance taxes on the higher levels of phosphate rock production that would be stimulated by these improvements in our port.

The Federal Government would receive increased tax revenues due to the reduction in demurrage deductions and increased sales of phosphates and derivative products.

In addition, I would note that the immediate revenue impact on the U.S. Treasury positive, as Agrico would be subject to a $1.6

million investment tax credit recapture and a $1.1 million capital gains tax on the sale of the facility.

These revenue gains more than offset the initial Federal revenue loss from the issuance of tax-exempt bonds.

In regard to earlier testimony of the Treasury's statement concerning S. 2548, the Tampa Port Authority in Agrico could accept the Treasury's modifications since Big Ben will be substantially renovated and rehabilitated provided the percentage of proceeds test is 25 percent or more of the facility's adjusted basis or per market value, particularly when there is a new substantial user involved.

In conclusion, Mr. Chairman, may I mention a few facts concerning the general status of the Port of Tampa and the favorable economic impact on the regions which are served by it?

First, the central and west coast sectors of the State of Florida are two of the fastest growing areas in our country. With the completion of our current harbor deepening project, the 35 miles of channels are being deepened from 34 to 43 feet. The harbor will then become one of the deepest ports in our Nation. The estimated increases in tonnages moving through the port resulting from this extra depth are only feasible if there are adequate loading and unloading facilities available to accommodate these cargoes.

Therefore, it is economically imperative for us to insure through proper planning and sound management that these facilities and capital improvements are built and/or maintained in a manner commensurate with our anticipated growth.

When this growth is accomplished, the maritime industry serving the port as well as the local populace of central and southwest Florida, the State of Florida itself, and the U.S. Government, all stand to gain significantly in economic benefits for many years to come.

Therefore, Mr. Chairman, we respectfully request your favorable consideration of this bill and its passage.

I appreciate your courtesy, and I would be delighted to answer any questions that I am able to.

Senator BYRD. Thank you.

At this point—I mentioned this earlier, but I want to mention it again—Senator Chiles and Senator Stone are very much interested in this legislation. Both of them have talked with me about it. Each of them would have been here today except for a situation that they couldn't avoid.

As I understand it the Treasury and you folks are pretty close to geting together on this legislation. Am I correct about that? Would Treasury comment on that?

## STATEMENT OF JOHN M. SAMUELS, TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. SAMUELS. Senator Byrd, we may be close to solving the problem. I am not sure we are close to getting together on this particular piece of legislation. We do oppose the legislation as it is currently drafted. However, we believe perhaps administratively, or if not administratively, certainly legislatively, we could solve the problem of the port in a fashion that represents sound use of tax-exempt financing.

Senator BYRD. Well, now, how does that help us to determine how to vote on this particular piece of legislation?

Mr. SAMUELS. Well, if we can't get together soon administratively, I would hope we would try to work with the proponents of the bill to modify the bill itself so that it would at least be acceptable, or indeed the Treasury would be able to support it.

Senator BYRD. Well, now, aren't you in pretty close agreement on getting together with the two of them?

Mr. SAMUELS. We do not have all of the facts yet to know whether or not a substantial renovation and reconstruction of the existing port facility is in fact going to occur in Tampa. That is, I think, the standard that—or the factual inquiry that we will have to satisfy ourselves of, and what the right quantitative test is and qualitative test is.

We just met with the taxpayers for the first time day before yesterday on this matter.

Senator BYRD. Mr. Sessums, do you have a comment?

Mr. SESSUMS. Senator, my chairman covered it so well I would defer any comments unless there are questions that I can assist in answering. Thank you.

Senator BYRD. I would think it would be well for all of you and Treasury to continue working on this, to see if it couldn't be worked out to your mutual satisfaction.

Mr. DELAVERGNE. Mr. Chairman, we would be delighted to do that, and will pledge our best efforts to work in with the Treasury to try to overcome any problem that they see that is consistent with our meeting the public interest of our port.

Senator BYRD. Thank you.

Senator Dole?

Senator DOLE. I am not certain I understand this completely, but I assume what we are doing is replacing the conventional financing with public financing, because it is less expensive? Is that the reason?

Mr. DELAVERGNE. Senator, in a nutshell———

Senator DOLE. Do you have one special interest group?

Mr. DELAVERGNE [continuing]. We have a demurrage problem in our port, and our port authority has said, we will try to solve this by buying Agrico's facility for a price that our appraiser says it is worth, approximately $43 million. We will then make approximately $20 million of improvements to modernize, rehabilitate it, and to substantially enlarge it so that we can move much more cargo through it and break the bottleneck that is causing or demurrage problem.

Agrico is delighted to participate in this, but they say, we can't stop putting our own product through, and as long as they continue to put their own product through, it is tainted by the substantial user rule, which is the problem for which we seek relief.

Mr. SAMUELS. Senator Dole, I might be able to explain to you briefly what the problem is. When you limited IDB's in 1968, you allowed them to be issued for wharves and sports stadiums and other permitted facilities. After you passed that legislation, there was an owner of a sports stadium in a major northeastern city that needed money; the stadium was already there. It was financed with taxable debt, and he talked the city fathers into borrowing $50

million against the sports stadium, which he would then use to pay off his other debts.

The IRS and Treasury felt at the time that that was not the kind of tax-exempt financing intended by Congress, and they said, that is not providing the facility. So, a rule was written into the regulations that says, if the same person owns the facility both before and after the issuance of the bonds, you can't issue tax-exempt bonds. You haven't really provided anything.

Now, that rule had two anomalous consequences. First, it prevented tax-exempt financing for substantial renovations, which sometimes may indeed be providing facilities that are new, and that is, I think, one of the problems that the Tampa Port Authority is running into.

It also, however, permitted—the owner of that sports stadium could have sold it to a third party and had the sale financed with tax-exempt bonds, which we think is not a sound result, there would be no new construction, no new provision of any facility. We would like to explore revising our regulation—or revising this legislation to come up with a more rational result. Allow tax-exempt financing for new facilities, for substantial renovations, but not for mere acquisitions.

Senator BYRD. Well, the renovation and modernization aspect of this would be—tax-exempt bonds could be issued for that, could they not, under the existing law, without any revision?

Mr. SAMUELS. Yes, sir, but as I understand it, and this is what we have to explore with the port, the very property that is being acquired is also the property that is being substantially renovated. The question then is, what is substantial renovation, and how do we determine that from something that is really just to repair——

Senator BYRD. Well, this would be pretty close to 50 percent. If you pay 43 for it and spend 20 on it, you have renovated to the extent of almost 50 percent of the total cost. How does that fit in with the Treasury's formula?

Mr. SAMUELS. We haven't devised a formula yet. We would like to—as I say, this legislation has caused us to focus on this regulation, which we probably should have done some time ago, and therefore it serves a very useful purpose.

Senator BYRD. Very good.

Thank you, gentlemen. I would hope that the Treasury and the Tampa Port Authority could work out something mutually—Dr. Fyfe, do you have a comment?

## STATEMENT OF DAVID FYFE, AGRICO CHEMICAL CO., ACCOMPANIED BY H. LAWRENCE FOX, WASHINGTON, D.C.

Mr. FYFE. Yes, sir. My name is David Fyfe. I am the director of commercial development for Agrico Chemical Co. On my right is Mr. H. Lawrence Fox of Davison, Riddell, Fox, Holroyd, & Wilson.

Agrico Chemical Co. is a substantial producer of phosphate rock from central Florida and a major worldwide manufacturer of fertilizers, and we are heavily involved in the very competitive domestic and international trade of both nitrogen and phosphate fertilizer materials.

Agrico supports S. 2548 and endorses the testimony submitted by the Tampa Port Authority. We feel that without this amendment,

the authority will be unable to expand and improve the Port of Tampa through its proposed acquisition of Agrico's existing terminal facilities and the vacant waterfront land which adjoins those facilities.

I would just like to spend a couple of minutes reviewing the importance of this amendment in the context of the $1.5 billion a year phosphate trade out of the Port of Tampa. That $1.5 billion is predominantly in exports.

In the past few years, ships loading phosphate rock and fertilizers at Tampa have been increasingly subjected to delays from port congestion. This has resulted in mounting demurrage charges to shippers and their customers, and in 1979 there were estimated demurrage charges amounting to some $7 million to $10 million.

For example, last year, in the summer, ships were taking up to 15 days in the port, compared to an optimum of 3 days if there was no congestion. That may give you an indication of the magnitude of the problem.

Such delays result obviously in demurrage costs, which have serious consequences for the industry's competitiveness abroad, and in addition, there are onerous financial consequences if we fail to supply a key raw material to fertilizer plants elsewhere in the world.

The solution to the problem is to expand the existing port facilities. This will relieve the present congestion and allow for the projected future growth at the port. For this reason, the port authority has been negotiating for some time with Agrico to purchase and expand our Big Bend facility, together with the acquisition of the 100 acres of adjacent land which would be suitable for future expansion.

Our present terminal is underutilized, in that it can handle substantially increased shiploadings, but it must be expanded and substantially changed to provide the capacity to ship phosphate materials it cannot presently handle.

This expansion is economic only if one or more new substantial users can be found.

We believe that the best long-term solution to the congestion at the other terminals, coupled with the capacity for expansion of Big Bend, is the proposed purchase by the authority. The Treasury regulations disqualify this transaction from tax-exempt financing. As a result of the regulations, potential new substantial users will not choose to participate in Big Bend when they can build a completely new facility, financed entirely with tax-exempt bonds.

Thus, unless S. 2548 is passed, Agrico and the port authority are effectively precluded from obtaining a new user, which in turn eliminates the full use and improvement of Big Bend, impedes the authority's plans for solving the demurrage problem, and prevents orderly growth of the port.

Obviously, Agrico will not sell its property to be precluded from participating in the lease-back, since they are needed to handle our shipping requirements beyond the turn of this century.

The benefits from the transaction would substantially reduce shipping delays, consequent demurrage costs, increase capacity in the port, and make U.S. fertilizer products more competitive in

world markets, both in terms of cost but particularly in reliability of supply, which is a key to any sales effort.

These benefits, viewed in conjunction with the cost to Agrico of recapture of investment tax credit, capital gains tax, and wharfage payments to the port authority substantially in excess of debt service make it clear that the total transaction is for commercial and public purposes.

Finally, as the Tampa Port Authority has indicated, both the State of Florida and the Federal Government would derive increased ongoing revenues as a result of the transaction. In particular, the taxes that Agrico would pay in the year of the sale to the authority exceed $2.5 million, substantially more than the alleged $500,000 revenue loss from issuance of the additional bonds.

I would like to just finally say that it should be noted that the Big Bend facility would be substantially renovated and expanded after the acquisition by the authority. However, the additional funds required for such change in nature, as you have pointed out, Mr. Chairman, will be slightly less than 50 percent of the value of the existing facility.

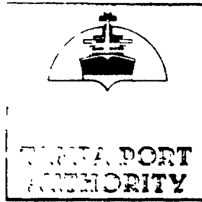
Thus, if Treasury's concept is that the cost of such rehabilitation, for example, equals or exceeds 25 percent of the fair mark. value of the existing facility, and that at least one new substantial user should be brought in or must brought in, Agrico itself would not object to changes in the bill.

It should be clear from the foregoing facts and, indeed, Treasury's own testimony, that legislation is required to amend the regulations.

I thank you for your attention, sir.

Senator BYRD. Thank you. Thank you, gentlemen.

[The prepared statements of the preceding panel follow:]



*Serving America's Eighth Largest Port*

S. 2548

To Amend the Internal Revenue Code of 1954
With Respect to Tax Exempt Financing for
Industrial Development Revenue Bonds

WRITTEN TESTIMONY

Presented to
The Senate Finance Subcommittee
on Taxation & Debt Management Generally
May 30, 1980

Submitted On behalf of the Tampa Port Authority
by

Ted DeLaVergne, Jr.
Chairman
Tampa Port Authority

And

T. Terrell Sessums
General Counsel
Tampa Port Authority

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Introduction

The Tampa Port Authority is attempting to fulfill its obligations to the U.S. Congress to expand and improve the Tampa Port. As the Port continues to expand, the majority of new acquisitions will be property (land and facilities) already owned and being used by taxpayers who would want to continue to be in business after the Authority purchases their property and improves it. Moreover, the economic viability of the Port is based upon the expertise and rental payments that will be provided by such taxpayers.

The Authority's mandate is severely restricted by a provision in Treasury Reg. §1.103-8(a)(5), which provides that the tax incentive contained in Section 103(b)(4) is not allowed if a lessee of the property to be acquired by the Authority is a prior substantial user. This rule will hinder and may eliminate the Port's future growth because it may not acquire existing property and lease it back to the prior owner. S. 2548 makes it clear that the Authority's activities qualify for tax exempt financing under Section 103(b)(4)(D).

Summary

1. The Tampa Port Authority believes that its statutory mandate, its method of operation, and the legislative history behind Section 103(b)(4)(D) supports the conclusion that the Code should be clarified as provided in S. 2548 to allow the Port Authority to issue its tax exempt bonds whether or not a previous owner is a co-tenant.

2. Without the passage of S. 2548, the Authority will be severely hindered in providing additional port facilities which is the antithesis of the intent of the State of Florida and the United States Congress.

3. In addition to being extremely important to the Port's future and the community's development, passage will have an immensely positive revenue impact upon the Port, the State of Florida and the Federal government. Further, passage will allow the Authority to acquire existing Port facilities and manage them to assure a more efficient port through the elimination of the demurrage problem, at present, a serious hindrance to the competitiveness of U.S. products in the world phosphate market.

## Background

### Statutory Rules

In general, industrial development bonds, as defined in Section 103(b)(2), do not bear tax exempt interest. However, if the proceeds of such a bond are used for certain designated projects,[1] called exempt facilities in Section 103(b)(4), it will nevertheless be treated as a state or local government's obligation and hence bear tax exempt interest.

### 1972 Regulatory Limitation

### No Retroactive Financing

Under Treasury Reg. §1.103-8(a)(5) the statutory incentive is not allowed even for exempt facilities if a lessee of the property to be acquired is a prior substantial user.[2]

### Basis of IRS Position

The foregoing rules, adopted in 1972, bar refinancing i.e., prevent a taxpayer from refinancing an existing facility with tax exempt obligations. The apparent justification is that the exempt activity exception is to be enjoyed only where

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1 Residential real property, sports facilities, convention or trade show facilities, certain public utilities, and air or water pollution control facilities.

2 Specifically the Regulation requires one, a bond resolution or "some other similar official action" must precede the commencement of construction or acquisition by a substantial user, and two, the bonds must be issued within one year from the date the facilities are completed and placed in operation.

the taxpayer can show that the tax incentive "induced" or spurred the construction or acquisition for use by the taxpayer. Obtaining local governmental support (as evidenced by a bond resolution or other similar official action) prior to acquisition or construction indicates reliance upon the statutory benefit.

Another rationale behind Reg. §1.103-8(a)(5) might be that the proceeds from an issue must be used "to provide" a qualifying facility; and accordingly, if bond proceeds are used to refinance a facility, they are used for a purpose other than "to provide" the facility.

Limitation Inappropriate as Applied to Docks and Wharves, In General

The regulatory modification of the statute is baffling when applied to docks and wharves being acquired by public authorities. This is because the most logical method of developing a major port is for a port authority, a public body, to acquire property and facilities adjacent to that which is already owned by the authority. Such a transaction is, in general, economically viable only by leasing the acquired property back to the original owner for a reasonable period of time. House Report No. 1533[3] supports this conclusion in describing the tax exempt treatment to be afforded obligations issued to

3 90th Cong., 2nd Sess. (1968)

acquire docks, wharves and related facilities:

> Subparagraph (D) of new subsection (c)(4) applies in respect of obligations issued to provide . . ., docks, wharves . . ., or storage or training facilities directly related to a[n] dock, wharf, . . . . For example, a grain elevator or warehouse which is on or adjoins a dock or wharf and which is directly related to it is an exempt storage facility.

The Committee Report indicates that so long as the proceeds are used to provide the issuer with a dock or wharf or related facilities on or adjoining a dock or wharf, the bonds bear tax exempt interest even though they are industrial development bonds. The fact that the facilities are used, after acquisition by the authority, by someone who also used the facility prior to the issuance of the bonds is immaterial.

Tampa Port Authority

Assuming that the rationale for Reg. §1.103-8( )(5) is the "to provide" concept and that this approach may be justified as a general rule, it is not supportable when applied to docks and wharves such as those to be acquired by the Tampa Port Authority, for the following reasons:

1. The proceeds of the Authority's bonds will be used "to provide" the Authority with improved and expanded port facilities (as distinguished from classic industrial development bond transactions in which a non-exempt person takes title to the property at some future time). Thus, when the Tampa Port Authority leases its property, title to the

property never reverts to a non-exempt person. It should be noted that this is the only practical method through which the Port can carry out its Florida statutory mandate. Moreover, it allows the Authority to satisfy its representation to the United States Congress that if Federal funds were made available for deepening the Port, the Authority would undertake to expand and improve the harbor facilities. Both the Authority and Congress undertook their respective commitments to the expansion prior to 1972 when it was clear under the Internal Revenue Code and Regulations that the Authority could issue its bonds to acquire existing facilities. We would also note that no amendment to this provision of the Code has been made since the Authority made its commitment to Congress and that this administrative restriction is clearly unjustified in this instance.

2. While the Authority has a statutory power of eminent domain, its exercise is severely limited without a corresponding lease back to an entity that includes a prior user. This is so for two reasons: (a) without the prior user, there is little likelihood that the Port Authority could obtain sufficient guaranteed income to amortize the financing for the acquisition, and (b) without the prior user, the facility would not have sufficient participation to justify acquisition of the facility.

3. Allowing the Authority to acquire and expand a facility which will be used in part by a prior owner and in

part by a new substantial user precludes the unnecessary building of duplicative facilities. In other words, if the prior user "taints" the existing facilities, the new substantial user will build duplicative facilities relying on tax-free financing.

4. The Authority uses the proceeds from its bonds to first purchase existing facilities and second to improve them. In other words, the Authority is not "refinancing" facilities for existing owners, but instead is acquiring property. In addition, the Authority fulfills its obligation to the State and Federal governments to improve the harbor facilities.

5. The Authority leases the acquired and improved property to a group of companies which may include the previous owner. It should be clear that the Authority benefits from the transaction because it will ultimately own title to the facilities and land on an unencumbered basis. In addition, the prior owner has not "refinanced" since it no longer owns title to the property and will pay taxes to the extent of its recapture of investment tax credit and gain on the sale to the Authority. Moreover, there will be an increase in the use of the port by virtue of the improvements and attraction of new users to the facility.

Regulatory Limitation Particularly in Contravention of Congressional Intent as Applied to Tampa Port

In 1970, Congress authorized the deepening of Tampa Harbor Channels from 34 to 44 feet. In approving this central harbor

project, Congress relied upon the Corps of Engineers' recommendation that the project was worthy. One of the Authority's representations to the Corps was that it would expand the port. (See Exhibit A). One of the principal methods of improving and developing the harbor is cooperation with private business interests and the issuance of long term industrial revenue bonds.

The Authority is complying with its commitment to Congress to expand the use of the Port. The key to effecting this commitment is for the Authority to facilitate the investment of private capital in the Port by obtaining land, properly placed for optimum future development. Private operators are expected to continue to operate terminals, either owned by the Authority or owned and operated by private owners. With the passage of time, however, the only land and facilities available will be those that are already owned and operated by existing businesses.

The application of a regulatory rule to restrict the Port's refinancing of docks and wharves will preclude the Port from acquiring existing facilities. Simply stated, the Authority cannot expand and improve the harbor if it is estopped from using the statutory benefits of Section 103(b)(4) by virtue of the fact that the prior owner will be a user of the facilities after acquisition by the Port Authority.

## Positive Revenue Impact

The Tampa Port Authority is actively considering the aquisition of Agrico Chemical Company's existing Big Bend

phosphate terminal at East Bay. This acquisition is desirable because it would eliminate the need for duplicative facilities at another location and would alleviate the Port's demurrage problem. In addition, this is a significant opportunity for the Authority to acquire approximately 100 acres of unimproved waterfront real estate, which would not otherwise be available to the Port, for future expansion. This land has particular value to the Authority because unlike other properties in the harbor area, it is outside the environmental "non-attainment" area of Tampa itself, which fact facilitates future expansion projects by the Authority. S. 2548 will allow the Authority to use tax exempt revenue bonds in the amount of $43 million to acquire the terminal which will be expanded and leased to a joint venture company which will include Agrico as a joint venturer.

Under existing Section 103(b), approximately $15 million of bonds can be issued to provide improvements to the existing facilities for the sole use of Agrico without regard to the addition of new substantial users. Another $3 million of bonds can be issued to acquire approximately 100 acres of unimproved land (adjacent to the Port) for future expansion of the Port. Without this legislation we do not believe that it is economically viable to attract a new substantial user to Big Bend. Rather a new substantial user would develop its own new facility using tax free industrial development bonds. We estimate

the cost of such bonds to be $30 million. Thus $48 million of tax exempt obligations can be issued without passage of S. 2548. Only $18 million of additional tax-exempt industrial development bonds will be issued if the amendment is enacted. This conclusion is illustrated by the following table:

Bonds to be Issued Assuming Passage

| | |
|---|---|
| Acquisition of existing Agrico facilities | $43,000,000 |
| Expansion and improvements at Big Bend for Agrico and new substantital users | $20,000,000 |
| Land | $ 3,000,000 |
| Total Obligations to be Issued if Passage | $66,000,000 |

Bonds to be Issued Assuming No Passage

| | |
|---|---|
| Duplicative facilities to be built by new substantial user | $30,000,000 |
| Improvements solely for Agrico | $15,000,000 |
| Land | $ 3,000,000 |
| Total Obligations to be Issued if No Passage | $48,000,000 |

| | | |
|---|---|---|
| Total Obligations to be Issued if Passage | | $66,000,000 |
| Total Obligations to be Issued if No Passage | - | 48,000,000 |
| Total Additional Bonds | | $18,000,000 |

The theoretical Federal tax revenue loss from the enactment of this bill would be between $450,000 and $540,000 per year, using Treasury estimates of a revenue loss of between $2.50 and $3.00 per $100 of bonds.

The significant annual economic benefits resulting from the entire transaction to the Port, the State of Florida, and the Federal government, are between $15,520,000 and $24,860,000 with an additional one year extraordinary Federal tax gain of $2.7 million from investment tax credit recapture and capital gains tax.[4]

The following discussion analyzes the benefits that will redound to the Tampa Port Authority, the State of Florida and the Federal Treasury if this amendment to Section 103 of the Code is enacted:

Tampa Port Authority

1. The existing Agrico facilities will be purchased by the Authority at their appraised value of $43 million. They will become a substantial asset of the Authority when unencumbered.

2. The financed improvements will inure to the Authority.

3. There will be an additional, immediate increase in Authority revenue of approximately $500,000 annually from dockage and wharfage charges on the movement of phosphate and related products in and out of the new and improved Big Bend Terminal facility. The lease and wharfage payments to be made by the joint venture company to the Authority will be

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4 See Exhibit B for a detailed economic analysis.



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sufficient to amortize the principal and interest on $3 million of bonds used to acquire approximately 100 acres of unimproved waterfront property which will be used for future Port development. This land obviously will appreciate in value with the passage of time as well as provide the Port with significant capacity to expand. Thus, this portion of the transaction offers the Authority the present value of the land and the future opportunity for subsequent Port development. Residual revenue will be used for continued Port development and will significantly decrease the Authority's dependence on tax funds in order to finance capital improvements.[5]

4. The acquisition will result in a substantial reduction of vessel demurrage costs now estimated at between $7,000,000 and $10,000,000 per year. These current costs reduce the attractiveness of the Port to vessel operators and which, if they remain unabated, will eventually result in diminished traffic at the Port. (Note: Since demurrage costs are tax deductible, their elimination will increase Federal taxable income and thus Federal taxes.)

Summary

The amendment will produce substantial present and future

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5 Additionally, this cash flow will enhance the Authority's ability to issue its governmental obligations (general revenue bonds) for other Port Authority projects at a more favorable interest rate.

economic benefits to the Port. The Authority will receive an immediate increase in revenues and about 100 acres of property for development. The additional land and facilities will inure to the Authority. Finally, the so-called Federal revenue loss associated with the "extra" tax exempt bonds will be more than off-set by the Authority's increase in revenue and by the elimination of tax deductible demurrage costs.

State of Florida

1. A significant number of jobs will be created in the construction industry by expanding the present facility.

2. The $20 million expansion will generate over $314,000 in additional sales taxes for the State of Florida.

3. If we assume that an additional 2.0 million tons of dry rock and 0.5 million tons of fertilizer will be shipped by virtue of the acquisition and improvement of the existing facility, an additional 2.8 million tons of phosphate rock will be mined. Based upon the present severance tax of approximately $1.50 per ton, the State would receive an additional $4.2 million per year from the increased export of phosphate rock.

Summary

The amendment will cause an immediate and significant increase in State revenues through sales and severance taxes. This increased revenue to the State will be significantly greater per annum than the theoretical revenue loss to the

Federal government from the "extra" tax exempt obligations. Finally, the project will spur employment in the construction industry which will benefit the State in terms of human welfare and the Federal government in increased individual income taxes.

United States

1. The improved and expanded terminal will be capable of handling eight million tons per annum of phosphate at the outset, and 14 million tons per annum in the future. Studies by the U.S. Department of the Interior's Bureau of Mines indicate that phosphate production will reach nearly 60 million tons by 1990, of which 30 million tons will move out of the Port of Tampa in foreign and domestic commerce. Without this amendment, the U.S. may not be able to reach these levels.

a. By 1990 the value of phosphate products in foreign commerce will amount to $1 billion annually. This will improve the U.S. balance of trade and will insure jobs for thousands in the phosphate and fertilizer industries.

b. The greater cost effectiveness of the expanded Big Bend Terminal and the effect of the expansion on the Tampa terminals as a whole will improve the competitiveness of U.S. phosphate exports, especially phosphate rock, against increasing competition from Morocco in Europe and other markets.

2. The stimulus to phosphate shipments occurring as previously described, will improve corporate profits and

therefore corporate taxes. Our sources indicate that the increase in annual export revenues would be approximately $175 million. In other words, but for this project, the $175 million may not be available for foreign commerce or be subject to Federal income taxes.

3. We have been advised that the transaction would result in substantial federal income taxes being collected from Agrico. Concerning the sale of the existing facility, investment tax credit recapture will be $1.6 million. Additionally, capital gains taxes will be $1.10 million. We do not believe that these revenues will be received if the Bill is not enacted.

