1981-82 MISCELLANEOUS TAX BILLS III

3

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

ON

S. 388, S. 446, S. 464, S. 476, S. 499, S. 500, S. 501

MARCH 30, 1981

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1981-82 MISCELLANEOUS TAX BILLS, III

MONDAY, MARCH 30, 1981

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

The subcommittee met, pursuant to notice, at 10 a.m., in room 2221, Dirksen Senate Office Building, the Hon. Bob Packwood (chairman of the subcommittee) presiding.

Present: Senators Packwood, Durenberger, Symms, Bentsen, Matsunaga, and Moynihan.

[The press release announcing this hearing and the bills, S. 388, S. 446, S. 464, S. 476, S. 499, S. 500, S. 501, and description of these bills follow:]

Press Release No. 81-116

P R E S S   R E L E A S E

FOR IMMEDIATE RELEASE
March 16, 1981

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 HEARING ON MISCELLANEOUS TAX BILLS

Senator Packwood, 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 March 30, 1981 on seven miscellaneous tax bills.

The hearing will begin at 10:00 a.m. on March 30, 1981, in Room 2221 of the Dirksen Senate Office Building.

The following pieces of legislation, grouped by topic, will be conside ed at the hearing:

Taxatior of Annuities

S. 388 --

Introduced by Senator Hatch for himself and Senator Tower. Would expressly overrule Revenue Ruling 77-85 which held that an annuityholder is currently taxable on accruing income if he holds certain investment powers over the amounts invested in the annuity.

S. 446 --

Introduced by Senator Symms for himself and Senator Lugar. Would overrule Revenue Ruling 80-274 to permit tax deferral for the purchaser of an annuity, the purchase price of which is invested by the issuing company in a financial institution, rather than being otherwise invested in regulated investments.

Taxation of Private Foundations

S. 464 --

Introduced by Senator Durenberger for himself and others. Would amend certain administrative rules and the minimum pay-out rules to permit private foundations both greater flexibility and certainty in operation.

S. 476 --

Introduced by Senator Durenberger for himself and Senator Boschwitz. Would provide an alternative valuation rule for shares by banks, bank related companies and bank holding companies held by a private foundation in computing income required to be distributed currently.

S. 500 and S. 501 --

Introduced by Senator Moynihan. Alternative bills which would amend the current requirements of pay-out by a private foundation of its income either to limit such required pay-outs to real income adjusted for inflation or to limit such required pay-out to only 5% of a private foundation's assets.

FCC-Ordered Exchanges

S. 499 --

Introduced by Senator Moynihan. Would amend I.R.C. Section 1071 to extend the special nonrecognition treatment now accorded to FCC-ordered dispositions of radio stations to television stations.

Requests to Testify. Witnesses who desire to testify at the hearing must submit a written request to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, to be received no later than the close of business on March 20, 1981. Witnesses will be notified as soon as practicable thereafter whether it has been possible to schedule them to present oral testimony. If for some reason a witness is unable to appear at the time scheduled, he may file a written statement for the record in lieu of the personal appearance. In such case a witness should notify the Committee of his inability to appear as soon as possible.

Consolidated testimony. Senator Packwood urges all witnesses who have a common position or who have the same general interest to consolidate their testimony and designate a single spokesman to present their common viewpoint orally to the Subcommittee. This procedure will enable the Subcommittee to receive a wider expression of views than it might otherwise obtain. Senator Packwood urges very strongly that all witnesses exert a maximum effort to consolidate and coordinate their statements.

Legislative Reorganization Act--Senator Packwood 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 not later than noon on the last business day before the witness is scheduled to appear.

(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 noon on Friday, March 27, 1981.

(4) Witnesses should not read their written statements to the Subcommittee, but ought instead to confine their oral presentations to a summary of the points included in the statement.

(5) Not more than five minutes will be allowed for the oral summary.

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 Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510, not later than Wednesday, April 15, 1981.

II

97TH CONGRESS
1ST SESSION

S. 388

To reinstate the tax treatment with respect to annuity contracts with reserves based on a segregated asset account as they existed prior to issuance of Revenue Ruling 77-85.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 3 (legislative day, JANUARY 5), 1981

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

---

A BILL

To reinstate the tax treatment with respect to annuity contracts with reserves based on a segregated asset account as they existed prior to issuance of Revenue Ruling 77-85.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That in the case of annuity contracts which have related
4 amounts based on a segregated asset account, the tax treat-
5 ment of such contracts under section 61 of the Internal Reve-
6 nue Code of 1954 (defining gross income) and section
7 801(g)(1)(B) of such Code (relating to contracts with reserves
8 based on a segregated asset account) shall be determined—

1 (1) without regard to Revenue Ruling 77-85 (and
2 without regard to any other regulation, ruling, or deci-
3 sion reaching the same result as, or a result similar to,
4 the result set forth in such Revenue Ruling); and
5 (2) with full regard to the rules in effect before
6 Revenue Ruling 77-85.

II

97TH CONGRESS
1ST SESSION

S. 446

Relating to the treatment of certain annuity contracts.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 6 (legislative day, JANUARY 5), 1981

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

---

A BILL

Relating to the treatment of certain annuity contracts.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That the Internal Revenue Code of 1954 shall be applied
4 with respect to any annuity contract—
5 (1) without regard to Revenue Ruling 80-274
6 (and without regard to any subsequent regulation,
7 ruling, or decision reaching the same result as, or a
8 result similar to, the result set forth in such revenue
9 ruling), and

1 (2) with full regard to the rulings in effect before
2 such revenue ruling.

II

97TH CONGRESS
1ST SESSION

S. 464

To amend the Internal Revenue Code of 1954 to adjust provisions governing private foundations.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 6 (legislative day, JANUARY 5), 1981

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

---

A BILL

To amend the Internal Revenue Code of 1954 to adjust provisions governing private foundations.

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. AMOUNT OF REQUIRED DISTRIBUTIONS.**
4 (a) GENERAL RULE.—
5 (1) Paragraph (1) of section 4942(d) of the Inter-
6 nal Revenue Code of 1954 (defining distributable
7 amount) is amended by striking "or the adjusted net
8 income (whichever is higher)".

1 (2) Paragraph (3)(A) of section 4942(j) of the In-
2 ternal Revenue Code of 1954 is amended to read as
3 follows:
4 "(A) which makes qualifying distributions
5 (within the meaning of paragraph (1) or (2) of
6 subsection (g)) directly for the active conduct of
7 the activities constituting the purpose or function
8 for which it is organized and operated—
9 "(i) equal to substantially all of its ad-
10 justed net income (as defined in subsection
11 (f)), or
12 "(ii) if that amount exceeds substantial-
13 ly all of its minimum investment return (as
14 defined in subsection (e)), equal to substan-
15 tially all of its minimum investment return,
16 and if its actual qualifying distributions
17 (within the meaning of paragraph (1) or (2)
18 of subsection (g)) exceed its minimum invest-
19 ment return, substantially all of such qualify-
20 ing distributions (within the meaning of para-
21 graph (1) or (2) of subsection (g)) are made
22 directly for the active conduct of the activi-
23 ties constituting the purpose or function for
24 which it is organized and operated; and".

1 (b) EFFECTIVE DATE.—The amendment made by sub-
2 section (a)(1) shall apply to the determination of a private
3 foundation's distributable amount for taxable years beginning
4 after December 31, 1980. The amendment made by subsec-
5 tion (a)(2) shall apply to the determination of a foundation's
6 status as an operating foundation for taxable years beginning
7 after December 31, 1980.

8 **SEC. 2. TECHNICAL AND ADMINISTRATIVE AMENDMENTS.**

9 (a) EXEMPTION OF CERTAIN SMALL GRANTS FROM
10 EXPENDITURE RESPONSIBILITY REQUIREMENT.—
11 (1) GENERAL RULE.—Paragraph (4) of section
12 4945(d) of the Internal Revenue Code of 1954 (defin-
13 ing taxable expenditure) is amended to read as follows:
14 "(4) as a grant to an organization unless—
15 "(A) the private foundation exercises expend-
16 iture responsibility with respect to such grant in
17 accordance with subsection (h),
18 "(B) such grant is to an organization de-
19 scribed in paragraph (1), (2), or (3) of section
20 509(a), or
21 "(C) the aggregate amount of grants made
22 during the private foundation's taxable year by
23 the foundation (and all other private foundations
24 effectively controlled, directly or indirectly, by the
25 same person or persons who control the founda-

1 tion in question) to such organization does not
2 exceed $10,000.".
3 (2) EFFECTIVE DATE.—The amendment made by
4 paragraph (1) shall apply to grants made after Decem-
5 ber 31, 1980.
6 (b) DEFINITION OF FAMILY MEMBER.—
7 (1) GENERAL RULE.—Subsection (d) of section
8 4946 of the Internal Revenue Code of 1954 (defining
9 members of family) is amended to read as follows:
10 "(d) MEMBERS OF FAMILY.—For purposes of subsec-
11 tion (a)(1), the family of an individual shall include only his
12 spouse, ancestors, children, grandchildren, and the spouses of
13 children and grandchildren.".
14 (2) EFFECTIVE DATE.—The amendment made by
15 paragraph (1) shall take effect on January 1, 1981.
16 (c) RELIANCE UPON DETERMINATIONS BY THE SEC-
17 RETARY.—
18 (1) GENERAL RULE.—Section 4946 of the Inter-
19 nal Revenue Code of 1954 is amended by adding at
20 the end thereof the following subsection:
21 "(e) RELIANCE UPON DETERMINATIONS BY THE SEC-
22 RETARY.—A grant by a private foundation to an organiza-
23 tion which has been determined by the Secretary to be an
24 organization described in paragraphs (1) and (2) of section
25 509(a) or in paragraph (3) of section 4942(j) shall be treated

1 as a grant to such an organization provided that the grant or
2 other expenditure is made prior to the earlier of the date of
3 publication of notice by the Secretary that the organization is
4 no longer described in paragraphs (1) or (2) of section 509(a)
5 or in paragraph (3) of section 4942(j) or the date on which
6 the foundation acquires actual knowledge that the organiza-
7 tion has been notified by the Secretary of such a change in
8 the organization's status or that the receipt of such grant will
9 cause such a change in the organization's status.".

10 (2) EFFECTIVE DATE.—The amendment made by
11 paragraph (1) shall apply to grants and other expendi-
12 tures made after December 31, 1980.

II

97TH CONGRESS
1ST SESSION

S. 476

To amend the Internal Revenue Code of 1954 with respect to the valuation of bank holding company assets for the purpose of determining the amount certain private foundations are required to distribute.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 6 (legislative day, JANUARY 5), 1981

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

---

A BILL

To amend the Internal Revenue Code of 1954 with respect to the valuation of bank holding company assets for the purpose of determining the amount certain private foundations are required to distribute.

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. SPECIAL VALUATION FOR BANK HOLDING COM-**
4 **PANY ASSETS.**
5 (a) GENERAL RULE.—Subsection (e) of section 4942 of
6 the Internal Revenue Code of 1954 (defining minimum in-

1 vestment return) is amended by adding at the end thereof the
2 following new paragraph:
3 "(3) SPECIAL VALUATION.—
4 "(A) IN GENERAL.—For purposes of para-
5 graph (1)(A), in the case of a private foundation
6 which is a bank holding company and which has a
7 substantial portion of its assets consisting of secu-
8 rities in—
9 "(i) banks,
10 "(ii) bank related companies, or
11 "(iii) a bank holding company,
12 the private foundation shall have the option of
13 valuing the banks and bank related companies
14 which are owned in whole or in part by the pri-
15 vate foundation (or by any bank holding company
16 in which the private foundation owns securities)
17 by capitalizing the dividends paid by the banks
18 and bank related companies at a capitalization
19 rate of 6 percent.
20 "(B) DEFINITIONS.—For purposes of this
21 paragraph—
22 "(i) BANK RELATED COMPANY.—The
23 term 'bank related company' means any cor-
24 poration or company which may be acquired
25 by a bank holding company under the provi-

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1 sions of paragraph (1) or (8) of section 4(c) of
2 the Bank Holding Company Act of 1956, as
3 amended.
4 "(ii) BANK HOLDING COMPANY.—The
5 term 'bank holding company' has the same
6 meaning as when used in the Bank Holding
7 Company Act of 1956.".
8 (b) EFFECTIVE DATE.—The amendment made by this
9 section shall apply to taxable years beginning after Decem-
10 ber 31, 1971.

II

97TH CONGRESS
1ST SESSION

S. 499

To amend a provision of the Internal Revenue Code dealing with involuntary conversions of broadcast property.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 19 (legislative day, FEBRUARY 16), 1981

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

A BILL

To amend a provision of the Internal Revenue Code dealing with involuntary conversions of broadcast property.

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. Subsection (a) of section 1071 of the Inter-
4 nal Revenue Code (relating to gains from sale or exchange to
5 effectuate policies of the FCC) is amended by striking the
6 term "radio broadcasting stations" in the first sentence of
7 such subsection and inserting in lieu thereof "radio or televi-
8 sion broadcasting stations". The subsection also is amended
9 by striking the term "radio broadcasting station" in the

1 second sentence and inserting in lieu thereof "radio or televi-
2 sion broadcasting station, or newspaper".
3 SEC. 2. The amendments made by this Act shall take
4 effect on January 1, 1980.

II

97TH CONGRESS
1ST SESSION

S. 500

To amend the Internal Revenue Code of 1954 with respect to the amount which certain private foundations are required to distribute.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 19 (legislative day, FEBRUARY 16), 1981

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

---

A BILL

To amend the Internal Revenue Code of 1954 with respect to the amount which certain private foundations are required to distribute.

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 (f) of section 4942 of the Internal
4 Revenue Code of 1954 (defining adjusted net income) is
5 amended—
6 (1) by inserting ", reduced as provided in para-
7 graph (5)," after "excess (if any)" in paragraph (1),
8 and

1 (2) by adding at the end thereof the following new
2 paragraph:
3 "(5) INFLATION ADJUSTMENT.—
4 "(A) IN GENERAL.—The amount of the
5 excess determined under paragraph (1) shall be
6 reduced by an amount equal to the product of—
7 "(i) the amount of such excess, multi-
8 plied by
9 "(ii) the inflation adjustment for the cal-
10 endar year in which the taxable year begins.
11 "(B) INFLATION ADJUSTMENT DEFINED.—
12 For purposes of subparagraph (A), the term 'infla-
13 tion adjustment' with respect to any calendar year
14 means the percentage by which—
15 "(i) the first revision of the implicit
16 price deflator for the gross national product
17 as of the last day of the calendar year pre-
18 ceding such calendar year, exceeds
19 "(ii) such deflator as of the last day of
20 the second calendar year preceding such cal-
21 endar year.".
22 (b) The amendments made by subsection (a) shall apply
23 to taxable years beginning after December 31, 1980.

II

97TH CONGRESS
1ST SESSION

S. 501

To amend the Internal Revenue Code of 1954 with respect to the amount which certain private foundations are required to distribute.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 19 (legislative day, FEBRUARY 16), 1981

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

---

A BILL

To amend the Internal Revenue Code of 1954 with respect to the amount which certain private foundations are required to distribute.

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 (1) of section 4942(d) of the Internal Rev-
4 enue Code of 1954 (defining distributable amount) is amend-
5 ed by striking out "or the adjusted net income (whichever is
6 higher)".
7 (b) Paragraph (1) of section 4942(f) of such Code (defin-
8 ing adjusted net income) is amended by striking out "For

1 purposes of subsection (d)" and inserting in lieu thereof "For
2 purposes of subsection (j)(3)".
3 (c) The amendments made by this section shall apply to
4 taxable years beginning after December 31, 1980.

DESCRIPTION OF TAX BILLS

(S. 388, S. 446, S. 464, S. 476, S. 499, S. 500, and S. 501)

ON MARCH 30, 1981

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on March 30, 1981, by the Senate Finance Subcommittee on Taxation and Debt Management.

There are seven bills scheduled for the hearing: S. 388 and S. 446 (relating to tax treatment of investment and wraparound annuities), S. 464 (relating to modifications of private foundation rules), S. 476 (relating to special distribution rule for private foundations constituting bank holding companies), S. 500 (relating to inflation adjustment of income payout requirement for private foundations), S. 501 (relating to repeal of alternative income payout requirement for private foundations), and S. 499 (relating to rollover of gain on FCC-ordered disposition of broadcast property).

The first part of the pamphlet is a summary of the bills. This is followed by a more detailed description of the bills (in the order the bills were listed in the press release announcing the hearing), including present law, issues, an explanation of the bills, effective dates, and estimated revenue effects.

I. SUMMARY

1. S. 388—Senators Hatch and Tower and 2. S. 446—Senators Symms and Lugar

Tax Treatment of Investment and Wraparound Annuities

Under rulings issued by the Internal Revenue Service in 1977 and 1980, earnings on assets invested in certain investment annuity contracts and "wraparound" annuity contracts are taxed currently to the individual owning the contract.

Under the bills, which are substantially identical in effect, tax would be deferred until benefits are paid under the contracts. Thus, investment annuities and wraparound annuities would receive the same tax treatment accorded traditional commercial annuities under present law (Code sec. 72(a)). The provisions of the bills would apply upon enactment.

3. S. 464—Senators Durenberger Moynihan, Baucus, Riegle, and Thurmond

Modifications of Private Foundation Rules

Payout rules

Under present law (Code sec. 4942), a private foundation is required to distribute for charitable purposes the greater of its minimum investment return (five percent of the fair market value of its investment assets) or its net income. The bill would repeal the alternative requirement under the foundation payout rule that, under present law, requires a private foundation to distribute any excess of net income over its minimum investment return.

The general distribution requirements are not applicable to private operating foundations. Under present law, to qualify as a "private operating foundation," an organization must expend directly in the active conduct of its exempt activities substantially all (85 percent) of its net income (and must need one of three alternative tests). Under the provisions of the bill, a foundation would be classified as a private operating foundation if it expends directly in the active conduct of its exempt activities an amount equal to the lesser of substantially all its net income or substantially all its minimum investment return (and meets one of the three alternative tests of present law).

The changes made by the bill in the payout rules would be effective for taxable years beginning after December 31, 1980.

Expenditure responsibility

Under present law, a private foundation is required to exercise "expenditure responsibility" over all grants to organizations other than public charities (Code sec. 4945). The Treasury regulations and Internal Revenue Service rules provide guidelines specifying the circumstances under which a donor foundation can rely on the Service's classification of a grantee organization as a public charity in determining that expenditure responsibility need not be exercised over grants to such organizations.

The bill would provide that a private foundation is not required to exercise expenditure responsibility over a grant to an organization if the aggregate amount of grants made during the year by the foundation (and by related foundations) to that organization does not exceed $10,000. Also, the bill would provide that a grant to an organization which the Internal Revenue Service has determined to be a public charity is not subject to the expenditure responsibility rules, even though the donee organization loses its public charity status, unless (1) the grant was made after the date of publication by the Service that the donee organization has lost its qualified status, (2) the grant was made after the date on which the foundation acquires actual knowledge that the donee organization has lost its qualified status, or (3) the donor foundation has actual knowledge that the grant will cause the donee organization to lose its qualified status.

The amendments made by the bill to the expenditure responsibility rules would be effective for grants made after December 31, 1980.

Definition of family member

Present law contains a number of restrictions imposed on private foundations (such as prohibitions on self-dealing and excess business holdings) which depend on determinations of "disqualified persons." The term "disqualified person" includes a substantial contributor, a foundation manager, or a member of the family of either a substantial contributor or foundation manager. For this purpose, a member of the family includes all lineal descendants of the substantial contributor or foundation manager (Code sec. 4946).

The bill would limit the definition of family member to exclude lineal descendants more than two generations from the substantial contributor or foundation manager. Thus, lineal descendants other than children and grandchildren would not be treated as family members. This provision of the bill would be effective on January 1, 1981.

4. S. 476—Senators Durenberger and Boschwitz

Special Distribution Rule for Private Foundations Constituting Bank Holding Companies

Under present law (Code sec. 4942), a private foundation is required to distribute for charitable purposes the greater of its minimum investment return (five percent of the fair market value of its investment assets) or its net income.

The bill would provide a special valuation rule for purposes of computing the minimum investment return with respect to securities of banks, bank-related companies, and a bank holding company where the private foundation is a bank holding company. The value of such

securities would be determined by capitalizing the actual dividends received at a six percent capitalization rate.

The intended beneficiary of the bill would be the Otto Bremer Foundation of St. Paul, Minnesota. The provisions of the bill would apply to taxable years beginning after December 31, 1971.

5. S. 500—Senator Moynihan

Inflation Adjustment of Income Payout Requirement for Private Foundations

Under present law (Code sec. 4942), a private foundation is required to distribute for charitable purposes the greater of its minimum investment return (five percent of the fair market value of its investment assets) or its net income.

The bill would adjust the amount of the foundation's income to account for inflation, so that a private foundation would be required to distribute the greater of its minimum investment return or its inflation-adjusted income. The provisions of the bill would be effective for taxable years beginning after December 31, 1980.

6. S. 501—Senator Moynihan

Repeal of Alternative Income Payout Requirement for Private Foundations

Under present law (Code sec. 4942), a private foundation is required to distribute for charitable purposes the greater of its minimum investment return (five percent of the fair market value of its investment assets) or its net income.

The bill would repeal the alternative requirement under the foundation payout rule that, under present law, requires a private foundation to distribute any excess of net income over its minimum investment return. The provisions of the bill would be effective for taxable years beginning after December 31, 1980.

7. S. 499—Senator Moynihan

Rollover of Gain on FCC-Ordered Disposition of Broadcast Property

Present law provides for nonrecognition of gain realized on the disposition of broadcast property, pursuant to an FCC order, to the extent the proceeds are reinvested in replacement property which is similar or related in service or use to the property sold or exchanged (Code secs. 1071, 1033(a)). The Internal Revenue Service has ruled that the nonrecognition provisions apply where proceeds from disposition of a newspaper are reinvested in a television station, but not where proceeds from disposition of a television station are reinvested in a newspaper.

The bill would provide for nonrecognition of gain realized on an FCC-ordered disposition of broadcast property where the proceeds are reinvested in a newspaper. The amendments made by the bill would be effective on January 1, 1980.

II. DESCRIPTION OF BILLS

1. S. 388—Senators Hatch and Tower
and
2. S. 446—Senators Symms and Lugar

Tax Treatment of Investment and Wraparound Annuities

Present law

In general

Under present law, tax on interest or other current earnings on a policyholder's investment in an annuity contract generally is deferred until amounts characterized as income are withdrawn or annuity payments are received (Code sec. 72(a)). Amounts paid out under a contract before the annuity payments begin, such as policy dividends or payments upon partial surrender of a contract, are first treated as a return of the policyholder's capital and are taxable (as ordinary income) only after all of the policyholder's investment in the contract has been recovered (sec. 72(e)). A portion of each amount paid to a policyholder as an annuity generally is taxed as ordinary income (under an "exclusion ratio" test),[1] as are policy dividends paid after annuity payments begin.

A life insurance company which issues an annuity contract is not taxed on its investment income[2] to the extent that income is required to be added to its policyholder reserves for the annuity contract (secs. 802(b), 804(a), and 809(a)).

Traditional commercial annuities

A commercial annuity contract is a promise by a life insurance company, to pay to the beneficiary a given sum for a specified period, which period may terminate at death. Annuity contracts permit the systematic liquidation of an amount consisting of principal (the pol-

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[1] Each annuity payment received is generally allocated between ordinary income and excludable return of capital on the basis of the capital investment in the contract at the time annuity payments begin (the exclusion ratio). This allocation between income and capital continues for all of the annuity payments received by the policyholder even after all capital invested in the contract has been recovered tax-free. If the annuity terminates (for example, by reason of death) before capital is exhausted, no loss deduction is allowed. Under rules applicable to annuities under qualified pension plans, an employee's investment in the contract may be recovered first (Code sec. 72(e)).

[2] Capital gains are taxed to the insurance company unless the annuity is issued under a tax-qualified pension, profit-sharing, or stock bonus plan, an individual retirement annuity, or a tax-sheltered annuity, and the assets under such arrangements are held in segregated asset accounts that are not part of the general assets of the insurance company (Code sec. 804(a)).

icyholder's capital) and income. The insurance company may take the risk that such amount will be exhausted before the company's liability under the contracts ends but may gain if the liability terminates before it is exhausted.

The starting date for annuity payments may be within one year after the initial premium is paid (an immediate annuity) or may be deferred to a later date (a deferred annuity). The period between the time the first premium is paid for an annuity and the time the first annuity payment is due is referred to as the "accumulation period." Annuity payments may be payable for a period which depends on the date of an individual's death (a life annuity), for a fixed period of time (a period certain annuity), or for the longer of a specified minimum period or life (an annuity for a period certain and life thereafter).

An individual may purchase an annuity by payment of a single premium or by making periodic payments. A deferred annuity contract may, at the election of the individual, be surrendered before annuity payments begin, in exchange for the cash value of the contract. Partial surrenders are similarly permitted under some annuity contracts.

If either the premium paid for an annuity contract or the annuity benefits under the contract is based on the investment return and the market value of a separate account established by the insurance company, the contract is a "variable annuity contract."

Investment annuities

Under an investment annuity contract, an individual could transfer an asset to an insurance company. (Typically, the transferred asset was a certificate of deposit in a bank or savings and loan association, but investments in mutual funds and certain publicly traded securities were also permitted.) Under the contract, the asset was held in a separate account by the insurer and invested, or reinvested, pursuant to the taxpayer's control.[3] The premium paid for the annuity contract and the annuity benefits were based on the investment return and the market value of the assets in the account. The taxpayer could surrender (or partially surrender) the contract at any time before annuity benefits began and receive cash equal to the amount held in the account (less any applicable charges).

Under a 1965 "private letter" ruling and numerous subsequent rulings, the Internal Revenue Service held that the usual rules for taxation of variable annuities applied to investment annuities. Accordingly, (1) income credited to invested assets was not taxed to the insurance company, (2) capital gains on invested assets were taxed to the insurance company unless the contract was held under a tax-qualified retirement arrangement (e.g., a contract under a qualified pension plan), and (3) an investor's tax on earnings on amounts invested under the contract was deferred until amounts were withdrawn or benefits were

[3] The contracts typically limited investments to assets which could be readily liquidated, for example, savings deposits, listed securities, or mutual funds. Where appreciated assets are transferred under an investment annuity arrangement, the appreciation is subject to tax in the year of the transfer.

paid. Benefits paid under the contract were taxable as ordinary income after the investment in the contract was recovered.[4]

In 1975, the Service suspended the issuance of rulings as to investment annuities and, after public announcement of the suspension, held meetings with affected issuers. In 1977, after these discussions, the Service announced its changed position on the taxation of investment annuities. Under Rev. Rul. 77-85, 1977-1 C.B. 12, earnings on assets first invested under an investment annuity contract after March 9, 1977 (the date the ruling was released) are taxed to the individual taxpayer currently, without deferral of the tax until benefits are paid under the contract. The Service's position was based upon the conclusion that the individual possessed such substantial incidents of ownership in the assets in the separate account (the insurer's reserve for the contract) that such assets were "owned" by the individual (rather than the insurance company) for income tax purposes.[5]

"Wraparound" annuities

The principles of Rev. Rul. 77-85 (earnings taxed currently to the individual) were recently extended by Rev. Rul. 80-274, 1980-42 I.R.B. 5, to certain "wraparound" annuity contracts. A wraparound annuity is generally the same as an investment annuity except that the individual does not retain control over the investment and the insurer's reserve for the contract may be a separate account or the insurer's general reserve.

Under the wraparound annuity contract described in Rev. Rul. 80-274, an individual could transfer cash, passbook savings, or a certificate of deposit in a savings and loan association to a life insurance company. Under the contract, the asset (reduced by a fee) was deposited by the insurer in a separate account of the originating savings and loan association,[6] and invested in a certificate of deposit. When the certificate of deposit matured, the insurance company was generally required to reinvest the proceeds in another certificate of deposit. The individual could surrender (or partially surrender) the contract before annuity benefits began and receive cash equal to the amount held in the account (less any applicable charges).

Issue

The issue is whether prior law, which permitted tax deferral under investment annuities and wraparound annuities, should be restored.

Explanation of the bills

Under the bills, which are substantially identical in effect, (1) the gross income of the owner of an investment annuity contract or a wrap-

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[4] The exclusion ratio test applies in computing the income element of an annuity payment under an investment annuity arrangement.

[5] In litigating challenging Rev. Rul. 77-85, the U.S. District Court for the District of Columbia issued a declaratory judgment that the ruling was unreasonable and that the Internal Revenue Service had exceeded its statutory authority in issuing it. On appeal, the order of the District Court was reversed. The appellate court held that the Anti-Injunction Act (Code sec. 7421(a)) barred relief to the plaintiff, marketers of investment annuities, and therefore did not address the merits of the investment annuity issue. *Investment Annuity, Inc.* v. *Blumenthal*, 609 F. 2d 1 (D.C. Cir. 1979), *rev'g* 442 F. Supp. 681 (D.D.C. 1977).

[6] Wraparound annuities could be invested in a mutual fund or publicly traded securities in addition to deposits in a bank or savings and loan association.

around annuity contract, and (2) the tax treatment of the reserves of a life insurance company under such a contract, would be determined without regard to Rev. Rul. 77-85 or Rev. Rul. 80-274. Accordingly, these types of annuity contracts would receive the same tax treatment accorded traditional annuity contracts under present law.

Effective date

The provisions of the bills would apply upon enactment.

Revenue effect

It is estimated that the bills would involve a moderate revenue loss for fiscal year 1981, but could involve substantial revenue losses for future years.

3. S. 464—Senators Durenberger, Moynihan, Baucus, Riegle, and Thurmond

Modifications of Private Foundation Rules

Present law

Payout requirement

The Tax Reform Act of 1969 imposed a series of requirements on private foundations. Under one of these rules (Code sec. 4942), a private foundation is required to distribute currently for its charitable or other exempt purposes the greater of its net income or five percent of the value of its investment assets (called the "minimum investment return").[1]

This minimum distribution requirement for a year generally must be met by making the required amount of charitable distributions in that year or in the following year. Graduated sanctions are imposed in the event of failure to distribute the required minimum amount.

These general distribution requirements do not apply to "private operating foundations." In general, a private operating foundation is a foundation which expends substantially all its net income directly for the active conduct of exempt activities and which meets one of three other tests (Code sec. 4942(j)(3)). The term "substantially all" is defined by the Treasury regulations to mean 85 percent or more (Reg. § 53.4942(b)-1(c)).

Under the first test, substantially more than one-half of the assets of the foundation must be devoted directly to the activities for which it is organized or to functionally related businesses. Under the second test, the organization must receive substantially all of its support from five or more exempt organizations and from the general public, and not more than 25 percent of the foundation's support may be received from any one exempt organization. Under the third test, the organization must normally spend an amount not less than two-thirds of the minimum investment return (five percent of the value of its investment assets) directly for the active conduct of activities which constitute the purpose or function for which it is organized and operated.

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[1] Prior to the Tax Reform Act of 1976, the minimum investment return was based on a variable percentage of the foundation's investment assets. The variable percentage was determined annually by the Treasury Department, pursuant to statutory authorization, based on the changes in money rates and investment yields since 1969, when the payout rate was established by the Tax Reform Act of 1969 at six percent.

In the Tax Reform Act of 1976, Congress changed the variable percentage to a fixed five percent on the grounds that the six percent rate established by the 1969 Act was too high and that a variable percentage resulted in significant uncertainty in planning grant programs.

Expenditure responsibility

The Tax Reform Act of 1969 also restricted the uses for which a private foundation can spend its resources to expenditures for charitable or other exempt purposes (Code sec. 4945). In order to assure that grants to other organizations will be properly utilized, the Act generally imposed upon the donor foundation the responsibility (called "expenditure responsibility") for determining that its grants are so utilized. There is no exception in present law from the expenditure responsibility rules for small grants.

The expenditure responsibility rules do not apply to grants made to "public charities" (i.e., those organizations described in Code secs. 509(a) (1), (2), or (3)). The category of "publicly supported" charities described in Code section 509(a)(2) includes generally a charitable organization that (1) receives more than one-third of its support for the taxable year from gifts, grants, contributions, membership fees, and certain gross receipts and (2) normally receives not more than one-third of its support for each taxable year from investment income. The Treasury regulations interpret the word "normally" to mean an average of the four preceding taxable years or, if for the current taxable year there is a substantial and material change in the foundation's sources of support, an average of the current year and the four preceding taxable years. For this purpose, "unusual grants" are excluded from the computation (Reg. § 1.509(a)-3(c)).

Under the Treasury regulations, once an organization has been classified as publicly supported, the determination of whether a grant is subject to the expenditure responsibility requirements of Code section 4945 generally will not be affected by the donee's subsequent loss of classification as a publicly supported organization until notice of loss of classification is published. However, a donor foundation may not rely on the donee organization's classification if the donor foundation is responsible for or aware of a "substantial and material" change in the donee organization's sources of support that results in the organization's loss of classification as a publicly supported organization. In general, the donor foundation will not be considered responsible for or aware of such a change in support if the grant is made in reliance on a detailed written statement by the grantee organization that the grant will not result in loss of public charity status, and the information in such statement would not give rise to a reasonable doubt as to the effect of the grant (Reg. § 1.509(a)-3(c)).

The Internal Revenue Service recently published guidelines specifying circumstances under which a donor foundation will not be considered responsible for a "substantial and material" change in support of the donee organization. Under these guidelines, a donor organization generally will not be considered responsible for a substantial and material change in support if the aggregate of gifts, grants, and contributions received from the donor organization for a taxable year does not exceed 25 percent of the aggregate support received by the donee organization from all other sources for the four taxable years immediately preceding the year of the grant (Rev. Proc. 81-6, 1981-10 I.R.B. 41). In such circumstances, the donor foundation can rely on the classification of the donee organization as publicly supported

without risk that its grant will later be treated as causing the donee organization to lose its public charity status (thereby subjecting the donor foundation to penalties for failure to exercise expenditure responsibility).

In addition, the Internal Revenue Service recently published guidelines specifying circumstances under which a grant will be considered "unusual" and hence will not cause the donee organization to lose its status as publicly supported. Under these guidelines, a grant generally will be considered "unusual" where six conditions are met: (1) the grant is not made by a donor foundation which created the donee organization or was a substantial contributor to the donee organization; (2) the grant is not made by a donor organization which is in a position of authority to the donee organization; (3) the grant is made in cash, readily marketable securities, or assets that directly further the exempt purpose of the donee organization; (4) the donee organization has received an advance or final ruling that it is classified as a publicly supported organization; (5) there are no material restrictions imposed on the grant; and (6) if the grant is intended to pay for the operating expenses of the donee organization, the grant is expressly limited to one year's operating expenses (Rev. Proc. 81-7, 1981-10 I.R.B. 42).

Definition of family member

Present law contains a number of restrictions imposed on private foundations (such as prohibitions on self-dealing and excess business holdings) which depend on determinations of "disqualified persons." A "disqualified person" includes a substantial contributor, a foundation manager, or a member of the family of either a substantial contributor or foundation manager (Code sec. 4946). For this purpose, a member of the family includes the spouse, ancestors, and lineal descendants and spouses of lineal descendants of a substantial contributor or foundation manager.

Issues

Payout requirement

The general issue is whether the payout rule applicable to private foundations should be modified to provide that a private foundation is required to distribute only its minimum investment return. A related issue is whether the definition of a "private operating foundation" should be modified so that an operating foundation is required to pay out only the lesser of (1) substantially all its income or (2) substantially all its minimum investment return.

Expenditure responsibility

The first issue is whether an exemption should be provided from the expenditure responsibility rules for small grants and, if so, what should be the amount of such an exemption. The second issue is whether a grant to an organization which the Internal Revenue Service has classified as a public charity should be exempt from the expenditure responsibility rules, even though the donee organization loses its public charity status, unless the grant is made after publication of the donee organization's loss of qualified status, the grant is made after the donor foundation acquires actual knowledge of the donee organiza-

tion's loss of qualified status, or the donor foundation has actual knowledge that the grant will cause the donee organization to lose its qualified status.

Definition of family member

The issue is whether the term "disqualified person" should include lineal descendants of a substantial contributor or foundation manager who are more than two generations younger than such person.

Explanation of the bill

Payout requirement

The bill would repeal the alternative requirement that, under present law, requires a private foundation to distribute any excess of net income over the minimum investment return. Under the payout rule as amended by the bill, a private foundation would be required to make charitable distributions equal to five percent of its net investment assets, without regard to the amount of its income for the year.

The bill would also modify the definition of a private operating foundation. Under the revised definition, an organization would be a private operating foundation if (1) it expends for the active conduct of its exempt activities an amount equal to the lesser of substantially all its income or substantially all its minimum investment return and (2) it meets one of the three alternative tests of present law (relating to use of assets, support, and operating expenditures).

Expenditure responsibility

Small grants.—The bill would provide that a private foundation is not required to exercise expenditure responsibility over a grant to an organization if the aggregate amount of grants made during the year by the foundation (and by all related foundations) to that organization does not exceed $10,000.

Reliance by donor foundation.—The bill would provide that a grant to an organization which the Internal Revenue Service has determined to be a public charity is not subject to the expenditure responsibility rules, even though the donee organization loses its public charity status, unless (1) the grant was made after the date of publication by the Service that the donee organization has lost its qualified status, (2) the grant was made after the date on which the foundation acquires actual knowledge that the donee organization has lost its qualified status, or (3) the donor foundation has actual knowledge that the grant will cause the donee organization to lose its qualified status. The bill would provide a similar rule for grants by a private foundation to a private operating foundation in connection with the payout requirements of Code section 4942.

Definition of family member

The bill would restrict the category of "disqualified persons" by limiting the persons in the family of a substantial contributor or foundation manager taken into account to the spouse, ancestors, children, grandchildren, and the spouses of children and grandchildren. The effect of this amendment would be to exclude from the definition of family member any lineal descendant who is more than two generations from the substantial contributor or foundation manager.

Effective dates

The changes made by the bill to the payout requirement for private foundations and the definition of private operating foundations would be effective for taxable years beginning after December 31, 1980. The amendments made by the bill to the expenditure responsibility rules would be effective for grants made after December 31, 1980. The amendment made by the bill in the definition of "family member" would be effective on January 1, 1981.

Revenue effect

It is estimated that this bill would reduce budget receipts by less than $2 million annually.

4. S. 476—Senators Durenberger and Boschwitz

Special Distribution Rule for Private Foundations Constituting Bank Holding Companies

Present law

The Tax Reform Act of 1969 imposed a series of requirements on private foundations. Under one of these rules (Code sec. 4942), a private foundation is required to distribute currently for its charitable or other exempt purposes the greater of its net income or five percent of the value of its investment assets (called the "minimum investment return").[1]

This minimum distribution requirement for a year generally must be met by making the required amount of charitable distributions in that year or in the following year. Graduated sanctions are imposed in the event of failure to distribute the required amount.

Issue

The issue is whether a special valuation rule should apply for purposes of determining the distribution requirement in the case of a private foundation which is a bank holding company and which has a substantial portion of its assets consisting of securities in banks, bank-related companies, or a bank holding company.

Explanation of the bill

The bill would provide a special rule for valuing securities of banks and bank-related companies, for purposes of the minimum investment return, in the case of a private foundation which is a bank holding company and which has a substantial portion of its assets consisting of securities in banks, bank-related companies, or a bank holding company. The value would be determined, at the election of the foundation, by capitalizing the dividends paid by such banks and bank-related companies at a rate of six percent (i.e., by multiplying the dividends by 16⅔).

For purposes of this rule, a bank holding company would be any company as so defined in the Bank Holding Company Act of 1956.

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[1] Prior to the Tax Reform Act of 1976, the minimum investment return was based on a variable percentage of the foundation's investment assets. The variable percentage was determined annually by the Treasury Department, pursuant to statutory authorization, based on the changes in money rates and investment yields since 1969, when the payout rate was established by the Tax Reform Act of 1969 at six percent.

In the Tax Reform Act of 1976, Congress changed the variable percentage to a fixed five percent on the grounds that the six percent rate established by the 1969 Act was too high and that a variable percentage resulted in significant uncertainty in planning grant programs.

A bank-related company would be any corporation or company which may be acquired by a bank holding company under the provisions of paragraphs (1) or (8) of section 4(c) of the Bank Holding Company Act of 1956.[2]

Because the capitalization rate specified in the bill (six percent) exceeds the percentage for the minimum investment return (five percent), the minimum investment return with respect to bank securities in the case of a private foundation using the special valuation method under the bill would always be less than the amount of dividends paid on such bank securities. Accordingly, such a private foundation would be required to make distributions for exempt purposes only in the amount of dividends actually paid on such securities.[3]

The intended beneficiary of the bill is the Otto Bremer Foundation of St. Paul, Minnesota, a private foundation which is a bank holding company. The Bremer Foundation is the sole shareholder of the Otto Bremer Company, also a bank holding company, which owns majority control of 29 banks and 39 bank-related companies.

Effective date

The provisions of the bill would apply to taxable years beginning after December 31, 1971.

Revenue effect

The revenue effect of the bill is indeterminate inasmuch as the effect would depend on ultimate resolution of disagreements between the Bremer Foundation (the intended beneficiary of the bill) and the Internal Revenue Service as to the valuation, for purposes of the foundation payout requirements, of bank securities held by the Foundation. If it were ultimately determined either that the securities have been correctly valued by the Foundation, or that any failure to value the

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[2] A bank holding company is defined generally to mean any company which has control over any bank or over any company that is or becomes a bank holding company under the Bank Holding Company Act (12 U.S.C. sec. 1841(a)(1)). Control is generally defined to mean 25 percent ownership.

Under 12 U.S.C. sec. 1843(a), a bank holding company generally may not acquire direct or indirect ownership or control of any voting shares of any company which is not a bank. The Act provides a number of exceptions to this prohibition.

One of the exceptions allows a bank holding company to acquire shares in companies engaged in one or more of the following activities: (1) holding or operating properties used wholly or substantially by any banking subsidiary of such bank holding company in the operations of such banking subsidiary or acquired for such future use; (2) conducting a safe deposit business; (3) furnishing services to or performing services for such bank holding company or its banking subsidiaries; or (4) liquidating assets acquired before May 9, 1956, or before the company became a bank holding company (12 U.S.C. sec. 1843(c)(1)). The law also exempts ownership or control of shares of any company whose activities are determined by the Board of Governors of the Federal Reserve System to be so closely related to banking or managing or controlling banks as to be a proper incident thereto (12 U.S.C. sec. 1843(c)(8)).

[3] To the extent that such a private foundation in fact has effective control over such banks or bank-related companies and is able to use such control to determine the amount of dividends paid on such securities, the foundation could thereby effectively determine the amount that it would be required to distribute with respect to such securities under Code section 4942 (as amended by the bill).

assets correctly was not willful and was due to reasonable cause, there would be no revenue effect from the bill. If it were ultimately determined that the valuation proposed by the Service was correct and also that failure to value the assets correctly was willful or not due to reasonable cause, it is estimated that the bill would reduce budget receipts by an amount in excess of $10 million, the exact amount depending on the ultimate resolution of the valuation issue and the length of time before such resolution is reached.

5. S. 500—Senator Moynihan

Inflation Adjustment of Income Payout Requirement for Private Foundations

Present law

The Tax Reform Act of 1969 imposed a series of requirements on private foundations. Under one of these rules (Code sec. 4942), a private foundation is required to distribute currently for its charitable or other exempt purposes the greater of its net income or five percent of the value of its investment assets (called the "minimum investment return").[1]

This minimum distribution requirement for a year generally must be met by makiing the required amount of charitable distributions in that year or in the following year. Graduated sanctions are imposed in the event of failure to distribute the required minimum amount.

Issue

The issue is whether the amount of income that a private foundation is required to distribute should be adjusted for inflation, so that the foundation would be required to distribute the greater of its inflation-adjusted income or its minimum investment return.

Explanation of the bill

The bill would reduce the amount of income that a private foundation is required to distribute by the amount of income attributable to inflation. The inflation adjustment would be based on the percentage change in the GNP implicit price deflator for the year preceding the year in which the income is earned. Under the payout rule as amended by the bill, a private foundation would be required to distribute the greater of its inflation-adjusted income or its minimum investment return.

Effective date

The provisions of the bill would be effective for taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this bill would reduce budget receipts by less than $2 million annually.

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[1] Prior to the Tax Reform Act of 1976, the minimum investment return was based on a variable percentage of the foundation's investment assets. The variable percentage was determined annually by the Treasury Department, pursuant to statutory authorization, based on the changes in money rates and investment yields since 1969, when the payout rate was established by the Tax Reform Act of 1969 at six percent.

In the Tax Reform Act of 1976, Congress changed the variable percentage to a fixed five percent on the grounds that the six percent rate established by the 1969 Act was too high and that a variable percentage resulted in significant uncertainty in planning grant programs.

6. S. 501—Senator Moynihan

Repeal of Alternative Income Payout Requirement for Private Foundations

Present law

The Tax Reform Act of 1969 imposed a series of requirements on private foundations. Under one of these rules (Code sec. 4942), a private foundation is required to distribute currently for its charitable or other exempt purposes the greater of its net income or five percent of the value of its investment assets (called the "minimum investment return").[1]

This minimum distribution requirement for a year generally must be met by making the required amount of charitable distributions in that year or in the following year. Graduated sanctions are imposed in the event of failure to distribute the required minimum amount.

Issue

The issue is whether the payout requirement applicable to private foundations should be modified to provide that a private foundation must distribute only its minimum investment return.

Explanation of the bill

The bill would repeal the alternative requirement under the foundation payout rule that, under present law, requires a private foundation to distribute any excess of net income over the minimum investment return. Under the payout rule as amended by the bill, a private foundation would be required to make charitable distributions equal to five percent of its investment assets, without regard to the amount of its income for the year.

Effective date

The provisions of the bill would be effective for taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this bill would reduce budget receipts by less than $2 million annually.

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[1] Prior to the Tax Reform Act of 1976, the minimum investment return was based on a variable percentage of the foundation's investment assets. The variable percentage was determined annually by the Treasury Department, pursuant to statutory authorization, based on the changes in money rates and investment yields since 1969, when the payout rate was established by the Tax Reform Act of 1969 at six percent.

In the Tax Reform Act of 1976, Congress changed the variable percentage to a fixed five percent on the grounds that the six percent rate established by the 1969 Act was too high and that a variable percentage resulted in significant uncertainty in planning grant programs.

7. S. 499—Senator Moynihan

Rollover of Gain on FCC-Ordered Disposition of Broadcast Property

Present law

Present law (Code sec. 1071) provides for nonrecognition of gain realized on the sale or exchange of property (including stock) if (1) the disposition is certified by the Federal Communications Commission (FCC) as necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, the FCC with respect to the ownership and control of "radio broadcasting stations," and (2) if the taxpayer elects to treat the disposition as an involuntary conversion. Pursuant to such an election, gain is not recognized to the extent that the taxpayer purchases replacement property that is similar or related in service or use to the property sold or exchanged (Code sec. 1033(a)).

Treasury regulations provide that the term "radio broadcasting" as used in Code section 1071 includes telecasting (Treas. Reg. § 1.1071-1(d)). Neither the statute nor the regulations expressly include other communications media property within the definition of "radio broadcasting."

In Rev. Rul. 78-269, 1978-2 C.B. 210, the Internal Revenue Service held that gain is not recognized under Code sections 1071 and 1033 where a corporation divests itself, pursuant to an FCC order and certification, of stock in a newspaper publishing company, and reinvests in stock of a television broadcasting station. In a later "private letter" ruling, the Service held that gain must be recognized where a corporation, pursuant to an FCC order and certification, divests itself of a television station and reinvests in newspaper stock.[1] In the private letter ruling, the Service distinguished its holding in Rev. Rul. 78-269 on the basis that a reinvestment in newspaper stock did not constitute an investment in broadcast property (within the meaning of Code sec. 1071) or in any property similar or related in service or use to the television station sold or exchanged.

Under present law, the FCC may order a taxpayer who owns multiple communication properties—for example, two television stations, a television station and a radio station, or a television station and a newspaper—within the same broadcast area to dispose of all but one of the properties. The FCC generally does not order the taxpayer to dispose of a particular station within the area of its multiple broadcast ownership. Rather, the taxpayer generally may decide which broadcasting media is sold or exchanged pursuant to such an FCC order.

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[1] IRS Letter Ruling 8050025, September 16, 1980.

Issue

The issue is whether gain should be recognized pursuant to an FCC-ordered and certified disposition of a television station if the proceeds are reinvested in a newspaper.

Explanation of the bill

The bill would extend the nonrecognition provisions of present law, relating to "rollover" of gain on certain FCC-ordered divestitures, to situations in which the proceeds are reinvested in newspaper property. Also, the bill would make a technical amendment to Code section 1071 by amending the statute to refer specifically to FCC-ordered dispositions of television broadcasting stations as well as to radio broadcasting stations.[3]

The amendments which would be made by the bill are intended to apply to the FCC-required disposition of television station WWNY in Watertown, New York, by Johnson Newspaper Corporation, and to other similarly situated taxpayers where disposition proceeds are reinvested in a newspaper.

Effective date

The amendment made by the bill would be effective on January 1, 1980.

Revenue effect

It is estimated that this bill would reduce budget receipts by an amount not to exceed $10 million annually.

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[3] This technical amendment would be consistent with existing Treasury Reg. § 1.1071-1(d).

Senator PACKWOOD. The meeting will come to order. We have a variety of tax bills this morning, and as is the custom in the past, we have allowed the Treasury Department to testify first on all of the bills that are before us and to offer their opinion for or against or neutral on the bills.

And, while we have instructed other witnesses that they will observe a strict time limit, we don't hold the Treasury Department to that exactly, because they are testifying on all of the bills.

Testifying for the Treasury Department today will be Buck Chapoton, the Assistant Secretary of the Treasury for Tax Policy.

Buck, are you ready?

Mr. CHAPOTON. Ready, Mr. Chairman.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. CHAPOTON. We appreciate the opportunity to be here this morning to testify on three main topics covered by bills pending before this subcommittee this morning.

The three topics are: the wraparound annuities, the minimum payout requirement of private foundations, and rollovers for dispositions required by certain FCC divestiture orders.

Senator PACKWOOD. I might say, Buck, as usual, your entire statement will be in the record, and to the extent that you can abbreviate a bit, we would appreciate it.

Mr. CHAPOTON. Yes, sir. My statement is rather long. I will attempt to abbreviate to the extent I can. It will take, probably, about 15 minutes—10 or 15 minutes.

S. 388 and S. 448 would overturn two rulings dealing with the treatment of wraparound annuity contracts, which I want to explain in some detail.

The Treasury Department strongly opposes both of those bills.

S. 464 would change the minimum payout requirement for private foundations in certain respects. The Department does not take a position on section 1(a) of S. 464, dealing with the minimum payout requirement, pending further study of that provision. It opposes all other sections of S. 464.

S. 476 would prescribe how certain private foundations are to value bank securities held by the foundation for purposes of the minimum payout requirement. The Treasury Department opposes this bill.

S. 499 would allow deferral of gain realized on the disposition of broadcasting property required by certain FCC divestiture orders. The Treasury Department does not oppose S. 499.

S. 500 would apply an inflation factor to a private foundation's adjusted net income for the purposes of the minimum payout requirement. The Treasury Department opposes this bill.

And, finally, S. 501, like section 1(a) of S. 464, would change the minimum payout requirement of private foundations to 5 percent of the fair market of the foundation's investment assets. The Treasury Department does not take a position on S. 501, pending further study.

The first matter I would like to address, Mr. Chairman, is S. 388 and 446, dealing with so-called wraparound annuities.

These two bills, while appearing to be narrow in their scope, are in fact quite significant. They would overturn two Internal Revenue Service rulings, Revenue Ruling 77-85 and Revenue Ruling 80-274, both of which deal with the tax treatment of so-called wraparound annuities.

These wraparounds use what purports to be an annuity as a vehicle to acquire, or as a wrapper for, investment assets that can be acquired directly, in an attempt to defer the tax on the income from the investment to the investor.

Revenue Ruling 77-85 denied the tax treatment otherwise available on the purchase of an annuity to the purchaser of an investment annuity, used to acquire and manage an individually selected, diversified investment portfolio.

Revenue Ruling 80-274 similarly denied annuity treatment to a savings and loan certificate of deposit acquired through an annuity wrapper.

It is the position of the IRS, as reflected in these two rulings, that an annuity wrapper may not be used to defer tax on otherwise currently taxable dividend and interest income derived from the underlying securities.

Revenue Ruling 77-85, Mr. Chairman, was controversial when issued. A Federal district court later enjoined enforcement of the ruling. That litigation was later dismissed on jurisdictional grounds. And this controversy was heightened by the issuance of Revenue Ruling 80-274 last year.

We have undertaken an thorough review of these two rulings and have concluded that they are consistent with applicable statutory provisions and legislative history.

We also believe that considerations of tax policy compel the conclusions reached in both rulings, and for that reason we do oppose strongly S. 388 and S. 446.

The arrangements considered in these rulings respresent an attempt to push to an unsupportable extreme the special tax treatment accorded deferred annuities under existing law. For most individuals, who report their income using the cash method of accounting, dividend and interest income is, of course, taxable in the year in which it is credited or paid.

There are two significant exceptions to this rule. The first is for series E savings bonds, and the other is deferred annuities.

A deferred annuity is a contract normally issued by a life insurance company. The issuer typically accepts the premiums paid for the contract and agrees to accumulate these premiums, together with interest at rates guaranteed in the contract, until some future date.

The contract purchaser has the right, in the future, to annuitize the contract, that is to convert it into a stream of payments for a specific period.

The tax laws specifically contemplate the issuance of variable annuities. While a straight annuity involves a guarantee by the issuing life insurance company of interest at some contractual rate, the purchaser of a variable annuity assumes the risk of upward or downward fluctuation in the pool of securities in which the premiums paid for his contract are invested.

During the period between the purchase of a deferred annuity contract and the date on which it is converted into a stream of periodic annuity payments, referred to as the accumulation period, earnings credited but not withdrawn are not taxed to the contract holder. Moreover, even earnings withdrawn from a deferred annuity during the accumulation period are not includable in the contract holder's income until the aggregate withdrawals from the contract exceed the aggregate premiums paid by the purchaser. That's a so-called cost recovery method of reporting income from annuities.

Thus, if one buys a certificate of deposit, corporate or Government bonds, or other interest or dividend bearing securities, the income from these securities is currently taxed.

If, on the other hand, one purchases a deferred annuity, the interest, dividends or other earnings, other than capital gains, credited to the contract are tax deferred.

Unlike other investments, deferred annuities may be converted into a lifelong stream of periodic payments when an individual retires. However, the favorable tax treatment of annuities is available even though the contract need not be, and in many cases never is, converted into a stream of annuity payments.

A typical deferred annuity contract allows the contract purchaser to surrender the contract, in whole or in part, and receive back his premiums, plus earnings on the contract to date at any time.

Thus, from the standpoint of the contract holder, a deferred annuity during its accumulation period does not significantly differ from a long-term certificate of deposit, or other portfolio investment which may be reduced to cash at any time.

Nevertheless, interest from other portfolio investments is taxed currently, whereas earnings credited to a deferred annuity are not.

To the extent that annuities can be fashioned to offer interest rates that are competitive with rates paid by other financial instruments, there is little reason why a potential investor should purchase anything but a deferred annuity.

Under existing tax rules the treatment of deferred annuities, considered in light of the fact that they may be surrendered for cash at any time, is anomalous. But neither Revenue Ruling 77-85 nor 80-274 questions the basic deferral available to the purchaser of a straight or variable deferred annuity.

Rather, the issue raised by these rulings is whether the tax treatment available to a deferred variable annuity contract also extends to what is in substance the direct purchase of an investment security.

That is, can an individual contemplating the purchase of some other, directly available investment security, the interest on which would be currently taxable to the individual, elect to acquire that same investment wrapped in an annuity contract, thereby securing deferral of tax in return for a fee paid to a life insurance company?

We have concluded that, under existing law, the answer is no. To conclude otherwise would allow direct investments and securities to be transformed into what purport to be tax-favored annuities without any meaningful change in the investor's position vis-a-vis the underlying securities.

We feel our conclusion is strongly supported by the language of the statute and the legislative history of 1959 and 1962. Both indicate that, in Congress' contemplation, a variable annuity involved a commingled investment fund managed by the life insurance company issuing the annuity.

The wraparound annuity contracts considered in these rulings do not fit that description. Both of those arrangements in the rulings, as I have described them, are far from the traditional variable annuity under which the issuing company managed a diversified portfolio of securities.

Now, Mr. Chairman, we are not unmindful of the fact that before promulgation of Revenue Ruling 77-85, the Service had issued a number of private rulings to the effect that investment annuities would be regarded as annuities for Federal tax purposes.

And for that purpose, when the earlier private rulings were revoked by Revenue Ruling 77-85, the revocation was made prospective only and, thus, inapplicable to those who had purchased investment annuities in reliance on previously issued private ruling letters.

Finally, and more generally, I would like to express my concern about legislation which, like S. 388 and 446, does not purport to change the underlying substantive law, but simply forecloses the Internal Revenue Service from interpreting that law by depriving it of authority to issue a particular ruling.

This approach can only create confusion. It obscures what is really at stake. If Congress were to pass S. 388 and S. 446, thereby condoning the use of annuity wrappers to purchase portfolio investments, within a short period of time the consequences could be quite sweeping.

Now, these consequences could include tax deferral on significant amounts of interest and dividend income and tax-free rollovers, since tax-free rollovers of true annuity contracts are allowed under existing law. It could also substantially undermine the limits of existing law on the extent to which participants in qualified pensions plans may make voluntary nondeductible contributions on which they may earn income on a tax-deferred basis.

For these reasons, Mr. Chairman, the Treasury Department, as I have stated, strongly opposes both of these bills.

Let me now turn to S. 464, 476, S. 500 and 501, all of which deal with the minimum payout requirements imposed upon private foundations.

These bills would change the formula for determining the minimum amount which private foundations must distribute to charity annually.

Under current law, the greater of 5 percent of the fair market value of the foundation's equity in investment assets, or its adjusted net income, must be distributed annually.

Both 464 and 501 would set the minimum payout rate at a flat 5 percent of asset value without regard to adjusted net income. S. 500 is different. It would attempt to express adjusted net income in real dollar terms.

The minimum payout rate was introduced as a part of the Tax Reform Act in 1969 to make certain that private foundations would make current distributions for charitable purposes. Congress felt

that because donors were receiving current deductions for their contributions to foundations, the foundations should provide a current benefit for charity.

The Treasury believes that the minimum payout requirement is still necessary for reasons that concerned Congress in 1969. We are, however, sympathetic to the claim that the formula for determining the minimum payout should be neutral with respect to foundation investments, and that the present formula would be improved by deleting the adjusted net income component.

Because long-term capital gains and unrealized capital appreciation are excluded from the definition of adjusted net income, the payout requirement now favors investment in assets whose total rates of return reflect more capital appreciation than current yield.

Thus, the alternative formula now in the law may discriminate against investments in high yield bonds, as contrasted with investments in common stock.

Nonetheless, the Treasury must consider the charitable sector as a whole, including both private foundations and public charities. It is possible that the change in the formula advanced by these two bills would cause a significant drop in the payouts of private foundations, and this will, of course, in turn curtail funds now made available to public charities by foundations.