4. If a new duplicative facility is built, the new substantial user will obtain approximately $2.8 million of investment tax credits for construction of a new $30 million facility. Agrico can be expected to obtain $1.5 million of investment tax credits from the $15 million expansion of its existing facility. Thus, there would be $4.3 million of investment tax credits under existing law versus only $2 million of investment tax credits if the bill is enacted.

5. The acquisition of the existing facilities will be accompanied by expansion and improvement. The latter will not only help employment in Florida, but will also create demands for items manufactured outside the State of Florida, i.e., there will be a favorable multiplier effect on goods and services from other States.

Summary

The amendment will benefit the nation's balance of payments, will generally increase corporate tax revenues, decrease the revenue loss associated with the investment tax credit and will increase employment in several states resulting in additional income tax. In summary, the increased Federal revenues will be overwhelming when compared to the estimated loss of revenue from the additional bonds."

Conclusion

In general, Congress did not intend to limit the incentive provided by section 103(b)(4) for wharfs and docks to only new facilities. In particular, Congress anticipated the Authority expanding the Tampa Port by acquiring and improving existing facilities. Such a course, as in the Agrico case, requires a lease back to the prior owner. To remedy the unintended prohibition contained in the regulations and to discourage duplicative facilities, an amendment to Section 103(b)(4) is needed which will make it clear that the Authority's program is not "refinancing" as precluded by the regulations.

S. 2548 ensures that Treasury Reg. §1.103-8(a)(5) will not improperly restrict the Tampa Port Authority from carrying out its responsibility to improve and expand the Tampa Port. In order to solve Tampa's demurrage problem and increase control over the harbor facilities, the Authority needs to acquire and improve this Agrico property. Private business interests are

willing to make such a sale to the Authority only if they can continue to stay in business after acquisition by the Authority. Moreover, from the Authority's position, economic viability of future wharves, docks and related facilities, is based upon such companies' expertise and rental payments.

Passage of S. 2548 will provide significant economic benefits to the Tampa Port Authority, State of Florida, and Federal government. Accordingly, we respectfully urge the passage of this bill.

EXHIBIT A

Excerpts From "An Economic Feasibility Study For Tampa Port Authority" Used By The Port in Its Negotiations With The Corps of Engineers

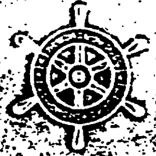
The Study notes on page 24 the effort by the Authority to provide more and improve existing facilities. Pages 53-55 indicate the need of the Authority to deal with inadequate existing facilities. In particular, the Study states that additional loading facilities for phosphate shipments will be needed.

Subsequent to the Study, the contract between the Authority and the United States of America provides as a condition to the United States undertaking the harbor project that the Authority will "c. Provide and maintain at local expense adequate public terminal and transfer facilities open to all on equal terms, and depths in berthing areas and local access channels serving terminals commensurate with the depth provided in the related project areas;". The Authority could not have accepted this condition without the right to issue tax exempt industrial development bonds to acquire land and facilities, improve same, and lease some of them back to prior owners.

The refinancing rule in the regulations as applied to the facts of Tampa Port Authority is wrong. In addition to redressing the general inequities associated with its application, an amendment is required to prevent it from undermining Congressional intent and reducing the Authority's ability to honor its contract with the U.S. Government.

# Tampa Harbor

## AN ECONOMIC FEASIBILITY STUDY FOR TAMPA PORT AUTHORITY



REYNOLDS, SMITH AND HILLS
ARCHITECTS AND ENGINEERS
JACKSONVILLE - ORLANDO - TAMPA - HUNTSVILLE

channel from the Hillsborough Channel to Port Sutton has been authorized; however, private interests have dredged the channel to 34 feet deep and 270 feet wide, with a turning basin 34 feet deep, 500 feet wide, and 1,300 feet long. The Alafia River Channel, 30 feet deep and 200 feet wide, was dredged from the Hillsborough Bay Channel to the Alafia River, with a turning basin 700 feet x 1,200 feet. A channel was dredged in the Manatee River 13 feet deep and 100 feet wide from Tampa Bay to McNeill Point, thence 9 feet deep and 100 feet wide to Rocky Bluff, and 4 feet deep and 75 feet wide to the Mitchellville Bridge. It also includes a cutoff from Manatee River into Terra Ceia Bay 6 feet deep and 100 feet wide. An entrance channel to St. Petersburg 24 feet deep and 300 feet wide was dredged, with a channel to the Port of St. Petersburg 24 feet deep and 200 feet wide, and a turning basin 24 feet deep and 1,200 feet long. Also included is a channel 15 feet deep and 100 feet wide into Bayboro Harbor, a turning basin 12 feet deep and 700 feet x 800 feet x 1400 feet, and a channel 12 feet x 75 feet x 300 feet in the mouth of Salt Creek.

2. Local Cooperation on Proposed and Prior Projects

The City of Tampa and local interests have been extremely cooperative in providing lands, rights of way, easements, and spoil disposal areas required to improve, expand, and maintain channels and navigational facilities within Tampa Bay. The City of Tampa, in order to insure that adequate areas were available for general commerce, with the approval of the Secretary of War, acquired

700-foot frontages on each side of Ybor Channel and constructed on the west side marginal wharves, a 30-foot-deep slip, a 9,375 square-foot warehouse, and constructed part of a municipal belt-line railroad connecting with Atlantic Coast Line and Seaboard Airline Railroad facilities. A 15,000 square-foot warehouse was erected by the City on the north side of the Garrison Channel, and a site was transferred to the United States Government on Ybor Channel for use as a dredge marshalling area. This site was not used by the Government and subsequently was returned to the City on March 8, 1948. To date, the City of Tampa and Tampa Port Authority have been very cooperative in supporting needed projects for upgrading and expanding the Tampa Harbor area.

During World War II, the Navy Department and the U.S. Government requested that a belt-line railroad and the paving of streets north and east of Ybor Channel be completed to facilitiate operations of the Tampa Shipbuilding Company. The paving was completed and a portion of the trackage owned by the Atlantic Coast Line Railroad north of the channel was relocated to City-owned rights of way at the expense of the railroad company. The Seaboard Airline Railroad, however, opposed extension of railroad service to an area that they had served exclusively for years. The Interstate Commerce Commission backed the complaints of the railroad with the result that the Navy Department withdrew their request and the Secretary of War advised the City extension of the belt-line was not required. With these exceptions, the City of Tampa complied with the requirements of the various Acts.

In the Rivers and Harbors Act, approved June 20, 1938, it was suggested that

in order for work to be completed in upper Tampa Harbor local interests must furnish free of cost necessary rights of way and spoil disposal areas for new work and continued maintenance. In addition, they should move and reconstruct all bulkheads, wharves, buildings, roads, railroad tracts, and structures as may be necessary and provide the lands necessary to install a breakwater at Peter O. Knight Airport. All of the requests were met by local interests.

The Rivers and Harbors Act, approved March 2, 1945, provided for further improvements in the upper harbor channels of the Hillsborough River, and required that local interests provide free of cost to the United States all lands required for the improvements and the disposal of dredged material during construction and for subsequent maintenance when needed. These included improvements to the Sparkman Channel, Ybor Channel and turning basin, and the Hillsborough turning basin. This bill also required that the City of Tampa agree to complete the construction of the belt-line railroad and the paving of additional streets on the north and east sides of the Ybor Channel. In addition, it requested that new bulkheads and retaining walls be constructed and that all structures be strengthened in order to safeguard both the channels and the adjacent lands and structures. It also stated that the City should make necessary alterations to structures crossing the Hillsborough River in order to protect the United States from claims of damages which result from channel and snagging improvements in the river. It requested that local interests construct and maintain a wharf with adequate depth alongside and a pre-cooling plant with a weekly capacity of not less than 840 tons open to all on equal terms. These

improvements were all satisfactorily completed.

In June of 1945, by the authority of Chapter No. 23338 (No. 824) (Senate Bill 504) Laws of the State of Florida, a Hillsborough County Port Authority and Hillsborough County Port District was created to operate independent of the City, County, or State. This authority was the governing body of an area defined as the Hillsborough County Port District, comprising approximately the northwest quarter and part of the southwest quarter of Hillsborough County. This includes all channel and terminal areas in Tampa and Port Tampa, but excludes the Alafia River, Port Sutton, and the relatively undeveloped area southeast of upper harbor. The Port Authority Board was comprised of five persons, each appointed to his post by the Governor of the State of Florida to serve a term not to exceed four years. Each member, however, would be eligible for reappointment. The Port Authority has been very active in supporting local Corps of Engineers and Government projects. In 1949, the Hillsborough County Port Authority locally sponsored the U.S. Corps of Engineers improvements to Ybor Channel. In this respect, they worked closely with the Corps of Engineers securing rights of way, spoil areas, and local assurances in connection with the work. The Port Authority, with other interested groups, has helped sponsor the Tampa Harbor Project, which provides deeper and wider channels for the Port. This project got under way in November of 1955 with an initial appropriation from the U.S. Congress of $977,000. In this instance, the Port Authority gathered the necessary information including testimony to be used by the various Governmental committees concerning

the Tampa Harbor Project. This Project included deepening the Egmont Channel to 36 feet; the Mullet Key Cut to 34 feet deep and 500 feet wide; the Tampa Bay, Hillsborough Bay, and Port Tampa Channels to 34 feet deep and 400 feet wide; the Port Tampa turning basin to 34 feet deep by 750 feet by 2,000 feet; the Sparkman Channel and Ybor turning basin to 34 feet deep and a channel 30 feet deep, 300 feet wide, including a turning basin 700 feet by 1,200 feet in the Alafia River. The Tampa Port Authority also cooperated with the Government in clearing and deepening the Hillsborough River from its mouth to the City water-works dam. Their efforts included securing additional rights of way, spoin disposal areas, and local assurances in connection with the work. In 1960, the Port Authority led local interests in cooperating with the Corps of Engineers in the projects for deepening Ybor Channel from 30 feet to 34 feet and the addition of Port Sutton Channel and turning basin to the Federal project for maintenance purposes. In 1963, the Hillsborough County Port Authority, in an effort to promote trade and use of the Tampa Port facilities, changed their name from the Hillsborough County Port Authority to the more familiar Tampa Port Authority.

3. Other Improvements

Throughout the years, there have been numerous improvements made to the Tampa Harbor area by local interests. The first improvements began in 1907 when the Tampa Northern Railroad Company dredged a 2,000-foot-long channel 20 feet deep from the main channel to their terminals at Hooker's Point. The westerly

portion of this channel, some 50 feet long, officially became part of the Sparkman Channel by the Rivers and Harbors Act approved June 25, 1910.

In 1909, a channel was completed eastward from the Hillsborough turning basin approximately 3,000 feet. This channel, 20 feet deep and 300 feet wide, was constructed at a cost of approximately $95,000, and later became part of the Garrison Channel by the Rivers and Harbors Act approved June 25, 1910.

The Port Tampa Channel has been approved numerous times by the Atlantic Coast Line Railroad, which has extensive facilities at that port.

The Weedon Island Channel, extending from the Port Tampa Channel to Weedon Island, is privately dredged and maintained to a depth of 34 feet.

A 10-foot channel with turning basin was dredged at the shore end of Tampa Bay to a United States Treasury Department quarantine station at Gadston Point. The cost of these improvements was approximately $80,000.

The initial dredging of a 27-foot channel from Hillsborough Channel to Port Sutton was started around 1930 by the American Cyanamid Company. They abandoned their site and subsequently the property was acquired by local interests.

The Seddon Island facilities, operated by the Seaboard Airline Railroad, have had numerous improvements in recent years. The railroad maintains two slips 36 feet deep on the east side of Seddon Channel, one 900 feet long, the other 1,100 feet long. In addition, they maintain a rail and vehicular bridge over the Garrison Channel.

Numerous local improvements have been made at the Sparkman and Ybor

Channels and subsequently much of this work was incorporated into the channel limits. These improvements include 3,000 lineal feet of channel from 20 feet to 30 feet on the west side of Ybor Channel; 800 lineal feet of 27-foot-deep channel on the east side of Ybor Channel dredged by the Texas Company; deepening of the channel in front of the Texas Company wharf in 1946, at a cost of $4,755; improvements by the Tampa Marine Company also located on the east side of Ybor Channel to its marine railway slip of from 22 feet to 30 feet, at a cost of approximately $3,800; improvements by the Tampa Shipbuilding Company to a marginal slip by their facilities of from 24 feet to 30 feet on the east side of Sparkman Channel, with a portion of these improvements dredged to 42 feet to accommodate a 10,000-ton floating drydock. Other improvements to the east side of Sparkman Channel include approximately 3,500 lineal feet of channel from 20 feet to 27 feet, a slip 18 feet deep, and a 24-foot access channel. The total estimated cost of this work is approximately $230,000. During the early part of the second World War, the United States Maritime Commission constructed a graving dock, three shipbuilding basins, and an outfitting slip with central pier at the Hooker's Point shipyard. All of these channels and improvements had a depth of 23 feet.

Subsequent improvements have been made to the Port Sutton Channel since it was initially dredged to 27 feet in 1929. In 1955, the channel and basin were reportedly dredged to 30 feet, while private maintenance dredging was performed in 1957 and 1960. Port Sutton, Incorporated, has just recently completed the deepening of the channel, basin, and slip to 34 feet.

The Tampa Electric Company has recently awarded a contract and initiated dredging improvement at their Big Bend plant site on the east side of Hillsborough Bay, five miles north of Ruskin. Site work will include the filling of 329 acres, while the dredging will consist of a channel 35 feet deep and 200 feet wide. The total cost of this contract is estimated in excess of $1,000,000.

4. Terminal and Transfer Facilities

a. General

Terminal facilities in the Tampa Harbor area are extensive and widespread. These facilities include piers, wharves, transit sheds, warehouses, tank farms, railroad trackage, and other utilities and appurtenances. They also include drydock facilities for repairing vessels, oil and coal bunkerage, water service, fire protection, general refrigeration and bonded storage. General transportation to these facilities is excellent, with good highways and rail facilities available at all sites. An effort has been made by the Tampa Port Authority, since its inception, to provide more available land for expansion and to improve the existing facilities to make them more attractive to prospective users.

b. Port Tampa

All of the terminal sites at Port Tampa are owned by the Atlantic Land and Improvement Company, which is a subsidiary of the Atlantic Coast Line Railroad, and leased to the various users. The terminal facilities are located at the entrance to and on both sides of a dredged slip 34 feet deep and 150 feet to



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200 feet wide and 3,800 feet long. The Atlantic Coast Line Railroad operates its phosphate loading facilities on the north side of the slip while the south side is shared by National Gypsum, Shell Oil, Gulf Oil, and Standard Oil. In addition, the Tampa Electric Power Company and the Hardeway Contracting Company each operate a pier at the entrance to the slip. The Atlantic Coast Line Railroad is the sole operator in and out of this port facility. Adequate rail siding capacity at ship side and yard marshalling are available. Ample highway connections are convenient to Tampa.

c. Alafia River

The U.S. Phosphoric Products Corporation operates an extensive terminal facility at the mouth of the Alafia River and is served exclusively by the Atlantic Coast Line Railroad.

d. Seddon Channel

The most southerly terminal is comprised of the phosphate loading facilities of the Seaboard Airline Railroad, while the Blocks Terminal is located in the northwest corner of Seddon Island. The Seaboard Airline Railroad serves this complex.

e. Garrison Channel

The Garrison Channel has numerous facilities located along its north and south shoreline. The south side of the channel is occupied by the Tampa Bay Terminal and by the Hillsborough County Health Department. The Tampa Bay Terminal facilities consist of wharves, transit sheds and warehouses.

The Hillsborough County Health Department has a channel and a wharf which are not used for handling water-borne commerce. The north side of the Garrison Channel contains terminal facilities for the Luckenbach Steamship Company, the Tampa Import and Export Terminal, Cargill, Sun Oil Company, Bull Steamship Lines, and Tampa Sand and Material Company. Facilities on the south side include wharves, transit sheds, warehouses, grain handling facilities and petroleum product storage. Both the Atlantic Coast Line and the Seaboard Airline Railroads serve these facilities.

f. Ybor Channel

Terminal facilities are located on both sides of the Ybor Channel. The major operators of these facilities include Gulf Florida Terminals Company, the Municipal Terminals, Tampa Terminals, Inc., Tampa Marine Company, Phillips Petroleum Company, American Bitumuls and Asphalt Company, and the Texas Company. These terminals are capable of handling general cargo, sulphur, potash, ammonium sulphate, petroleum products, both bulk and packaged, and general outfitters for repairing and mooring small vessels. These facilities are served by both the Atlantic Coast Line and the Seaboard Airline Railroads. Ample highway facilities are available to all the terminals.

g. Sparkman Channel

Seddon Island is not developed on the west side of Sparkman Channel for handling water-borne transportation. Instead, the port terminals are located on the east side of the channel. These facilities include: the George B. Howell

Maritime Center, the Tampa Electric Company, the Florida Portland Cement Company, the Sinclair Refining Company, the American Oil Company, the Freeport Sulphur Company, the Tampa Ship Repair and Drydock Company, the Tampa Port Authority, and the River-Gulf Terminal, Inc. Facilities are available for mooring, outfitting, and repairing vessels, the handling of dry raw materials, such as gypsum and sulphur, general cargo and petroleum products, including bulk petroleum storage and general drygoods and cargo. Berthing spaces along the channel have been dredged to a depth from 20 feet to 34 feet. The terminals in this area are served exclusively by the Seaboard Airline Railroad with numerous highway connections into Tampa.

h. Hillsborough River

Along the Hillsborough River, between its mouth and the Lafayette Street Bridge, are the terminals of Bay Dredging and Construction Company, the Steamways Corporation, the Felicione & Sons Fish Company, the Gulf Oil Corporation, Knight and Wall Company, Tampa Electric Company, and the Mirabella Fish Company. All of these facilities are equipped to handle shallow-draft vessels. Ready highway access is available to the City and the Atlantic Coast Line Railroad furnishes the rail transportation.

i. Port Sutton

Port Sutton is located on the east side of Hillsborough Bay and is a facility owned by Port Sutton,Incorporated. Tenants at this port include the Florida Phosphate Terminal Corporation, the Pan American Sulphur Company,

Grace Company, Ideal Cement and Morton Salt. The Tampa Electric Company has a plant on the north side of the site which they own. The Florida Phosphate Terminal Corporation has recently completed a phosphate processing, storage, and shipping facility which includes outdoor storage for about 160,000 tons of undried phosphate rock, a chemical storage silo with 65,000-ton capacity, and a 6,240-ton-per-day dryer. Loading facilities are rated at 1,800 tons per hour and have exceeded 2,300 tons per hour over short periods. This facility is served exclusively by the Atlantic Coast Line Railroad. Although the Corps of Engineers has authorized channel and turning basin maintenance to 30 feet, all improvements to date have been privately financed and have been deepened to 34 feet.

5. Difficulties Attending Navigation

An overall review was made of navigational problems in Tampa Harbor. It established the fact that difficulties presently encountered by ships serving Tampa's ports are not generally the result of lack of markers, wind or tides, but, rather, maintenance and the obsolescence of the existing channel dimensions to accommodate the larger vessels presently serving this port. The Tampa Bay Pilots have aptly summarized these problems with the following statement: "With regard to the need for channel and harbor improvements and the inability of the channels to accommodate certain vessels with full cargoes, we believe two facts become immediately apparent: First, the depths and widths of the existing channels and turning basins are presently being utilized to their maximum limits. Second,

| Year | Under 16,000 | 16,000 16,999 | 17,000 29,999 | 30,000 49,999 | 50,000 and over | Total |
|---|---|---|---|---|---|---|
| 1962 | 9.7 | 10.5 | 34.2 | 37.6 | 8.0 | 100 |
| 1963 | 8.6 | 8.9 | 32.0 | 38.0 | 12.5 | 100 |

During the year 1963 only, the portion of world carrying capacity in ships of under 17,000 dwt declined by 2.7 percentage points, while the portion in tankers of 30,000 dwt or more increased by 4.9 percentage points." There is little doubt that the trend will continue to be toward larger and deeper draft tankers and ore carriers.

The German transportaion company, Unterwesser, one of the largest companies engaged in the ocean transportation of bulk phosphate, has ordered three giant ore carriers specifically for the phosphate trade. These vessels with a cargo capacity of 35,000 tons and a draft of 35 feet 3 inches, will be calling on the Tampa Harbor. The first vessel, the HAHNENTOR, is scheduled to arrive in Tampa Harbor June 1, 1965, with the sister ships following in the fall.

5. Trends in Terminal Development

Like several other harbors in rapidly growing areas, Tampa Harbor is entering into a transitional period in which the needs for efficient port terminal services are accumulating faster than its ability and capacity to accommodate them satisfactorily. This is an almost inevitable consequence of extensive economic growth of the tributary area, advances in terminal operation and handling methods, trends in vessel sizes, obsolescence of existing facilities, and encroachment of higher

land usage in adjacent areas. Most of these elements are already in evidence here.

Area economic growth has been a major influence in boosting harbor commerce several-fold. Many of the aging terminals are not adaptable to modern, efficient equipment and methods nor do they have the needed room for expansion. The physical layout and dimensions of the harbor channels and basins limit the port's ability to accommodate the new larger and more economical vessels. Obsolescence of many of the existing terminal facilities discourages further growth in harbor commerce as well as port-dependent industrial development. Encroachment of higher land usage and the increase in community objections to nuisance characteristics of port operations limits further expansion of port terminals.

It would appear that the first steps in the transition towards modern and adequate terminal facilities have been started. The general planning of the Tampa Port Authority for the expansion and development of the Hooker Point area may be considered an initial step in this direction. The development of extensive terminal facilities by private interests in the Port Sutton area constitutes an already accomplished step toward the desirable objective of adequate freight handling in Tampa Harbor.

Much more needs to be done, however, and it should be done as quickly as feasible, if Tampa Harbor is to maintain its place as the principal shipping and receiving point for the water-borne commerce of the greater part of the western half of the Florida peninsula. Some of the older facilities have reached a stage of obsolescence which can only result in abandonment or complete rebuilding in

a short period of time. Such instances usually are found in locations where land access or water access, or both, are so badly congested that rebuilding and modernizing the obsolete facilities would not be warranted. Oil terminals are now scattered throughout the harbor area, at Port Tampa, and along the already congested Sparkman, Garrison and Ybor Channels in the inner harbor. With the very large added volume of petroleum products which will be needed to meet the demands of the high population growth of the tributary area, it appears inevitable that these terminals must gradually move to new locations where ample space is available, and fire hazards and community objections may be held to a minimum.

Existing phosphate terminals are widely dispersed. In some instances, they are highly conducive to community objections from the standpoint of dust and noise during loading operations, and serious interference with vehicular traffic at railroad crossings during the transfer of phosphates by rail from the mines to the ship loading terminals. The railroad-owned loading facilities have insufficient capacity to load the new larger carriers quickly enough to take full advantage of the economies obtainable with these vessels. A careful review of the outlook for future phosphate shipments leads to the conclusion that additional loading facilities with greater capacities will soon be needed. This opens up the opportunity for the installation of additional facilities in a more suitable location along the east shore of Hillsborough Bay.

The only recently-installed phosphate loading facility is located at the

## EXHIBIT B

### Revenue Estimate For S.2548

I. **Assumptions**

A. Treasury's informal estimate of the loss of revenue associated with the issuance of tax exempt industrial development bonds ($2.50 to 3.00 per $100.00) is accurate.

B. The $15 million required for improvements at Big Bend solely for Agrico can be financed without the amendment; $20 million required for expansion and improvements by Big Bend for Agrico and a new substantial user can be financed without the amendment.

C. The acquisition of 100 acres of land for $3 million can be financed without the amendment.

D. No value has been assigned to the increase in foreign commerce and the favorable impact upon the balance of payments.

E. No value has been assigned to the jobs created by construction and improving facilities.

F. Ten to twenty percent of the gross revenues associated with gross phosphate sales is subject to Federal income tax.

G. There is no estimate of the reduction in the Port Authority's interest costs on its general revenue obligations.

H. If S.2548 is not enacted, a new duplicative facility will be constructed for the new substantial user at a cost of $30 million which will generate a $2.8 investment tax credit. Similarly, $15 million of improvements for Agrico will produce a $1.5 million investment tax credit. Thus, without the amendment, $4.3 million of investment tax credits will be generated. With passage, there will be an investment tax credit only upon the $20 million of improvements of $2 million.

## II. Economics

A. Tampa Port Authority -- Benefits

1. Approximately $500,000 net revenue will be generated annually by dockage and wharfage charges on the movement of phosphate and related products in and out of the new and improved Big Bend Terminal Facilities.

2. Unencumbered real estate valued at $3 million will be used for further Port development.

3. Unencumbered title to the property will inure to the Port Authority.

B. State of Florida -- Benefits

1. The State will receive an additional $314,000 in sales tax from the $20 million expansion.

2. The State will also receive an additional indefinite annual severance tax of $4.2 million per year.

C. Federal Government -- Benefits and Detriment

1. The annual revenue loss will be between $450,000 and $540,000 ($18 million x 2.5% and 3.0%) for the term of the bonds.

2. An indefinite annual revenue gain from a federal tax of $3.22 million to $4.6 million results from the elimination of demurrage costs of $7 to $10 million.

3. An indefinite annual revenue gain of between $8,050,000 and $16,100,000 will result from an additional $175 million of phosphate sales ($175 million x 10% and 20% x 46% rate).

4. There will be an investment tax credit recapture of $1.6 million and a capital gains tax of $1.10 million.

## III. Summary

**A.** Annual Revenue Gain during term of bonds -- $15,520,000 to $24,860,000

| | Low | High |
|---|---|---|
| Port Authority Revenue Gain | $ 500,000 | $ 500,000 |
| State Severance Tax | 4,200,000 | 4,200,000 |
| Revenue Gain, Elimination of demurrage charges | 3,220,000 | 4,600,000 |
| Federal Tax from $175 million additional phosphate sales | 8,050,000 | 16,100,000 |
| Subtotal | 15,970,000 | 25,400,000 |
| IDB, Revenue Loss | - 450,000 | - 540,000 |
| Total Indefinite Gain per annum | $15,520,000 | $24,860,000 |

**B.** One year extraordinary Benefits

| | |
|---|---|
| Recapture Investment Tax Credit | $1,600,000 |
| Capital Gains Tax | 1,100,000 |
| State Sales Tax | 314,000 |
| 100 acres to Port | 3,000,000 |
| Difference in availability of investment tax credit | 2,300,000 |
| Total | $8,314,000 |

**C.** First year Federal Revenue Gain

| | | |
|---|---|---|
| IDB Revenue Loss | (450,000) | (540,000) |
| Recapture Investment Tax Credit | 1,600,000 | 1,600,000 |
| Capital Gains Tax | 1,100,000 | 1,100,000 |
| | $2,250,000 | $2,160,000 |

The net benefits to the Authority, State and Federal government are readily apparent.

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S. 2548

To Amend the Internal Revenue Code of 1954
With Respect to Tax Exempt Financing for
Industrial Development Revenue Bonds

WRITTEN TESTIMONY

Presented to
The Senate Finance Subcommittee
on Taxation & Debt Management Generally
May 30, 1980

Submitted on behalf of Agrico Chemical Company
by

Dr. David Fyfe
Director of Commercial Development
Agrico Chemical Company

And

H. Lawrence Fox, Esquire
Dawson, Riddell, Fox, Holroyd & Wilson, P.C.
Counsel

## Summary

Agrico Chemical Company, a substantial producer of phosphate rock from Central Florida mines and a major manufacturer of fertilizers, is heavily involved in the highly competitive domestic and international trade of phosphate materials.

Agrico supports S.2548 and endorses the testimony submitted by the Tampa Port Authority at this hearing. Without this amendment, Agrico will not be able to maximize the use of the Big Bend Phosphate Terminal and its demurrage costs will continue to rise. Without this amendment, the Authority will be unable to expand and improve the Port of Tampa through its proposed acquisition of Agrico's existing terminal facilities and vacant waterfront land at the Port.

## The Port of Tampa Today -- Background

The Port of Tampa today ranks as the 7th largest port in the United States. Phosphate materials comprise more than 50 percent of all shipments through the Port. In the past several years, ships loading phosphate rock and fertilizers at Tampa have been subject increasingly to delays resulting in mounting demurrage charges to shippers and their customers as a result of port congestion. In the summer of 1979, for example, ships

were taking up to 15 days in the Port compared to an optimum of 3 days with no congestion. The reasons for these increasing delays are, principally, an increasing volume of shipments[1] and a shift in the pattern of trade to a higher proportion of fertilizers, a commodity which is slower to load than phosphate rock.

As the Florida phosphate industry seeks to maintain its competitiveness in the international marketplace against offshore phosphate rock suppliers, such as Morocco, these increased costs from demurrage are of serious concern given mounting freight differentials caused by rising energy costs and distance from the export markets. The industry is also concerned that these delays in shipping from the Port of Tampa threaten our reputation and capability as a reliable supplier to international customers. For instance, in 1979, one of Agrico's major international customers was twice within 24 hours of running out of dry phosphate rock supplies due to

---

1 Phosphate Shipments from Tampa (million short tons)

| | 1976 | 1977 | 1978 | 1979 |
|---|---|---|---|---|
| Rock | 16.1 | 19.9 | 19.4 | 20.8 |
| Fertilizers | 3.4 | 3.9 | 4.6 | 4.9 |
| Total | 19.5 | 23.8 | 24.0 | 25.7 |

loading delays at other Tampa terminals. The financial consequences of such a failure to supply a key raw material to a world-scale fertilizer plant make the Tampa Port Authority's estimate of $7 to $10 million in annual demurrage costs at the Port, as a whole, pale in comparison.

It has been recognized by the Port Authority and a number of shippers at the Port that the key to a solution of the demurrage problem facing all users of the Port is the expansion of the existing port facilities. Such an expansion is necessary both to relieve the present congestion and to allow for future growth at the Port. For this reason, the Tampa Port Authority has been negotiating for some time with Agrico to buy Agrico's Big Bend Phosphate Terminal at East Bay Tampa along with approximately 100 acres of adjacent waterfront land which is suitable for future expansion by the Authority.

## Agrico's Position

Agrico's Big Bend Phosphate Terminal ships 2.8 million tons of phosphate rock and 0.4 million tons of fertilizers per year with no vessel delays. Without expansion and improvements, Agrico's other phosphate shipping cannot be handled at Big Bend. An additional 2.3 million tons of phosphate rock is shipped through other Tampa terminals where substantial delays are experienced due to congestion. The problem for Agrico is

that the Big Bend Terminal is underutilized in that it can handle increased ship loadings, but its terminal and other segments of the infrastructure must be expanded to handle the additional phosphate materials. It is economic to undertake this expansion only if one or more new substantial users can be brought in to use the Big Bend facility. Following such expansion, the Big Bend facility can handle up to 5 million additional tons per year of dry phosphate rock which provides the capacity needed for a new substantial user. The capital investment so required would be substantially less than the investment if a new terminal is built to handle the same volumes generated by the new substantial user.

Agrico believes that the best, long-term solution to the demurrage problem and the underutilization of Big Bend is the proposed purchase of the terminal by the Port Authority. The Authority would undertake an expansion of these facilities, leasing back the old and new facilities to Agrico and at least one other substantial user. In its search for other substantial users for the terminal after its sale and expansion, Agrico has become aware of the barrier presented by the Treasury Regulation, §1.103-8(a)(5), which disqualifies the proposed purchase from tax exempt financing by the Port Authority if there is a leaseback to a joint venture that includes Agrico. It is this disqualification that S.2548 is intended to remove.

This regulatory provision is a barrier because potential new substantial users will not choose to use Big Bend when they can build a new facility financed entirely with tax exempt bonds under existing law and regulations. In other words, it is more economic for a substantial user to build new, duplicative facilities than to make the lesser commitment to participate with the Authority in an expanded Big Bend Terminal. Thus, Agrico and the Port Authority are effectively precluded from obtaining a new user for this project which, in turn, one, eliminates the full use and improvement of Big Bend, two, impedes the Authority's plans for solving the demurrage problem, and three, prevents orderly growth of the Port. While Agrico is willing to sell its property to the Authority to achieve these results, it is unable to do so where it is precluded from leasing back the facilities which are needed to handle its shipping requirements.

Finally, it should be noted that the Big Bend facility offers particular advantages for both immediate expansion and future growth. Much of the Port of Tampa is an environmental "non-attainment" area, which imposes severe limitations on the ability to expand existing facilities in those areas. However, Big Bend is outside the non-attainment area and can be expanded substantially while remaining within all environmental limits.



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Benefits from Transaction

From Agrico's standpoint, the cost savings from the resulting increase in the efficiency of the Big Bend Terminal and the Port of Tampa as a whole, make this a desirable transaction. The transaction would substantially reduce Agrico's demurrage costs, increase its capacity to ship from this facility and make U.S. fertilizer products more competitive in the world market. These benefits, in conjunction with the costs to Agrico, *i.e.*, recapture of investment tax credits, capital gains tax and use payments in excess of the debt service, make it clear that the total transaction is for commercial and public purposes. Further, if the Authority acquires and improves Big Bend, there would be a substantial change in its nature because the facility will handle dry phosphate rock as well as wet rock. It is thus not a "refinancing" of existing facilities which the Treasury Regulation was intended to prohibit.

From the Authority's standpoint, the proposed transaction benefits the Port of Tampa by improving the efficiency of the Port, reducing the demurrage problem, acquiring Agrico's existing facilities and vacant waterfront land for future expansion, and increasing its net revenues available for other projects.

As the Tampa Port Authority has indicated in its statement, both the State of Florida and the Federal Government would derive increased revenues as a result of the transaction.

## Conclusion

Enactment of S.2548 will aid the entire phosphate industry using the Port of Tampa solve a serious hindrance to its future business success of predominantly export markets. Agrico is clearly one of the beneficiaries. Moreover, all governmental bodies (Tampa Port Authority, State of Florida, and Federal Government) will derive increased revenues from the sale and expansion of Agrico's Big Bend Terminal.

In order that these benefits can be achieved, we respectfully urge that S.2548 be passed at the earliest practicable time.

Senator BYRD. One additional witness relative to S. 2503, and the committee is pleased to have Senator Kassebaum here today. I believe it is the first time that this committee has had both Kansas Senators present at the same time. We are pleased to have you, Senator Kassebaum.

## STATEMENT OF HON. NANCY KASSEBAUM, U.S. SENATOR FROM THE STATE OF KANSAS

Senator KASSEBAUM. Thank you, Mr. Chairman.

I am assuming you have saved the best bill for the last. Is that right?

Senator BYRD. That is correct.

Senator KASSEBAUM. I am very pleased to have Senator Dole here as well, because of his expertise in agricultural matters as well as those issues coming before this committee. It is a pleasure for me to be here. I would like to speak just briefly to Senate bill 2503. Its cosponsors are Senators Durenberger, Exon, Zorinsky, Culver, Young, Pressler, Thurmond, and Stewart.

It was certainly my belief in introducing this bill that there is a unique problem facing the agricultural community at this time. I have been supportive of the policy of the Federal Reserve in trying to exercise monetary restraint in the interest of reversing inflationary pressures. Agriculture markets, however, represent a unique problem.

The farmer is not able to pass along the cost of production. The embargo measures have hurt the farming community. Because of these two facts, farmers were particularly caught in the credit crunch, which has effected many other segments, of course, as well. To maintain a viable support for the monetary policy now, it was important to have this segment of the economy strong and supportive. One way that can be done would be to stabilize interest rates at 12 percent through the refundable tax credit mechanism proposed in this bill. I feel very fortunate this morning to have a Kansan here who is representative of a family farm with around 500 acres, Mrs. Van Nahmen. Mildred Van Nahmen always provides valuable insights to agriculture concerns.

Senator BYRD. We are glad to have you, Mrs. Van Nahmen.

## STATEMENT OF MILDRED VAN NAHMEN, AMERICAN AGRICULTURAL MOVEMENT

Mrs. VAN NAHMEN. Thank you, Senator Kassebaum, Senator Byrd, Senator Dole.

Speaking in favor of Senate bill 2503, I am Mildred Van Nahmen of Kinsley, Kans., a farmer partner with my husband, Vernon. We are small farmers with less than 500 acres in production, mainly wheat and summer fallow 500 acres.

Mr. Chairman, the confidence of the American farmer in the economic policies of this Nation must inspire trust in the equity and viability of those policies, and this trust does not come from empty promises. When President Carter announced his most recent antiinflation program, he assured us that the farmer would get special attention for his particular need, and there was an inherent tendency to believe him.

The attention turned out to be the highest interest rates this country has ever seen, precisely at spring planting time, when farmers were borrowing money to stay in business.

According to the news meals, prime interest rates have gone down. My neighbor went to his Dodge City, Kans. bank yesterday and had to pay 16.5 percent interest to renew his operating loan. In other words, although we welcome decreases in the prime rate, most farmers have already borrowed money at much higher rates in anticipation of spring planting and summer harvest.

Farming has become a highly capital-intensive industry. By the beginning of fiscal year 1980, outstanding farm debt was estimated at an all-time high of $157 billion. This debt is expected to increase another $25 billion in 1981, and has more than tripled since 1970.

Farmers do not borrow because they want to. They borrow because they have to. Credit provides essential operating cash flow. Tight, costly credit in an industry such as agriculture can cause interruptions in this cash flow and result in economic disruptions of both producer and consumer.

Credit is particularly important when the cost-price squeeze on American farmers is tight, as it is today. Fuel prices have increased 83 percent from 1979 to 1980, and fertilizer 35 percent. Farmers are forced to pay increased costs for parts and production.

Since manufacturers will not make parts for older equipment, farmers must purchase new machinery to continue operating. Grain prices have not kept pace with inflation. We can say with certainty that this is due to the intervention in export markets and the administration's ineffective grain embargo.

When farm prices are depressed, the high cost of credit exacerbates the farmers' economic problems. It is estimated that a 2-percent increase in the interest rate decreases net farm income by 6 to 8 percent.

The latest USDA figures figures on cost of production of wheat is $4.63 a bushel. Compare that to the prices we get in Kinsley-Offerle, Kans., area, where we truck our wheat at $3.21 a bushel, and you can readily see the price-cost squeeze we are in.

Farmers are not in a position to pass increased costs on to consumers. They are price takers, not price makers.

I believe this legislation, authorizing refundable tax credit for interest charges exceeding a 12 percent rate on agricultural operating loans, provides for reassuring that the capital essential to continue farm operations will be made available. The $25,000 cap on the amount of loans to which the bill will apply makes this a modest approach which will particularly benefit the small farmer.

Do understand that in the reality of farm operating expenses and costs, this $25,000 limit is a small figure. Some concern will undoubtedly be expressed that the refundability of the tax credit will operate as a boon to inefficient farmers who are losing money.

This is not the case, because farmers have not had a fair price for the products. Many farmers now encountering difficulties have been successful operators for years. This bill will extend them the hope of resuming that productive farming. We are not interested in Government subsidies, and this bill avoids that approach.

A farmer must still have the confidence of his banker to procure money for his operation. Under this proposal, the Government will

not be doling out vast sums of money to support inefficient farmers. This bill will allow for easier repayment of loans through the use of tax credit. This bill is a definite step forward in farm legislation.

The essential capital made available for continued farm operation is an excellent starting point.

Many times we fail to say thank you for your continued interest in agriculture and in projecting ways to solve our problems. From the bottom of our hearts, we thank you, Mr. Chairman and the committee.

Senator BYRD. Thank you, Mrs. Van Nahmen.

I certainly agree with you about the high interest rates. I think they are terrible, the interest rates that not only of farmers but all Americans have to pay these days.

This is a novel approach, I must say, I had never thought about using investment tax credit for interest rates. Give us an example as to how that would work.

Senator KASSEBAUM. Mr. Chairman, as Mrs. Van Nahmen said, there is a $25,000 cap as proposed right now. There are some who think that is too low, that perhaps $50,000 would be more reasonable for many of the loans. We picked $25,000 because, according to figures of USDA, that represents about 40 percent of the agricultural operating loan applications.

This, then, would mean that a farmer could effectively get an agricultural operating loan at interest of 12 percent. The tax credit would either be applied against the tax liability if the farmer has one, or a dollar-for-dollar refund if there is no tax liability.

Senator BYRD. You mean, if the tax rate exceeds 12 percent?

Senator KASSEBAUM. Right.

Senator BYRD. Senator Dole?

Senator DOLE. That is how it would work, and I think the Treasury has some mild opposition. I think you made the point that even though interest rates may be falling now, most of the farmers have already borrowed the money at higher rate.

Mrs. VAN NAHMEN. That is right.

Senator DOLE. Apparently the rate still in Dodge City was, a couple of days ago, 16.5 percent?

Mrs. VAN NAHMEN. Yes.

Senator DOLE. So it hasn't really fallen that much out in the midwest.

Mrs. VAN NAHMEN. It has not fallen.

Senator KASSEBAUM. I might say, Mr. Chairman, as this legislation is designed to be effective for ony 2 years. It is really to meet this particular situation we are confronting right now, helping to stabilize not only the credit and the economic security of the farming community, but of small banks.

Senator DOLE. I think some of the objections raised by Treasury could be addressed, particularly the question of whether it is appropriate to include as eligible for the proposed credit interest on loans for conversion of farms to ranchland or recreational purposes or interest on loans to supplement farm income. There are a number of areas where farm credit might not be appropriate. If this problem was addressed and the issue of the refundable credit was addressed, would Treasury still oppose the bill?

Senator BYRD. Would Treasury indicate its position on the legislation?

## STATEMENT OF JOHN M. SAMUELS, TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. SANUELS. We do oppose the bill, Senator Byrd and Senator Dole, but we are sympathetic to the problems high interest rates pose for farmers and everyone else. It is painful to wring inflation out of our economy, but Senator Dole is—very painful for all of us.

Senator Dole has indicated two of the objections that we have with the bill, one making the credit refundable, which raises questions, serious questions, of tax policy that are addressed in the testimony. The second construes the category of loans for which this credit would be eligible. I think what is partiularly relevant there is, the category of loans for which this credit is eligible are loans that the Secretary of Agriculture today currently has authority to make at well below market interest rates to farmers or to guarantee such loans, and we would much prefer to see that direct program used, under which I believe there are currently roughly $900 million in loans outstanding, than to go through the back door of using the tax system.

I also question whether it is advisable to insulate one group in this country from the effects of the tight monetary policies but not others. That is obviously a judgment for the Congress to make. However, if you do make it, we would much prefer to see you use the existing program to which this credit is cross referenced, so that the Secretary of Agriculture could exercise discretion in determining whether or not a particular farmer is entitled to or should be entitled to a low interest rate loan or a guaranteed loan.

I think there are 38,000 loans currently outstanding under that program. It seems to be working. We don't really know why this credit is needed, or at least, if it is needed, why we don't pursue that program.

Senator DOLE. I think they are out of money.

Senator KASSEBAUM. They are.

Mr. SAMUELS. Well, then, we would rather see you spend the money through the program, through the budget process——

Senator KASSEBAUM. But they are out of money, through the moneys that they have to loan, and of course there is some question how equitable the distribution of that money is.

Mrs. VAN NAHMEN. That is absolutely right.

Mr. SAMUELS. That program, I think, provides that the Secretary of Agriculture is to make loans only if the farmer can show he needs it, and one of our concerns with the proposed credit is, every farmer would be entitled to the interest paid over 12 percent and under the ceiling, regardless of whether or not the farmer was prosperous.

Senator KASSEBAUM. Well, there is a limit, of course, as I say, a cap on the size of the loan. For many this is a very small amount of money, as a matter of fact, that is usually borrowed to meet the capital intensive needs at the time of spring planting or fall planting. If is a perennial credit need.

Mrs. VAN NAHMEN. Sometimes it is difficult for us to think in terms of thousands when we hear nothing but millions and billions,

and small farmers instead of huge farmers or large farmers, and I know that—I am a teacher, have been a professor in college, and I know the transition is difficult for us to make, to get ourselves down to the problem of the small farmer.

We have also heard from the administration and from the Secretary of Agriculture stressing the small farmer will not benefit, but this bill will do something for the small farmer, and I think we need to keep that in mind.

Senator BYRD. You mentioned millions and billions. I contend that one of the great problems we have is, so many of us in Congress don't know the difference between millions and billions. [General laughter.]

Senator KASSEBAUM. I would agree with you, Mr. Chairman. [General laughter.]

Mr. SAMUELS. Senator, speaking of millions and billions, this bill would cost millions, about $22 million for fiscal 1980, and $263 million for fiscal 1981. That is assuming it expired in 24 months, as Senator Kassebaum indicated, although it is not currently drafted to expire in 24 months.

Mrs. VAN NAHMEN. Mr. Chairman, may I rebuttal by saying that we have paid and paid and paid, and now we are in a position where we need a little help in the farming sector, and I think that after we have paid for these many, many years, we have finally come to you and said, the small farmer of this Nation needs a little bit of help, and I think that Senator Kassebaum has given us a way that we might have a little bit of that help, and I think that it would be great if the committee could see fit to finally listen to our plea some way.

Senator DOLE. Is that a net figure? If you didn't have credit, you would get a deduction.

Mr. SAMUELS. Well, yes, I think that is a net figure. In other words, if the interest were paid over 12 percent—yes, it takes into account the offset of the deduction. Yes.

Senator BYRD. Treasury raised a point that seems to me needs to be considered, whether, if this bill were to be enacted, could it be confined only to one group. Can we justify giving a tax credit to farmers for interest rates and not give it to other individuals?

Senator KASSEBAUM. I would agree, Mr. Chairman. It was a concern that I wrestled with. I mean, small business is hurting. Home builders are hurting, and while there are some other avenues there of assistance to them as well, basically, I think, as I said earlier, there seems to me to be a unique situation with the farmer. The farmer can't pass along any costs of production, and that is something that I think does differentiate that segment of the economy from some of the others that are suffering problems as well.

Plus, the Government policy that was initiated at the time of the embargo has caused dislocations in the market and is a consideration. I would agree it is a problem that we are going to have to deal with. To me, there is justification.

Senator BYRD. Thank you very much.

Senator DOLE. That is in line with the President's statement last December, when he imposed the embargo, that he would keep the farmer whole. I suggest that probably has not happened. That is one justification for singling out farmers, because they were singled

out last December to pay a special price to stop the Soviets, or whatever.

They made a sacrifice. The prices for wheat in Kinsley, Kans., are probably 40 to 50 cents lower now than they were before the embargo——

Mrs. VAN NAHMEN. Even more so.

Senator DOLE [continuing]. And the cost of money has doubled. I think the justification is in that area, that it is a special circumstance brought about by Government. Had the Government not interfered with the normal marketing process, the prices would be 50 to 60 cents higher. The farmer could have afforded to absorb the additional interest cost with everybody else in the country. He has been singled out for special treatment, and that is why Senator Kassebaum and others now seek this special treatment.

Senator BYRD. Maybe Mr. Samuels could discuss this with the President and get his endorsement. [General laughter.]

Senator DOLE. You are going to see the President this afternoon at the Rock Island signing. Maybe you could bring this up. [General laughter.]

Senator BYRD. Thank you, very much.

[The prepared statement of Mrs. Van Nahmen follows:]

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Testimony of Mildred VanNahmen
on S. 2503
Before Taxation and Debt Managment Subcommittee
of the Senate Finance Committee
May 30, 1980

I am Mildred VanNahmen of Kinsley, Kansas, a farm partner with my husband, Vernon. We are small farmers, with less than 500 acres in production, mainly wheat, and summer fallow 500 acres. We let these 500 acres lay idle, keeping them out of production and enabling us to do without fertilizer applications thus saving a small amount of energy for others who need it. We feel that having one-half of our farming land in production will eliminate the use of these items and will keep surplus production down.

Mr. Chairman, the confidence of the American farmer in the economic policies of this nation must inspire trust in the equity and viability of those policies, and this trust does not come from empty promises.

When President Carter announced his most recent anti-inflation program, he assured us that the farmer would get "special attention" for his "particular" need, and there was an inherent tendency to believe him. The "attention" turned out to be the highest interest rates this country has ever seen, precisely at spring planting time when farmers were borrowing money to stay in business. According to the news media prime interest rates have gone down. My neighbor went to his Dodge City, Kansas, bank yesterday and had to pay 16.5 percent ot renew his operating loan. (So what good does it do to lock the barn after the horse is stolen?)

In other words, although we welcome decreases in the prime rate, most farmers have already borrowed money at much higher rates in anticipation of spring planting and summer harvests.

Farming has become a highly capital intensive industry. By the beginning of fiscal year 1980, outstanding farm debt was estimated at an all-time high of $157 billion. This debt is expected to increase another $25 billion in 1981 and has more than tripled since 1970. This is not a result of imprudent fiscal practices by farmers. Farmers don't borrow because they want to, they borrow because they have to. Credit provides essential operating cash flow. Tight, costly credit in an industry such as agriculture can cause interruptions in this cash flow and results in economic disruptions for both producer and consumer.

Credit is particularly important when the cost-price squeeze on farmers is tight, as it is today. Fuel prices have increased 83 percent from 1979 to 1980, and fertilizer 35 percent. Due to the high cost of new equipment, we overhaul and use older machinery, but the cost of parts has increased 100 to 300 percent and more. Farmers are forced to pay these increased costs for parts and equipment. Since manufacturers will not make parts for older equipment, farmers must purchase new machinery to continue operating. Many farmers would be glad to use their old machines if they could get parts, but instead they must pay inflated costs for new equipment.

Grain prices have not kept pace with the inflating costs. We can say with certainty that this is due to the intervention in export markets and the Administration's ineffective grain embargo. When farm prices are depressed, the high cost of credit exacerbates the farmers economic troubles. It is estimated that a 2 percent increase in the interest rate decreases net farm income by 6 to 8 percent.

The latest USDA figure on cost of production of wheat is $4.63 a bushel. Compare that to the price we get in the Kinsley-Offerle, Kansas, area where we truck our wheat, at $3.21 a bushel and you can readily see the price-cost squeeze wheat farmers are in. Farmers are not in a position to pass increased costs on to consumers; they are price takers, not price makers.

The farmer needs an increased ability to repay, not to borrow. We hear the hue and cry concerning saving the small family farm and this cry must be heard. I believe this legislation, authorizing refundable tax credits for interest charges exceeding a 12 percent rate on agricultural operating loans, provides for assuring that the capital essential to continue farm operations will be made available. The $25,000 cap on the amount of loans to which the bill would apply makes this a modest approach that will particularly benefit the small farmer. This bill, gentlemen, will aid these small farmers who are so vital to this country's economy. We understand that in the reality of farm operating costs, this $25,000 limit is a small figure. It will be an aid to those younger farmers trying to get started in agriculture and it will help the older, small farmer to refrain from using their equity to stay in business.

Some concern will undoubtedly be expressed that the refundability of the tax credits will operate as a boon to inefficient farmers who are losing money. This is not the case. Many farmers now encountering difficulties have been successful operators for years. This bill would extend them the hope of resuming their productive farming. We are not interested in government subsidies and this bill avoids that approach. A farmer must still have the confidence of his banker to procure money for his operations. Under this proposal the government will not be doling out vast sums of money to support inefficient farmers. This bill will allow for easier repayment of loans through the use of tax credits. This bill is a definite step forward in farm legislation. The essential capital made available for continued farm operation is an excellent starting point.

Mildred VanNahmen

[Whereupon, at 12:30 p.m., the subcommittee was adjourned, subject to the call of the Chair.]

[By direction of the chairman the following communications were made a part of the hearing record:]

MAX BAUCUS
MONTANA

1107 DIRKSEN OFFICE BUILDING
WASHINGTON D.C. 20510
(202) 224-2651

MONTANA TOLL FREE NUMBER
1-800-332-6106

United States Senate
WASHINGTON, D.C. 20510

COMMITTEE ON FINANCE
CHAIRMAN, SUBCOMMITTEE ON THE OVERSIGHT OF THE INTERNAL REVENUE SERVICE

COMMITTEE ON JUDICIARY
CHAIRMAN, SUBCOMMITTEE ON LIMITATIONS ON CONTRACTED AND DELEGATED AUTHORITY

SELECT COMMITTEE ON SMALL BUSINESS

May 15, 1980

Honorable Harry F. Byrd, Jr.
417 Russell Senate Office Building
Washington, D.C. 20510

Dear Harry:

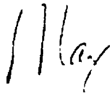
I am writing to ask that you add S. 2526 to the list of bills scheduled for a hearing by your Subcommittee on Taxation and Debt Management Generally on May 30, 1980.

S. 2526 is a bill I have introduced to amend the Internal Revenue Code to exclude from taxation interest on industrial development bonds which are used to provide financing for railroad transportation, including rolling stock. Thus, my bill is similar to S. 2486, which is already scheduled for consideration on May 30. The bills differ in that my bill extends the tax exemption to rolling stock, while Senator Culver's proposal does not. Because of the similarity, it would be appropriate to consider both bills during the same hearing.

I appreciate your consideration of this request.

With best personal regards, I am

Sincerely,



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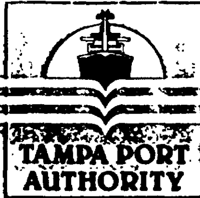
RECYCLED PAPER

TESTIMONY OF SENATOR RICHARD (DICK) STONE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE FINANCE COMMITTEE
MAY 30, 1980

I appreciate having this opportunity to submit testimony on my legislation, S. 2548, which will enable the Tampa Port Authority to use tax-exempt industrial development bonds to expand and improve the Port of Tampa. This legislation is the companion bill to legislation, H.R. 5847, introduced in the House of Representatives by Congressman Sam Gibbons.