Without further information about the effect of these provisions on both private foundations and public charities, we are unable to take a position on section 1(a) of 464 and S. 501.

We would like to work further with this subcommittee in developing an appropriate formula.

The approach of S. 500 is to deflate the adjusted net income of a foundation so that the minimum payout rate would be the maximum 5 percent of current investment asset value, or the real income of the foundation.

We think that approach is unduly complicated when compared to a flat percentage rate, and for that reason we oppose S. 500.

The next subsections of S. 464 deal with expenditure responsibility. Section 2(a) would allow a private foundation to make grants totaling $10,000, or less, per year to a private organization without exercising expenditure responsibility.

Expenditure responsibility was also imposed in 1969 as a part of the overall statutory framework of the private foundation provisions of the act enacted in that year.

Expenditure responsibility helps insure that private foundations will make grants for charitable purposes and that the grantees will carry out the terms of these grants.

We do not think this statutory scheme should be dismantled piecemeal.

We would be happy to consider suggestions for administratively streamlining the procedures involved with expenditure responsibility if a showing could be made that the present rules are unduly burdensome.

However, the congressional intent in making foundations publicly accountable for their grants is still of concern and valid for all grants, regardless of their size.

Section 2(c) of 464 deals with reliance on a published list of publicly supported charities by grantors. A private foundation must

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exercise expenditure responsibility only if it makes a grant to an organization that is not a public charity. Section 2(c) of this bill would allow a private foundation to rely in all cases upon the established status of a grantee that it is a public charity, provided the grantor had no actual knowledge to the contrary.

Well, Mr. Chairman, we question the need for this legislation in light of the recent publication of two revenue procedures, Revenue Procedures 81-6 and 81-7, both published earlier this year.

These revenue procedures create safe harbors with which private foundations will not be penalized for not having exercised expenditure responsibility if the grantee organization loses its status after the grant is made.

We think these new administrative rules handle those problems—the problems addressed by section 2(c), of 464, and, therefore, we would oppose that subsection of the legislation.

Section 2(b), of 464, deals with the definition of disqualified persons. Basically, the disqualified person provisions of the law restrict economic transactions between private foundations and the class of persons labeled "disqualified persons" and also relate to the excess business holding requirements of section 4943 in stating to what level a private foundation must reduce its business holdings.

Section 2(b) would basically exclude from the definition of disqualified person the lineal descendants of a substantial contributor to the foundation below the grandchildren of the substantial contributor.

We are reluctant to accept this change. We think that both the self-dealing provisions and the excess business holding requirements of existing law must be stringently enforced and, therefore, we would oppose narrowing the class of disqualified persons.

We do want to state, however, that there may be situations where the necessity to keep track of numerous descendants might be an undue burden and we would consider a narrower approach to this recordkeeping problem if one could be developed

Section 1(a)(2) of 464, would amend the definition of a private operating foundation by revising the requirement that a private operating foundation distribute substantially all of its adjusted net income directly for the active conduct of its charitable activities.

A private operating foundation, unlike other private foundations, is treated much like a public charity for certain purposes. It may be given grants without exercising expenditure responsibility and the deductible limits for individual contributions to it are more liberal than in the case of a private foundation.

Thus, we think the rules which prevent private operating foundations from accumulating their income and requiring them to pay out their income in the direct carrying on of their charitable purposes is correct and should not be diminished without removing some of the other benefits accorded private operating foundations under the present statutory scheme.

And, therefore, we do oppose section 1(a)(2) of 464.

S. 476 deals with a private foundation that is a bank holding company. It provides a special method for valuing the foundation's assets, in effect capitalizing the actual dividends received from the foundation's assets at a 6-percent rate.

This is directly contrary to the congressional purpose in enacting the minimum distribution requirements of section 4942 of the Code and we see no reason why there should be a special rule in this regard for foundations which are bank holding companies.

In addition, S. 476 would be retroactive to January 1, 1972.

And, for both of these reasons, we do oppose S. 476.

Finally, S. 499 would permit rollovers for broadcast properties. If the property is required under a Federal Communications Commission order to be disposed of, this legislation would permit the sale proceeds to be reinvested tax free in a newspaper.

Under existing law, the rollover treatment is available if a newspaper is disposed of and a television or radio broadcasting property is acquired, but not vice versa.

We think there is no reason for not providing for neutrality between these two situations. We are not opposed, therefore, to S. 499.

We would point out, however, that the bill is retroactive to January 1, 1980. Normally we are opposed to retroactivity in legislation. In this case we have not been made aware of a reason to depart from our normal opposition to retroactivity.

Mr. Chairman, that concludes my summary of our position on this legislation.

[The written statement of Mr. Chapoton follows:]

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY (TAX POLICY)

Mr. Chairman and members of the subcommittee, I am pleased to appear before you to express the views of the Treasury Department on bills dealing with three main topics: wraparound annuities, the minimum payout requirement of private foundations, and rollovers for dispositions required by FCC divestiture orders.

SUMMARY

S. 388 and S. 446 would overturn two revenue rulings dealing with the tax treatment of "wraparound" annuity contracts. The Treasury Department strongly opposes both bills.

S. 464 would change the minimum payout requirement of private foundations to 5 percent of the fair market value of the foundation's investment assets, and would make other technical changes concerning private foundations. The Treasury Department does not take a position on section 1(a) of the bill dealing with the minimum payout requirement, pending further study; it opposes all other sections of the bill.

S. 476 would prescribe how certain private foundations are to value bank securities held by the foundation for the purposes of the minimum payout requirement. The Treasury Department opposes this bill.

S. 499 would allow deferral of gain realized on the disposition on broadcasting property under FCC divestiture orders. The Treasury Department does not oppose S. 499.

S. 500 would apply an inflation factor to a private foundation's adjusted net income for the purposes of the minimum payout requirement. The Treasury Department opposes this bill.

S. 501, like section 1(a) of S. 464, would change the mimimum payout requirement of private foundations to 5 percent of the fair market value of the foundation's investment assets. The Treasury Department does not take a position on S. 501, pending further study.

S. 388, S. 446—"WRAPAROUND" ANNUITIES

S. 388 and S. 446, while appearing to be narrow in scope, in fact are quite significant. They would overturn Rev. Rul. 77-85 and Rev. Rul. 80-274, both of which deal with the tax treatment of so-called "wraparound" annuities. These "wraparounds" use what purports to be an annuity as a vehicle to acquire—as a "wrapper" for—investment assets that can be acquired directly, in an attempt to defer tax on the income from the investment. Rev. Rul. 77-85 denied the tax treatment otherwise available on the purchase of an annuity to the purchaser of an

"investment" annuity, used to acquire and manage an individually selected, diversified investment portfolio. Rev. Rul. 80-274 similarly denied annuity treatment to a savings and loan certificate of deposit acquired through an annuity wrapper. It is the position of the Internal Revenue Service, as reflected in these two rulings, that an annuity wrapper may not be used to defer tax on otherwise currently taxable dividend and interest income derived from the underlying securities.

Rev. Rul. 77-85 was controversial when issued. Legislation has since been introduced (but never enacted) to overturn that ruling; and, while a Federal District Court enjoined enforcement of the ruling, *Investment Annuity, Inc.* v. *Blumenthal*, 442 F. Supp. 681 (D.D.C. 1977), the litigation was dismissed on jurisdictional grounds by the Court of Appeals, 609 F. 2d 1 (D.C. Cir. 1979), and the Supreme Court denied review, 100 Sup. Ct. 2961 (1980). The controversy was heightened by the issuance of Rev. Rul. 80-274 late last year.

We have undertaken a thorough review of these two rulings. We have concluded that the rulings are consistent with the applicable statutory provisions and legislative history. We also believe that considerations of tax policy compel the conclusions reached in both Rev. Rul. 77-85 and Rev. Rul. 80-274. For these reasons the Treasury strongly opposes S. 388 and S. 446.

The arrangements considered in these rulings represent an attempt to push to an unjustified extreme the special tax treatment accorded deferred annuities under existing law. For most individuals, who report their income using the cash method of accounting, dividend and interest income is taxable in the year in which it is credited or paid. Thus, for example, the taxable interest paid on corporate or Treasury bonds or credited to bank or savings and loan accounts or certificates of deposit, are all taxed on a periodic basis.

There are two significant exceptions to this rule. One is for series E savings bonds, the income from which the holder may elect not to report until the bonds are redeemed at maturity. The other is the deferred annuity.

A deferred annuity is a contract normally issued by a life insurance company. The issuer typically accepts the premiums paid for the contract and agrees to accumulate those premiums, together with interest at rates guaranteed in the contract, until some future date. The contract purchaser has the right, in the future, to "annuitize" the contract—that is, to convert it into a stream of payments for a specified period, for the life of one or more individuals, or for some combination of the two.

The tax laws specifically contemplate the issuance of "variable annuities," so-called because the contract purchaser, rather than receiving interest at rates guaranteed by the issuing life insurance company, is entitled to an investment whose results vary with the "investment experience of the company issuing the contract." That is, while a "straight" annuity involves a guarantee by the issuing life insurance company of interest at some contractual rate, the purchaser of a variable annuity assumes the risk of upward or downward fluctuation in the securities in which the premiums paid for the contract are invested

During the period between the purchase of a deferred annuity contract and the date on which it is converted into a stream of periodic annuity payments—referred to as the "accumulation period"—earnings on a deferred annuity enjoy more favored tax treatment than normal dividend or interest income. Earnings credited to but not withdrawn during the accumulation period are not taxed to the contract holder. Moreover, even earnings withdrawn from a deferred annuity during the accumulation period are not includible in the contract holder's income until the aggregate withdrawals from the contract, since its inception, exceed the aggregate premiums paid for the contract (so-called "cost recovery" accounting).

Thus, if one buys a certificate of deposit, corporate or government bonds, or other interest or dividend bearing securities, the income from those securities is currently taxed. If, on the other hand, one purchases a deferred annuity, the interest, dividends, or other earnings (excluding capital gains) [1] credited to the contract are tax-deferred.

The treatment of annuities has been a feature of the tax laws almost from their inception. Unlike other investments, deferred annuities may be converted into a life-long stream of periodic payments when an individual retires. Nevertheless, the favorable treatment of annuities is available even though the contract need not be,

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[1] The deferred annuity works most effectively for securities producing current interest or dividend income. Such income is taxable neither to the issuing life insurance company nor currently to the contract holder. In contrast, capital gains are taxed to a life insurance company that issues straight or variable annuities and are taxed again when eventually paid to the annuity contract holder. Thus, the deferred annuity is relatively attractive, compared to other investment vehicles, for current portfolio income and relatively unattractive, compared with other investment vehicles, for capital gains.

and in many cases never is, converted into a stream of annuity payments. Indeed, a typical deferred annuity allows the contract purchaser to surrender the contract (in whole or in part) and receive back his premiums, plus earnings on the contract to date, at any time. While most deferred annuity contracts impose some penalty for premature surrender, such penalties typically are far less than the earnings credited to the contract and in any event become inapplicable after the contract has existed for a period of years.

Thus, from the standpoint of the contract holder, a deferred annuity during its accumulation period does not significantly differ from a long term certificate of deposit (which, incidentally, also may be subject to penalty if it is surrendered prematurely), or any other portfolio investment which may be reduced to cash at any time. Nevertheless, interest from other portfolio investments is taxed currently, whereas earnings credited to a deferred annuity are not. To the extent that annuities can be fashioned to offer interest rates that are competitive with rates paid by other financial instruments there is little reason why a potential investor should purchase anything but a deferred annuity.

Under existing tax rules the treatment of deferred annuities, considered in light of the fact that they may be surrendered for cash at any time, is anomalous. But neither Rev. Rul. 77-85 nor Rev. Rul. 80-274 questions the basic deferral available to the purchaser of a straight or variable deferred annuity.

Rather, the issue raised by these two rulings is whether the tax treatment available to a deferrred variable annuity also extends to what is in substance the direct purchase of an investment security. That is, can an individual contemplating the purchase of some other, directly-available investment security, the interest on which would be currently taxable to that individual, elect to acquire that same investment "wrapped" in an annuity contract, thereby securing deferral of tax in return for a fee paid to a life insurance company?

We have concluded that, under existing law, the answer is no. To conclude otherwise would allow direct investments in securities to be transformed into what purport to be tax-favored annuities without any meaningful change in the investor's position vis-a-vis the underlying securities. Moreover, our conclusion is supported by both the language and the legislative history of the 1959 and 1962 legislation that facilitated the issuance of variable annuities by life insurance companies. Both indicate that, in Congress contemplation, a variable annuity involved a commingled investment fund managed by the life insurance company issuing the annuity.[2]

The wraparound annuity contracts considered in these rulings do not fit that description. In the case of the "investment annuity" described in Rev. Rul. 77-85, the individual had discretion, within wide limits, to select his or her portfolio investments just as though they were managing an individual portfolio outside of the annuity.

With the bank wraparound annuity described in Rev. Rul. 80-274 the individual had selected, in the contract or the application for the contract, the type of certificate that would be purchased and the Federally insured depository institution from which it would be acquired. Both such arrangements are far from the traditional variable annuity under which the issuing insurance company managed a diversified portfolio of securities.

We are not unmindful of the fact that, before promulgation of Rev. Rul. 77-85, the Service had issued a number of private ruling letters to the effect that investment annuities would be regarded as annuities for the Federal tax purposes. As you know, private letter rulings cannot be taken as representing the general position of the Internal Revenue Service, but only as ensuring to the persons who obtained the ruling the tax consequences described in the ruling for as long as it remains outstanding. If private ruling letters were held to bind the Internal Revenue Service from a later change in position the number of private ruling letters issued, which are of benefit to the taxpaying public, would radically decline. In this connection, when the earlier private ruling letters were revoked with publication of Rev. Rul. 77-85, the ruling was made prospective in application to those who had purchased investment annuities in reliance on previously issued private ruling letters. Similarly, Rev. Rul. 80-274 was not applied retroactively to those companies who had previously received favorable private rulings from the Service.

Finally, and more generally, I would like to express my serious concern about legislation which, like S. 388 and S. 446, does not purport to change underlying

[2] The statute itself describes a variable annuity as "a contract which provides for the payment of a variable annuity computed on the basis of * * * the investment experience of the company issuing the contract." Section 801(g)(1)(A). Similarly, the Committee reports refer to "variable annuities" as those whose "benefits * * * vary with the insurance company's overall investment experience." See, S.Rpt. 291 (86th Cong. 1st Sess.) 1959-2 C.B. 770, 795; S.Rept. 2905 (87th Cong. 2nd Sess.) 1962-3 C.B. 1180, 1184.

substantive law but simply forecloses the Internal Revenue Service from interpreting that law by depriving it of authority to issue a particular ruling. This approach can only create confusion. It also can—and in this particular instance it does—obscure what is really at stake. If Congress were to pass S. 388 and S. 446, thereby condoning the use of annuity wrappers to purchase portfolio investments, within a short period of time the consequences would be sweeping. Specifically, if one were to consider substantive legislation whose effects were equivalent to the potential consequences of passing S. 388 and S. 446, the list of revisions to the Internal Revenue Code would include the following:

(1) Tax Deferral for Significant Dividend and Interest Income.—Most forms of dividend and interest income derived by individuals are taxable and are includible in income in the year in which actually or constructively received. Since current taxation could be avoided by interposing a life insurance company between an individual and his investments, the rules requiring current inclusion would be seriously undermined.

(2) Tax-Free Rollover of Certain Investments.—Since existing law allows tax-free "rollover" of true annuity contracts, allowing securities of any sort to be "wrapped" in annuities, as would S. 388 and S. 446, would mean that these investments also could be rolled-over tax free.

(3) Expansion of Limitations on Voluntary Contributions to Qualified Plans.—Existing law limits the extent to which participants in qualified pension plans may make voluntary, nondeductible contributions to the plan which then may earn income on a tax deferred basis. S. 388 and S. 446 would undermine these limits.

This is just a sampling of the substantive implications of S. 388 and S. 446. I do not mean to suggest that any of these changes necessarily is undesirable.

This Administration is seriously concerned about the level of savings in our country, and is committed to a review of possible changes to the tax laws that would encourage both savings and investment. Changes of this sort raise very serious policy issues, many with significant revenue implications [3] and should receive careful examination on their merits. They should not be indirectly brought about by legislation which, like S. 388 and S. 446, purports to do nothing more than overturn two revenue rulings.

For these reasons, the Treasury strongly opposes S. 388 and S. 446.

S. 464, S. 476, S. 500, S. 501—PRIVATE FOUNDATIONS

Minimum payout requirement

Section 1(a) of S. 464, S. 500, and S. 501 would change the formula for determining the minimum amount which private foundations must distribute to charity.

Under present law, a private foundation must distribute the greater of either 5 percent of the current fair market value of the foundation's equity in its investment assets, or its adjusted net income. Adjusted net income does not include long-term capital gains, either realized or accrued. Both S. 464 and S. 501 would set the minimum payout rate at a flat 5 percent of asset value without regard to adjusted net income; S. 500 would attempt to express adjusted net income in real dollar terms.

The minimum payout rate was introduced in 1969 to ensure that private foundations would make current distributions for charitable purposes. It was designed to apply even if the income from a foundation's assets is low or nonexistent. Congress felt that because donors were receiving current deductions for their contributions to foundations, the foundations should provide a current benefit to charity. The minimum payout rate was set at the greater of the foundation's adjusted net income or 6 percent of assets, with liberal transition rules. The 6 percent was adjusted annually by the Treasury to reflect the ratio of the difference in money rates and investment returns for the year preceding the taxable year as compared to those rates and returns in 1969. In 1976, the percentage was reduced to 5 percent without future adjustments.

The Treasury believes that the minimum payout requirement is still necessary for the reasons that concerned Congress in 1969. But the minimum payout requirement should be considered in perspective—it does not tell foundations where they should spend their resources, nor does it dictate the maximum amount that they should

[3] Preliminary statistics of income data for 1978, before the dramatic increase in interest rates that occurred during 1980, showed interest and dividend income reported on individual returns well in excess of $100 billion. If the average marginal tax rate applicable to such income was approximately 35 percent, the revenue involved in the taxation of dividend and interest income, based on 1978 data, is in the $35-$40 billion range. It is reasonable to assume that, if the free use of wraparound annuities is sanctioned, a sizable portion of this income will be shifted from direct investment to investment through annuity wrappers.

spend. Rather, the minimum payout requirement protects the public trust given to foundations with a minimum of regulation, and leaves to the ability of private foundation managers the social choice of where foundation monies flow.

On this basis, we are sympathetic to the claim that the formula for determining the minimum payout should be neutral with respect to foundation investments, and that the present formula would be improved by deleting the adjusted net income component. We understand that because long-term capital gains and unrealized capital appreciation are excluded from the definition of adjusted net income, the payout requirement now favors investments in assets whose total rates of return reflect more capital appreciation than current yield. Thus it may be argued that, under today's market conditions, exacerbated by inflation, the alternative formula now in the law discriminates against investments in high yield bonds, as contrasted with investments in common stocks.

Nonetheless, the Treasury is committed to a meaningful payout rate. We must consider the charitable sector as a whole, including both private foundations and public charities. It is possible that the change in the formula advanced by these two bills would cause a drop in the payouts of private foundations, and that this will curtail the funds now made available to public charities by foundations. Without further information about the effect of these provisions on both private foundations and public charities, we are unable to take a position on section 1(a) of S. 464 and S. 501. We are willing to work with you in developing an appropriate formula.

The approach of S. 500 is to deflate the adjusted net income of a foundation so that the minimum payout rate would be the maximum of 5 percent of current investment asset value or the real income of the foundation. We think that this kind of approach is unduly complicated when compared with a flat percentage of asset value.

More importantly, the adjustment will not correct for real income when the income of a foundation arises from a mixed portfolio. If Congress retains the alternative formula in present law but corrects it for inflation, the inflation adjustment should be applied against the total income of the foundation, both accrued and realized. We oppose S. 500.

Expenditure responsibility—small grants

Section 2(a) of S. 464 would allow a private foundation to make grants totalling $10,000 or less per year to a private organization without exercising expenditure responsibility. For these purposes, grants to an organization made by foundations under common control would be aggregated. We oppose section 2(a) of S. 464.

Expenditure responsibility was imposed upon private foundations as part of an overall statutory framework enacted in 1969 to make private foundations publicly accountable for the funds they apply to charitable purposes. Expenditure responsibility helps ensure that foundations will make grants for charitable purposes and that grantees will carry out the terms of these grants. We do not believe that this statutory scheme should be dismantled piecemeal.

We would be happy to consider suggestions for administratively streamlining the procedures involved with expenditure responsibility if a showing could be made that the present rules are unduly burdensome. However, the Congressional intent in making foundations publicly accountable for their grants is still of concern, and is valid for all grants, regardless of their size. A threshold dollar amount for grants that may be made without regard to expenditure responsibility is an arbitrary distinction that is unrelated to the purpose of the statute.

Expenditure responsibility—reliance on published lists

A private foundation must exercise "expenditure responsibility" if it makes a grant to an organization that is not a public charity. One type of public charity—the "publicly supported" charitable organization—remains a public charity only as long as it meets percentage support requirements showing broad-based support. A grantor is not affected by the change of status of a publicly supported grantee organization until a notice of the change of status is published, unless the grantor was aware of, or was responsible for, a substantial and material change in the grantee's sources of support that results in the loss of status.

If a grant from a private foundation to a publicly supported organization cannot be excluded from the calculation of the grantee's support because it is not an "unusual grant," and the grant swings the status of the grantee to that of private foundation, the grantor private foundation will incur a tax unless it exercised expenditure responsibility in making the grant. In order to determine whether a grantee will remain publicly supported after a grant so that no expenditure responsibility is necessary, the grantor foundation must determine that its grant will not change the grantee's status, either by the grantee applying for a private ruling that

the grant will be excluded as an unusual grant, or by the grantee demonstrating that even with the grant, it will continue to meet the public support tests.

Section 2(c) of S. 464 would allow a private foundation to rely upon the established status of a grantee organization as publicly supported if the grant was made before the earlier of the date that a loss of status is published by the Internal Revenue Service, or the date that the foundation acquires actual knowledge of either the grantee's impending loss of status as a publicly supported organization or of the negative effect of the grantor foundation's grant.

We question the need for this legislation in light of the recent publication of Revenue Procedures 81-6, 1981-10 I.R.B. 41, and 81-7 1981-10 I.R.B. 42. These revenue procedures create two safe harbors within which privte foundations will not be penalized for not having exercised expenditure responsibility if the grantee organization loses its status after the after the grant is made. First, the grantor will not be considered to be responsible for the grantee's loss of public support if the grantor foundation's aggregate gifts, grants, and contributions to the grantee for the taxable year are not more than 25 percent of the grantee's support from all sources other than the grantor (and its disqualified persons) for the immediately preceding four years. Second, a grant will be excluded from the support tests as an "unusual grant" if it adversely affects the status of the grantee and meets certain other requirements that would indicate that the grantor will not control how the grant is used.

These revenue procedures specifically except from their guidelines grants made by persons who may control the grantee. S. 464 does not contain this type of safeguard, which we believe is paramount. Accordingly, we oppose section 2(c) of S. 464.

We would like to take this opportunity to emphasize the interdependence of the private foundation provisions in present law, and thus the hazards of tinkering with them. Although section 2(a) and 2(c) of S. 464 may appear inconsequential when viewed separately, their enactment in tandem would mean that private foundations would be relieved of expenditure responsibility for grants of up to $10,000 and for larger grants that change the status of the grantee, even where control of the grantee by the grantor may exist. Erosion, no matter how slow, will wear down the framework so carefully built by Congress in 1969.

Definition of "disqualified persons"

The private foundation provisions define a specific class of persons—called "disqualified persons"—who are related to a private foundation. The definition of a "disqualified person" has two principal applications. First, the private foundation self-dealing rules place restrictions on the permissible economic transactions between a private foundation and a disqualified person. Second, under the excess business holdings rules, the permissible holdings of a private foundation in a business enterprise are reduced, in most cases, by the holdings of disqualified persons in the business enterprise.

A disqualified person with respect to a foundation is defined to include, among others, substantial contributors to the foundation and foundation managers. In addition, members of the family of a substantial contributor or a foundation manager are also disqualified persons. For these purposes, members of an individual's family include only his or her spouse, ancestors, lineal descendants and spouses of lineal descendants.

Section 2(b) of S. 464 would limit the family of an individual for this purpose by substituting "children, grandchildren and spouses of children and grandchildren" for "lineal descendants and spouses of lineal descendants." In particular, lineal descendants (and their spouses) of substantial contributors further down than grandchildren would no longer be disqualified persons. We oppose section 2(b) of S. 464.

It is urged that the foundations face a geometrically-increasing burden in having to keep track of all descendants of a substantial contributor. However, in connection with long-term trusts, trust managers routinely keep track of descendants and their spouses.

From a self-dealing viewpoint, even third and fourth generation descendants of a substantial contributor to a foundation would, as a practical matter, be considered by the foundation managers as part of the family of the contributor. Thus, there remains a need to monitor possible self-dealing between such descendants and the foundation.

From an excess business holdings viewpoint, the law provides transitional rules allowing extended disposition periods for pre-1969 business holdings of private foundations. If the class of disqualified persons were contracted at this time, the permitted holdings of foundations subject to these transitional rules might increase. We believe that permitting increases in the business holdings of such foundations would

be unwarranted in view of the policy of requiring foundations with large pre-1969 business holdings to dispose of these holdings in an orderly fashion and the already liberal transitional rules providing long periods for such dispositions.

However, we do recognize that there may be situations where the necessity to keep track of numerous descendants might be an undue burden. Accordingly, we would consider a narrower approach to this problem which would nonetheless be consistent with our concerns expressed above.

Change in definition of private operating foundation

Section 1(a)(2) of S. 464 would amend the definition of a private operating foundation by revising the requirement that a private operating foundation distribute substantially all of its adjusted net income directly for the active conduct of its charitable activities. Under the bill, an operating foundation would be required to make qualifying distributions in an amount equal to the lesser of substantially all of its adjusted net income or substantially all of its minimum investment return.

The intent of this section of the bill is unclear; it is possible that it was meant to be a conforming change to reflect the change in the minimum payout requirement for nonoperating foundations that is found in section 1(a) of the bill. Whatever the intent, we are opposed to this section of the bill because it makes substantive changes in the income payout requirement of operating foundations, and we think the provisions of present law work well.

Under Treasury regulations, an operating foundation must distribute an amount equal to 85 percent ("substantially all") of its adjusted net income. Furthermore, a private foundation that meets the alternative assets test must directly devote at least 65 percent of its assets to the active conduct of its activities. Since minimum investment return is computed only with respect to investment assets, if the bill is interpreted consistently with these regulations, a private foundation would have to pay out only 4.25 percent of the income from 35 percent of its assets to meet the payout requirement for a private operating foundation. This would be a dramatic and unwarranted drop in the payout requirement.

The requirement that a private operating foundation distribute substantially all of its adjusted net income has a different purpose than the requirement that a private nonoperating foundation distribute a minimum amount annually. Nonoperating foundations must distribute a minimum amount to prevent unreasonable accumulations of assets, but no maximum amount is stipulated. However, a nonoperating foundation is restricted in other ways and deductions for charitable contributions to it are limited.

A private operating foundation, on the other hand, is an organization which is treated like a public charity for certain purposes—for example, another private foundation may give it grants without exercising expenditure responsibility, and the limit on deductible contributions are more liberal in the case of gifts to an operating foundation. Thus, private operating foundations are not allowed to accumulate their income, but must pay out income for the direct conduct of their charitable activities. Limiting the payout, as the bill would do, without removing some of the other benefits accorded operating foundations undermines this statutory scheme.

Valuation of foundation assets

As described above, a private foundation must distribute the greater of (i) 5 percent of the current net fair market value of its noncharitable assets and (ii) the foundation's adjusted net income. S. 476 would provide, for purposes of the 5 percent test, a special rule for valuing the assets of a private foundation which was a bank holding company having as a substantial portion of its assets securities in banks, bank related companies or a bank holding company. Under this special rule, the qualifying private foundation would have the option of valuing its securities in banks and bank-related companies by capitalizing the dividends paid by these companies at a rate of 6 percent (i.e., multiplying these dividends by 16⅔).

We understand that S. 476 is intended to benefit the Otto Bremer Foundation of Minneapolis, Minnesota.

Under the bill, the value of a qualifying foundation's assets is computed by capitalizing its dividends at 6 percent. Another way of stating this result is that the "value" of the foundation's assets will be deemed to be an amount such that the dividends actually received by the foundation will be 6 percent of such amount. Accordingly, 5 percent of the "value" of the foundation's assets will always be less than the amount of the dividends actually received by the foundation (i.e., 6 percent of the "value" of its assets). Thus, the minimum payout for a foundation qualifying for special treatment under the bill will simply be its adjusted net income rather than the greater of (i) 5 percent of the value of its assets and (ii) its adjusted net income.

Moreover, a foundation qualifying for special treatment under the bill—a foundation which is a bank holding company—may well control the banks and bank-related companies represented in its portfolio.[4] If the foundation were in control of these banks and bank-related companies, it could control the dividends paid out by these companies and could thereby control its adjusted net income. In effect, such a foundation could decide exactly how much it wished to pay out each year.[5]

This is directly contrary to Congress' purpose in enacting the minimum distribution requirements of section 4942. Moreover, we see no reason why there should be a special rule in this regard for foundations which are bank holding companies. The considerations involved in valuing bank securities are no different than those involved in valuing many other kinds of closely-held assets. Indeed, other foundations have had to sell low-return business assets to comply with the requirements of section 4942. It would thus be unfair to legislate a special rule for one foundation.

In addition, S. 476 would be retroactive to January 1, 1972. We understand that the reason for the retroactive effective date is that the Otto Bremer Foundation is currently being examined by the Internal Revenue Service with respect to certain past years. There is apparently some disagreement between the foundation and the Service about the valuation of the foundation's assets for purposes of the minimum distribution requirement. In support of the bill, the foundation argues (i) that it would not be sound banking practice for the banks and bank-related companies to pay much higher dividends; (ii) that the foundation cannot sell the bank holding company which owns its portfolio of bank and bank-related securities because the local bank holding companies with sufficient resources to purchase it are constrained by anti-trust considerations and nonlocal bank holding companies are constrained by the statutory constraints on the multi-state bank holding companies; and (iii) that the various banks serve an important function in their respective local communities.

The first two arguments go to proper valuation of the foundation's securities. This is a question of fact, appropriate for administrative or judicial resolution, and does not justify special relief legislation for the foundation.

As to the third argument, the foundation seems really to be arguing that a local bank fulfills a charitable purpose by serving a rural community. This is a principle of potentially wide-ranging application. It should be considered directly and not tangentially in what is essentially a bid for special relief.

For these reasons, we oppose S. 476.

S. 499—ROLLOVERS FOR BROADCAST PROPERTY

S. 499 would amend section 1071 of the Code to permit the deferral of gain realized on the disposition of broadcasting property pursuant to a Federal Communications Commission order, if the sale proceeds are reinvested in a newspaper. Under existing law, this "rollover" treatment is available if a newspaper is disposed of and a television or radio broadcasting property is acquired, but not vice versa. This amendment is intended to apply to the FCC required sale of television station WWNY in Watertown, New York by Johnson Newspaper Corporation and to other similarly situated taxpayers where sale proceeds are reinvested in a newspaper.

The Treasury Department does not oppose this bill. Section 1071 was first enacted in 1943 to help the FCC implement a policy of discouraging individuals from owning more than one radio station per city. FCC policy has now expanded to cover cases, like Watertown, where both a television station and a newspaper are commonly-owned. The new policy is to require sale of either the television station or the newspaper. Under the existing statute the Internal Revenue Service has ruled that the newspaper may be exchanged for a new television station, but not the reverse. The tax law should be neutral as between these two situations. Once it is determined, as Congress has done, that FCC-ordered dispositions are entitled to tax deferral, that policy should apply equally in equivalent situations.

We note that the provisions of this bill are retroactive to January 1, 1980. In general, we are opposed to retroactive effective dates for tax legislation. In this case, we have not been made aware of a reason to depart from this view.

Senator PACKWOOD. Mr. Secretary, thank you.

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[4] Apparently, the Otto Bremer Foundation possesses majority control of 29 banks and 39 bank-related companies.

[5] If the adjusted net income component of the minimum payout rate were generally deleted (as proposed in section 1(a) of S. 464 and S. 501), the result would be the same. The private foundation could control the capitalized value of its holdings by controlling the dividend rate and could thereby control the amount required to be paid out by the foundation (i.e., 5 percent of this value).

I don't have any specific questions. But let me thank you for meeting our deadlines as we are going along with many of these bills.

We will have dozens, or perhaps hundreds, by the time the year is over, and we won't have hearings on all of them. But if we held them up until the last part of the session, you would be here every day, or somebody would be here every day testifying.

I, obviously, don't agree with all of your conclusions, but I find it very well crafted, and I hope we will be having these hearings every 2 to 3 weeks in trying to get out of the way three to four to five to six bills a day.

Next, we will have a panel consisting of Mr. W. Thomas Kelly, Mr. Robert Ruffin Barrow and Mr. Wayne Spencer.

Gentlemen, I think you have been advised of our time limits. You will see a signal light here that will turn yellow when you have a minute left. It will turn red and a bell will ring when your time is up.

Your entire statement will be placed in the record. You may testify in the order you choose.

Mr. Kelly, are you going first?

Mr. KELLY. Yes, I am.

Senator PACKWOOD. Go right ahead.

Mr. KELLY. Before my alloted time commences, may I request that the record of the hearing held on November 19, 1980, on S. 3082 and S. 3094 before this committee be included by reference.

[See page 64 of Finance Committee hearing of Nov. 19, 1980 (No. 106).]

Senator PACKWOOD. They will be.

Mr. KELLY. Thank you. It will be very helpful.

STATEMENTS OF W. THOMAS KELLY, PRESIDENT, INVESTMENT ANNUITIES INSTITUTE, INC., VALLEY FORGE, PA.; ROBERT RUFFIN BARROW, PRESIDENT, INTERNATIONAL GENERAL INSURANCE CORP., MILWAUKEE, WIS.; WAYNE SPENCER, VICE PRESIDENT, WISCONSIN EMPLOYERS INSURANCE CO., GREEN BAY, WIS.

Mr. KELLY. My name is W. Thomas Kelly. I am the president of the Investment Annuities Institute.

Senate bill S. 388 and the companion bill S. 446 are most worthy of speedy committee approval.

There is absolutely no question that the IRS's actions were, as the U.S. District Court, of the District of Columbia declared, illegal, unreasonable, ignorant of the law, a usurpation of the powers of Congress, and an attempt of fashioning a taxation mode that makes no sense, and that produces an unreasonable result.

While the appellate court overturned the district court on other grounds—namely jurisdiction—without considering the merits, the appellate court invited Congress to listen to it with a grievance and plea.

As reflected by Treasury officials, Lubick and Halperin's testimony before this committee and by Commissioner Kurtz' actions in the issuing revenue ruling 77-85 and 80-274, these individuals were adamant in their desire to tax all annuities in the same

manner as illegally imposed by them upon innovative segments of the annuity industry, as per ruling 77-85 and 80-274.

While these attacks tried, but could not destroy the annuity industry by legislation, they wrecked what they could by administrative fiat, safe in the knowledge that the unlimited power of the Government in terms of time, money, and the impervious shield of the Anti-Injunction Act was on their side.

Neither of these revenue rulings has legal merit nor tax policy merit.

Senate bills S. 388 and S. 446 are proper corrective measures, in that they reaffirm existing law that is already crystal clear and needs no revision.

In my testimony for this hearing I have challenged the Joint Committee of Taxation 1978 report that stated: "The relative advantage of the annuity is greater for taxpayers in higher brackets."

I have prepared an improved illustration that more clearly reflects my position and this visual aid, I believe, has been distributed to you.

If my position is correct, and challenge it, if you will, the Joint Tax Committee's conclusion is entirely wrong. And, what they portrayed as black turns out to be, in fact, white.

This raises two concerns:

First, Congressmen must have the facts for a balanced judgment. Such distortions have occurred many times in this matter.

My second concern, reflected in this illustration, is the horrible erosion of an individual's true rate of interest return that is imposed by the existing mode of taxing income. Note that even a person in the 20-percent tax bracket loses 44 percent of his true interest return because of taxation. That's 120 percent more than his tax bracket.

Is it any wonder that our citizens, from all walks of life, find it so hard to save for life's later years, for that rainy day, for children's education, for illness expense, for retirement years, or for whatever future purpose?

Is it any wonder that everyone turns to the Government for financial help.

Annuity taxation in the exact form as now constituted makes sense. It provides tax equity and encourages people to save, which all Congressmen and the administration, presumably, agrees our Nation needs so badly. Annuity taxation should not be destroyed by the zealous tax expenditure proponents, whose slavish adherence to tax expenditure theory does not make sense, at least insofar as this subject is concerned.

It is entirely proper to call your attention to the diverse group of individuals and institutions that have come here and supported this legislation. Like myself and my constituency, they and those who testified last November represent a broad range of grassroots citizenry.

Not only do the buyers of these annuities need them so badly in our perilous economic times, the institutions involved need them very badly also, as does our Government.

Included among those in support are the grassroots savings and loans in the cities and the towns all across our Nation. The same

could be said of the grassroots mutual savings banks, credit unions, and commercial banks.

The teachers of our Nation have testified, the Professional Association of Financial Planners have testified, insurance companies and their agents have testified.

In short, gentlemen, these annuities are not investment annuities, savers annuities, or wraparound annuities as they have become known in the trade jargon. These annuities are public annuities. They are the grassroots, the mom and pop, the main street, U.S. annuities. This legislation deserves your support. Your active support for immediate action is very badly needed by our Nation and by your constituency.

Thank you very much. May I ask that my illustration be inserted in the record.

[The following table was submitted for the record:]

ANALYSIS OF JOINT TAX COMMITTEE'S APRIL 14, 1978, CERTIFICATE VERSUS ANNUITY COMPARISON OF INVESTMENT RETURN ON $1 INVESTED AT 8 PERCENT FOR 35 YEARS

Item	Taxpayer's tax bracket							
	20 percent [1]		30 percent		50 percent		70 percent	
	Certificate	Annuity	Certificate	Annuity	Certificate	Annuity	Certificate	Annuity
Committee comparison: [2]								
After-tax return	$7.77	$11.02	$5.73	$9.65	$2.95	$6.89	$1.29	$4.14
Annuity excess [3]		$3.25		$3.92		$3.94		$2.85
Percent [3]		42		68		132		221
Correct comparison: [4]								
Before-tax return	$13.78	$13.78	$13.78	$13.78	$13.78	$13.78	$13.78	$13.78
After-tax return	$7.77	$11.02	$5.73	$9.65	$2.95	$6.89	$1.29	$4.14
Lost due to taxes	$6.01	$2.76	$8.05	$4.13	$10.83	$6.89	$12.49	$9.64
Percent	44	20	58	30	79	50	91	70
Reduction in loss due to taxes via annuities		$3.25		$3.92		$3.94		$2.85
Percent		55		49		36		23

[1] 20 percent tax bracket was not included in the committee's report.
[2] Only figures shown by committee.
[3] Committee conclusion.
[4] Comments: Is it any wonder that people have trouble saving for life's later years when the before-tax "true return" on their savings is crushed so badly by our present mode of income taxation. It is incredible that the 20 percent bracket taxpayer loses 44 percent of his "true return" because of the way income is taxed. Higher bracket taxpayers lose unconscionable portions that reach confiscatory levels, and all of this is before the added burden of inflation is taken into account.
Annuity taxation provides relative tax bracket equity, and reduces these losses due to taxes relatively more for lower bracket taxpayers.

I'll be pleased to answer any questions that you have.

Senator PACKWOOD. Your illustration will be inserted in the record.

That was a very enthusiastic presentation, Mr. Kelly. [Laughter.]

Mr. KELLY. Sir, now for 4 years I have been trying to get this message across and I hope that we will succeed.

Senator PACKWOOD. We will take the rest of the panel and the questions.

Mr. Barrow.

STATEMENT OF ROBERT RUFFIN BARROW, PRESIDENT, INTERNATIONAL GENERAL INSURANCE CORP.

Mr. BARROW. My name is Robert Ruffin Barrow. I am the president of International General Insurance Corp., in Milwaukee.

On September 24, 1980, the Internal Revenue Service issued Revenue Ruling 80-274—without notice, without hearings, without opportunity for judicial review, and without respect for the numerous prior rulings issued to several small insurance companies, three to my company alone.

The IRS, by issuing Revenue Ruling 80-274, critically wounded the middle-income saver, providing for his own retirement. And, in doing so, denied those potential savings from being productively used to create new jobs. And, thus, the families of America who depended now prayed for those new jobs that had been denied the investment that produces these jobs.

Last year's election was a mandate for a new economic policy which would not penalize savings by stemming inflation and building the productivity that stabilizes and reduces these inflationary pressures.

The Service's action in issuing this revenue ruling is to the middle-income saver as the parent telling a child that he must immediately spend his allowance on candy, rather than saving for a bicycle which would enable him to deliver newspapers.

These annuities create a long-term stable deposit base for the savings and loans to support their long-term local residential mortgages. These annuities will help ameliorate the crushing squeeze that the savings and loans are in.

I would like to sort of, by reference, include the testimony of Allen Greenspan before the Joint Economic Committee of the U.S. Congress on January 22, 1981, where he referred to the savings and loans, basically, as the first victim in this fight on inflation.

I would also like to go on and say that in summary of the points of my written testimony, Revenue Ruling 80-274 is a usurpation of the legislative authority of Congress. It undertakes administratively to reflect an amendment to the Internal Revenue Code, which the prior administration had proposed, but which the Congress had rejected.

The annuity and Revenue Ruling 80-274, which the 80-274 has banned encourages savings by middle America. It provides the banks and savings and loan associations with the stable deposits and creates a pool for local mortgage money.

Finally—well, third, Revenue Ruling 80-274 is discriminatory, it only goes after the savings and loans and the banks of America. It does not go after—and if I might just briefly include three ads out of—four ads out of one day's Wall Street Journal of the money market wrapped annuities, which I am not advocating any change in, in their present structure.

But, here is one from Fidelity Income Plus: "Money market yields not tax-deferred." Here is one that says: "How much money has your money market fund earned for the Federal Government?" And, here is, finally, one: "April 15, the joy of money market interest becomes the pain of taxes."—one day's Wall Street Journal, last week.

Fourth, the Revenue Ruling 80-274 is a reversal of the position taken by the IRS in the rulings we had received. In reliance on these rulings, we launched our annuity business. And, I might add, that when they issued the Revenue Ruling 80-274, they did not grandfather in it. It only took the very kind intervention of this

committee that finally led to the IRS grandfathering the existing contract 3 months later and $5 million in liquidations in our firm, which was a penalty of over $400,000 lost to our company.

And then, finally, I would like to say that Revenue Ruling 80-274 is predicated on Revenue Ruling 77-85, which annotated the rulings which we had received.

The Internal Revenue Service, in connection with these rulings that we received considered the Revenue Ruling 77-85 and concluded our annuity was distinguishable. And, yet, in their later day judgment, decided that 77-85 was applicable.

I would like to thank you and I am sure that other people will talk about the stability of deposits, but I refer you in my written testimony to a survey done by First Savings of Wisconsin, which was our largest customer and the largest savings and loan in the State of Wisconsin:

On page 3, "This is a middle-income, middle-America savings program. Our average enrollee was 54 years old, had an income of $26,300, and placed in the annuity $9,943." And, I might add, without this backbone of such middle-income savers, the savings institutions cannot continue.

Thank you.

Senator PACKWOOD. Thank you very much.

We will take Mr. Spencer.

STATEMENT OF WAYNE W. SPENCER, VICE PRESIDENT, WISCONSIN EMPLOYERS INSURANCE CO.

Mr. SPENCER. Thank you, Mr. Chairman.

My name is Wayne W. Spencer. I am vice president of Wisconsin Employers Insurance Co., of Green Bay, Wis. I have asked to testify here this morning in support of Senate bill 446.

In late 1977, my company designed a product called TDA. It was a tax-deferred annuity created specifically to be distributed by and through financial institutions.

This tax-deferred annuity was filed and approved by our regulatory body, The Wisconsin State Insurance Department. We then requested review by the Internal Revenue Service of the program.

In two private letter rulings, one dated November 9, 1978 the other dated December 3, 1979, the IRS, in effect, confirmed our belief in the tax deferred status of TDA.

TDA was then offered by our financial institutions as a tax deferred annuity. It contained benefits that are only contained in a tax deferred annuity, such as guaranteed lifetime income.

As it was an annuity, and not simply a wraparound or another type of savings plan, approval was granted by both the Wisconsin State Commissioner of Bank and the Wisconsin State Commissioner of Savings and Loan for distribution by their respective financial institutions.

We also requested and received insurance on our corporate premium deposits by both the FSLIC and FDIC,

On September 24, 1980, the IRS issued Revenue Ruling 80-274. In effect, they took the same facts that they had reviewed numerous times before and reversed their position, declaring that TDA no longer enjoyed tax deferred status.

My company, the financial institutions work with us, and, more importantly, the people who had purchased these TDA's were stunned by this reversal without warning. This apparent total disregard for the reliance we had placed on their previous position would seem to make any further attempt to provide similar incentives to the American saver suspect.

The confidence factor can only be restored by an immediate reversal of Revenue Ruling 80-274.

Annuities have long enjoyed tax deferred status as a result of early congressional wisdom. This wisdom based on the fact that Americans, given an incentive, are not only willing, but eager to set aside part of their current income to provide for their future.

Reversal of Revenue Ruling 80-274 and restoration of TDA will provide the incentive and allow financial institutions to perform their traditional role in maintaining an stable ecomony.

The present cost of mortgage money, if you can find it, is so high that most Americans can no longer afford a home.

The frightening decline in the number of new homes being built and the escalating unemployment in the construction industry all result from financial institutions being unable to attract and maintain long-term deposits.

Our premium deposits through TDA would provide these funds. Everyone seems to be offering their own solution to the problems confronting financial institutions and everyone of them seems, in some way or another, to involve governmental intervention. The simple fact of the matter remains that the solution is already available and has already, more importantly, met with congressional approval.

That solution is the restoration of TDA and the overturning of Revenue Ruling 80-274.

Through our counsel we have attempted to reason with the IRS. This process has proved fruitless.

It is apparent, therefore, that Congress must once again assert its belief and reemphasize its original wisdom, that is by overturning 80-274.

It is my hope we take the first step today with this committee's approval.

With your permission, Mr. Chairman, I would like the supporting documents, such as the private letter rulings and various approval letters mentioned in my statement entered into the record.

Senator PACKWOOD. They will be included with your statement.

[The letters follow:]

WISCONSIN EMPLOYERS INSURANCE CO.,
Green Bay, Wis., March 15, 1978.

Re Group Single Premium Annuity Contract Form WEIC 382, Application for Group Single Premium Annuity Contract Form WEIC 383. Enrollment Application and Certificate for Group Single Premium Annuity Contract Form WEIC 381.

OFFICE OF THE COMMISSIONER OF INSURANCE,
State of Wisconsin, Madison, Wis.

Attention: Mr. L. L. Schlinkert, Insurance Rate and Forms Analyst.

DEAR MR. SCHLINKERT: The above-captioned Forms were submitted to your department on February 17, 1978 and received Tentative Approval on February 20, 1978. We now submit these forms to your department for final approval; they will be issued in the form submitted.

Please note that the Form numbers had been assigned incorrectly (WEG 381, WEG 382 and WEG 383) on these Forms submitted to your department on February 17, and have been changed (WEIC 381, WEIC 382 and WEIC 383).

We will await your response to our request for final approval of these forms. Please feel free to contact me if you have any questions.

Thank you.

Respectfully,

JOHN M. LADWIG, CLU.

Enclosures.

DEPARTMENT OF THE TREASURY,
Washington, D.C., November 9, 1978.

WISCONSIN EMPLOYERS INSURANCE CO.
Green Bay, Wis.

GENTLEMEN: This is in reply to a request for a ruling submitted on your behalf by your representative concerning the ownership of deposits placed in savings and loans in connection with the insurance of group single premium annuity contracts.

The Company in an insurance company taxable under section 802 of the Internal Revenue Code of 1954.

The Company has developed a group single premium annuity contract to be sold by the Company to depositors of savings and loans. The Company intends to sell annuity certificates to depositors of savings and loans who hold master policies. The savings and loan will act as contractholder and will enroll depositors into the plan just as most employers hold group health policies and enroll their employees into their plans. The Company will reimburse the savings and loan for their expenses associated with the enrollment procedure.

Any premiums received by the Company under the program will be deposited into the savings and loan. These deposits will be segregated accounts with the Company holding legal title to the accounts. The Company will hold the passbooks for the accounts, and each passbook will read, "The insurance company holds this account as agent for annuitant X, subject to the terms of the Annuity Plan." The savings and loan will pay the usual interest on these deposits.

The annuitant's cash value in his Annuity Plan will be the premium paid plus interest accumulated at a guaranteed rate of four percent (4 percent) per year, compounded annually. 100 percent of the premiums paid will be included in the cash value. If the savings and loan only paid three-and-one-half percent (3½ percent) interest on the deposits made by the Company for the benefit of the annuitant involved, the Company would have to make up the extra one-half percent (½ percent). In addition, certain "excess interest" may increase the cash value of the policy, if so determined by the Board of Directors of the Company. In no case can the amount of excess interest credits be less than the interest paid by the savings and loan on the pertinent deposits, diminished by one-half percent (½ percent) and further diminished by the guaranteed rate.

The Annuity Plan provides various options for payment of the benefits, e.g. lump sum, payment over a period of years. The benefits are paid under a permanent purchase rate guarantee.

The annuitant does not have direct access to the interest earned on the deposit in the savings and loan, except as the terms of the Annuity Plan allow him payments of benefits, loans on the cash value of the policy, or surrender of the policy for its cash value less a cash surrender charge. Further, the annuitant has no right or authority to direct the insurance company to cancel any amount or withdraw funds from any account that the Company has with any financial institution. If the annuitant dies prior to the annuity starting date, having designated a contingent payee, the contingent payee will receive in one sum the payment due after the death of the annuitant.

Based on the foregoing, the provisions of the Annuity Plan indicate that the Company will be the recipient of the interest earned on the deposits placed in savings and loans in connection with the Plan. Further, the annuitant has no direct access to the assets in the account, but instead has a right only to receive annuity payments in amounts pursuant to the Company's obligations under the terms of the Annuity Plan.

Accordingly, it is held that the Company will be the owner of the deposits in the savings and loans placed there in connection with the annuity plan, for purposes of determining the Company's gross investment income under section 804(b) of the Code.

This ruling letter is based on the present provisions of the Internal Revenue Code. President Carter, in his special tax message to Congress on January 21, 1978, proposed that taxes be imposed currently on the holders of certain deferred annuities not purchased under qualified retirement plans. The holding of this ruling

letter may not be relied upon in the event that legislation affecting the plan described herein is enacted by the Congress.

A copy of this letter should be attached to your Federal income tax return.

In accordance with the power of attorney on file, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

JOHN L. CRAWFORD,
Chief, Corporation Tax Branch.

DEPARTMENT OF THE TREASURY,
Washington, D.C., December 3, 1979.

WISCONSIN EMPLOYERS INSURANCE CO.,
277 Ridge Road, Green Bay, Wis.
(Attention of Mr. John Ladwig, C.L.U. Manager, Technical Services.)

DEAR MR. LADWIG: This letter is in reference to your Group Single Premium Retirement Annuity Contracts that were the subject of our letters to you dated November 9, 1978, (Written Determination Number 7906058) and April 3, 1979.

After careful consideration of the matters discussed in our conference with you on May 8, 1979, and your subsequent communications with our office, we have concluded that it will be necessary for us to modify our earlier ruling letter for the following reasons.

If the language on the passbooks representing the deposits held in financial institutions pursuant to the annuity plan refers to any party other than the taxpayer, such language is inconsistent with the actual relationships involved. You have represented that the annuitant derives benefits solely pursuant to the terms of the annuity contract. The taxpayer will be the legal owner of the accounts and will have control, along with the financial institutions, over the investment of the funds in the accounts.

In Revenue Procedure 79-14, 1979-10 I.R.B. 30, the Internal Revenue Service announced, in section 4.01, that it will not issue advance rulings or determination letters as to who is the true owner of property or the true borrower of money in cases in which the formal ownership of the property or liability for the indebtedness is in another party.

Our earlier ruling letter to you involved an arrangement whereby each passbook would state that the taxpayer owned the account as agent for the annuitant. Based on the inconsistency between this language and Rev. Proc. 79-14, we can no longer continue that ruling letter in effect. Moreover, if the taxpayer is to be held to be the owner of the accounts, and to hold them as part of its total reserves, it is inconsistent for the passbooks to note any designation other than that the taxpayer is the owner of the accounts.

Accordingly, our ruling letter to you dated November 9, 1978, cannot be relied upon for any annuity contracts issued subsequent to 90 days after the date of this letter. The prior ruling letter will be valid for contracts issued prior to that date pursuant to section 7805(b) of the Internal Revenue Code.

Pursuant to a power of attorney on file in this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

GERALD PORTNEY,
Assistant Commissioner (Technical).

STATE OF WISCONSIN,
OFFICE OF COMMISSIONER OF BANKING,
August 30, 1978.

Re Single Premium Deferred Annuity Contracts.

DEAR MS. GRITZMACHER: I have received your letter of August 25, 1978, in which you request an opinion relative to the authority of Wisconsin state banks to participate in the offering and administration of deferred annuity programs.

After reviewing this material and applicable sections of the Banking Code, it is my opinion that Wisconsin state chartered banks may participate in the offering and administration of single premium deferred annuity contracts of the type described by Wisconsin Employers Insurance Company.

In order to avoid misunderstandings on the part of your bank's customers, you should, when announcing and promoting the annuity program, distinguish clearly between the bank's functions on the one hand and those of the insurance company on the other hand. It should be pointed out to your customers that the bank is

merely accepting deposits and engaging in certain non-discretionary administrative duties and is therefore, not a party to or has any responsibility for the insurance and annuity features of the contract.

These narrowly defined functions would obviate the need for an insurance license or for fiduciary powers on the part of the bank. This approval is conditioned upon your bank's adherence to these functional limitations.

This letter deals exclusively with the regulatory issues pertaining to an annuity program and should not be viewed as a recommendation or endorsement of the plan.

In conclusion, I again emphasize the importance of a full and thorough explanation of the annuity program as well as the bank's limited role to all participants. Should you have any other questions, please contact me.

Yours very truly,

T. E. PEDERSON,
Deputy Commissioner of Banking.

STATE OF WISCONSIN,
OFFICE OF COMMISSIONER OF SAVINGS AND LOAN,
March 28, 1978.

Mr. JOHN M. LADWIG, CLU,
Wisconsin Employers Insurance Co.,
Green Bay, Wis.

DEAR MR. LADWIG: Thank you for your letter of March 15 broadly outlining the group annuity program which Wisconsin Employers Insurance Company plans to implement through savings and loan associations in Wisconsin. As you indicated in your letter, it is the position of this office that no statutory or regulatory obstructions to the plan which you describe exist, provided the plan falls within the group exclusion contained in state insurance law.

I would, however, like to make a couple specific comments concerning the procedure noted in your letter. First, you state "The savings and loan will have the authority to issue individual Certificates to the depositor of that institution." It is my understanding that an association's records in fact would only indicate at most a beneficial interest on the part of an individual, and that in reality the association would be a depository for Wisconsin Employers Insurance Company. Restated, it is my impression that the association's account would either show Wisconsin Employers as the sole depositor or might indicate Wisconsin Employers as the depositor "for the benefit of 'John Jones' ". But in any event, it is my understanding that the "retail customer" does not have a direct contractual relationship with the association.

My second comment, again intended to clarify, could perhaps best be defined as an amplification of the foregoing thought. You indicate that a savings and loan would be paid an expense allowance for each certificate that is issued. We have no problem with such a procedure, provided that the institution's role is in effect that of agent for Wisconsin Employers. My reason for emphasizing this is because as you know Wisconsin state chartered savings and loan associations do not have the capacity to act as a trustee for a plan such as that which you describe.

I hope that these comments are of assistance to you in formulating your program. Should you have any additional questions please do not hesitate to contact us at any time.

Sincerely,

BRIAN T. KAYE, CFE,
Deputy Commissioner.

FEDERAL HOME LOAN BANK BOARD,
Washington, D.C., May 5, 1980.

Ms. JUDITH A. HASENAUER,
Blazzard, Grodd & Hasenauer,
Westport, Conn.

DEAR Ms. HASENAUER: This is in response to your two letters of March 26, 1980 in which you advanced your opinion about Wisconsin "segregated account" law, and asked about the insurance of accounts held under an annuity contract offered by Wisconsin Employers Insurance Company (WEIC).

In your letter you describe the WEIC annuity program as follows:

1. Wisconsin Employers proposes to establish one or more [segregated][1] accounts pursuant to the insurance laws of the State of Wisconsin. Such [segregated] accounts will be used exclusively for the Wisconsin Employers Annuity Contracts described herein.

2. Wisconsin Employers proposes to issue Group Annuity Contracts (the "Annuity Contracts"). Participants under said Annuity Contracts will be certain owners of deposit instruments issued by savings and loan associations ("Member Associations") whose accounts are insured by the FSLIC.

3. Such deposit instruments from the underlying investment for participation under the Annuity Contracts will be held in the name of the Wisconsin employers [Segregated] Account as the legal owner.

4. The records of the Member Association will reflect that the particular deposit instrument is held by the Wisconsin Employers [Segregated] Account under the Annuity Contract for the ultimate benefit of the Annuitant (Participants under the Group Contract).

5. All deposit instruments held by the Wisconsin Employers [Segregated] Account will be segregated by Participant (Annuitant) and Wisconsin Employers records will clearly reflect the Individual Participant's certificate under which each deposit instrument is held.

6. Interest credited by Wisconsin Employers on each Annuity Contract will reflect the interest yield in the underlying deposit instrument with a basic minimum guaranteed interest rate. The interest rate actually credited on the Annuity Contract will not be the exact interest credited on the deposit instrument. Wisconsin Employers will retain a portion of the interest yield as its compensation for providing the annuity guarantees contained in the Annuity Contract.

7. At maturity, the proceeds from each deposit instrument held under the Annuity Contract will be re-deposited in a deposit instrument which reflects the investment needs of the Annuitant under the Annuity Contracts.

The WEIC annuity program appears to be substantially similar to other savings account funded annuity programs that we have evaluated in the past. The WEIC program allegedly permits account holders to obtain tax deferred income while maintaining the safety of an investment in an insured savings account.[2] In the earlier annuity programs, the savings accounts were held either by a custodian in trust for the insurance company, or held by the insurance company as agent for the annuitant. In the first case the beneficial interest of the insurance company in each account was separately insured at that time for up to $40,000, and in the second case each account was insured for up to $40,000 as an individual account of the annuitant.