The Port of Tampa is the nation's seventh largest port, with a net tonnage of 49,830,441 tons in 1979. Over half that tonnage consists of phosphate products. In order to handle these shipments in a more timely and efficient manner the Port Authority is seeking to acquire and expand an existing phosphate terminal for lease-back to a joint venture group, which includes the previous owner. The Port is prohibited by Treasury regulations from using tax-exempt industrial development bonds for this purpose because of the previous owner's inclusion in this joint venture company. My legislation would amend the substantial user rules for industrial development bonds used in this expansion by the Tampa Port. This expansion will produce substantial economic benefits for the state and local community, and will result in a revenue gain to the federal government through the elimination of demurrage charges and a tax gain on the increased business.

I would like to include for the hearing record a letter from the Tampa Port Authority outlining the need for this legislation. I would urge the Committee to take early action on this bill so that this much-needed expansion can get underway.




*Serving America's Eighth Largest Port*

March 25, 1980

The Honorable Richard "Dick" Stone
Senate Office Building
Washington, D. C. 20510

Dear Senator Stone:

Re: H.R. 5847 - Relating to the application of Section 103(b) of the Internal Revenue Code of 1954 to certain bonds for harbor improvements

As you may know, the Phosphate Industry has suffered greatly by virtue of the terminal capacity within the Tampa range not being able to meet the current-day demand for foreign and domestic shipments in a timely and efficient manner. Demurrage costs for ships waiting to be loaded are quite substantial and these are absorbed by the industry, resulting in higher prices being passed along to customers and consumers.

One very positive action to help solve this problem, as viewed by the Board of Commissioners of the Tampa Port Authority, is a project wherein the Authority will acquire and expand the capacity of an existing phosphate terminal for lease-back to a joint venture group. More specifically, the project envisions our acquisition of the Agrico Chemical Company's Big Bend terminal in the lower East Bay area of our port and the lease-back to a new company, one of whose owners will be Agrico.

The proposed legislation will enable the Authority to issue tax-exempt bonds whereas Agrico's inclusion in the joint venture company will, under an existing Treasury regulation, prohibit this endeavor. We believe this regulation to be inconsistent with the tax incentive contained in other sections of the Internal Revenue Code and seek to have it set aside for this project.

Over and above the major benefits to accrue through increased efficiency in movement of phosphate through the Port of Tampa, there are substantial corollary benefits. The Authority will net in the neighborhood of one half million

GEORGE B. HOWELL MARITIME CENTER
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dollars annually from the project which can support port improvements at no cost to taxpayers. Additionally, some 100 acres of waterfront property will pass to the Authority in the transaction and can be used to support further growth within the port.

Quite frankly, Senator, we are quite concerned that with the exceedingly high costs involved, this very important development in our port could rise or fall on the issue of tax-exempt financing. Because of this concern we request your assistance in bringing this legislation before the Senate. Specifically, we ask that you introduce a companion bill in the Senate to that introduced by Congressman Gibbons in the House, and that you urge Senator Byrd to take up the bill for hearing during the session, which I understand is set for April 24/25, 1980.

Our Authority staff and Mr. Hector Alcalde, whose firm represents the Authority in the matter, are at your service, should you require additional information. I understand that Hector has provided your office with specifics concerning the project and its benefits. For that reason I have held to generalities in this letter.

We are, as always, grateful for your support in developing the Port of Tampa into one of America's finest. We would be exceedingly grateful for your additional support in this matter.

With kindest regards, I am

Respectfully,

Ted DeLaVergne, Jr.
Chairman

TD:dcr

STATEMENT BY SENATOR LAWTON CHILES REGARDING
S. 2548 BEFORE THE SUBCOMMITTEE
ON TAXATION AND DEBT MANAGEMENT
Senator Harry F. Byrd, Jr., Chairman
May 30, 1980

Mr. Chairman, I thank you for allowing me the opportunity to voice my support for S. 2548 introduced by my colleague from Florida, Senator Stone. As you know, S. 2548 would permit the Tampa Port Authority to issue tax exempt revenue bonds to finance the acquisition and improvement of the Agrico Chemical Company's Big Bend phosphate terminal located in the port area. The Authority, which oversees the seventh largest port in the nation, is seeking to fulfill its obligation to Congress to expand and improve the port and acquisition of this facility would certainly be a major step in this direction.

The problem that S. 2548 addresses stems from the fact that the Authority's ability to issue revenue bonds in this situation is restricted by a provision in Treasury Regulation §1.103-8(a)(5). This provision states that the tax incentive in section 103 (b)(4) is not authorized if a lessee of a property to be acquired is a prior substantial user. This is particularily painful for the Authority because it would be precluded from acquiring property and then leasing it back to the prior owner, in this case Agrico Chemical Company. What S. 2548 seeks to do is allow the Authority to issue tax exempt bonds whether or not the previous owner of the acquired facility is a future co-tenant. I am concerned that if this legislation is not given favorable consideration the future growth and viability of the Port must be called into serious question.

While its been argued that the incentives provided by section 103(b)(4) were meant to apply only to new facilities, I question whether this is the case when applied to docks, wharves or related facilities. It's generally acknowledged that the most logical and cost effective means for a port to develop is through the acquisition of property and facilities adjacent to the port. In most cases, such acquisition only can occur when a lease-back agreement is reached with the original owner for a specified period of time. I think prior Congressional report language supports this and indicates that as long as proceeds from the bonds are used to provide the issuer with a dock, wharf or related facility, they are tax exempt. Whether or not a prior user utilizes the facility afterwards is immaterial.

In addition to its commitment to expand and improve the Port, the Authority seeks to acquire this terminal facility because of the substantial economic benefits it would provide everyone involved including the Federal government. The Authority would realize an immediate increase in revenues, phosphate capacity, reduced ship demurrage and would acquire some 100 acres of property for future development. The State of Florida would realize an immediate increase in revenues through sales and severance taxes and certainly many construction related jobs would be created. The Federal government would also benefit because of an improved trade balance, increased corporate tax revenues, decreased revenues losses associated with the investment tax credit and increased employment. On the whole, I think the economic benefits outweigh Treasury revenue losses.

In closing, I really do not believe that Congress intended to disallow the tax incentives contained in section 103(b)(4) for docks and wharves as they may relate to the acquisition of existing facilities that would substantially improve a port. To insure that the Tampa Port Authority will not be restricted in its efforts to carry out its Congressional obligations to improve its port, I would urge favorable consideration of S. 2548.

LAWTON CHILES
FLORIDA

COMMITTEES:
APPROPRIATIONS
BUDGET
GOVERNMENTAL AFFAIRS
SPECIAL COMMITTEE ON AGING
DEMOCRATIC STEERING COMMITTEE

United States Senate

June 25, 1980

The Honorable Russell B. Long
Chairman, Finance Committee
2227 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Russell:

I understand you'll be meeting with a group this afternoon to talk about S. 2548, a bill introduced by Senator Stone dealing with tax exempt financing for industrial development revenue bonds. As you know, the Subcommittee on Taxation and Debt Management held hearings on this bill May 30th and received a great deal of very positive testimony. I strongly support S. 2548 and want to underline the importance of this proposal to the future development of the Port of Tampa. I'm sure you can appreciate the significance of this bill to Tampa and Florida's economy and I would greatly appreciate your assistance toward its favorable consideration by the Finance Committee.

With warmest personal regards, I am

Sincerely,

LAWTON CHILES

LC/cdc

Statement Of

THE MAYTAG COMPANY

Newton, Iowa

To The

Subcommittee on Taxation and Debt Management

Of The

United States Senate Committee on Finance

In The Matter Of

S. 2486

"Railroad Rehabilitation Bonding Act of 1980"

May 30, 1980

The following statement is submitted on behalf of the Maytag Company of Newton, Iowa in support of S. 2486, the Railroad Rehabilitation Bonding Act introduced by Senator Culver on March 27, 1980, which would allow states to offer tax exempt industrial development bonds to repair and upgrade essential railroad main lines and branch lines.

Maytag is one of the largest manufacturers of laundry and kitchen appliances in the United States. Its plants in Newton, Iowa, have been served by the Rock Island Railroad for many years. The Rock Island was the only railroad serving Newton, Iowa and Maytag is one of the largest non-agricultural shippers located on the Rock Island system. The company has approximately 3,000 employees located in Newton, Iowa.

During the past two years, approximately 35% of Maytag's outbound shipping has been in boxcars and piggyback trailers with piggyback shipping being far greater than boxcar shipping. In addition to this usage of the Rock Island for outbound shipping, the company receives approximately 85% of its steel via the railroad. Additionally, it receives numerous other commodities and materials that go into the production of appliances or the operation of facilities. These would include fuel oil, propane, crude rubber, plastic granules, zinc, aluminum and many other items.

The temporary loss of the Rock Island rail service during a strike which began on August 28, 1979, had an immediate and adverse impact upon Maytag. The strike began in the midst of a traditionally heavy shipping period and shipping and receiving schedules were badly disrupted for several days while alternate methods of shipping products and receiving necessary materials were developed.

Motor carriers were utilized for handling of necessary inbound supplies and materials and their use was increased for handling outbound shipments of products. The company was forced to utilize the piggyback services of other railroads located in Des Moines, some 35 miles away. While these roads did provide a great measure of relief, it was much more expensive than shipping from the home facilities. The six-week strike against the Rock Island cost Maytag approximately $185,000 in additional freight charges.

A termination of rail service to Newton, Iowa, could quite conceivably result in a loss of sales for Maytag with a corresponding reduction in jobs if the increased cost of transportation reduced its ability to compete in the market place. Abandonment of the Rock Island lines in Iowa would be a severe economic blow to all shippers who have been served by the Rock Island and would certainly have a drastic impact on future industrial and agricultural development in the State of Iowa. Maytag supported the attempted merger between the Rock Island and Union Pacific Railroads many years ago and has long believed that both the company and Newton, Iowa need and are entitled to a strong railroad. The company's long range transportation needs would be severely impacted by the complete abandonment of a very much needed railroad in the Mid-West.

Under the Kansas City Terminal Railway Company, the directed service carrier, there was a marked improvement in the service provided by the railroad. Maytag believes that with adequate financing, capable management and the return of traffic to the rails which would result from improved service, the Rock Island Railroad's successor would become an important factor in the Middle West railroad structure. Indeed, Maytag's economic health is dependent upon strong and dependable rail service and the company will support the Rock Island's successor through continued heavy use of rail service.

The company is aware of interest by various other railroads in purchasing parts of the Rock Island. It has an earnest hope that through legislative action such as the recently passed Rock Island Railroad Transition and Employee Assistance Act (S. 2253) and Senator Culver's pending Railroad Rehabilitation Bonding Act (S. 2486), the so-called "Iowa Core" of the Rock Island will be preserved. We respectfully urge the Subcommittee to act favorably and expeditiously on this important legislation.

Thank you for the opportunity to present this statement.

United States Bankruptcy Court
CENTRAL DISTRICT OF CALIFORNIA
901 U. S. COURT HOUSE
LOS ANGELES, CALIFORNIA 90012

JAMES E. MORIARTY
BANKRUPTCY JUDGE

May 22, 1980

The Honorable Harry F. Byrd, Jr.
Chairman, Subcommittee on Taxation
and Debt Management
Senate Finance Committee
Room 2227
Dirksen Building
Washington, D. C. 20510

Dear Senator Byrd:

I have been advised that your subcommittee will be holding hearings on the proposed Bankruptcy Tax Act (H.R. 5043) next week.

I wish that I could be there to testify on this pending legislation, since I consider the tax problems relating to bankruptcy matters most important. Our workload under the new Bankruptcy Code has substantially increased, and I cannot at this time spare the time to come East.

There is a further reason why I would like to come East and that is that I am a native of Alexandria, Virginia; and such a trip would give me an opportunity to visit members of my family and friends. Since I cannot be with you at the hearings, I am submitting the following information which I hope will assist you and your committee:

I am a Bankruptcy Judge stationed in Los Angeles, which is within the Central District of California. I have served in this capacity for 17 years, and prior thereto I had 12 years of service with the Department of Justice both in Washington and in Los Angeles. The remarks I make are my own and do not necessarily represent the views of any other person or organization.

The filing of bankruptcy cases in the Central District of California exceed the filings in any other district in the Federal Judicial System. Filings for the first six months of Fiscal Year 1980 show a 50 percent increase. If this trend continues, the filings for this year will exceed 22,000 in this district.

Our bankruptcy courts have in the past received a substantial number of cases filed under Chapter X, XI, and XII of the Bankruptcy Act. Under the new Bankruptcy Code, we anticipate that debtors will use Chapter 11 to accomplish a reorganization or rehabilitation from their financial problems. During my 17 years as a Bankruptcy Referee/Judge I have handled a number of large corporate reorganization cases, notably Equity Funding Corporation of America and Daylin, Inc., which were highly successful in their reorganization efforts.

The Equity Funding case was the largest fraud case ever filed in our bankruptcy courts. The reorganized debtor taking the new name of Orion Capital Corporation has been most successful and has been the subject of several take-over attempts. While I am not a tax expert, I do have some understanding of the impact of the tax statutes on bankruptcy proceedings and how they may affect the reorganization of a debtor.

When I first received a copy of H.R. 5043, which was the Committee print of November 7, 1979, I called a member of the Ways and Means Committee, James C. Corman, a friend of mine for many years, and expressed my concern that if the bill were enacted into law in its then language, it may very well defeat the whole purpose of Chapter 11 of the Bankruptcy Code, commonly referred to as the Bankruptcy Reform Act of 1978. In all my years of service with the Bankruptcy Court, I can recall only one case in which the debtor was able to fund its Plan of Reorganization from profits derived during the time the debtor was operating under the jurisdiction of the Bankruptcy Court.

That debtor, Guidance Technology, Inc., experienced serious financial problems due primarily to poor management. G.T.I. manufactured the Sommers gyroscope. Practically all of their income was derived from contracts with the Department of Defense.

When G.T.I. was unable to bid on government contracts, other manufacturers of this type of military hardware doubled the price of this item at great cost to the government. When we were able to straighten out some of the operational problems and G.T.I. was again able to bid on government contracts, the price of this item was reduced to the cost paid prior to the filing of the debtor's petition by G.T.I.

In all other cases, it has been necessary for the debtor to bring in outside capital in which to fund the Plan. This new capital is either raised by persons investing in the reconstituted debtor or the debtor is forced to negotiate and obtain substantial loans to be paid off from future profits.

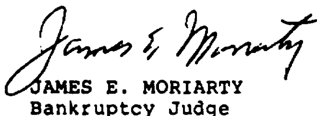
One of the selling points that a debtor in a reorganization has in obtaining new capital is that there is generally a tax loss carried forward which in many cases wipes out many tax obligations that the debtor would normally be liable for several years to come after the reorganization had been approved by the Bankruptcy Court. While the final version of H.R. 5043 as passed by the House did make some minor adjustments in the treatment of net operating loss carried forward, I am still concerned about the adverse effect the bill now before your committee will have on the rehabilitation of debtors under Chapter 11 of the Bankruptcy Code.

Looking at the problem from a very objective standpoint, there is no doubt that the recognition of the tax credit was in any way a subsidization of the debtor's business by tax revenues of the federal government, but when you consider the benefits to be derived from a reconstituted and ongoing business in a given community, the end results far outweigh the tax relief given by the government. Many businesses and jobs are saved; the business if it flourishes helps stabilize the economy in a given community; and its effect of its future success is far reaching.

I am sure that your committee will receive testimony from persons who are highly qualified in tax and bankruptcy matters and such testimony or submitted statement will enable your committee to report this pending legislation to the full Senate Finance Committee at an early date.

If I can be of any further assistance to you or the subcommittee, please let me know. Copies of this letter are forwarded to Michael Stern, Esquire, counsel to the Senate Finance Committee, for appropriate distribution.

Sincerely yours,



JAMES E. MORIARTY
Bankruptcy Judge

/hj

cc: Michael Stern, Esquire

National Railroad Passenger Corporation, 400 North Capitol Street, N.W., Washington, D.C. 20001 Telephone (202) 383-3000

May 29, 1980

The Honorable Harry F. Byrd, Jr.
Chairman
Senate Subcommittee on Taxation
and Debt Management
Senate Finance Committee
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Byrd:

It is my understanding that the Senate Finance Subcommittee on Taxation and Debt Management will hold hearings on miscellaneous tax bills on May 30, 1980. Of particular interest to Amtrak are S. 2486, the Railroad Rehabilitation Bonding Act of 1980, introduced by Senator Culver and S. 2526 introduced by Senator Baucus. Both bills would enable states to issue Federal tax-exempt industrial development bonds for the express purpose of financing railroad rehabilitation. Senator Baucus' bill would also allow such funds to be used for railroad facilities, including rolling stock.

I wish to take this opportunity to comment on the pending legislation and to commend the Subcommittee's efforts in exploring new avenues of financing railroad rehabilitation. As Senator Culver noted in his floor statement introducing S. 2486, the United States is approaching a critical shortage of capital funds for maintenance of tracks and equipment. Amtrak's and the Federal Government's efforts to upgrade the Northeast Corridor tracks have been costly. However, the benefit with regard to accessible and energy efficient transportation to the Northeastern states is vast, affecting every aspect of the economy of the Northeast.

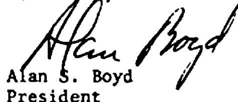
Outside the Northeast Corridor, Amtrak operates a majority of its routes over tracks of other railroads and is dependent upon these railroads to maintain their tracks at a level which allows for safe and efficient rail passenger use. It has been Amtrak's experience through our 403(b) state-supported train service that many States are interested in providing their citizens with rail passenger service and are willing to share the costs involved with that service. Amtrak currently operates 17 jointly funded routes with several more states expressing interest in the service.

AN EQUAL OPPORTUNITY EMPLOYER

Recently passed legislation provides $38 million for marketing and design work on 13 designated corridors between major metropolitan areas. If further investment is found to be cost effective, Amtrak would, within the next few years, begin operating increased daily frequencies on these routes at higher speeds. Track upgrading would be necessary on most of these corridors requiring federal funding. As provided for in the Culver and Baucus bills, the corridor States could help raise the funds needed to upgrade the tracks by issuing the tax-exempt industrial development bond. The issuing of such bonds would help reduce the cost to the Federal Government. This approach would be useful elsewhere on Amtrak's route system.

During this time of budget constraints, Amtrak is exploring every aveneue to help reduce the direct cost of rail passenger service to the Federal Government. I applaud Senators Culver's and Baucus' efforts to find new ways to finance railroad rehabilitation and hope the Subcommittee will give the legislation careful consideration.

Sincerely,



Alan S. Boyd
President

THE UNIVERSITY OF MICHIGAN
**LAW SCHOOL**
Hutchins Hall
Ann Arbor, Michigan 48109

FRANK R. KENNEDY
*Thomas M. Cooley Professor of Law*

May 28, 1980

Michael Stern, Esq.
Staff Director
Senate Finance Committee
2227 Dirkson Senate Office Building
Washington, D.C. 20510

Dear Mr. Stern:

It is my understanding that the Senate Finance Committee has scheduled hearings on the Bankruptcy Tax Act of 1980, H.R. 5043, for May 30, 1980. I am unable to appear at the hearing, but I should like to take this means of communicating through you to the Committee my opposition to provisions in H.R. 5043 that injuriously restrict the availability of net operating loss carryovers for debtors under Chapter 11 of Title 11 of the United States Code.

The Commission on Bankruptcy Laws of the United States, for which I served as Executive Director, recommended in its report (House Doc. No. 93-137, Part I, 93d Cong., 1st Sess. 284-86 (1977)) that restrictions on the availability of net loss carryovers should not be permitted to impede or frustrate reorganizations by reason of the arbitrary operation of the Internal Revenue Code respecting reorganizations under the bankruptcy laws. As one deeply involved in the Commission's study and a long-time student of the relationship between the tax laws and the bankruptcy laws, I am anxious to support efforts to preserve the net operating loss in corporate reorganizations under the bankruptcy laws and in out-of-court workouts. The reason for according protection to the NOL for enterprises reorganized out of court as well as under the bankruptcy laws is that limiting the tax benefit to businesses reorganized under Chapter 11 will needlessly force many reorganizations into the bankruptcy court that could be effected out of court. When the interested parties—creditors and equity security holders—are agreeable to a plan of reorganization, there is no sound policy reason why the reorganization should be routed through the bankruptcy court to obtain tax benefits; on the contrary, processing a reorganization in the bankruptcy courts entails

administrative costs to the government well as to the creditors and equity security holders. When these interested parties are able to reconcile their differences without going to court, the social and economic benefits of reorganization are attainable without the costs and delays incident to reorganization under the aegis of the court. The important point, however, is to remove the impediment of restriction on the availability of net operating loss carryovers to debtors reorganized under Chapter 11.

The proposal in H.R. 5043 to require a net operating loss of the debtor to be reduced to the extent that indebtedness of an insolvent taxpayer is discharged in an out-of-court workout or a bankruptcy reorganization will sound the death knell of many potential reorganizations. While not every business entity deserves to be reorganized and continued in existence, it is unsound fiscal and economic policy to limit the opportunity for economic survival to those that can get along without the net operating loss carryover.

The consequences to the United States Treasury of passage of H.R. 5043 afford no justification for its enactment. Allowance of the net operating loss carryover will encourage creditors to maintain their investment and to extend new credit to businesses in the process of reorganization. Reorganization, of course, means that jobs and resources will remain in place. When businesses are liquidated, creditors take bad debt deductions, with adverse effects on taxable revenues. This is no time to discourage business rehabilitation by diminishing the availability of net loss carryovers in reorganizations where that carryover is crucial to the continuity of the enterprise, as it is in a very substantial percentage of cases.

It would indeed be regrettable if after the notable progress in bankruptcy reform achieved in Public Law No. 95-598 should now be impaired by the retrogressive step proposed to be taken in H.R. 5043. I urge the Senate Finance Committee to approve an amendment of H.R. 5043 that will eliminate the deleterious provisions in respect to net operating loss carryovers.

Sincerely yours,

Frank R. Kennedy

FRK/ajd

May 28, 1980

Honorable Harry F. Byrd, Jr., Chairman
Subcommittee on Taxation and Debt Management
Senate Committee on Finance
2227 Dirksen Senate Office Building
Washington, D. C. 20510

Attention: Michael Stern, Staff Director

Dear Senator Byrd:

On behalf of National Farmers Union, we respectfully request that this letter be made a part of the record of hearings set for Friday, May 30, on miscellaneous tax bills. I also would appreciate very much if the attached statement dealing in general terms with high interest rates, which was recently presented at a hearing before the Senate Agriculture Committee, would also be made a part of the hearings.

We note that one of the bills before the Subcommittee is S. 2503 introduced by Senator Nancy Kassebaum. This bill would provide for a refund and tax credit for farmers on loans up to $25,000, and would provide a 12 percent limit on such loans, with a repayment period limited to 12 months.

As the chief sponsor pointed out in her "Dear Colleague" letter, the intent of the bill is to stabilize operating loan rates at no more than 12 percent. The sponsor also pointed out that this legislation is intended to establish a concept of helping the agricultural sector deal with excessively high rates of interest which they are unable to recoup by passing increased costs to those with whom they do business.

Again, we would appreciate it very much if you would make this letter and the accompanying general statement on interest rates in agriculture a part of the record of the hearing.

Sincerely,

Reuben L. Johnson
Director of Legislative Services

RLJ:bg
Attachment

cc: Senator Nancy Kassebaum
Lee Kimball, Deputy Press Secretary
Ron Wilson, Legislative Assistant

Suite 600, 1012 14th Street, N.W., Washington, D.C. 20005 — Phone (202) 628-9774

STATEMENT OF

REUBEN L. JOHNSON
DIRECTOR OF LEGISLATIVE SERVICES
NATIONAL FARMERS UNION

PRESENTED TO

THE AGRICULTURAL CREDIT AND RURAL ELECTRIFICATION
SUBCOMMITTEE

OF THE

SENATE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY
WASHINGTON D. C.

Relative to the Effect of Current Interest Rates
on American Agriculture

December 18, 1979

Mr. Chairman, I want to commend you very highly for conducting these hearings upon the impact of current federal money and credit policies upon American farmers.

Early in 1977 -- about two-and-a-half years ago -- the prime interest rate was at 6.25 percent. The prime rate, which is the pace-setter for interest rates generally, advanced to 11.75 percent by the opening of this year and since June, we have seen an interest rate explosion which has driven the prime rate nearly to 16 percent.

In opening, we just want to observe that these record interest rates, coming at a time when farm debt was also ballooning to record levels, has extracted a fearful price from farmers. We maintain that had the basic interest rate remained in the neighborhood of 6 to 7 percent, the net income of U. S. farmers would have been substantially higher than it was in 1978 and this year.

According to our calculations, about $5 billion in income has been diverted from the income side to the cost side of farm balance sheets due to the impact of the higher interest rates.

In our formal statement, which we trust that you will place in the record of this hearing, we attempt a general overview of the money and credit crisis.

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However, we recognize that, important as these overall statistics and trends may be, there is always the possibility that we may lose sight of the human element -- the farmers and the farm wives and family members and the manner in which they feel the effects of the debt burden and the high interest rates.

We therefore want to devote some of our presentation to a look at conditions as they are reported to us by our state Farmers Union organizations and by individual farm families attempting to cope with the interest rate situation.

We call your attention to the dimensions of the credit crisis in ATTACHMENT "A."

On next January 1, just two weeks away, the outstanding debt of U. S. farmers will be $157 billion -- that is almost twice what it was in 1975, and six times what it was in 1960.

During 1978, farm debt increased by $18.2 billion, this year it is increasing by $20 billion, and next year it is projected to increase by almost $25 billion.

In ATTACHMENT "B," we show the annual average prime rate for the past 30 years together with the monthly figures for the past four years.

The prime rate is now almost 8 times higher than it was in 1949, and about 2.5 times what it was early in 1977.

In ATTACHMENT "C," we show the interest outlays by farmers over the past 20 years, from a grand total of $1,269 million in 1960, to a projected $14 billion for 1980. That is more than a ten-fold increase from 1960, and a doubling in just four years.

It is sometimes maintained that the changes in interest rates do not make themselves immediately felt. The interest rates in some mortgages and many promissory notes are fixed and so the new rates do not become an immediate problem. However, that assumption can be misleading.

If you will refer to ATTACHMENT "D," we show that only about 36 percent of real estate debt and only 12 percent of short-term debt is not immediately affected by interest rates changes.

About 31 percent of the outstanding real estate debt each year is new borrowing -- so that will be affected by the new rates. The Federal Land Bank system, which accounts for one-third of the real estate lending, is now largely on a variable interest rate basis. The rates float according to prevailing market conditions and so these loans are affected soon, if not immediately, by the new rates.

On the short-term loan side, almost all of the debt on many farms is rotated every year. It is paid off and new loans are drawn. There are some loans, for example, on farm machinery purchases, which may run three to five years in duration. But, as best as we can calculate, these longer-term "short-term" loans make up only about one-eighth of the non-real estate debt burden.

In ATTACHMENT "E," we show the farm debt-to-asset ratio over the past forty years.

While the ratio looks modest-- about one dollar of debt for each six dollars of assets -- the figure is still on the high side.

The January 1, 1979, ratio of 16.8 was equal to the 1970 and 1972 ratios, which were the most unfavorable since 1941.

A more meaningful measurement is the rate of substitution of credit for income which we show in ATTACHMENT "F" relating to the cash sources of funds of farm operators.

What this shows is that farm operations are not generating internal capital as they have or as they should, but instead are increasingly dependent on borrowed funds for cash operating money.

In 1970, new loans -- or the net increase in loans -- represented only 5 percent of the cash sources of funds of farmers.

By 1975, this figure had risen to 12 percent, and in 1978 and 1979 it has amounted to more than 17 percent. Projections are that farmers in 1980 will have to look to borrowed money for 21 percent of their cash sources of operating funds.

In ATTACHMENT "G," we look at several measures of the ability of farmers to handle their debt burden.

The first of these is the U. S. parity ratio -- currently at 68 percent of parity -- what it means is that farmers are able to pass through only 68 percent of their operating costs (including interest) in the price of their products.

The second item shows the per capita income of farmers from farming compared to the per capita income on non-farmers. The ratio of 42 percent is not a good omen of the viability of farming as an economic enterprise.

In the third item, we show the return to farm equity compared to the rates of profits in selected manufacturing industries. Again the 3.6 percent farm rate does not compare well with the 24 percent rate in all manufacturing enterprises.

It is sometimes contended that the growth of farm debt and the high interest rates are offset by the spectacular growth of the value of farm assets.

However, item four is worth some study. It shows that in the past five years, if you take inflation out of it, farm real estate values have actually declined.

Now, of course, the higher land values do make it possible to incur larger debts.

But what it does is increase farmers' ability to borrow, without increasing their ability to repay.

Repayment depends on income -- and we should never lose sight of that.

In closing, let us observe that the Nation's farmers are also affected by what high interest rates do to the remainder of the national economy. Obviously, the higher interest rates are diverting consumer purchasing power which could be used for food, for housing, for automobiles and other manufactured goods.

Should anyone be surprised that the housing construction industry is ailing with housing mortgages at interest rates of 14, 15 percent, and more?

Should anyone be surprised that American cars are not selling with car finance costs where they now are?

You have all been told many times that these tight-money, high-interest rate policies are justified on the basis that they will reverse inflationary pressures and save the value of the dollar.

Perhaps farmers would be willing to go through the wringer, workers to be unemployed, and other citizens to forego purchases of a house, a car, or other major item, and our whole society to accept a lower standard of living, if it achieved anything in the war on inflation.

But that policy is not succeeding -- it never has without precipitating depression -- and it probably never will.

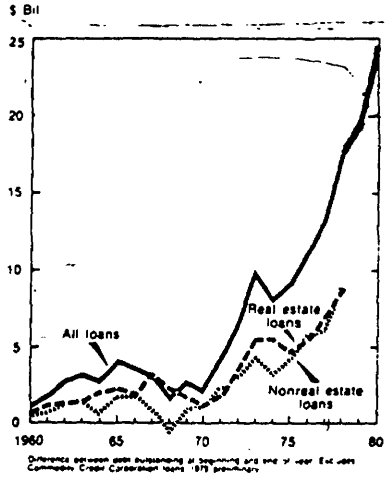
A better remedy is available -- better for the national economy and the American people than the severe hardships now being endured for no effective purpose. That would be to use the authority on the federal statute books in the Emergency Credit Control Act of 1969. Under that law, the President has power to limit credit use, to prescribe interest rates and credit terms and, if needed, to allocate credit to productive uses. We believe it would be preferable for him to use those powers, severe as they are, than to continue in the present policies.

ATTACHMENT "A"

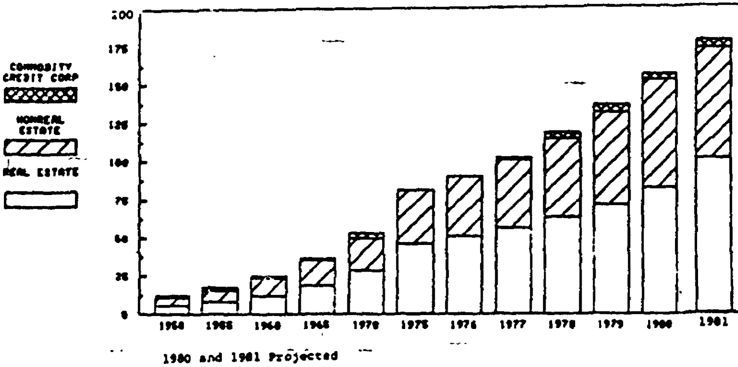
OUSTANDING FARM DEBT, ANNUAL CHANGE IN DEBT AND THE COMPOSITION OF FARM DEBT

Outstanding Farm Debt
As of January 1

| Year | Debt.in Bil. $ | Increase in Bil. $ | Increase in % |
|---|---|---|---|
| 1960 | 24.8 | | — |
| 1970 | 53.0 | 28.2 | 113.0% |
| 1971 | 54.5 | 1.5 | 2.8% |
| 1972 | 59.1 | 4.6 | 8.4% |
| 1973 | 65.3 | 6.2 | 10.4% |
| 1974 | 74.1 | 8.8 | 13.4% |
| 1975 | 81.8 | 7.7 | 10.3% |
| 1976 | 90.8 | 9.0 | 11.0% |
| 1977 | 102.7 | 12.1 | 13.3% |
| 1978 | 119.3 | 16.6 | 16.1% |
| 1979 | 137.5 | 18.2 | 15.2% |
| 1980 | 157.8 | 20.3 | 14.8% |
| 1981 | 182.4 | 24.6 | 15.5% |




REAL ESTATE, NON-REAL ESTATE AND OTHER FARM DEBT




1980 and 1981 Projected

ATTACHMENT "B"

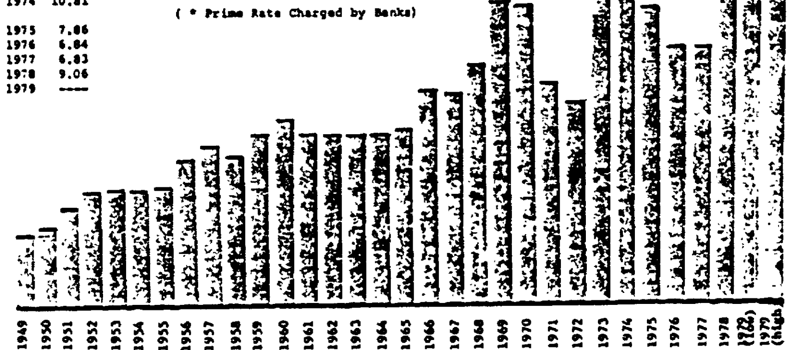
## THE PRIME INTEREST RATE --- NOW ALMOST 8 TIMES HIGHER THAN IN 1949

| Year | Prime Rate * |
|---|---|
| 1949 | 2.00 |
| 1950 | 2.07 |
| 1951 | 2.56 |
| 1952 | 3.00 |
| 1953 | 3.17 |
| 1954 | 3.05 |
| 1955 | 3.16 |
| 1956 | 3.77 |
| 1957 | 4.20 |
| 1958 | 3.83 |
| 1959 | 4.48 |
| 1960 | 4.82 |
| 1961 | 4.50 |
| 1962 | 4.50 |
| 1963 | 4.50 |
| 1964 | 4.50 |
| 1965 | 4.54 |
| 1966 | 5.63 |
| 1967 | 5.61 |
| 1968 | 6.30 |
| 1969 | 7.96 |
| 1970 | 7.91 |
| 1971 | 5.72 |
| 1972 | 5.25 |
| 1973 | 8.03 |
| 1974 | 10.81 |
| 1975 | 7.86 |
| 1976 | 6.84 |
| 1977 | 6.83 |
| 1978 | 9.06 |
| 1979 | ---- |

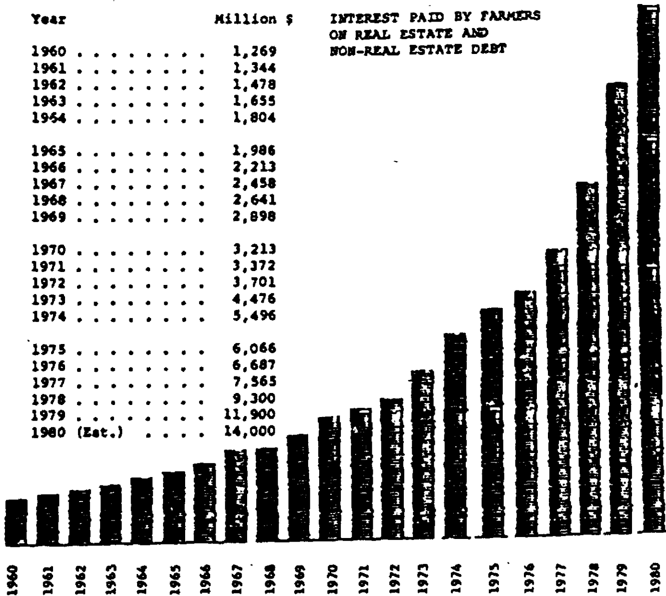
| Year & Month | Prime Rate |
|---|---|
| 1976 | |
| Jan. | 7¼ - 6 3/4 |
| Feb. | 6 3/4 |
| Mar. | 6 3/4 |
| Apr. | 6 3/4 |
| May | 6 3/4 |
| June | 7 - 7¼ |
| July | 7¼ |
| Aug. | 7¼ - 7 |
| Sept. | 7 |
| Oct. | 7 - 6 3/4 |
| Nov. | 6½ |
| Dec. | 6½ - 6¼ |
| 1977 | |
| Jan. | 6¼ |
| Feb. | 6¼ |
| Mar. | 6¼ |
| Apr. | 6¼ |
| May | 6¼ - 6 3/4 |
| June | 6 3/4 |
| July | 6 3/4 |
| Aug. | 6 3/4 - 7 |
| Sept. | 7 - 7¼ |
| Oct. | 7¼ - 7 3/4 |
| Nov. | 7 3/4 |
| Dec. | 7 3/4 |

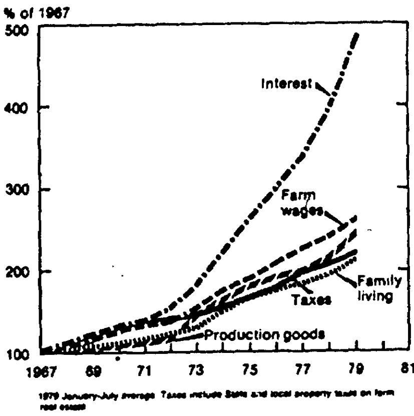
| Year & Month | Prime Rate |
|---|---|
| 1978 | |
| Jan. | 7 3/4 - 8 |
| Feb. | 8 |
| Mar. | 8 |
| Apr. | 8 |
| May | 8 - 8¼ |
| June | 8¼ - 9 |
| July | 9 |
| Aug. | 9 - 9¼ |
| Sept. | 9¼ - 9 3/4 |
| Oct. | 9 3/4 - 10¼ |
| Nov. | 10¼ - 11¼ |
| Dec. | 11¼ - 11 3/4 |
| 1979 | |
| Jan. | 11 3/4 |
| Feb. | 11 3/4 |
| Mar. | 11 3/4 |
| Apr. | 11 3/4 |
| May | 11 3/4 |
| June | 11 3/4 - 11½ |
| July | 11½ - 11 3/4 |
| Aug. | 11 3/4 - 12¼ |
| Sept. | 12¼ - 13¼ |
| Oct. | 13¼ - 15 |
| Nov. | 15 - 15 3/4 |

( * Prime Rate Charged by Banks)



ATTACHMENT "C"




1979 January-July average. Taxes include State and local property taxes on farm real estate

FARM INTEREST OUTLAYS

UP 5 TIMES SINCE 1967

UP 11 TIMES OVER 1960

*Prices Farmers Pay*

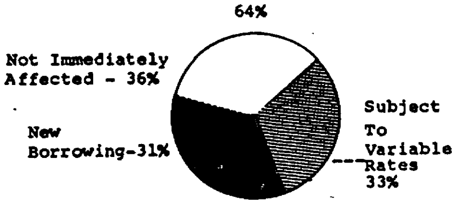
| | 1975 | 1976 | 1977 | 1978 | 1979[1] |
|---|---|---|---|---|---|
| | *Percentage of 1967* | | | | |
| Production | 182 | 193 | 200 | 216 | 240 |
| Interest[2] | 262 | 299 | 339 | 396 | 487 |
| Taxes[3] | 166 | 178 | 196 | 207 | 221 |
| Farm wage rates | 192 | 210 | 226 | 242 | 262 |

[1] January-May average. [2] Interest on farm real estate debt.
[3] Taxes on farm real estate.

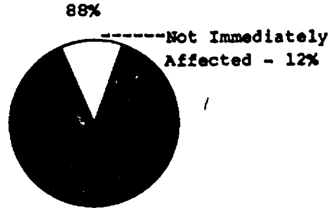
ATTACHMENT "D"

ESTIMATED SHARE OF FARM DEBT BURDEN EXPOSED TO CHANGES IN EFFECTIVE INTEREST RATES

REAL ESTATE DEBT




NON-REAL ESTATE DEBT




ATTACHMENT "E"

FARM DEBT TO ASSET RATIO
1940 - 1979

| Year | % | Year | % | Year | % | Year | % |
|---|---|---|---|---|---|---|---|
| 1940 | 18.9 | 1950 | 9.3 | 1960 | 11.8 | 1970 | 16.8 |
| 1941 | 19.1 | 1951 | 8.5 | 1961 | 12.4 | 1971 | 16.7 |
| 1942 | 16.6 | 1952 | 8.6 | 1962 | 13.0 | 1972 | 16.8 |
| 1943 | 13.4 | 1953 | 9.6 | 1963 | 13.8 | 1973 | 16.6 |
| 1944 | 10.6 | 1954 | 10.3 | 1964 | 14.6 | 1974 | 15.5 |
| 1945 | 8.9 | 1955 | 10.5 | 1965 | 15.1 | 1975 | 15.8 |
| 1946 | 7.6 | 1956 | 10.8 | 1966 | 15.6 | 1976 | 15.7 |
| 1947 | 7.2 | 1957 | 10.6 | 1967 | 16.0 | 1977 | 15.7 |
| 1948 | 7.2 | 1958 | 10.7 | 1968 | 16.5 | 1978 | 16.7 |
| 1949 | 8.4 | 1959 | 11.3 | 1969 | 16.7 | 1979 | 16.8 |

ATTACHMENT "F"

INCREASE IN BORROWING BY FARMERS AS SOURCE OF CASH FUNDS

Cash Sources and Uses of Funds in the Farm Sector 1970-1979

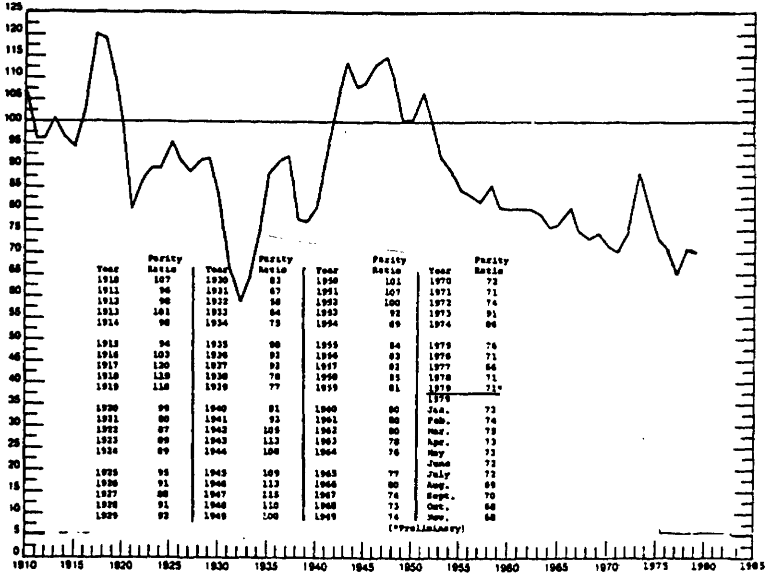
| Items | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 |
|---|---|---|---|---|---|---|---|---|---|---|
| Cash Sources of Funds: | Billion dollars | | | | | | | | | |
| 1 Net cash income from farm and nonfarm sources | 37.9 | 39.7 | 48.2 | 66.8 | 63.4 | 60.8 | 64.8 | 64.5 | 79.1 | 96.8 |
| 2 Net flow of real estate loans | 1.0 | 1.7 | 3.2 | 4.9 | 4.5 | 4.3 | 4.9 | 6.3 | 7.7 | 9.6 |
| 3 Net flow of nonreal estate loans | 1.1 | 2.4 | 3.2 | 4.3 | 3.1 | 4.2 | 5.7 | 6.0 | 8.9 | 10.2 |
| 4 Total cash sources of funds | 40.0 | 43.8 | 54.6 | 76.0 | 71.0 | 69.3 | 75.4 | 76.8 | 95.7 | 116.6 |
| Proportion of Cash Funds Obtained by Borrowing (%) | 5.2 | 9.3 | 11.7 | 12.1 | 10.7 | 12.2 | 14.0 | 16.0 | 17.3 | 17.0 |

ATTACHMENT "G"

## MEASURES OF ABILITY TO REPAY FARM INDEBTEDNESS

### Item I

U.S. FARM PARITY RATIO




| Year | Parity Ratio | Year | Parity Ratio | Year | Parity Ratio | Year | Parity Ratio |
|---|---|---|---|---|---|---|---|
| 1910 | 107 | 1930 | 83 | 1950 | 101 | 1970 | 72 |
| 1911 | 96 | 1931 | 67 | 1951 | 107 | 1971 | 71 |
| 1912 | 98 | 1932 | 58 | 1952 | 100 | 1972 | 74 |
| 1913 | 101 | 1933 | 64 | 1953 | 92 | 1973 | 91 |
| 1914 | 98 | 1934 | 75 | 1954 | 89 | 1974 | 86 |
| 1915 | 94 | 1935 | 88 | 1955 | 84 | 1975 | 76 |
| 1916 | 103 | 1936 | 92 | 1956 | 83 | 1976 | 71 |
| 1917 | 120 | 1937 | 93 | 1957 | 82 | 1977 | 66 |
| 1918 | 119 | 1938 | 78 | 1958 | 85 | 1978 | 71 |
| 1919 | 110 | 1939 | 77 | 1959 | 81 | 1979 | 71* |
| | | | | | | 1979 | |
| 1920 | 99 | 1940 | 81 | 1960 | 80 | Jan. | 73 |
| 1921 | 80 | 1941 | 93 | 1961 | 80 | Feb. | 74 |
| 1922 | 87 | 1942 | 105 | 1962 | 80 | Mar. | 75 |
| 1923 | 89 | 1943 | 113 | 1963 | 78 | Apr. | 73 |
| 1924 | 89 | 1944 | 108 | 1964 | 76 | May | 73 |
| | | | | | | June | 72 |
| 1925 | 95 | 1945 | 109 | 1965 | 77 | July | 72 |
| 1926 | 91 | 1946 | 113 | 1966 | 80 | Aug. | 69 |
| 1927 | 88 | 1947 | 115 | 1967 | 74 | Sept. | 70 |
| 1928 | 91 | 1948 | 110 | 1968 | 73 | Oct. | 68 |
| 1929 | 92 | 1949 | 100 | 1969 | 74 | Nov. | 68 |

(*Preliminary)

### Item II

COMPARISON OF PER CAPITA INCOME OF FARMERS FROM FARMING

WITH PER CAPITA INCOME OF NON-FARMERS

1978

Farmers From Farming — $2,830.

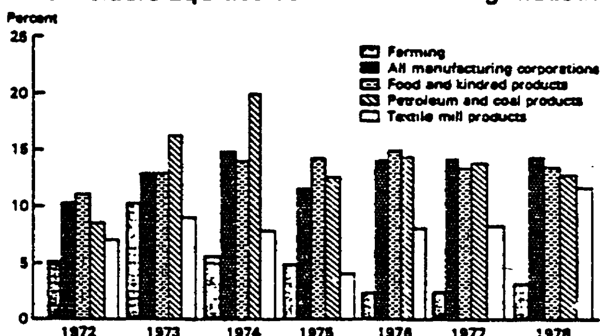
Non-Farmers From All Sources — $6,665

Per Capita Income of Farmers from Farming as a % of Non-farm .... 42%

ATTACHMENT "G" (Continued) MEASURES OF ABILITY TO REPAY

Item III

## Return to Farm Equities and Annual Rates of Profits on Stockholders Equities for Manufacturing Industries




RETURN TO FARM EQUITIES AND ANNUAL RATES OF PROFITS ON STOCKHOLDERS' EQUITIES FOR MANUFACTURING INDUSTRIES, BEFORE INCOME TAXES

[Percentage]

| Year | Farming — Current value | All manufacturers | Food and kindred products | Petroleum and coal products | Textile mill products |
|---|---|---|---|---|---|
| 1972 | 5.3 | 18.4 | 20.2 | 11.0 | 13.8 |
| 1973 | 10.6 | 21.8 | 22.8 | 14.9 | 16.5 |
| 1974 | 5.9 | 23.0 | 23.8 | 25.8 | 15.4 |
| 1975 | 4.9 | 18.8 | 24.6 | 17.8 | 9.0 |
| 1976 | 2.6 | 22.7 | 24.9 | 20.3 | 15.1 |
| 1977 | 2.5 | 23.2 | 22.0 | 19.9 | 16.4 |
| 1978 | 1.6 | 24.0 | 22.2 | 19.0 | 21.6 |

Item IV

## VALUE OF FARM ASSETS IN 1967 DOLLARS 1975-1979 (Jan. 1)

| | 1975 | 1976 | 1977 | 1978 | 1979 |
|---|---|---|---|---|---|
| | *Billion dollars* | | | | |
| Physical assets: | | | | | |
| Real estate | 197.7 | 197.4 | 197.3 | 197.2 | 197.2 |
| Nonreal estate: | | | | | |
| Livestock[1] | 22.2 | 21.4 | 20.8 | 19.9 | 19.2 |
| Machinery and motor vehicles | 30.9 | 30.9 | 31.1 | 31.1 | 31.0 |
| Crops stored on and off farms[3] | 9.6 | 11.5 | 11.4 | 14.5 | 15.5 |
| Household equipment and furnishings | 9.9 | 9.5 | 9.8 | 10.9 | 12.0 |
| Financial assets: | | | | | |
| Deposits and currency | 8.6 | 8.3 | 8.0 | 7.8 | 7.2 |
| U.S. savings bonds | 2.5 | 2.3 | 2.2 | 2.1 | 2.1 |
| Investments in cooperatives | 6.9 | 7.0 | 7.2 | 7.4 | 7.3 |
| Total | 288.3 | 288.3 | 287.8 | 290.9 | 291.5 |

## COMMENTS FROM FARMERS UNION STATE OFFICES

HAROLD DODD, PRESIDENT OF ILLINOIS FARMERS UNION, informs us that interest rates in the mid-Illinois area for operating loans are at 14.5 percent for loans running six to nine months (some running for a year).

Regarding real estate loans, practically no one is making loans except the Federal Land Bank. Their rate is 9.75 percent. Five percent of the loan must be placed in stock, with nothing back in return on that stock. The 5 percent required in stock amounts to approximately three-quarters of a percent added to 9.75 interest. Dodd thinks interest rates in metropolitan areas like Chicago or St. Louis would be more than that.

Dodd notes that agriculture has traditionally looked to the Federal Credit agencies to provide the lowest and most reasonable rates. However, these agencies do have to secure their loan funds through the private money market which means that it is very difficult for them to provide farmers with substantially lower interest rates.

* * *

DONNA COOTWARE, PRESIDENT OF MICHIGAN FARMERS UNION, reports that her local banker estimates that average operating loans in Michigan are now running at 15 percent. Real estate loans are a little lower -- approximately 13 percent. Typical operating loan in Michigan is short term, not necessarily annual. High interest rates are eating up much working capital.

Comparing with about 15 years ago, farmers are becoming more and more dependent on loans.

* * *

BRAD SHAFFER OF MONTANA FARMERS UNION STAFF reports that Production Credit Association is charging 11.5 percent for operating loans.

Federal Land Bank is charging 9.75 percent for real estate loans.

* * *

ALAN AUSTAD OF NORTH DAKOTA FARMERS UNION STAFF reports that at the Production Credit agency in Jamestown, the farm operating loan rate is running at 12.7 percent as of December 1979. In December of 1978, they were running at 10.6 percent.

The Federal Land Bank farm ownership loans are currently 9.75 percent; in 1978, they were 8.25.

FmHA is loaning at 10 percent currently; a year ago, the figure was 8.5.

Rates are all tied to cost at which the lending agencies have been able to obtain money. It is expected that interest rates will be up in the Spring as funds currently held are used up and new money is sought on the market at the current rates.

* * *

J. D. FLEMING, ASSISTANT TO THE PRESIDENT OF OKLAHOMA FARMERS UNION, reports that most of the financing of land for farmers is done through the Federal Land Bank. Up to June 1979, the interest rate was 9 percent and increased to 9.5 percent where it is still holding at the present time. It is slated to go to 10.5 percent during January 1980.

What little financing of land that is done by insurance companies is at 12.5 percent.

The demand for loans for land is high, running at about $65 million per month for the Federal Land Bank in Wichita. They currently have on hand requests for loans that will take approximately six months to process.

Currently, the bank has $3.5 billion on loan and practically no delinquencies.

Operating interest costs vary from 12.5 percent to 14.5 percent, slated to go higher after January.

Oklahoma has experienced record production in 1979 for wheat, cotton, and hay, with prices fair for all crops and good comparatively for cattle.

There is no indication that interest rates are causing farmers to back off from seeking credit. As long as the money is available, they are going hell-bent regardless of cost.

The only evidence of any slackening is in the purchase of cattle. For a cow-calf operation, the interest on a cow may run to $100 annually.

The effect of the interest rate is that net income is reduced and farmers really do not know where they are on that score until the show is over.