You are now asking us to consider a savings account funded annuity in which the underlying deposit is held neither in trust for the insurer, nor as agent for the annuitant. Instead, the underlying savings accounts are placed in a "segregated account" established pursuant to §§ 611.24 (1), (3)(b) and (3)(c) of Wisconsin Stat. Ann. (Wisconsin is the domiciliary State of WEIC). Section 611.24 which you have indicated was adopted as part of the Model Variable Contract Law recognized by the National Association of Insurance Commissions, provides in relevant part that:

§ 611.24 Segregated accounts in general

(1) Mandatory segregated accounts. A corporation shall establish segregated accounts for the following classes of insurance business, if it also does other classes of insurance business: (a) Mortgage guaranty insurance; and (b) Life insurance including fixed and ~~variable~~ annuities. Disability insurance may be included in a life insurance account.

* * * * * * *

(3)(b) *Identification.* The income and assets attributable to a segregated account shall always remain identifiable with the particular account but unless the commissioner so orders, the assets need not be kept physically separate from other assets of the corporation. The income, gains and losses, whether or not realized, from assets attributable to a segregated account shall be credited to or charged against the account without regard to other income, gains or losses of the corporation.

(c) *Charges.* Except under par. (e), assets attributable to a segregated account shall not be chargeable with any liabilities arising out of any other business of the

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[1] You have indicated that since the WEIC annuity is a fixed contract, Wisconsin law (referred to below) requires the use of a "segregated" account.

[2] The tax treatment of such annuities is a matter within the jurisdiction of the Internal Revenue Service; we, therefore, express no opinion on such matters.

corporation, nor shall any assets not attributable to the account be chargeable with any liabilities arising out of it, except under par. (i).[3]

While insurance companies generally lack the authority to act as trustees, we noted in our opinion of January 28, 1980, that as a general principle of insurance law, when an insurance company "is required to create a special fund or to segregate certain assets to secure its performance under certain policies, courts are prone to treat these arrangements as trusts, as contrasted with the debt created by a company's contractual obligation to pay a policy claim out of its general assets." *Rohm and Haas Co.* v. *Continental Insurance Company,* 58 Ill. App. 3rd 378, 374 N.E. 2nd 727 (1978). In that case, the Illinois Court held that under the Illinois version of the above Model Variable Contract Law, a "separate account" is not subject to claims arising out of any other business the insurer may conduct. In our opinion of January 28, 1980, we determined that the relationship between the insurer and the annuitant for whom the company holds this separate account is sufficiently similar to a trust arrangement to qualify as a trust for purposes of § 564.10 of our Insurance Regulations (12 CFR 564.10). In the instant case, Wisconsin law provides for substantially identical insulation of assets with respect to Wisconsin Employers' "segregated account". Accordingly, accounts at insured institutions held by an insurer in a "segregated account" for its annuity policy holders, such as you have described, would be separately insured for up to $100,000 in any one institution (as provided by the new insurance ceiling in P.L. 96-221) with respect to each annuitant interest in such account.

As you may know, while Federal associations have no express or implied power to act as insurance agents, we have long held that such associations may make insurance programs available to their members. Federal associations may aid in the marketing of such insurance programs, as long as they do not act as insurance agents within the purview of applicable state law. Moreover, any commissions received by such associations which exceed the expenses of administering the program must be proportionately distributed among the participants. If the foregoing criteria are satisfied, Federals may participate in annuity programs such as the one described above. The extent to which State-chartered associations may participate in such annuity programs, is a question for determination under pertinent state law.

Sincerely yours,

MILAN C. MISKOVSKY,
General Counsel.

FEDERAL DEPOSIT INSURANCE CORPORATION,
OFFICE OF THE GENERAL COUNSEL,
Washington, D.C., June 4, 1980.

JUDITH A. HASENAUER, Esq.,
Blazzard, Grodd & Hasenauer,
Westport, Conn.

DEAR MS. HASENAUER: This is in response to your inquiry regarding the deposit insurance coverage of certain bank deposits to be held in accordance with an annuity contract plan.

As set forth in your letter of May 27, 1980, the annuity contract plan will operate as follows: The depositor purchases an annuity contract by transferring his or her account with the bank to the Wisconsin Employers Life Insurance Company ("Insurance Company") in exchange for an annuity contract funded by that account. The account is re-registered in the Insurance Company's name. The bank pays its usual interest on the deposits and receives expense reimbursements for services.

You also noted that: (1) as permitted by Wisconsin Law, the Insurance Company will maintain the deposit instruments in a segregated account; (2) pursuant to Wisconsin law, the assets held in a segregated account may not be charged with liabilities arising out of any other business of the Insurance Company; (3) according to the contract, the annuitant shall have the benefit of the entire principal of and income from the depository account, except that the Insurance Company is entitled to receive its service fee from the account; (4) the Insurance Company's record will identify each depository account with a particular annuity contract; and (5) accord-

[3] In your opinion on Wisconsin "segregated account" law, you indicate that paragraph (e) of § 611.24 provides for liquidation of any general or segregated account without affecting other segregated accounts maintained by the company. Paragraph (i) of the section authorizes the general account of the company to receive "fair consideration." for acting as an insurer for the segregated account (we understand no rules have been adopted implementing this section). Further, you conclude that these provisions do not affect the insulated nature of the segregated account, and therefore should not affect its eligibility for insurance as a trust account.

ing to Wisconsin law, upon liquidation of the Insurance Company, a liquidator may not invade the assets of the segregated account to satisfy claims of other creditors.

As you know, FDIC deposit insurance coverage limitations are a function of the rights and capacities in which deposit accounts are held. Where deposits are held in different and distinct rights and capacities, separate insurance coverage may be warranted with respect to each individual in whose interest the deposits are held. See 12 U.S.C. § 1813(m) and 12 CFR Part 330.

The contract between the Insurance Company and the annuitant provides that each deposit instrument will be maintained in the segregated account established by the Insurance Company. The contract also provides that the Insurance Company's records will identify each deposit account with a particular annuity contract. State law prescribes that assets held in a segregated account may not be charged with liabilities arising out of any other business conducted by the Insurance Company. State law also prescribes that, upon the liquidation of an insurance company, a segregated account may not be invaded to satisfy claims of other creditors. It follows, therefore, that an annuitant has a contractual right to the depository funds and that this right is not only contractually enforceable but also statutorily enforceable.

Because of these factors, the various bank deposits in question are deemed to be held in separate rights and capacities. This conclusion, however, is based in part upon the premise that an annuitant has no rights with respect to the deposit accounts of other annuitants. The insulation of each deposit account held exclusively for the purposes of an annuity contract is in addition to the insulation of the segregated account itself and may stem from state statute, regulation or the contract between the annuitant and the Insurance Company.

In accordance with the foregoing analysis and subject to the preceding conditions, the nature of the annuity contract plan is such that the deposits held by the Insurance Company qualify for separate insurance. Each deposit account, therefore, will be insured to the maximum amount of $100,000.

Please note that this correspondence does not represent the FDIC's opinion as to the propriety of the applicable banking institution's involvement in the annuity contract plan. The appropriate federal or state law should be consulted regarding the permissible scope of banking activities.

Sincerely,

ROGER A. HOOD,
Assistant General Counsel.

Senator Symms.

Senator SYMMS. Thank you very much, Mr. Chairman, and members of the committee, and members of the panel.

I'd like to first take this opportunity, Mr. Chairman, to thank you for taking the initiative in holding these hearings on Revenue Ruling 77-85 and Revenue Ruling 80-274.

In reviewing this matter this morning, I believe three separate items need to be reviewed, of which some have been touched upon by our first witnesses.

First, and most importantly, this committee should review the legality of these rulings. I believe, as did the U.S. District Court, District of Columbia, and the House and Senate, that the rulings are not only completely illegal, but arbitrary, capricious, and a usurpation of the legislative powers by the Internal Revenue Service.

This entire matter represents a most classic case of the IRS abuse in bringing about tax reforms via administrative fiat route safe in the knowledge that the Anti-Injunction Act is their shield against the taxpayer.

This committee should examine who makes the law, the IRS or the Congress. It has always been my understanding that the IRS was supposed to interpret the law, not make the law.

Second, this committee should examine the aftereffects of the IRS actions. Quite clearly their actions have caused severe disruptions in the market; displaced many hardworking taxpayer Ameri-

cans; and deprived middle-class Americans of a viable product which would help them plan their retirement years.

Third, I believe it's important to recognize the benefits of variable annuities. Both the investment annuity and the annuity wrapped around savings accounts, added to the capital base in our economy provided a viable product to all classes of people, helping them plan their retirement years.

The annuity wrapped around savings accounts significantly improved the position of local savings and loan institutions and increased their ability to lend the money for such items as home loans.

It is very clear that the intent of the IRS in promulgating these regulations was not in the best interests of the country nor the citizenry.

Mr. Chairman, I'd ask unanimous consent to include with my statement today material that was placed in the Congressional Record by Senator Hatch and myself for part of our hearing record.

Senator PACKWOOD. It will be placed in the record.

[The information follows:]

Mr. Chairman, I would like to take this opportunity to thank you for taking the initiative in holding these hearings on Revenue Ruling 77-85 and Revenue Ruling 80-274.

In reviewing this matter this morning, I believe that three separate items need to be reviewed.

First, and most importantly, this Committee should review the legality of these rulings. I believe, as did the U.S. District Court, District of Columbia, and the House and Senate, that the rulings are not only completely illegal but arbitrary, capricious and a usurpation of Legislative powers by the Internal Revenue Service. This entire matter represents the most classic case of IRS abuse and bringing about tax reform via the administrative fiat route, safe in the knowledge that the Anti-Injunction Act is their shield and weapon against the taxpayer.

This Committee should examine who makes the law—the IRS or the Congress. It has always been my understanding that the IRS was supposed to interpret the law, not make the law.

Secondly, this Committee should examine the after-effects of the IRS' actions. Quite clearly, their actions have caused severe disruptions in the market, displaced many hardworking, taxpaying Americans, and deprived middle class Americans of a viable product which would help them plan for their retirement years.

Thirdly, I believe it is important to recognize the benefits of variable annuities. Both the investment annuity and the annuity wrapped around savings accounts added to the capital base in our economy and provided a viable product to all classes of people helping them plan for their retirement years. The annuity wrapped around savings accounts significantly improved the position of local savings and loan institutions and increased their ability to lend money for such items as home loans.

It is very clear that the intent of the IRS in promulgating these regulations was not in the best interest of the country or the citizenry.

(I would also like to include with my statement today, material that was placed in the Congressional Record by Senator Hatch and by myself for the hearing record.)

RELATING TO THE TREATMENT OF CERTAIN ANNUITY CONTRACTS

Mr. SYMMS. Mr. President, today I am introducing legislation which addresses a gross injustice in the administration of our tax laws. The legislation I am introducing provides for the revocation of Internal Revenue Service Ruling 80-274, which prohibits the tax deferral for an individual who purchases an insurance annuity from an insurance company, with the insurance company's proceeds being held at a financial institution.

Revenue Ruling 80-274 was based upon Revenue Ruling 77-85 which in the opinion of the U.S. District Court, many of my colleagues both in the House and Senate, and myself is completely illegal. The Internal Revenue Service, in issuing Revenue Ruling 80-274, proceeded via the "administrative fiat" route, to slice away

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at segments of annuities industry, safe in the knowledge that the Anti-Injunction Act is their shield and weapon against the taxpayer.

The issuance of this regulation was not only a matter of tax law, but also a matter of who makes the law. This is yet another instance of a Government agency usurping the authority vested in the United States Congress to make the law. In addition, not only have they usurped the law, but they have shown their disregard for the Legislative Branch by remaking the tax law without our consultation and in the face of our opposition.

However, in addition to their usurpation of legislative powers, I would also like to mention that their intent in promulgating these regulations was not in the best interest of the country or the citizenry.

Presently, the U.S. economy is experiencing a severe and growing shortage of capital, which contributes to high interest rates and the slowing of economic growth. Every industry is being affected by the growing shortage of capital, and the housing industry, one of the nation's major industries, is in a severe bind.

The savings associations in the United States finance about two-thirds of America's housing and their ability to lend depends directly on individual savings deposited in those institutions. Because of the increasing cost of living, taxes, inflation, etc., the amount of individual savings has steadily declined which has, in turn, decreased the ability of the savings and loan institutions to lend.

Tax deferred annuities have proven to be very successful, particularly with lower to middle income people because it enables them to work with their financial institution as a facilitator of their annuity purchase. The program encourages individuals to save which has a two-fold benefit to our society—(1) it encourages the formation of capital which is desperately needed in our economy, and (2) it provides a needed service to senior citizens in that it enables them to build a personal retirement account at a time when the Social Security program is in jeopardy.

In a letter to Treasury Secretary G. William Miller, Chairman Jay Janis of the Federal Home Loan Bank Board wrote on October 10, 1980:

"I am concerned about the adverse impact of ruling on savings account funded annuity plans because these plans can be a significant incentive for increased savings by a major segment of the American public, and because these annuity plans have the potential to become a significant source of stable funds for Federally insured savings and loan associations."

The arbitrary and capricious Revenue Ruling 80-274 fails to provide any reasoned legal analysis for its conclusion. In fact, as I stated earlier the U.S. District Court found that Revenue Ruling 77-85, upon which Revenue Ruling 80-274 was based, was incorrect as a matter of law.

I am very hopeful that my colleagues both in the House and Senate will quickly address this problem, and be mindful that it is just another example of the government's regulatory process being used as a vehicle to not only usurp the powers of the Legislative Branch but to inhibit the normal functioning of the economy.

HATCH AMENDMENT TO FINANCE COMMITTEE TAX BILL (INVESTMENT ANNUITY)

Madam President, I wish to present a specific matter that is important to the authority and integrity of the United States Senate and to the laws of this country. It is a matter of tax law, but, more importantly, also a matter of who makes the law. The Internal Revenue Service has in a specific instance usurped that authority in the face of opposition of the United States Senate, a United States District Court decision and the expressed will of the House Committee on Ways and Means.

Last year the United States Senate clearly indicated by a vote of 57-26 that it did not intend for the IRS to change tax policy in this specific matter without consultation with the Congress. The IRS has demonstrated its contempt for the Senate by proceeding to remake tax laws without consulting with us and in the face of our opposition. They have called our bluff and are betting that Senators are too preoccupied with numerous narrow constituency interests to defend the authority and integrity of the Senate itself.

The specific matter at hand is one that pertains to the issuance of revenue ruling 77-85 by the IRS on March 9, 1977. This ruling reversed over 70 consistent public and private rulings that cover a time span of more than a decade. These rulings pertain to an innovative form of variable annuity called the investment annuity.

On April 29, 1977 the United States Senate expressed its will that "this ruling be delayed for a period of 1 year to give Congress—which should make the change if a change is to be made—an opportunity to check into this matter and see what's involved."

When the expression of the Senate's will proved insufficient to deter the IRS' immediate effectuation of Revenue Ruling 77-85, the Treasury and IRS were sued for arbitrary, capricious, and illegal acts. On November 9, 1977 the United States

District Court, District of Columbia, declared the IRS action in issuing Revenue Ruling 77-85 to be illegal, unreasonable, ignorant of the law, and that the IRS had usurped the powers of Congress.

When this very strong expression of the court's will also proved insufficient to deter the IRS and Treasury from continuing their illegal acts, the House Committee on Ways and Means expressed its will on April 17, 1978 that the tax treatment of the investment annuity must be reinstated to that which had existed prior to the IRS issuance of its illegal revenue Ruling 77-85.

All these expressions of the will of Congress and the court have been and continue to be, ignored by the Treasury and the IRS simply because Congress generally, and the Senate specifically, are so lax in insisting that it is Congress that writes the laws and not an unelected and unaccountable bureaucracy.

I will retrace some of the factual steps of this sordid affair—an affair that shows the arrogance with which bureaucrats remade the law. I retrace these steps because they reveal the way Congress laws are twisted, broken, and remade by bureaucrats who are apparently accountable to no one.

Such acts in this case have not only strangled an innovative industry to the detriment of our Nation's citizens' wellbeing. They also constitute a documentable case showing the impunity with which bureaucrats thumb their noses at Congress and the courts, and provide misleading, unfair, and incomplete information to the Congress. We have here a case in which the Treasury either attempted to deliberately mislead the Congress or acted in ignorance of the law—neither of which can be acceptable nor tolerable to the Senate.

Congress must certainly insist upon competence, completeness, and fairness in the dealings of the IRS and the Treasury before Congress, as well as in their administering the laws of our land on behalf of our citizens.

In 1962 Congress revised the Internal Revenue Code to provide for the "segregated accounts" of life insurers in the underwriting of variable annuities. The law is clear, it has not been changed in any relevant way to this very date.

In 1963 following several years of extensive study, a new life insurer was formed to underwrite variable annuities that delegated (within prescribed limits set by the insurer) the investment management of its segregated accounts to each policyowner. This was an appropriate, legal, and reasonable step to provide a better annuity for the American public. For brand and corporate identification purposes this innovative variable annuity later became known as the investment annuity and is often referred to in trade jargon as the "wrap-around annuity."

In 1963 appropriate tax rulings for the policyowner and the taxpayer were requested of the National Office of the Internal Revenue Service. The Internal Revenue Service recognized from the start that this innovative variable annuity involved the delegation of broadly limited investment management to the policyholder.

In 1965, after 2 years of intensive study by all relevant departments of the IRS, including the Chief Counsel's office, the IRS insisted that the variable annuity was fully in conformity with the law and issued clear rulings to that effect. From that point forward until 1976, over a full decade, the IRS consistently reaffirmed its original, basic decision over 70 times in both public and private rulings that covered a wide variety of applications of this variable annuity in different markets and for different groups and individuals.

In 1976 the IRS stopped issuing favorable rulings and the following events ensued:

1976: Naturally, being concerned by the stoppage of favorable rulings to individuals and other insurers who were attracted to this mode of annuity underwriting, the industry started making inquiries of the IRS in the late spring of 1976. The IRS responded that they were reviewing their position but would not state why or how; nor would they meet with members of the industry to discuss their considerations. Finally, due to external pressure, including inquiries from Members of Congress, the IRS called for a meeting of interested parties in late September of 1976 in order that these invitees might listen to the IRS articulate its position as it was then being formulated over the past several months.

At a standing-room-only meeting at the IRS offices the IRS spokesman proceeded to describe their views. After only perhaps 3 to 5 minutes, the assembled industry professionals thought they might be in the wrong room because the spokesman made no sense at all. Finally, an industry representative interrupted the spokesman and pointed out that, after all, the so-called investment annuity was only a variable annuity and that the IRS had insisted upon this fact in 1965 after 2 years of very thorough study and had issued over 70 rulings to that effect since 1965. The IRS spokesman's response was: "What's a variable annuity? I'm not familiar with variable annuities!" The assembled industry professionals almost fell off their chairs from such a shocking display of IRS unconscionable ignorance of the subject matter.

The IRS senior officials recovered their composure and asked the industry attorneys to prepare a "statement of the facts" albeit the IRS had had full facts on the so-called investment annuity from 1963, and had issued over 70 public and private rulings thereafter. During that 13-year period (1963-1976) neither the facts nor the relevant law had changed one iota.

The "statement of facts" was prepared in a few days and delivered to the IRS. Such facts were summarily ignored as reflected by the following events:

In late October 1976 (just a relatively few days after the 1976 Revenue Act had been completed), the IRS issued a news release stating that they were reconsidering their position on investment annuities and requested interested parties to supply responses to three questions that the IRS considered to be significantly relevant to their reconsideration.

All insurers then offering the investment annuity combined forces to furnish one complete and thorough brief to save the Government and the industry both time and money. Every question posed by the IRS was fully answered and clearly showed the legal, actuarial and industry practice correctness and appropriateness of the IRS historic position established in 1965 and reaffirmed over 70 times by subsequent IRS public and private rulings. Even the former Chief Actuary of the Internal Revenue Service certified to the correctness of relevant portions of the industry brief.

The IRS never permitted any discussions with the industry as to its position on the substance and correctness of the industry brief.

The industry was informed in early March 1977 that the IRS was prepared to issue a revenue ruling that reversed their consistent position since 1965.

At about this time the chairman of one of the insurers involved received in the mail from an anonymous source a copy of an internal Treasury Department memorandum addressed to the Secretary of the Treasury stating that the Treasury was drafting a ruling reversal on the investment annuity. This memorandum was subsequently established as being authentic.

Included in the memorandum that was seeking the Secretary's approval was a brief description of the investment annuity upon which the Secretary must rely. This description was grossly at variance with the facts and omitted well-known, key elements.

The Treasury memorandum also stated that the description of the investment annuity, (as included in the said memorandum) had been confirmed by the insurer of which this individual was the chairman. This individual has stated that such confirmation is a complete lie. The insurer immediately disclosed to the Treasury that it had received this memorandum and protested its gross distortion of relevant information in the most forceful manner. The insurer's very legitimate complaint was shrugged off by the Treasury. I ask unanimous consent to include these relevant documents in the Record at the conclusion of my remarks.

The PRESIDING OFFICER. Without objection, it is so ordered.

(See exhibit 1.)

Mr. HATCH. Mr. President, concurrently with these bizarre events many Congressmen were informed by concerned insurers, agents, and policyholders of the irrational and highly questionable acts of the Internal Revenue Service.

As a result of this broad-based protest many Congressmen contacted the IRS and Treasury and asked for an explanation because after over a decade and over 70 IRS rulings, the investment annuity had become imbued with the force of law. Members of Congress expressed the view that Congress should be consulted before the IRS unilaterally changed tax law.

Two of these letters were introduced into the Congressional Record last year when the Senate voted to overturn the IRS ruling by a vote of 57 to 26. Shortly before the IRS issuance of revenue ruling 77-85, Senators Curtis and Tower wrote a strong letter to Secretary Blumenthal "registering" their "strong opposition" to the possible reversal of the IRS' long-standing ruling based upon their "further strong position that when such rulings are reaffirmed over such a lengthy period of time as in excess of a decade they become imbued with the force of law and must not be changed except for the expressed direction of Congress pursuant to the legislative process." This strong and wise counsel was ignored by the Treasury.

Again, shortly after Revenue Ruling 77-85 was issued but before it was published, Chairman Long of the Senate Finance Committee together with Senators Ribicoff, Curtis, Hansen, and Bentsen of that committee expressed their "urgent request" of the Treasury, that the "IRS defer publication and application of Revenue Ruling 77-85 for 90 days or until Congress could consider a proposal to postpone application of such ruling pending the IRS's completion of its studies of annuities and Congress has had the opportunity to consider this area." This strong letter also points out that "sound tax administration should avoid the result of causing irreparable harm to the investment annuity industry, unless the law is clear and then certainly not

prior to the time that the Revenue Service has a firm position on the law governing alternative areas that offer the affected taxpayers some chance of surviving this administrative change of longstanding IRS rulings." This strong, wise, and prophetic letter was ignored by the Treasury.

As another clear indication of Senators' recognition of the IRS's gross abuse of its unfettered, big government power against helpless citizens, Senators Gravel, Thurmond, and Matsunaga introduced S. 1939 on July 27, 1977, that was designed to remedy a problem in the administration of our tax laws which has vexed taxpayers for many years—the periodic revision of longstanding interpretations of the tax law that can produce drastic consequences.

The Congressional Record statement accompanying that bill includes a description of the investment annuity matter as the classic "chamber of horrors" example of IRS acts. The statement properly points out also that * * * rulings of longstanding are relied on by taxpayers and the Service alike, and by virtue of their age take on the color of law."

These Senators clearly and properly stated that what was needed was "a much needed correction in the balance between the power of the Government and the protection of the people" and that "such correction would well help reconfirm that there is justice in America."

When informed in early March 1977 that the Treasury had approved the IRS' reversal of tax policy, one insurer, the one that had developed this form of annuity, was able to get an agreement that the IRS meet with them to discuss other forms of the variable annuity to which they could convert.

At the subsequent meeting with the IRS the insurer was shocked to learn that not only was the so-called investment annuity form of variable annuity under attack, but the IRS was also considering similar action against most other forms of variable annuities—accounting in total for upward of 70 percent of all variable annuities being sold in the United States.

Pursuant to the full disclosure requirements to its shareholders, the insurer prepared a news release reflecting these incredulous events. The news release was first shown to the IRS to be certain that the facts stated therein were accurate. While the IRS was not pleased with such a pronouncement, it did find the news release to be an accurate reflection of its statements.

When the news release was subsequently presented to the Treasury for its clearance of the facts, the Treasury violently objected by stating that the IRS views on these variable annuities were confidential and that a public disclosure of this information would result in the denial of the insurer of the good offices of the Treasury in this matter. A revised news release acceptable to the Treasury and acceptable to the insurer was then issued.

It is appropriate to observe that virtually every other variable annuity being offered to the public by any other insurer has been offered without any IRS rulings whatsoever in view of the fact that the law was so clear. The investment annuity is the only one that had IRS rulings—and over 70 of them stretched out over more than a decade—and it was the so-called investment annuity that was being killed, and no disclosure was permitted concerning the IRS' views on the others.

During the meetings with the IRS that led to the insurer's news release, the insurer inquired of the IRS specialists dealing with this specific annuity matter as to just how the annuity benefits would be taxed to the policyowner—after benefits commenced—under the ruling reversal procedures the IRS was imposing. The IRS' presumed expert, after some hesitation and profound silence, responded with a counter question—"tell me again, how do these things work?" Here we would seem to have a case of the IRS destroying a product and an industry on the basis of subject-matter ignorance plus nothing but some vague notions about "tax reform."

The next subject on the IRS agenda at those meetings was the so-called "grandfathering" of existing policyowners. The IRS was insisting that "grandfathering" would not be permitted. Here, in this instance, tens of thousands of policyholders had purchased investment annuities based upon the cumulative power of over 70 consistent IRS public and private rulings, and the IRS wanted to deny these policyowners their rights under the contracts they had purchased. This would have been a legal nightmare that was totally inappropriate.

The IRS kept insisting that the insurer force existing policyholders to convert their investment annuities to some other form of variable annuity that was "acceptable" to them. And, when it was pointed out to the IRS by the insurer that the IRS could not assure the insurer as to what other form of viable variable annuities would be acceptable to them—the IRS told the insurer that that was their problem, not the IRS'. What arrogance! Obviously, the IRS thinks that it is unaccountable to anyone. We seem to have here the case of another rogue agency out of control.

Finally, in desperation for the rights of the policyholders, the insurer wound up in a table-thumping Saturday morning session in the Treasury with IRS representatives present, where it was finally agreed by the Assistant Secretary for Tax Policy that the "grandfathering" of existing policyholders would be permitted. To this day the Treasury and the IRS keep telling people that they did the insurer and the industry a great favor by their magnaminous act in "grandfathering." But the IRS has not been deterred by the U.S. Senate or, according to the U.S. District Court, by tax law itself from illegally wiping out an innovative industry created in the public's interest.

Soon after the Saturday morning session with the Treasury, the insurer's attorneys had another meeting with the Treasury to pursue another relevant position relating to a recently-issued Supreme Court decision that should persuade the Treasury to hold off on issuing a ruling reversal. This proper request was equally unsuccessful, but the Treasury indicated that the investment annuity was but the first of the variable annuities slated to be wiped out, with others following in a year or so. Obviously, all of this arrogant action was expected to take place via bureaucratic fiat and salami-slicing tactics without consulting Congress.

On March 9, 1977, the Internal Revenue Service issued Revenue Rule 77-85 that wiped out the investment annuity industry.

Shortly after the issuance of Revenue Ruling 77-85, the 1977 Tax Reduction and Simplification Act was debated by the Senate. The late Senator Jim Allen of Alabama, a member of the Judiciary Committee, upon becoming aware of this grave injustice perpetrated by the IRS and the Treasury, introduced an amendment to the tax bill that would defer the effective date of the revenue ruling for 1 year in order to give Congress the opportunity to consider the matter. An entirely reasonable proposition. Many Senators supported Mr. Allen on the floor of the Senate and some of the letters by Senators to the Treasury protesting its actions, such as those cited above from Senators Long, Curtis, and others were inserted into the Congressional Record.

The Senate vote was a very strong vote of 57 to 26 against the IRS on the investment annuity matter. Naturally, the matter was then included in the items for consideration by the conference committee. There, as the result of Treasury lobbying and misstatements of fact—such as claiming that the Service had reversed its ruling on the prior October 20, 1976, and that the insurers had continued selling without notifying purchasers, and that the Senate's entirely fair "one-year deferral" was a "fire sale arrangement"—the investment annuity amendment was "traded away." In actuality, the only "fire sale" was the disastrous effect on investment annuity employees, agents, policyowners, and shareholders.

After being traded away in conference committee, one insurer thereupon sued the Treasury and the Internal Revenue Service for arbitrary, capricious, and illegal acts. The resulting U.S. District Court, District of Columbia, decision issued on November 9, 1977, after many months of thorough court deliberation, is as set forth below. The court did not just rule against the IRS, it denounced the IRS.

The U.S. District Court, District of Columbia, declared in its memorandum opinion on this matter as follows:

Revenue Ruling 77-85 is an erroneous and unreasonable interpretation of the Internal Revenue Code, and, in view of this fact that substantial deference to the Agency's expertise is not warranted by the facts of the case, the court will declare the ruling to be unlawful and beyond the Service's statutory authority.

Revenue Ruling 77-85 is unlawful and beyond the Service's statutory authority in that its determination that the policyowner, rather than the issuing life insurance company, is the owner of the investment annuity custodial account assets is erroneous and unreasonable.

The Service's decision in Revenue Ruling 77-85 was not contemporaneous with the enactment of section 801(g)(1)(B), does not reflect a long-standing agency position, and is inconsistent with earlier pronouncements and even one subsequent announcement of the agency. Accordingly, substantial deference to the Service's expertise is unwarranted in the instant case.

Substantial deference to the Service's expertise is also unwarranted because the Service was improperly motivated by considerations of tax reform when it issued revenue ruling 77-85.

These court declarations are remarkable indeed. In plain language, the court's strong decision not only declared the Treasury and the IRS' act as being illegal, unreasonable, and beyond their statutory authority; it has also declared that such actions were improperly motivated by considerations of tax reform which is Congress business, and that substantial deference to the Service's expertise is unwarranted. In plain language, the court declared that the IRS and the Treasury circumvented the tax law deliberately and that their claimed perspective of the tax law is

absurd. The court is referring to the actions of the regulatory authorities charged with the responsibility of administering the tax laws of Congress.

Permit me now to comment upon certain relevant and revealing events that took place during the court proceedings.

Every conceivable and inconceivable argument was presented to the court by the IRS and Treasury to defend its position. These arguments ranged from trying to cite "alleged abuses" of the law by the insurer by citing newspaper advertisements that stressed the investment annuities' tax deferral aspects—which is true of all annuities and cash value life insurance, and theories of "grantor trusts" that they claimed supported the IRS position, but which the judge actually found to support the insurer's position. The judge even inquired of the defendants to tell him more about alleged abuses because he was interested, and the defendants backed off.

In the middle of the arguments on the merits of the IRS' position the insurer discovered that the IRS had just issued a ruling to a competing insurer that permitted said competitor to enter the very same investment annuity business that the IRS had shut all other insurers out of. Upon being informed of this incredulous IRS action, the judge sent a U.S. Marshall to the Commissioner of Internal Revenue to immediately present his demand for a full explanation. The explanation provided was that the IRS had made a "procedural error" and of course, the judge did not buy that.

On two different occasions the judge requested two different Justice Department attorneys arguing this case for their IRS and Treasury client to "take off their hats" as advocates for their client and to stand before the judge as an officer of the court and to state their views as to the merits of their clients' positions. Both attorneys could not respond. The judge repeatedly stated to the defendants' lawyers that as an administrative body the IRS and Treasury had the duty to be fair, to be fair, to be fair. Fairness to the law-abiding victim in this matter was never in evidence.

With the issuance of the court's clear and unequivocal decision, the court also stated that it was its "confident assumption that the defendants will proceed appropriately, in good faith, and in a manner fully consistent with the declaratory relief granted herein without the coercion of a court order." The IRS and Treasury flatly rejected such a "confident assumption" and stated that they would "appeal", and if they should win their appeal they would tax retroactively any interim investment annuity purchaser. This "appeal" killed any possibility of renewing sales in spite of the strong court victory.

As a direct result of this bureaucratic "dragging out" process that enjoys no bounds upon time and money since both come from the public trough, the English majority owners of the suing insurer ran up the white flag, accepted a liquidation value bid for the insurance company "shell" and headed back to England shaking their heads at the way the IRS and Treasury run roughshod over the American people, the courts, and the U.S. Senate itself.

As a result of this gross travesty of justice, over 4,500 agents and employees of just one insurer lost their ability to make a living from the company and had to start over elsewhere. The insurer's shareholders took a staggering loss of over $20 million directly attributed to these court-adjudged ignorant, illegal, and unreasonable actions of the IRS and Treasury. Other insurers, of course, suffered comparable tragedies.

It can be stated in fairness that following the court's decision the Justice Department utilized its good offices to set up meetings with the IRS to see if any accommodation could be worked out with the IRS to permit the insurer who won the suit to weather the appeal hiatus. These meetings failed because the IRS and Treasury would have none of it. They knew full well that the insurer would be forced to its knees and liquidated if no accommodation was reached. And they thus achieved their goal by the brutal exercise of power unconstrained by law.

With that concluding travesty of regulatory fairness, the insurance company was sold. And the shareholders thereof suffered over a $20 million loss directly attributable to the illegal, unreasonable, unfair acts of the IRS and Treasury. But these irregularities of the IRS and Treasury do not stop there. Permit me to continue.

In its acts to protect the interests of their policyholders, the innovative insurer arranged that the bulk of its $380,000,000 of variable annuity reserves would be reinsured with another insurer. Again, an irrational unaccountable act of the IRS transpired that cost the insurer $2 million.

This arose because the reinsurance treaty that was consummated between the insurer and another company was subject to a separate IRS ruling on that specific matter. There was nothing unusual about the structure of the reinsurance arrangement. It was similar to many others on many occasions by many other insurers over many years. However, in this instance the IRS refused to provide the relevant favorable ruling, because it stated that it was reconsidering its historic position.

Thus, the expiration date between the insurers for the required IRS clearance passed without the favorable ruling at a cost to the insurer of $2 million. The IRS has not yet made its decision on these matters, and apparently this delay is the result of internal disagreements over its new position within both the IRS and Treasury. And yet, this bureaucratic refusal to honor old rules while they rethink possible new positions has cost this victimized insurer $2 million.

Following the strong court victory in late 1977 that was frustrated by IRS and Treasury intransigence, the matter was taken to the House of Representatives where the Ways and Means Committee was considering the administration's proposals in regards to the 1978 tax bill. Included in the Treasury proposals was a section entitled "tax shelter annuities" that, in short, proposed to Congress that the laws should be revised to treat all annuities sold to the general public in the same way that the IRS had ruled on the investment annuity. In other words, change the law such that it would support the IRS' illegal position.

Competent authorities from throughout the annuity industry testified before the Ways and Means Committee that the Treasury proposal was irrational, uninformed, and that the Treasury's descriptions were misleading. Some of the Treasury's errors, half-truths, or misrepresentations are as follows:

In no way can any annuity fit the defined term of "tax shelter" and the term was used by the Treasury solely for obvious pejorative purposes.

The Treasury's proposals make it seem like huge revenues are lost to the Government via annuities when, in fact, the Treasury's own revenue estimates show that only a $12 million revenue gain from their proposed taxation would accrue to the Government from the entire annuity industry in 1979, gradually increasing to $80 million in 1983. The investment annuity segment of that total can be but a small fraction thereof. It can be stated also that even the $12 million entire annuity industry figure is obviously specious, because taxes are merely deferred under annuities and are recaptured with interest when benefits are ultimately paid out. Common sense tells us that counting as a loss today that which will be repaid is hardly a reasonable measurement of the loss to the Government, particularly when the repayment includes an interest element.

In regards to the Treasury's use of the pejorative term "tax shelter" and the relative cost to the Government of tax deferral under annuities, including the investment annuity, the respected accounting firm of Coopers & Lybrand was requested to provide their professional analysis of the subject. In that regard the accounting firm was supplied with a relevant segment of Professor Stanley Surrey's book entitled, Pathways To Tax Reform, wherein he stipulates that an appropriate way to compensate the Government for tax deferral would be to charge interest thereon. I ask unanimous consent to include in the record a report from the respected accounting firm of Coopers & Lybrand that deals with this particular question.

In the Cooper & Lybrand report appropriate tables clearly show that annuity taxes when deferred are recaptured by the Government with interest. This report refers to Professor Stanley Surrey, Harvard law professor and former Assistant Secretary for Tax Policy during the Kennedy and Johnson administrations. Much of the so-called "tax expenditures" theories now practiced by our Government reflect his personal thinking. Mr. Surrey's book entitled "Pathways to Tax Reform" included a chapter on how the Government could be appropriately paid for granting tax deferral. The reference in the Coopers & Lybrand report are to Mr. Surrey's recommendations along that line. I cite the brief conclusions of the Coopers & Lybrand report.

"In conclusion it is evident that:

"1. Deferred annuities (including the investment annuity) lack a 'prime ingredient of tax shelters' namely, an interest-free loan from the Government in the amount of tax deferred.'

"2. The existing mode of interest annuity taxation results in an interest element being charged to that taxpayer as proposed by Mr. Surrey;

"3. In fact, under most circumstances the existing mode of annuity taxation provides more tax dollars for the Government than Mr. Surrey's proposals;

"4. The existing mode of deferred annuity taxation is similar to the Governments own 'series E' bond (unless an election is made to be taxed currently);

"5. Because of the foregoing it is quite inappropriate to lump deferred annuities (including the investment annuity) in with so-called 'tax shelters.'"

Since Professor Stanley's "corrective measure" has always existed under all annuities, including the investment annuity, how can it possibly be claimed that an annuity is a tax shelter in the first place? It certainly cannot.

The Treasury's presentations also attempted to convince the Congress that an annuity is little more than a fund that the policyholder has free access to. Compe-

tent authorities have always rejected that notion, as has Congress, over the entire history of the Internal Revenue Code. Many court cases have universally shot down the erroneous "access to fund theory" including the very suit cited on page 137 of the Treasury's report. This was a case that the Treasury lost on this very point. It is truly incredible that the Treasury report would have Congress believe that the "access to fund theory" is part of the present law when (A) the Treasury must know full well that it is not and (B) the courts have stated vigorously and repeatedly that this theory is foreign to law. Such a failure to communicate accurately and fully to Congress appears as a very serious disregard of responsibility and fairness. It shows utter contempt for the U.S. Congress on the part of bureaucrats who have no outside check imposed on their power.

The Treasury's stated "reasons for change" of annuity taxation are bottomed on totally erroneous perceptions plus an illogical and erroneous attack on the value of annuities. For example:

It is factually incorrect for the Treasury to state that "traditionally, most annuity contracts purchased were immediate annuities" (i.e., those starting benefits immediately as contrasted with those annuities that defer benefits until some future date.) Clear facts easily gleaned from the life insurance fact book show this to be erroneous. The Treasury's statements are obviously meant to infer that deferred annuities are a new phenomenon hardly contemplated under the law. Such a perspective is totally at variance with the facts.

They also stated that annuities were O.K. when interest rates were low and insurance company expense charges high, but now when interest rates are high and insurers have lowered their expense charges, the annuity demon is to be exorcised. Such convoluted, myopic reasoning, leaves much to be desired and appears contrary to the public interest.

The Treasury's report is filled with excerpts from advertising and literature that the Treasury claims prove deferred annuities are "tax shelters marketed by promoters." First, "advertising puffery" does not make the law. Second, their frequent use of perjorative terms make the Treasury itself the "promoter" of its unsound, half-baked proposals. Clearly, the Treasury should spend more time learning and understanding existing law rather than clipping advertisements and literature. What the Treasury's academics do not comprehend in their ivory tower is that in selling a product in a competitive market, the marketing thrust is to emphasize differences and advantages. General Motors does not waste a lot of money advertising that its cars provide transportation. Nor do insurance companies and their agencies waste their time and money advertising what the prospect already knows, namely, that annuities provide benefits in life's later years. You advertise and market legitimate features that the prospect would want to know about, and you attempt to show him why he needs your product now. What's wrong with that? Obviously, too, you create advertising to support and motivate the salesman and make the product attractive to the buyer. After all, annuity sales must not only compete among insurance companies, but against other forms of savings, and even more importantly, against other ways the prospect could use his money.

It is particularly revealing of the Treasury's lack of candor and fairness with Congress to note that the portion of the Treasury's report to Congress dealing with the investment annuity contains no mention that the court, after thorough consideration, declared the Treasury and the IRS actions in issuing revenue ruling 77-85 unreasonable, beyond their statutory authority and that deference to the Treasury's and IRS's expertise on this matter is unwarranted. The Treasury's sole reference to the court decision stated that, if sustained, it would permit taxpayers active control over their investment portfolios as though the annuity never had been purchased. This incredulous statement is exactly what the court had just stated was not the case, what clear law shows is not the case, and what the IRS had insisted over 70 times during an 11-year period was not the case. Clearly, such deliberate misrepresentation to Congress of the documentable facts is absolutely intolerable.

Nor did the Treasury's report provide any mention that the IRS had consistently reaffirmed their previous position on the investment annuity as being merely a variable annuity for well over a decade and over 70 rulings. Clearly, the Treasury report wanted the Congress to perceive the investment annuity as some "device promoted for use by high income taxpayers." The investment annuity is but a more useful, flexible annuity to the advantage of the entire American public, and its tax treatment is no better nor worse than any other annuity. The total omission in the report of the prior, substantive, affirmative history of the investment annuity is clearly designed to withhold relevant facts from Congress and again reflects the lack of completeness and fairness in the Treasury's report and a contempt for Congress. The crux of the Treasury's report seems to be not the law but the tax reform argument that "deferred annuities" should be taxed because "they are now

virtually the only remaining, widely available investment vehicle that enables investors to defer taxes on regular recurring investment income." The report also argues that since no changes have been made in the way investment income is taxed under annuities for years, it's therefore deemed to be outmoded law and in need of change. In other words, anything sound and workable has to be changed.

Following the Treasury's presentation of its proposals to Congress and in contemplation of Ways and Means Committee consideration of the Treasury's proposals on "annuities," the ranking Republican on the Ways and Means Committee and the ranking Democrat on that committee after the chairman, together with others, cosponsored H.R. 12173 to correct the IRS' grave abuse of justice. H.R. 12173 merely reinstated the IRS rulings on these variable annuities as said rulings existed prior to the IRS issuance of the illegal Revenue Ruling 77-85. The Congressional Record remarks relating to H.R. 12173 stated that this matter has "resulted in severe inequities and injustice, and the Government should not deal with its citizens in such a high-handed manner."

When the Ways and Means Committee proceeded with its "markup" on the annuity proposals of the Treasury, the Treasury's proposals were completely rejected by that committee. Additionally, the committee voted, by the strong vote of 22 to 14, to restore the investment annuity to its proper place under the law as it existed prior to the issuance of the IRS illegal Revenue Ruling 77-85. I ask unanimous consent that a copy of H.R. 12173 be included in the Record, as it is this amendment that I am proposing the Senate adopt.

I believe the Senate should also know that during the debate on annuities within the House Ways and Means Committee "markup," the Treasury representatives again displayed gross ignorance of the subject matter by making the following factual errors:

The Treasury stated that annuities can be compared with certificates of deposit because annuities have no mortality risk. This statement is absolutely incorrect. Annuities involve very serious mortality risks that exist from the moment the annuity is purchased. And, the younger the purchaser, the greater can be the risk. Anyone, who knows anything about annuities, knows that this is so. The Treasury's statement is not only wrong it is totally misleading, because it incorrectly compares apples and oranges (annuities and certificates)—they are not the same. To claim that they are the same misleads Congressmen who are not experts on this subject.

The Treasury stated that the investment annuity is more like a "grantor trust." Such a "grantor trust" likeness is totally incorrect, and its use by the Treasury in the markup session is grossly misleading. The IRS attempted to proceed on that erroneous theory early in the convoluted reconsideration of investment annuity taxation. As a matter of fact, in reaching its conclusions, the court was guided by the seminal cause of Helvering against Clifford and concluded that "in contrast to the respondent in Clifford investment annuity policyholders have manifestly effected a substantial change in their economic positions." Thus, the court concluded that the very "grantor trust" theory put forth by the Treasury and the IRS does in fact support the conclusion that the investment annuity is not a grantor trust, and is in fact a variable annuity just as the IRS had insisted upon for over a decade and for over 70 rulings prior to its unreasonable, illegal act in issuing revenue ruling 77-85. Clearly, such obvious stupidity of the IRS is unconscionable but when the Treasury tries to force on Congress as fact that which the court has so clearly just shot down in a suit over that very matter, the Treasury's actions become intolerable and an insult to the integrity of the U.S. Congress.

Due to procedural constraints that arose within the Ways and Means Committee in its resolution of the impasse over proposed capital gains taxation, and which was unrelated to the investment annuity matter, the investment annuity amendment was not included in H.R. 13511 as reported out of the committee to the House of Representatives.

Although Senate Finance Committee members strongly supported the investment annuity in last year's Senate action, this time representatives of the investment annuity industry were denied opportunity to present oral testimony because of the crush of other items. Thus, written testimony has been filed by the Investment Annuities Institute, with copies supplied to all other Senate Finance Committee members.

During the Senate Finance Committee markup the investment annuity subject was brought up for consideration, but it was felt that since the originating insurer had been sold and its parent liquidated—as a direct result of illegal, unreasonable, and ignorant IRS acts—the IRS had already triumphed over the law and the Senate. Due to the administration's opposition to its bill, the committee apparently felt that it should avoid an issue that the administration would try and demagog as "narrow."

The U.S. District Court decision and the Coopers & Lybrand report show that the IRS ruling on the investment annuity is illegal, unreasonable, ignorant, and beyond their statutory authority.

The whole challenge to the investment annuity shows what happens when a small group of "reformers" gets hold of a major Government agency and believes that they have the moral right to overturn tax law and to remake it in the image of their personal views.

What is at stake here is not just a matter of tax law. What is at stake is the authority and integrity of the Finance Committee and the U.S. Senate. If we allow the IRS bureaucrats to ride roughshod over us and over the American people just because we are too busy with constituency interests to stand up for general principles, we will continue to allow the power of the people as represented in the Congress to be usurped by unelected, arrogant bureaucrats. Whoever comes along who believes he has a divine right to remake the Nation to reflect his personal view of a reformed society will have a free hand. This is regulatory anarchy.

As stated by the Ways and Means Committee sponsors of the amendment I propose to the Senate, such precipitous action by the IRS in this matter has resulted in severe inequities and injustice, and the Government should not deal with its citizens in such a high-handed manner. I urge each Senator to vote favorably on this amendment.

I also request and urge that the Senate condemn these documented acts perpetrated by the Treasury and IRS and to provide for an appropriate oversight investigation, with subpena powers to all parties concerned, to assess the means by which such acts are tolerated and pursued. Such acts are not just inconsistent with certainty in the law. They are also inconsistent with a free society.

Before concluding my comments permit me to state emphatically that this matter is certainly not a "narrow" one in any sense of that word. The authority and integrity of the Senate is at stake—a most important matter that commands our immediate and resolute action.

Further, the true victims of these arrogant, unreasonable, and ignorant IRS and Treasury actions are our Nation's citizens who are being illegally denied one of the most innovative and useful annuities ever devised in the public interest—and certainly that is no narrow matter.

It is tragically true that the company that had the foresightedness, ability, and guts to pioneer from scratch, and to dare create a better free enterprise means for our citizens to save and invest for financial independence in life's later years, has been strangled to death before our own eyes by outrageous bureaucratic lawlessness.

Its annuity did not die, however, because other life insurers can offer it, and many want to, and will upon the restoration of the investment annuity to its rightful place under the law.

EXHIBIT 1

LEE, TOOMEY & KENT,
Washington, D.C., February 8, 1977.

DR. LAURENCE N. WOODWORTH,
Assistant Secretary for Tax Policy,
Treasury Department, Main Treasury, Washington, D.C.

DEAR DR. WOODWORTH: My clients and I appreciate your invitation to confer with you on the status of the review of the investment annuity being conducted by your Office.

A purported memorandum from Charles M. Walker to Secretary Simon on the investment annuity ruling recently came into the hands of one of my clients through an anonymous source. Because of the nature of the document, I thought it important that you know before the meeting that it was in our possession. Therefore, I have enclosed a copy. You should also be aware that we are greatly disturbed by the manner in which this very important issue has been presented and the erroneous implications thereof. While there are a great number of points which require comment, there are three points of paramount concern which should be brought to your attention before the meeting.

(1) The description of the investment annuity in the memorandum on which the proposed decision is based does not accurately state the situation and is inadequate. Moreover, First Investment Annuity Company (FIAC) did not agree to those facts. The investment annuity contains all the elements of an annuity contract and an annuity is in fact, purchased either in a deferred form or an immediate form at the time the contract is entered into. The memorandum conceded that FIAC, in 1965, decided to restructure its policy to accommodate to the position then taken by the Internal Revenue Service that the contract constitutes the purchase of an annuity

and that the assets are those of the insurance company. FIAC further modified its contract in 1968, at the insistence of the Internal Revenue Service in order to conform the contract to the requirements of a deferred annuity contract. This led to the issuance of Rev. Rul. 68-488 in which the Internal Revenue Service definitely concluded that an annuity was purchased at the time the contract was issued. This ruling was not even mentioned in the Walker memorandum. The Insurance Commissioner of Pennsylvania has confirmed that the Pennsylvania insurance laws under which the investment annuities are authorized are the same as those for variable annuities and that their status is consistent with the present Federal tax treatment of investment annuities. Investment annuities have been approved for sale in over 38 states under the applicable laws of those states.

(2) The FIAC investment annuities are simply not structured to hold such assets generally referred to as "tax shelters". The memorandum asserts that the investment annuity could develop into a substantial tax shelter industry and that the promoters are "already exploring ways to shelter the income from oil ventures through the use of an investment annuity". This assertion apparently is a ground for the policy decision to recommend reversal of the IRS rulings. If the reference to "promoters" is intended to identify FIAC, I want to emphasize that FIAC has not and does not contemplate the inclusion of oil ventures and other such tax shelters within the custodian account as acceptable investments.

The investment annuity is merely a form of variable annuity and, as such, shares the same tax treatment as other annuities. It does not involve any of the write-offs, leverage, or speculative investment devices which result in a real cost to the government of permanently lost taxes as those involved with devices attacked by the Tax Reform Act.

(3) No meaningful dialogue has yet been established between the IRS and industry representatives despite repeated requests for such dialogue. The reference in the memorandum to the meeting on September 30, 1976 leaves an impression that the fundamental issues of the investment annuity have been discussed with the industry. Before the meeting, we were told that its purpose was to allow the Internal Revenue Service to describe its proposed position and give industry representatives an opportunity to ask questions. This did not happen. The Internal Revenue Service merely informed us that the prior rulings were under reconsideration, and that no final decision had been made. Because it was apparent that the reconsideration had been initiated with very little knowledge of the facts, it was suggested by the Service that a meeting be held to ascertain the facts. Discussion on the facts was subsequently held but the objections of the Internal Revenue Service to the investment annuity were never detailed. In spite of the length of time that this matter has been under review, and the detailed memorandum which we filed at the Service's request, we have never been informed of any specific objections to the investment annuity contract which require either modification of existing contracts or a reversal of the rulings issued by the Internal Revenue Service over the last eleven years.

I hope that the meeting on February 9 will lead to a better understanding of our respective positions and that an agreement can be reached for resolving the issues as expeditiously as possible in a manner satisfactory to the Treasury, the Internal Revenue Service, the insurance companies involved, and the tens of thousands of individuals who hold investment annuity contracts.

Respectfully,

JOHN A. CARDON.

INVESTMENT ANNUITY RULING

We are in the process of drafting a revenue ruling which we propose to publish reversing the prior favorable revenue rulings on the investment annuity arrangements developed by the First Investment Annuity Company of America (FIAC) and other insurance companies.

Over the past several months, both Treasury and the IRS have been reviewing the tax status of investment annuities. On September 30, 1976, we met with industry representatives in order to obtain a better understanding of the investment annuity product. On October 20, 1976, we solicited public comment on the three technical problems under consideration, and as a result, we received several submissions, including a lengthy brief submitted on behalf of FIAC and nine other insurance companies. Based upon our analysis of the investment annuity product and applicable law, we have concluded that the position previously taken by the Service in certain private letter rulings is incorrect as a matter of law.

THE INVESTMENT ANNUITY DESCRIBED

Basically the purchaser of an investment annuity will deposit cash or securities with a custodian. An annuity is not purchased at the time these deposits are made; instead, the purchase is deferred until the depositor reaches retirement age, at which time one-year term annuity contracts are acquired with the funds held by the custodian. In the interim, the assets held by the custodian are invested at the direction of the depositor, even after he reaches retirement age, as though, in effect, these assets were held in his own personal brokerage account or trust.

PROPOSED RULINGS POSITION

Given these facts (which have been confirmed by FIAC), we have concluded that these brokerage, or custodial, accounts do not represent assets of the insurance company which will ultimately provide the annuity. Unlike the traditional variable annuity, where the insurance company invests the assets but the policyholder bears the investment risk (as in a mutual fund), the holder of an investment annuity retains full investment control.

Under the proposed ruling, dividends and interest earned on assets held in a custodial account will be taxed directly to the policyholder, unlike the result under current law, where these earnings have been accumulating on a tax-free basis as life insurance company assets. Capital gains will also be taxed to the policyholder, although here, the change will not be as significant, because, under existing law, capital gains are currently subject to tax at insurance company rates.

IMPLICATIONS OF THE RULING

Apart from our legal analysis of the problems raised by investment annuities, there are important policy considerations. In our view, investment annuities, while presently in their infant stage, could develop into a substantial tax shelter industry if the present rulings posture remains unchanged. Although all of the various uses of these products are not yet known, we have been advised informally that promoters are already exploring ways to shelter the income from oil ventures through the use of an investment annuity.

In reversing the outstanding rulings position, both Treasury and IRS recognize the problems faced by those companies which have entered into the investment annuity market in reliance upon the rulings which have been issued to private taxpayers over the past 10 years. The problem is particularly acute for FIAC. In 1963, it sought a ruling which would have reached the result which we are now proposing. But the Rulings Division of the Service concluded that the insurance company should be regarded as the owner of assests in a custodial account, for reasons that are not entirely clear. After lengthy negotiations, FIAC, in 1965, decided to restructure its policy to accommodate the Service's view. FIAC is understandably concerned about the possibility that the rules are about to be changed on it again. Thomas Kelly, the Chairman of the Board of FIAC, has made his concerns known to a number of Congressmen and to a number of people here at Treasury. Questions about the continuing financial viability of FIAC have also been raised by a British company. Save & Prosper, which loaned approximately $7 million to FIAC between 1973 and 1975 when it was on the verge of bankruptcy. The British Embassy in Washington has inquired about the matter, although they have taken no position on behalf of FIAC.

While we recognize FIAC's problems, we understand that many conservative attorneys have been advising their clients not to purchase investment annuities, because of the concern about the validity of the Service's old rulings positions—a position which we think is invalid and should be changed, as the Service proposes to do. We also understand that, within the life insurance industry itself, there has been a growing concern that unless the tax treatment of investment annuities is changed soon, they will become such a widespread tax shelter that Congress will end up reevaluating the favorable tax treatment given to all annuities and life insurance. We have already been contacted by the Joint Committee staff, which apparently favors a reversal of the present rulings positions.

To allow sufficient time for FIAC and similarly situated insurance companies to adapt to the proposed new rules and develop annuity contracts in accordance with them, and to allow Congress time to consider whether or not to change the new rules legislatively, we propose to make them effective only after January 1, 1978. In that case the new rules would apply to all investment annuity contracts entered into before or after the date, but we would propose to allow policyholders to convert tax-free from such contracts to annuity contracts under which the assets held in a separate account are clearly insurance company assets.

We understand, however, that the Service's tentative conclusion is not to allow the old tax treatment to apply to "new" contracts, i.e., those entered into after October 20, 1976, the date of the News Release announcing the Service's reconsideration of the old rules. The Service's would allow the old rules to continue to apply to "old contracts (those entered into before October 20, 1976) until January 1, 1978. This will allow policyholders of the "old" contracts time to convert tax-free to contracts that will meet the new rules. But the Service is apparently opposed to extending the favorable tax treatment of the old rules to any new policyholders for any period of time.

We propose to allow the old rules to continue to apply to "new", as well as "old", contracts until January 1, 1978, because this will afford some time for FIAC and the other insurance companies to adjust, after having built up their business in reliance on the old Service rulings policy. We do not think the potential loss of revenue from new policies of just one year will be significant enough to warrant the potential harm to these insurance companies, particularly when we consider the fact that it was the Service who insisted on imposing the old rules on these companies in the first place.

Recommendation: We recommend publication of the proposed ruling containing the new rules described above, with an effective date of January 1, 1978, for "new" as well as "old" contracts, after advising industry representatives of the positions set forth herein.

ATTENDANCE LIST OF CONFERENCE ON THE INVESTMENT ANNUITY

First Investment Annuity Company: Anthony H. Doggart, President, W. Thomas Kelly, Chairman of the Board, H. William Brown, Sr. Vice President, Arthur P. Hartel, Secretary.

E. Wayne Thevenot.

Lee, Toomey & Kent: John A. Cardon, John M. Skilling, Jr., David A. Hildebrandt.

COOPERS & LYBRAND,
Philadelphia, Pa., June 2, 1978.

MR. W. THOMAS KELLY,
Malvern, Pa.

DEAR MR. KELLY: As you requested, we comment, hereinafter, upon whether the existing federal income taxation of deferred annuities allows the annuitant benefits similiar to those contained in "tax shelters" or whether annuity taxation meets certain criteria set forth by Stanley S. Surrey in his book "Pathways to Tax Reform".

In Chapter VII of the book entitled "Corrective Reform Measures to Moderate Tax Expenditures Abuses" Mr. Surrey proposes that one corrective measure would be a payment for the deferral ingredient as follows:

"A prime ingredient of tax shelters is the deferral of tax on current income, achieved through the acceleration of deductions provided by the shelter. This deferral, as described earlier, is an interest-free loan from the government in the amount of the tax deferred. Here, also, the ingredient suggests an appropriate restraint—eliminate the interest-free character of the deferral loan by charging interest on the deferred tax."

We have prepared and attach as Exhibit I a simple illustration of Mr. Surrey's corrective measure using as a model the accelerated depreciation deferral. Here a taxpayer obtains an interest free loan from the Government equal to the difference between accelerated and straight line depreciation tax-effected at 50 percent. The loan increases each year that the accelerated depreciation exceeds the hypothetical straight-line depreciation and then decreases when the hypothetical straight-line depreciation exceeds that claimed whether it be accelerated or straight-line. The taxpayer would pay interest to the Government each year on the deferral loan and be entitled to a deduction for the interest paid as it would for interest on any other loan. The net result would be a payment of $232 to the Government on the deferral loan.

Extending Surrey's theory to a deferred annuity we have prepared Exhibit II which compares the taxation of a certificate of deposit with the taxation of a deferred annuity to arrive at the deferral loan. Since no interest is paid currently on the deferral loan, we have added the unpaid interest to the deferral loan. The interest rate used is an after tax rate of four percent assuming the market rate of interest is eight percent and the annuitant is in the 50 percent tax bracket.

The conclusion one can draw from Exhibit II is that when the annuitant withdraws his funds the payment made to the Government ($5,794) contains an element of interest on the deferral loan since the actual taxes paid on the certificate of deposit total $4,804 and the compound interest on the deferral loan is $891 or a total of $5,695. The additional $99 paid by the annuitant results from the fact that an amount derived from compounding at eight percent and then halved is more that the amount derived from compounding at four percent.

If a period different than 10 years was used, the spread between the annuitant's payment and the deferral loan would be greater if the period was longer and less if the period was shorter, but the annuitant would always pay more to the Government than he would under Mr. Surrey's proposal. If the tax bracket of the taxpayer was greater than 50 percent the spread would also be greater since the interest rate compounding on the deferral loan is a function of the tax bracket and would decrease in proportion to the rise in tax bracket while the interest rate on the deferred annuity would remain constant. Conversely, if the tax bracket of the taxpayer was less than 50 percent, the spread would narrow and eventually the amount paid as the withdrawal of the deferred annuity would be less than that on the deferral loan.

In conclusion, it is evident that:

1. Deferred annuities (including the investment annuity) lack of "prime ingredient of tax shelters" namely, "an interest-free loan from the Government in the amount of the tax deferred;"
2. The existing mode of deferred annuity taxation results in an interest element being charged to the taxpayer as proposed by Mr. Surrey;
3. In fact, under most circumstances, the existing mode of annuity taxation provides more tax dollars for the Government than Mr. Surrey's proposals;
4. The existing mode of deferred annuity taxation is similar to the Government's own "Series E" bond (unless an election is made to be taxed currently); and
5. Because of the foregoing it is quite inappropriate to lump deferred annuities (including the investment annuity) in with so-called "tax shelters."

Very truly yours,

COOPERS & LYBRAND.

W. THOMAS KELLY

EXHIBIT I.—COMPUTATION OF INTEREST ON THE "DEFERRAL LOAN" ACCELERATED DEPRECIATION

[Cost of asset, $10,000]

Year	Depreciation [1]		Excess (1) minus (2)	Tax deferral (3) times 0.50 [2]	Deferral loan	Interest on deferred loan at 4 percent
	DDB/SL	SL				
	(1)	(2)	(3)	(4)		
1	$2,000	$1,000	$1,000	$500	$500	
2	1,600	1,000	600	300	800	$20
3	1,280	1,000	280	140	940	32
4	1,024	1,000	24	12	952	38
5	819	1,000	(181)	(90)	862	38
6	655	1,000	(345)	(173)	689	34
7	655	1,000	(345)	(172)	517	28
8	655	1,000	(345)	(173)	344	21
9	656	1,000	(344)	(172)	172	14
10	656	1,000	(344)	(172)		7
Total	10,000	10,000				232

[1] A useful life of 10 years and no salvage value was used in computing depreciations.
[2] Interest rate of 8 percent tax-effected at 50 percent.

EXHIBIT II.—COMPUTATION OF INTEREST ON THE "DEFERRAL LOAN" OF A DEFERRED ANNUITY

Year	Certificate of deposit, at 8 percent	Payment to Government	Deferred annuity, at 8 percent	Deferral loan
1 Principal invested	$10,000		$10,000	
Interest	800		800	

EXHIBIT II.—COMPUTATION OF INTEREST ON THE "DEFERRAL LOAN" OF A DEFERRED ANNUITY—Continued

Year	Certificate of deposit, at 8 percent	Payment to Government	Deferred annuity, at 8 percent	Deferral loan
Tax [1]	−400	$400		$400
2 Balance	10,400		10,800	400
Interest	832		864	[2] 16
Tax	−416	416		416
3 Balance	10,816		11,664	832
Interest	865		933	33
Tax	−433	433		433
4 Balance	11,248		12,597	1,298
Interest	900		1,008	52
Tax	−450	450		450
5 Balance	11,698		13,605	1,800
Interest	936		1,088	72
Tax	−468	468		468
6 Balance	12,166		14,693	2,340
Interest	973		1,175	94
Tax	−487	487		487
7 Balance	12,652		15,868	2,921
Interest	1,012		1,269	117
Tax	−506	506		506
8 Balance	13,159		17,137	3,544
Interest	1,053		1,371	142
Tax	−527	527		527
9 Balance	13,685		18,508	4,213
Interest	1,095		1,481	168
Tax	−548	548		548
10 Balance	14,232		19,989	4,929
Interest	1,139		1,599	197
Tax	−569	569		569
Total	14,802	4,804	21,588	5,695
Tax ($21,588 minus $10,000 times 0.50)			[3] 5,794	

[1] All tax computations at 50 percent.
[2] Hypothetical interest to Government computed at after tax rate as per exhibit I.
[3] Assumes complete withdrawal of funds at end of 10th year.

H.R. 11182

A bill to reinstate the tax treatment with respect to annuity contracts with reserves based on a segregated asset account as they existed prior to issuance of Revenue Ruling 77-85

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That in the case of annuity contracts which have related amounts based on a segregated asset account, the tax treatment of such contracts under section 61 of the Internal Revenue Code of 1954 (defining gross income) and section 801(g)(1)(B) of such Code (relating to contracts with reserves based on a segregated asset account) shall be determined—

(1) without regard to Revenue Ruling 77-85 (and without regard to any other regulation, ruling, or decision reaching the same result as, or a result similar to, the result set forth in such Revenue Ruling); and

(2) with full regard to the rules in effect before Revenue Ruling 77-85.

Mr. HATCH. This amendment was brought up last year and received 57 votes on the floor of the Senate. Frankly, I think a majority of Senators would support this amendment at this time. That is the reason I have brought it up.

I intend to ask for the yeas and nays at the appropriate time.

Statement of Senator Orrin G. Hatch to the Finance Subcommittee on Taxation and Debt Management

Mr. Chairman, I greatly appreciate the opportunity of testify at this important hearing. I congratulate you, Mr. Chairman, in bringing this matter before your Committee in order that action may be taken to correct a gross injustice in the administration of our tax laws.

I am here not only to represent my constituency, but also as a member of the Judiciary Committee and Senate Select Committee on Small Business. I join many others in expressing extreme concern with the brazen and outrageous manner in which unelected bureaucrats, who know all the ropes, use their omnipotent power to crush legal business activities just because those activities do not fit the Bureaucrat's current perception as to how they prefer to run our government regardless of clear law, and their own precedents, that they so freely violate.

S. 3094 and my Congressional Record statement concerning it clearly present my strong views and my urgent request for immediate remedial action. Not long after S. 3094 was introduced to correct the injustice of Revenue Ruling 77-85 the IRS issued Revenue Ruling 80-274 that has no legal rationale and merely states a conclusion based upon Revenue Ruling 77-85. By this action another segment of the annuity industry has been crippled to the detriment of our nation.

Clearly, there is only one proper action for the Congress to take and that is to restore the mode of annuity taxation to that which existed prior to the IRS issuance of Revenue Ruling 77-85. This action is long overdue and is of critical, immediate importance to protect the vital interest of those taxpayers impacted by the very recent Revenue Ruling 80-274.

These revenue rulings, and the IRS' and the Treasury's actions related thereto, constitute a documentable case of arbitrary, capricious and illegal acts that can not be acceptable nor tolerable to the Senate. This situation warrants immediate approval of this proposed legislation; an action that will also restore the authority of the Congress in the writing of our tax laws—a most important matter.

[T.K. Note to Letter Writers: I have included this "statement" because it is short, articulate and hits the nail on the head. When you write, use your own language, but don't be afraid to tell it like it is. Do it now—and follow-up—more than once. Don't settle for a "bland" response along the line of "thank you for your letter, I'll keep your thoughts in mind." Call the Legislative Assistant (the Congressman's telephone operator will get you the right Assistant after you tell her the subject and the bill number). Don't be taken aback if the Assistant sounds vague, particularly if the Congressman is not on a tax writing committee. Tell the Assistant of the bills' importance in the Congressman's District or State. Ask for the Congressman's favorable "vote" and if they say yes, ask them to cosponsor. You will find that the conversation will be both friendly and rewarding.]

[S. 388 97th Cong. 1st sess.]

A BILL To reinstate the tax treatment with respect to annuity contracts with reserves based on a segregated asset account as they existed prior to issuance of Revenue Ruling 77-85

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That in the case of annuity contracts which have related amounts based on a segregated asset account, the tax treatment of such contracts under section 61 of the Internal Revenue Code of 1954 (defining gross income) and section 801(g)(1)(B) of such Code (relating to contracts with reserves based on a segregated asset account) shall be determined—

(1) without regard to Revenue Ruling 77-85 (and without regard to any other regulation, ruling, or decision reaching the same result as, or a result similar to, the result set forth in such Revenue Ruling); and

(2) with full regard to the rules in effect before Revenue Ruling 77-85.

S-388 97th Congress

Senate Bill S-388 co-sponsored by Senators Hatch and Tower is identical to House Bill HR-743 as introduced by Representative Barber Conable, Ranking Member of the House Committee on Ways and Means. Identical bills (1) were favorably voted (22-14) by the House Committee on Ways and Means in the 95th Congress and (2) were the subject of hearings before the Senate Finance Committee Sub-committee on Taxation and Debt Management in the 96th Congress. Unrelated procedural constraints in these instances prevented their enactment.

By Mr. Hatch (for himself and Mr. Tower):

S. 388. A bill to reinstate the tax treatment with respect to annuity contracts with reserves based on a segregated asset account as they existed prior to issuance of Revenue Ruling 77-85; to the Committee on Finance.

INVESTMENT ANNUITIES

Mr. HATCH. Mr. President, this proposed legislation is very important not only because it rights a tremendous injustice in the administration of our tax laws, but because it is important to the authority and integrity of the U.S. Senate and the laws of our country. It is a matter of tax laws, but more importantly, also a matter of who makes the law. The Internal Revenue Service has in the specific instance pertaining to this matter unsurped that authority in the face of opposition of the U.S. Senate, a U.S. district court decision and the expressed will of the House Committee on Ways and Means.

The specific matter at hand pertains to IRS Revenue Ruling 77-85 that reversed over 70 consistent public and private rulings that covered a time span of more than a decade. This ruling not only strangled an innovative annuity industry to the detriment of the well being of our Nation's citizens, this ruling, and the IRS actions related thereto constitute a documentable case of arbitrary, capricious, and illegal acts that cannot be acceptable nor tolerable to the Senate.

The merits of this proposed amendment are clearly reflected in the various courts' pronouncements. The U.S. District Court, District of Columbia declared that:

Revenue Ruling 77-85 is an erroneous and unreasonable interpretation of the internal revenue code, and in view of this fact that substantial deference to the agency's expertise is not warranted by the facts of the case, the court will declare the ruling to be unlawful and beyond the services' statutory authority.

Revenue Ruling 77-85 is unlawful, erroneous, unreasonable, and beyond the services' statutory authority in that its determination that the policyowner, rather than the issuing life insurance company, is the owner of the investment annuity custodial account assets.

The services' decision in Revenue Ruling 77-85 was not contemporaneous with the enactment of section 801(g)(1)(b), does not reflect a longstanding agency position, and is inconsistent with earlier pronouncements and even one subsequent announcement of the agency. Accordingly, substantial deference to the services' expertise is unwarranted in the instant case.

Substantial deference to the services' expertise is also unwarranted because the service was improperly motivated by consideration of tax reform when it issued Revenue ruling 77-85.

While the appellate court never addressed the merits of this matter, because it based its findings upon a jurisdiction question, the appellate court stated:

This is not a situation where there are no remedies, however. Congress keeps a watchful eye on developments in this tax field and will listen to citizens with a grievance or plea.

Predictably, the failure of Congress to remedy our citizens' very serious grievances and pleas arising from the illegal Revenue Ruling 77-85 emboldened the IRS to issue Revenue Ruling 80-274 that totally destroyed another important segment of the annuity industry, the so-called savers' annuity. The IRS bottomed their new ruling (80-274) upon Revenue Ruling 77-85 that the court had adjudged as being illegal, unreasonable, beyond the IRS' authority and ignorant of the law. (See citation above.) This bill reinstates the taxation of annuity contracts as it existed prior to the IRS' issuance of Revenue Ruling 77-85 and thereby also provides the needed remedy for annuities subject to Revenue Ruling 80-274 because Revenue Ruling 80-274 was bottomed on Revenue Ruling 77-85.

The true victims of these illegal, unreasonable IRS actions are our Nation's citizens who are being illegally denied most innovative and useful annuities that were developed in the public interest. Thus, this is a situation that warrants remedial action by the Senate, action that will also restore the authority of the Congress in the writing of our tax laws—a most important matter that commands our immediate and resolute action.

Mr. TOWER. Mr. President, I am pleased to cosponsor legislation introduced by Senator Hatch, designed to rectify an injustice caused by the Internal Revenue Service's sudden departure from longstanding procedure in the taxation of investment annuities. This bill is identical to H.R. 743, introduced in the House by Congressman Barber Conable, and to S. 3082 that I introduced in the 96th Congress. Hearings were held on S. 3082 by the Finance Committee Subcommittee on Taxation and Debt Management. Senate procedural constraints subsequent to the hearing precluded further Senate action in the 96th Congress.

This bill would reinstate the tax treatment of annuity contracts with reserves based on a segregated asset account as they existed prior to the issuance of Revenue

Ruling 77-85. This ruling was subsequently held unlawful by the U.S. District Court, District of Columbia, on the ground that it constituted an illegal, arbitrary, and conscious act beyond the statutory authority of the IRS, based on an unreasonable intrepretation of the Internal Revenue Code. The appellate court, while not addressing the merits of the district court's decision, did invite Congress to provide relief, which this bill is designed to accomplish.

From 1963 to 1965, when the IRS issued basic rulings on the subject of variable, or investment annuities, all relevant departments of the national office of the IRS insisted that an innovative form of annuity upon which the Service had been asked to rule was purely and simply a variable annuity pursuant to the separate account laws that had previously been enacted in 1962.

During the ensuing 12 years after 1965, the IRS reaffirmed its basic position over 70 times, including the issuance of Revenue Ruling 68-488 pertaining to deferred annuities. On March 9, 1977, the IRS issued Revenue Ruling 77-85, which completely reversed its longstanding rulings upon which an important segment of the life insurance industry had relied. The result was, and continues to be, devastating to this segment of the industry.

Several Members of Congress protested this action to the Treasury and the IRS. On April 29, 1977, the Senate passed, by a vote of 57 to 26, an amendment to H.R. 3477, the Tax Reduction and Simplification Act of 1977, which would have deferred the effective date of Revenue Ruling 77-85 for 1 year in order to permit Congress to study the matter and to consider any appropriate legislation. Unfortunately, this amendment was not adopted in subsequent negotiations on H.R. 3477 by the House-Senate conference committee.

Immediately after the conference committee completed its work, one insurance company, the originator of the investment annuity and whose entire business was destroyed by the IRS's sudden flip-flop of position on this matter, sued the Internal Revenue Service in Federal District Court for the District of Columbia for arbitrary, illegal, and capricious acts.

On November 9, 1977, the court ruled that Revenue Ruling 77-85 was indeed unlawful and beyond the statutory authority of the IRS. Judge Charles R. Richey expressed the "confident assumption" that the IRS would proceed to rectify its error without the need for the issuance of an injunction.

However, the IRS refused, stating that it would appeal any injunction issued and would retroactively tax any annuities sold during the interim of the appellate process, should the IRS prevail on appeal.

The President's 1978 tax program proposed the taxation of all nonqualified deferred annuities in the same way as that imposed upon the investment annuity by Revenue Ruling 77-85, which, of course, had been declared unlawful by Federal district court.

The President's 1978 tax proposals relating to all annuities were wisely rejected by the House Ways and Means Committee during its consideration of H.R. 12173, to override Revenue Ruling 77-85, which was approved by committee by a vote of 22 to 14. Due to a procedural constraint at that time, however, H.R. 12173 was not incorporated in the tax bill reported by the committee.

The appellate court declared that it did not have jurisdiction and, therefore, reached no decision on the merits of the case. The appellate court added language, however, inviting Congress to fashion appropriate relief:

"This is not a situation where there are no remedies, however, Congress keeps a watchful eye on developments in the tax field, and will listen to citizens with a grievance or plea."

Shortly after the introduction of S. 3082 last year to remedy this serious grievance and to reaffirm the law clearly ignored by Revenue Ruling 77-85, the IRS, without giving interested parties the opportunity to be heard, issued Revenue Ruling 80-274. This ruling wiped out the important "savers' annuity" segment of the annuity industry at great economic loss. Revenue ruling 80-274 contains no rational legal analysis and cites as its authority Revenue Ruling 77-85, which, as indicated above, was declared by the district court upon its merits as being unreasonable and in contravention of well-established law. The passage of the legislation introduced today reinstates the tax treatment with respect to those annuities subject to Revenue Ruling 80-274.

Mr. President, the entire matter, quite frankly, is a classic case of the will of Congress being frustrated and subverted by agency action in influencing the legislative process. The advocates of these annuities have a serious grievance which, in my mind, requires a prompt congressional remedy. I believe that the action by the IRS in issuing the manifestly unreasonable and unsupportable Revenue Rulings 77-85 and 80-274 deserves the attention of the Senate in order to restore these annuities to their proper place, taxwise, under the law and to resolve the severe inequities

which have resulted from the Internal Revenue Service's arrogant disregard for sound judicial authority.

Senator SYMMS. And then I would like to ask one to each of these three witnesses that are here this morning.

In your experience in dealing with these wrapped around savings annuities, what is the average income of the people that are using this? Is this a rich man's deal, or this a middle class deal, or—or, Mr. Kelly, would you want to comment on that?

Mr. KELLY. I would say that these are the middle-class types of annuities as reflected by the illustration which I have distributed, which I believe is correct.

Obviously, the person who has substantial wealth, who is already being taxed at 70 percent is not going to be investing in annuities; he'll get into tax-free bonds, or whatever else it might be.

This is really a grassroots form of annuity, which is very, very important for our Nation. And our experience is exactly along that line.

Senator SYMMS. So, that in other words, you are talking about people in the $25,000 income range?

Mr. KELLY. Yes. Oh, indeed. They are trying—they are trying like mad to save for emergencies, for retirement, any—any form of deferred savings.

Senator SYMMS. And, Mr. Barrow.

Mr. BARROW. Well, I would like to say that this is a survey—which I will be glad to enter into the record—done by First Savings over about 2,500 accounts.

The average family income was $26,300; the average age was 54 years of age; 46 percent of the people, the spouse worked full or part time.

These are people—71 percent of them were concerned that social security would not—and other savings in their corporate pension plans, et cetera—would not be adequate to provide for their retirement. These people are scared. These people went into the voting booths last year with a shotgun.

Senator SYMMS. Mr. Spencer.

Mr. SPENCER. Our experience, sir, pretty well tracks, except that we are pretty well diversified across the State of Wisconsin. We work with about 135 different financial institutions.

And as a result of, perhaps, more of a rural base, we find our income situation is somewhat lower. It ranges anywhere from $10,000, $15,000 on up. Our average size case is about $7,000, $7,200.

Senator SYMMS. The size of the account, you mean?

Mr. SPENCER. Yes, sir.

Senator SYMMS. So——

Mr. SPENCER. And, again, these are people who are trying to put money aside for their own retirement.

Senator SYMMS. For their own retirement.

Mr. SPENCER. Based on what they read in the paper, I am afraid they may have lost some faith in the social security system and, as a result of it, they are saying to themselves: If I want to live with a certain amount of choice and/or dignity in my later years, I better find some way to accumulate now.

Senator SYMMS. And in the process, of course, the money is going right in where it is most needed in the weak part of our economy right now—into the home loan banks.

Mr. SPENCER. Right. If you would discuss this with the IRS, they will tell you that the primary reason that people are doing it is tax deferral. That may be true, but just as importantly is the local aspect. The fact that they can keep the money in their own community, working with the people that they see everyday, if you would.

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

I also want to thank all these witnesses. I think the record should note the enthusiasm of all three of the witnesses, Mr. Chairman.

Senator PACKWOOD. Senator Bentsen.

Senator BENTSEN. Thank you very much, Mr. Chairman. And I want to say that, unfortunately, I won't be able to stay through them because we have the Intelligence Committee also meeting on a matter I am quite concerned about.

But, I wanted to be here to hear your testimony, because, frankly, I am a cosponsor of 388, and as I recall the situation, you had for 11 years the Internal Revenue Service approving the fact that you did not mature the income until you drew down on the annuity. And you had a situation where the investment annuity was looked on a bearable annuity, really. And, here you have had some innovativeness, some creativity, in the kind of a retirement program that is being set up.

And I would say to Senator Symms: He's so right in that this is not the refuge of the rich. The rich are not going into this kind of an approach. In all candor, they are going into something that is a little more exotic than this. It may work for them and it may not. But, at least, they think it is.

This is something that is more secure. At least, that's the way it's structured to be, until the Internal Revenue Service moved into it and decided that they were going to rewrite the law insofar as section 72. And, I strongly disagree with them.

As I recall, it was done in 1976. Then we had a court case with the lower courts where the taxpayer prevailed. But upon appeal, I believe, the case was dismissed.

So, in effect, what you see here is the Internal Revenue Service doing what they have done often in the past, deciding that they're going to write the law the way they want it to occur.

Now, I understnad there's some ambiguities in section 72, but the overall thrust of what we are trying to achieve in the way of investment for the retirement of people is quite clear in what the Congress was trying to do.

Now, when you've got saving in this country now at the rate of about 5½ percent and you have the Germans and the French saving at about 13 percent and the Japanese all the way from 22 to 25 percent, this is, obviously, an economic objective that's terribly important for our country.

And, so the IRS is really not only contravening the law, as we write it here, but, I think, is ill-serving the country in their present mood.

And, I would urge, very strongly, that we move expeditiously in the passing of this legislation and get it up to the full committee, Mr. Chairman.

And, once again, let me thank you for your leadership in this regard.

I have no questions of the gentlemen, because I, obviously, frankly, am very much in accord. Used to be in their business. [Laughter.]

Senator PACKWOOD. I want to thank you. Gentlemen, thank you very much for coming.

[The statements of the preceding panel follow:]

SUMMARY OF PRINCIPAL POINTS OF STATEMENT BY W. THOMAS KELLY

The Internal Revenue Code provides for the underwriting of variable annuities by life insurers. The only substantive difference between the investment annuity and other variable annuities is that (1) the insurer establishes a separate "Segregated Asset Account" for each policyholder and (2) upon such terms as established solely by the insurer, the insurer delegates to the policy holder how the account's assets are to be invested.

After 13 years of affirmative investment annuity rulings, the IRS reversed itself in 1977, thereby destroying an entire industry that relied, as it has to, upon the IRS' prior rulings.

The District Court, District of Columbia, denounced the IRS' action as being illegal, unreasonable, erroneous, beyond the IRS' statutory authority, and improperly motivated by ideas of tax reform which is Congress' business. The Appellate Court overturned the District Court "on other grounds" (jurisdiction) while inviting Congress to provide a remedy for citizens with a grievance and plea. The Supreme Court declined to review.

Since the IRS and Treasury continue to claim policyholder ownership of the segregated account assets even though said claim was totally rejected by the Court, the abused annuity industry urges Congress to reaffirm the application of clear existing law to these annuities by the enactment of Senate Bill S-388.

Not only does the enactment of S-388 reaffirm existing law, thereby permitting the renewal of investment annuity sales, such an event will materially assist the thrift and banking industries to attract and hold the long term monies so badly needed by them. Our nation needs significant ways to encourage savings and investment. It is counter-productive to permit the illegal destruction of an innovative and entirely legal mode of annuity underwriting. The enactment of Senate Bill S-388 will also correct the erroneous issuance of Revenue Ruling 80-274 albeit Senate Bill S-446 for the same purpose is equally meritorious.

STATEMENT OF W. THOMAS KELLY

My name is W. Thomas Kelly. I am the President of Investment Annuities Institute, Inc. This Institute reflects the interests of the many individuals, businesses, institutions and professionals who consider the IRS' issuance of Revenue Ruling 77-85 as a gross abuse of regulatory authority that not only illegally destroyed viable, legal businesses, it greatly eroded the confidence of our citizens in the moral and professional competence of our National Office tax administration.

S-388 is simple, proper, effective legislation that warrants this Committee's enthusiastic acceptance. This is so from three important bases; legal, public interest and tax policy.

LEGAL BASIS

The matter concerns the tax treatment accorded the so-called investment annuity form of variable annuity. As is the case in all annuities, the investment annuity is predicated on actuarially-derived mortality and expense guarantees made by the insurer to the policyholder. As the Court noted and to which all parties agreed, the unique feature of the investment annuity contract—and the only substantive difference between it and other variable annuity contacts—is that the insurer establishes a separate "segregated asset account" for each policyholder, and the insurer "delegates" to the policyholder how said account's assets are to be invested. All of the conditions surrounding this "delegation" of investing the insurer's assets, are established solely by the insurer and are limited pursuant to state insurance law.

In 1965, after two years of thorough consideration by every relevant department of the IRS, and IRS issued rulings stipulating that the so-called investment annuity must be taxed like any other variable annuity. This IRS consideration was contemporaneous with the enactment in 1962 of expressly relevant legislation. During the ensuing twelve years until 1977 the IRS issued over 70 rulings, including Revenue Ruling 68-488, that always reaffirmed the IRS's original position. Thousands of individuals and hundreds of businesses relied, of course, as they must, upon these rulings.

In 1977, the IRS issued Revenue Ruling 77-85 that completely reversed their prior, insisted upon tax rulings, and by so doing completely destroyed one major insurer and severely damaged many others. Thousands of agents and employees were forced to seek other methods of employment. During the interval from 1963 to 1977 neither the relevant law nor the relevant facts had changed one iota.

The IRS and Treasury Department were sued for arbitrary, capricious and illegal acts. As the U.S. District Court, District of Columbia, stated, it was guided by the well established principle that as a matter of jurisprudence and efficient tax administration, courts have regularly paid deference to the expertise attributed to the IRS in tax related matters and therefore, judicial interference is reluctantly employed. However, as the Court also noted, this exhibition of restraint is predicated upon the assumption that administrative rulings will do no more than effectuate, implement and clarify the provisions of the Code which have been congressionally enacted. . . when this assumption is proven wrong, the Court must act to rectify any administrative determination which is not in accordance with the Code. Thus, as the Court cited, a Revenue Ruling which runs counter to the provisions of a statute is a legal nullity.

The Court's consideration of this matter was extremely thorough and focused precisely upon the very theories that the IRS and Treasury continued to espouse.

The Court concluded that Revenue Ruling 77-85 was unlawful and beyond the IRS' statutory authority in that its determination that the policyholder, rather than the insurer, was the owner of the segregated account asset(s) was erroneous and unreasonable. The Court also concluded that substantial deference to the IRS' expertise was unwarranted by the facts of this case.

The Court specifically addressed the notion argued by the IRS and Treasury that since Congress only contemplated annuity arrangements where the insurance company exercised investment control, and since Congress expressly focused on this aspect of annuity contracts in the legislative history, Congress must have intended to limit the applicability of the segregated asset account section of the Code to so-called standard variable annuities. The Court found these IRS arguments entirely unpersuasive: the mere fact that Congress did not consider an as-yet uninvented alternative to a "statutorily-approved" arrangement cannot be said to bar application of the statute to a later-invented alternative if that alternative is comparable to the "approved" arrangement in substantially all respects. The Court declared that the IRS' argument ignored the generally accepted canon of statutory construction that where "Congress has made a choice of language which fairly brings a given situation within a statute, it is unimportant that the particular application may not have been contemplated by the legislators." This principle, the Court declared, is particularly apposite to tax cases; the excellence of our jurisprudence is its flexibility; and in applying general statutory language to particular situations, Courts best conform to the tradition of growth of our system when they adopt realistically general principles to different or constantly changing situations. The Court observed that in applying tax statutes, the best result is always achieved when harsh crystallizations are avoided.

For the above reasons, the Court concluded that the legislative history should not be read as either expressly or implicitly supporting the IRS and Treasury's constricted interpretation of the relevant section of the Internal Revenue Code.

Further, the Court noted that Revenue Ruling 77-85 was premised expressly on the IRS' determination that an investment annuity policyholder's substantial incidence of ownership with regards to the assets in the segregated asset account, and particularly his investment control over such assets, warrant the conclusion that the policyholder and not the issuing life insurance company is the owner of the account assets for federal tax purposes.

After thorough consideration of the above IRS conclusion, the Court found that the following reasons warrant the Court's conclusion that the investment annuity policyholder is not the owner of the account assets and should not be taxed as such:

First, the Court found that the rights surrendered by the policyholder are sufficiently extensive to divest him of ownership for the purposes of tax laws.

Second, the retention of investment control by the policyholder is not such a significant incident of ownership to warrant disparate treatment of investment annuity contracts and other variable annuity contracts.

Third, attribution of ownership of the segregated account assets to the policyholder produces unreasonable results. In particular, the IRS' interpretation would result in current taxation of the appreciation of the segregated account assets even though the policyholder may never receive that income or any benefit derived therefrom.

The Court also concluded that rather than administering law as it is written, the IRS was creating law, which was Congress' business.

It was clear to the Court from its thorough analysis of facts (and these facts were not in dispute by the parties concerned) that the IRS' actions were, as the Court declared, illegal, unreasonable and beyond the IRS' statutory authority.

Even the Appellate Court, in overturning the Lower Court's decision "on other grounds" (jurisdiction), invited Congress to fashion the needed remedy by listening to its citizens with a grievance and plea.

Thus, it is clear that an industry has been grossly abused by the illegal administrative actions of the IRS and Treasury in their issuance of Revenue Ruling 77-85, and in their continuing efforts to achieve annuity taxation results that are not in accordance with the law. This usurpation of the power of Congress continues, as does the IRS' abuse of a most important segment of the annuity industry. These factors should provide a most important impetus toward the prompt enactment of S-388.

See Exhibit B for a listing of the Court's declarations.

Public interest basis

Congressional enactment of Senate Bill S-388 is totally in the public interest from a host of perspectives.

As noted by the Court, "nowhere do the defendants even contend that they have discovered some new source of legislative history in the intervening . . . years." Also, the Court observed that "defendants' Counsel candidly admitted at the last hearing on the merits that Revenue Ruling 77-85 was the result of a massive reconsideration of policy of the Service." Accordingly, the Court concluded that the IRS was improperly motivated by considerations of tax reform when it issued Revenue Ruling 77-85, and the Congress, not the IRS, was the appropriate body to consider such substantive changes in the tax law.

It is also so clearly evident to all concerned that Congress, being so involved in its host of other legislative matters, has permitted this obvious bureaucratic usurpation of their congressional authority to continue. This thereby emboldened the IRS to press further in its basic, admitted desire to wipe out all annuities. This action is evidenced in their recent issuance of Revenue Ruling 80-274 where the IRS had the audacity to bottom said Ruling upon no rational legal analysis (there is no rationality for the Ruling) and in substitute thereof, based their Ruling upon the Court denounced Revenue Ruling 77-85! As Senator Hatch aptly put it: "This situation warrants immediate approval of this proposed legislation; an action that will restore the authority of the Congress in the writing of our tax laws—a most important matter.

Congress is well aware of the tremendous financial disintermediation that plagues many of our financial institutions that are so important to our nation's economic well-being. Clearly, as evidenced by the remarkably broad-based support for this legislation, these financial institutions recognize the singular attributes of these annuities to attract and hold the savings and investments of individuals, thereby contributing to the building up of our nation's store of long-term savings and investments, and thereby aiding in the reduction of our high interest rates, inflation, and at the same time, helping to provide capital to our nation's industry in order to improve productivity, while providing more jobs with higher pay without increasing inflation.

Clearly too, with the most unusual volatility in interest rates, bond yields and prices, and stock prices and yields, that our nation has been, is, and will be experiencing, it makes absolute, sound business sense to provide annuities that permit the individual to change his or her investment focus to better meet his or her needs and desires in saving for life's later years. An axiom of investing and saving is to "never lock youself into an investment position." Without question, *all* annuities are, and must be, legitimate forms of financial instruments that must conform to this axiom. Thus, the flexibility inherent in the investment annuity form of variable annuity is singularly advantageous to all concerned—the policyholder, the insurer, and our government.

The innovativeness of these annuities is no less important to our nation's well-being than those innovations found within the electronic, communications, and

other dynamic fields. Illogical, illegal, counter-productive bureaucratic constraints upon such innovation is a curse upon our nation's vitality that must be shackled and removed.

Tax policy

Our nation has been and is suffering from chronic anemia when it comes to savings and investment within the private sector. There is virtually universal acceptance by Congressmen, the Administration and the public that bold steps can and should be taken to reverse this deterioration of our economic life blood that has been occurring over the past 30-50 years.

Also, personal tax reduction, in whatever form or amount that will emerge from this Session of Congress, need be channeled to the extent possible into the private saving and investment stream.

As reflected by the broad spectrum of support from our nation's diverse and very competitive financial institutions, annuities are particularly useful to individuals in all walks of life as they strive to save and invest for life's later years. Additionally, and most important, they are simple to understand and are readily available; they can be utilized in a host of successful ways to the great advantage of our citizens and our economy.

Our nation needs to return to the joy and pride of saving and investing regularly; and to know that wealth is not a dirty word. It was this natural drive for personal economic independence by our citizens that helped so materially in making our country grow to the economic giant that it is today. Annuities, in their very innovative forms, can help return our nation to these most important habits.

It is also relevant to point out that a misconception exists as to the relative advantage of annuity taxation in relation to the policyholder's tax bracket. In 1978 the Carter Administration proposed to Congress that the law be changed so that all annuities would be taxed in the same manner as illegally imposed upon the investment annuity by the IRS' issuance of Revenue Ruling 77-85. In its analysis of the Treasury's proposal, the Joint Committee on Taxation prepared a table comparing annuity taxation with the taxation of CDs and stated its conclusion that "the relative advantage of the annuity is greater for taxpayers in higher brackets . . ."

Unfortunately, it would appear that the Joint Committee's analysis left out significant underlying data which, if taken into account, leads one to the opposite conclusion, i.e., the relative advantage of the annuity over the certificate of deposit is greater for taxpayers in lower brackets! [See Exhibit A attached.]

Conclusion

The IRS' action in issuing Revenue Ruling 77-85 was illegal, not in the public interest, and poor tax policy. Senate Bill S-388 is most worthy of passage by this Committee.

EXHIBIT A

COOPERS & LYBRAND,
Philadelphia, Pa., January 22, 1981.

Mr. W. THOMAS KELLY,
Malvern, Pa.

DEAR MR. KELLY: We have received your letter of January 12, 1981 that discusses an analysis by the Joint Committee on Taxation comparing the after-tax rates of return of certificates of deposit and deferred annuities.

In its comparison the Joint Committee concludes that the annuity offers a greater return and that for "any accumulation period, the relative advantage of the annuity is greater for taxpayers in higher brackets . . .". You have pointed out that the Joint Committee's latter conclusion is superficially correct but that the Joint Committee leaves out significant underlying data which, if taken into account, leads one to the opposite conclusion, i.e., the relative advantage of the annuity over the certificate of deposit is greater for taxpayers in lower brackets.

In your analysis you use the pre-tax return of an annuity as the base from which to measure the advantage to the low and high bracket taxpayers whereas the Joint Committee used the after-tax return as its base. We are in agreement with your analysis and feel the analysis of the Joint Committee is misleading and therefore not correct. Additionally, had the Joint Committee taken inflation into account in its comparison, it would become evident that the high bracket taxpayer suffers greater erosion in purchasing power than the lower bracket taxpayer as a direct result of current tax policy. Specifically, current tax law fails to consider the inflation component of the stated rate of interest as merely a return of constant dollar capital, and not true economic income. As anticipated rates of inflation advance to historically new highs, the taxation of the full rate of interest earned

results in ever increasing taxation of constant dollar capital. This erosion in purchasing power is obviously absolved to a greater extent by those in high brackets. Examination of the long term bond market performance in recent years empirically illustrates the disincentive resulting from a tax policy which fails to make the above adjustment in periods of high inflation. In summary, no analysis is complete unless the total return is divided between the return of constant dollar capital and true economic return. It is only on this latter element that one should measure the after tax advantages or disadvantages to the respective tax brackets. It is respectfully submitted that in periods of high tax rates and high inflation the true economic return to high bracket taxpayers is negative when investments are made in vehicles such as certificates of deposit.

We are also of the opinion that the various attacks on deferred annuity taxation are not warranted in view of current annuity tax law and the professed interest by Congress in capital formation and individual saving. Regardless of tax bracket savers today have a difficult task locating riskless vehicles that can stay up with inflation and also offer liquidity. The deferred annuity is one of the very few investments available to the "man on the street" that can solve these very real economic problems. The government's own vehicle similar to the deferred annuity, Series "E" Bonds converted to Series "H" Bonds, has in the past few years left the saver in poor financial straits as inflation rates have been almost double the yields offered on these investments.

We congratulate you on your tireless and continuing efforts to promote personal savings in a way that enables one to maintain purchasing power without taking an undue amount of risk.

Very truly yours,

COOPERS & LYBRAND.

W. THOMAS KELLY,
Malvern, Pa, January 12, 1981.

MR. LANGHORNE B. SMITH,
Coopers & Lybrand,
Philadelphia, Pa.

DEAR MR. SMITH: Appended hereto are two examples taken from a Joint Committee on Taxation Report dealing with the taxation of annuities. An appropriate excerpt from that report is attached.

The report state on pages 36–37 in reference to Table I of this Report: "For any particular accumulation period, the relative advantage of this annuity is greater for taxpayers in higher brackets, but the amount of gain is not necesarily greater in higher brackets."

While the above statement is a correct reflection of the facts as presented in Table I, not all the relevant facts were included in Table I that would enable a reader to properly evaluate the statement for tax policy purposes. My analysis is as follows and is based on the 35-year period illustrated in Table I.

JOINT COMMITTEE COMPARISON OF AFTER-TAX RETURN AS PER TABLE I

	Taxpayer's tax bracket	
	30 percent	70 percent
Certificate	$5.73	$1.29
Annuity	9.65	4.14
Annuity excess	3.92	2.85
Percent	68	[1] 221

[1] Thus, the Committee concludes that the relative advantage of an annuity is greater for taxpayers in higher brackets.

WHAT THE JOINT COMMITTEE DIDN'T SHOW ARE BASIC FACTS AS TO THE BASE LINE FIGURES FROM WHICH THE ABOVE CERTIFICATE AND ANNUITY FIGURES ARE DERIVED

	Taxpayer's tax bracket	
	30 percent	70 percent
(a) Certificate figures:		
Before tax return of $1 invested at 8 percent (not shown in committee report)	$13.78	$13.78

WHAT THE JOINT COMMITTEE DIDN'T SHOW ARE BASIC FACTS AS TO THE BASE LINE FIGURES FROM WHICH THE ABOVE CERTIFICATE AND ANNUITY FIGURES ARE DERIVED—Continued

	Taxpayer's tax bracket	
	30 percent	70 percent
Return after taxes	5.73	1.29
Portion lost to taxes	8.05	12.49
Percent in excess of taxpayer's tax bracket	[1] 93	30
(b) Annuity figures:		
Before tax return of $1 invested at 8 percent (not shown in committee report)	$13.78	$13.78
Return after taxes (see (1) above)	9.65	4.13
Portion lost to taxes	4.13	9.65
Percent	30	70
Percent lost in excess of taxpayer's tax bracket percent	([2])	([2])

[1] Example: $8.05 lost over 13.78 equals 58 percent lost. 58 percent lost divided by 30 percent bracket equals 1.93. That is 93 percent more is lost due to taxes than the individual's tax bracket. The 70 percent tax bracket individual loses 30 percent more.
[2] That is neither taxpayer losses more than their tax bracket.

THE REDUCTION IN TAXPAYER'S TAXES FROM ANNUITY TAXATION

	Taxpayer's tax bracket	
	30 percent	70 percent
Portion lost due to:		
Taxes on certificate	$8.05	$12.49
Taxes on annuity	4.13	9.65
Tax savings	3.92	2.84
Percent	49	[1] 23

[1] For example, tax savings 2.84 divided by portion lost via CD taxes 12.49 equals 23. Thus the relative advantage of the annuity over the certificate of deposit is greater for taxpayers in lower brackets.

CONCLUSIONS

Clearly, the taxation of the certificate results in the taxpayer paying taxes during the investment period that aggregate more than the taxpayer's tax bracket. This negative result is relatively more disadvantageous for the lower bracket taxpayer. Annuity type taxation provides relative tax bracket equity and improves the aggregate return relatively more for the lower bracket taxpayer.

Thus, contrary to the Joint Committee's conclusion, it is evident that existing taxation of investment income (i.e., certificate taxation) is relatively disadvantageous, rather than annuity taxation being relatively advantageous. This conclusion is buttressed by the clearly evident debilitating effect of existing taxation on the taxpayer's after-tax return over a period of time and that the existing taxation of investment income is relatively regressive whereas annuity taxation provides relative tax bracket equity.

I would greatly appreciate your reviewing this information and advising me of your conclusions.

Sincerely yours,

W. THOMAS KELLY.

RELEVANT EXCERPT FROM A PAMPHLET PREPARED BY THE STAFF OF THE JOINT COMMITTEE ON TAXATION FOR USE BY THE COMMITTEE ON WAYS AND MEANS IN ITS CONSIDERATION OF THE CARTER ADMINISTRATION'S 1978 TAX REDUCTION AND REFORM PROPOSAL—APRIL 14, 1978

ISSUES

The Administration proposal raises questions as to (1) whether tax deferral is appropriate under deferred annuity contracts, (2) whether limitations are needed where tax deferral is appropriate, and (3) to what extent tax should be deferred

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where funds accumulated under a deferred annuity contract are partially withdrawn (or used to secure a loan) before a retirement annuity is paid.

The Administration's proposal is based on the belief that the increase in sales of deferred annuities, which some sources estimate to have exceeded $1 billion in 1977, reflects the promotion and sale of such contracts for their tax deferral features, features which are unavailable through other forms of savings other than life insurance.[1] The Administration argues that where, as in the case of deferred annuity contracts, an investor may liquidate his investment at any time, tax on earnings from that investment should not be deferred.

Table 1 shows the advantage that tax deferral under annuity contracts has over current taxation of other investments. The table assumes that one taxpayer initially invests in a certificate of deposit issued by a savings institution which yields interest at an 8-percent annual rate, pays taxes on the interest each year, and reinvests the after-tax interest. The second taxpayer purchases a single-premium annuity contract providing an 8-percent annual rate of return, pays no taxes on the accumulated interest. The table shows how the amount of after-tax funds available to the two taxpayers depends on their tax bracket and the length of the accumulation period.

TABLE 1.—COMPARISON OF AFTER-TAX RETURN PER DOLLAR OF INVESTMENT

Length of period between investment and withdrawal (accumulation period)	Tax bracket: 30 percent		Tax bracket: 50 percent		Tax bracket: 70 percent	
	Investment vehicle: Certificate	Annuity	Certificate	Annuity	Certificate	Annuity
5	$0.31	$0.33	$0.22	$0.23	$0.13	$0.14
10	.72	.81	.48	.58	.27	.35
15	1.26	1.52	.80	1.09	.43	.65
20	1.97	2.56	1.19	1.83	.61	1.10
25	2.90	4.09	1.67	2.92	.81	1.75
30	4.13	6.34	2.24	4.53	1.04	2.72
35	5.73	9.65	2.95	6.89	1.29	4.14

Note.—Table assumes (1) 8-percent return for both certificate and single premium annuity, and (2) investors are in same tax bracket throughout entire period.

In all cases, the taxpayer who invested in the annuity contract has a greater after-tax return per dollar of investment than the taxpayer who invested in the savings certificate. In all tax brackets, the amount of the tax benefit of the annuity increases as the length of the accumulation period increases. For any particular accumulation period, the relative advantage of the annuity is greater for taxpayers in higher brackets, but the amount of gain is not necessarily greater in higher brackets. These comparisons do not take account of commissions or other charges.

The Administration further believes that tax-favored retirement savings should be channelled primarily through the vehicles specifically provided by Congress, and that, if deferred annuities are to continue to be used for that purpose, they should be subject to limits.

EXHIBIT B

THE COURT ADJUDGED ILLEGALITY OF IRS REVENUE RULING 77-85

The United States District Court, District of Columbia, declared in Judge Charles R. Richey's Memorandum Opinion of November 9, 1977:

"Revenue Ruling 77-85 is an erroneous and unreasonable interpretation of the Internal Revenue Code, and, in view of this fact that substantial deference to the agency's expertise is not warranted by the facts of the case, the court will declare the ruling to be unlawful and beyond the services' statutory authority."

"Revenue Ruling 77-85 is unlawful and beyond the services' statutory authority in that its determination that the policyowner, rather than the issuing life insurance company, is the owner of the investment annuity custodial account assets is erroneous and unreasonable.

"The services' decision in revenue ruling 77-85 was not contemporaneous with the enactment of section 801(g)(1)(B), does not reflect a long-standing agency position, and is inconsistent with earlier pronouncements and even one subsequent an-

[1] Some of the promotional literature is cited in the "Detailed Explanation and Supporting Analyses," of the 1978 Tax Program, pp. 184-188.

nouncement, of the agency. Accordingly, substantial deference to the services' expertise is unwarranted in the instant case.

"Substantial deference to the services' expertise is also unwarranted because the service was improperly motivated by considerations of tax reform when it issued Revenue Ruling 77-85."

SUMMARY OF PRINCIPAL POINTS IN STATEMENT OF ROBERT R. BARROW ON S. 446

Rev. Rul. 80-274 usurps the legislative authority of the Congress. It undertakes administratively to effect an amendment to the Internal Revenue Code which the prior administration proposed, but which the Congress rejected.

The annuity which Rev. Rul. 80-274 has banned encourages savings by middle America. It provides banks and savings and loan associations with stable deposits and creates a pool for local mortgage money.

Rev. Rul. 80-274 is discriminatory.

Rev. Rul. 80-274 is a reversal of a position taken by the IRS in rulings we received. In reliance on those rulings we launched our annuity business.

Rev. Rul. 80-274 is predicated on Rev. Rul. 77-85, which antedated the rulings we received. The Internal Revenue Service, in connection with the rulings we received, considered Rev. Rul. 77-85 and concluded our annuity was distinguishable.

STATEMENT OF ROBERT R. BARROW, PRESIDENT, INTERNATIONAL GENERAL INSURANCE CORP., ON S. 446, 97TH CONG., 1ST SESS.

My name is Robert Ruffin Barrow. I am president of International General Insurance Corp. We support S. 446 which would revoke Rev. Rul. 80-274.

As a preliminary observation, the annuity, which Rev. Rul. 80-274 has banned, fosters the President's program of encouraging savings. It should be emphasized too that the premiums paid for the purchase of this annuity are not tax deductible, but represent "after tax" dollars. Additionally, annuities do not escape the income tax. The tax is merely deferred. Also, this annuity can and should play a role in stemming the flight of savings from thrift institutions.

Rev. Rul. 80-274 is a usurpation of the legislative power of the Congress. In order to provide an honorable and dignified retirement, the Internal Revenue Code provides an annuity holder with tax deferral of earnings accumulated on the premiums paid for deferred annuities. The prior administration was unable to persuade the Congress to amend the Code to curtail this tax deferral. Nevertheless, that administration undertook to achieve the same objective by administrative fiat. To this end, the Internal Revenue Service issued Rev. Rul. 80-274 and reversed the position that it had taken for years which honored the annuity deferral provisions of the Code.

Not only does Rev. Rul. 80-274 usurp the legislative power and authority of Congress, but it is also discriminatory in its intent and effect. The burden of this arbitrary and capricious ruling falls uniquely on four small life insurance companies and the local savings industry of this country.

Rev. Rul. 80-274 has sounded the death knell for an annuity which encourages savings by middle America. People today are simply concerned about retirement and providing for their older years. Understandably, they are not convinced that they will receive adequate retirement benefits from Social Security or otherwise. In an effort to provide for their own self-sufficiency in retirement, they have looked to an annuity such as ours for an assured income they cannot outlive.

Our annuity is funded with certificates of deposit of banks and savings and loan associations in the locale of the annuitant. It provides these institutions with stable deposits, thereby creating a pool for local mortgage money. The benefits redound to the prospective homeowner, the local construction industry and its suppliers and workers, as well as those of ancillary industries. The importance of these savings institutions as a source of mortgage money is evidenced by the fact that in 1978 savings and loan associations held approximately 47 percent of the outstanding residential mortgage loans and commercial and savings banks held 31 percent.

The experience of First Savings of Wisconsin, Wisconsin's largest savings and loan association, testifies to the importance of our annuity. First Savings has a group annuity contract with our company for our single payment deferred annuity that fell victim to Rev. Rul. 80-274.

In 1979, premiums paid by enrollees under this contract provided approximately one-third of First Savings' net increase in savings after accounting for interest credited. In 1980, in spite of new annuity enrollments with premiums in excess of $16 million, First Savings suffered a net savings decrease. Both in 1979 and 1980, approximately 75 percent of these premiums represented new money to First Savings. Cancellations have been minimal.

First Savings has found that, on average, the enrollee is 54 years old, has a family income from all sources of approximately $26,300, and has paid an annuity premium of $9,943. Without the backbone of such middle income savers, the savings institutions cannot continue to support local home mortgages.

Under these circumstances, it is not surprising that, upon the announcement of Rev. Rul. 80-274, Jay Janis, then Chairman of the Federal Home Loan Bank Board, urged G. William Miller, then Secretary of the Treasury, to withdraw the ruling immediately and to convene a hearing on the important policy considerations and legal questions involved, noting that there are strong legal arguments for concluding that Rev. Rul. 80-274 is legally incorrect. This suggestion is still a good idea. Even now it should be pursued by the Treasury Department, as I suggested in a letter of February 12, 1981, to Secretary Regan.

Rev. Rul. 80-274, as I have indicated, is discriminatory. It denies annuity tax treatment to our savings funded annuity. On the other hand, the Service has taken no such Draconian action against annuities funded with shares of mutual funds and of money market funds, and I am not advocating any such action. This discrimination and the Treasury Department's explanation is accounted for in the following striking passage from a story about Rev. Rul. 80-274 in The Wall Street Journal of October 6, 1980 (p. 46):

The ruling naturally raises questions about the potential for an IRS attack on annuities wrapped around mutual funds. Several funds offer variable annuities that have money-market shares as an investment option, which are keyed to short-term interest rates. Some funds also offer fixed-rate annuities, which have a set rate for the first year that is then adjusted quarterly.

"We could hardly deal with one (the thrift institutions) and not the other," says a Treasury Department spokesman. He confirms that the IRS is discussing another ruling that would declare the annual interest income on all mutual-fund annuities taxable. He adds, however, that with the November election just around the corner, "It doesn't make sense to create another firestorm right now."

A ruling on these mutual fund and money market annuities has not been issued in the intervening six months. Nor, in my opinion, should one be expected. Consequently, these mutual fund annuities continue to be marketed by brokerage houses, and they continue to be regularly advertised in the daily financial press. They thrive, but we, along with the local thrift institutions, have been doomed.

Our policy, just like any other annuity, provides a long term and meaningful mortality guarantee with various annuity options as well as cash surrender values. It has been approved for sale as an annuity by the insurance commissioners in all 15 states in which we have been admitted to do business.

The premium is deposited in a certificate of deposit of a federally insured bank or savings and loan association so that the annuity owner enjoys federal deposit insurance coverage. Like the traditional fixed dollar annuity, our policy guarantees a minimum interest yield on the premium. In addition, the annuity owner is guaranteed "excess interest". This is additional interest that the deposit earns in excess of the guaranteed minimum, less either a 1 percent or 2 percent charge the first year, and either 1 percent or ¾ of 1 percent annually thereafter. These are the only charges that are made, and they are payable only from "excess interest". There are no other fees, expenses, or "loadings."

I originated this annuity. I discussed it and the tax implications at length with the Service. Indeed, we tailored our annuity to meet suggestions made by the Service. Thereafter, on August 30, 1977, we obtained a ruling from the Service according our contract annuity tax treatment.

In good faith reliance on this ruling, we transformed our operations and essentially limited ourselves to developing this annuity business. Again, on January 15, 1980, we received another ruling when we accommodated our annuity to a change that the Service had required. At least as recently as March 24, 1980, the Service issued a favorable ruling to another company offering a comparable type of annuity.

Then suddenly, and without any notice or opportunity to be heard, on September 24, 1980, the Service completely reversed its position. It issued Rev. Rul. 80-274, and we were advised that it revoked the rulings that had been issued to us. This was done even though our contract uniquely provides for our assumption of Regulation Q penalties and is, therefore, materially distinguishable from the situation described in Rev. Rul. 80-274, as I pointed out in my testimony before this Committee on November 19, 1980, during the hearings on S. 3082, S. 3094 and H.R. 6806, 96th Cong., pp. 126, 127. Incidentally, thanks to the intercession of this Committee, we finally did receive the "grandfathering" to which I there referred.

This precipitous reversal by the Service was not made because of any change in the Code or in the regulations or because of a new judicial decision. It came about because our type of annuity was understandably receiving widespread public accept-

ance, with imitators following in our wake. This distressed and perturbed the prior administration, which was fundamentally opposed to the Code's treatment of deferred annuities. This hostility was expressed most recently to this Committee in the above-referenced hearings on November 19, 1980, p. 24. Earlier, in 1978, the prior administration had proposed legislation that would have eliminated tax deferral for all non-qualified deferred annuity contracts, with a limited exception for fixed dollar annuities.[1]

As a reason for urging the enactment of this legislation, the administration specifically referred to the savings annuity addressed by Rev. Rul. 80-274.[2] I understand that rulings on such annuities issued to others, after the proposal for amendment was initiated, specifically cautioned that should the proposal be enacted the rulings would be nullified. The House Ways and Means Committee, however, decisively rejected the proposal for statutory amendment.

The "flip flop" embodied in Rev. Rul. 80-274 is simply an effort, by administrative legerdemain, to effect a statutory amendment which the Congress rejected. Needless to say, if the Code is to be amended that is the prerogative of the Congress and not of the Service.

Moreover, Rev. Rul. 80-274 is noteworthy as an exercise in bureaucratic gymnastics. As the predicate for Rev. Rul. 80-274, the Service suddenly decided to invoke a revenue ruling that had antedated the rulings we had received, namely, Rev. Rul. 77-85, which was issued in March 1977, shortly before we received our first ruling. The Service obviously concluded, and correctly, that its rulings to us, as well as to others over a four-year period, did not conflict with the previously issued Rev. Rul. 77-85. Our situation was distinguishable.

Nor was Rev. Rul. 77-85 overlooked. I, and my counsel, had discussed the ruling and its relevance to our situation with the Service before it issued its first ruling to us in August 1977. Rev. Rul. 77-85, which has now even been judicially discredited,[3] has no more relevance today than it did in August 1977 and in January 1980 when we received our rulings. Rev. Rul. 77-85 is simply being used now as a pretext to mask an administrative amendment to the Code.

Finally, Rev. Rul. 80-274 is devoid of any meaningful legal exposition or explanation. It concludes that the insurance company is not the owner of the certificates of deposit funding the annuity. In our case, we are the legal owner of the certificates. They are solely in our name. We alone possess the dominion and control over those certificates. And we also bear the consequences and risks of that ownership. It was the liability engendered by this ownership that prompted my apperance before this Committee last November to urge that our outstanding contracts be "grandfathered". As the owner of the certificates, we, unlike our imitators, bear the burden of the Regulation Q penalty for any early termination. Because of these penalites, had our contracts not been "grandfathered" we faced the prospect of approaching insolvency. In these circumstances, it is fanciful to suggest that we are not the owner of the certificates of deposit that fund our annuities. Ironically, we assumed the liability for the Regulation Q penalty at the verbal suggestion of the Service so that any question as to our ownership would be foreclosed.

I want to thank you for your time and attention. I urge upon you the need for a speedy resolution of this matter.

INTERNAL REVENUE SERVICE,
DEPARTMENT OF THE TREASURY,
Washington, D.C., January 15, 1981.

Mr. ROBERT R. BARROW,
INTERNATIONAL GENERAL INSURANCE CORP.,
Milwaukee, Wis.

DEAR MR. BARROW: This is in response to a request dated December 14, 1979, made on your behalf by your authorized representative, concerning the ownership of deposits placed in savings and loan institutions in connection with your group single premium retirement annuity plan. A similar annuity plan was the subject of our letters to you dated August 30, 1977, and December 4, 1979, but the current ruling letter contains some changes in facts which are reflected in the description below.

The information submitted indicates that the taxpayer is a life insurance company taxable under section 802 of the Internal Revenue Code. The taxpayer will enter into agreements with savings and loans whereby the savings and loans will be the

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[1] The President's 1978 Tax Program, pp. 139, 141-142.

[2] *Ibid.*, pp. 184-185.

[3] *Investment Annuity Inc.* v. *Blumenthal*, 442 F. Supp. 681 (D.C. 1977); reversed on jurisdictional grounds, 609 F. 2d 1 (D.C. Cir. 1979); cert. denied, 446 U.S. 981 (1980).

group contract holders, and will enroll their depositors in the annuity plan in the same way as most employers enroll employees in health and other insurance plans. The savings and loans will receive expense reimbursements for their services. The taxpayer will deposit the preminums in the savings and loans, as segregated accounts. The taxpayer will have all the incidents of ownership of the deposits, and the deposits will be held in the taxpayer's own name, and not as an agent for the annuitant. The savings and loans will pay their usual interest on these deposits.

The annuitant's cash value in his annuity plan will be the premium paid plus interest accumulated at a minimum of 3 percent per year, compounded annually. If the savings and loan pays less than the quaranteed rate, the taxpayer will make up the difference to reach the guaranteed rate. In addition, excess interest may increase the cash value of the policy, as determined by the Board of Directors of the taxpayer.

The annuity plan provides various options for payment of benefits, including lump sum payments, installments for a specified period, installments for a specific period and life thereafter, and joint and survivor life income. The benefit are paid under a permanent purchase rate guarantee.

The annuitant does not have direct access to the deposits in the savings and loan, except as the terms of the annuity plan allow him payments of benefits, loans on the cash value of the policy, or surrender of the policy for its cash value less a cash surrender charge. If the annuitant dies prior to the annuity starting date, having designated a contingent payee, the contingent payee will receive in one sum the payment due after the death of the annuitant.

The provisions of the annuity plan indicate that the annuitant has no direct access to the assets in the account in the savings and loan, but instead has a right to receive payments in amounts and under conditions specified under the terms of the annuity plan. The taxpayer will be the recipient of the interest earned on the deposit placed in the savings and loans in connection with the annuity plan, and the annuitant will receive increases in cash surrender value, only as specified under the guaranteed and excess interest provisions of the annuity plan.

Accordingly, it is held that the taxpayer will be the owner of the deposits in the savings and loans placed there in connection with the annuity plan, for purposes of determining the taxpayer's gross investment income under section 804(b) of the Code.

Pursuant to a power of attorney on file in this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

JOHN L. CRAWFORD,
Chief, Corporation Tax Branch.

VORYS, SATER, SZYMOUR AND PEASE,
Washington, D.C., December 14, 1979.

MS. MINDY SPIER, TLS,
Internal Revenue Service, Corporate Tax Division, Washington, D.C.

DEAR MS. SPIER: This letter is in reference to your letter to International General Insurance Company, dated December 4, 1979. Clarification is requested to the effect that your ruling letter to International General Insurance Company, dated August 30, 1977 will be valid under certain circumstances. Specifically, it is requested that the August 30, 1977 letter can be relied upon when International General Insurance Company is the legal owner of the pertinent deposits in the financial institution and such ownership is reflected on the passbooks of the deposits.