* * *

NEIL OXTON, PRESIDENT OF NEBRASKA FARMERS UNION, reports the following conditions at particular localities:

Verdigre -- 10.5 percent on all farm loans. (Slightly reduced for good risks and larger loans. The bank says that they are losing money at these rates.)

York -- Prime rate - 12 percent
Operating loans - 12.5 percent
Term loans -- over one year - 13 percent
Large farm and real estate loans (if they have to go out of the bank for the money) - 14.5 percent

Hartington Federal Land Bank -- 9.5 percent since April; effective February 1 - 10 percent.

Beatrice -- Operating loans - 12.5 percent
Real estate loans - 12.5 percent (not taking much right now)

(Rates above fairly representative for that area.)

Production Credit -- 13 percent

* * *

CHARLES NASH, EXECUTIVE DIRECTOR OF THE OHIO FARMERS UNION, reports the prevailing interest rates now in the 13 to 14 percent range, with some city banks in Ohio at 15 to 15.5 percent on farm real estate loans.

Life insurance companies are active in farm loans in some areas of the state, with interest rates running around 12 percent.

On farm real estate, the Federal Land Bank has an average percentage rate of 10.75 percent on loans up to $300,000, Nash reports, but closing fees add the equivalent of another 2.25 percent.

Production Credit Associations, on December 1, were charging 11.5 percent interest on operating loans up to $50,000, with an 11 percent rate on loans above $50,000.

* * *

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<u>MARK MCAFEE OF MINNESOTA FARMERS UNION STAFF</u> reports the following prevailing interest rates:

Federal Land Bank of St. Paul - 10.25 percent on farm loans, 10.75 percent on rural housing.

Farmers Home Administration - 10 percent on farm ownership loan program; 10.5 percent on farm operating loans; 4 to 5 percent on limited resource loans.

Farmers State Bank of Trimont - 10.25 percent to 12.5 percent on real estate; 13 percent to 15.5 percent on farm operating loans.

McAfee cites three individual case studies:

Mr. E. D., a Moose Lake cattle rancher who until recently was able to obtain loans for operating costs at 9 to 10 percent interest. On a $700 cow, this meant an interest charge of $63 to $70. Now, he faces an interest charge of 15 percent if he wishes to expand his herd. This would mean an interest charge of $105 per cow. Other operating costs, such as fertilizer are rising rapidly in cost and also require 15 percent interest rates on financing.

Mr. R. R., a Fisher grain and sugar beet raiser, reports that five years ago he was able to borrow for operating purposes at 8 percent and money was always readily available. Now, credit is harder to obtain and the interest rate is 13 percent. He is in the process of taking over farming operation from his father. He is in a situation where farm equipment must be replaced, but this poses a difficulty since grain prices have not kept pace with energy and equipment costs.

Mr. A. G., a Richmond dairyman, tried for two years to get an FHA loan, now has obtained one at 5 percent. He has been obtaining loans for personal property from his local bank at 9.5 percent, but reports he will face 12 to 13 percent interest rates next time he applies. He is seriously thinking of expanding his dairy herd, but despairs that he will be able to do so at current 15 percent loan rates.

* * *

LEROY SCHARTZ, PAWNEE COUNTY, BELPRE, stated that current interest rate on operating loans made by the First State Bank, Larned, Kansas, are 14.45 percent. He indicated that real estate interest rates in the area are ranging around 12 percent.

VERNON DEINES, BOX 6, RAMONA, stated that from his personal experience, the present interest rate on machinery loans through the Ramona State Bank is 13.5 percent. He thinks that this rate is the approximate rate for other operating loans.

LARRY CONYAC, R. R. 2, BOX 172X, STOCKTON, stated that operating loans made by the Stockton Production Credit Association have an interest rate of 11.62 percent. Longer term real estate loans at the Hays Federal Land Bank Association are at 10 percent.

MORRIS BURWELL, ROUTE 4, ABILENE, states that the Federal Land Bank loans on real estate are 10 percent, and that operating credit from the Farmers National Bank for cattle are 13.5 percent and up to 14 percent on other operating loans.

VERN FRANKHAUSER, ELMDALE, stated that operating loans through the Peoples Exchange Bank are 14 percent, but that he receives one-half of one percent reduction because he owns stock in the bank. His outstanding real estate indebtedness bears an interest of 9.5 percent. It would appear that he negotiated his real estate loan several years ago.

KEITH NELSON, PAWNEE ROCK, stated that the First National Bank, Larned, Kansas, has the same rate, 14.45 percent, for both operating and real estate loans.

FRED HORNBAKER, R. R. 3, STAFFORD, states that the Farmer National Bank has interest rates on operating loans of 13.5 percent, and so-called longer "short-term" loans on livestock at 10.25 percent.

* * *

DAVE WENTZLAFF OF SOUTH DAKOTA FARMERS UNION STAFF reports that the situation appears to be bleak.

Many of the state banks have been forced to the maximum interest rates allowed by state usury laws -- 12 percent. National banks can go higher and have.

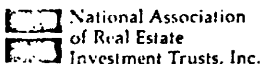
One bank officer consulted advised that the high interest rates have had a "numbing effect" on an already troubled agricultural industry in South Dakota. The banker added that he doesn't feel that high interest rates slow or lessen the inflation rate, but instead contribute directly to its continued increase. He continued that because his bank follows an aggressive lending policy, they are having trouble getting funds to loan to fill their need. On the other hand, he remarked that non-aggressive banks are enjoying the high interest rates as they seek out bigger and better ways to invest their funds.

FmHA reportedly has a sizeable waiting list for 10.5 percent interest loans in many areas, and agrees that there is a severe credit crunch in South Dakota.

While the Federal Land Bank seems to have plenty of available capital to loan at 9.5 percent (10 percent effective February 1), it is said that they are selective to the extent that the small or beginning farmer is not usually helped.

All lending agencies consulted emphasized the fact that agriculture is an industry which needs to have adequate credit, and that farmers will have to borrow even at the high rates of interest in order to have working capital.

* * *




May 20, 1980

The Hon. Russell B. Long
United States Senate
217 Russell Senate Off. Bldg.
Washington, D. C. 20510

Re: Letter of Comment Regarding the Adverse Impact of Provisions of H.R.5043, the "Bankruptcy Tax Act of 1980", on Real Estate Investment Trusts - Submitted on behalf of the National Association of Real Estate Investment Trusts, Inc.

Summary: By making recapitalization or refinancing resulting in partial or total discharge of indebtedness an income recognition event, the Bankruptcy Tax Act of 1980, as proposed, will require REITs to forego opportunities to improve their capital structure, or risk "disqualification", since such unrealized income may not be considered qualified income or may be required to be distributed pursuant to Sections 856 and 857 of the Internal Revenue Code, respectively.

Dear Senator Long:

We are writing to you on behalf of the National Association of Real Estate Investment Trusts, Inc., regarding the significant adverse impact which provisions of H.R.5043, the "Bankruptcy Tax Act of 1980" (the "Act"), would have on a number of members of the real estate investment trust industry, if the Act is enacted in its present form. As proposed, H.R.5043 would partially repeal the option now provided in sections 108 and 1017 of the Internal Revenue Code of 1954 (the "Code") for solvent taxpayers to defer income otherwise required to be recognized upon the discharge of indebtedness, through an election to reduce basis in certain assets. The apparent rationale for partial elimination of the "sections 108 - 1017 election" (the "Election") by solvent taxpayers as to non-depreciable assets is that deferral of such income does not serve a legitimate purpose in the case of large business organizations, not otherwise in financial distress, which make use of the election as to non-depreciable assets solely to provide an indefinite and unwarranted deferral of otherwise taxable income.

The example given in the Report of the Committee on Ways and Means

1101 Seventeenth Street N.W., Suite 700, Washington, D.C. 20036, (202) 785-8717

on the Act* indicates, at page 9, that the Committee's concern in this regard related to basis reduction of "non-depreciable assets which may never be sold, such as stock in a subsidiary corporation or the land on which the company operates its business, thereby avoiding completely, rather than deferring, the tax consequences of debt discharge". In the case of REITs, however, it is not land or stock in subsidiaries (which REITs are effectively precluded from owning by the provisions of section 856 of the Code) which is at issue, but mortgages or other security interests in real property which are not depreciable.

There are a substantial number of REITs with a very large percentage of their total assets represented by mortgages or other non-depreciable security interests in real property ("Mortgage REITs"). For Mortgage REITs, the Act, for the reasons set forth below, would be an extreme and unreasonable change in the Election as to solvent taxpayers, a change inappropriate and unnecessary in what purportedly is a bill to conform the federal tax laws to the Bankruptcy Reform Act of 1978(P.L.95-598) with regard to bankrupt and other insolvent taxpayers.

I. Special Case of Real Estate Investment Trusts

Recommendation: If the Election as an alternative to income recognition on cancellation of indebtedness is to be limited generally to depreciable assets, it would be appropriate to retain the Election as under present law in the special case of real estate investment trusts.

The rationale for the change in the Election, whatever its soundness in the case of business organizations generally, has no application in the case of real estate investment trusts, which, by their nature, must distribute virtually all of their income (at least 95%) to their shareholders, in order to retain qualified tax status under the Code. Accordingly, unlike business corporations generally, which do not usually pay out a majority of their earnings in the form of dividends, and therefore retain substantial cash or other current assets, REITs do not have the financial capability either to meet the tax liability imposed on discharge of indebtedness income or, alternatively, to pay out this hypothetical income to their shareholders.

In addition, there have been numerous cases in the past, which may be repeated, in which a qualified REIT, because of cyclical changes in the real estate sector of the economy, found itself with strong institutional creditors, such as major banks, and financially weak

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*Bankruptcy Tax Act of 1980, Report of the Committee on Ways and Means, U.S. House of Representatives, on H.R.5043, 96th Congress, 2nd Session, Report No. 96-833 (March 19, 1980).

borrowers, such as large real estate developers and other entrepreneurs. Such situations would arise for some REITs, as a direct consequence of their role as financial intermediaries, during downturns in the economy.

At such time, a REIT, although solvent, notwithstanding that the trust would be in difficulty with regard to making scheduled debt payments, might come under strong pressure from its unsecured institutional lenders, to "swap" some of its assets with its lenders in return for debt reduction. Cancellation of indebtedness income could easily arise as a result of such "swaps", since the REIT's lenders might well be willing to surrender unsecured indebtedness which they held greater in principal amount than the value of assets, such as mortgage indebtedness secured by real property, to be received by the lenders in the "swap".

Accordingly, in such case a Mortgage REIT, already in financial difficulty and forced by pressure from creditors to "swap" some of its assets, would, absent availability of the Election as to non-depreciable assets, face recognition of substantial non-cash income and would not have the resources to make distributions in equal amounts to its shareholders, or, alternatively, pay corporate income tax. Even if the basis reduction in depreciable assets of the REIT were sufficient to avoid all income recognition, that reduction might consume the trust's entire depreciable asset basis, with an obvious immediate and substantial effect on a trust's annual depreciation deduction.

If the Act is enacted in its present form, Mortgage REITs would be faced with the unreasonable burden of being forced to forego desirable, albeit optional, changes in their capital structure on the one hand, or face substantial non-cash income recognition and possible loss of tax qualification on the other hand.

In view of the consistent legislative history indicating the importance the Congress attaches to investment in real estate by small investors through real estate investment trusts, we cannot believe that the Congress intended such an inequitable result and one so unique and burdensome to the real estate investment trust industry. We believe that provisions in the proposed legislation which increase REIT tax liability in the event non-cash income is recognized would result in a present or potential hardship for a significant number of real estate investment trusts.

Accordingly, we recommend that if elimination of the present Election, in the case of nondepreciable assets, as an alternative to income recognition on cancellation of indebtedness is to be enacted as to solvent taxpayers generally, it would be appropriate to retain the

Election in the special case of real estate investment trusts.

II. Technical Concerns

Recommendation: If the present Election as to nondepreciable assets is to be repealed in the case of solvent taxpayers, including real estate investment trusts, we recommend that (a) section 856(c) of the Internal Revenue Code be amended so that any discharge of indebtedness income which must be recognized by a REIT will be "neutral" for purposes of the section 856(c) income source tests and that (b) section 857(a) of the Code be amended so that any discharge of indebtedness income required to be recognized by a REIT will be exempted from the section 857(a) income distribution requirement.

In addition to the general problem which the repeal of the Election as to non-depreciable assets would raise for a number of REITs, enactment of the Act in its present form raises technical difficulties as to certain requirements of sections 856 and 857 of the Internal Revenue Code. Under section 856(c)(2) of the Code, at least 95% of a REIT's income each year must be derived from certain, mainly real estate, sources, or the REIT risks loss of its tax qualification. A similar type of requirement is found under Section 856(c)(3). Discharge of indebtedness income, which might in a given year be substantial, does not qualify for favorable treatment under either section 856(c)(2) or (3). If the Act, with regard to changes in the Election, is to be enacted in its present form, we believe that section 856 should also be amended by the Act so that discharge of indebtedness income is at least "neutral" for purposes of the section 856(c) income source tests.

Second, under section 857(a) of the Code, 95% of a REIT's income must be distributed each year if REIT qualification is to be maintained. If the Act becomes law in its present form, we believe that section 857 must at the same time be amended so that discharge of indebtedness income, as to which the REIT will have realized no cash income, will be exempted from the section 857(a) income distribution requirement.

Should the Members or the staff of the Committee wish to discuss the issues raised by this letter further, industry representatives would be pleased to meet with you at your convenience.

Sincerely yours,

Joseph D. Riviere
President

STATEMENT OF POSITION OF THE NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS, INC. WITH REGARD TO H.R. 5043, THE "BANKRUPTCY TAX ACT OF 1980"

H.R. 5043, the "Bankruptcy Tax Act of 1980" (the "Act") would partially repeal the option presently provided in sections 108 and 1017 of the Internal Revenue Code which permits solvent taxpayers to defer income, otherwise required to be recognized upon certain discharge of indebtedness, by reducing basis in certain assets (the "Election"). Under the Act, basis reduction in non-depreciable assets would no longer be allowed in the case of solvent taxpayers. The apparent rationale for this partial elimination of the Election is that basis is usually reduced in stock of subsidiaries or land on which a company might operate its business, neither of which type of asset will ever be sold, therefore resulting in complete avoidance rather than deferral of income related to debt discharge. However, this rationale does not apply to real estate investment trusts, which do not own subsidiaries and whose non-depreciable assets are primarily mortgages.

The change in the Election as to solvent taxpayers by the Act, which purportedly is to conform the federal income tax laws in the treatment of bankrupt or other insolvent taxpayers to the provisions of the Bankruptcy Reform Act of 1978, would be particularly burdensome for real estate investment trusts with very heavy investments in mortgages or other nondepreciable security interests in real property ("Mortgage REITs"). Mortgage REITs generally have limited depreciable assets in which to reduce basis as an alternative to income recognition.

In addition, business corporations, which do not usually pay out a majority of their earnings in the form of dividends to stockholders, generally retain substantial cash or other current assets with which to pay taxes on the non-cash income resulting from indebtedness discharge. However, REITs, which under the provisions of the Code must pay out at least 95% of their income each year to their shareholders, seldom would have the financial capability to meet tax liability imposed on discharge of indebtedness income. Neither, of course, would they have the resources to pay out the hypothetical income to their shareholders and avoid any tax liability.

In light of the consistent legislative history making clear the importance Congress attaches to investment in real estate by small investors through the vehicle of REITs, it is difficult to believe that Congress can intend the inequitable results for a number of Mortgage REITs which the changes in the Election now provided by the Act would provide.

In addition to the general problem which the Act creates for Mortgage REITs, there are specific technical problems caused by the Act under the REIT provisions of the Code. Specifically, if the Act is passed in its present form, section 856(c) of the Code should be amended so that any discharge of indebtedness income which must be recognized by the REIT will be "neutral" for purposes of the section 856(c) income source tests. Otherwise, a Mortgage REIT could face loss of its REIT tax status as a consequence of such discharge of indebtedness income because it would not be "qualified" under section 856.

Further, section 857(a) of the Code should be amended by the Act so that any discharge of indebtedness income which a REIT must recognize is exempted from the section 857(a) income distribution requirement, inasmuch as a REIT will seldom have the cash resources available to pay out the non-cash income to its shareholders.

WRITTEN STATEMENT

OF

GEORGE H. LAWRENCE, PRESIDENT

AMERICAN GAS ASSOCIATION

BEFORE THE

SENATE COMMITTEE ON FINANCE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

REGARDING THE

BANKRUPTCY TAX ACT OF 1980, H.R. 5043

June 6, 1980

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The American Gas Association (A.G.A.) is a national trade association which represents over 300 natural gas distribution and transmission companies serving over 160 million U.S. Consumers. In serving these consumers, A.G.A. member companies account for approximately 85% of the gas utility sales in our nation. On behalf of these member companies, we are pleased to submit this written statement setting forth A.G.A.'s views on Section 2 of the Bankruptcy Tax Act of 1980 (H.R. 5043). Section 2 would modify the application of sections 108 and 1017 of the Internal Revenue Code of 1954 (IRC) to non-bankrupt, solvent corporations.

Summary of A.G.A. Comments

- H.R. 5043, as presently drafted, provides that a non-bankrupt, solvent corporation purchasing its own debt at a discount and electing to reduce the basis of its assets must reduce the basis of "depreciable" assets. Therefore, a parent holding company having few or no depreciable assets, but which has issued debt for its operating subsidiaries, is effectively denied the use of the election.

- H.R. 5043 should be amended to make it clear that a parent holding company described above which files a consolidated return with its subsidiaries may elect to reduce the basis of the depreciable assets of the subsidiaries included in the consolidated group.

Introduction

Under present law, a non-bankrupt, solvent corporation which purchases its own debt at a discount may elect to reduce the basis of its assets instead of recognizing current income from cancellation of its indebtedness. Treasury regulations prescribe the particular order of basis reduction among the taxpayer's assets. H.R. 5043 would modify present law by providing that the election to reduce basis allowed to the non-bankrupt, solvent corporation requires a reduction in the basis of "depreciable" assets. This limitation to depreciable assets is generally similar to the rules of H.R. 5043 that would apply to bankrupt or insolvent debtors.

Historically, large regulated natural gas utilities are often structured so that the parent company is a holding company. As such, it either has no depreciable assets or only insignificant depreciable assets, such as office furniture, etc. The depreciable assets of the utility are in operating companies which are usually wholly-owned subsidiaries filing a consolidated return with the parent. Since it is often the parent which issues debt for the benefit of its subsidiaries, if H.R. 5043 is interpreted as allowing a basis reduction only for the depreciable assets of the issuing company, the practical effect will be to deny the election to natural gas utilities having this holding company structure.

I. H.R. 5043 Should Be Clarified to Permit Use by Holding Companies With Few or No Depreciable Assets

H.R. 5043 should be amended to make it clear that if a non-bankrupt, solvent parent holding company filing a consolidated return with its subsidiaries, purchases its own debt at a discount and has no significant depreciable assets in comparison to the total depreciable assets of the consolidated group, the parent may elect

to reduce the basis of the depreciable assets of the subsidiaries included in the consolidated group in the order prescribed by Treasury regulations.

II. Many Factors Support Such a Clarifying Amendment

Numerous factors support the clarification of Section 2 of H.R. 5043 to ensure that non-bankrupt holding companies, with few or no depreciable assets, may utilize the election under IRC sections 108 and 1017 to reduce the basis of depreciable assets belonging to a subsidiary of such a holding company.

First, the proposed amendment would prevent insubstantial differences in corporate structure between holding companies and non-holding companies from affecting the use of the election. This would ensure that affiliated groups which are alike in substance are treated alike for tax purposes under H.R. 5043.

Second, the proposed amendment is sound from both a tax policy and technical standpoint because a consolidated group is treated as a single taxpayer under the IRC; thus, it is appropriate under the election to reduce the basis of the depreciable assets of the subsidairies in the group.

Third, the proposed amendment is conceptually sound because, as a holding company with little or no assets of its own, the parent issues debt for the benefit of its operating subsidiaries; thus, it is appropriate to reduce the basis of the depreciable assets of those subsidiaries.

Finally, regulated natural gas utilities generally do not voluntarily purchase their own debt at a discount. To the extent a utility does purchase its own debt, it is usually because such utilitiy is effectively required to do so under the sinking fund

provisions of its indenture. Moreover, utilities often retain only a part of the savings on repurchase because regulatory commissions require an equitable portion to be passed-on to ratepayers.

Conclusion

For the foregoing reasons, A.G.A believes that the clarifying amendment, which is described above, is reasonable, warranted and equitable.

United States Bankruptcy Court
CENTRAL DISTRICT OF CALIFORNIA
801 U. S. COURT HOUSE
LOS ANGELES, CALIFORNIA 90012

JAMES E. MORIARTY
BANKRUPTCY JUDGE

May 22, 1980

The Honorable Harry F. Byrd, Jr.
Chairman, Subcommittee on Taxation
and Debt Management
Senate Finance Committee
Room 2227
Dirksen Building
Washington, D. C. 20510

Dear Senator Byrd:

I have been advised that your subcommittee will be holding hearings on the proposed Bankruptcy Tax Act (H.R. 5043) next week.

I wish that I could be there to testify on this pending legislation, since I consider the tax problems relating to bankruptcy matters most important. Our workload under the new Bankruptcy Code has substantially increased, and I cannot at this time spare the time to come East.

There is a further reason why I would like to come East and that is that I am a native of Alexandria, Virginia; and such a trip would give me an opportunity to visit members of my family and friends. Since I cannot be with you at the hearings, I am submitting the following information which I hope will assist you and your committee:

I am a Bankruptcy Judge stationed in Los Angeles, which is within the Central District of California. I have served in this capacity for 17 years, and prior thereto I had 12 years of service with the Department of Justice both in Washington and in Los Angeles. The remarks I make are my own and do not necessarily represent the views of any other person or organization.

The filing of bankruptcy cases in the Central District of California exceed the filings in any other district in the Federal Judicial System. Filings for the first six months of Fiscal Year 1980 show a 50 percent increase. If this trend continues, the filings for this year will exceed 22,000 in this district.

Our bankruptcy courts have in the past received a substantial number of cases filed under Chapter X, XI, and XII of the Bankruptcy Act. Under the new Bankruptcy Code, we anticipate that debtors will use Chapter 11 to accomplish a reorganization or rehabilitation from their financial problems. During my 17 years as a Bankruptcy Referee/Judge I have handled a number of large corporate reorganization cases, notably Equity Funding Corporation of America and Daylin, Inc., which were highly successful in their reorganization efforts.

The Equity Funding case was the largest fraud case ever filed in our bankruptcy courts. The reorganized debtor taking the new name of Orion Capital Corporation has been most successful and has been the subject of several take-over attempts. While I am not a tax expert, I do have some understanding of the impact of the tax statutes on bankruptcy proceedings and how they may affect the reorganization of a debtor.

When I first received a copy of H.R. 5043, which was the Committee print of November 7, 1979, I called a member of the Ways and Means Committee, James C. Corman, a friend of mine for many years, and expressed my concern that if the bill were enacted into law in its then language, it may very well defeat the whole purpose of Chapter 11 of the Bankruptcy Code, commonly referred to as the Bankruptcy Reform Act of 1978. In all my years of service with the Bankruptcy Court, I can recall only one case in which the debtor was able to fund its Plan of Reorganization from profits derived during the time the debtor was operating under the jurisdiction of the Bankruptcy Court.

That debtor, Guidance Technology, Inc., experienced serious financial problems due primarily to poor management. G.T.I. manufactured the Sommers gyroscope. Practically all of their income was derived from contracts with the Department of Defense.

When G.T.I. was unable to bid on government contracts, other manufacturers of this type of military hardware doubled the price of this item at great cost to the government. When we were able to straighten out some of the operational problems and G.T.I. was again able to bid on government contracts, the price of this item was reduced to the cost paid prior to the filing of the debtor's petition by G.T.I.

In all other cases, it has been necessary for the debtor to bring in outside capital in which to fund the Plan. This new capital is either raised by persons investing in the reconstituted debtor or the debtor is forced to negotiate and obtain substantial loans to be paid off from future profits.

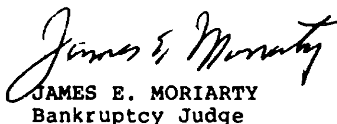
One of the selling points that a debtor in a reorganization has in obtaining new capital is that there is generally a tax loss carried forward which in many cases wipes out many tax obligations that the debtor would normally be liable for several years to come after the reorganization had been approved by the Bankruptcy Court. While the final version of H.R. 5043 as passed by the House did make some minor adjustments in the treatment of net operating loss carried forward, I am still concerned about the adverse effect the bill now before your committee will have on the rehabilitation of debtors under Chapter 11 of the Bankruptcy Code.

Looking at the problem from a very objective standpoint, there is no doubt that the recognition of the tax credit was in any way a subsidization of the debtor's business by tax revenues of the federal government, but when you consider the benefits to be derived from a reconstituted and ongoing business in a given community, the end results far outweigh the tax relief given by the government. Many businesses and jobs are saved; the business if it flourishes helps stabilize the economy in a given community; and its effect of its future success is far reaching.

I am sure that your committee will receive testimony from persons who are highly qualified in tax and bankruptcy matters and such testimony or submitted statement will enable your committee to report this pending legislation to the full Senate Finance Committee at an early date.

If I can be of any further assistance to you or the subcommittee, please let me know. Copies of this letter are forwarded to Michael Stern, Esquire, counsel to the Senate Finance Committee, for appropriate distribution.

Sincerely yours,



JAMES E. MORIARTY
Bankruptcy Judge

/hj

cc: Michael Stern, Esquire

**CATERPILLAR TRACTOR CO.**

Peoria, Illinois 61629

May 27, 1980

The Honorable Harry F. Byrd
Chairman, Subcommittee on Taxation
and Debt Management
Senate Finance Committee
U.S. Senate
Washington, D.C. 20510

Dear Chairman Byrd:

In the near future the Taxation and Debt Management Subcommittee will consider the Bankruptcy Tax Act of 1980 (H.R. 5043). I am writing to request your support of H.R. 5043 as passed by the House of Representatives March 24, 1980.

Specifically, Caterpillar Tractor Co. supports retention of two provisions of H.R. 5043 pertaining to solvent taxpayers:

1. Modifications of the present rules under Internal Revenue Code Sections 108 and 1017 to permit an election to reduce the basis of depreciable assets rather than reporting income from the discharge of indebtedness; and

2. An overturning of the unwarranted position taken by the Internal Revenue Service in Rev. Rul. 74-184, which treated an election to adjust basis of assets under Section 1017 as a disposition resulting in investment tax credit recapture. Under H.R. 5043, no investment tax credit recapture is incurred because the reduction is not to be considered a disposition, which of course it is not.