Best regards,

M. PETER MCPHERSON.

Attachments: Letter referred to above.

DEPARTMENT OF THE TREASURY,
INTERNAL REVENUE SERVICE,
Washington, D.C., December 4, 1979.

INTERNATIONAL GENERAL INSURANCE CORP.,
Milwaukee, Wis.

Attention: Mr. Robert R. Barrow,
Taxpayer, International General Insurance Corp.

DEAR MR. BARROW: This letter is in reference to your Group Single Premium Retirement Annuity Contracts that were the subject of our letters to you dated August 30, 1977, (Written Determination Number 7748012) and March 5, 1979.

After careful consideration of the matters discussed in our conference with you on April 18, 1979, and your subsequent communications with our office, we have concluded that it will be necessary for us to modify our earlier ruling letter for the following reasons.

If the language on the passbooks representing the deposits held in financial institutions pursuant to the annuity plan refers to any party other than the taxpayer, such language is inconsistent with the actual relationships involved. You have represented that the annuitant derives benefits solely pursuant to the terms of the annuity contract. The taxpayer will be the legal owner of the accounts and will have control, along with the financial institutions, over the investment of the funds in the accounts.

In Revenue Procedure 79-14, 1979-10 I.R.B. 30, the Internal Revenue Service announced, in Section 4.01, that it will not issue advance rulings or determination letters as to who is the true owner of property or the true borrower of money in cases in which the formal ownership of the property or liability for the indebtedness is in another party.

Our earlier ruling letter to you involved an arrangement whereby each passbook would state that the taxpayer owned the account as agent for the annuitant. Based on the inconsistency between this language and Rev. Proc. 79-14, we can no longer continue that ruling letter in effect. Moreover, if the taxpayer is to be held to be the owner of the accounts, and to hold them as part of its total reserves, it is inconsistent for the passbooks to note any designation other than the taxpayer is the owner of the accounts.

Accordingly, our ruling letter to you dated October 23, 1978 cannot be relied upon for any annuity contracts issued subsequent to 90 days after the date of this letter. The prior ruling letter will be valid for contracts issued prior to that date pursuant to section 7805(b) of the Internal Revenue Code.

Pursuant to a power of attorney on file in this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

GERALD PORTNEY,
Assistant Commissioner (Technical).

DEPARTMENT OF THE TREASURY,
INTERNAL REVENUE SERVICE,
Washington, D.C., August 30, 1977.

INTERNATIONAL GENERAL INSURANCE CORP.,
Milwaukee, Wis.

Attention: Mr. Robert R. Barrow.

DEAR MR. BARROW: This is in response to your request for a ruling dated June 27, 1977, dealing with the ownership of deposits placed in savings and loans in connection with the annuity plan described below.

The Group Single Premium Retirement Annuity Contract (hereinafter referred to as the Annuity Plan) will be sold by International General Insurance Corporation, P.O. Box 3667, Milwaukee, Wisconsin 53217; Texas International Life Insurance Company, Suite 500, First Federal Plaza, Austin, Texas 78701; and companies associated with International General Insurance Corporation (the selling company hereinafter referred to as the insurance company).

It is proposed that the insurance company sell the Annuity Plan to depositors of savings and loans, and to that end, the insurance company proposes to enter into agreement with savings and loans whereby the savings and loan will be the Group Contract Holder. The savings and loan will enroll its depositors in the program just as most employers enroll employees in health and other insurance plans. The savings and loan will receive expense reimbursements for their services. The insurance company will deposit the premiums in the savings and loan. These deposits will be segregated accounts with the insurance company holding legal title to the accounts. The insurance company will hold the passbooks for the accounts, and each passbook will read, "The insurance company holds this account as agent for annuitant X, subject to the terms of the Annuity Plan." The savings and loan will pay its usual interest on these deposits.

The annuitant's cash value in his Annuity Plan will be the premium paid plus interest accumulated at three percent (3 percent) per year, compounded annually. (In the case of Annuity Plans sold by International General Insurance Corporation, 100 percent of the premiums paid will be included in the cash value, and for plans sold by Texas International Life Insurance Company, 98 percent of the premium paid will be included in the cash value for the first year, and 100 percent for each

subsequent deposit.) In effect, the above is the annuitant's minimum interest in this annuity; if the savings and loan only paid two-and-one-half percent (2½ percent) interest on the deposits made by the insurance company for the benefit of the annuitant involved, the insurance company would have to make up the extra one-half percent (½ percent). In addition, certain "excess interest" may increase the cash value of the policy, if so determined by the Board of Directors of the insurance company. (Annuity Plans to be sold by International General Insurance Corporation include additional wording to the effect that in no case can the amounts of excess interest credits be less than the interest paid by the savings and loan on the pertinent deposits, diminished by one percent (1 percent) and further diminished by the guarantee rate.)

The Annuity Plan provides various options for payment of the benefits, e.g. lump sum, payment over a period of years. The benefits are paid under a permanent purchase rate guarantee.

The annuitant does not have direct access to the interest earned on the deposit in the savings and loan, except as the terms of the Annuity Plan allow him payments of benefits, loans on the cash value of the policy, or surrender of the policy for its cash value less a cash surrender charge. If the annuitant dies prior to the annuity starting date, having designated a contingent payee, the contingent payee will receive in one sum the payment due after the death of the annuitant.

Based on the above, the provisions of the Annuity Plan indicate that the insurance company will be the recipient of the interest earned on the deposits placed in the savings and loans in connection with the Plan. The annuitant has no direct access to the assets in the account, but instead has a right to receive annuity payments in amounts pursuant to the insurance company's obligations under the terms of the Annuity Plan.

Therefore, it is ruled that the insurance company will be the owner of the deposits in the savings and loans placed there in connection with the Annuity Plan, for purposes of determining the insurance company's gross investment income under section 804(b) of the Internal Revenue Code.

Pursuant to a power of attorney on file in this office, a copy of this letter is being sent to M. Peter McPherson at Vorys, Sater, Seymour and Pease, 1800 M Street, N.W., Suite 800-South, Washington, D.C. 20036.

A copy of this letter should be attached to your Federal income tax return.

Sincerely yours,

JOHN L. CRAWFORD,
Chief, Corporation Tax Branch.

FEDERAL HOME LOAN BANK BOARD,
Washington, D.C., October 10, 1980.

Hon. G. WILLIAM MILLER,
Secretary, Department of the Treasury,
Washington, D.C.

DEAR MR. SECRETARY: I am writing to express my concern over the recent issuance of Revenue Ruling 80-274. The practical effect of the ruling is to preclude the use of group single premium retirement annuity contracts under which Federally insured savings and loan associations are designated as group contract holders. I believe the Internal Revenue Service should withdraw this recent ruling, and that the Treasury Department and the Internal Revenue Service should reconsider carefully the legal and policy implications of the ruling.

I am concerned about the adverse impact of the ruling on savings account funded annuity plans because these plans can be a significant incentive for increased savings by a major segment of the American public, and because these annuity plans have the potential to become a significant source of stable funds for Federally insured savings and loan associations.

Although Revenue Ruling 80-274 is limited obstensibly to the facts of a specific type of annuity contract involving savings and loan associations, as a practical matter, it raises major policy questions concerning the tax treatment of other types of annuities as well. The ruling fails to provide any reasoned legal analysis for its conclusion. In fact, strong legal arguments and precedent exist for concluding that the ruling is incorrect as a matter of law.

In view of the important policy considerations and the complex legal questions raised by the ruling, I believe it is more appropriate for a decision on the tax treatment of these annuity contracts to be the subject of a proceeding that would provide interested individuals and governmental agencies, including the Bank Board, an opportunity to participate. Therefore, I recommend immediate withdraw-

al of Revenue Ruling 80-274 and commencement of a rulemaking proceeding to consider the important and difficult issues raised by this ruling.

Sincerely,

JAY JANIS,
Chairman.

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* * * equal to the cash settlement * * * beneficiary, however, may instead elect to receive either an annuity for a term certain or a lifetime annuity, subject to a guaranteed minimum number of monthly installments.

LAW AND ANALYSIS

Section 61(a) of the Internal Revenue Code provides that gross income means all income from whatever source derived, including interest.

To the extent that a policyholder under an annuity contract with a life insurance company possesses substantial incidents of ownership in an account established by the insurance company at the direction of the policyholder, the policyholder may be considered the owner of the account for federal income tax purposes. See Rev. Rul. 77-85, 1977-1, C.B. 12.

Under the annuity contract, the policyholder's position is substantially identical to what the policyholder's position would have been had the investment been directly maintained or established with the savings and loan association. Prior to the annuity starting date, L is little more than a conduit between the policyholder and the savings and loan association.

HOLDING

Prior to the annuity starting date, the policyholder, and not L, is the owner of the savings and loan account for federal income tax purposes and the interest on the account is thus includible in the policyholder's gross income under section 61(a) of the Code.

DEPARTMENT OF THE TREASURY,
INTERNAL REVENUE SERVICE,
Washington, D.C.

WASHINGTON, D.C.—The Internal Revenue Service today announced that life insurance companies will not be considered the owner of certain savings and loan association accounts held in connection with so-called "wrap-around annuity" contracts sold to depositors. The interest on these accounts is therefore includible in the gross income of the depositors.

This announcement is contained in Revenue Ruling 80-274, which is attached and will also appear in Internal Revenue Bulletin No. 1980-42, dated Oct. 20, 1980.

ISSUE

Is the life insurance company or the depositor the owner for federal income tax purposes of the savings and loan accounts established in accordance with the annuity plans described below?

FACTS

L, a life insurance company taxable under section 802 of the Internal Revenue Code, has developed so-called group single premium retirement annuity contracts ("annuity plans") that have been approved in several states by their respective regulatory departments. The terms "annuity" and "policyholder" as used in this revenue ruling are for descriptive convenience only and are not intended to have any substantive legal significance.

L has entered into agreements with participating federally-insured savings and loan associations. Under each agreement, the participating association is designated as the group contract-holder under an annuity plan. *L* sells annuity contracts under the plan to existing depositors of the participating association and others wishing to establish accounts with the association ("depositors").

Under a plan, a depositor transfers cash, an existing passbook savings and loan account, or certificate of deposit to *L* in exchange for an annuity contract. The amount paid by the depositor to *L* is reduced by *L* from 2 to 5 percent for sales expenses, administrative expenses, and any premium tax imposed on *L*. This reduced amount is segregated by *L* and deposited into a separate account of the

savings and loan association of the depositor. The amounts deposited are invested in a certificate of deposit for a term designated by the depositor. When the certificate of deposit expires, *L* is required under the contract to reinvest the proceeds in a certificate of deposit for the same duration unless an investment of the same duration would extend beyond the annuity starting date. In that event, a certificate of deposit with a maturity not extending beyond the annuity starting date will be purchased. If no such certificate of deposit is available, the funds will be invested in a passbook savings account.

At the option of the depositor (referred to in the contract as the "policyholder") additional amounts may be transferred to *L* that become part of the consideration for the contract.

Pursuant to the agreement between *L* and the participating savings and loan association, *L* may not dispose of the deposit, or convert it into a different asset, other than in accordance with the reinvestment provisions described above. *L* may not use the deposit for any purpose other than to benefit the particular policyholder. This arrangement is intended to afford each policyholder's deposit the maximum federal insurance coverage of $100,000 per account under federal regulations.

L does, however, retain the right to withdraw the deposits from a failing savings and loan association or from an association that terminates the plan. in the event of withdrawal, *L* must deposit the withdrawn amounts in another federally-insured savings and loan association.

Interest earned on the investments is credited annually to each annuity account by *L* after payment to *L* of an annual management fee of one percent of the accumulated value of the account. *L* guarantees that the deposit will earn interest at 4 percent per year compounded annually from the date of deposit. The current yields for certificates of deposit offered by the association range from 7 percent to 11 percent depending upon the term of the certificate. The policyholders have no contractual relationship with the association. Their rights are derived solely from their annuity contracts, and *L* may satisfy its obligations to the policyholders under these contracts using funds derived from sources other than the accounts held pursuant to the plans.

A policyholder may withdraw all or a portion of the cash surrender value of the contract at any time prior to the annuity starting date upon written request to *L*. The cash surrender value of the contract is the amount deposited plus interest credited less a charge for withdrawal. The withdrawal charge is the early withdrawal penalty charged by the savings and loan association plus any premium tax resulting from the withdrawal. The association does not have the right to distribute any assets from the savings and loan account directly to any policyholder or to any beneficiary or assignee.

The annuity contract allows the policyholder to elect one of a variety of settlement options including a lump-sum payment, a life income option, installment options for a specified amount or a specified period, and installment payments for a period certain and for life thereafter.

If a policyholder dies prior to the annuity starting date, a lump-sum is payable to the beneficiary in an amount * * *.

WISCONSIN EMPLOYERS GROUP,
Green Bay, Wis., March 30, 1981.

To: Senate Finance Subcommittee on Taxation and Debt Management.
Subject: S. 446.

STATEMENT OF POSITION

Mr. Chairman, members of the Committee, my name is Wayne W. Spencer, CLU. I am Vice President of Wisconsin Employers Insurance Company, Green Bay, Wisconsin. I have asked to testify here this morning in support of Senate Bill 446.

In late 1977 my company designed a product called "T.D.A.". It was a Tax Deferred Annuity created specifically to be distributed by financial institutions. This Tax Deferred Annuity was filed and approved by the Wisconsin State Insurance Department. We then requested review by the Internal Revenue Service of the program. In two private letter rulings—one dated November 9, 1978, the other dated December 3, 1979—the IRS, in effect, confirmed its tax deferred status. T.D.A. was then offered by our financial institutions as a tax deferred annuity. It contained benefits, such as guaranteed lifetime income, that are only available in a tax deferred annuity. As it was a tax deferred annuity and not simply another type of savings plan, approval was granted by both the Wisconsin State Commissioner of Banking and Wisconsin State Commissioner of Savings and Loan for distribution by

their respective financial institutions. We also requested and received insurance on our corporate premium deposits by both the FSLIC and FDIC.

On September 24, 1980 the IRS issued Rev. Rul. 80-274. In effect, they took the same facts that they had reviewed numerous times before and reversed their position, declaring that T.D.A. no longer enjoyed tax deferred status.

My Company, the financial institutions working with us and their customers were stunned by this reversal without warning. This apparent total disregard for the reliance we had placed on their previous position would seem to make any future attempt to provide similar incentives to the American saver suspect. The confidence factor can only be restored by an immediate reversal of Rev. Rul. 80-274.

Annuities have long enjoyed tax deferred status as a result of early congressional wisdom. This wisdom based on the fact that Americans—given an incentive—are not only willing, but eager to set aside part of their current income to provide for their future. Reversal of Rev. Rul. 80-274 and restoration of T.D.A. will allow financial institutions to perform their traditional role in maintaining a stable economy. The present cost of mortgage money—if you can find any—is so high that most Americans can no longer afford the price of a home. The frightening decline in the number of new homes being built and the escalating unemployment in the construction industry all result from financial institutions being unable to attract and maintain long-term deposits. Our premium deposits will provide those funds. Everyone seems to be offering their own solution to these problems. Most of the solutions call for some type of governmental intervention. I maintain that the solution is already available and more importantly, has already met with congressional approval. That solution is restoration of T.D.A.!

Through our counsel we have attempted to reason with the IRS. This process has proved fruitless. It is apparent, therefore, that Congress must once again assert its belief and re-emphasize its original wisdom by overturning Rev. Rul. 80-274. It is my hope that we take the first step today with this Committee's approval of S. 446. With your permission, Mr. Chairman, I would like the supporting documents such as private letter rulings and various approval letters mentioned in my statement entered into the record.

Thank you for giving me the opportunity to present my views. I would be happy to answer any questions the Committee may have.

Senator PACKWOOD. Next we will have a panel consisting of Mr. Blazzard, Mr. Bunker, Mr. Berlin, and Mr. Hesselbein.

Before we start, I believe Senator Burdick would like to say a few words about one of the witnesses.

STATEMENT OF SENATOR QUENTIN N. BURDICK OF NORTH DAKOTA

Senator BURDICK. Mr. Chairman, it's indeed a pleasure for me to introduce one of the members of the panel this morning. He is Art Bunker, from Fargo, N. Dak., who enjoys a fine reputation in our State; has been in the insurance business since 1954; distinguished himself as a fine legislator in our State legislature; and he was speaker of the house, 1973 and 1974; and he is very conversant with the problems we have before us today.

The issue that he is going to talk about revolves around the action by the Internal Revenue Service.

September 9, 1977, the American Life, he represents, questioned a private letter of the Internal Revenue Service canceling an annuity plan it hoped to market through banks and savings and loan associations.

After waiting nearly a year for an answer to their request, American Life received their favorable ruling, dated September 6, 1978. On March 5, 1979, the Service advised American Life that a modification of their ruling was being contemplated.

Then on December 3, 1979, the IRS did in fact modify its prior ruling of September 6, 1978. This modification had the effect of negating insurance of accounts by the Federal Savings and Loan Insurance Corporation.

I think this is a very serious question, Mr. Chairman, and I hope we go into it in depth. Now, whether or not these rulings can be made off and on, and not be able to rely upon what the findings have been, I think this is a very serious question to look at in depth.

Senator PACKWOOD. Senator Burdick, thank you.

Gentlemen, you know our time limits. Your entire statements will be placed in the record and I would appreciate your summarization of them.

And, we will start with Mr. Blazzard.

STATEMENTS OF NORSE N. BLAZZARD, BLAZZARD, GRODD & HASENAUER, WESTPORT, CONN.; ART BUNKER, MARKETING DIRECTOR, FINANCIAL INSTITUTIONS, AMERICAN LIFE & CASUALTY INSURANCE CO., FARGO, N. DAK.; DENNIS B. BERLIN, EXECUTIVE VICE PRESIDENT, NATIONAL SAVINGS & LOAN LEAGUE, WASHINGTON, D.C.; PHILIP J. HESSELBEIN, EXECUTIVE VICE PRESIDENT, FIRST SAVINGS ASSOCIATION OF WISCONSIN, MILWAUKEE, WIS.

Mr. BLAZZARD. Mr. Chairman, I am Norse Blazzard, of the Westport, Conn., law firm of Blazzard, Grodd & Hasenauer. I am here as counsel to the Ad Hoc Committee on Individual Taxation of Annuities, which is a committee which represents a broad scope of the annuity industry. We have representatives from life insurance companies, stock brokerage firms, mutual fund management companies, bank institutions, insurance agencies, and so on.

The committee was formed in response to revenue ruling 80-274. And, I think it is important to put this ruling in its proper context.

Revenue Ruling 80-274 does nothing more than state that the product which was the subject of that ruling is not an annuity contract for purposes of Federal tax law.

We believe that there is no legal basis for this conclusion. We particularly believe that there is no legal basis for this conclusion in light of the Treasury Department's own regulations, section 1-72-2(a)(1), which states:

> The contracts under which amounts paid will be subject to the provisions of section 72 include those contracts which are considered to be life insurance, endowment and annuity contracts in accordance with the customary practice of life insurance companies.

We submit that the companies which were selling the products, which were the subject of Revenue Ruling 80-274, had in fact established that these were annuity contracts. And, if they are annuity contracts, then they are subject to taxation under section 72, of the code.

Section 72 has been in the code since it was initially enacted in 1954.

The tax treatment of annuities under section 72 was reconsidered again in the Life Insurance Company Tax Act of 1959, when section 801(g)(1) was enacted. And again in 1962, when section 801(g)(1)(B) was enacted.

At that time, presumably, Congress considered the tax deferral policy considerations involved in annuity contracts.

It is my belief that what the Treasury Department is saying to us, by the testimony they have presented, and by the actions they

have taken with these revenue rulings which are the subject of this legislation, is that the only kind of annuity which will qualify as an annuity for Federal tax purposes is one which is so bad an investment no one could buy it. [Laughter.]

Basically, it is the end result of these products they dislike. And they have enacted these rulings, basically, to usurp the prerogatives of Congress in establishing the laws applicable to annuity contracts.

And, I think Congress has very accurately stated their intent in the sections involved.

The Treasury Department has stated that there is no question that a straight annuity or variable annuity will qualify as annuities for tax purposes. And, yet they have refused and continued to refuse to issue any rulings to the insurance industry specifying what those kinds of annuity contracts are.

It is impossible for a businessman to function in an area where they do not know the rules under which they are playing.

We believe that the bills which are presently pending before this subcommittee are an important statement by you that it is you who make the tax laws of this country and not the Internal Revenue Service.

The constituency that I represent, which is made up of the full scope of the annuity industry, is asking you to please take active and prompt action on these bills so that we can ameliorate this problem and so that the companies involved can go back to selling the products which are so desperately needed by the public in these times of inflation and financial uncertainty.

Thank you.

Senator PACKWOOD. Thank you, Mr. Blazzard.

STATEMENT OF ART BUNKER, MARKETING DIRECTOR, AMERICAN LIFE & CASUALTY INSURANCE CO.

Mr. BUNKER. Now, Mr. Chairman, my name is Art Bunker. I am marketing director, Financial Institutions, American Life & Casualty Insurance Co., Fargo, N. Dak.

First of all, I certainly appreciate the opportunity to testify and appreciate the fact that this hearing is being held at a relatively early date.

I certainly appreciate, Senator Burdick, your appearing on our behalf, and more supportive in our problem since its inception, and our company and all of our citizens in North Dakota that are in this program do appreciate your support.

Mr. Chairman, much of my written formal testimony has already been touched on. I won't replough that ground. But, in Senator Burdick's statement he gave you a chronology of events, whereby we applied for a private letter ruling in September 1979.

After a year—short of a year, about 3 or 4 days—we finally received that ruling. The Revenue Service then advised us of a potential modification, then did that.

As the Senator pointed out, the effect of this modification caused us to lose the insurance of accounts offered by the Federal Savings and Loan Insurance Corporation.

To continue on with this chronology of events, American Life then sought a new private letter ruling covering a new annuity policy form. This was filed on January 11, 1980.

Incidentally, by filing this new policy form, we had to again go to every State insurance department, in which we were doing business and seeking to market this annuity, to get another approval of a policy form. And we also had to go back to the Federal Home Loan Bank Board and the FDIC to effect insurance of accounts.

After we had applied for this ruling on January 11, 1980, on March 24, the Service issued a private letter ruling, the terms of which American Life is operating under at the present time. Or, I should say, was operating under until it suspended sales on September 24 when they learned of the release of that date.

This release seemed to be so ambiguous, confusing, that American Life and its 220 contract financial institutions and over 3,350 annuitants were in a significant state of confusion and concern.

After an agonizing period of several weeks, waiting to learn the status of Ruling 80-274, as it pertained to the tax status of American Life and its annuitants, it was determined by the IRS that all annuitants were "grandfathered" and would have income tax deferrals for the life of their annuity.

American Life and its contracted financial institutions have expended vast sums of money, time, and energy in developing a product that appears to benefit all parties. It, obviously, benefits the individual saver; it benefits the financial institution, because it has a tendency to stabilize their deposits and enhance new deposits into the thrift industry which then trickles on down to the building industry and makes more money available for mortgages at a more attractive rate.

And it, of course, benefits our company and that's primarily why I am here. We wouldn't be in the business if it wasn't a benefit to us.

And, even it benefits the U.S. Treasury, as income tax is only deferred. In fact, income tax collections on the interest earnings at a deferred date should provide greater ultimate tax revenues than current taxation would generate.

Several financial institutions had expended vast sums promoting the annuity through various media sources. Some had placed advertising in national magazines such as Newsweek, Sports Illustrated and others that they were unable to cancel.

The abrupt issuance of 80-274 caused considerable unrecoverable expense, confusion and consternation.

American Life's annuity policy forms, administration, and sales methods totally complied to previously issued rulings. Ruling 80-274, which was issued without notice or opportunity of hearing, was at least arbitrary, capricious, and ill-timed.

There had been no change in the law; no change in regulations; simply, the IRS had a change of their mind.

Thank you very much, sir.

Senator PACKWOOD. Thank you very much.

Mr. Berlin.

STATEMENT OF DENNIS B. BERLIN, EXECUTIVE VICE PERSIDENT, CHEVY CHASE SAVINGS & LOAN

Mr. BERLIN. Thank you.

Mr. Chairman and members of the committee, my name is Dennis B. Berlin. I am executive vice president of Chevy Chase Savings and Loan in Chevy Chase, Md. And I am also the vice chairman of the Governmental Affairs Committee of the National Savings and Loan League, whose views I represent today.

The National League appreciates the opportunity to express its views on S. 388 and S. 446, which have very important implications for our business and for the capital formation needs of our economy.

These IRS rulings, besides exceeding the statutory reach of the Service, are detrimental to the capital formation, one of the most serious problems this country faces and recognized as such by the Reagan administration.

The savings and loan associations in this country are desperately trying to induce additional savings. That is why we support expanded IRA/Keogh authority and tax exemption of interest on savings, among others.

These rulings work against this very desirable goal.

Tax deferred annuities have proven to be a successful and convenient method for certain individuals to save, and their potential is significant.

These prospects for increased levels of savings, without this annuity program, the other incentives we mentioned are not bright.

It is difficult to make an estimate as to the impact of 80-274 on the saver annuity program. At the time it was released, there were approximately 400 savings and loans across the country who were managing or implementing such a program.

Although we suspect that the actual amount of dollars invested in these accounts have been low, simply because these annuities were just getting started. We are very concerned about the potential which has been lost.

In particular, the Iowa Savings and Loan League was active in marketing these annuities. They tell us that more than $50 million of these annuities have been sold between March and mid-September when the ruling was released.

One association, Leader Federal in Memphis, Tenn., received over $5 million in savings annuity deposits in the 4-month period prior to the issuance of Revenue Ruling 80-274.

This is a significant figure, considering the fact that the savings public was not particularly familiar with them.

The association reports that these accounts appealed to a broad segment of the savings market, including young two-income families who found these accounts to be an effective way to build savings for the future.

In summary, we would strongly urge the committee to reject Revenue Rulings 77-85 and 80-274, not only because they are overreaching on the part of the IRS, but because they aggravate the very serious savings investment and capital formation problems which we are faced with today.

We, therefore, respectfully urge this committee and the Congress to enact this legislation.

Thank you very much.
Senator PACKWOOD. Thank you.
Mr. Hesselbein.

STATEMENT OF PHILIP HESSELBEIN, FIRST SAVINGS ASSOCIATION, MILWAUKEE, WIS.

Mr. HESSELBEIN. Mr. Chairman, my name is Philip Hesselbein, from Milwaukee, Wis. I appear today on behalf of the U.S. League of Savings Associations.

I support S. 446, the legislation by Senators Symms and Lugar to overturn Revenue Ruling 80-274.

That action by the IRS last September denied tax deferred treatment to the earnings on certain annuities funded by certificates of deposit purchased from savings and loans associations and banks, known as "savers' annuities".

This was a relatively new, and immensely promising, source of savings for the thrift institutions which provide the bulk of home mortgages for Americans.

Prior to last September, our savings association, the First Savings Association of Wisconsin, one of the pioneers in this product, had attracted 3,400 customers and $35 million in savings.

The insurance company invested in our money market and small saver certificates, paying top dollar to the annuitants. As a rough estimate, these funds enabled us to make 700 home loans.

This committee is well aware of the sad state of housing and the home finance business in these inflationary times.

Building permit figures and commitments to lend suggest that real estate activity could remain depressed for some time. The slowdown in housing is damaging to sawmills, lumber dealers, and many other suppliers of products that go into homes.

Savings and loan associations are poorly equipped to compete for savings in periods of high inflation. Our long-term mortgage portfolio yields cannot keep up with our short-term savings costs, leading to our much publicized earnings squeeze.

With this structural problem, it is essential that the savings and loan business be encouraged to develop systematic longer term sources of funds, if we are to continue to fulfill our congressionally mandated mission of home finance.

That is why the savers' annuity is so promising. There are, of course, other worthwhile savings programs to plan for one's retirement years. But, under current rules, the individual retirement account, the IRA, is not available to wage earners in a qualified pension program. And it is carefully limited, because both principal and interest are tax deferred.

A need remains for encouraging retirement savings in the private sector without such eligibility in dollar restrictions.

At my association, the ability to defer taxes on earnings alone, the savers' annuity, has proven its appeal.

Obviously, all private-sector programs to encourage retirements savings help relieve the escalating burden on entitlement programs such as social security.

Enactment of S. 446 would encourage individuals to plan for their retirement. It would enable our Nation's home finance specialists, the savings and loan associations, to compete more sucess-

fully with other tax-deferred opportunities in the marketplace for savings.

It would reinstate a useful source of funds for housing and real estate, and do so when it is needed.

Mr. Chairman, I appreciate this opportunity to testify and urge you and Congress to act favorably on S. 446.

Senator PACKWOOD. Gentlemen, thank you.

Let me ask you one question and it doesn't relate to the substance of the issue. I agree with you on that.

There are frequent references in the testimony to the Internal Revenue Service's letter rulings. This is a continuing problem, not new to this hearing. Frequently, constituents of mine will besiege me to ask the IRS simply to issue a letter—not one way or the other—just issue it.

And the letter rulings are always issued with a caveat that the letter does not bind the IRS for the future. And, yet, today there runs through the thread of your testimony that we had these letter rulings and, therefore, the IRS, more or less, ought to be estopped from changing its position.

I know that if that were the rule, the IRS simply would not issue the letter rulings, period. And all issues would either have to be changed by statute or litigated.

How do we solve that problem so that—you are fully aware that the letter rulings is just that, a ruling relating to the circumstance you've asked about, binding only so long as the IRS doesn't issue a more formal opinion.

How should we solve the problem?

Mr. BLAZZARD. Perhaps I can speak to that, Mr. Chairman, you know, being the technician in the group.

There is no easy solution to that problem. Everyone who obtains a private letter ruling does so with the understanding that it is not precedent and that it is not necessarily binding on the Service itself.

However, it is the opinion of the Internal Revenue Service as to what the law in fact is. Obviously, in the event litigation were going to take place, the Internal Revenue Service in the standard crucible of the courtroom would have a very difficult time saying that what they said the law was, was not the law. So, it does provide a great deal of protection in the event litigation should come about.

The problem is, under the anti-injunction statute, it is very difficult for the real party in interest to have any recourse to the courts. And, I think the case that Mr. Kelly referred to during his testimony is a very good example of this.

The court of appeals said that, in essence, an insurance company has no right to question the tax status of the contracts it issues. Which makes it impossible in today's very highly regulated environment for an insurance company to make any representations, whatsoever.

I will give you an example: As a result of Revenue Ruling 80-274, the Securities and Exchange Commission is requiring all issuers of traditional variable annuities to add additional disclosure to their prospectuses describing that Revenue Ruling 80-274 is so

broad in its context that it could conceivably be applied to any kind of an annuity.

Without a revenue ruling to rely on, in many instances, the State insurance departments will not permit a new type of contract to be issued.

When Revenue Ruling 77-85 was issued in 1977, every insurance department that had previously permitted the issuance of investment annuities suspended their sales immediately. So, it is very difficult for business people. It takes as much as a $1 million to $1½ million to get one of these annuity products up online, to get it through the various regulatory processes.

That being the case, it is very difficult for business people to make that kind of expenditure unless they, at least, have something they can grasp with some hope that the law will be applied uniformly.

Senator PACKWOOD. Senator Durenberger.

Senator DURENBERGER. No, thank you, Mr. Chairman.

Senator PACKWOOD. Senator Matsunaga.

Senator MATSUNAGA. No, thank you, Mr. Chairman.

Senator PACKWOOD. Senator Burdick.

Senator BURDICK. I agree with the chairman. What do we do about this in the future? We have a letter ruling and then within a year, or about a year, it's overturned. In the meantime, we've expended money and set up a business along these lines. Now, all of a sudden, we find ourselves in a different ball game. Will this legislation take care of it?

Mr. BLAZZARD. In this case, I believe it will, Senator, yes.

Senator PACKWOOD. This legislation will take care of this problem, but won't solve the generic problem about letter rulings binding the IRS.

Mr. BLAZZARD. We have a specific problem here in that although the term annuity is used some 200 times in the Internal Revenue Code, it is nowhere defined.

The only definition we have is in that Treasury regulation that I cited earlier, and they didn't even comply with their own regulations on the subject. So, I don't know what we do.

Senator PACKWOOD. You're right.

Any other questions?

If not, gentlemen, thank you very much.

[The statements of the preceding panel follow:]

SUMMARY OF PRINCIPAL POINTS IN THE STATEMENT BY NORSE N. BLAZZARD, ESQ., ON BEHALF OF THE AD HOC COMMITTEE ON INDIVIDUAL ANNUITY TAXATION

1. The Ad Hoc Committee on Individual Annuity Taxation supports legislation to obtain a satisfactory clarification of what is an annuity for purposes of federal income tax law.
2. Revenue Rulings 77-85 and 80-274 are contrary to tax laws enacted by Congress in Sections 72 and 801(g)(1) of the Internal Revenue Code.
3. There are various types of annuities. The annuities which were the subject of Rev. Rul. 80-274 fit the commonly accepted definitions of annuities as well as the specific provisions of the Internal Revenue Code.
4. Annuities enable individuals to provide for retirement security.
5. Annuities provide a source of savings to add to and stabilize the capital base of the nation.
6. There is no legal basis for Rev. Rul. 80-274.
7. Rev. Rul. 80-274 is inconsistent on its face.

8. The revocation of previously granted tax rulings is, in effect, a change in the law. Such changes adversely affect business' willingness to invest in new products and methods.

9. Rev. Rul. 80-274 has a chilling effect on capital formation.

10. Rev. Rul. 80-274 is an attempt by the IRS to usurp Congressional powers and to enact legislation.

11. Rev. Rul. 80-274 is an attempt by the IRS to limit the types of investment held under annuities which is not a legitimate use of its power.

12. Beware of the use of "loaded" terms which are not applicable to annuities.

13. Action is needed to correct an injustice and to clearly indicate that Congress, not the IRS, makes the tax laws for this nation.

Statement by Norse N. Blazzard, Esq., on Behalf of the Ad Hoc Committee on Individual Annuity Taxation

On September 24, 1980 the Internal Revenue Service (the "IRS") released the text of Rev. Rul. 80-274 (the "Ruling"). The vague legal reasoning contained in such Ruling made it difficult for insurers, marketing firms, individual taxpayers and their Counsel to determine which types of annuities were affected and which were not. As a result, representatives from a number of firms involved in the annuity business gathered at a meeting in Washington, D.C. on October 2, 1980, less than nine days after the Ruling was released.

More than seventy persons attended the meeting in an attempt to resolve the questions presented by the Ruling. These were representatives from life insurance companies, insurance agencies, stock brokerage firms, mutual fund managers, banking institutions and accounting and law firms.

After thorough discussion the group decided that the Ruling was so vague that it posed a severe threat to all types of annuities. This concern proved warranted when the Securities and Exchange Commission later required special disclosure about the Ruling in prospectuses for traditional types of variable annuity contracts.

It was also decided at the meeting that the Ruling had no legal basis and was, in fact, a direct contradiction of existing tax laws applicable to annuities. The group decided to establish a formal structure to resolve the problems raised by the Ruling. Thus, the Ad Hoc Committee on Individual Annuity Taxation (the "Committee") was born.

The Committee has established a mission: To obtain a satisfactory determination of what an annuity is for federal income tax purposes.

The Committee has resolved to seek redress through negotiation with appropriate government agencies and through legislative actions.

The Committee is represented by its General Counsel, Norse N. Blazzard, Esq., of the Westport, Connecticut law firm of Blazzard, Grodd & Hasenauer. It is also represented by legislative Counsel, Vorys, Sater, Seymour, & Pease, 1828 "L" Street, Washington, D.C.

Scope of this statement

This statement will discuss only those annuity contracts which are not used with "qualified" retirement plans which receive favorable tax treatment under Sections 401, 403, 404, 408 and 457 of the Internal Revenue Code of 1954, as amended (the "Code"). The annuity contracts discussed herein are, in all cases, purchased with funds which have already been subject to tax. No purchaser of any annuity discussed herein receives any tax benefits with respect to the annuity purchase payments. Although the general discussion about annuities contained in this statement also applies to annuities issued in connection with "qualified" retirement plans, the Ruling does not appear to apply to such annuities. Therefore, my discussion is limited to annuities used by individuals which are not issued under such "qualified" plans.

What is an annuity?

Generally, Section 72 of the Code provides for the tax treatment of annuities to individual taxpayers. Although the term "Annuity" is used several hundred times in the Code, it is nowhere defined therein. However, Treasury Regulations 1-72-2(a)(1), in determining what an Annuity is for purposes of Section 72 of the Code contains the following definition:

The contracts under which amounts paid will be subject to the provisions of Section 72 include those contracts which are considered to be life insurance, endowment and annuity contracts in accordance with the customary practice of life insurance companies.

Even though the Code itself contains no definition of an "Annuity," the life insurance industry and the Internal Revenue Service have long been in accord as to

what an annuity is and how an annuity is to be taxed. This accord began with the enactment of the Code in 1954. With the 1954 Code, Congress provided a specific scheme for taxing annuity income to individuals. Subsequent amendments to the 1954 Code included a "variable annuity" as an annuity for purposes of Section 72.

Most commentators would agree that an annuity (whether defined for general insurance purposes, for tax purposes or as understood by the public) is a contractual promise to make a series of payments for life or for a specified period of time.

It is generally believed that the annuity is the oldest form of life insurance!

Types of annuity contracts

There are numerous types of annuities, the characterizations of which sometimes overlap. To understand the different types of annuities it is best to characterize them in three different ways:

1. As to time annuity payments begin.
2. As to duration of annuity payments.
3. As to investment orientation.

Classification as to time annuity payments begin

The classification of annuities as to the time annuity payments begin includes two different kinds of annuities: Deferred Annuities and Immediate Annuities.

A Deferred Annuity is one in which the purchaser invests funds to accumulate until a future date when annuity payments are to begin. (In the Code this date is called the "Annuity Starting Date").

An Immediate Annuity is one in which the purchaser invests funds with an immediate Annuity Starting Date. (Usually, any annuity with the Annuity Starting Date within twelve months of the date of purchase is called an Immediate Annuity).

Classification as to duration of annuity payments

The classification of annuities as to duration of annuity payments generally refers to annuities which are either Life Annuities, Term Certain Annuities or Combination Life and Term Certain Annuities.

A Life Annuity is one where annuity payments are guaranteed for the entire life of the Annuitant (or Annuitants in the case of a joint annuity). This guarantee prevails regardless of the longevity of the individual payees or of the longevity of all Annuitants as a group. A life annuity contains an insurance element and, under the laws of most states, can be sold commercially only by a licensed life insurance company.

A Term Certain Annuity guarantees payments only for a specified time period (such as ten or twenty years). It contains no insurance element.

A Combination Life and Term Certain Annuity is one where the insurer guarantees payments to continue for the life of the payee (or payees) regardless of longevity, but with a provision that provides for continuation of payments to the beneficiary in the event the payee dies before receipt of payments for a specified number of years. Thus, the most commonly selected form of annuity is for a Ten Year Certain and Life Contract. Under such a Contract the Annuitant will receive monthly payments for life. However, if he or she should die before receiving payments for ten years, the monthly payments would be continued to the beneficiary for the remainder of the ten year period.

Classification as to investment orientation

Traditionally, all annuity contracts issued by insurers would guarantee a specified amount of money to be paid to the Annuitant. This guaranteed amount, payable at maturity of the contract (either in the form of monthly annuity payments or in lump sum), includes all principal plus a guaranteed interest rate. This is a "fixed annuity."

In the mid 1950's a new type of annuity was developed in an attempt to provide a protection against the inflation related erosion in purchasing power which is inherent in a fixed return investment. The new product was called a "variable annuity" and provided for the value of the annuity contract to fluctuate in accordance with the investment results of a specified underlying investment maintained by the insurer.

Although there is not complete agreement as to the precise definition of a "variable annuity," it is my opinion that a "variable annuity" is one in which the Annuitant bears the investment risk. A "fixed annuity" is one in which the insurer bears the investment risk.

Congress, in Section 801(g)(1)(A) of the Code, which was originally enacted in 1959, recognized a "variable annuity" as an annuity for purposes of the Code.

The tax law applicable to annuities

Section 72(a) of the Code includes amounts received under an annuity in an individual's gross income. However, Section 72(b) provides that certain amounts received under an annuity may be excluded from income. Basically, the amount of such exclusion represents the return of the initial investment (the basis) in the contract which was already subject to tax.

If an amount is received under an annuity contract prior to the Annuity Starting Date, the amount representing the basis in the contract is presumed to be recovered first. Only after all of the original contribution is recovered is there includable in individual income the amount which represents accumulated interest (Section 72(e) of the Code).

Congress, in Section 72(g) of the Code, provided rules for determining the basis of annuity contracts transferred by assignment or otherwise for valuable consideration. Section 72(h) put forth the concept of non-constructive receipt in the case of a contract which provided for payment of a lump sum in full discharge of an obligation thereunder, subject to an option to receive an annuity in lieu of the lump sum if the option was exercised within sixty (60) days after the lump sum became payable.

Congress also added Section 1035 to the 1954 Code to enable individuals to exchange one annuity contract for another better suited to their needs without recognizing a gain or a loss.

The Life Insurance Company Income Tax Act of 1959 (Public Law 86-69, June 25, 1959) included a provision for variable annuities. This provision, (originally § 801(g) of the Code, now § 801(g)(1)(A)), was explained by the report of the Senate Finance Committee as follows:

"Your committee has added a provision to the House bill to make it clear that variable annuities are in general to be taxed in the same manner as other annuities." (86th Cong., 1st Sess., S. Rep. No. 291 (1959) 13.)

In 1962, Congress expanded the variable annuity section of the Code to include a new type of contract. Section 801(g)(1)(A) reenacted in substance the provisions of the 1959 Act and thus continued the inclusion of a variable annuity within the definition of an annuity. However, Congress also added Section 801(g)(1)(B) to the code to deal with "contracts with reserves based on a segregated asset account," which it defined as a contract which provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to state law or regulation, is segregated from the general asset accounts of the Company; which provides for the payment of annuities; and under which the amounts paid in or the amounts paid as annuities reflect the investment return and market value of the segregated asset account. Congress also added several provisions dealing with accounting for life insurance companies which issue such Contracts, requiring generally that the companies separately account for various items of income, exclusions, deductions, assets, reserves and other liabilities attributable to such separate accounts.

The legislative history of 801(g)(1)(B), as stated in the reports of the Senate Finance Committee and of the Conference Committee (attached hereto as Exhibits A and B respectively) indicate no concern about the nature of the investments underlying a variable annuity contract. This history merely reiterates the qualifications necessary to qualify as a "contract with reserves based on a segregated asset account." These are:

1. Contributions and accumulations are applied to a separate account, the assets of which, under State law, are segregated from the general asset accounts of the Company.

2. The contracts must provide for the payment of annuities.

3. The amounts paid in or the amounts paid as annuities reflect the investment return and the market value of the assets held in the separate account.

There is nothing in § 801(g)(1)(B) nor in the legislative history which would show a Congessional intent to limit the type of investment underlying a variable annuity contract.

The purposes served by annuities

Annuity contracts serve two basic public policy purposes:

1. They enable individuals to accumulate funds for retirement security.

2. They provide a source of savings to add to and stabilize the capital base of the nation.

Until the advent of the variable annuity nearly a quarter century ago, purchase payments made by the public under annuity contracts were invested with the other general assets of the insurer. The sales and other expenses were relatively high and the yields relatively low. Therefore, the product had little appeal. The variable

annuity enabled an annuitant to select an investment orientation with a greater potential investment yield and even a potential growth of capital. It also enabled an annuitant to receive the bulk of the entire investment yield on the assets underlying the annuity—rather than merely a fraction of the yield as had been the case with traditional fixed annuities. The price the annuitant paid for this advantage was assumption of investment risk—there was no longer a guarantee of principal and interest.

The expansion of annuity sales

The advent of the variable annuity and its market success stimulated insurers to expand their annuity sales efforts. At the same time the public, concerned over the highly publicized troubles of the Social Security System and plagued by inflation and suffering from the rash of pension plan terminations which followed the enactment of the Employee Retirement Income Security Act of 1974 ("ERISA"), embraced annuities to provide retirement security. Thus, from 1975 to the present, there has been a greater public interest in annuities than ever before.

Revenue Ruling 80-274

The Ruling describes an annuity which does not exist and has never, to the best of my knowledge, existed in the real world. The Ruling describes a group single premium retirement annuity contract owned by a savings and loan association. Under the facts stated, the policyholder transfers cash, a passbook savings account or a certificate of deposit to the insurance company for the purchase of the annuity contract. This amount is then reduced from 2 to 5 percent for sales, administrative and premium tax expenses. The reduced amount is segregated, placed in a separate account of the savings and loan association and invested in a certificate of deposit. When the certificate expires, the insurance company must reinvest the proceeds in a certificate of deposit in the same savings and loan association for the same duration unless that duration would extend beyond the annuity starting date. If so, a certificate of shorter duration would be purchased. If such a certificate of deposit was not available, then the funds would be invested in a passbook savings account.

Under the annuity described in the Ruling the insurance company retains the right to withdraw the deposits from a failing savings and loan association or from one that terminates the plan. If withdrawn, the insurance company must deposit such amount in another federally insured savings and loan association. The insurer deducts an annual management fee from the interest earned on the investments. The remaining interest is credited to each annuity account. The insurer guarantees to credit the annuity with at least 4 percent per year compounded annually from the date of deposit regardless of what is actually earned on the investment.

The policyholder may withdraw all or a portion of the cash surrender value of the contract at any time prior to the annuity starting date. The cash surrender value is the amount deposited plus interest credited less a charge for withdrawal. The withdrawal charge is the early withdrawal penalty charged by the savings and loan association plus any premium tax resulting from the withdrawal.

The annuity contract allows the policyholder to elect one of a variety of settlement options. If a policyholder dies prior to the Annuity Starting Date, a lump sum is payable to the beneficiary in an amount equal to the cash surrender value on the date of death. The beneficiary could also elect to receive a lifetime annuity or an annuity for a term certain.

The Ruling found that under these facts the policyholder's position is substantially identical to what the policyholder's position would have been had the investment been directly maintained or established with the savings and loan association. The insurance company is little more than a conduit between the policyholder and the savings and loan association.

The Ruling determined that due to the "substantially identical" position of the policyholder, he or she still possesses substantial incidents of ownership and therefore the policyholder and not the insurance company is the owner of the account for federal income tax purposes.

The Ruling cites a previous ruling issued in 1977 which affected the so-called "investment annuity." This previous ruling, Rev. Rul. 77-85, determined that an annuity which permitted a policyholder a broad degree of investment control over the assets underlying the annuity was inconsistent with ownership of such assets by the insurer—a prerequisite to tax treatment as an annuity.

Rev. Rul. 80-274 presents no legal argument for its position

The Ruling arrives at a conclusion, but presents no legal arguments to substantiate such conclusion. In fact, the Ruling is inconsistent on its face. It concludes that the policyholder is in a "substantially identical" position to that which he or she would have been if the underlying investment were owned directly. Yet no consider-

ation is given to the facts included in the Ruling which establish that the policyholder has a far different position than he or she would have had without the annuity. When the annuity is purchased the following occurrences change the policyholder's position irrevocably:

1. A charge is paid equal to 2 to 5 percent of the purchase payment.
2. Premium taxes may be incurred.
3. The policyholder loses control over the underlying investments. They can never be distributed in kind.
4. The insurer guarantees principal and interest.
5. The policyholder receives a guarantee of lifetime annuity payment, regardless of longevity.

The foregoing hardly makes the annuity merely a "conduit" for the underlying investments. In fact, the purchase of the annuity has materially changed the policyholder's status. Therefore, the type of annuity described in the Ruling is, in reality, an "annuity" which should be taxed under Section 72 of the Code, rather than to have the underlying assets taxed to policyholders directly.

In this context, it is helpful to analogize to other situations which have given rise to concern about tax treatment of annuity contracts. The analysis in the Ruling can be compared to the circumstances where the doctrine of "constructive receipt" has been considered in determining whether a policyholder should be currently taxed on accumulations to an annuity. Thus, in Rev. Rul. 68-482 it was held that except in the very unusual case, the surrender of an annuity contract will subject the policyholder to substantial limitations. It was concluded that because of reincurred loading charges, the cash value of the surrendered annuity contract will not normally purchase a new annuity of comparable or greater value to the policyholder and therefore there will not be any constructive receipt of the income.

It would seem that this reasoning regarding constructive receipt is equally valid in considering all annuities. If the owner of any annuity foregoes some privilege or suffers some penalty in the purchase of the annuity that would not occur if he or she owned the underlying investment directly, then ownership of such underlying investment cannot be imputed to the Contract Owner! This is true even under the facts stated in the Ruling!

It is also important to note that the Ruling cites Rev. Rul. 77-85 as precedent for its position. The United States District Court for the District of Columbia, in the only decision on the merits involving Rev. Rul. 77-85 has determined that Rev. Rul. 77-85 is without legal merit and is merely an attempt by the IRS to usurp Congressional legislative prerogatives. Although the District Court was overruled on appeal—solely on jurisdictional grounds, I believe the decision on the merits is a correct statement of the law and would be re-stated if tax law would permit access to a forum. I believe that it is important that the IRS has yet to present any legal arguments to support its position! The Ruling remains merely a policy statement and is, in my opinion, contrary to the specific provisions of the law as enacted by Congress.

The effect of inconsistent actions by the IRS

Prior to issuance of the Ruling the IRS had issued at least six previous private letter rulings over a period of nearly three years which were totally contradictory to the Ruling. Numerous insurers, marketing companies and financial institutions, in reliance on these IRS actions, and in the belief that tax laws on the subject were clear and unambiguous, expended considerable amounts of time and money to bring an annuity product to market. All these expenditures were wasted!

Business cannot exist in a climate of shifting rules. No intelligent business person will invest in new products and methods if government can wipe out all efforts at a whim without due process and with no legal recourse. It will be difficult to convince insurers to take the plunge to develop new products when their previous experience has been so bad.

The chilling effect on capital formation of the IRS actions

There appears universal agreement that there is a desperate need for increased savings and capital formation in our nation. The plight of the banking and savings and loan industry has been widely publicized. The savings annuity provided a potential solution to all these problems. It is product which was on line, ready to be sold. The tax law appeared clear.

The marketplace was there. Yet despite the national need the IRS killed the product without legal basis merely because of what seemed to be tax policy considerations. This action has a chilling effect on capital formation and is, I believe, contrary to our present national policy.

Rev. Rul. 80-274 is an attempt by the IRS to legislate

In the last session of Congress, the Treasury Department submitted legislation to change the tax treatment of annuities. Such legislation was soundly defeated. The Ruling is so broad in its effect that the IRS is attempting to accomplish administratively that which it could not accomplish legislatively—change the tax law applicable to annuities. If Congress intends to retain its Constitutional power to make the laws, it should restrain the IRS from clearly frustrating Congressional intent in the manner utilized in the Ruling.

Public policy considerations

The ruling is merely an attempt by the IRS to limit the investment orientation of assets held by insurers under annuity contracts. Apparently, the IRS wants only annuities which are poor investments for taxpayers. Congress has never been concerned with the nature of the investments underlying annuities. The more appealing the underlying investment, the better the product for the citizen! A better product will be more successfully sold; will create more investment capital; will better stabilize financial institutions such as banks and savings and loan associations and will provide more secure retirements for our citizens. Congress should clearly enunciate the policy that the nature of the investment underlying an annuity has no relevance to the status of the annuity under federal tax law.

Beware of "loaded" terms

In past discussions about annuities the IRS and the Treasury have attempted to bolster their positions by the use of loaded terms. "Tax-shelter," "Tax dodge," and "Tax gimmick" are all terms which have been raised in previous statements. The annuities under consideration are purchased with after tax dollars! Therefore they do not fit the definition of a "tax-shelter." Congress has clearly enumerated a policy with respect to annuities in Section 72 of the Code. If it had intended to limit underlying investments, it would have done so. It would seem that a clearly enumerated Congressional policy can hardly be characterized as a "tax dodge" or a "tax gimmick." It should not be possible for the IRS to legislate tax policy administratively, without hearing, prior notice or other concepts of due process, particularly after a failed attempt to obtain legislation on the same subject. Congress should not permit the use of "loaded" terms to cloud the basic issue of whether Congress or the IRS establishes the tax laws for this nation. The IRS has also attempted to characterize annuities as a tax benefit for the "rich." The statistics available indicate this is untrue. The major company affected by Rev. Rul. 77-85 had as the majority of its policy holders school teachers! Hardly the "rich."

Conclusion

This subcommittee is presently considering two bills on taxation of annuities. Senate Bill 388 would, in effect, revoke Rev. Rul. 77-85. Senate Bill 446 would accomplish the same goal for Rev. Rul. 80-274. These bills would reverse a great injustice and would state Congress' position that its laws mean what they say. The Ad Hoc Committee on Individual Annuity Taxation stands willing to assist this sub-Committee in any further consideration it may feel appropriate, not only of the pending bills but in any other matters involving the proper place of annuities in the tax status of our nation. It is our position that the annuities described in the Ruling, as well as the annuities described in Rev. Rul. 77-85, fit the Treasury's own definition specified in Treasury Regulations 1.72-2(a)(1) quoted above in that the annuity contracts are considered to be annuity contracts in accordance with the customary practice of life insurance companies. The annuities are regulated by and approved by state insurance regulations. They fit all the definitions of the Code, of the Regulations and of the customs of the industry. Moreover, the IRS itself, previously agreed that they were annuities. We believe these circumstances are determinative of the question and that this sub-Committee and Congress should act accordingly.

Exhibit "A"

2. Variable annuities.—Your committee has added a provision to the House bill to make it clear that variable annuities are in general to be taxed in the same manner as other annuities. This was considered especially desirable in view of the recent Supreme Court case in this area (*Securities and Exchange Commission* v. *Variable Life Insurance Company of America et al.*, March 23, 1959). Thus, companies issuing such contracts will, if they otherwise qualify, be treated as life insurance companies. Variable annuities differ from the ordinary or fixed dollar annuities in that the annuity benefits payable under the variable annuity vary with the insurance company's overall investment experience. The fixed dollar annuity, on the other hand,

guarantees the payment of a specified amount irrespective of the actual investment earnings. Both the fixed dollar annuities and the variable annuities, however, are based upon the principle of paying out either specified amounts, or specified units with values which vary with investment experience, over the life of each member of an annuitant group. Thus, in both cases the insuring company bears the mortality risk. In view of this your committee believes variable annuities should in general be treated like other annuities for tax purposes.

Your committee's amendments provide that variable annuity contracts using recognized mortality tables but with annuity payments based on the investment experience of the company issuing the contract are to be treated as regular annuity contracts for purposes of the life insurance company tax. Therefore, such reserves will qualify as life insurance reserves and companies primarily issuing such policies will qualify as life insurance companies for Federal income tax purposes. The current earnings rate of such a company to be used in determining the portion of investment income belonging to the policyholder and the portion representing the life insurance company's share is to be computed in the usual manner, except that there is to be deducted from the company's current earnings rate any actuarial margin charge prescribed by the contract. This same rate is also to be used as the company's assumed rate of interest.

This actuarial margin charge represents a charge made by the company to cover general expenses which are over and above the expenses provided for in the charges made against premiums. In addition, this actuarial margin provides contingency mortality reserves, as well as the profit margin for the shareholders of the company.

In the case of these variable annuity contracts, additions in reserves for tax purposes are to include only increases made by reason of premium receipts and investment income, and decreases in these reserves for tax purposes are to take into account only benefits paid under these contracts. The effect of this is to exclude from reserve additions or decreases capital gains and losses, both realized and unrealized. These are ordinarily reflected in these reserves by such companies. In the case of unrealized gains and losses, the tax laws generally do not take such amounts into account; and in the case of realized gains and losses, an entirely separate 25 percent tax is imposed with respect to any net long-term capital gains, both in the case of these companies and in the case of other insurance companies generally.

Your committee's bill provides that this treatment for variable annuity contracts is to apply only for the years through 1962. This special cutoff date for variable annuity contracts has been provided by your committee in order to give assurance that there will be an opportunity to review the tax treatment of variable annuities after these contracts have been in existence for a period of time. It is thought that, in view of the relative newness of such contracts, special problems may develop which will warrant review. (86th Cong., 1st Sess., S. Rep. No. 291 (1959) 13.)

Exhibit "B"

SECTION 3. LIFE INSURANCE COMPANIES

(a) Variable Annuities and Other Segregated Asset Accounts.—The Senate amendment to the text of the bill, and the conference agreement, amend section 801(g) of the 1954 Code, relating to variable annuity contracts—

(1) To remove the termination provisions contained in existing paragraph (6) of subsection (g) of section 801 (which provides that such subsection (g) is not to apply to taxable years beginning after December 31, 1962),

(2) To provide for separate accounting by life insurance companies with respect to contracts with reserves based on segregated asset accounts, and to define such a contract as one—

(A) Which provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company.

(B) Which provides for the payment of annuities, and

(C) Under which the amounts paid in, or the amounts paid as annuities, reflect the investment return and the market value of the segregated asset account,

(3) To provide, in effect, that income allocated to the contracts described in paragraph (2) is not be taxed to the life insurance company, and

(4) To provide, in effect, that, in the case of qualified pension contracts for which segregated asset accounts are maintained, capital gains allocated to such contracts are not to be taxed to the life insurance company. (87th Cong., 2d Sess., H. Rep. No. 2542 (1962) 4.)

STATEMENT OF ART BUNKER, MARKETING DIRECTOR, AMERICAN LIFE AND CASUALTY INSURANCE CO., ON INDIVIDUAL ANNUITY TAXATION

SUMMARY

1. American Life and Casualty Insurance Company is a chartered company licensed in thirty-six states. Since September 1978, it has offered annuity contracts to depositors and savers of banks and savings and loans; a five thousand dollar minimum contribution was required and the annuitant must have been under ninety years of age. This program was approved in twenty-seven states, the largest volume being written in Kansas, Missouri, Utah, Illinois, and the Dakotas.

2. (a) American Life's experience in this program demonstrates the kinds of problems encountered with the Internal Revenue Service.

2. (b) On September 9, 1977, American Life requested a private letter of the Internal Revenue Service concerning an annuity plan it hoped to market through banks and savings and loan associations. After waiting nearly a year for an answer to that request, American Life received its ruling, dated September 6, 1978.

2. (c) Then on March 5, 1979, the Service advised American Life that modification of its ruling was being contemplated. On December 3, 1979, the IRS did in fact modify its prior ruling of September 6, 1978. This modification has the effect of negating insurance of accounts by the Federal Savings and Loan Insurance Corporation.

2. (d) On January 11, 1980, American Life sought a new private ruling covering a new annuity policy form, a policy requiring approval by the Insurance Departments of the various states and a further determination by the Federal Home Loan Bank Board.

2. (e) On March 25, 1980, the Internal Revenue Service issued a private letter ruling the terms of which American Life was operating under until it suspended sales on September 24, 1980 when it learned of Revenue Ruling 80-274. American Life and its 220 contract financial institutions and 3350 annuitants were in a significant state of confusion and concern.

2. (f) After an agonizing period of several weeks, waiting to learn the status of Ruling 80-274 as it pertained to the tax status of American Life and its annuitants, IRS determined that all annuitants were "grandfathered" and would have income tax deferrals for the life of their then existing annuities.

3. In summary, American Life and its contracted financial institutions expended vast sums of money, time and energy in developing a product that appeared to benefit all parties, the individual saver, the financial institution, the insurance company and even the United States Treasury in that the income tax was only deferred. In fact, income tax collections on the interest earnings at a deferred date should provide greater ultimate tax revenues than current taxation would generate.

Mr. Chairman, the timeliness of today's hearings on legislation to redress a serious wrong done to principally middle income savers through ill-conceived and unwarranted Revenue Rulings cannot be overstated. It is not only that the historic responsibilities of both savings industry and annuity offerors have been frustrated by these Rulings, it is also that the deposit of funds into that industry for such annuities has all but stopped and that the annuitants themselves have been done grievous harm in their attempts to save for their and their family's futures. Mr. Chairman, you are to be commended for having set these hearings at an early date, and the Senators and their and the committee and subcommittee staffs are to be commended for their time and attentiveness in this effort to arrive promptly at the right policy answer.

American Life and Casualty Insurance Company, which I represent as its Marketing Director, is a North Dakota chartered company licensed in thirty-six states. Since September 1978, it has offered annuity contracts to savers and depositors of banks and savings and loans. A five thousand dollar minimum contribution was required and the annuitant must have been under ninety years of age. This program was approved in twenty-seven states, the largest volume being written in the Dakotas, Kansas, Missouri, Illinois, Tennessee, South Carolina, Georgia and Utah.

American Life's experience

On September 9, 1977, American Life requested a private letter of the Internal Revenue Service concerning an annuity plan they hoped to market through Banks and Savings and Loan Associations. After waiting nearly a year for an answer to our request, American Life received their ruling dated September 6, 1978.

On March 5, 1979, the Service advised American Life that modification of their ruling was being contemplated. Then on December 3, 1979, the IRS did in fact

modify its prior ruling of September 6, 1978. This modification had the effect of negating insurance of accounts by the Federal Savings and Loan Insurance Corporation.

Therefore American Life sought a new private ruling covering a new annuity policy form on January 11, 1980. Incidentally, this new policy required seeking approval by the Insurance Departments of the Various States and seeking a further determination by the Federal Home Loan Bank Board.

On March 24, 1980, the Internal Revenue Service issued a private letter ruling the terms of which American Life is operating under at the present time. Or I should say was operating under until it suspended sales on September 24th when they learned of a release of that date. This release seemed to be so ambiguous and confusing that American Life and its 220 contract financial institutions and 3350 annuitants were in a significant state of confusion and concern. After an agonizing period of several weeks waiting to learn the status of Ruling 80-274 as it pertained to the tax status of American Life and its annuitants, it was determined by IRS that all annuitants were "grandfathered" and would have income tax deferrals for the life of their annuity.

American Life and its contracted financial institutions have expended vast sums of money, time and energy in developing a product that appears to benefit all parties, the individual saver, the financial institution, the insurance company and even the United States Treasury as income tax is only deferred. In fact, income tax collections on the interest earnings at a deferred date should provide greater ultimate tax revenues than current taxation would generate.

Several financial institutions had expended vast sums promoting the annuity through various media sources. Some had placed advertising in magazines such as Newsweek, Sports Illustrated and other magazines that they were unable to cancel. The abrupt issuance of Ruling 80-274 caused considerable unrecoverable expense, confusion and consternation.

American Life's annuity policy forms, administration and sales methods totally complied to previously issued rulings. Ruling 80-274 which was issued without notice or opportunity of hearing was at least arbitrary, capricious and ill-timed.

The role of annuities

For many years in the various versions of Federal tax law, there has been provision for the taxation of annuities. In the Internal Revenue Code of 1954, Congress again recognized the need for a particular tax status for annuity contracts to permit citizens to accumulate funds for retirement and other long-term financial goals. (Section 72 of the Code provided that investment yield credited to an annuity contract would not be taxed to the annuitant until such investment yield was distributed, usually in the form of monthly installments over the life of the annuitant after retirement.)

Although most annuities have been traditionally directed toward retirement benefits, thereby relieving pressure for greater public and company retirement assistance, they have also been used for other purposes such as providing payments for college education, thereby relieving pressure for that kind of public assistance.

Annuity contracts permit individuals to accumulate funds to supplement social security and company pension payments. The type of annuities I am here discussing are not connected with formal "qualified" pension plans provided by employers. The annuities under discussion receive no special tax treatment as to the purchase payments made by the annuitant. All purchase payments are made from after-tax dollars. Therefore, such annuities cannot be termed a "tax-shelter" as that term is commonly used. Moreover, all investment yield will eventually be taxed—at ordinary income rates. The main tax advantage to be derived by an annuitant is deferral of taxes on investment yield until retirement, when reduced income will perhaps result in a lower income tax bracket.

IRS and annuities

Traditionally, annuities were a minor part of any insurer's business. The main reason for the lack of interest in annuities was because the tax, regulatory and accounting structure of life insurers did not permit the crediting of attractive interest rates on deposits held under annuities.

In 1962, Congress amended the Code by including a new Section, 801(g)(1)(B), to permit issuance of variable annuity contracts which utilize segregated asset accounts of insurers to hold assets underlying the annuity contracts. Designed to provide protection against inflation, such segregated asset accounts enabled insurers to give annuitants a chance for a greater return on their annuity contracts, because under the new tax laws, the insurer was able to pass the investment yield on the assets underlying annuity contracts on to annuitants, rather than utilizing the bulk of the investment gain for taxes.

As a result of the competitive market in variable annuities, a new era developed in the annuity business. A wide variety of new annuity products has been developed in the past decade and a half, all characterized by the crediting of more attractive and competitive rates of interest. In addition, insurers began searching for new methods to make the annuity better for consumers—all within the Congressional mandate of Section 72 and 801(g)(1)(B) of the Code.

In the 1970's, inflationary pressures began artificially increasing income tax brackets. Likewise, the advent of the Employee Retirement Income Security Act of 1974 ("ERISA") caused massive termination of private pension plans. These factors, when combined with the extensive publicity about the crisis in the social security system and the attractiveness of the new annuities caused consumers to buy such annuities in greater quantities than ever before in an attempt to defer taxes and insure retirement security.

As annuities became more popular, the Internal Revenue Service began contesting them. This contest has more recently taken the form of revocation by the Service of previously issued public and private revenue rulings which had determined that the annuities under consideration were, in fact, "annuities" within the meaning of Sections 72 and 801(g)(1)(B) of the Code.

The first contest by the Service was in the form of Revenue Ruling 77-85 which revoked nearly 70 previously issued rulings dating back over a decade. The latest was by Revenue Ruling 80-274 which also revoked a number of rulings previously issued by the Service.

Indeed, it appears that the policy of the Service towards annuities is that they are acceptable when there is no market for them. However, as soon as annuities become attractive to consumers, the IRS takes the position that they are merely a "subterfuge", fulfilling no legitimate purpose.

Eminent tax counsel have concluded that there is no legal basis for Revenue Ruling 77-85 and 80-274. Unfortunately, the tax laws do not permit an insurer to challenge such a Revenue Ruling. The only litigation on the matter involved Revenue Ruling 77-85 where the Federal District Court determined that the Ruling was illegal and void. However, the Appellate Court ruled that under the Code, the insurer had no standing to question the tax status of one of its products.

The chilling effect on capital formation

Annuities of the type which have been attacked by the Service in Revenue Ruling 77-85 and 80-274 provide funds for capital formation, a much needed commodity in today's economy. The purchase payments from such annuity contract are invested in bank certificates and savings and loan certificates. More importantly, because of the long-term nature of the annuity and its tax deferral feature, the result is a stable pool of capital which ameliorates the problems of savings outflow so prevalent in our economy in recent years. Studies by some of the largest sellers of annuities for the past decade indicate that in excess of 90 percent of annuity purchase payments remain on long-term deposit. Certainly such a stable pool of capital should be encouraged in today's economy. However, the constant uncertainty about what is or is not an annuity for tax purposes, makes insurers reluctant to invest in the development of new innovative products.

The social usefulness of annuities

Annuity contracts provide an incentive for middle income Americans to invest in American industry. They also provide a meaningful tax benefit to our citizens at a cost which is relatively lower than other types of tax incentives.

Annuity purchase payments are made with after-tax dollars. Thus, there is no adverse impact on government revenue at time of purchase. Likewise, taxes on investment yield are not lost, merely deferred. However, annuities help to accomplish a necessary social goal—independence and financial security for citizens—particularly when government sponsored retirement programs have questionable capability to accomplish such a goal.

Representatives of the Service have, on several occasions, termed annuities as "gimmicks" and "tax shelters for rich fat cats." However, studies show that the average annuitant earns less than $25,000 and rarely has any other form of investment than the annuity. The average annuity of our company has less than $22,000 in total held under the contract. Many companies selling annuities have average size contracts less than $15,000. As a practicable matter, an annuity is not a likely investment for the rich. The rich have far more attractive methods for sheltering their income from taxes.

The annuity is what it appears to be—a method for the average citizen to achieve financial security in his or her old age by currently deferring taxes.

VOGEL, VOGEL, BRANTNER & KELLY,
Fargo, N. Dak., September 9, 1977.

CORPORATION TAX BRANCH,
Internal Revenue Service,
Washington, D.C.

(Attention: Mr. Grindle).

GENTLEMEN: This letter is written on behalf of American Life and Casualty Insurance Company, 207 North 5th Street, Fargo, North Dakota, which company is a life and casualty insurance company which has recently developed a group single premium retirement annuity contract that has been approved in several of the states by their respective insurance regulatory departments or agencies.

The group single premium retirement annuity contract (hereinafter referred to as the annuity plan) will be sold by American Life and Casualty Insurance Company and insurance agencies associated with it.

It is proposed that American Life sell the annuity plan to depositors of various financial institutions to include those of savings and loan associations. To accomplish this, the insurance company proposes to enter into agreements with various financial institutions whereby said institution will be the group contract holder. The financial institution will enroll its depositors in the program just as most employers enroll employees in health and other insurance plans. The financial institution will receive expense reimbursements for the services they render. The insurance company will deposit the premiums in the financial institutions to include savings and loan associations and these deposits will be segregated accounts with the insurance company holding legal title to them and will have in their possession the passbooks, if any, for said accounts. Said passbooks or certificates of deposit will read, "the insurance company holds this account as agent for John Doe, subject to the terms of the annuity plan." The financial institutions will pay their usual interest on these deposits.

The annuitant's cash value in their respective annuity plans will be the premium paid plus interest accumulated. Under the terms and conditions of the insurance policy American Life guarantees a three percent return on the value of the purchase. Interest paid by the federally insured financial institution on the annuity value in excess of three percent, less a two percent first year premium charge, and a three-quarters percent annual service charge, will be credited annually as excess interest to the annuity value. Neither the assests represented by the annuity value nor by dividends credited to the annuity value shall be distributed or distributable by the financial institution to the enrollee or to any beneficiary or assignee. Earnings of the annuity reserve will be recorded as American Life income and increases in annuity value as expenses.

The annuity plan provides the enrollee the option to receive one of a variety of conventional forms of settlement. The amount of any annuity payment made under the annuity plan shall be determined, as provided in the policy, on the basis of guaranteed interest at three percent a year, compounded annually, from the date the payment is received by American Life. In addition, excess interest will be credited to the annuitant account as determined by the Board of Directors of American Life, but in no case shall the amount of excess interest credit be less than the interest paid the insurer by the financial institution and diminished by the guaranteed rate and further diminished by the percentage charges as referred to in the paragraph above.

In addition to the initial contribution to the account, additional annuity purchase contributions may be made from time to time prior to, or on the annuity date, subject to the conditions that the minimum amount which may be contributed in a subsequent contribution shall be $100.00, and the maximum amount which may be contributed without the consent of American Life during each successive period of 12 months, commencing with the effective date of the policy, shall be twice the amount contributed during the first period.

After the annuity date, the annuitant can make no further contribution and shall receive annuity payments, generally payable monthly, for the period provided by the form of payment which he has elected to receive.

In the event the annuitant dies prior to the annuity date, a lump sum is payable to the beneficiary on the date of death measured by the then value of the annuity. However, the beneficiary shall be entitled to elect to receive either an annuity for a term certain or an annuity with a lifetime income, subject to a guaranteed minimum number of monthly installments.

The annuitant does not have direct access to the interest earned on the deposit in the financial institution, except as the terms of the annuity plan allow him pay-

ments of benefits, loans on the cash value of the policy, or surrender of the policy for its cash value less a cash surrender charge.

Based on the foregoing information submitted, it is my opinion that:

1. The insurance company will be the owner of the deposits placed in federally insured financial institutions to include savings and loan associations.

2. As the owner of the deposits in federally insured financial institutions to include savings and loan associations, the insurance company, for the purposes of determining the insurance company's gross investment income under Section 804(b) of the Internal Revenue Code, will include the earnings of the annuity reserve as income and increases in annuity value as expenses.

A ruling is respectfully requested as to the conclusions reached in my foregoing opinion based on the facts as I have set them forth herein.

I am enclosing in duplicate a Power of Attorney duly executed by my client, American Life and Casualty Insurance Company, in order for you to respond directly to the undersigned. I shall look forward to hearing from you.

Yours very truly,

VOGEL, VOGEL, BRANTNER & KELLY.

DEPARTMENT OF THE TREASURY,
INTERNAL REVENUE SERVICE,
Washington, D.C., September 6, 1978.

AMERICAN LIFE AND CASUALTY INSURANCE CO.,
207 North Fifth Street,
Fargo, N. Dak.

(Attention: Mr. Gordon H. Heller).

GENTLEMEN: This is in reply to a request for a ruling filed by your authorized representative, dated September 9, 1977, and subsequent communications with our office, regarding the group single premium retirement annuity contract described below.

The information submitted indicates that the taxpayer is a life insurance company taxable under section 802 of the Internal Revenue Code of 1954, as amended (the Code). The taxpayer has recently developed a group single premium retirement annuity contract (the annuity plan) that has been approved in several states by their respective insurance regulatory departments or agencies. The annuity plan will be sold by the taxpayer and insurance agencies associated with it.

It is proposed that the taxpayer sell the annuity plan to depositors of various federally insured financial institutions including savings and loan associations. To accomplish this, the taxpayer proposes to enter into an agreement with each participating financial institution whereby the institutions will be the group contractholders. The financial institutions will enroll their depositiors in the program just as most employers enroll employees in health and other insurance plans. The financial institutions will receive expense reimbursements for their services. The taxpayers will deposit the premiums it receives from depositors in the financial institutions to be held in segregated accounts. Legal title to the accounts will be held by the taxpayer. The financial institutions will pay their usual interest on these deposits.

The annuitants' cash values in their respective annuity plans will be the premiums paid plus interest accumulated. The taxpayer guarantees interest at the rate of 3 percent per year, compounded annually. If a financial institution pays interest in excess of 3 percent, excess interest will be added to the account, less a 2 percent first year premium charge, and ¾ percent annual service charge. neither the assets represented by the annuity value, nor the earnings credited to the annuity value, shall be distributed by the financial institutions to any enrollee or to any beneficiary or assignee.

The annuity plan provides the enrollee the option to recieve one of a variety of settlement options, including a lump sum payment, a life income option, installment options for a specified amount or a specified period, and installment payments for a specified period and life thereafter.

In addition to the initial contribution to the account, additional annuity purchase contributions may be made from time to time prior to or on the annuity date, subject to certaim minimum and maximum amounts.

In the event an annuitant dies prior to the annuity date, a lump sum is payable to the beneficiary on the date of death measured by the cash value at that date. The beneficiary may instead elect to receive either an annuity for a term certain or an annuity with a lifetime income, subject to a guaranteed minimum number of monthly installments.

The annuitant does not have direct access to the interest earned on the deposit in the financial institution, except as the terms of the annuity plan allow him payments of benefits, loans on the cash value of the policy, or surrender of the policy for its cash value less a cash surrender charge.

The planning of the investment of the funds in the accounts will be decided by the financial institutions and the taxpayer. It is expected that the funds will be invested primarily in Certificates of Deposit. The individual annuitants have no role in the actual investment of the funds in the accounts. The annuitants' rights are derived solely from the annuity plan, and the taxpayer may meet its obligations to annuitants under the plan using funds derived from sources outside of the accounts held pursuant to the plan.

Based on the above, the provisions of the annuity plan indicate that the taxpayer will be the recipient of the interest earned on the deposits placed in the financial institutions in connection with the annuity plan. The annuitant has no direct access to the assets in the account, but instead has a right to receive annuity payments in amounts pursuant to the taxpayer's obligations under the terms of the annuity plan.

Therefore, it is ruled that the taxpayer will be the owner of the deposits in the financial institutions placed there in connection with the annuity plan, for purposes of determining the taxpayer's gross investment income under section 804(b) of the Code.

This ruling letter is based on the present provisions of the Internal Revenue Code. President Carter, in his special tax message to Congress on January 21, 1978, proposed that taxes be imposed currently on the holders of certain deferred annuities not purchased under qualified retirement plans. The holding of this ruling letter may not be relied upon in the event that legislation affecting the plan described herein is enacted by the Congress.

Pursuant to each power of attorney on file in this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter should be attached to your federal income tax return.

Sincerely yours,

JOHN L. CRAWFORD,
Chief, Corporation Tax Branch.

DEPARTMENT OF THE TREASURY,
INTERNAL REVENUE SERVICE,
Washington, D.C., March 5, 1979.

AMERICAN LIFE AND CASUALTY INSURANCE CO.,
207 North Fifth Street,
Fargo, N. Dak.

(Attention: Mr. Gordon H. Heller).

GENTLEMEN: This letter is in reference to your request for a ruling dated September 9, 1977, and our response dated September 6, 1978, (Written Determination Number 7849013), concerning the ownership of deposits held in financial institutions pursuant to your group single premium retirement annuity plan.

Upon review of our files dealing with your ruling request, we have noted that under the terms of your plan, each passbook for deposits will state that the insurance company holds the account as agent for the annuitant, subject to the terms of the annuity plan. We believe this to be inconsistent with the holding that the insurance company is the owner of the deposits for purposes of determining its gross investment income under section 804(b) of the Internal Revenue Code, because if the insurance company holds the account as an agent, the principal (annuitant) appears to be the owner.

Therefore, we are proposing to modify our earlier ruling letter to state that the validity of the holding will be continued only on the condition that all assets of the insurance company will be held in its own name and not as an agent for the annuitant.

If you do not agree to the terms of the proposed superseding letter, you may request a conference by contacting the person whose name and telephone number are shown above, within 21 days from the date of this letter. If we do not hear from you within 21 days, we will issue a superseding letter as described above.

Pursuant to the power of attorney in our files, a copy of this letter is being sent to your authorized representative.

Thank you for your cooperation.

Sincerely yours,

JOHN L. CRAWFORD,
Chief, Corporation Tax Branch.

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE,
Washington, D.C., December 3, 1979.

AMERICAN LIFE AND CASUALTY INSURANCE CO.,
207 North Fifth Street,
Fargo, N. Dak.

(Attention: Mr. Gordon H. Heller).

DEAR MR. HELLER: This letter is in reference to your Group Single Premium Retirement Annuity Contracts that were the subject of our letters to you dated September 6, 1978, (Written Determination Number 7849013) and March 5, 1979.

After careful consideration of the matters discussed in our conference with you on April 18, 1979, and your subsequent communications with our office, we have concluded that it will be necessary for us to modify our earlier ruling letter for the following reasons.

If the language on the passbooks representing deposits held in financial institutions pursuant to the annuity plan refers to any party other than the taxpayer, such language is inconsistent with the actual relationships involved. You have represented that the annuitant derives benefits solely pursuant to the terms of the annuity contract. The taxpayer will be the legal owner of the accounts and will have control, along with the financial institutions, over the investment of the funds in the accounts.

In Revenue Procedure 79-14, 1979-10 I.R.B. 30, the Internal Revenue Service announced, in section 4.01, that it will not issue advance rulings or determination letters as to who is the true owner of property or the true borrower of money in cases in which the formal ownership of the property or liability for the indebtedness is in another party.

Our earlier ruling letter to you involved an arrangement whereby each passbook would state that the taxpayer owned the account as agent for the annuitant. Based on the inconsistency between this language and Rev. Proc. 79-14, we can no longer continue that ruling letter in effect. Moreover, if the taxpayer is to be held to be the owner of the accounts, and to hold them as part of its total reserves, it is inconsistent for the passbooks to note any designation other than that the taxpayer is the owner of the accounts.

Accordingly, our ruling letter to you dated September 6, 1978, cannot be relied upon for any annuity contracts issued subsequent to 90 days after the date of this letter. The prior ruling letter will be valid for contracts issued prior to that date pursuant to section 7805(b) of the Internal Revenue Code.

Pursuant to a power of attorney on file in this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

GERALD PORTNEY,
Assistant Commissioner (Technical).

VOGEL, BRANTNER, KELLY,
KNUTSON, WEIR & BYE, LTD.,
Fargo, N. Dak., January 11, 1980.

CORPORATION TAX BRANCH,
Internal Revenue Service,
Washington, D.C.

(Attn: P: C: C: 2: 3, Ms. Mindy Spears, Room 5135).

This letter is written on behalf of American Life and Casualty Insurance Company, 207 North 5th Street, Fargo, North Dakota, which company is a life and casualty company which has recently developed individual as well as group deposit administration retirement annuity contracts which have been approved in several states by their respective insurance regulatory departments or agencies.

We have previously received a ruling from your office dated September 6, 1978 covering the subject of group annuities, along with modifications of that ruling relating to the holding of all assets of the insurance company in its own name and not as an agent for the annuitant issued on March 5, 1979 and December 3, 1979.

On October 12, 1979, we requested a ruling covering the subject of individual annuities. We hereby withdraw that request of October 12, 1979 and its accompanying request for expeditious handling, and would now like to receive from your office a ruling with reference to both individual and group annuity plans to be sold under the following conditions:

The individual and group deposit administration retirement annuity contracts (hereinafter referred to as the annuity plans) will be sold by American Life and Casualty Insurance Company and insurance agencies associated with it.

It is proposed that American Life sell the annuity plans to depositors of various financial institutions to include those of savings and loan associations. To accomplish this, the insurance company proposes to enter into agreements with various financial institutions whereby said institution will be the contract holder. The financial institution will enroll its depositors in the program and will receive expense reimbursements for the services they render. The insurance company will deposit the premiums in the financial institutions to include savings and loan associations, and these deposits will be segregated accounts with the insurance company holding legal title to them and will have in their possession the passbooks, if any, for said accounts. The financial institutions will pay their usual interest on these deposits.

The annuitant's cash value in his respective annuity plan will be the premium paid plus interest accumulated. Under the terms and conditions of the insurance policy, American Life guarantees a three percent return on the value of the purchase. Interest paid by the federally insured financial institution on the annuity value in excess of three percent, less a two percent first year premium charge, and a three-quarters percent annual service charge will be credited annually as excess interest to the annuity value. Neither the assets represented by the annuity value, nor by dividends credited to the annuity value shall be distributed or distributable by the financial institution to the enrollee or to any beneficiary or assignee. Earnings of the annuity reserve will be recorded as American Life income and increases in annuity value as expenses.

The annuity plans provide the enrollee the option to receive one of a variety of conventional forms of settlement. The amount of any annuity payment made under the annuity plan shall be determined as provided in the policy, on the basis of guaranteed interest at three percent a year, compounded annually, from the date the payment is received by American Life. In addition, excess interest will be credited to the annuitant account as determined by the Board of Directors of American Life, but in no case shall the amount of excess interest credit be less than the interest paid the insurer by the financial institution and diminished by the guaranteed rate and further diminished by the percentage charges as referred to in the paragraph above.

In addition to the initial contribution to the account, additional annuity purchase contributions may be made from time to time prior to, or on the annuity date, subject to the conditions that the minimum amount which may be contributed in a subsequent contribution shall be $100.00, and the maximum amount which may be contributed without the consent of American Life during each successive period of 12 months, commencing with the effective date of the policy, shall be twice the amount contributed during the first period.

After the annuity date, the annuitant can make no further contribution and shall receive annuity payments, generally payable monthly, for the period provided by the form of payment which he has elected to receive.

In the event the annuitant dies prior to the annuity date, a lump sum is payable to the beneficiary on the date of death measured by the then value of the annuity. However, the beneficiary shall be entitled to elect to receive either an annuity for a term certain or an annuity with a lifetime income, subject to a guaranteed minimum number of monthly installments.

The annuitant does not have direct access to the interest earned on the deposit in the financial institution, except as the terms of the annuity plan allow him payments of benefits, loans on the cash value of the policy, or surrender of the policy for its cash value less a cash surrender charge.

Based on the foregoing information submitted, it is my opinion that:

1. The insurance company will be the owner of the deposits placed in federally insured financial institutions to include savings and loan associations.

2. As the owner of the deposits in federally insured financial institutions to include savings and loan associations, the insurance company, for the purposes of determining the insurance company's gross investment income under Section 804(b) of the Internal Revenue Code, will include the earnings of the annuity reserve as income and increases in annuity value as expenses.

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A ruling is respectfully requested as to the conclusions reached in my foregoing opinion based on the facts as I have set them forth herein.

In compliance with Internal Revenue Code section 6110 relating to public inspection of written determinations, no deletions need be made except names, addresses, and taxpayer identifying numbers.

Enclosed in duplicate is a Power of Attorney duly executed by my client, American Life and Casualty Insurance Company, in order for you to respond directly to the undersigned.

Yours very truly,

VOGEL, BRANTNER, KELLY, KNUTSON, WEIR & BYE, LTD.

Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and to the best of my knowledge and belief, the facts presented in support of the requested ruling or determination letter are true, correct and complete.

AMERICAN LIFE AND CASUALTY INSURANCE CO.

DEPARTMENT OF THE TREASURY,
INTERNAL REVENUE SERVICE,
Washington, D.C., March 24, 1980.

AMERICAN LIFE AND CASUALTY INSURANCE CO.,
207 North 5th Street,
Fargo, N. Dak.
(Attn: Mr. Gordon H. Heller).

DEAR MR. HELLER: This is in response to a request filed on your behalf by your authorized representative for a ruling regarding the individual and group single premium retirement annuity contracts described below.

The taxpayer, a life insurance company taxable under section 802 of the Internal Revenue Code, proposes to sell the annuity plans to depositors of various federally insured financial institutions to include those of savings and loan associations. In the case of the group annuity contracts, the financial institution will be the group contract holder, and will enroll its depositors in the program and will receive expense reimbursements for its services. In the case of the individual annuity contracts, there will be no group contract holder, but the individual will stipulate a financial institution through which he will participate.

The taxpayer will deposit the premiums it receives in the financial institutions, and these deposits will be segregated accounts for which the insurance company will hold the title and passbooks, if any. The financial institutions will pay their usual interest on these deposits.

The annuitant's cash value in his annuity plan will be the premiun paid plus interest accumulated under the terms of the plan. The taxpayer guarantees an annual interest rate of 3 percent, and will also credit excess interest at a rate at least equal to the rate of the interest paid by the financial institution in excess of 3 percent, less a 2 percent first-year premium charge, and a ¾ percent annual service charge.

Neither the assets represented by the annuity value, nor by dividends credited to the annuity value, shall be distributed or distributable by the financial institution to the participant or to any beneficiary or assignee. The participant's rights are derived solely under the terms of the annuity plan. Earnings on the deposits will be recorded as income to the taxpayer, and increases in annuity value will be recorded as expenses.

The annuity plans provide the participant the option to receive one of a variety of conventional forms of settlement, including a lump sum payment, life income, installments for a specified amount or a specified period, and installments for a specified period and life thereafter. The amount of any annuity payment made under the annuity plan shall be determined on the basis of guaranteed interest from the date the premium is received by the taxpayer, plus excess interest credited to the annuitant's account as determined by the taxpayer as described above.

In addition to the initial contribution to the account, additional annuity purchase contributions may be made from time to time prior to, or on the annuity date, of at least $100. The amount which may be contributed without the consent of the taxpayer during each successive period of 12 months shall be twice the amount contributed during the first period.

In the event the annuitant dies prior to the annuity date, a lump sum is payable to the beneficiary measured by the value of the annuity on the date of death. The beneficiary may instead elect to receive an annuity for a term certain or an annuity for life with a guaranteed period certain.

The annuitant does not have direct access to the interest earned on the deposits in the financial institution, except as the terms of the annuity plan allow him payment of benefits, loans on the cash value of the policy, or surrender of the policy for its cash value less a cash surrender charge.

Based on the above, the provisions of the annuity plan indicate that the taxpayer will be the recipient of the interest earned on the deposits placed in the financial institutions in connection with the annuity plan. The annuitant has no direct access to the assets in the account, but instead has a right to receive annuity payments in amounts pursuant to the taxpayer's obligations under the terms of the annuity plan.

Section 801(b) (1) of the Code defines life insurance reserves in general as follows:

(A) Amounts which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) Which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

Section 1.801-4(d) of the Income Tax Regulations presents illustrative examples of reserves which, provided they meet the requirements of section 801(b) of the Code and paragraph (1) of section 1.801-4(a) of the regulations, shall be included as life insurance reserves. Section 1.801-4(d) (2) includes reserves held under annuity contracts, and section 1.801-4(d) (5) includes reserves held under deposit administration contracts.

It is the mortality table used in the construction of the table of guaranteed annuity purchase rates which satisfies the requirement of section 801(b) (1) (A) of the Code that a life insurance reserve be computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest. The presence of permanent purchase rate guarantees substantiates the fact that the amounts held in the accumulation accounts are being set aside at the outset to satisfy policy obligations stemming from life contingencies.

Section 809(d) (2) of the Code provides that one of the deductions allowed in computing a life insurance company's gain or loss from operations is the net increase in reserves which is required by section 810 to be taken into account. Section 810(c) provides that among the items to be taken into account are the taxpayer's life insurance reserves as defined in section 801(b).

In the present case, the annuity contracts contain tables of guaranteed monthly installments under settlement options which involve life contingencies. Accordingly, the reserves held in the financial institutions pursuant to the annuity contracts are life insurance reserves under section 801(b) of the Code, and any increase in such reserves is to be taken into account as a deduction from gain or loss from operations pursuant to section 809(d) (2) of the Code.

Accordingly, it is held as follows:

(1) The taxpayer will be the owner of the deposits placed in federally insured financial institutions to include savings and loan associations; and

(2) The taxpayer, for purposes of determining its gross investment income under section 804(b) of the Code, will include the earnings of the annuity reserve as income, and will deduct the increases in annuity value from gain or loss from operations under section 809(d) (2) of the Code.

Pursuant to a power of attorney on file in this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

JOHN L. CRAWFORD,
Chief, Corporation Tax Branch.

SUMMARY OF POINTS

STATEMENT OF PHILIP HESSELBEIN ON BEHALF OF THE U.S. LEAGUE OF SAVINGS ASSOCIATIONS

MARCH 30, 1981

1. The U.S League supports S. 446, a bill to overturn Revenue Ruling 80-274, issued September 24, 1980. The legislation would reinstate tax deferral treatment for certain variable annuity plans funded by certificates of deposit purchased from savings and loan associations and other depositories—so-callled savers' annuities.

2. First Savings of Wisconsin was a pioneer with savers' annuities to encourage retirement savings; it held great promise as a source of funds for home finance.
3. Housing and home finance are in a prolonged recession, and meager savings flows to thrift institutions suggest continued depressed conditions for some time.
4. It is essential that savings and loan associations develop stable, systematic, longer-term deposits if they are to fulfill their Congressionally-mandated home finance function.
5. Savers' annuities are ideal funds for home finance.
6. The U.S. League reaffirms its support for other retirement savings incentives such as broadened dollar limits and eligibility for Individual Retirement Accounts as contained in S. 12 and S. 243, the subject of recent hearings by the Subcommittee on Savings, Pensions and Investment Policy.
7. Savers' annuities (where earnings only are tax-deferred are marketable, too, since they do not have eligibility restrictions and contribution limits as do IRA and Keogh plans.
8. Congressional approval of S. 446 would reinstate this useful source of funds for housing when it is needed . . . a preferable approach to a lengthy challenge of the IRS action in the courts.

MR. CHAIRMAN: My name is Philip J. Hesselbein. I am Executive Vice President of First Savings Association of Wisconsin, headquartered in Milwaukee, and appear today on behalf of the U.S. League of Savings Associations and its 4,400 member savings and loans associations nationwide.[1]

I am testifying in support of S. 446, legislation introduced by Senators Symms and Lugar to overturn Revenue Ruling 80-274.

On September 24 of last year, as the 96th Congress was drawing to a close, the Internal Revenue Service unexpectedly revoked a number of private letter rulings. The result was to deny tax-deferred treatment to the earnings on certain annuity plans funded by certificates of deposit purchased from savings associations and other depository institutions—so-called "savers' annuities."

This was a relatively new, and immensely promising source of savings for the thrift institutions which provide the bulk of home mortgages for Americans. Prior to September 24, 1980, our savings association—one of the pioneers with this product—has attracted 3,400 customers and $35 million in savings, for an average of a little over $10,000 per account. The funds were invested in market-related savings such as the 6-month Money Market Certificate and the 30-month Small Saver Certificates by the insurance company offering the annuities. As a rough estimate, this provided our institution and the Milwaukee community with the funding for 700 home loans.

When we initiated the savers' annuity product, it was our expectation that its appeal would be greatest among doctors, lawyers, and other professionals who might appreciate the opportunity to defer taxes on interest earned.

Interestingly though, the product has a broker audience, including many wage-earners concerned about adequacy of their retirement income.

I am sure that the Subcommittee is well aware of the sad state of the housing and home finance business in these inflationary times. Housing starts declined 25 percent from January to February to a mere 1.2 million annual rate.

The 1980 performance of only 1.3 million starts was woefully short of what is needed to house the Korean War "baby boom" and the rapidly growing demand for housing generally. Reflecting the minimal deposit inflows at savings associations in recent months, savings and loan mortgage lending in February amounted to only $3.5 billion, an 18 percent drop from January, and about half the comparable monthly activity in 1978 and 1979. Building permits figures and commitments to lend in future months suggest that real estate activity could remain at its low ebb for some time. A depression in housing and real estate is quickly felt in the timber, lumber and other supplier industries and in all of the manufacturers and businesses which provide the products which go into new homes.

Savings and loan associations are poorly equipped to compete for savings in periods of high inflation. Our investments are overwhelmingly long-term home

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[1] The U.S. League of Savings Associations has a membership of 4,400 savings and loan associations representing over 99 percent of the assets of the $625 billion savings and loan business. League membership includes all types of associations—Federal, and state-chartered, stock and mutual. The principal officers are: Rollin Barnard, President, Denver, Colo.; Roy Green, Vice Pres., Jacksonville, Fla.; Stuart Davis, Legislative Chairman, Beverly Hills, Calif.; William B. O'Connell, Executive Vice Pres., Chicago, Ill.; Arthur Edgeworth, Director-Washington Operations; Glen Troop, Legislative Director, Washington; and Phil Gasteyer, Assoc. Director-Washington Operations. League headquarters are at 111 E. Wacker Dr., Chicago, Ill. 60601. The Washington Office is located at 1709 New York Ave. NW., Washington, D.C. 20006, Telephone: (202) 637-8900.

mortgages—many made at rates of 6 percent, 7 percent, and 8 percent, years ago. Our deposits, however, are increasingly short-term—with over half now in the six-month Money Market Certificates or very-short $100,000 "jumbo" CDs sold to corporate treasurers, etc. at rates as high as 15 percent and 16 percent. The inability of long-term portfolio yield to keep up with short-term savings costs has led to the much-publicized squeeze on S&L earnings. The public is "rate-sensitized" and our MMC and jumbo savers, along with holders of longer-term time deposits, may move their deposits as they mature to chase advertised yields in the money market funds or other investment media.

With this structural problem, it is essential that the savings and loan business be encouraged to develop systematic, longer-term sources of funds if we are to continue to fulfill our Congressionally-prescribed mission of home finance. That is why our association found the savers' annuity program so promising. The average policy was opened for slightly more than $5,000—our minimum requirement was $1,000. As I mentioned above, in just a few months of operation, the typical customer has accumulated slightly more than $10,000 in these annuity plans.

There are, of course, other savings programs to plan for one's retirement years. Your sister Subcommittee on Savings, Pensions and Investment Policy, recently held hearings on S. 243 by Subcommittee Chairman Chafee and S. 12 by Chairman Dole of the full Committee. Those bills would encourage thrift and help redress the bias in our tax laws against savings. They would also provide for expanded eligibility for the familiar and successful Individual Retirement Account. I reiterate again today the U.S. League's support for those initiatives by your colleagues, and repeat our recommendation that the annual IRA contribution levels enacted back in 1974 be increased (at a minimum) to $2,000 to keep pace with the escalating costs of retirement.

Under current rules, of course, the Individual Retirement Account is not available to wage-earners in a qualified pension program. Furthermore, it is carefully structured to limit annual contributions amounts because both principal and earnings are tax-deferred.

A need remains for encouraging retirement savings plans in the private sector without such eligibility restrictions and dollar limitations. At my association, the ability to defer taxes on earnings alone as an incentive to a retirement savings objective—the savers' annuity—has proven its appeal to a broad audience.

Obviously, all private-sector programs to encourage our citizens to save toward their retirement years help relieve the escalating burden on entitlement programs such as Social Security.

Congressional action to override Revenue Ruling 80-274, and resumption of the savers' annuity program, can help in that effort.

We, of course, feel that the IRS acted improperly in its decision of last September. It is our opinion that the deferral for savers' and other variable annuity products is well within the tax treatment prescribed by Sections 72 and 801(g) of the Internal Revenue Code. The insurance company, as in all annuity arrangements, assumes the longevity risk of the annuitant. These, and other issues raised by Revenue Ruling 80-274 might well take years to resolve in the courts.

A far better solution is enactment of S. 446. It would encourage individuals to plan for their retirement. Not incidentally, it would enable our nation's home finance specialists, savings and loan associations, to compete more successfully with other tax-deferred opportunities in the marketplace which remain unchallenged by the IRS—the Treasury's own Savings Bond program and tax-deferred annuities "wrapped around" mutual funds. It would reinstate a useful source of funds for housing when it is needed.

In sum, Congressional approval of S. 446 would restore an important new product which holds the promise of increased, stable, and long-term savings to support the hard-pressed housing and real estate markets.

Mr. Chairman, I appreciate this opportunity to testify on behalf of the U.S. League and urge you and the Congress to act favorably on S. 446.

Summary of Statement of Dennis B. Berlin on Behalf of the National Savings and Loan League, March 30, 1981

NSLL supports S. 388 and S. 446 repealing IRS Revenue Rulings 77-85 and 80-274.

These rulings reverse longstanding Treasury policy and were made without input from or discussion with the Congress and affected parties.

The rulings are inequitable in that they only affect the savers annuity segment of the annuity market.

The rulings are detrimental to capital formation. Because of these rulings, potential for increased savings has been lost.

Mr. Chairman and members of the Committee, my name is Dennis B. Berlin. I am Executive Vice President of Chevy Chase Savings & Loan, Inc. in Chevy Chase, Maryland. I am also the Vice Chairman of the Governmental Affairs Committee of the National Savings and Loan League, whose views I represent today. The National League appreciates this opportunity to express its views on S. 388 and S. 446, which have very important implications for our business and for the capital formation needs of our economy.

As you know, the Internal Revenue Service has issued two rulings, Revenue Rulings 77-85 and 80-274, which have an extremely adverse impact on the treatment of certain annuity accounts. These annuities are essentially contracts between an individual and an insurance company, under which the insurance company agrees to pay the original investment, plus the interest it has earned, at a later date. Because the legal owner of the deposit is the insurance company, the depositor's investment qualifies as an annuity. Therefore, the depositor does not have to pay income tax on the interest until he or she withdraws the funds. Each annuity account is maintained separately, qualifying the accounts for FSLIC insurance coverage.

In the two Revenue Rulings mentioned above, particularly the second, the IRS has taken issue with the assertion that the insurance company, as opposed to the depositor, has ownership of the funds. Although it is somewhat unclear, the IRS apparently believes that if the underlying investment of the annuity is available to the depositor other than through the annuity, then the contract should not be treated as an annuity. We strongly disagree with this interpretation for the following reasons.

First, both of these ruling reverse longstanding Treasury policy. In the early and mid 1960's and extending until early 1977, the IRS ruled many times in private opinions that the establishment of annuity contracts was a legal investment, and they authorized insurance companies to proceed with such annuities. Then, in early 1977, the Service issued Revenue Ruling 77-85, completely reversing the over seventy opinions given to date. What troubles us greatly in the business world, and what happens time and again, is that this ruling was made without input from or discussion with the Congress and affected parties. The U.S. District Court for the District of Columbia agreed with that, finding in part:

"Revenue Ruling 77-85 is an erroneous and unreasonable interpretation of the Internal Revenue Code, and . . . the Court will declare the Rule to be unlawful and beyond the Service's statutory authority . . ."

Despite that very explicit ruling, the Service nonetheless issued Revenue Ruling 80-274 on September 14, 1980, severely affecting the savers annuity segment of the annuity industry, which particularly troubles us. This ruling only applies to saver annuities offered by savings and loan associations and not to tax-deferred annuities of money market funds. Also it seems not to cover annuity plans of commercial banks. Newspapers still run advertisements, epecially by money market funds, on variable rate annuities. The lack of equity in this IRS decision is especially disturbing.

Second, these IRS rulings, besides exceeding the statutory reach of the Service, are detrimental to capital formation, one of the most serious problems this country faces and recognized as such by the Reagan Administration. The savings and loan associations in this country are desperately trying to induce additional savings. That is why we support expanded IRA/Koegh authority, and tax exemption of interest on savings, among others. These rulings work against this very desirable goal by arbitrarily determining that these annuities are technically deficient. We strongly urge the Congress to adopt legislation to correct this misinterpretation by the Service.

Tax-deferred annuities have proven to be a successful and convenient method for certain individuals to save, and their potential is significant. As you know, increased savings are sorely needed today. The U.S. Department of Commerce recently announced that the personal savings rate in February declined to an all-time low of 4 percent of disposable income. The prospects for increasing that level of savings, without this annuity program and the other incentives we mentioned, are not bright. Former Federal Home Loan Bank Board Chairman Jay Janis, in a letter to then Secretary of the Treasury Miller, agreed with the need for these annuities, and he urged the Treasury to rescind 80-274.

It is difficult to make an estimate as to the impact of 80-274 on the saver annuity program. At the time it was released, there was approximately 400 S&Ls across the country who were managing or implementing such a program. Although we suspect that the actual amount of dollars invested in these accounts may have been low

simply because these annuities were just getting started, we are very concerned about the potential which has been lost. In particular, the Iowa Savings and Loan League was active in marketing these annuities. They tell us that more than $50 million of these annuities has been sold beween March and mid-September when the ruling was released.

One association, Leader Federal in Memphis, Tennessee, received over $5 million in savings annuity deposits in the four-month period prior to the issuance of Revenue Ruling 80-274. This is a significant figure considering the fact that the savings public was not particularly familiar with them.

The association reports that these accounts appealed to a broad segment of the savings market including young two-income families who found these accounts to be an effective way to build savings for the future. Certainly one obvious advantage of this type of account for younger "small savers" is its effectiveness in accumulating funds for a downpayment on a new home.

In summary, we would strongly urge the Committee to reject Revenue Rulings 77-85 and 80-274, not only because they are overreaching on the part of the IRS, but because they aggravate the very serious savings investment and capital formation problems we now face. We therefore respectfully urge this committee and the Congress to enact this legislation.

I would be pleased to respond to any questions you might have.

Senator PACKWOOD. We will move to S. 476 and we have Mr. Robert J. Reardon as the witness.

Are you ready, Mr. Reardon?

Mr. REARDON. Yes, thank you.

Senator PACKWOOD. Go right ahead, Mr. Reardon.

STATEMENT OF ROBERT J. REARDON, TRUSTEE, OTTO BREMER FOUNDATION, ST. PAUL, MINN., ACCOMPANIED BY SHERMAN WINTHROP

Mr. REARDON. On behalf of the Otto Bremer Foundation, thank you very much for the opportunity to appear before your committee in support of Senate bill S. 476.

My name is Robert Reardon. I am one of three trustees of the Otto Bremer Foundation, a private charitable foundation located in St. Paul.

The foundation is also a bank holding company.

With me today is our general counsel, Sherman Winthrop.

We have presented to you our written statement explaining our reasons for needing and supporting S. 476, with the request that it be placed in the record. I would like to now summarize our written statement.

None of the individual trustees of the foundation nor any members of our families are related in any way or manner to the sole donor of the foundation, Otto Bremer, or to his family. None of us have ever been contributors to the foundation; none of us hold any stock in the foundation or in any related corporations, other than director's qualifying shares.

An independent investment banking firm has concluded that the only feasible means of divestiture under the Tax Reform Act for the foundation would be through a public stock offering.

Because of antitrust laws, banking laws, and general economic consideration, there is no market for the foundation's assets except at an extreme discount or fire sale price. We are awaiting new regulations which we are hopeful will allow the foundation to proceed with its proposed plan of divestiture.

Under section 4942, of the Internal Revenue Code, the foundation is required to distribute the greater of its adjusted net income, or 5 percent of the fair market value of its assets.

The method of determining value used by the IRS has resulted in a value placed on the foundation's assets substantially in excess of the value placed upon the assets by the foundation.

The position taken by the IRS places the foundation in a direct conflict between the various bank regulators and the IRS.

Banking law requires that banks maintain a sound capital position. The position of the IRS would obligate the banks owned by the foundation to pay out substantially all of their income in dividends. This would be directly contrary to the capital needs of the banks as well as contrary to sound banking practices.

The soundness of the foundation's dividend policies has been commented upon very favorably by the Federal Reserve Bank of Minneapolis in a letter which is attached to our written statement as exhibit A.

The Minnesota attorney general has also expressed his concerns about this conflict of laws in his letter attached to the written statement as exhibit B.

This matter of conflicting law is of crucial concern to the Otto Bremer Foundation. The very existence of the foundation is at stake.

The foundation is unique. It is the only private foundation in the United States which is also a registered bank holding company.

S. 476 would correct the inequities now existing under section 4942 as applied to the foundation. It will enable the foundation to continue to meet its charitable commitments and at the same time maintain sound dividend and banking policies in conformance with regulations of the various banking authorities.

We do not believe it was the intent of Congress in 1969 to force reputable foundations to liquidate, nor do we believe that is the intent of Congress at this time.

We thank you for the opportunity to present testimony requesting your support of S. 476.

Senator PACKWOOD. A good job, Mr. Reardon. You present the problem very clearly, very well.

Senator Durenberger.

Senator DURENBERGER. Just a comment and a question.

I want to express my appreciation to you, Mr. Chairman, for taking the time to listen to a problem which may seem to be peculiar to only one institution.

In my other life, when I was a minuscule philanthropist in the corporate area, I gained a great deal of respect, not only for the individuals who are here, but for the impact that this foundation has had on a variety of communities in the State of Minnesota and, particularly, rural communities, where access to the foundation funding of the kind that's located in the big cities, or outside the State, is quite different.

So, I have been concerned since I got here about the problems that are peculiar to this particular foundation, and very supportive of their case.

Now, I just have one question, Bob. Have you looked at alternative means of valuation; or, are there alternative means of valuing the assets of the foundation? Or, is this it?

Mr. REARDON. It's more or less under the fact. What we are trying to do is solve the requirements of section 4943, which re-

quire the foundation to divest over a period of years. But, in order to divest, the investment banking people that we have consulted with said: Rather than giving it away at deep discounts, it would be best to have a public-held company. But, in order to become a publicly held company, another bank, or another first bank system, if you will, we have to get rid of this valuation method and the payout requirements. We cannot go to market with this valuation.

As far as conforming to divestiture, we've tried everybody. We've tried—we are restricted under banking law under domestic owners. We have tried foreign investors. The Arabs think—we can't convince them that that snow is sand. [Laughter.]

We've tried everybody and the only way is through the publicly held company. And in order to do that, we have to get rid of the requirements of 4942 on the payout and we'd have to have this relief that we are seeking that will allow a reasonable payout; a payout that's consistent with good banking.

We also have minority shareholders that are watching over our shoulders, too, to make sure that we follow a reasonable payout of dividends.

Senator DURENBERGER. Thank you very much.

Senator PACKWOOD. Senator Matsunaga.

Senator MATSUNAGA. No questions. I am here just to listen today.

Senator PACKWOOD. Thank you very much, Mr. Reardon, for taking the time to come. I appreciate it.

Mr. REARDON. Thank you, Senator. Thank you.

[Prepared statement of Robert J. Reardon, trustee, Otto Bremer Foundation, follows:]

OTTO BREMER FOUNDATION,
St. Paul, Minn., March 30, 1981.

COMMITTEE ON FINANCE,
U.S. Senate,
Washington, D.C.

GENTLEMEN: We are appearing before you today in support of Senate Bill S. 476 being a bill to amend the Internal Revenue Code of 1954 with respect to the valuation of bank holding company assets for the purpose of determining the amount certain private foundations are required to distribute.

By way of background, the Otto Bremer Foundation (the "Foundation") is a private foundation and a bank holding company. The Foundation is the sole shareholder of the Otto Bremer Company (the "Company") which is also a multi-state bank holding company. The Company owns majority control of 29 banks and 39 bank related companies, all of which are located in the three-state area of Minnesota, Wisconsin and North Dakota. The Foundation is the only private foundation in the United States which is also a registered bank holding company. The Foundation is classified as a private foundation for purposes of Chapter 42 of the Internal Revenue Code and is thus subject to the special rules imposed upon private foundations by the Tax Reform Act of 1969.

The Foundation focuses its grant making on the 29 communities in which the banks are located, substantially all of which are smaller rural communities. During the fiscal year ended June 30, 1980, grants paid by the Foundation were in the total amount of $1,203,076.00. Charitable grants made by the Foundation have increased substantially over the last ten years from $489,274.00 in fiscal year 1971 to an amount estimated to exceed $1,500,000.00 for the Foundation's fiscal year ending June 30, 1981.

The affairs of the Foundation are administered by three individual trustees, William Lipschultz, Gordon Shepard and Robert J. Reardon. None of the three trustees has ever been a contributor to the Foundation, none of the trustees owns any stock in any related corporations (other than directors' qualifying shares), and none of the trustees nor any members of their families are related to the sole grantor of the Foundation, Otto Bremer, or to any members of the Otto Bremer family.

At the present time, the Foundation is faced with a problem arising under Section 4942 of the Internal Revenue Code, For the Foundation's fiscal years ended June 30, 1974, 1975, 1976 and 1977, the method of determining value of the Foundation's assets used by the Internal Revenue Service has resulted in a value placed on the Foundation's assets which is substantially in excess of the value placed upon the assets of the Foundation as reflected in its income tax returns for the applicable years. If the method of valuation used by the Internal Revenue Service were to prevail in this regard, the Foundation would be required, under Section 4942, to distribute substantial additional assets, the result of which would threaten the very existence of the Foundation itself.

Under the provisions of Internal Revenue Code Section 4942, a private foundation is required to distribute the greater of its "adjusted net income" or a percentage (now 5 percent) of the fair market value of its assets. For this purpose, the Foundation has determined the fair market value of its assets by capitalizing the net income derived from such assets at a 6 percent capitalization rate. This method of valuation has been consistently used by the Foundation since the enactment of the Tax Reform Act of 1969. In fact, under date of September 15, 1973, the Foundation sought a ruling from the Internal Revenue Service approving its method of valuation. By letter dated January 21, 1974, however, the Internal Revenue Service refused to rule on the question for the stated reason that the requested determination was primarily one of fact, e.g., the market value of property.

The crux of the problem is the method of valuation to be used. The Internal Revenue Service, in arriving at its valuation of the Foundation's assets, has calculated the total value of all of the Foundation's banks, each valued independently rather than as part of a "banking system." That approach, in our view, incorrectly fails to value the Foundation's assets as they exist which is as an existing bank holding company or "banking system."

Moreover, the position taken by the Internal Revenue Service unfairly and improperly places the Foundation in a conflict between the policies and position of the various bank regulators and that of the Internal Revenue Service. On the one hand, sound banking practices require that banks maintain a sound capital position. The staff of the Ninth Federal Reserve Bank in Minneapolis has specifically commented that the dividend practices of the Company's banks have been sound. A copy of the letter of the Federal Reserve Board staff dated June 17, 1980, in this connection is attached as Exhibit A for your information. In that letter, you will note that the Federal Reserve Board staff specifically stated that the Company's dividend policy has given consideration to earnings available for dividends as well as the future capital needs of the banks to support deposit and assets growth and risk. That policy is well recognized to be the policy that is endorsed not only by the Federal Reserve Board but by the various state banking commissioners, the Comptroller of the Currency and the Federal Deposit Insurance Corporation to which the various banking interests of the Foundation are subject. On the other hand, the position of the Internal Revenue Service in the instant situation would, in effect, obligate the individual banks to pay out substantially all of their income in the form of dividends, a practice which, if followed, would be directly contrary to the capital needs of the banks as well as contrary to sound banking practice. The end result would be to dilute the capital position of the individual banks which would in turn be directly contrary to the policies of the various bank regulators.

The Attorney General of the State of Minnesota, in commenting on this conflict by letter dated July 16, 1980, a copy of which is attached as Exhibit B, specifically stated that the Internal Revenue Service's position would result in a weakening of the Foundation's member banks which would in turn be harmful to the communities that are served by the banks, particularly rural areas where insufficient capital is an ongoing problem. This result would also be inconsistent with the Foundation's practice of aiding the communities in which its member banks are located by direct charitable gifts as well as by maintaining strong local banking institutions to aid the individual communities' economic condition.

The uniqueness of the Company as a registered bank holding company makes the use of "comparables" inappropriate in arriving at a proper valuation. As a practical matter, the Company is not salable. Because of antitrust considerations, the two largest bank holding companies in the Ninth Federal Reserve District are not in a position to acquire the banks. No other existing bank holding company in the Ninth Federal Reserve District has sufficient financial resources to acquire the Company or any significant portion of its assets. Bank holding companies outside the Ninth Federal Reserve District are, as a practical matter, legally prevented from acquiring the banks as a system or individually due to the fact that by statute, multi-state bank holding companies may only acquire banks in their state of domicile or where the majority of their banks are located. Additionally, under Federal banking laws,

non-banking corporations have substantial restrictions imposed upon them with respect to acquiring banks and bank-related companies.

In effect, there is no real market for the Company's banks as a system, and thus, the real value of the underlying banks to the Company and in turn to the Foundation is the dividend flow from these banks. It is for this reason that the Foundation, in determining the fair market value of its banking system, has looked to a capitalization of this dividend flow.

Obviously, this matter is of crucial concern to the Trustees of the Foundation. The very existence of the Foundation is at stake. The Foundation has been an important factor in each of the rural communities in which its banks are located. The dividend policy of the Foundation's banks and resulting sound capital structure of its banks has enabled the Foundation to reinvest its earnings in these rural communities either in the form of grants to charitable organizations located in or serving the communities or by its banks supplying needed capital to finance agricultural, business, government and individual loans in these rural areas.

In summary, it is the Foundation's position that Senate Bill S. 476 would correct the inequities now existing under Internal Revenue Code Section 4942 as applied to the Foundation. The proposed bill would permit the Foundation, the only private foundation in the country which is also a bank holding company, to value its assets by capitalizing its income at 6 percent and thus preserve its status as a bank holding company. This result will enable the Foundation to continue to meet its charitable commitments to the communities in which its banks are located and at the same time maintain sound dividend and banking policies in conformance with the applicable rules, regulations and policies of the various bank regulatory agencies.

In conclusion, for the reasons stated above, your support of Senate Bill S. 476 is earnestly requested.

Respectfully submitted.

ROBERT J. REARDON,
Trustee.

EXHIBIT A

FEDERAL RESERVE BANK OF MINNEAPOLIS,
Minneapolis, Minn., June 17, 1980.

Mr. ROBERT J. REARDON,
President, Otto Bremer Co.,
St. Paul, Minn.

DEAR MR. REARDON: Last week, you expressed concern about the method used by the IRS to value the assets of Otto Bremer Foundation. That concern centered on the negative effect the IRS valuation method would have on the financial condition of the Bremer banks.

As a result of your concern, I reviewed this situation. Based on this study, I share your concern that the IRS's position has implications for the Bremer banks of increased cash dividends, decreased retention of earnings, less than optimal capital support for future deposit growth, and a potentially more limited future dividend stream to charity than might otherwise be the case.

At this point, I am reminded that a very fundamental objective of all profit-seeking businessmen is to maximize profit and perpetuate the organization. When maximizing profit, we must look to long-term profitability. In banking, long-term profitability, as well as perpetuity may be enchanced by prudent earnings' retention today.

Among other things, our review shows that the dividend practices at the Bremer banks have given consideration to earnings available for dividend payments, as well as the future capital needs of the banks to support deposit and asset growth and risk. Our review also shows the Otto Bremer Foundation organization is in generally sound financial condition. Asset quality of the subsidiary banks is generally sound, and capital is generally adequate.

Your situation suggests to me that the Bremer organization is caught between conflicting public policy objectives which have been committed to law, supervisory direction, and the like. On the one hand, public policy dictates that we have sound, well capitalized banks able to meet the banking needs of the communities they are charted to serve. On the other hand, public policy dictates that charitable foundations fulfill their charitable obligations.

In many ways, the business of banking is reconciling these conflicting objectives. (See attached paper.) It is my hope that all parties concerned, including the IRS,

your management, trustees and directors, and bank supervisors will find acceptable compromise solutions to these conflicts.

It simply does not make sense to me as a bank supervisor that we would, in the name of public tax policy or anything else, jeopardize the long-term soundness and profitability of a banking organization to meet an unsound dividend payment required by unrealistic asset valuation dictated by tax law.

Very truly yours,

L. G. GABLE,
Vice President.

FEDERAL RESERVE BANK OF MINNEAPOLIS,
November 29, 1977.

THE BANK DIRECTOR IN THIS PERIOD OF CRITICAL CHANGE AND CRISIS

For those of you who may be awed by the title assigned to my talk you may relax as what I am really going to talk about is your responsibilities as bank directors. Before I get to that though, I would like to make just a couple of observations.

My first observation is that I think there is an excessive amount of lip service devoted to the prestige associated with service as a bank director. I believe that prestige is a very personal thing. And really, I don't believe that any of you should expect to get much prestige or personal status just from serving as a bank director. On the other hand, you may find considerable prestige and personal status if you are a director of a sound, well managed bank and know that you as a director, make a significant contribution to its being that way.

Another observation is that there is too much emphasis placed on liabilities of bank directors. I don't mean to belittle the idea that directors do sometimes incur personal liability. However, if you fulfill your responsibilities as a bank director, there is precious little risk of incurring any personal liability.

The last observation I want to make is that our world and the environment in which we operate is not as complex as we sometimes think and others would like us to believe it is. The point I want to make from this observation is that as bank directors you have a responsibility to make sure that your bank and its various operations do not become excessively complex. With some imagination and ingenuity, and on occasion a hard-nosed approach, I think this responsibility can be fulfilled. Let me give you just a couple of suggestions. First, insist that all proposals, reports and policies which are submitted to the Board for information or approval are written in English. Second, don't accept or approve any report, proposal, policy or the like that you do not understand or that doesn't make sense. And last, recognize that few banks can be all things to everybody. Know your bank's strengths and weaknesses, and stay out of those areas where you lack expertise.