The adoption of H.R. 5043, designed to bring federal tax laws into conformity with 1978 changes in bankruptcy laws, will improve the cash flow for corporations providing essential revenues for capital formation necessary to the continued well-being and growth of our industrial sector.

Sincerely,

A. C. Greer

A. C. Greer
Manager, Tax Department

Telephone: (309) 675-4478
alb

LAW OFFICES

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ROBERT JAY MOORE
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DENNIS L. LIVINGSTON
JOHN R. TATE
GARY P. LONG
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LOUIS E. KEMPINSKY
HOWARD J. STEINBERG
KENNETH A. KRAMARZ
*A PROFESSIONAL CORPORATION

CABLE ADDRESS GENRAS

TELEX 69 6133

TELECOPIER (213) 556-3631

LEONARD G. LEIBOW
(1937-1975)

IN REPLY REFER TO:

May 23, 1980

Senator Harry F. Byrd, Jr.
Committee on Finance
Subcommittee on Taxation
and Debt Management
United States Senate
227 Dirksen Senate Office Building
Washington, D. C. 20510

Re: H.R. 5043; Bankruptcy Tax Act of 1980

Dear Senator:

You successfully fought for repeal of carryover basis for estate and income tax purposes.

H.R. 5043, scheduled for hearing before you on May 30, 1980, is a similar theoretically plausible but administratively unworkable and practically unsound tax measure. I told this to the House members, as did everyone else who knows a bankruptcy case from the case of verbal diarrhea which this bill represents. They chose to listen to staff advisors who have never watched a corporation die. Our objections are in the record of the House hearings.

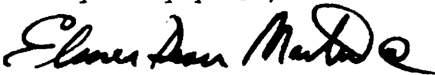
I am a tax lawyer, a CPA, and I represented the State Bar of California in the House hearings. I am one of the very few lawyers in the United States who attempt every day to reconcile the tax laws and bankruptcy laws of this country. If Congress isn't willing to listen to me, to the American Bar Association, to the American Institute of Certified Public Accountants, and to the National Bankruptcy Conference, then Congress be damned and ridiculed because as

GENDEL, RASKOFF, SHAPIRO & QUITTNER
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

Senator Harry F. Byrd, Jr.
Page 2
May 23, 1980

the economy of this country disentegrates in the following months, Congress will be compelled to retroactively repeal this law.

Very truly yours,



ELMER DEAN MARTIN III

EDM/aw

THE ASSOCIATION OF THE BAR
OF THE CITY OF NEW YORK
42 WEST 44TH STREET
NEW YORK, NEW YORK 10036

COMMITTEE ON BANKRUPTCY AND CORPORATE REORGANIZATION

BURTON M. FREEMAN
CHAIRMAN
BANKERS TRUST COMPANY
280 PARK AVENUE, 10-W
NEW YORK, NEW YORK 10017
692-8386

EILEEN FOX
SECRETARY
BANKERS TRUST COMPANY
280 PARK AVENUE, 10-W
NEW YORK, NEW YORK 10017
692-6956

May 28, 1980

Senator Harry F. Byrd, Jr.
Chairman of the Subcommittee on Taxation
and Debt Management Generally
417 Russell Senate Office Building
Washington, D. C. 20510

Re: H.R. 5043; The Bankruptcy Tax Act of 1979

Dear Senator Byrd:

I understand that your Committee is presently considering the bankruptcy tax reform measure. The Committee on Bankruptcy and Corporate Reorganization of the Bar Association of the City of New York has very carefully studied this legislation and the various problems it raises. As a result of our study, we prepared a statement setting forth our Committee's position on the proposed legislation. This statement was supplemented by my letter dated January 16, 1980 to John M. Martin, Jr., Esq., Chief Counsel of the House Committee on Ways and Means and further supplemented by my letter dated February 5, 1980 to the Honorable Don Edwards of the House Judiciary Committee. I enclose the statement and the two letters in the hope that they will be helpful in your consideration of this important legislation.

While we concede that reform in this area is required, we believe that the legislation in its present form is inconsistent with the Bankruptcy Reform Act of 1978 -- legislation which our Committee generally endorsed.

Respectfully yours,

Burton M. Freeman

BMF/jb
Encls.
cc: Edward J. Hawkins, Esq.
Chief Tax Counsel

THE ASSOCIATION OF THE BAR
OF THE CITY OF NEW YORK
42 WEST 44TH STREET
NEW YORK, NEW YORK 10036

COMMITTEE ON BANKRUPTCY AND CORPORATE REORGANIZATION

BURTON M. FREEMAN
CHAIRMAN
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280 PARK AVENUE, 10-W
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692-8369

EILEEN FOX
SECRETARY
BANKERS TRUST COMPANY
280 PARK AVENUE 10-W
NEW YORK, NEW YORK 10017
692-6856

February 5, 1980

The Honorable Don Edwards
House Judiciary Committee
2329 Rayburn House Office Building
Washington, DC 20515

Re: HR 5043, Bankruptcy Tax Act of 1979

Honorable Sir:

Enclosed find a copy of my letter transmitting our Committee's Report on the referenced bill together with a copy of the Report itself.

I understand that our views generally coincide with those you have expressed so effectively and in such a practical fashion in recent days. I express the sentiment of the entire Committee when I thank you for your efforts in that direction.

The central issue of course is the preservation of the NOL in corporate reorganizations and out-of-court restructurings. Both types of matters are generally very complex, and these cases do not fall into neat patterns. Indeed, Tolstoy's aphorism that each unhappy family is unhappy in its own particular fashion has special application to the practice of corporate reorganization law. Furthermore, each reorganization or restructuring is based upon a complex set of motivations on the part of the creditors and debtors, and no single factor or motivation really controls any situation.

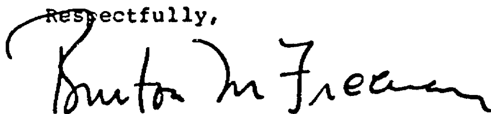
Nevertheless, it has been my experience as a practitioner in this area that the availability of the NOL has been important in many of the cases. One particular matter comes to mind -- a case involving a New York Stock Exchange company which owned chains of pharmacies, department stores,

drug manufacturing firms, health supply companies, and home supply companies as well as various other retail and wholesale operations. Many factors contributed to the successful rehabilitation of this company in Chapter XI, but clearly one essential ingredient was a very sophisticated tax plan which would not have been possible had HR 5043 been law at the time. This company emerged successfully from Chapter XI and was subsequently acquired by another major corporation. Its creditors fared very well and indeed its shareholders fared very well. I think it would be the universal judgement of the attorneys and accountants who worked on this matter that the success achieved would not have resulted but for the tax plan.

There are no statistics available to establish the value of the NOL in these cases, and I realize that an anecdotal approach is not particularly useful, unless it represents the experience of a number of practitioners. Accordingly, I am sending a copy of this letter to my colleagues on our Committee with a request that they also provide you with the benefit of their experiences. Hopefully the collective experiences of the Bar will establish our case.

Again, thank you for your efforts and feel free to call upon our Committee or me for any help we can render in your good efforts.

Respectfully,



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Enclosures

THE ASSOCIATION OF THE BAR
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COMMITTEE ON BANKRUPTCY AND CORPORATE REORGANIZATION

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January 16, 1980

<u>BY COURIER</u>

John M. Martin, Jr., Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth Building
Washington, D.C. 20515

Re: <u>H.R. 5043, Bankruptcy Tax Act of 1979</u>

Dear Sir:

Pursuant to the Release of December 30, 1979 by the Honorable Dan Rostenkowski, I am submitting on behalf of the Bankruptcy and Corporate Reorganization Committee of the Bar Association of the City of New York, the enclosed statement.

Pursuant to Clause (3) under the heading "Details For Submission of Statements" of the Release, the following are the summaries of the three points made in the statement:

1. Since we believe no persuasive argument can be made to the effect that the fisc will be materially affected, we believe that the net operating loss should be retained by insolvent companies as is the case under the present law.

2. We oppose the adverse tax consequences upon the issuer provided for in proposed section 108 where new stock is exchanged for old debt which does not qualify as a "security".

3. We oppose the provision that the receipt of stock by a creditor be deemed a tax event. In lieu of the present proposal, we believe our suggestion on page 7 of the statement is one realistic solution to the problem.

The foregoing summaries do not fully explain the views of our Committee and we respectfully refer you to the statement as a whole.

In addition to the positions taken in the statement, I have been requested by the Committee to make the following points:

(a) Definition of "title 11 or similar case"

In reviewing H.R. 5043, the Committee has noted what appears to be a technical defect in drafting. Proposed section 368 defines the term "title 11 or similar case" to mean " ... a receivership, foreclosure or similar proceeding in a Federal or State court [Emphasis added]". The expansion of the term 'title 11' to include similar administrative proceedings is necessary because the Bankruptcy Code excludes from its scope various types of enterprises, especially banks and insurance companies. The rehabilitation or liquidation of these entities is left to State law or other Federal law, which in many cases provide for administrative proceedings, and not court proceedings. Thus, the section, as now worded, fails to include many of the cases it appears to mean to include. A similar problem arises under proposed section 108, which limits its application to cases where the taxpayer receives a discharge under title 11 or where the taxpayer is insolvent. Section 108 limits the meaning of insolvency to "excess of liabilities over fair market value of assets". The state administrative proceedings similar to title 11 proceedings may be instituted on a lesser showing of insolvency, such as failure to pay debts as they fall due. We see no policy distinction that would give favorable tax treatment to companies in title 11 proceedings, but deny that treatment to companies in proceedings under other Federal statutes or under State-authorized proceedings.

(b) The Effective Date

We see a substantial deterrent to the successful negotiation of plans of reorganization so long as there is uncertainty as to the retroactive effect of the pending bill. In many reorganization cases, the parties negotiate on the basis of the tax consequences of various provisions in the plans of reorganization. If the tax consequences are uncertain, the negotiations are in effect "chilled", if not totally inhibited. Our Committee recognizes that this is a difficult problem and could not agree upon any specific recommendation. Nevertheless, our Committee wished this problem be brought to your attention.

(c) Continuity of Interest

We hope, for the reasons given in my letter of September 27, 1979 to the Ways and Means Committee, that your Subcommittee will delete proposed section 368(a)(3)(C) from the Bill. We agree with our Association's Committee on Taxation, which on pages 6 and 7 of its written statement to your Subcommittee concluded that the question of continuity of interest has been well handled by the courts and should be left there.

(d) "G" Reorganizations

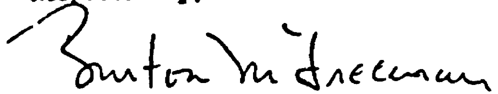
We also support our Association's Committee on Taxation's recommendations on page 9 of of its written statement to you for revising the terms of the proposed "G" reorganization provisions. We believe, however, that these recommendations do not go far enough, and we support the proposals made by the New York State Bar Association's Tax Section on pages 14-15 of its written statement to the Subcommittee on Select Revenue Measures that the apparent exclusivity of the proposed "G" reorganization provisions be eliminated in order to permit the greatest degree of flexibility in creating reorganization plans.

(e) Liquidation Time Periods

We welcome the principle contained within proposed section 337(f) giving non-recognition treatment to sales or exchanges of property of a corporation in liquidation, but we know that the twelve-month limitation is too short. We would recommend, in place of a specified time, that, so long as the sale or exchange occurred as part of a plan of liquidation in Chapter 11 or a liquidation in Chapter 7, the period that sales or exchanges of property by a liquidating corporation in a bankruptcy reorganization be given non-recognition treatment be the period while the bankruptcy case remains open or beyond the closing of the case, upon entry of an order of the bankruptcy court for cause shown, after notice and hearing is accorded the Treasury Department.

If there are any questions on the points made in our statement or in my letter, please feel free to address any inquiry to us. We are most anxious to be of assistance to your Committee in accomplishing its important work.

Respectfully,



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# STATEMENT ON H.R. 5043, THE BANKRUPTCY TAX ACT OF 1979, BY THE COMMITTEE ON BANKRUPTCY AND CORPORATE REORGANIZATION OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

## Committee Position

The provisions of the Bankruptcy Tax Act of 1979 (the "Bill") clarify, and, for the most part, represent an improvement over existing law. However, certain provisions, described below, are either inconsistent in policy with Title 11 of the United States Code (the "Bankruptcy Code"), or will create difficulties for reorganizations without a sufficient compensating tax benefit. We believe that in order to further the Bankruptcy Code's policy of debtor rehabilitation, substantive amendments to these provisions would be desirable. We limit our comments to those provisions affecting reorganizations of insolvent companies under the protection of the bankruptcy courts.

## The Net Operating Loss

Proposed Section 108 will reduce favorable tax attributes of an insolvent company by the amount

of discharge of indebtedness. As individuals who have experience with reorganizations, we know that "The tax attributes of a bankrupt corporation that survive the proceeding can be a substantial asset of the surviving corporation". [Gaffney, "Net Operating Loss, Basis and Other Tax Attributes of Corporations in Bankruptcy and Insolvency Situations," 34 N.Y.U. Institute on Federal Taxation, 479 (1976).] Existing law preserves the most important of these attributes-- the Net Operating Loss ("NOL")-- for the benefit of the reorganized company. Our experience has shown us that the existence of this favorable tax attribute which, of course, would disappear in the event of liquidation, has often persuaded creditors to take the risk of permitting an insolvent company to continue its existence. Part of the express policy governing the statutory changes in the new Bankruptcy Code was to encourage creditors to choose to make the effort to rehabilitate rather than liquidate insolvent companies. These changes in the statute were not to benefit creditors. Rather they were a rational response to the loss and disruption, including the loss of jobs for employees, that a liquidation normally implies. Proposed Section 108's protection of hypothetical Federal revenues undercuts profoundly the Bankruptcy Code's encouragement of debtor rehabilitation.

We understand that the Subcommittee has before it proposals to modify proposed Section 108's treatment of NOL's in ways which would preserve some, but not all of their value

to the reorganized company. While these proposals would be less prejudicial to the possibility of reorganization than would proposed Section 108, they still conflict in concept and policy with the Bankruptcy Code's rehabilitation policy, and for that reason should not be adopted.

Proposed Section 108 also changes the rules with respect to basis of the insolvent company's property. Under existing law, the basis may not be reduced below the fair market value of the property. In the Bill there is no such limitation on reduction of basis. This change in law could create very adverse tax consequences with respect to an insolvent company's inventory. As the reorganized company begins to sell its existing inventory, a disproportionate percentage of its revenues (conceivably all of its revenues) will constitute taxable income, thus significantly reducing the possibility of a successful reorganization. For these reasons we strongly recommend retention of the results reached under present law.

## The Effect on the Issuer of a Stock-for-Debt Exchange

Proposed Section 108 (e) (1) apparently permits indebtedness which qualifies as "securities" to be exchanged for stock in the reorganized company without adverse tax consequences to the issuer, but creates discharge of indebtedness income to the issuer for the identical exchange if the indebtedness is not evidenced by a "security". This changes existing

law in the name of conceptual logic, and as the Committee on Taxation of the Association of the Bar of the City of New York in its written statement to you has already pointed out (at pages 5-6), the conceptual logic is neither necessary nor compelling. In a reorganization plan the creditors agree to take from the insolvent company various promises to make payments in the future, ranging from scrip to stock. Experience tells us that the negotiations leading to an acceptable plan are between parties with necessarily differing outlooks. For example, a financial institution is often willing to take an equity position because it is in a position to monitor closely the reorganized company's performance, while trade debt will accept what appears to be less value, so long as it is in cash or its near equivalent. Proposed Section 108 adds a new level of complication, adverse tax consequences to the reorganized company, should the creditors desire to put forward a plan giving stock for debt not evidenced by securities. We join with our Association's Committee on Taxation in finding that the case for this change in tax law is not compelling, and we add that if the change is made, reaching agreement on reorganization plans will become even more difficult. We fail to see any tax benefit that would justify this complication in the already difficult task of creating effective reorganization plans.

## The Effect upon the Recipient of a Stock-for-Debt Exchange

Under proposed Section 351 (d) (2), a transferee corporation whose indebtedness is not evidenced by a security will not have its debt considered "property" for the purposes of Section 351, with the result that the receipt by such a creditor of the reorganized company's stock will cause it to pay tax at ordinary income rates on the difference between the value of the stock it receives and its basis in the debt it exchanges for the stock. By rendering taxable an event which under present law is not taxable, the Bill will further complicate the process of creating an effective reorganization plan.

We see two major problems resulting from proposed Section 351 (d) (2): First, the creditor who receives stock and who has to pay tax on it will have a strong motive to negotiate for a distribution of cash as part of the reorganization plan. Any creditor who seeks cash as part of a reorganization plan is ordinarily a problem. Second, unless the value of the distributed stock is determined within the bankruptcy proceeding, the creditor will view the stock he receives as the source of a potential dispute with the Internal Revenue Service over the value of the stock. This burden alone will make creditors reluctant to take the reorganized company's stock as part of the reorganization plan.

Both of these problems would not be significant if the stock that the creditors received in the reorganization proceedings were publicly traded. However, in most reorganizations there is either no market or an extremely limited market for the reorganized company's securities. We believe that the provisions of proposed Section 351 (d) (2) are unduly harsh unless one assumes public trading of the reorganized company's stock.

In the absence of public trading in the stock, there is no guarantee that the question of value will be determined within the bankruptcy proceeding. While Section 1125 of the Bankruptcy Code requires that solicitation of approval of a plan must be on the basis of a disclosure statement which contains adequate information, it explicitly authorizes the court's approval of a disclosure statement where there has been _no_ valuation of the debtor or appraisal of the debtor's assets. In a reorganization it is often sufficient for the creditors to know that the stock they are receiving has some potential worth, as their only alternative is the debtor's liquidation in which they might receive nothing. The stock, at the time the creditors receive it, has no known value, and no creditor will want to use the debtor's limited resources to determine what some hypothetical reasonable investor would pay for the stock. As drafted, proposed Section 351 (d) (2) would create a motive for that valuation, simply to avoid a dispute with the Internal Revenue Service.

We recognize that present law makes possible a tax advantage to a creditor whose debt is not evidenced by a security. It may deduct as a loss against ordinary income much (if not nearly all) of the unpaid debt. The stock received has a reduced basis and the gain resulting from its sale or exchange is taxed at capital gain rates. Although proposed Section 351 (d) (2) would cure this defect, we believe that the value of such cure is far outweighed by the prejudicial effect upon successful reorganizations. Accordingly we urge that present law governing income to the stock recipient be retained except where the stock received is publicly traded at the time of receipt.

June 11, 1980

STATEMENT ON H.R. 5043, THE BANKRUPTCY TAX ACT OF 1980, BY THE COMMITTEE ON TAXATION OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

The Committee on Taxation of the Association of the Bar of the City of New York supports the enactment of H.R. 5043, the Bankruptcy Tax Act of 1980. In general, the provisions of the bill represent a long-awaited clarification of, and substantial improvement over, existing law. Although the Committee believes that certain changes in the bill would be desirable, this should not obscure our support of the legislation.

The Bankruptcy Reform Act, signed by the President on November 6, 1978, codified and enacted Title 11 of the United States Code entitled "Bankruptcy." As originally drafted, the Bankruptcy Reform Act would have accomplished not only the modernization of the substantive law of bankruptcy, but also would have provided rules governing the federal, state and local income taxation of debtors and their estates in bankruptcy proceedings. However, to expedite congressional consideration of this bill, these tax provisions were made applicable only to State and local taxes.

H.R. 5043, the Bankruptcy Tax Act of 1980, passed by the House of Representatives on March 24, 1980, would amend the Internal Revenue Code of 1954 (hereinafter the "Code") to provide rules governing the Federal income tax consequences of bankruptcy and to conform the tax treatment of similar transactions outside of bankruptcy.

Many of the provisions of the bill are noncontroversial but of vital importance. The existence of these provisions, all the product of many years of intensive staff work, make passage of this legislation imperative. These provisions include the following:

1. Conforming the tax determination and collection procedures of the Code to the Bankruptcy Reform Act.

2. Promulgation of a comprehensive set of rules which determine when a bankruptcy estate is a separate taxpayer, how its taxable income is computed, and what special filing requirements are imposed.

3. Amendment of many corporate tax provisions to take account of special problems created by Title 11 proceedings including the definition of a personal holding company, redemptions of railroad company stock, adjustment of the Section 337 requirement, eligibility for Subchapter S filing, transfers to controlled corporations, earnings and profits

calculations, reorganization definitions and carryover of tax attributes.

While some of these provisions could be improved by technical amendments, they all represent needed changes in the law. The staff of the Joint Committee on Taxation should be congratulated for a job well done.

Our specific comments are as follows:

ATTRIBUTE REDUCTION

The Committee on Taxation strongly supports the principle of attribute reduction in connection with the non-recognition of discharge of indebtedness income in bankruptcy proceedings and in the case of insolvent taxpayers. The traditional function of nonrecognition in the federal income tax laws is tax deferral, not tax exemption. This is usually accomplished by the reduction of basis, which results in the recapture of lost revenues through decreased depreciation deductions or through recognition of increased gain on the ultimate disposition of the assets having a reduced basis. There is no bankruptcy policy which necessitates avoidance of this fundamental principle.

In our letter to the Subcommittee on Select Revenue Measures of the House Ways and Means Committee dated January 18, 1980, we noted:

"Use of loss carryovers to absorb unrecognized income is a rational mechanism. It merely requires the reorganized debtor to pay tax on current income without offset by tax benefits rooted in the prebankruptcy past. Furthermore, primary application of loss carryovers rather than asset basis to unrecognized debt discharge income is the only sound policy. When loss carryovers are reduced, the government is more likely to collect the deferred tax out of current and future income. When asset basis is reduced, the government may never collect the deferred tax if the assets affected are nondepreciable and are not subsequently sold or exchanged."

For these reasons, our Committee supported H.R. 5043 as originally introduced. Since that time, the House Ways and Means Committee amended the bill to provide that the debtor could elect, in lieu of the statutory order of attribute reduction, to reduce the basis of depreciable assets first. The bill as revised passed the House of Representatives unanimously. Although this revision is not as theoretically sound as its predecessor, we believe the revised version should be viewed as an acceptable compromise.

STOCK-FOR-DEBT EXCHANGES

Section 2(a) of the bill would amend Section 108 of the Code to provide that a transfer of stock by a corporation to a creditor in satisfaction of its indebtedness (other than indebtedness which qualifies as a security under Section 354

of the Code and is issued either with interest coupons or in registered form) shall be treated as a satisfaction of such indebtedness for an amount equal to the fair market value of the stock. Under present law, the issuance of stock in exchange for debt, in or out of bankruptcy, does not result in the realization of cancellation of indebtedness income. We believe that the reversal of this rule (except with respect to certain securities) in the proposed bill is unnecessarily harsh.

The proposed statute in effect bifurcates the exchange, treating the transaction as though the obligor had issued its stock for cash and applied the cash to retire its indebtedness. While that is certainly one logical characterization, it is by no means the only possible interpretation. It is equally rational to consider the transaction as having the effect of substituting equity for debt in the capital structure. It could well be argued that the corporation should be in no worse position than it would have been in had it issued stock initially for the consideration received upon the issuance of the debt.

The proposed provision would take away any existing incentive for creditors to accept stock for their claims.

Removing such incentive increases the likelihood that the proceedings will evolve into a liquidation rather than a reorganization. Moreover, the provision would drive a wedge between holders of securities and other debt holders and, thus, further complicate already difficult negotiations among creditors. For these reasons, we believe that existing law should remain undisturbed insofar as this issue is concerned.

The House Committee Report indicates an intention to make a valuation of stock issued in exchange for debt binding upon the Internal Revenue Service where (i) such valuation is made by the bankruptcy court after notice to the Service or (ii) such valuation is made by the parties themselves outside of bankruptcy where they are dealing at arms-length. It appears that this is an important element of a compromise worked out in the House. However, it is too far-reaching a principle to be left to a statement in a committee report. An effort by the bankruptcy court, in the absence of specific statutory authority, could arguably be a prohibited declaratory judgment under 28 U.S.C. § 2201.

Also, the conclusion that agreement between private parties could bind the Service may be contrary to present law. Accordingly, it is urged that that portion of the Committee Report be incorporated directly into the statute.

TREATMENT OF ACCRUED INTEREST

Section 4(e) of the bill would amend Section 354 of the Code to provide that the receipt of property (including stock or securities) will be taxable to the recipient as ordinary income to the extent such property "is attributable to interest which has accrued on securities on or after the beginning of the holder's holding period." Under present law, the accrued interest portion of a security is treated as part of the security surrendered so that gain is not normally recognized upon the exchange of a security with accrued but unpaid interest. Carman v. Comm'r., 189 F.2d 363 (2d Cir. 1951); Rev. Rul. 59-98, 1959 - 1 C.B. 76.

We generally support the reversal of the Carman rule but recommend that certain changes be made to Section 4(e) of the bill.

Section 4(e) of the bill would require recognition

of interest income whether or not the taxpayer has realized an economic gain on the exchange, i.e., whether or not the fair market value of the property received exceeds the tax-payer's cost in the security surrendered. We believe this rule to be unduly harsh especially in view of Code Section 354's preclusion of recognition of the (capital) loss. In its stead we would support a rule which provides that no income should be recognized except to the extent gain is realized. In addition, it should be made clear that the new rule is exclusive, i.e., it cannot be amended by a specific allocation in the reorganization plan providing, for example, that no property was exchanged for accrued interest. Finally, if, as the House Committee Report states, a security-holder who previously had accrued the interest as income would recognize a loss to the extent the interest is not paid in the exchange, this should be included in the statute itself.

### DISCHARGE OF INDEBTEDNESS FOR SOLVENT TAXPAYERS OUTSIDE BANKRUPTCY

Under present law, a solvent taxpayer may in certain cases elect not to recognize income from the discharge

of indebtedness under Section 108 of the Code if he elects to reduce the basis of his assets in a manner prescribed by Section 1017 of the Code and the Regulations thereunder. The regulatory sequence may allow the taxpayer to reduce basis in nondepreciable assets such as unimproved real estate and intangible assets such as goodwill. In the former case, the deferral of tax would be enjoyed until the property is disposed of. In the latter case, the deferral may be permanent. If the asset is the stock of a subsidiary, a subsequent tax-free liquidation would make the deferral equivalent to an exemption.

Repeal or modification of Section 108 was not part of H.R. 5043 as originally introduced. At the hearings before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee the Treasury Department first publicly proposed repeal. The Treasury argued that the election was principally availed of by large corporations refinancing their public debt rather than by financially troubled debtors for whom the election was intended to provide relief. The Subcommittee was apparently persuaded by these arguments and



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included a repeal of this election in the bill it reported to the full Ways and Means Committee. The Committee remanded the bill to the Subcommittee for further consideration and the Subcommittee requested written comments from the public on this and other provisions.