In describing for you what I believe to be the responsibilities of bank directors, I am first going to review the several different groups that you are responsible to. This approach, I believe, helps to clarify your responsibilities. I will then explain how you can go about fulfilling these reponsibilities through overseeing the operations of the bank you serve and providing direction where necessary.

As I see it, bank directors are responsible to: (1) stockholders, (2) depositors, (3) borrowers, (4) trust customers and beneficiaries, (5) management, (6) employees, (7) other directors, and (8) bank examiners and supervisors. I will make a few comments about your responsibilities to each of these groups.

Stockholders

Director responsibilities to stockholders are: First, to select and employ competent top management for the bank. Second, provide assurance that the bank is a good corporate citizen within its community. Third, provide assurance that the bank is operated on a profitable basis, that expenses are closely controlled, and that stockholders are rewarded for their investment. And last, but certainly a very important responsibility of directors to the stockholder group is to perpetuate the banking organization. Included in this major responsibility are: (a) providing adequate capital relative to the size, corporate responsibilities, and inherent risk involved in the operation; (b) providing assurance that adequate liquidity is available to meet depositor withdrawals and ligitimate loan requirements of the community; (c) provide assurance that credit and market risk in assets is held to reasonable limits; (d) assure that risk of loss through fraud or embezzlement is held to reasonable limits; and (e) assure that adequate insurance protection is in force.

Depositors

Depositors rightfully hold bank directors responsible for providing a balanced array of depositor services at a fair and competitive price. Depositors also have a right to hold directors responsible for assuring that the bank to which they have entrusted their funds is operated in a safe and sound manner, and employs their funds wisely to improve the general welfare of the community.

Borrowers

Bank borrowers have the right to expect the Board of Directors to manage the affairs of the bank in such a manner that if fulfills the legitimate borrowing needs of the community to the best of its ability. They also have the right to expect that available loan funds will be allocated among applicants in an unprejudiced, fair, and impartial manner, which in general is required by law. Corporate or business loan customers expect the affairs of their bank to be administered in such a manner that the bank won't be just a fair-weather lender and will be able to take care of their borrowing needs during temporary business setbacks. And all borrowers expect that loan terms and rates will be reasonable, fair, and competitive.

Trust customers and beneficiaries

Bank directors are responsible to trust providers and beneficiaries to accept only those accounts within the bank's sphere of expertise and ability to handle in a prudent manner. After acceptance you have a responsibility to provide assurance that each trust account is administered prudently, in accordance with the trust instrument, and in the best interests of the beneficiaries.

Management

We usually think of bank management as being responsible to the Board. As a result, it is a bit hard to focus on director responsibilities to management. However, as I think about this subject, I failed to identify any situation where people interact with one another, that responsibility is completely one-sided or flows only in one direction.

The first responsibility of directors to management is to oversee and direct the affairs of the bank, and then to step back and let management administer the affairs of the bank as you have so directed. Simply put, this means that directors should direct, but no matter how strong the temptation, avoid attempting to manage the bank. You have a responsibility to give your management reasonable authority to carry out your directions. And management has the right to make some mistakes and to learn from them. You have an obligation to support your management. And I think you also have a responsibility to avoid the temptation to second-guess management and to avoid nitpicking. Continuous nitpicking and second-guessing on the part of directors does not do anyone any good.

You also have a responsibility to provide fair and competitive compensation to your management team.

I hope you agree that directors have these responsibilities to management. I also hope you agree that in most cases such responsibilities are relatively easy to fulfill. There are, however, some additional responsibility that directors have to management that are not quite so easy to fulfill. Here I refer to the responsibility you have to your management to stand up and be counted when you don't agree with the way the affairs of your bank are being administered. When you observe adverse trends such as excessive employee turnover, excessive risk in assets reflected by low quality loan originations, delinquencies, examiner classifications, security purchases involving high credit and market risks, concentrations of credit, or whatever that management, and possibly even other directors, appear oblivious of, you must let your feelings be known and insist that there be a change for the better.

Among the most unpleasant responsibilities of a director, and fortunately it doesn't require fulfilling very often, is the removal or replacement of management. I won't argue that this is a responsibility to management as opposed to a responsibility to stockholders. Nevertheless, when it needs doing it is an unpleasant responsibility that has to be fulfilled. And let me point out that directors generally don't do anyone any favors by continuously delaying this type decision and action and in effect forcing the incompetent manager to prove his incompetence beyond all doubts to all concerned parties.

Bank employees

To employees directors have a responsibility to provide a fair and equitable compensation program that gives consideration to job responsibilities and performance. While there are arguments pro and con for being progressive in providing fringe benefits, the determination of which benefits will be provided is a responsibil-

ity of the Board to its employees. I believe you also have a responsibility to provide job security to employees. And lastly, acceptable and safe working conditions.

It should go without saying that you have an obligation to provide equal employment opportunities, both in the selection of new employees, and in promotions of existing staff members. As I interpret the rules, this means that opportunities must be equal for all people, regardless of race, sex, national origin, religion, or age.

A less well publicized responsibility of directors to employees is to provide safe working conditions. Here I specifically refer to a piece of Federal legislation which became known as the Bank Protection Act of 1968. That legislation was created to help prevent crimes against banks and to assist in the identification, apprehension, and prosecution of those who commit such crimes. Among other things, the law provides that all bank employees must be instructed on what to do before, during, and after a robbery, and requires banks to install and maintain certain security devices to help prevent crimes from being committed. I bring this up because I think it is a very real responsibility of directors to their employees to provide assurance that the bank does have reasonable security procedures, that they are communicated to employees, and that the bank does use security devices aimed at preventing robbery and other crimes against the bank.

Other directors

To your fellow directors you have a responsibility to attend Board meetings and to make your position known on the issues discussed. I might add that your co-directors have a similar responsibility to you. Thus, if a member of your Board is consistently or frequently absent you have a right, if not an obligation, to encourage the entire Board to seek that director's resignation.

Among other responsibilities you have to each other are selection of new people to be nominated for election to the Board. Indoctrination of new directors is a responsibility that gets too little attention too often. And determination of a director retirement policy is another responsibility you have as directors to one another.

Bank examiners and supervisors

And last, if not least, as bank directors you have some responsibilities to bank examiners and supervisors. Speaking in generalities, your primary responsibility to your bank supervisor is to make sure your group fulfills its responsibilities to all the other groups you are responsible to. If you do this, I think you will pretty well fulfill most of what we supervisors expect of you.

Going from generalities to specifics, you have a responsibility to read, review, and evaluate the report of examination, and correspondence from the supervisor relating to that examination. As directors you should provide yourselves with assurance that action is being taken by managment to: (1) correct any deficiencies or operating weaknesses noted, (2) conform to recommendations for reversing unsatisfactory trends, and (3) comply with any demands to discontinue unsafe or unsound banking practices or violations of governing laws and regulations.

As a practical matter there will be times when your management disagrees with the conclusions of the examiner and as a result is opposed to taking action that will conform with the examiner's suggestions or recommendations. In such situations I would encourage you to use a good deal of caution. On the one hand your management should understand the situation better than the examiner and could be right. And I don't think any of us will claim all our examiners are perfect. On the other hand there are a lot of hard-working, dedicated, and competent people out examining banks. They have the benefit of exposure to a lot of banks, and have no vested interest in any one bank or the manner in which it operates.

Please don't make the mistake one Board made. A director confided to me that their review of examination reports consisted of the managing officer going through the report page by page during a Board meeting explaining what the examiners did wrong and how they reached such erroneous conclusions. That director later acquired a larger financial interest in the bank and took a greater interest in its general welfare. He then discovered the examiners were more right than wrong.

And lastly, your objectives as directors and ours as supervisors have many parallels. Thus, I think you have one last responsibility to your supervisor and that is to communicate. If you don't think we are doing very well at our supervisory job as it relates to your bank, by all means communicate those observations to us and we will try to do better. As you know, all three of the Federal bank supervisory agencies are attempting to improve communications with directors. You can expect to be invited to meetings at the conclusion of examinations more often than in the past. Two-way communications at such meetings will help make them more productive.

To summarize up to this point, I view the responsibilities of bank directors as running to stockholders, depositors, borrowers, Trust Department customers, bank

management and staff, co-directors, and bank examiners and supervisors. When we view a bank director's responsibilities in this manner, it is obvious that there are some conflicting responsibilities, and that these conflicts must be reconciled. To do so requires the use of good judgment. And even more important is the balancing of good judgment to give proper consideration to all parties to whom a director is responsible.

I now want to move on and discuss how directors can go about fulfilling their many responsibilities. From the bank director's title it is obvious that a basic part of the job is to provide direction. An all-encompassing yet simple definition of providing direction is to cause to follow a prescribed course. But before anyone can prescribe a proper course for someone or something to follow, he must first know where the subject, to be directed, is currently situated. Such knowledge is obtained from overseeing. My point is that there are two primary functions of a bank director's job: Overseeing and directing. And I maintain that you cannot effectively provide direction without first performing the overseeing function.

There are three basic methods that I know of that directors can use in overseeing the operations of their bank: The first is through direct observations and keeping one's ear to the ground. Second is through audit and examination reports prepared by auditors who are not responsible to management, and supervisory examiners. And the third method directors have for overseeing the operations of their bank is through comprehensive reports prepared by bank management and staff. I want to go into more detail on each of these overseeing methods.

From your phone calls into the bank and visits to the bank premises you can make some pretty good observations about such things as: (1) Housekeeping—do the premises appear neat, orderly, and efficient or do they appear sloppy and inefficient. (2) Atmosphere—is there a spirit of friendliness, helpfulness, and cooperation, or are employees grouchy and unpleasant. (3) Alertness—does someone see and recognize you as you come in the door, or can you wander around the place without being noticed. And if you can come and go without being noticed, think of what someone else can do who may be up to no good. (4) Telephone courtesy—do you get prompt, courteous responses to telephone inquiries into the bank, or do you get long holds, or comments like "Sorry he is not in yet!" or "He is still out to coffee." or "He has gone home already!" These kinds of observations can give you some pretty good insights about the bank you are directing.

Another good source for direct observations is your bank's advertising. Listen in to your radio and TV commercials, and read and analyze your bank's newspaper and direct-mail advertisements. Do they communicate well? Can you understand them? Are they easy to understand or do they tend to mislead? And what do other people say about your bank? Don't just ask a friend what he thinks of your bank; he will probably tell you what he thinks you want to hear. Instead ask him what he hears other people saying. And then don't be too defensive if you really want to know what he thinks.

Lastly, through the financial press attempt to keep abreast of what's going on in the banking industry on a local, regional, and national basis. While this may not give you a great deal of information about your own bank, it will provide some perspective and a base for comparison.

All these relatively simple, direct observations can provide useful information to a bank director and help fulfill the overseeing part of the job. Use this kind of information for what it is worth, but bear in mind that it will not do the whole overseeing job.

Audits and examinations are tools that can be used effectively by bank directors in fulfilling their overseeing function. Audits and examinations are primarily fact-gathering operations, and thus the people performing these tasks are principally engaged in overseeing. It is true that auditors occasionally and examiners frequently provide direction as a part of their job. But it is well to remember that most often auditors and examiners are in effect recommending that certain direction be provided. The final responsibility rests on directors and management to implement the recommended course of action.

Frequently the words or functions of audit and examination are used synonymously in banking. They are not, however, the same functions and you should use them differently. An audit is primarily aimed at determining that the bank has all the assets it claims to have, that its liabilities are no greater than stated, that the bank gets all the income it is entitled to, and that expenses are no greater than authorized. Some auditors go beyond the basics and get involved in procedural audits which is a form of management consulting. Here you can expect that auditors will examine certain operating policies and procedures and offer suggestions on how to strengthen operations to provide better controls or a sounder operation.

A bank examination as conducted by the supervisory authorities is aimed primarily at determining how soundly the bank is managed, its financial condition at the time of the examination, and what the condition of the bank will be in the future if it follows its present course. If the present condition or the projections for the future do not reflect a sound, well-managed bank, the examiner and sometimes his boss, the regional supervisor, will suggest or recommend a course of action that will change the future direction of the bank to a sounder position. And where necessary, supervisors must sometimes take legal action to force a bank to alter its direction.

A common weakness that I have observed in both supervisory examinations and audits conducted by public accounting firms is that examiners and auditors frequently identify only the symptoms of a problem. In other words, an examiner may include a comment in his report that loan delinquencies are excessive or that the quality of a bank's loan account is deteriorating as reflected by the trend of loan classifications. These may be accurate observations, but they are only symptoms of a problem which is not identified. The real problem may be that loan policy which governs loan originations is weak. Or the policy may be alright but is not adhered to. Or that collections are ineffective. Or that the local economy is depressed. We recognize this common weakness in our examinations and are attempting to correct it. But until examiners get skilled in zeroing in on the causes of bank problems, it is best that you also recognize the weakness. In dealing with problems and in taking action to provide direction that will overcome problems, you must know the cause of the problem and not just the symptoms.

In summary, audits and examinations can provide very useful information to directors in helping to fulfill the overseeing part of the director's job. Properly utilized these reports can give a pretty good picture of where the major component parts, as well as the whole bank have been, presently are, and are likely to go without a change in the course of direction.

The last method you have for overseeing your banks is through analysis and evaluation of reports provided to you by the management and staff of the bank. It should go without saying that the Board of Directors should determine the type and timing of such reports received. My guess is, however, that more often than not management determines the type and timing of information reports provided to directors.

In attempting to determine the type of information reports directors should receive, a good place to start is to go back and review the types of responsibilities you have to the several groups. As I worked through this exercise I see the potential for numerous reports, each of which would provide valuable information to directors and help you to determine which operations are proceeding on a sound course and those areas where a change in the course of direction may be needed. Obviously there has to be a limit. You don't pay management and staff just to prepare reports to directors. And directors' time for reading and analysis is not unlimited either. My time is limited also, but I do want to break into it part way just to point out some of the possibilities.

I said bank directors have a responsibility to stockholders to make sure the bank is a good corporate citizen within its community. If you accept this as a responsibility you should then get some kind of report, perhaps annually, showing charities supported by such donations, other efforts, contributing to civic good works, and endeavors of the bank, its officers, and staff to help make the community a good place to live, work, and do business.

Another responsibility you have to stockholders is to make sure the bank is operated profitably and that expenses are closely controlled. To keep track of earnings and expenses, you should get some kind of reports, perhaps quarterly, which would include sources of earnings, total earnings, trends based on comparison with the past, actual performance compared to budget, and perhaps the same kind of information on expenses.

Earlier I identified five separate responsibilities to shareholders under the general heading of perpetuating the banking organization. The first was to provide adequate capital. To keep track of your bank's capital position, you should get and review, perhaps annually, some kind of a report with trend comparisons of capital to deposits, loans, and total assets. Comparisons with regional averages or competition may also be helpful.

If you accept the responsibility to provide assurance that your bank maintains adequate liquidity to meet depositor and creditor demands as well as the legitimate loan demands of the community, and I think you have this responsibility, then you should be getting and evaluating reports showing the liquidity position of your bank. Bear in mind that there are two basic factors to be considered in evaluating liquidity. The first is needs and the second is provisions. Needs are determined from the potential volatility of deposits and other liabilities; in other words, the maturity

of deposits and how much can be expected to be withdrawn, and from loan commitments and normal borrowing needs of customers. Liquidity provisions are determined from the maturity and marketability of assets and how quickly and at what cost assets can be converted to cash. Thus, reports for your analysis should show both potential needs and provisions, including estimates of the cost to convert these assets to cash. You should be concerned with the margin that is maintained between liquidity provision and potential need, and at what cost. In some banks such information should be provided to directors on a monthly basis. In others a semiannual review may be adequate.

To oversee credit and market risk in assets so that you can assure stockholders that such risks are held to reasonable limits may require several reports. While there are generally only two major categories of assets in banks that involve risk, and I refer to loans and investments, you should not overlook the others. Others might include overdrafts, other real estate, certain cash items, Federal funds, and other assets which probably includes repossessed personal property.

When looking at loans, the variety and type of reports that can be generated and which will give valuable insight into the amount of risk involved in those loans is limited only be one's imagination. One way to limit the possibilities and attempt to get some logic into a director's loan review process would be to get some information on the three stages of bank loans. These stages are origination, the holding period, and collections. And it may be necessary to subdivide various classes of loans for these three stages. In other words, the type of information you need to evaluate the degree of risk in your consumer installment loan operation is significantly different from the type of information necessary to evaluate risk in your commerical lending operaiton.

Taking consumer installment loans as an example, the kind of information you may need to evaluate the degree of risk might include a quarterly report on originations, a semiannual or annual report on the overall condition of the portfolio, and a bimonthly or quarterly report on collections.

From here I could go on and write a book about the many reports that directors could and should get to keep informed of the many operations of their bank. The point is that management information reports are essential to overseeing a bank's operations. And without overseeing you cannot fulfill the bank director's role.

One other point I want to make about management information reports relates to the time such information reports are provided to directors.

Too often directors arrive at the appointed hour for a Board meeting and are handed several reports that are to be gone over and discussed at the meeting. For the kind of information reports that I have in mind, and as I see a director's responsibility for review and evaluation of the information, this is just not a satisfactory arrangement. I think bank management has a responsibility to the Board to get these reports produced and delivered to directors at least a week before the meeting to provide adequate time for review, analysis, and prepare for discussion.

Too often the confidentiality of the information in such reports is used as an excuse for not providing them to directors prior to a meeting. And that reminds me of a personal experience with a former president of our bank, Hugh Galusha. I had just handed him a document containing sensitive information and made quite a point of reminding him of the confidentiality of the information. Hugh gave me a queer look and asked, "What did you do, shoot the secretary who typed it?" The point is, if directors cannot be trusted to maintain the confidentiality of bank information, they shouldn't be bank directors. And that is a responsibility of directors that I didn't even mention when discussing your many responsibilities.

To summarize to this point, a bank director has many responsibilities that run to several different groups. To fulfill these responsibilities you must know where your bank and its component parts have been, currently are, and are likely to go without direction. To effectively perform this overseeing function you have opportunities to make direct observations, should utilize audit and examination reports, and should obtain and evaluate meaningful and timely reports prepared by your bank's management and staff.

And now comes the important part and final step in fulfilling the responsibilities of a bank director. It is providing direction to the bank you serve. While you must recognize your responsibilities, and you must oversee the bank's operations, just having this knowledge does not really accomplish anything. In providing direction you use the knowledge from recognizing responsibilities and overseeing to prescribe the course the bank, its varied operations, and component parts will follow in the future.

There are two basic functions involved in providing direction. The first is prescribing direction, which for a Board of Directors is generally accomplished through

policy formulation. The second is providing assurance that the policies are being adhered to and followed.

Policies are basically a communication device used to coordinate and control the efforts or behavior of a group of individuals. They are tools used to direct the course of a business or an operation. And, hopefully, if well-devised and adequately controlled, will maintain that business or operation on a sound course in spite of changing individuals or circumstances.

And I want to emphasize that unless you have well-devised written policies governing your bank's operations, you, in effect, are going to have not much more than a bunch of independent contractors extending credit, purchasing and selling securities, accepting deposits, administering salaries, and the like on behalf of your bank. In addition, without governing policies your director group and your management are going to have numerous ad hoc decisions to make and it will be difficult if not impossible to get any consistency into those decisions.

Again, a good place to start to determine the types of policies your bank needs is to go back and review your responsibilities. From such a review one might conclude that it is essential for the bank to have policies governing its audit program, its lending operation, its investment security portfolio, its liquidity position, the acceptance and administration of trust accounts, a service charge policy on deposit accounts, equal employment and salary administration, and advertising. Such a list is limited only by one's imagination.

There are two other methods for determining the need for a governing policy. First, where ad hoc decisions must frequently be made and it is difficult to get consistency in the decision-making process, you may have an area that requires a governing policy. Second, where knowledge gained through overseeing indicates that an operation is stumbling along or is on unsound course, you probably have an operation that requires some policy direction.

At this point I want to back off a bit. I stated that the potential number of areas in a bank that can be covered by policy directives is limited only by one's imagination. Some people have very active imaginations. It appears that some of these people want to eliminate all decisionmaking, sin, and potential sin through policy directives. One or two mistakes, a few customer complaints, or a wiggle or two on a trend line and they want to create a new governing policy or amend an existing policy to eliminate the problem forever. Give these people a free reign and you will end up with a policy covering the use of the employee parking lot, another covering employee coffee breaks, one on appropriate salutations for business letters, and what have you.

What I am trying to say here is that each bank needs policies to prescribe direction and to coordinate and control the efforts of its employees. But there is a limit. No policy or group of policies can be so all inclusive, either in the coverage of an individual policy, or in the aggregate coverage of a group of policies, that they eliminate the need for judgment and decision-making. Excessively tight or inflexible policies and an excessive number of policies can be stifling and confusing and can be almost as bad as no policy directives at all.

In addition to establishing reasonable policy directives for your bank and its component parts to follow, it is equally important for you to provide assurance that such policies are followed. To do this we go back to the overseeing part of your job. The knowledge you gain from direct observations, review of audit and examination reports, and analysis of information reports provided by management and staff can be used to determine how closely the bank and its component parts are following the direction you have prescribed through governing policies.

One last comment here on policies. If you want your policy directives to be followed, make sure they are not confused with goals and objectives.

In our complex world there has developed considerable confusion between policies and objectives and goals. I like to think of policies as a prescribed course that one expects will be followed. On the other hand, goals and objectives are what one would like to achieve, or as someone recently commented they sometimes appear more on the order of hopes and dreams.

In conclusion I have attempted to review the responsibilities of bank directors by looking at the several groups you are responsible to. I have also concluded that to fulfill these many responsibilities you must oversee the affairs of your bank and provide direction. In working through the mental exercise of preparing this paper I have developed, at least for myself, some new concepts on the responsibilities of bank directors. I hope that in listening you too have a better understanding of your responsibilities and as a result your job of bank director becomes more interesting and rewarding.

EXHIBIT B

STATE OF MINNESOTA,
OFFICE OF THE ATTORNEY GENERAL,
St. Paul, July 16, 1980.

Mr. ROBERT J. REARDON,
Otto Bremer Foundation,
St. Paul, Minn.

DEAR MR. REARDON: In our recent meeting held on July 8, 1980, you advised me of the Internal Revenue Service's Examination Report dated June 24 addressed to the Otto Bremer Foundation (the "Foundation") covering the tax years ended June 30, 1974, 1975, 1976 and 1977. In that discussion, as well as in several of our other recent meetings, you expressed your concern with respect to the position taken by the Internal Revenue Service in their Examination Report.

Over the years we have been most appreciative of the cooperation and thoroughness with which the Foundation has kept this office apprised of its activities and the results of its operations. In addition, you have kept us apprised of the Foundation's concerns over the various issues raised under the charitable foundation provisions of the Tax Reform Act of 1969.

The Internal Revenue Report for the years in question is addressed to the provisions of § 4942 of the Internal Revenue Code which requires a foundation to distribute the greater of its adjusted net income or a percentage (presently 5 percent) of the fair market value of its assets. In its Report, the Internal Revenue Service placed a fair market value on the Foundation's assets by the Foundation. For the purpose of § 4942, the Foundation determined the fair market value of its assets during the years in issue by capitalizing the net income derived from such assets using a yield basis of 6 percent.

To our knowledge, the Foundation has always distributed all of its net income to charitable beneficiaries. In addition, the Foundation has always conducted its affairs in a prudent, businesslike manner. We are also mindful of the Foundation's efforts to distribute its grants in the communities in which its various banking activities are conducted and its efforts to otherwise contribute to the well-being of those communities.

We share the concern you have expressed with respect to the position taken by the Internal Revenue Service in its Examination Report for the tax years referred to above. The position taken by the Internal Revenue Service has placed the Foundation in a conflicting position between the various bank regulators and the Internal Revenue Service.

On the one hand, sound banking practice requires that banks maintain a strong capital position which in turn requires that a bank's dividend policy not be inconsistent with maintaining a strong capital position. That policy, to our knowledge, is the policy that has always been expressed by the Federal Reserve Board, the State Banking Commissioners, the Comptroller of the Currency and the Federal Deposit Insurance Corporation to which the various banking interests of the Foundation are subject. On the other hand, the Internal Revenue Service by the position taken in the Examination Report is, in effect, obligating the individual banks to pay out substantially all of their income in the form of dividends, a practice which, if followed, would be directly contrary to sound banking practice. The effect, of course, would be to dilute the capital position of the individual banks contrary to the policies of the various bank regulators.

The resulting dilution would result in a weakening of the Foundation's member banks which is, in effect, harmful to the communities that are served by the banks, particularly rural areas where insufficient capital is an on-going problem. Such a result is inconsistent with the Foundation's goal of aiding the communities in which its member banks are located by direct charitable gifts and by maintaining strong local banks to aid the individual communities' economic condition. This irreconcilable conflict between the banking regulators and the Internal Revenue Service would force the Foundation to liquidate its individual banks with the result that there would be a forced dissipation of its assets. The end result would be to reduce the value of the Foundation's assets and adversely affect the individual communities in which the various banks are located.

As the State official to which charitable foundations are subject, I am deeply concerned over the position now taken by the Internal Revenue Service in its Examination Report for the tax years in question. I want you to know that I am supportive of the manner in which the Foundation has been operated in the past and wish to assure you of my continued support.

If I can be of any help to you in support of your position before the Internal Revenue Service or otherwise, please do not hesitate to ask.

Very truly yours,

WARREN SPANNAUS.

Senator PACKWOOD. Next, we will consider bills S. 464, 500, and 501.

And we will first start out with a panel: Mr. Robert Bothwell and Mr. Christopher Edley.

I might say before this panel starts: All three of the bills that we have had—or three of the different panels relating to about six bills we have had today—all relate to trying to correct some action of the Federal Government that would preclude in form or another what we regard, normally, as desirable ends.

I am in sympathy with the objectives of all of the bills, including the ones we are about to hear testimony on now, because I have discovered that the ends, indeed, are legitimate and we are more likely to obtain them through the private sector, be it foundations or charitable efforts, or savings and loans. We are more likely to achieve them than we are if we are to follow the rulings and decisions that have affected the various parties concerned.

Are you Mr. Bothwell?

Mr. BOTHWELL. Yes, sir.

Senator PACKWOOD. You may start.

STATEMENTS OF ROBERT E. BOTHWELL, EXECUTIVE DIRECTOR, NATIONAL COMMITTEE FOR RESPONSIVE PHILANTHROPY, WASHINGTON, D.C.; CHRISTOPHER EDLEY, EXECUTIVE DIRECTOR, UNITED NEGRO COLLEGE FUND, INC., WASHINGTON, D.C.; JACK MOSKOWITZ, SENIOR VICE PRESIDENT, GOVERNMENT RELATIONS DIVISION, UNITED WAY OF AMERICA, ALEXANDRIA, VA.; MATHEW AHMANN, ASSOCIATE DIRECTOR FOR GOVERNMENTAL RELATIONS, NATIONAL CONFERENCE OF CATHOLIC CHARITIES, WASHINGTON, D.C.; FRANCES HESSELBEIN, NATIONAL EXECUTIVE DIRECTOR, GIRL SCOUTS OF THE U.S.A., WASHINGTON, D.C.; RUSSELL MAWBY, CHAIRMAN, LEGISLATIVE AND REGULATIONS COMMITTEE OF THE COUNCIL ON FOUNDATION, BATTLE CREEK, MICH., ACCOMPANIED BY THOMAS A. TROYER, CAPLIN & DRYSDALE, WASHINGTON, D.C.

Mr. BOTHWELL. Yes, sir. Thank you very much.

I am Robert Bothwell, executive director of the National Committee for Responsive Philanthropy.

I did want to introduce to the committee some of my board members who are here. Behind me: Mary Watanabi, from the Pacific Asian Coalition; Kenn Allen, the head of Volunteer National Center for Citizen Involvement; and Pablo Eisenberg, one of our cochairs, Center for Community Change. What follows is our oral summary testimony. Our complete testimony was submitted for the record March 27.

The National Committee, its members and affiliates, and the thousands of local and State organizations we work closely with, are all private nonprofit organizations. So, too, are the private foundations that are the subject of these three bills.

Our comments—and I want to underline this—are aimed at strengthening the private, nonprofit sector. We think it is vitally

important to this country as a balance wheel to government and to business.

The three bills propose a major reduction, however, in foundation spending. We estimate that S. 464 and S. 501 could reduce foundation spending by between $100 and $200 million or 5 to 10 percent of total foundation spending.

We think that the reduction of S. 500 would be the same or less.

This reduction will be most severely felt by the private, nonprofit organizations, which are the principal beneficiaries of foundation spending.

And this major change in foundation spending is proposed while the Federal Government is considering even greater spending cuts.

Five years ago the Filer Commission on Private Philanthropy and Public Needs shocked the private nonprofit community by estimating that the amount of money that the Government provides as revenues to the private, nonprofit sector are equal to the amount of private contributions.

So, as major cuts in Government spending are implemented this year and next, the private, nonprofit sector, will experience a depression unlike any it has ever known.

Together, foundation and Government cuts will seriously jeopardize the capacity of this country's estimated 6 million nonprofit organizations to meet the public needs of our population which are simply not met by direct Government assistance.

However, this is a complicated issue. We want to make very clear to the committee that we think the foundation proposals for reduction of the payout rate have independent merit. The combination of inflation and the payout rate requirement have helped erode foundation assets. We have looked carefully at the data in support of this and do come to that conclusion.

If no change is made in the current payout requirement, foundations' capacity to respond to the future needs of the nonprofit sector and the community at-large will be much further diminished than it already is.

Nevertheless, foundations have contributed somewhat to their own demise. The Twentieth Century Fund a few years ago, reported that 6 out of 10 of the very largest foundations had more than half of their assets invested in a single company. We don't think this is a very prudent investment policy. In some cases foundation assets and income were seriously reduced by the policy.

Also, despite tax advantages for the creation, growth, and maintenance of foundations, many foundations do not inspire public confidence in having them exist perpetually. A study we did last year indicated that 30 percent of the largest foundations refused to provide information to the public, even when requested repeatedly.

Unless foundation accountability to the public is improved substantially, we do not think changes should be made in the foundation payout requirement.

Therefore, we recommend:

First, that the foundation payout rate be reduced to 5 percent of investment assets at market value, or this figure plus one-half of adjusted net income exceeding 5 percent of investment assets at market value, whichever is larger, provided;

Second, that all the larger foundations be required to prepare and disseminate to the public annual reports which contain basic information essential to anyone interested in evaluating foundation activity or in seeking foundation grants.

We think this proposal is a clear compromise responding to the short-term needs of the nonprofit community, and the long-term needs of foundations to maintain their assets and their public viability.

Senator PACKWOOD. I am going to have to ask you to conclude your statement, Mr. Bothwell.

Mr. BOTHWELL. Thank you.

Senator PACKWOOD. Let's take the rest of the group together. It is a panel and was set as a panel.

If you would come up and then we will take your testimony in order: Mr. Edley, Mr. Moskowitz, Mr. Ahmann, Ms. Hesselbein, and Mr. Mawby, if you want to take the table.

STATEMENT OF CHRISTOPHER EDLEY, EXECUTIVE DIRECTOR, UNITED NEGRO COLLEGE FUND INC.

Mr. EDLEY. Mr. Chairman and Senators, the United Negro College Fund is the official fundraising body for 41 fully accredited private black senior colleges in this country and I am the executive director.

These colleges and universities enroll more than 50,000 students studying toward baccalaureate and advanced degrees and several thousand more who are involved in noncredit continuing education courses and programs.

The Nation's black colleges enrolled almost half of all blacks attending the Nation's institutions of higher learning.

I appreciate this opportunity to appear before this distinguished committee. I have submitted a formal written statement for the record. While my statement will not cover the technical amendments that are part of this legislation, I fully support their enactment.

Only 28 blacks in the United States held college degrees in 1860. And this had increased to only 2,500 by 1900. Largely due to the existence of black colleges over the last 132 years, there are now 600,000 blacks in this country who hold baccalaureate and professional degrees.

This would not be the case if these schools and the United Negro College Fund had not been the recipients of generous philanthropy and, more recently, sustained donations from the Nation's foundations.

The United Negro College Fund recently completed the most successful fundraising drive for private higher education in the history of this Nation. Under the able and energetic leadership of Thomas A. Murphy, the then chairman of the board of General Motors, UNCF was able to raise $60 million in capital campaign funds over a 3-year period. Of this total, $29 million, or slightly over 49 percent came from the Nation's foundations.

The Kresge Foundation gave the United Negro College Fund $6 million, the largest single grant that they have ever awarded. These funds are earmarked for construction projects at our 41 member institutions.

The Kellogg Foundation donated over $3½ million to the capital campaign. This allocation is being used to establish an Integrated Management System at United Negro College Fund institutions. This grant will help insure that the management systems at member institutions are availing themselves of the latest and most effective management tools possible consistent with their resources.

The McArthur Foundation donated $2 million in our drive for a specific purpose.

I will not take the committee's time to list all of UNCF's 96 foundation gifts for our capital campaign. It suffices to say that this effort would not have been successful without the generosity and deep concern of many foundations.

Over the last 10 years foundation giving to our UNCF annual campaign has averaged 20 percent of all dollars raised. Importantly, most of these funds have been given for general operating support of UNCF's member colleges and universities.

We have also been the recipient of significant and important grants to our annual campaign.

The Lilly Endowment has given an annual gift for many years which is targeted for faculty development at our member schools. For the past 3 years this donation has been at the $300,000 level.

It is not my intent to impress you with UNCF's success stories in the foundation area. Rather, I seek to impress upon you the important contributions that foundations are making to black higher education and indeed to society as a whole.

On first blush, it would appear that the Tax Reform Act of 1969, with its guaranteed substantial levels of foundation giving would have been a great boon to donee organizations. This legislaticn, however, has had an adverse effect on foundations by inadvertently forcing them to liquidate. Probably, no one in Congress in 1969 envisioned our current inflation rate of more than 10 percent a year.

Since the average annual inflation rate was 2 percent during the 1959–69 decade, double-digit inflation would have been hard to imagine. Today's high inflation has brought high interest rates and dividend yields; thus, foundations are in a particularly pressed situation.

Today's high rate of returns are a direct result of higher inflation.

Noting that my time is up, it is not to the advantage of charitable organizations, such as my own, for foundations to be further eroded, and for us to lose the future capacity if foundations to make grants to institutions such as mine.

And in my closing sentence, let me point out, Senator, that our schools, on the average, have been in existence for more than 100 years, and we are going to be around for another 100 years. Booker T. Washington went, hat in hand, to foundations begging funds and 50 years from now our Presidents will still be going hat in hand. We want the foundations to survive as viable institutions.

Thank you.

Senator PACKWOOD. So do we, I feel.

Jack Moskowitz.

STATEMENT OF JACK MOSKOWITZ, SENIOR VICE PRESIDENT FOR GOVERNMENTAL RELTIONS, THE UNITED WAY OF AMERICA

Mr. MOSKOWITZ. Mr. Chairman, my name is Jack Moskowitz. I am senior vice president for Government Relations, the United Way of America.

I have a statement that I would like submitted for the record.

Senator PACKWOOD. As usual, Jack, it will be.

Mr. MOSKOWITZ. I'd like to confine to my remarks, brief remarks, to Mr. Bothwell's statement about the shortfall of $200 million.

First, I think, in our Board of Governors, Government Relations Committee endorsed the Durenberger-Moynihan bill and this question arose during the committee meeting and, just simply stated, I think the position is—that Mr. Edley stated—is we believe the long-term viability of foundations is what is at stake here. And that a shortfall, whether it's $200 million or $150 million, in a near term in a year is not what the problem is. It's the question of erosion in the future.

And when you look at the numbers—I was just looking at a report. Individual giving was about $40 billion last year. It is hard to believe that a $200 million shortfall is going to have that kind of dramatic drop in the provision of social services by the private sector.

And, again, I'd just like to reiterate that point that we support this legislation. Our committee supports this legislation because what we think is at stake is the long-term viability of foundations.

Thank you, Mr. Chairman.

Senator PACKWOOD. Jack, thank you very much.

Mr. Ahmann.

STATEMENT OF MATHEW AHMANN, ASSOCIATE DIRECTOR FOR GOVERNMENT RELATIONS, NATIONAL CONFERENCE OF CATHOLIC CHARITIES

Mr. AHMANN. Chairman Packwood, I am associate director of the National Conference of Catholic Charities, which is pleased to join this panel testifying on the importance of changing the private foundation payout rule in order to preserve the ability of these private foundations to maintain and strengthen their contribution to a vital, and free, and pluralistic society.

S. 464, introduced by Senators Durenberger and Moynihan and H.R. 1364, its counterpart in the House, would overcome the unintended effect imposed by inflation on the 1969 amendment requireing these foundations to distribute the greater of 5 percent of the value of their assets or their actual realized current income.

While Catholic Charities does participate in a publicly funded system of delivery of services to the needy and suffering, we rely on private funding—religious, United Way, and foundation—to experiment, innovate, and explore new ways in which we might help people help themselves.

Let me mention only one thrust in our Catholic Charities movement which has been foundation funded and is central to our nationwide mission, and direction, and the future viability of our ability to serve.

This project and another I cited in my written testimony, by its nature, required private nonprofit, nongovernmental funding beyond our resources.

Five years ago our grassroots leadership and our national leadership realized that our agencies had become professionalized and centralized. While our services still involved thousands of volunteers around the country, we had in many places gotten away from the parishes and neighborhoods and become downtown centered institutions.

Both the Lilly Foundation and the Raskob Foundation for Catholic Activities responded to our request to fund a parish outreach initiative designed to seed and organize a process to decentralize and involve countless more people in the community building and service work of Catholic Charities.

This project initiative never involved more than two or three people at our modest national office, but it has become central to the Catholic Charities movement around the country, involving minimal staff resources serving countless people working on rural housing, the energy and social security needs of the aging, child care, and so on. It's not gone as far as it should, but it's taught Catholic Charities a lesson that professionalism almost let it forget—the boundless commitment and enterprise and energy of citizens who are nonprofessional.

This lesson was made possible by the crucial grants of two important private foundations committed to constantly help revitalize society in the United States.

We understand the experience under the 1969 amendments, and the ensuing inflation, the trend line has real assets of private foundations declining by several billion dollars. We regard this as a threat to our free society. It results, in part, from the requirement that the foundations spend the larger of their current income or 5 percent of their investment assets.

As one effort to help sustain the role of private foundations in our Nation's future, and in the future of our people, we support the proposal which requires that a private foundation pay out 5 percent of its investment assets, but not the actual current income of the foundation if that income exceeds 5 percent of those assets.

We think the proposed amendment overcomes the unintended effect of the 1969 amendment.

Thank you.

Senator PACKWOOD. Thank you.

Ms. Hesselbein.

STATEMENT OF MS. FRANCES HESSELBEIN, NATIONAL EXECUTIVE DIRECTOR, GIRL SCOUTS OF THE U.S.A.

Ms. HESSELBEIN. I am Frances Hesselbein, the national executive director of Girl Scouts of the U.S.A. And I am pleased to have this opportunity to join my colleagues in speaking to the subcommittee on behalf of the largest organization serving girls and women in the world in support of the proposed amendment of the law to require that foundations pay out only 5 percent of assets.

My formal statement has been submitted for the record, and in summary, may I say that the primary funding for our ongoing services to almost 3 million members comes from two major

sources: the modest, annual dues of our members and income generated through sales of official Girl Scout uniforms, equipment and publications.

Girl Scouts of the U.S.A. gets no United Way campaign funds. Our 337 Local Girl Scout councils, which are responsible for their own operations, do benefit from United Way allocations which, together with proceeds from their cookie sales, help provide essential services locally.

At the national level, Girl Scouting, traditionally, has turned to the philanthropic community to secure funds for special projects that are beyond the resources of our annual operating budget.

No national movement, such as Girl Scouting, can progress without taking risks to meet, or anticipate, needs without testing the changing environment in which it functions.

And many private foundations, operating in the public interest, have effectively allied themselves with Girl Scouts of the U.S.A. in our efforts to reach a more diversified membership among urban and rural minorities to develop our national program centers and their services and to test new program and leadership training concepts.

This additional support provides the national Girl Scout movement with what the financial community might term "venture capital." And over the years it has made it possible for us to undertake a whole spectrum of demonstration or experimental projects, as we have sought ways to respond to the growth and changing interests of our young constituency.

For example, in 1974, the Girl Scouts launched a major project designed to stimulate and assure continuity of service to girls of migrant families, traveling the midcontinent migratory route from south Texas to the Great Lakes area.

This was a 3-year pilot, conducted in collaboration with local councils, to reach out to these children who frequently were isolated from the mainstream activities of children in the established community.

This pilot program was wholly funded by the Irwin-Sweeney-Miller Foundation which committed $363,500 of its grant resources to the migrant project over a 3-year period.

During the course of our 69-year history, Girl Scouts have been able to make a difference in the lives of millions of girls by the use of foundation funds for programs which were needed, were innovative and far reaching.

The needs for these projects will not cease and if foundations are drained by the current payout restrictions, the long-term prospect of foundation help for them appears to be dim under the present law.

Thank you very much.

Senator PACKWOOD. We will conclude this panel with Mr. Mawby.

STATEMENT OF RUSSELL MAWBY, PRESIDENT, W. K. KELLOGG FOUNDATION, BATTLE CREEK, MICH.

Mr. MAWBY. Mr. Chairman, I am Russell Mawby, president of the W. K. Kellogg Foundation, of Battle Creek, Mich. I am appearing this morning as chairman of the Legislation and Regulations

Committee of the Council on Foundations, a nonprofit, membership organization whose members include some 930 foundations from across the country.

With me is the council's legal counsel, Thomas Troyer, partner in the Washington law firm of Caplin and Drysdale.

We appreciate the opportunity to testify this morning on S. 464, a bill of vital importance to foundations and their charitable beneficiaries.

I will focus on the income payout issue. The bill also includes three useful technical changes, which are addressed in my prepared statement.

As members of the panel have already indicated, foundations play a special and vital role in responding to the needs of society.

To insure that foundations faithfully discharge their public trust, Congress has enacted a comprehensive and detailed set of rules regulating every aspect of foundation operations.

In setting up this system of regulations, Congress explicitly and decisively rejected proposals to require foundations to go out of existence after a fixed period. In particular, the income payout requirement was specifically not designed either to erode the purchasing power of foundations or to restrict foundation investment policy.

Unfortunately, the long-term ability of foundations to continue to support the array of charitable activities to which they are committed is in serious doubt. Why? Well, as a result of the high inflation and high interest rates of recent years, the requirement of the present law that foundations distribute their entire current income is contributing to rapid erosion of assets and is distorting foundations' investment policy.

The present law requires foundations to distribute annually the greater of 5 percent of the value of their investment assets or their entire current income.

The basic objective of this payout rule to insure that every foundation makes a substantial current distribution to charity is sound. On the other hand, under current economic conditions, the requirement that foundations distribute their entire current income amounts to a delayed death sentence.

When Congress enacted the income payout rule, the current yields on a well-managed balanced portfolio were significantly below 5 percent. Inflation had averaged 2 to 3 percent over the preceding decade and stocks were growing in value much more rapidly than inflation.

Today, interest rates on debt securities, like Treasury bills and certificates of deposit, range from 13 to 17 percent; inflation persists at 10 to 12 percent; and real stock values have declined sharply over the last decade.

Under these radically different economic conditions, the income payout requirement makes it virtually impossible for a foundation to reserve its grant capability. While colleges, universities, and every other class of charitable organization can take advantage of the high yields available on bonds and other debt investments to help preserve their charitable purchasing power, foundations cannot.

Consequently, the income payout rule presents foundations with a genuine dilemma. Traditional investment strategies result in rapid erosion of grant capability, while alternative strategies involve inappropriate risks. As a result of these factors, foundation assets in real dollars have fallen dramatically. In addition, there has been widespread termination of foundations and the rate of creation of new foundations has fallen dramatically to virtually zero.

S. 464 is designed to cope squarely with these problems by amending the law to remove the requirement that foundations distribute their entire current income, while leaving in effect the requirement that they distribute at least 5 percent of their assets value each year for charitable uses.

In summary, representatives here of major national organizations who are beneficiaries of foundations' support feel that this legislation is in the best long-term interest of philanthropy.

Therefore the Council on Foundations strongly supports S. 464 as a way of protecting the continuing ability of foundations to serve society.

Thank you.

Senator PACKWOOD. Thank you very much.

Senator Durenberger.

Senator DURENBERGER. Thank you very much, Mr. Chairman. And thank you for your comments in introducing the panel.

I have an opening statement that I'd like very much to have made part of the record.

Senator PACKWOOD. It will be made part of the record.

[The prepared statement of Senator Durenberger follows:]

STATEMENT FOR HEARINGS ON FOUNDATION PAYOUT RULE

Mr. Chairman, I thank you for holding this hearing today on S. 464 to modify the payout rule by eliminating the requirement that foundations pay out their net income if it is greater than 5 percent of their assets.

I have taken a sneak preview of today's testimony, and it speaks for itself in telling the story of the vital contribution of foundations to American society. Foundations provide bread and butter operating funds as well as funds for innovation such as the National Conference of Catholic Charities' program to generate greater individual involvement at the parish level. And, as the representatives of the United Negro College Fund and the Girl Scouts will testify, foundation support has been a cornerstone of capital projects as well.

As government support for social and other services is cut, the need for foundation and other private philanthropy will increase dramatically, Government does not have a monopoly on the ability to deliver services. In fact, volunteerism has been at the core of many of our nation's successes. Our government policies should encourage private philanthropy, not discourage it. That is why my distinguished colleague, Senator Moynihan, and I have introduced this legislation.

I will stop now and let the witnesses elaborate on the need for this legislation, for they will be able to express it more eloquently from their direct experiences than I.

Thank you, Mr. Chairman.

Senator DURENBERGER. If I might, I would like to address my question to Mr. Bothwell. And, I do that only because he seems to be opposing my bill. [Laughter.]

So, on behalf of three of my friends who are sitting in the second row. I don't know why they moved from the first row to the second row. They're there.

It seems to me as I look over the printed statement that clearly your testimony comes down heavy on the side of accountability in a variety of ways. And a statement is made here in terms of your

condition on the altered formula that it is essential to have this basic information: One, to evaluate foundation activity; and, two, to help those who are seeking a foundation grant.

And, I can't argue with, either of those objectives. My question is the degree to which you think all of this information is helpful to accomplish those ends.

I cannot argue the issues of information, nobody can. But I can say that as I sit here and watch the categorical grant process at work on behalf of the national Government that a lot of this information is not available to anybody out there either. And, I question whether making it available would help the process work any better.

I can't argue some of the issues of governance, for example, which have concerned me for a long time in terms of some foundations.

No on can argue the need for greater professionalism. But, certainly, there are a lot of things that would help the philanthropic process work better through the private foundation process.

But, my concern is based on the fact that I just can't agree with the presumption that people who are charged with philanthropy want to give out less money than more. And, having watched the 1969 act, as amended in 1976, at work over the last 10, 12 years, and having participated indirectly in it, it seems to me that the concern for legality; the concern for tax consequences; the concern for Government or other oversight over investment, all of that sort of thing does more to discourage flexibility and innovation, to discourage support for advocacy groups—the kind of things that Pablo, back there, represents—support for nontraditional, nonprofit activities, than just about anything else that I can think of.

So, I get to my bottom line, which is: What is it that leads you and your organization to believe that foundation giving will be reduced, even though it seems ridiculous to call $100 million to $200 million minuscule. But, in the total environment it is. What leads you to believe that it will be reduced?

And, second, you do make the observation about the erosion of assets and I am wondering if you can give us some figures as to the degree to which the assets have eroded in foundation giving?

And then match the two together and tell me why we are wrong.

Mr. BOTHWELL. Fair enough.

On the issue of why we think foundation giving will be reduced, I think we have to start off by recognizing that if the amount of money is insignificant concerning proposals for reduction, the payout rate, none of us would be here. We are here, obviously, because the money is significant, and that is why the three bills have been drafted.

And, if in fact there was no expectation that the payout would be reduced, there would not be the pressure from the foundation community to reduce it.

We have not seen any studies from the foundation community nor from Treasury that indicate what exactly happened with foundations in implementing the payout rate that was enacted in the 1969 legislation. Lacking such studies, it's pretty hard to estimate how much a change in the payout rate would reduce foundation spending now. So, we have developed a simple estimate as follows:

If 5.6 percent of assets currently are being paid out, then the chances are that one-half to all of the excess over 5 percent might not be paid out if the payout rate is dropped to a flat 5 percent.

The $100 million is a conservative estimate, taking into consideration that not all foundations would take advantage of the reduction of payout rate.

But, not seeing data from any source on what has happened with the implementation of the 1969 Tax Reform Act's payout rate, one has to resort to back of the envelope estimates.

Senator DURENBERGER. I would just make an observation before I turn it over to my cosponsors, that may or may not be true. But, I suspect those studies don't exist and maybe one of the reasons they don't exist is that the philanthropic community has been scared to death of the U.S. Government for a long time.

And, I'll just tell you one personal thing that happened to me when I came down here as the U.S. Senator. I met with some of the leadership of the foundation community and said: I am sympathetic to your problems because I have lived with them and I would like to do something about it now that I am on the Senate Finance Committee. And, he said: Well, we just don't want to rock any boats; and don't call us, we'll call you. And, so, you know, I suspect that if they haven't done their homework from your standpoint, it isn't because the problem does not exist out there.

Senator PACKWOOD. Senator Matsunaga.

Senator MATSUNAGA. I would like to ask those who favor the private foundation bills what they think about the alternative payout and accountability proposals made by Mr. Bothwell.

Mr. MAWBY. Well, sir, I would—Senator, I would respond by simply saying that I think there is substantial evidence and included as a part of the statement that I have submitted that long-term returns are in the nature of 4½ percent—4 to 4½ percent—so that even a payout requirement of 5 percent will require over the long-term some erosion of working capital held by foundations.

I think as we—Then, to go beyond that, with whatever variation, simply changes the nature of the degree of erosion over time.

I think we should recognize also that there is a study submitted as a part of our statement indicating that, yes, in fact, if some foundations do move from the average, as has been indicated, of 5.6 percent to 5 percent, that some reduction would be experienced. But these studies indicate that that reduction is temporary. There is a study which shows that the intermediate and long-term effect is, in fact, an increase.

And, so, it depends on whether we want to look at the very short term, or whether, as Mr. Edley and others have suggested, we have a longer term view of the need.

Senator MATSUNAGA. What do you think about the accountability proposal; that is the proposed requirement for larger foundations to provide to grant applicants within 60 days, information on the foundation's program and information necessary to complete a grant request?

Mr. MAWBY. I think, again, Senator, that all of us in the foundation field are concerned with accountability, with responsible exercise of our reponsibilities. And, we are concerned that information be available. It should be recognized that all foundations do file

two reports that are available and that each year they must prepare an annual report, advertise the availability of this report for review and inspection.

So, in fact, information about the foundation's operation is available.

Senator MATSUNAGA. If that be the case, the requirement ought not be burdensome at all. But, according to the study by the National Committee for Responsible Philanthropy, 30 percent of the country's largest foundations refused to provide any information about their grantmaking, finances, and operations, even after repeated requests. And, another 30 percent provided only minimal information.

Now, if that is true, then I would think that perhaps some of the foundation managers are not complying with the spirit of their charitable and tax-exempt charter in helping those who are seeking help.

Mr. MAWBY. Well, I think, again, I would emphasize that there are legal requirements regarding reporting and making of information available.

With your permission, I might have our legal counsel who is more knowledgeable about the details of this respond.

Mr. TROYER. The 1969 legislation, Senator, required two separate public reports from private foundations, imposes monetary penalties day by day on foundations which do not make public reports available.

They are available now, under existing law. Certainly, the Council on Foundations is all for public reporting, public accountability. But, we believe that those requirements are being met and are adequately enforced by the requirements that Congress, itself, devised and imposed in 1969.

Senator MATSUNAGA. I see that my time is up, but if I may proceed for just another 30 seconds, assuming that a college, a private college, is seeking some assistance and would like to have some information. It would call, say, the foundation you represent. Would your foundation then say, "Oh, the information has been filed with the Internal Revenue Service and is available to the public through that office," and refuse to provide the information to the inquiring college? Or, would your foundation provide the basic information required to be filed with the Internal Revenue Service as well as additional information on the foundation grant program and application procedure which is not required to be filed with the IRS?

Mr. TROYER. Well, if we didn't make a requirement—didn't make the information available under the requirements of law, we would be not subject to a penalty of $10 a day, but to $250 a day.

Senator MATSUNAGA. My question is where would the basic information and grant program information be available to that inquiring college?

Mr. TROYER. From the Internal Revenue Service or from the Foundation Center, both of which are quite accessible. The Foundation Center has a number of regional offices around the country from which they can—from which any grantee can get information on foundation grants and other information that foundations are legally required to report now.

Senator MATSUNAGA. Well, again, what disturbs me is the finding that 30 percent, or even up to 60 percent of the foundations, when requested to, make such information available or provide minimal information.

To me, a response such as: "Well, that basic information of the foundation's address, officers, and past grants, has been filed with the IRS. Why don't you go get that information from the IRS?" is tantamount to a refusal. That's just giving the applicant the good ole runaround.

Mr. TROYER. The other—remember we said, Senator, that there are two reports required. One is required to be filed with the Internal Revenue Service; one is required to be made available to the public, advertised in the newspaper.

Now, I hate to see the hearing going off on the track of reporting of information, because I don't think there is any essential disagreement with——

Senator MATSUNAGA. Well——

Mr. TROYER [continuing]. Your position that foundations ought to be able to—ought to be making available information on their operations; ought to be making it reasonably available. If they are not doing it, and we can see a reliable study that that is the case, then we'd be happy to work with the committee and others——

Senator MATSUNAGA. Well——

Mr. TROYER [continuing]. To devise something to do that.

Senator MATSUNAGA. That's what I was——

Mr. TROYER. That has absolutely nothing to do with the question that——

Senator MATSUNAGA. All right. Well, that's what——

Mr. TROYER [continuing]. Foundations are—assets are being eroded year after year, very substantially. And they are going to be driven out of existence. There's not going to be anything to report in a few years.

Senator PACKWOOD. Sparky, you can ask further questions on the second around.

Mr. TROYER. Fine. Well——

Senator PACKWOOD. We want to go to Senator Moynihan next.

Senator MATSUNAGA. If the Senator from New York will yield, let me say that I am glad to learn of the Council's willingness to examine the foundations' reliability in satisfying the public need for information. I am glad to hear you say that. But, of course, rhetoric and action can differ. And, what I am trying to say here is, your willingness and the foundations' positive actions will likely remove objections to your legislative proposals. You say, well, this has nothing to do with reducing the minimum distribution requirement. It has a lot to do with the minimum pay-out proposal. I, for one, would be much more receptive to the proposal if the foundations have been open and responsive in other respects.

I have had people come to me who were frustrated at being unable to obtain basic information.

Anyone who has tried to get information from the Internal Revenue Service knows the runaround and delay in store for someone who approaches the IRS. So, the foundation which has the very programs and application information that is needed, should be willing to make that information available immediately and, cer-

tainly, within 60 days. If the law requires that that information be made available, the foundation will provide such information, but if the law does not require that such information be made available, the foundation may likely withhold the information.

I will agree to a reduction of the payout requirement to 5 percent of investment income, but only with a public information requirement.

I thank the Senator from New York for yielding. I appreciate it.

Senator PACKWOOD. Is that all the time you need?

Senator MATSUNAGA. Yes. I just made my statement.

Senator MOYNIHAN. Mr. Chairman, I thank you for the opportunity just to speak at all.

I would only make a very simple observation which is: What I find striking today is the number of charities, charitable groups, that have appeared before us—Messrs. Edley and Ahmann, of course, Jack Moskowitz, Ms. Hesselbein—at first appearances you might think you would be up here saying: Make the foundations spend their money faster; we need it all the more.

But, I think, to the contrary, your statement is that we need those foundations. You mean to be around another 100 years, as you said Mr. Edley in 1967, and need those foundations with you.

And I think it is very responsible and very important.

I think it should be noted that it is not surprising that we are at this legislation. Mr. Chairman, Boris Bittker, who is certainly a distinguished professor of law at Yale, has written a book called "Federal Income Taxation of Corporations and Shareholders." It is one of those books you write over and over the rest of your life. It's his life's work. [Laughter.]

And, speaking of this, he writes:

> The Tax Reform Act of 1969 effected a massive overhaul in the tax treatment of foundations and exempt organizations. These provisions constitute the most complex and restictive feature of the 1969 legislation. And even a brief summary of their scope and effect is well beyond this work. Suffice it to say that the 1969 changes can be characterized as modern mortmain legislation. So much so, that amelioration of its harsher aspects may be the order of the day when the passions of 1969 fade away.

And I think they have faded away.

I'd like to say to my friend, and principal sponsor of this legislation, Senator Durenberger, I hope he would share with me the view that the 1969 act passed at a time when there was an intense politicization of life going on in America. At the time there was an irresistible insistence that all institutions become miniatures of the polity, a profoundly statist idea and one which has gotten into our legal system and into our bloodstream and we don't even recognize it.

But, the point about foundations is that they have every right to be cranky, individual, eccentric, and even if it came right to it—I'm not so appalled—private, because they are private. It is their variety, their eccentricity. The time when people would give money to the United Negro College Fund, there were not many people who would. Some were cranky and individual and eccentric enough to do so. And that's what the private world is about. And, that's why we want to see you persist in all your indiosyncracy. It doesn't bother me one bit. [Laughter.]

Thank you.

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Senator PACKWOOD. Well said, Pat.

Dave, anything more?

Senator DURENBERGER. Just one last question of Mr. Bothwell.

Does your organization have a position on the other provision than S. 464, the private operating foundation provision, the $10,000 limit on expenditure responsibility, and limitation on family members.

Mr. BOTHWELL. We have not taken a position on those or investigated those.

I would say one thing, however. In the past, the National Committee for Responsive Philanthropy has favored relaxation of the expenditure responsibility requirement. And, I don't think I'd be speaking out of turn to state that here today.

Senator DURENBERGER. Thank you very much.

Thank you, Mr. Chairman.

Senator PACKWOOD. Thank you all very much for coming.

[The prepared statements of the preceding panel follows:]

SUMMARY OF WRITTEN STATEMENT OF ROBERT O. BOTHWELL, EXECUTIVE DIRECTOR, NATIONAL COMMITTEE FOR RESPONSIVE PHILANTHROPY

Private foundations are proposing a significant reduction in the monies they are required by law to pay out annually in grants. (Their proposal is embodied in S. 464 and S. 501) A 5-10 percent reduction in total foundation spending could result. This would amount to $100-200 million out of the total $2.2 billion that foundations spend annually.

This major change in foundation spending is being proposed while the Federal Government is considering even greater spending cuts.

Five years ago the Filer Commission on Private Philanthropy and Public Needs shocked the private philanthropy community when it estimated that government funding provided as much support for private, nonprofit organizations as did private contributions. As the major cutbacks now being proposed in Federal Government programs are implemented this year and next, the private, nonprofit sector will experience a depression unlike any it has ever known.

Together the proposed cuts in foundation and Federal Government spending will seriously jeopardize the capacity of this country's estimated 6,000,000 private, nonprofit organizations to continue to meet the public needs of our population which are not provided for by direct government assistance.