Comments received from the public indicated some support for retention of Section 108. The result of the Subcommittee's deliberations was another compromise; it retained the election but limited it to the reduction of basis of depreciable assets. This version is now before the Senate.

As a result of the House changes, an illogical distinction is made. A taxpayer in a Title 11 proceeding who has income from the discharge of indebtedness may elect to reduce the basis of his depreciable assets. Thereafter, he would reduce net operating loss carryovers, credit carryovers, capital loss carryovers and the basis of his remaining assets, but not below his undischarged liabilities. The same rule applies to an insolvent taxpayer. However, a solvent taxpayer may elect to reduce the basis of his depreciable assets. Thereafter, his debt discharge income is recognized. Of course, against this income he would use up first net

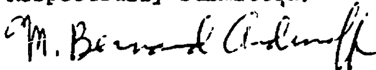
operating loss carryovers and then credit carryovers. He would not be able to use capital loss carryovers and the basis of nondepreciable property. On the other hand, he may be able to avail himself of a "purchase price" adjustment inexplicably made applicable to solvent taxpayers but not to insolvent taxpayers or those in bankruptcy proceedings.

Congress could strike a small blow for simplification while ameliorating some of the graver abuses of present law. H.R. 5043 should be amended to provide that if a solvent taxpayer outside of bankruptcy elects nonrecognition of income from discharge of indebtedness, the extent and order of attribute reductions will be the same as for taxpayers in bankruptcy. Such a scheme would have another positive side effect. The bankruptcy rules would in the present version of the bill apply to insolvent taxpayers to the extent they are insolvent and a different set of rules would apply to the extent they are rendered solvent. Much could turn on the accuracy of the valuation of the taxpayer's assets. If our proposal is adopted, the taxpayer claiming insolvency could make the election to the extent he is rendered solvent and the accuracy of the valuation wouldhave no relevance. We urge this Subcommittee to consider this small amendment which would

go far to ease administrative problems and to rationalize and simplify the law.

In any event, an amendment should be made to cover the case where a parent company reduces its own debt but has insufficient or no basis in depreciable assets of its own. The statute should provide that in the case of an affiliated group of corporations, the basis reductions permitted would include reduction in the basis of assets of any member of the affiliated group which consents to such a reduction.

Respectfully submitted,



M. Bernard Aidinoff, Chairman,
Committee on Taxation,
Association of the Bar
of the City of New York

JAMES B. KRAMER
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907 SOUTH MONROE
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May 23, 1980

Honorable Nancy Landon Kassebaum
United States Senate
Washington, DC 20510

Dear Senator Kassebaum:

I received a copy of your Senate Bill No. S.2503 and viewed it with interest, no pun intended. Agriculture is indeed in dire straights. It appears to me that our insistence as a nation to support the free market system while our trading partners abroad do not is already but surely doing us in. The net effect has been profits for them, in some cases exorbitant, and losses for us. I think its time we develop a fair market system. No contract between parties can long endure that is not fair to both parties. In our zeal to maintain the so called free market system we have not been fair to ourselves and in the long run fair to our trading partners. And in the case of American agriculture, who has been asked to mortgage a little more of the farm each year, ultimately is not free either.

While my analogy of the long range problem is perhaps over simplified, the solutions are not simple and certainly will take time. Time that much of agriculture does not have. So short run solutions must be found to ensure survival for many of our good farmers and stockmen. To this need your bill is directed.

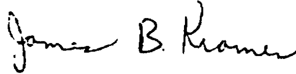
Even though I have a degree in economics, the logic of a blanket policy of raising interest rates to cool off the economy escapes me. There is a vast difference in production economics and consumption economics both in how they effect the economy and how they respond to inflation. In my business of agriculture, borrowing money is one of the tools of my business, as necessary for business as seed, fertilizer and fuel, no more or no less important, nor any different in value. And yet when the price of these other tools exceed government guidelines in price increases, the companies responsible are chided for causing increased inflation while the cost of money can move up many times the level of the government guidelines and that is called anti-inflationary. The truth is that is as inflationary in production economics as any other item even when it can be helpful in curbing inflation when viewing consumption economics. It is understandable how credit has allowed us, as consumers, to chase too few goods with too many dollars causing inflation.

Therefore, in my view, Senator Kassebaum, your bill will attack the problem in a two-prong manner. First, it will give a much needed relief to agriculture so that survival for many will be possible. Secondly, it will

distinguish between and compensate for the difference that the increase in interest rates mean for producers while allowing for the tightening of consumer credit to curb inflation.

I would like to note in closing that the problem has not passed because of the recent decline in prime interest rates. Agriculture lenders had to commit for much of their funds at higher than present rates and will not be able to follow the prime rate down for several months. Therefore, the relief to agriculture that your Bill No. S.2503 addresses is still there and will remain there for several months. I certainly feel that this relief will be needed for the 1980 tax year and provisions made so that any time interest rates get out of hand this relief can be reinstated quickly.

Very truly yours,



James B. Kramer

JBK:s

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June 11, 1980

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Lauren Scott
Ted Thurston
Mary Lou Westerfield
Ellsworth Wright

Honorable Harry F. Byrd, Jr.
Chairman, Subcommittee on Taxation
and Debt Management
Committee on Finance
Room 2227, Dirksen Senate Office Building
Washington, D. C. 20510

Re: S.2500 -- Theatrical Investment Tax Credit Bill

Dear Senator Byrd:

The Council of Actors' Equity Association, representing 30,000 professional actors throughout the United States, strongly endorses S.2500 for all of the reasons set forth in the testimony that has already been given. Increased and broader based investment in theatrical productions are prerequisites to the economic health of the commercial theatre upon which many of our members depend.

Enactment of this bill into law will have virtually no effect on the national budget, but it will have a very significant impact on our industry. It will also correct the present unfair situation where the film industry is able to enjoy the advantages of an investment tax credit, but the commercial theatre cannot. The commercial theatre, in fact, is the only major segment of the arts that now receives no Government support of any kind.

We thus urge your favorable consideration of S.2500. We would appreciate having this letter included in the record of the hearings on this bill.

Sincerely yours,

Willard Swire

WILLARD SWIRE
Associate Executive Secretary

WS/cb

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# AMERICAN FEDERATION OF MUSICIANS

OF THE UNITED STATES AND CANADA

AFFILIATED WITH THE A.F.L.-C.I.O.

OFFICE OF THE PRESIDENT
1500 Broadway
New York, N. Y. 10036

(212) 869-1330

June 5, 1980

The Honorable Harry F. Byrd, Jr.
Chairman, Subcommittee on
Taxation and Debt Management
Committee on Finance, Rm. 227
Dirksen Senate Office Bldg.
Washington, D.C. 20501

Re: S. 2500-Theatrical Investment
Tax Credit Bill

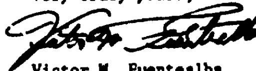
Dear Senator Byrd:

As President of the American Federation of Musicians, the largest entertainment union in the world, I support passage of S. 2500, which would allow an investment tax credit for investments in live theatrical productions. Many of our members are employed in this area of our profession and any increase in investment in theatrical productions will quite naturally benefit our members and increase employment.

The economic well-being of the commercial theater is absolutely essential to the livelihood of our members, and we are concerned that the high risk and cyclical nature of the industry prevents it from achieving long term stability. I anticipate that this bill will attract a larger and more diverse group of investors to theatrical productions by lessening the existing disparity between investments in this industry and other available investment opportunities. It would also remove the disparity which currently exists with the movie industry which already enjoys investment tax credit privileges. On behalf of our members employed in the theatrical field, I therefore strongly urge that you and your colleagues pass this legislation as soon as possible. Its benefits will be great and it should have no adverse effect on the overall economic picture. In fact, stimulation of theatrical investment should create more stage productions, more jobs both in and out of our industry, and result in substantially greater future tax revenues.

I would appreciate it if you would include this letter in the record of hearings on the bill.

Very truly yours,



Victor W. Fuentealba
President

VWF/rs

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OFFICE OF THE PRESIDENT

June 5, 1980

Honorable Harry F. Byrd, Jr.
Chairman, Subcommittee on Taxation
and Debt Management
Committee on Finance
Room 2227, Dirksen Senate Office Building
Washington, D. C. 20510

Re: S.2500 -- Theatrical Investment Tax Credit Bill

Dear Senator Byrd:

The membership of the International Alliance of Theatrical Stage Employes is seriously concerned with the volatility of job opportunities and security in the live theatre industry. Theatre jobs ebb and flow with the economic expectations of theatrical investors. S.2500 -- a bill now before your Committee -- is viewed by us as a good means to attract a broader spectrum of investors to the commercial theatre, and we are very much in favor of it.

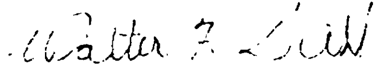
The non-profit segment of the theatre receives direct governmental grants from the National Endowment for the Arts and the motion picture industry already receives investment tax credit benefits. The tax-paying commercial theatre as a result, suffers badly from this unfair treatment since it now receives no government support at all.

Allowing a small tax credit for investments in commercial theatre productions will go a long way toward eliminating this form of discrimination, and it will have a negligible impact on the budget.

We thus strongly urge favorable action on S.2500 as an important means of support for jobs in the live theatre.

Please include this statement in the record of hearings on this bill.

Sincerely,



INTERNATIONAL PRESIDENT

WFD:mf

NEW YORK STATE BAR ASSOCIATION
TAX SECTION

SUPPLEMENTAL REPORT ON H.R. 5043
(THE BANKRUPTCY TAX ACT OF 1979)

By

Committee on Bankruptcy and Insolvency*

June 19, 1980

## Introduction

The Subcommittee on Taxation and Debt Management of the Senate Finance Committee recently held hearings on H.R. 5043, the "Bankruptcy Tax Act of 1980" (the "Bill"). The Bill would effect substantial changes in the Federal income tax rules applicable to bankruptcy and insolvency. In addition, the Bill would have an impact on certain transactions involving solvent taxpayers, particularly as regards cancellation of indebtedness. In October of 1979, the Committee on Bankruptcy and Insolvency filed a lengthy report (the "Original Report") dealing with the Bill in the form which it bore as initially introduced in the House. The Original Report included a summary of the legislation

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* This report was drafted by the Committee's Chairman, Peter C. Canellos. Valuable contributions to the report were made by Paul H. Asofsky and Richard M. Leder.

and extended comments regarding the provisions thereof which would amend Subchapter C of the Internal Revenue Code (the "Code"). It is the purpose of this supplemental report (i) to update the discussion in the Original Report to reflect the Bill in its present form; and (ii) to comment upon the sections of the Bill which deal with income from discharge of indebtedness and related issues. The provisions regarding discharge of indebtedness were not covered in the Original Report because of the accelerated consideration of the Bill by the House Ways and Means Committee. Together with the Subchapter C changes covered in the Original Report, the changes relating to income from discharge of indebtedness are central to the tax treatment of business reorganizations.

## The Original Report

The Original Report contained nine recommendations for amendments and clarifications to the proposed Subchapter C changes in the Bill. These recommendations remain applicable to the present form of the Bill except as noted below. The Committee reiterates its view that those recommendations should be reflected in the final version of the Bill.

Many of the recommendations in the Original Report related to clarification of the continuity of interest rule

as applied to bankruptcy reorganizations. The original Bill contained an express statutory rule regarding continuity of interest. That rule has been eliminated from the current version of the Bill. Accordingly, the application of the continuity of interest rule to bankruptcy reorganizations has been left largely to the courts. While the Original Report recommended a revised statutory provision regarding continuity, it is the view of the Committee that the present Bill's solution of leaving the question to the courts is acceptable. The doctrine of continuity of interest was developed initially by the courts, and there is every reason to expect that they will apply that doctrine in a reasonable and flexible manner to future bankruptcy reorganizations.

One concern that had prompted the Committee to recommend a statutory rule on continuity was the possibility that the courts would treat the relaxation of the "absolute priority" rule under the Bankruptcy Reform Act of 1978 as somehow undermining the Alabama Asphaltic authorities treating creditors as the equitable owners of a bankrupt corporation. See Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942). The report of the Ways and Means Committee on H.R. 5043 (the "House Report") makes it clear, however, that the Alabama Asphaltic doctrine should survive this change in bankruptcy law. A second concern expressed in the Original Report related to the failure of the Bill to apply

a consistent treatment of creditors as deemed former shareholders for Subchapter C purposes. For example, the Committee was concerned that a distribution of boot to short-term creditors would not come within Section 361(b)(1)(A) of the Code, which eliminates corporate-level tax on boot distributed pursuant to the plan of reorganization. The House Report indicates that such a distribution will come within the statutory provision in question. The Committee is concerned, however, that the question may remain open despite the House Report. Accordingly, the Committee recommends that an express statutory resolution to the ancillary questions regarding the status of creditors be adopted.

The Original Report also recommended that the new "G" reorganization include acquisitions of stock as well as asset acquisitions. While that recommendation was not adopted, the current version of the Bill does extend the "reverse merger" provisions of Section 368(a)(2)(E) to certain bankruptcy reorganizations. The reverse merger technique is often a viable alternative to achieve, in effect, a stock acquisition. However, the provision included in the Bill is so narrowly drafted that it could not be utilized in many cases. Under the Bill, the reverse merger provisions will apply only if (i) no former shareholder of the surviving corporation received any consideration

for his stock, and (ii) the former creditors of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, debt of the surviving corporation which had a fair market value equal to 80 percent or more of the total fair market value of the debt of the surviving corporation. The Committee believes that tax-free reverse triangular mergers should be permitted where the former shareholders and creditors receive the consideration transferred in the merger. Thus, the provision should be modified so as to permit reverse mergers in which the acquirer winds up with a controlling interest upon the issuance of consideration at least 80% of which consists of the parent's voting stock, even if recipients include former shareholders as well as creditors.

Description of Bill Provisions Relating to Discharge of Indebtedness (Section 2 of the Bill)

Section 2 of the Bill contains proposed amendments to Sections 108, 111, 382 and 1017 of the Code.

Under Section 108 as revised, gross income does not include income arising by reason of the discharge of taxpayer's indebtedness (i) in a Title 11 bankruptcy case; (ii) when the taxpayer is insolvent (*i.e.*, to the extent his liabilities exceed the fair market value of his assets prior to giving effect to the debt cancellation); or (iii) if the

taxpayer elects to reduce basis in connection with the discharge of "qualified business indebtedness". The amount excluded from income in a Title 11 case is applied to reduce the taxpayer's tax attributes in the following order: net operating loss carryovers, certain credit carryovers, capital loss carryovers, and asset basis. Asset basis is not to be reduced below the amount of surviving liabilities. However, the taxpayer can elect to reduce the basis of depreciable assets in lieu of other attributes. If the basis of depreciable assets is reduced under this election, the reduction is not limited to the amount of remaining liabilities. Similar rules obtain in the case of a discharge of indebtedness by an insolvent taxpayer outside of bankruptcy. Finally, an insolvent taxpayer can eliminate income arising from the discharge of qualified business indebtedness by reducing the basis in his depreciable assets.

In addition to these operative rules regarding discharge of indebtedness, new Section 108 contains several provisions defining discharge of indebtedness to include transactions not treated as such under present law. Thus, an acquisition by a person related to the debtor within the meaning of Sections 267(b) or 707(b)(1) of the Code is treated as the acquisition of such debt by the debtor. In addition, the satisfaction of debt through the issuance of stock of the debtor is treated as a discharge of debt to the

extent that the amount of the debt exceeds the fair market value of the stock. An exception is provided for a security described in Section 165(g)(2)(C) and Section 354 of the Code. For purposes of this provision, stock of a corporation in control of the debtor (within the meaning of Section 368(c)), is treated as stock of the debtor. The Bill creates an exception from the discharge of indebtedness rules (in the case of solvent taxpayers) for purchase money indebtedness. Reductions in such indebtedness are treated as a purchase price adjustment. Finally, new Section 108 contains a number of rules relating to the discharge of partnership indebtedness. In essence, these rules would undo the effect of the Stackhouse case by treating discharge of indebtedness at the partner level. Stackhouse v. Commissioner, 441 F.2d 465 (5th Cir. 1971).

Section 1017 of the Code would be amended by the Bill in a number of respects. First, the reduction in basis is to take effect as of the first day of the taxable year following the discharge. Second, the reduction under Section 1017 applies only to depreciable property (i.e., property owned by the debtor subject to depreciation but only if a basis reduction will reduce the amount of depreciation actually allowable following such reduction). An interest in partnership property is considered a depreciable asset to the extent of the partner's share of the partnership's



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depreciable assets. Any reduction in the basis of a partner's interest is to be accompanied by a corresponding reduction in the basis of partnership property with respect to such partner. New Section 1017 provides that a reduction in basis is not treated as a "disposition" thus assuring the absence of investment tax credit recapture on such reduction. Finally, any reduction in basis under Section 1017 is subject to recapture under rules analogous to Sections 1245 and 1250.

Section 111 would be amended to make it clear that an increase in a carryover which has not expired shall be treated as a reduction in tax for purposes of the Section 111 exclusion.

Finally, Section 382 of the Code would be amended by the Bill (i) to exclude stock of the debtor acquired by a creditor in a Title 11 or similar case from the category of "purchases" subject to existing Section 382(a) (prior to the 1976 Act revisions) unless the claim was acquired for the purpose of acquiring stock and (ii) to treat a creditor who receives stock in a "G" reorganization as a former shareholder for purposes of existing Section 382(b).

Comments on Section 2 of the Bill

The Committee is in general agreement with Section 2 of the Bill. The Bill is consistent with bankruptcy

policy in that it excludes discharge of indebtedness from income in the case of a debtor in a Title 11 proceeding or a debtor which is insolvent. At the same time, the Bill is consistent with sound tax policy in requiring the debtor to reduce its tax attributes to reflect the exclusion of such income. Moreover, the Bill allows for considerable flexibility by affording the debtor an election to reduce the basis of depreciable assets. By electing to reduce basis, the debtor can avoid near-term adverse tax effects which might result from elimination of loss carryover or other attributes. Of course, eliminating any of the debtor's tax attributes is disadvantageous as compared with the outright exclusion of discharge income. Elimination of discharge income without attribute reduction is conceivably in furtherance of the desire to rehabilitate the bankrupt. The Committee, of course, is not qualified to pass judgment on matters of pure bankruptcy policy. Nevertheless, the Committee is of the view that the Bill strikes a compromise between bankruptcy and tax policy which should be upheld in the absence of a persuasive showing to the contrary on the part of bankruptcy experts. At the same time, the Bill eliminates the worst abuse of the Section 108-1017 election under present law -- namely, the ability to reduce basis on non-depreciable assets as a means of avoiding the impact of discharge income.

While we are in general agreement with Section 2 of the Bill, we believe that it would benefit from a number of changes described below:

1. Stock For Debt Rules. We believe the Bill creates an unreasonable distinction between securities and other indebtedness in treating exchanges of stock for non-security debt as a discharge event. We believe that the substitution of the debtor's stock for its outstanding debt obligation (of any type) should be treated as an adjustment in its capital and liability accounts rather than a discharge event. In effect, this would place the debtor in no worse position than would be the case if it had issued stock originally. This result would be consistent with a long line of consistent judicial authority treating debt-stock exchanges as not resulting in discharge income. *See, e.g.*, *Alcazar Hotel Inc.*, 1 T.C. 872 (1943). Treating debt-stock exchanges in this manner would also comport with apparent strong bankruptcy policy encouraging the reorganization of companies through the issuance of stock for debt. Of course, there would be need for some rule to cover transactions in which a nominal amount of stock is issued for debt solely to preserve tax attributes. But that need exists in the Bill as well insofar as securities are concerned. The House Report indicates that a *de minimus* rule will be applicable to security-stock exchanges. Such a rule could equally apply to other debt-stock exchanges.

Even if the stock for securities rule is retained, there is a need for clarification. First, where the debtor issues stock and other property for its security debt, there is need for a rule determining the amount of discharge. The House Report takes the position that the reacquired debt is allocated between stock and other property based on the relative values of each. Accordingly, discharge income may arise when security debt is exchanged for stock and boot even though an exchange of securities for stock (without boot) would not result in discharge income. This appears to be an anomalous result. Subject to the _de minimus_ rule discussed above, the entire discharge amount should be attributed to the stock in an exchange of securities for stock and boot, thus eliminating discharge income on the exchange. For example, if $20 of cash and $60 worth of stock are exchanged for $100 principal amount of securities, the debtor should be deemed to have reacquired $20 principal amount of securities for the cash and $80 for the stock.

A second problem relates to the divergent rules in the Bill for stock-debt exchanges and contributions of debt to the debtor's capital. In the latter case, the measure of discharge is the difference between the face amount of the debt and the holder's basis therein. It would appear desirable to have a uniform rule regarding contributions to capital and debt-stock exchanges since, in most cases, the economic

effect on the debtor would not be significantly different.

Finally, there is need to integrate the related party rules (discussed below) with the rule treating a controlling shareholder's stock as debtor's stock. For example, if a parent company acquires debt of a 50% or more owned subsidiary for parent stock, the related party rules come into play. Nevertheless, neither the parent nor the subsidiary could benefit from the securities-stock rule unless the parent owned more than 80% of subsidiary's stock.

2. Related Party Rules. Under the related party rules, acquisition of debt by a party related to the debtor can result in discharge income.* The rules of relationship provided for under these provisions are quite extensive. Particularly in the case of affiliated groups of companies, these rules may often come into play. The Bill fails to grapple with the complex ancillary consequences of an acquisition by a related party which is treated as a discharge event. A principal defect is the failure to provide a statutory mechanism to prevent a second inclusion in

* The Tax Section has previously recommended that the economic gain arising on such an acquisition be treated as ordinary income resulting from discharge of indebtedness. See the Report on International Finance Subsidiaries of a subcommittee of the Tax Section, reprinted at 28 Tax Law Review 439 (1973).

income (or a recognition of gain) upon subsequent disposition or collection of the debt by the related party. The House Report states that the Treasury is expected to issue regulations providing a deduction to the debtor in the event it pays the debt to the related party. That rule appears highly unsatisfactory since it would permit the ready conversion of debt discharge ordinary income into capital gain. For example, the debtor's affiliate could acquire the debt at a discount resulting in ordinary income. More than one year after the acquisition, the debtor could pay off the debt at face value generating capital gain to the holder and a deduction eliminating the previously included discharge income. A better rule, particularly in the case of corporations within an affiliated group, would appear to be to allow a basis adjustment to the related party in respect of the discharge income reported by the debtor. (For example, if a parent acquired $100 principal amount of its subsidiary's debt for $80, the subsidiary would report $20 of income and the parent would take a basis of $100 in the debtor.) Whatever rule is adopted should be reflected in the statute.

3. Election to Reduce Basis and Depreciable Property. The Bill does not permit a controlling corporation to treat its investment in a subsidiary as depreciable property. That result is contrary to the rule provided for

in the case of partnerships. As a result, a pure holding company will not be able to avail itself of the basis reduction alternative. There would appear to be no reason to punish a company that operates through subsidiaries rather than divisions. Accordingly, the holding company should be permitted to reduce the basis in a consolidated subsidiary's stock, provided that the subsidiary in question makes a corresponding reduction in the basis of its depreciable assets.

The basis reduction rules appear to create an opportunity to escape the operation of the "at risk" rules contained in Section 465 of the Code. The Bill would permit a taxpayer to exclude discharge income by reducing its basis in depreciable assets employed in an unrelated activity subject to the at risk rules. The Bill should either exclude such assets from the basis-reduction election or provide that basis reduction constitutes a "loss" within the meaning of Section 465(d) of the Code.

4. Purchase Price Adjustment. The provision treating certain discharges of acquisition indebtedness as purchase price adjustments appears both overly narrow and too broad. On the one hand, the provision is limited to solvent taxpayers. Taxpayers who are insolvent or in Chapter 11 face income or attribute reduction (assuming

no election to reduce basis) rather than a purchase price adjustment. On the other hand, solvent taxpayers can make use of this rule even if the debt in question was not incurred in connection with a trade or business, which goes beyond the scope of the new Section 108-1017 basis election.

The House Report takes the position that an adjustment in purchase-money indebtedness will constitute an adjustment for purposes of the investment credit rules of the Code. While that position is consistent with the present Internal Revenue Service position on basis reduction of investment tax credit property, it is not clear that the Service position is sustainable as a matter of law. Accordingly, the legislative history should not attempt to decide this contested issue. The matter should be either left to the courts or consciously addressed in the statute.

The Bill does not address itself to the case where purchase money indebtedness is reduced by an amount in excess of the adjusted basis of the property. Presumably, gain should result in such a case. This question should be addressed in the statute or the Senate Report.

6. Partnership Issues. The statutory changes relating to partnerships are most confusing and inconsistent. Section 108(d)(5) as amended by the Bill would provide that "in the case of a partnership, subsections

(a) [exclusion of discharge income], (b) [reduction of attributes] and (c) [reduction in basis of depreciable property] shall be applied at the partner level". However, the term "qualified business indebtedness", which is the type of debt as to which a solvent taxpayer may elect to reduce basis, is limited to debt incurred or assumed "by a corporation" or "by an individual in connection with property used in his trade or business". Partnership debt is not incurred by a corporation or an individual. Presumably, the rule is intended to mean that the partner is deemed to have incurred the partnership debt. If so, however, it is not clear that such debt was incurred in connection with property used in the partner's trade or business since a partner is not necessarily engaged in the business of his partnership. Compare Section 875 which expressly provides that a nonresident partner "shall be considered as being engaged in a trade or business within the United States if the partnership of which such [non-resident] is a member is so engaged." The Bill should clarify the application of the "qualified business indebtedness" definition to a partnership.

Section 1017 as amended by the Bill would permit a taxpayer to reduce the basis of his partnership interest as a means of excluding discharge income and would require the partnership to make a corresponding reduction in his share

of the partnership's depreciable property. Thus, the partnership is compelled to make what amounts to a quasi-Section 754 election in such a case. Given the accounting and other complexities of such an election, the partnership should not be forced to make the adjustment in question. Rather, the partner's election to reduce basis in his partnership interest should be contingent upon consent by the partnership.

7. Section 382 Changes. The exclusion of debt-stock exchanges from the strictures of Section 382 contained in the Bill is narrowly drafted. The exclusion from Section 382(a) applies only to exchanges which take place in a Title 11 or similar case. It does not apply to other debt for stock exchanges involving solvent or insolvent companies. The distinction between the treatment of the insolvent taxpayer in and out of bankruptcy could conceivably encourage debtors to file under Chapter 11 in order to obtain the benefits accorded under Section 382(a). This is undesirable from both a bankruptcy and tax viewpoint. Similarly, the exclusion from Section 382(b) applies only to "G" reorganizations and not to other reorganizations involving solvent or insolvent companies. Again, this rule should be expanded to prevent recourse to bankruptcy to achieve a tax goal.