However, the proposals before this Subcommittee to reduce the foundation payout rate do have independent merit. Inflation and the payout rate requirement (5 percent of investment assets at market value or total adjusted net income, whichever is larger) clearly have helped erode foundation assets during recent years. If no change is made in the current situation, foundations' capacity to respond to future public needs will be further diminished.

Nevertheless, some foundations are guilty of contributing to their own demise. A study by the Twentieth Century Fund reported that 6 of the 10 largest foundations had more than half their money invested in a single company. The purchasing power of the assets of each of these foundations, therefore, was riding primarily on the fortunes of one company, whether for good or bad. This does not seem to be prudent investment policy. In at least some cases, this seriously reduced foundations' assets and income.

Also, despite the considerable tax advantages that the public provides for the creation, growth and maintenance of private foundations, many do not operate in a way that inspires public confidence in their perpetual existence. A recent study by the National Committee for Responsive Philanthropy documented that many foundations remain aloof and isolated from the public. Thirty percent of the country's largest foundations refused to provide any information about their grantmaking, finances and operations even after repeated requests and another 30 percent provided only minimal information. Thirteen (all with assets exceeding $25 million) had unlisted phone numbers.

Unless foundation accountability to the public is substantially improved, no changes should be made in current laws regulating foundation payout requirements. The National Committee for Responsive Philanthropy, therefore, recommends the following:

(1) That the foundation payout rate be reduced to 5 percent of investment assets at market value, or this figure plus one-half of adjusted net income exceeding 5 percent of investment assets at market value, whichever, is larger, provided

(2) That all larger foundations be required annually to prepare and disseminate to the public reports which contain basic information essential to anyone interested in evaluating foundation activity or in seeking foundation grants. Basic information to be contained in the reports should include the following which already must be reported to the IRS:

(a) The name, address and phone number of the foundation;

(b) A list of all trustees, officers, and key staff;

(c) A list of all recent grants, including name and location of the grantees, the amounts and adequate description of the grant purposes; and

(d) The total amount of grants disbursed.

Additional basic information to be included in the reports which is fundamental to any grant-seekers:

(e) Guidelines about the programs or types of organizations a foundation will or will not fund;

(f) An explanation of criteria that are taken into account in accepting or rejecting requests for funds;

(g) Grant application procedures and deadlines; and

(h) The name, address and phone number of the principal official who grant-seekers could contact for more information or to whom they could send their funding requests.

(3) That penalties be imposed on any foundation for repeated failure to provide the annual report within 60 days to persons requesting it, unless any such failure is due to reasonable cause.

The NCRP proposal for a reduction in the foundation payout rate is a clear compromise between the short term and long term financial needs of the private nonprofit sector. Simple adoption of the foundations' proposal for a flat 5 percent minimum payout rate will sacrifice nonprofit organizations in the short term in order to maintain foundations' funding capacity over the long term. Complete rejection of the foundations' proposal will provide more fully for nonprofit organizations in the short run, but will doom foundations to extinction if current economic conditions continue. NCRP's proposal strikes a balance.

The public reports required from foundations would go far to make foundations accessible to all grant-seekers, not just to those that have fund-raising expertise or that know people on a foundation's board of directors. The reports would thus help foundations fulfill what they claim is one of their most important roles: "to provide venture capital to the philanthropic sector," and "to fund new ideas and new enterprises and help new groups to gain a toe-hold" (from a recent Council on Foundations paper).

Statement of Robert O. Bothwell, Executive Director of the National Committee for Responsive Philanthropy

I. SUMMARY OF RECOMMENDATIONS

(1) That the foundation payout rate be reduced to 5 percent of investment assets at market value, or this figure plus one-half of adjusted net income exceeding 5 percent of investment assets at market value, whichever is larger, *provided,*

(2) That all larger foundations[1] be required to prepare and disseminate to the public annual reports which contain basic information essential to anyone interested in evaluating foundation activity or in seeking foundation grants, and

(3) That penalties be imposed on any foundation for repeated failure to provide the annual report within 60 days to persons requesting it, unless any such failure is due to reasonable cause.

II. INTRODUCTION

Mr. Chairman, Members of the Committee, I am Robert O. Bothwell, Executive Director of the National Committee for Responsive Philanthropy. The National Committee thanks you for this opportunity to offer our testimony on S. 464, S. 500

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[1] Over $1 million in assets or which make grants of $100,000 or more a year. This includes only about 3,100 of the 21,000 active grant-making foundations in existence, but covers over 90 percent of all foundations' assets.

and S. 501, which embody proposals to reduce the amounts that private foundations are required to pay out annually.[2]

The National Committee was organized in 1976 to represent the aspirations and interests of the many nonprofit organizations around the country which are at a disadvantage in seeking funds for their operations because of their smaller size, recent origins, and sometimes controversial programs.

The Board of Directors, members of the National Committee and affiliated local Committees for Responsive Philanthropy represent organizations which work closely with thousands of local and state groups in every state in the union. These groups are pursuing charitable and educational activities in every conceivable area of public need: education, health, employment, housing, neighborhood revitalization, and concerns of the aged, youth, minorities, women, and Vietnam veterans.

The National Committee, its members and affiliates are all private, nonprofit organizations. So too are the private foundations which are the subject of the bills before this Committee today. Our comments are aimed at strengthening the private, nonprofit sector, of which we and foundations are both a part. We think the sector is of critical importance to this country.

While this nation has a system of checks and balances among the Executive Branch, the Legislature and the Courts, so too does the country have an equally important system of checks and balances among business, government and the private nonprofit sector. And as government and business grow larger and further removed from the citizens of this great country, the importance of the private nonprofit sector increases as a balance sector because of its often closer connections to the country's citizens.

Yet as government has grown so magnificently and blunderingly since the 1930's, the private, nonprofit sector has shrunk considerably in dollar importance compared to the government sector.

The third sector, therefore, needs careful Congressional attention if it is to be expected to take up, even in part, the slack in meeting public needs that will occur as the Federal Government cuts its commitment to domestic programs.

With these general thoughts in mind, we proceed to the issue at hand.

III. NONPROFIT ORGANIZATIONS MAY LOSE $100–$200 MILLION IF FOUNDATION SPENDING IS REDUCED AS PROPOSED

The three bills at issue propose significant reductions in the monies private foundations would be required under law to pay out annually. A 5–10 percent reduction in total foundation spending could result from S. 464 and S. 501. This would amount to a $100-200 million reduction from the total $2.2 billion that foundations pay out annually.[3] (1) This reduction will be most severely experienced by the private nonprofit organizations which are the principal beneficiaries of foundation spending.

The reduction in foundation spending that might result from S.500 is not clear; it could be the same or less than that estimated for S. 464 and S. 501. (2)

IV. MEANWHILE PROPOSED GOVERNMENT SPENDING CUTS WILL SEVERELY AFFECT NONPROFIT ORGANIZATIONS

This major change in foundation spending is being proposed while the Federal Government is considering even greater spending cuts.

Five years ago the Filer Commission on Private Philanthropy and Public Needs shocked the private philanthropy community when it estimated that government funding provided as much support for private, nonprofit organizations as did private contributions.

As the major cutbacks now being proposed in Federal Government programs are implemented this year and next, the private, nonprofit sector will experience a depression unlike any it has ever known.

For instance, the proposed elimination of the $3.5 billion Comprehensive Employment and Training Act (CETA) public job programs will mean important staff reductions in many nonprofits, particularly in neighborhood and other grassroots organizations for which CETA was often the only source of Federal funds. For another instance, the proposed consolidation of about 40 domestic programs into block grant programs also carries with it proposed funding cuts amounting to 38

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[2] For the purpose of simplifying the discussion, this statement will only address the payout rate issues concerned with private grantmaking foundations, i.e. foundations which are not "operating foundations" or do not operate "extended care facilities." The payout rules are similar, but not exactly the same for the other types of foundations.

[3] All reference notes are contained at the end of this testimony.

percent of earlier Federal budget estimates for these programs. (3) These cutbacks will play havoc with more established agencies, from those which have used the billions from Title XX of the Social Security Act to expand social services in recent years, to those which have operated community health centers, mental health programs, and alcohol and drug abuse programs under special categorical programs.

While data are scarce (the potential full impact of the proposed Federal Government cutbacks on the private, nonprofit sector is only now being calculated by the Urban Institute), nevertheless, it is not unreasonable to estimate that proposed Federal spending cuts could reduce income to private nonprofit organizations by $10-15 billion, or maybe 10 percent of total revenues for the private, nonprofit sector. (4)

V. TOGETHER PROPOSED GOVERNMENT AND FOUNDATION SPENDING CUTS WILL SHARPLY CURTAIL THE SERVICES AND JOBS PROVIDED BY THE PRIVATE, NONPROFIT SECTOR

Together the proposed cuts in Federal Government and foundation spending will seriously jeopardize the capacity of this country's estimated 6,000,000 private, nonprofit organizations (5) to continue to meet the public needs of our population which are not provided for by direct government assistance.

At stake also are nonprofit sector jobs. According to a recent Scientific American article, the private nonprofit sector in 1977 accounted for 6 percent of all jobs in the U.S. This is a larger proportion of jobs than mining and construction (5-6 percent) and agriculture (1-2 percent), and is ¼ the proportion of jobs for all manufacturing (24 percent). (6)

VI. ON THEIR OWN MERIT THE PROPOSALS TO REDUCE THE FOUNDATION PAYOUT RATE MAKE SOME SENSE

The proposals before the Senate Finance Subcommittee on Taxation and Debt Management to reduce the foundation payout rate do have independent merit, however. Inflation and the current payout rate requirement (5 percent of investment assets at market value or total adjusted net income, whichever is larger) clearly have helped erode foundation assets during recent years. If no change is made in the current situation, foundations' capacity to respond to future public needs will be further diminished.

Not wanting to duplicate data already submitted or to be submitted to the Committee by the Council on Foundations, which data support the proposal for providing some relief to foundations on the payout rate requirement, we want to call the Subcommittee's attention to a recent study by the Colonial Consulting Corporation of New York, a study reported in the Wall Street Journal March 6th. According to John K. Goodrich, Colonial's President, this study of the investment results of 53 foundations and endowments "is the only extensive analysis of its kind specifically and exclusively covering the endowments and foundations."

Analyzing investment results over recent three and five year periods, ending Dec. 31, 1980, Colonial Consulting concluded that the investment performance of the foundations and endowments as a group had exceeded that of the market in general,[4] yet that their performance had failed to keep pace with the Consumer Price Index. (7)

VII. SOME DOUBTS ABOUT THE PROPOSALS TO REDUCE THE FOUNDATION PAYOUT RATE

Some foundations have managed to do better than the Colonial Consulting foundation-endowment group. The investment portfolio of the largest foundation, the Ford Foundation, has "stayed ahead of the game (over three recent years), with an average annual return of 12.3 percent versus a 6.7 percent average annual rise in consumer prices," according to a 1979 New York Times financial page report. (8).

A small east-coast foundation has reported to us by letter that "over the past two years, in spite of our payout rate (of 8-10 percent annually) we have increased the value of our endowment by more than 67 percent." (9)

After sponsoring two of the very few major studies of foundations during the 1970s, the Twentieth Century Fund carried this observation from its Director in its 1979 Annual Report:

"* * * while total foundation assets have increased from what they were ten years ago, the shrinkage in the purchasing power of the dollar has meant a reduc-

[4] "Investment performance" here refers to "total return," i.e. dividend and interest income, realized and unrealized capital gains. "Market in general" here means using a mix of the Standard and Poor's 500 stock index (61 percent) and the Salomon Brothers long term, high grade bond index (39 percent), which mix equals the portfolio mix of the foundations and endowments studied.

tion in real terms even after the accretion resulting from the creation of new foundations is taken into account. This poor showing is not solely the result of unfavorable economic developments and fumbling economic policies here and abroad—foundations have themselves contributed by the mediocre management of their endowments . . . there is no doubt that the current federal rule calling for a minimum 5 percent annual payout penalizes those foundations earning more than the minimum because they must then pay out the excess in grants. A proposal currently before Congress would fix the payout rate at 5 percent but would allow foundations earning more to accumulate the excess. This proposal would enhance the prospects for preserving capital. But given the current levels of both interest rates and inflation, so low a rate would probably bring too great a curtailment in present grants. It would be preferable to increase the payout rate to, say, 7.5 percent, in return for accumulating the excess, or else to set flexible payout rates that give foundations the incentive to improve the management of their endowments."

The Wall Street Journal article mentioned earlier, using the Colonial Consulting Corporation Study, reported that "Some endowments . . . haven't any stocks at all and remain fully invested in bonds; they have lagged substantially behind ones with heavy stock investments. Several funds have 70 percent to 90 percent of assets in stocks and have done well over the past year and longer periods." John Goodrich, President of Colonial Consulting adds: "This suggests to me that some of these managers are contemporary in strategy and flexible and aren't being whipsawed by this market."

But just how "contemporary" have most foundations been in managing their sizeable investment assets? One of the substantial assumptions made by J. Peter Williamson, adviser to the Council on Foundations, is that because colleges and university endowments have had a mix of 60 percent stocks, 30 percent bonds and 10 percent U.S. Treasury bills, foundations should have the same. Also despite the improved performance of the stock market in recent years, and the poor performance of the bond market, Williamson assumes that foundations should continue to remain 30 percent invested in the bond market and only 60 percent in stocks.(10) Would this be "prudent" investment management, as Williamson suggests, or would this be failure to assess the current economic situation and to develop "contemporary" investment strategies?

In addition some foundations are guilty of contributing to their own demise. A 1977 study by the Twentieth Century Fund reported that 6 of the 10 largest foundations had more than half their money invested in a single company. The purchasing power of the assets of each foundation, therefore, was riding primarily on the fortunes of one company, whether for good or bad. This does not seem to be prudent investment policy. In at least some cases, this investment approach seriously reduced foundation assets and income.(11) How prevalent throughout the foundation world is this tendency for foundations to maintain their assets in a single company? Unfortunately we do not know.

Also, there are some questions about the Foundation Center data offered in support of the need for a reduction in the payout rate. The Center's data show a strong decline in the real value of the larger foundations' assets from 1972 to 1977. But this period includes one of the worst years for the stock market since 1929. In 1974 the assets of foundations declined by about $10 billion, almost a third.(12) Furthermore, what is downplayed by the Council on Foundations is that the same Foundation Center data also show that the larger foundation assets have only declined 10 percent in inflation adjusted dollars from 1965 to 1977.(13) Moreover, since the foundations whose assets were tallied in 1972 are not the same foundations whose assets were tallied in 1977, one has to wonder about the validity of these data.(14)

Finally, the Council on Foundation's bleak projection for the future assumed a 10 percent inflation rate continuing through the end of the century. Given the current efforts to control inflation, this projection raises major questions about what will happen to foundation assets and payouts in the future if changes are made now based on current inflation rates.

VIII. FOUNDATION COMMUNICATIONS WITH THE PUBLIC DO NOT INSPIRE PUBLIC CONFIDENCE—NO CHANGES SHOULD BE MADE IN THE PAYOUT RATE OF FOUNDATIONS UNTIL THEIR PUBLIC ACCOUNTABILITY IS IMPROVED

Despite the considerable tax advantages that the public provides for the creation, growth and maintenance of private foundations, many do not operate in a way that inspires public confidence in their perpetual existence. A recent study by the National Committee for Responsive Philanthropy documented that many foundations remain aloof and isolated from the public. Thirty percent of the country's

largest foundations refused to provide any information about their grantmaking, finances and operations even after repeated requests, and another 30 percent provided only minimal information. Thirteen (all with assets exceeding $25 million) had unlisted phone numbers.(15) And according to the Council of Foundations, less than 500 of the country's 21,000 foundations voluntarily publish annual reports.

Foundations control vast assets of approximately $35 billion. They spend and distribute over $2 billion annually. These significant monies exist under foundation control because U.S. tax laws have given favored treatment to wealth donated to charity. These huge pools of dollars, therefore, are quasi-public monies. As such, they need serious public review regarding their management and expenditure.

As nationally syndicated newspaper columnist James J. Kilpatrick, a respected spokesman for conservative politics in America, said recently:

Foundations' tax exemptions "inescapably imbue them with at least some of the aspects of a government agency, providing at least quasi-government services. And whatever is public business is the public's business.

"On these principles, I would go for full financial disclosure—salaries, expenses, income, outgo, the whole works—in sufficient detail to permit some public judgement on the desirability of the diversion of otherwise taxable income." (16)

Congress, of course, has recognized the need for serious public review of foundations for some time now. But neither the procedures it has legislated, nor the subsequent administration of those procedures by IRS are adequate.[5]

The public clearly needs more information about foundations in order to know, evaluate, and influence what foundations do with their money, and the several hundred thousand grant-seeking nonprofit organizations clearly need more information in order to determine whether or not to apply to certain foundations for support of their activities, and how to apply. Current arrangements favor the well connected individuals and the well funded organizations which have "financial development" staffs. If changes are to be made in current law to give foundations greater flexibility in managing their assets and in determining what they will pay out each year, then improvements also must be made in what and how foundations inform the public about their grant making, finances and operations.

IX. FIVE SPECIFIC PROBLEMS WITH EXISTING REQUIREMENTS FOR INFORMATION ON FOUNDATIONS AND PUBLIC ACCESS TO SAME

There are five specific problems with the existing requirements for information on foundations and public access to such information.

(1) *The IRS is not overly diligent in overseeing that ALL the information required is submitted.* A recent survey of 100 random private foundation annual returns (990-PFs) and annual reports (990-ARs) showed that "only two foundations had filled out the 990-AR forms in complete accordance with section 6056 of the Internal Revenue Code . . . Almost half the 990-AR's . . . checked failed to fully comply with the requirement to list the name and address of the grant recipient." Almost a quarter of the forms checked ignored entirely the requirement to state the purpose of the grant. (17)

Several years ago, F. Emerson Andrews, the former President of the Foundation Center in New York, which is the principal national collector and disseminator of information about foundations, reported that only 59 percent of 1000 randomly-selected foundations he studied supply "satisfactory reports." Another one-third "omitted one or more required items." Andrews reported that almost 5 percent of the 1000 foundations studied had "severe omissions", such as "no list of trustees, no schedule of grants, no statement of market values of corporate stocks." (18)

While Andrews thought that the increased reporting requirements in the Tax Reform Act of 1969 "should result in a great improvement in this area", the recent survey of 990s mentioned above certainly doesn't suggest that improvement has occurred. Obviously, something else is needed to assure adequate public scrutiny of foundation activity and reasonable access to information important to grant seekers.

(2) *The information presently required isn't enough for organizations to make effective applications for grants or for concerned citizens to evaluate how well the public good is being served by private foundations in the management of their assets or the allocation of their grants.* The Filer Commission on Private Philanthropy and

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[5] In 1969 Congress gave the Internal Revenue Service major new tasks for governmental scrutiny of foundations. Then Congress invited public review by requiring that foundations prepare annual reports, sent them to appropriate state offices, publicize notices about the reports' availability, and permit interested citizens to inspect the reports in foundations' home offices under certain conditions.

The IRS also has made available copies of foundations' annual tax returns through the Foundation Center in New York and its affiliate libraries throughout the country.

Public Policy recommended that "at least" the following items be reported that are not now required:

(a) purpose of foundation,

(b) description of program and priorities, and

(c) explanation of criteria that are taken into account in accepting or rejecting requests for funds, products or services. (19)

Grantseekers also need the following two items not now required:

(d) grant application procedures and deadlines, and

(e) the name, address and phone number of the principal foundation official who grantseekers could contact for more information or to whom they could send their funding requests.

These five items are minimal reasonable additional information requirements. When provided to the public along with selected items of presently required information, they will provide greater opportunities for newer, smaller, and less well known grantseekers to obtain foundation funding, and they will encourage greater dialogue between citizens, their representatives and foundations about "the public good" to be served by foundation spending.

As Robert F. Goheen said when he was Chairman of the Council on Foundations in 1973:

Today in America there is a general disposition to scrutinize, question and test all institutions. Conviction that foundations perform functions vital to the well-being of pluralistic society is not universally shared. In the face of the doubts foundations—like universities and churches, corporations and labor unions—must be prepared to demonstrate their worth in the effectiveness of their activities and by making these activities better known. They must be prepared to exhibit their wares in the marketplace of ideas to gain and hold public understanding, the good will of the people, the support of elected representatives.(20)

(3) *The public generally gains access to foundations' annual tax returns only after the information they contain is almost a year old, and sometimes 18 months old.* Thomas Buckman, President of the Foundation Center, after conducting a recent survey, concluded that "The average delay is ten (10) months between the time the Foundation Center receives IRS-provided copies of 990-PFs and 990-ARs and the close of foundations' fiscal years; but the delay does run to eighteen (18) months in some cases."(21) The Foundation Center and its regional affiliate libraries are the major source of information about foundations for potential grant applicants or concerned citizens wishing to evaluate foundations' actions.

(4) *The public's access to foundations' annual tax returns through state government offices is impossible in some states, difficult in other states, and limited in some states.* A few states, however, do provide good access.

Foundations are required by Federal law to send copies of their annual tax returns to appropriate state government offices. A recent study about the availability of information on foundations from state governments discovered that at least six states do not make foundation returns publicly available (Alabama, Connecticut, Georgia, Indiana, North Carolina and Vermont). Noting that finding out about foundation returns was "a particularly difficult task" in a few other states, the study then concluded that the major problem in gaining access to 990s in states "is the incompleteness of the collection, (because) many foundations are unaware of, or ignore, the requirement that they file a copy of the 990 with the state."(22)

State disclosure requirements for foundations and other tax exempt organizations may be suggested as an already available alternative to helping the public gain access to foundation information. But a study by state attornies-general done for the Filer Commission on Private Philanthropy and Public Needs concluded that "state disclosure requirements are incomplete and uneven at best."(23)

(5) *The requirement that a foundation make its annual report available for public inspection in its principal office within 180 days after the publication of notice of its availability assures public access only for the most dedicated and persistent seekers of foundation information.* The President of one Midwest foundation states part of the problem well. Noting that the law requires a foundation to publicize its notice of the availability of its annual report "in a newspaper of general circulation in the county in which the principal office of the private foundation is located," the foundation official reported that almost 1000 foundations had placed their required advertisements in the New York Law Journal one year. However, he added, the circulation of this publication was only 8,969, reaching not even ⅓ of the 33,000 lawyers who practiced in New York City. The foundation official concluded that "it is apparent that some foundations will surrender their 'right' to absolute secrecy with the greatest reluctance."(24) Granted that this was soon after passage of the new requirement in the Tax Reform Act of 1969, we must wonder, however, in light

of having no evidence to the contrary, whether or not the publication practices of foundations have changed any.

The other part of the problem of public access to foundations' annual tax returns through inspection at foundations' principal offices is connected with geography. How many citizens in the Midwest, South and West have the travel funds to go to New York, the capital of the private foundation world?(25)

All in all, as the Filer Commission on Private Philanthropy and Public Needs observed in its final report, "the 1969 reporting regulations for foundations have been honored, the evidence suggests, with bare minimal compliance in some cases as far as easy availability of annual reports goes."(26)

X. RECOMMENDATIONS FOR A CHANGE IN THE FOUNDATION PAYOUT RATE AND FOR IMPROVED PUBLIC REPORTING BY FOUNDATIONS

In order to meet private, nonprofit organizations' short term need for substantial operating monies as sizeable Federal Government spending cuts are implemented, and to meet private foundations' long term need to maintain the purchasing power of assets, yet also to get more information to the public about how foundations operate, the National Committee for Responsive Philanthropy proposes the following:

(1) That the foundation payout rate be reduced to 5 percent of investment assets at market value, or this figure plus one-half of adjusted net income exceeding 5 percent of investment assets at market value, whichever is larger,[1] *provided*

(2) That all larger foundations[2] be required to prepare and disseminate to the public annual reports which contain basic information essential to anyone interested in evaluating foundation activity or in seeking foundation grants.

These reports should be made available at or below reproduction cost. A notification that a report is available should be run annually in the largest circulation newspaper in the county in which the foundation's principal office is located. Basic information to be contained in the reports should include the following which already must be reported to the IRS:

(a) The name, address and phone number of the foundation;

(b) A list of all trustees, officers, and key staff;

(c) A list of all recent grants, including name and location of the grantees, the amounts and adequate descriptions of the grant purposes; and

(d) Total grant dollars awarded during the year covered.

Additional basic information to be included in the reports which would be fundamental to any grant-seekers:

(e) Guidelines about the activities or types of organizations a foundation will or will not fund;

(f) An explanation of criteria that are taken into account in accepting or rejecting requests for funds;

(g) Grant application procedures and deadlines; and

(h) The name, address and phone number of the principal official who grant-seekers could contact for more information or to whom they could send their funding requests.

(3) That penalties be imposed on any foundation for repeated failure to provide the annual report within 60 days to persons requesting it, unless any such failure is due to reasonable cause.

The proposal for a reduction in the foundation payout rate is a clear compromise between the short term and long term financial needs of the private, nonprofit sector. Simple adoption of the foundations' proposal for a flat 5 percent minimum payout rate will sacrifice nonprofit organizations in the short term in order to maintain foundations' funding capacity over the long term. Complete rejection of the foundations' proposal will provide more fully for nonprofit organizations in the short run, but will doom foundations to extinction if current economic conditions continue. NCRP's proposal strikes a balance.

The public reports required from foundations would go far to make foundations accessible to all grant seekers, not just to those that have fund-raising expertise or that know people on a foundation's board of directors. The reports would thus help foundations fulfill what they claim is one of their most important roles: "to provide venture capital to the philanthropic sector," and "to fund new ideas and new

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[1] Currently grant-making foundations are required to pay out 5 percent of their investment assets at market value, or their total adjusted net income, whichever is larger.

[2] Over $1 million in assets or which make grants of $100,000 or more a year. This includes only about 3,100 of the 21,000 active grant-making foundations in existence, but covers over 90 percent of all foundations' assets.

enterprises and help new groups to gain a toe-hold" (from a recent Council on Foundations paper).

REFERENCE NOTES

1. $2.2 billion was the total foundation spending in 1979, the last year for which data are available. American Association of Fund-Raising Counsel, Giving USA, 1980 Annual Report, New York.

The $200 million reduction figure is a rough calculation as follows: $35 billion total foundation assets X 0.6 percent, which is the difference between the current average payout rate of 5.6 percent of assets (according to the President of the Council on Foundations) and the flat 5 percent payout rate proposed in S.464 and S.501. The $100 million reduction figure is a conservative one which recognizes that all foundations will not immediately reduce their payout to a flat 5 percent, even if the law allows them to do so.

2. If the "real income" of foundations is greater than a flat 5 percent of investment assets, the reduction in foundation spending would be less, while if the "real income" is less than the 5 percent figure, the reduction in foundation spending would be equal to the $100-200 million estimated.

3. Estimate by the National Association of Social Workers, Washington, D. C.

4. Based on projected 1981 private contributions ($50 billion) and on Filer Commission estimates of government revenues as a source of private, nonprofit organizations' income (equal to private contributions).

5. Estimate by the Commission on Private Philanthropy and Public Needs (Filer Commission), final report, Giving in America, Washington, D.C., 1975.

6. Eli Ginzberg and George J. Vojta, "The Service Sector of the U.S. Economy," Scientific American, Vol. 244 No. 3, March 1981, pp. 49 and 51.

7. "Endowment and Foundation Data Base/Index," Colonial Consulting Corporation, New York, December 31, 1980.

8. "Ford Foundation Beats Inflation," New York Times, May 1, 1979.

9. The Edward W. Hazen Foundation, New Haven, Connecticut.

10. J. Peter Williamson, "Inflation and the Foundation Payout Rate," December 31, 1980.

11. Chris Welles, Conflicts of Interest: Nonprofit Institutions, The Twentieth Century Fund, New York, 1977, pp. 51-88.

12. The Foundation Directory, 7th Edition, The Foundation Center, New York, 1977, p. xxii.

13. Ibid., Chart B, p. xxiv. Decline of assets in inflation adjusted dollars from $18.6 billion in 1965 to $16.8 billion in 1977.

14. In 1972 the assets of all foundations (a) with assets of $1 million or more or (b) with grants amounting to $500,000 or more were tallied, while in 1977 the latter criterion was modified so that assets of foundations with grants amounting to only $100,000 or more were included. Also, dramatic changes in foundations' assets from 1972 to 1977 might have included some foundations in one tally and excluded them in the other.

15. Foundations and Public Information: Sunshine or Shadow?, The National Committee for Responsive Philanthropy, Washington, D.C. 1980.

16. At the Council on Foundations 29th Annual Conference, in the session entitled: "Public Information: Stone Wall or Open Door", May 4, 1978, Washington, D.C.

17. The Grantsmanship Center News, "The 990-AR: Does the Government Really Look at Them?", Vol. 2, No. 4 (Issue 12), July-August 1975.

18. F. Emerson Andrews, "Foundation Reports to the I.R.S.", Foundation News, Vol. XI, No. 4, July-August, 1970.

19. Commission on Private Philanthropy and Public Needs, Giving in America, Washington, D.C., 1975, p. 165. The Commission's recommendation was targeted to apply not only to foundations, but also to all larger tax-exempt charitable organizations.

20. Foundation News, January-February, 1973.

21. Telephone conversation with Robert O. Bothwell, May 18, 1978.

22. Carol Schulkey and Timothy Saasta, "How to Locate a Hidden Treasure (of information about foundations)," The Grantsmanship Center News, Issue 22, October-December 1977, pp. 41-50.

23. Commission on Private Philanthropy and Public Needs, op. cit., p. 164.

24. H. Thomas James, "Perspective on Internal Functioning of Foundations" p. 212, in Fritz Heimann, ed. for the American Assembly, The Future of Foundations, Prentice Hall, Inc., Englewood Cliffs, N.J., 1973.

25. New York State has almost one-fifth of all foundations in the United States. These control almost one-third of all foundation assets nationwide.

26. Commission on Private Philanthropy and Public Needs, op. cit., p. 164.

STATEMENT: IN SUPPORT OF SENATE BILL 464, PRESENTED ON BEHALF OF THE UNITED NEGRO COLLEGE FUND

I am Christopher F. Edley, Executive Director of the United Negro College Fund. I speak as an official representative of the private traditionally black colleges and universities. The United Negro College Fund is America's first united educational chest. It is the official fund-raising body for forty-one of the 47 fully accredited private black senior colleges in this country. These colleges and universities enroll more than 50,000 students studying towards baccalaureate and advanced degrees, and several thousands more who are involved in noncredit continuing education courses and programs.

These institutions represent a strategically important segment of American higher education. Although the predominantly black colleges and universities comprise less than five percent of American institutions of higher education, and their enrollments comprise less than three percent of all college students, these black colleges enroll almost half of all blacks attending the nation's institutions of higher education.

I appreciate this opportunity to appear before this distinguished committee to speak on behalf of the passage of Senate Bill 464. I have submitted a formal written statement for the record, which I will summarize orally. While my statement will not cover the technical amendments that are a part of this legislation, I fully support their enactment and feel that their implementation would remove unnecessary burdens from both the donor foundations and the donee charitable organizations.

Only twenty-eight blacks in the U.S. held college degrees in 1860 and this had increased to only 2500 by 1900. Largely due to the existence of black colleges, over the last 132 years, there are now 600,000 blacks in this country who hold baccalaureate and professional degrees. This would not be the case if these schools and the United Negro College Fund had not been the recipients of generous philanthrophy, and, more recently, sustained donations from the nation's foundations.

The United Negro College Fund recently completed the most successful fund-raising drive for private black higher education in the history of this nation. Under the able and energetic leadership of Thomas A. Murphy, the then Chairman of the Board of General Motors, UNCF was able to raise $60,000,000 in Capital Campaign funds. Of this total, $29,000,000 or slightly over 49 percent came from the nation's foundations.

The Kresge Foundation gave UNCF six million dollars ($6,000,000), the largest single grant that they have ever awarded. These funds are earmarked for construction projects at our 41 member institutions.

The Kellogg Foundation donated over three and a half million dollars ($3,500,000) to the Capital Campaign. This allocation is being used to establish an Integrated Management System at UNCF institutions. This grant will help insure that the management systems at member institutions are availing themselves of the latest and most effective management tools possible consistent with their resources.

The McArthur Foundation donated two million, five hundred thousand dollars ($2,500,000) to the CRDP to be used for an academic scholars program. This grant will allow faculty members of member institutions to seek advanced degrees and thus strengthen the institutions they serve.

I will not take the committee's time to list all of UNCF's 96 foundation gifts for our Capital Campaign, however, I would like to make it abundantly clear that this effort would not have been successful without the generosity and deep concern of many foundations.

The United Negro College Fund's foundation experience, of course, is not limited to gifts to our Capital Campaign. Over the last ten years foundation giving to our Annual Campaign has averaged twenty percent of all dollars raised. Importantly, most of these funds have been given for general operating support of UNCF's member colleges and universities.

While it is the policy at UNCF to encourage foundations to give unrestricted grants, we have been the recipient of significant and important program grants to our Annual Campaign.

Lilly Endowment Inc. has given an annual gift for many years which is targeted for faculty development at our member schools. For the past three years this donation has been at the three hundred thousand dollar level.

Four years ago, a $750,000 program grant from the Carnegie Corporation enabled UNCF to engage a motivational psychologist in an examination of an issue immensely important to all concerned with black higher education. The study was

entitled, "The Impact of Predominantly White College Environments on Black College Students." The results of this study are scheduled for publication this year and we at UNCF feel that these findings are of monumental importance.

The Ford Foundation gave UNCF an Intern Development grant in 1975 that is still paying dividends today. The foundation underwrote the salaries of 20 new employees who were being trained as fund raisers. The majority of the individuals trained under this grant are still with us and hold, in some instances, top level fund-raising or administrative positions in the organization.

It is not my intent to impress you with UNCF success stories in the foundation area, rather I seek to impress upon you the important contribution that foundations are making to black higher education and indeed to society as a whole.

REASONS FOR UNCF SUPPORT OF SENATE BILL 464

On first blush, it would appear that the Tax Reform Act of 1969 with its guaranteed substantial levels of foundation giving would have been a great boon to donee organizations. This legislation, however, has had an adverse effect on foundations by inadvertently forcing them to liquidate. Further, it is my contention that this supposedly pro-charity legislation has had a devastating effect on these organizations it sought to protect and aid.

Probably no one in Congress in 1969 envisioned our current inflation rate of more than 10 percent a year. Since the average annual inflation rate was 2 percent during the 1959-69 decade, double-digit inflation would have been hard to imagine. Today's high inflation has brought high interest rates and dividend yields. Thus foundations must distribute their net income from investment, an amount usually larger than the alternative payout requirement of five percent of asset values. This situation was not anticipated when the payout regulation was adopted. Since today's higher rate of returns are a direct result of higher inflation, such returns are not real dollars. The requirement of total income distributions means the inevitable erosion of desirable grant making capacity in future years.

The 1969 Tax Reform Act, in another inadvertent step, has tended to dictate the investment policies of foundations. In order to somehow slow the erosion of their assets, foundations have been forced to adopt an investment policy that concentrates on acquisition of equities rather than high yield debt securities.

Thus, while every other class of tax-exempt organizations can take advantage of the high yields available on long-term bonds to preserve their charitable purchasing power against inflation, foundations cannot. Foundations are being handicapped by an artificial and, I believe, by a wholly unintended investment constraint.

The erosion of foundation assets partially caused by the present payout provisions has presented a dual problem to donor organizations. At UNCF, for example, there has been a constant gradual, shrinkage in the number of donor foundations over the last ten years. I have personal knowledge that a large proportion of this shrinkage can be directly traced to the present payout provisions.

In addition to shrinkage another problem that we have experienced at UNCF is an increase in the number of restricted or program grants that we receive from foundations. In an April 17, 1980 article in the *New York Times*, Mr. Alan Pifer, President of the Carnegie Corporation, one of the country's oldest and wealthiest foundations, while commenting on the problems being caused by inflation and government regulation stated "In the future, administrators will have to be more selective about their spending, asking themselves are we getting leverage from this grant?" This attitude, which I feel is quite natural, has led foundations to target their limited assets to specific areas and problems that their dollars can directly impact and show some significant change.

Anyone with any experience in the funding of black higher education can attest to the fact that the unrestricted dollar is the "mother's milk" without which these institutions simply will not survive.

Therefore, the payout provisions, even though they might have been written with the intent of being pro-charity, have hurt UNCF's fund-raising efforts.

CONCLUSION

I find myself in a unique position. For the ten years before I became Executive Director of the UNCF, I was a program officer at the Ford Foundation. I feel that I am able, by reason of this experience, to look at the 1969 Tax Reform Act and the bill that is now before this committee from both sides of the proverbial fence.

My choice to support this legislation was not a hard one to make. In this era of increasing limitations and government cutbacks, we in education must look more toward the private sector for our survival. Therefore, I am in favor of any legisla-

tion that would help to insure that there will be, for the foreseeable future, a large and diversified foundation community, with differing goals and objectives.

Senate Bill 464, with its five percent limitation on foundation payouts, should be passed without delay. I cannot envision a reasonable argument against this legislation. I urge that the passage of this bill be expedited so that no more foundations will have to close their doors because of the unintended, inadvertent, problems caused by the 1969 Tax Reform Act.

Statement of Jack Moskowitz Senior Vice President for Government Relations, United Way of America

At its March 11 meeting, the Government Relations Committee of the United Way of America Board of Governors voted unanimously to recommend to local United Ways that they support efforts of foundations in their communities to enact legislation adjusting the Foundation Payout Requirement. The adjustment would eliminate the mandatory dispersal of the entire realized income of a foundation, but would keep the requirement to distribute at least five percent of the value of its investment assets. The Durenberger-Moynihan bill (S 464) accomplishes this result.

This United Way of America Volunteer Committee felt that the proposed Durenberger-Moynihan amendment to the Internal Revenue code would prevent the continuing diminution of foundation assets. Foundation asset value has steadily declined in the past ten years (11 percent from 1977-1979). If allowed to continue, it will certainly impair the ability of foundations to support charitable activities in the future.

Passage of S 464 will remove a handicap to prudent management of foundation assets and at the same time, maintain the substantial payout requirement. Thus, the purposes of the 1969 private foundation rules will remain intact while an onerous provision that might possibly have put many foundations out of business will be removed. S 464 is in keeping with express Congressional intent. Its enactment would preserve the ability of private foundations to support varied and innovative charitable activities.

United Way of America is a national service office for over 2,100 independent and autonomous United Ways across the nation. United Ways organize volunteers who raise funds and who allocate those funds each year to over 37,000 charities in the health and human services fields.

Some of the income to United Ways—we estimate about 1.4 percent of the total—comes from private foundations. Though this amount is not large in comparison to the over $1.3 billion raised by local United Ways last year, this foundation support is important. It is the source of funds for innovative programs that very often cannot and should not be funded from monies raised to provide for human care services. For example, a $630,000 Kellogg Foundation grant to United Way of America funded a program to train volunteers from local United Ways, non United Way agencies and emerging organizations on volunteer board functions.

A list of the members of the United Way of America Board of Governors, Government Relations Committee is attached:

United Way of America, Government Relations Committee

Mr. William Ellinghaus, president, American Telephone & Telegraph, 195 Broadway, New York, N.Y.

Vice Chairman: Dr. LaSalle Lefall, professor and chairman, Department of Surgery, Howard University Hospital, 2041 Georgia Avenue, N.W., Washington, D.C.

MEMBERS

Mr. Lisle C. Carter, Jr., president, University of the District of Columbia, Building 9, Third Floor, 4200 Connecticut Avenue, N.W., Washington, D.C.

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Summary of Testimony—National Conference of Catholic Charities on the Foundation Payout Requirements

1. Evidence suggests that since the 1969 amendments to the Internal Revenue Code, unprecedented, sustained high rates of inflation have been sapping the assets of our private foundations and thus their long range contribution to sustain a pluralistic, free and vital society is endangered.

The trend line has real assets of private foundations declining by several billion dollars since 1969.

2. This trend results from common investment practices in the foundation world and the 1969 requirement that private foundations distribute the greater of 5 percent of the value of their investment assets or their actually realized current income. This requirement has the unintended effect of holding foundation assets back from investment in money market funds and other short term high yield investments which would help foundations offset the erosion of assets due to high sustained inflation and the declining rate of real dollar growth in the overall economy.

3. Catholic Charities generally around the country, and the National Conference of Catholic Charities in particular, can cite specific examples where only private foundation contributions have enabled us to innovate, move in vital new directions, decentralize and develop models for involving countless new volunteers in delivering human services. Such innovating funds are not available from government funding sources, and given the impact of recessions on those we serve and our normal budgets, have not been available from our own resources either.

4. Consequently, to insure the future ability of private foundations to contribute to a pluralistic and free society, the National Conference of Catholic Charities supports the legislation introduced in the Senate by Senators Durenberger and Moynihan (S. 464) and in the House by Representatives Conable, Brodhead and Frenzel (H.R. 1364) which would overcome the unintended effect imposed by inflation on the 1969 amendment by changing the law to require private foundations to pay out five percent of their investment assets, but not the actual current income of the foundation if that income exceed five percent of those assets.

We believe this will enable the formation of new foundations, and insure the viability of assets and the ability of foundations to make a more vital contribution to our nation's future.

The "Pay-out" Requirements of the Internal Revenue Code and the Ability of Private Foundations to Preserve Their Ability to Contribute to a Vital and Free Society

* * * * * * *

Testimony of the National Conference of Catholic Charities

(By Mathew H. Ahmann, Associate Director)

Chairman Packwood, the National Conference of Catholic Charities is pleased to join this panel testifying on the importance of changing the private foundation payout rule in order to preserve the ability of these foundations to maintain and strengthen their contribution to a vital and free society in the United States. Since the 1969 amendments to the Internal Revenue Code we have experienced unprecedented, sustained inflation which saps at the vitals of our private foundations and their contribution to sustain a pluralistic and vital society just as it saps at the vitals of all our people and institutions.

A small change to the law enacted in 1969, however, will help the private foundations continue and, we hope, strengthen their important role in our free society. That change is proposed in S. 464 proposed by Senators Durenberger and Moynihan in the Senate, and in H.R. 1364, proposed in the House by Congressmen Conable, Brodhead and Frenzel.

S. 464 and H.R. 1364 would overcome the unintended effect imposed by inflation on the 1969 law requiring private foundations to distribute the greater of 5 percent of the value of their investment assets or their actually realized current income.

The passage of this amendment is important to those whom the affiliates of the National Conference of Catholic Charities serve. The National Conference of Catholic Charities is a federation of religiously sponsored and inspired agencies and institutions located in all parts of the United States. Our affiliates compose the largest network of agencies delivering human services in this country. And we face large problems. The very sustained high inflation referred to has impaired our ability to serve. In recessions we run a deficit. The impending budget cuts proposed by the current Administration threatens to severely curtail our services to needy and hurting people.

While Catholic Charities does participate in a publicly funded system of delivery of services to the needy and suffering, we rely on private funding—religious, United Way and foundation—to experiment, innovate and explore new ways in which we might help people, and in which people might help themselves.

Catholic Charities has countless examples of the benefits and effects of private foundation philanthropy at our local level. Let me mention but two thrusts in our Catholic Charities Movement which have been foundation funded and are central to our nationwide mission, direction, and the future vitality of our ability to serve. Both projects, by their nature, require private non-profit, non-governmental funding beyond our resources.

1. Five years ago our grass roots and our leadership realized that our agencies had become over professionalized and centralized. While our services still involved countless thousands of volunteers, we had in many places, indeed, gotten away from the parishes and the neighborhoods, and the vital role of stimulating, convening, building on the talents of an ever-growing cadre of neighborhood volunteers involved in services and advocacy on behalf of needy people and vital mediating institutions.

Both the Lilly Foundation and the Raskob Foundation for Catholic Activities responded to our request to fund a "Parish Outreach" initiative designed to seed and organize a process to decentralize and involve countless more people in the community building and service work of Catholic Charities. This project initiative, never more than two or three people in our modest national office, has become central to the Catholic Charities Movement since that time, and involves minimal staff resources serving countless people working on rural housing, the energy and social security needs of the aging, child care, community organization, and the human service needs of urban areas all over the country. It has not gone as far yet as it should, but "Parish Outreach" has taught Catholic Charities a lesson professionalism almost let it forget—the boundless commitment and enterprise and energy of citizens who are "non-professional." And this lesson was made possible by the crucial grants of two important private foundations committed to constant revitalization of our society in the United States.

2. In giving this second example of the vital contribution of private foundations to the Catholic Charities Movement, I do not want in any way to deprecate the important role we believe the federal government, with the ability to meet national

interest, and with its taxing powers, should play in funding the human services. Nonetheless, as the proportion of government funding in our affiliate programs grew we became concerned about our ability to remain free and independent and innovative agencies and organizations. In response to our concern the directors of our agencies formed a Committee on Pluralism in the Delivery of Services. This Committee undertook an initial survey of our agency and institutional structures and relationships with government-sponsored programs at the state level, many financed with matching funds from the federal level. This survey demonstrated the need to develop models of organizational form which would enable our agencies and institutions to remain free and to remain faithful to their religiously inspired commitment and insure their ability to remain part of a vitally needed pluralistic delivery system of human services with partial funding from the public sector. The need to conduct the sociological, theological and legal research was beyond the resources of our Conference budget and again a private foundation responded to what we perceived to be a vital effort to research organizational forms for Catholic Charities to continue to play a useful servant role in our nation's future. We consider this venture crucial to the future of Catholic Charites, but without foundation funding we would not be able to undertake it.

Not all is perfect in the world of Catholic Charities, nor is all perfect in the world of private foundations. We believe that the past service of both justifies that reasonable efforts be made to improve the ability of both to serve the needs of our people.

In the case of private foundations, we believe the unintended effects of the 1969 amendments resulting from the sustained inflation we are experiencing suggests the change in the law proposed by S. 464 and H.R. 1364.

As we understand the experience under the 1969 amendments, and the ensuing inflation, the trend line has real assets of private foundations declining by several billion dollars. This is a threat to our free society. It results, in part, from the requirement that the foundations spend the larger of their current income or five percent of their investment assets.

The "prudent man" (or woman) rule holds foundation investments to conserve assets, wisely we think. But the 1969 income payout rule holds assets back from investment in money market funds and other short term high yield investments which would help the private foundations offset the erosion of assets due to high sustained inflation and the declining rate of real dollar growth in the gross national product. The shrinking assets of foundations diminishes their ability to contribute to building a growing and vital society here and around the world.

Accordingly, as one effort to help sustain the role of private foundations in our nation's future, and in the future of our people, we support the proposal which requires that a private foundation pay out five percent of its investment assets, but not the actual current income of the foundation if that income exceeds five percent of those assets. We think the proposed amendment overcomes the unintended effect of the 1969 amendments.

Testimony of Frances Hesselbein, National Executive Director, Girl Scouts of the United States of America

My name is Frances Hesselbein, National Executive Director of Girl Scouts of the U.S.A. I am pleased to have this opportunity to join my colleagues in speaking to the subcommittee on behalf of the largest organization serving girls and women in the world in support of the proposed amendment of the law to require only that foundations pay out 5 percent of assets. My formal statement has been submitted for the record, and I will summarize it for you.

The primary funding of our on-going services to membership comes from two major sources: the modest annual dues of our members and income generated through sales of official Girl Scout uniforms, equipment and other aids.

It should be noted at the outset that Girl Scouts of the U.S.A. gets no United Way campaign funds. Our local Girl Scout councils, which are responsible for their own operations, do benefit from United Way allocations which together with profits from their cookie sales help toward their expenses.

At the national level, Girl Scouting traditionally has turned to the philanthropic community to secure funds for special projects that are beyond the resources of our annual budgets.

No national movement such as Girl Scouting can progress without taking risks to meet, or anticipate, needs—without testing the changing climate in which it functions. Many private foundations, operating in the public interest, have effectively allied themselves with Girl Scouts of the U.S.A. in our efforts to reach a more diversified membership among urban and rural minorities, to develop our national

program centers and their services, to test new program and leadership training concepts.

This additional support provides the national Girl Scout movement with what the financial community might term "venture capital." Over the years it has made it possible for us to undertake a whole spectrum of demonstration or experimental projects, as we have sought ways to respond to the growing and changing interests of our young constituency. For example:

In 1974, Girl Scouts of the U.S.A. launched a major project designed to stimulate and assure continuity of service to girls of migrant families, travelling the mid-continent migratory route from South Texas to the Great Lakes area.

This was a three-year pilot, conducted in collaboration with local councils, to reach out to these children who were frequently isolated from the mainstream activities of their peers in the established community. Services were provided in their winter home communities as well as at migrant camps and schools. As a result, girls of migrant families have been able to participate in Girl Scouting throughout the year, despite the mobility of their families as they followed the crop-harvests.

The findings and experiences of councils that originally took part in the "Migrant Project" have been shared with other councils nationwide. And resources in Spanish and English were developed, providing guidelines for organization and program in support of increased council participation.

This pilot program was wholly funded by the Irwin-Sweeney-Miller Foundation, which committed $363,500 of its grant resources to the "Migrant Project" over a three-year period.

More recently—in 1980—Girl Scouts of the U.S.A. launched a major priority project: a ten million dollar capital campaign, to construct a year-round contemporary residential/conference facility at our Edith Macy Girl Scout National Center. This 269-acre site in Westchester County has earned a world-wide reputation as a training ground for Girl Scout leaders since it opened in 1926.

The new development will provide a cost-effective and totally new learning environment, where adult Girl Scout volunteers—and staff specialists—will have access to the best, most varied contemporary training resources, and girls can participate in a range of innovative demonstration programs.

Our progress in this ambitious undertaking has been considerably enhanced by the generosity of the Max C. Fleischmann Foundation. The Foundation's grant of two million dollars—the largest contribution ever received by the national organization—is serving as a "bellwether" gift which has already generated additional support and will, we are sure, enlist the interest of other potential donors.

Other individual foundations provide funds for a variety of restricted and unrestricted purposes. Many of these grants are quite modest—certainly in comparison with those I have just described in detail. But, in the aggregate, they add considerably to the progress of our work as a national youth-serving movement. Here is just a random sampling to illustrate the kind of assistance they provide:

Early this year, the W. Alton Jones Foundation pledged $10,000 toward funding "Tribal Trails," a national project scheduled to be held at National Center West in the summer of 1982. This two-week event will bring together a group of teenage Girl Scouts and adult leaders of various American Indian backgrounds for inter-tribal cultural exchanges and leadership development.

Over the past ten years, annual grants from the Jessie Smith Noyes Foundation have made a total of $25,000 in unrestricted funds available, for discretionary allocation by our National Board of Directors. Others too numerous to mention, also contribute funds which assist us in meeting special needs.

During the course of our 69-year history, Girl Scouts have been able to make a difference in the lives of many girls by the use of Foundation funds for programs which were needed and were innovative and creative. The need for these projects will not cease if the Foundations are drained by the current pay-out restrictions, but the long-term prospect of foundation help for them appears to be dim under the present law.

SUMMARY

Foundations play a special and vital role in responding to the needs of our society. Unfortunately, the ability of foundations to continue to support charitable activities is in serious doubt. From 1972 to 1979 the real value of foundation assets fell by nearly 40 percent, and from 1970 to 1979 foundation grants fell from 9.2 percent to 5.2 percent of all charitable contributions.

As a result of high interest rates and high inflation, the requirement of current law that foundations distribute their entire current income has contributed significantly to this erosion of foundations' ability to serve the public. While all other

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classes of charitable organizations can use the high yields available on certificates of deposit and other debt securities to try to preserve their charitable purchasing power against the inroads of inflation, foundations cannot. Consequently, foundations must either accept the rapid erosion of their grant capability or skew their investment decisions in favor of more risky investment strategies offering the chance of capital appreciation.

Neither of these damaging results was intended by Congress when it enacted the payout rule in 1969. In fact, in 1969 Congress specifically rejected a proposal to impose a fixed duration on foundations' period of existence.

S. 464 would amend the payout requirement to eliminate the damaging effects of current law. Specifically, S. 464 would eliminate the requirement that foundations distribute their entire current income while leaving in effect the requirement that they distribute annually 5 percent of the value of their investment assets. By maintaining the 5 percent payout requirement the bill would insure that all foundations continue to make substantial current charitable distributions. Indeed, 5 percent is more than historical real returns on a balanced investment portfolio. At the same time, by eliminating the requirement that foundations distribute their entire current income, S. 464 would give foundations the investment flexibility which they need if they are to preserve their long-term ability to serve the public.

Statement by Russell G. Mawby Before Subcommittee on Taxation and Debt Management of the U.S. Senate Finance Committee

S. 464: The Foundation Payout Requirement

I. Introduction

My name is Russell Mawby, I am President of the W. K. Kellogg Foundation of Battle Creek, Michigan. However, I am appearing this morning as Chairman of the Legislation and Regulations Committee of the Council on Foundations (the "Council"). The Council on Foundations is a nonprofit, membership organization whose members include some 638 private foundations from across the country. The Council appreciates the Subcommittee's invitation to testify on S. 464, a bill of vital importance to foundations and their charitable beneficiaries.

Current law requires that private foundations annually distribute to operating charities the greater of 5 percent of the value of their investment assets or their total current income, that is, total income less long-term capital gains. Because of persistent high interest rates and high rates of inflation, the requirement that foundations pay income above 5 percent of asset value seriously distorts their investment decisions and reduces the long-term capacity of foundations to support charitable work.

S. 464 would eliminate the requirement that all income be paid out, but would not alter the present rule that foundations must each year distribute for charitable purposes at least 5 percent of their asset value. Because S. 464 preserves this 5 percent distribution requirement of present law, it insures that foundations will continue substantial current support of charitable activities. At the same time, it would give foundations the investment flexibility which they so desperately need if they are to preserve their continued ability to respond to human needs.

II. Why we will need foundations in the future

Foundations contributed 9.2 percent of all charitable gifts from private sources in 1970; by 1979 they accounted for only 5.2 percent of such gifts. This diminution in the capacity of foundations affects the entire charitable sector. Foundations give charitable, educational, cultural and scientific service organizations an alternative source of funds to government support. Foundations provide venture capital to the philanthropic sector by funding new ideas and new enterprises and by helping new agencies and new groups to gain a toe-hold. Foundations fund many of the sector's research and development efforts, and use their relatively flexible resources to meet society's emergencies and its newly perceived needs. Accordingly, in the measure that foundation grant capacity is less in the future than it is now, operating agencies and philanthropy as a whole will be more vulnerable, less able to react to emergency, less able to take advantage of opportunity, and less able to plan for the future.

The early years of foundation giving in the United States offer dramatic testimony to the service foundations render. In those years, foundation funds helped free the South of hookworm, virtually eliminated malaria and yellow fever from the United States, and reformed medical education to rank American health care with the world's best.

In later years foundation funding of science supported Goddard's early research in rocket engineering, the construction of the first nuclear accelerator, the development of the electron microscope and the oscilloscope, and research leading to our current knowledge of DNA which some observers term the single most significant advance in biology in this century.

When television emerged, private foundations recognized its educational potential and gave massive support. All 282 public TV stations received foundation funds for equipment, operation and other services, and one foundation alone committed $293 million to public TV in the 25 years beginning in 1952.

Following World War II, foundations mirrored the society in responding to the aspirations of Blacks and other minorities to achieve full status as citizens and participants in the bounty of our society. There was a trend from research toward action in housing, education, employment and inner-city problems.

As the decade of the 80's begins, foundations seem to be emphasizing regional approaches, working toward cooperation among themselves and with government. There is a growing emphasis on community development and the preservation and furtherance of neighborhoods and communities.

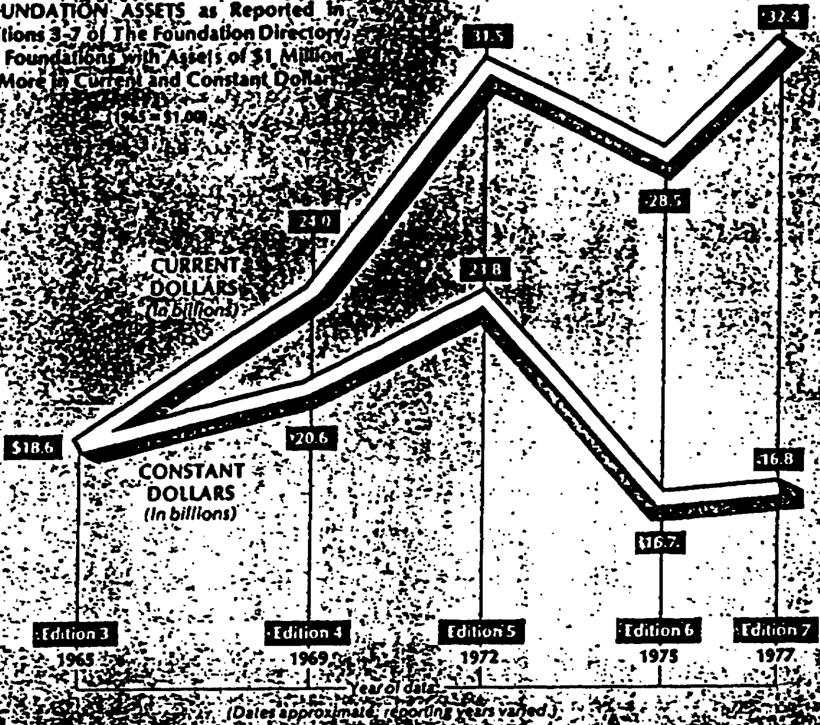
At the same time, foundations have continued to support research at private universities and have sought to strengthen traditional institutions in their role as private alternatives to government-funded institutions. Foundations provide technical assistance and financial support to community groups of every kind; they grant funds for the special needs of the local hospital and the local school; they provide services for the preschooler and for the elderly. Foundations continue to support art and cultural activities as well as traditional social service organizations serving youths, the aged and all other groups in our society.

The need for foundations to support innovative charitable activities will be as great tomorrow as it is today. It would, therefore, be shortsighted to totally restrict the use of foundation resources to current problems at the sacrifice of foundations' capability to respond in the future as they have in the past.

What foundations have done in the past suggests what foundations can do in the future—if they have sufficient resources.

III. Foundation grant capability is rapidly eroding

However, the rapid erosion of foundation grant capability in recent years threatens to eliminate foundations as a vital part of American philanthropy. This decline in the real value of foundation assets, and thus foundation grant capability, is documented by data presented in the most recent edition of The Foundation Directory and summarized in the chart on page 6. The chart shows the changes, for all foundations with assets of over $1 million, in both the nominal and real value of assets over the period from 1965 through 1977. These foundations account for 93 percent of all foundation assets and 92 percent of all foundation grants. As the chart indicates, foundations injoyed a significant increase in both the nominal and real value of their assets from 1965 through 1972. However, from 1972 to 1977 the nominal value of foundation assets increased only slightly and the real value fell by 29.2 percent.


Effect of Inflation on Foundation Assets
FOUNDATION ASSETS as Reported in Editions 3-7 of The Foundation Directory for Foundations with Assets of $1 Million or More in Current and Constant Dollars
CURRENT DOLLARS (In billions)
CONSTANT DOLLARS (In billions)
$18.6
20.6
23.8
31.5
28.5
32.4
16.8
$16.7
Edition 3
1965
Edition 4
1969
Edition 5
1972
Edition 6
1975
Edition 7
1977
Year of data
(Dates approximate; reporting years varied.)

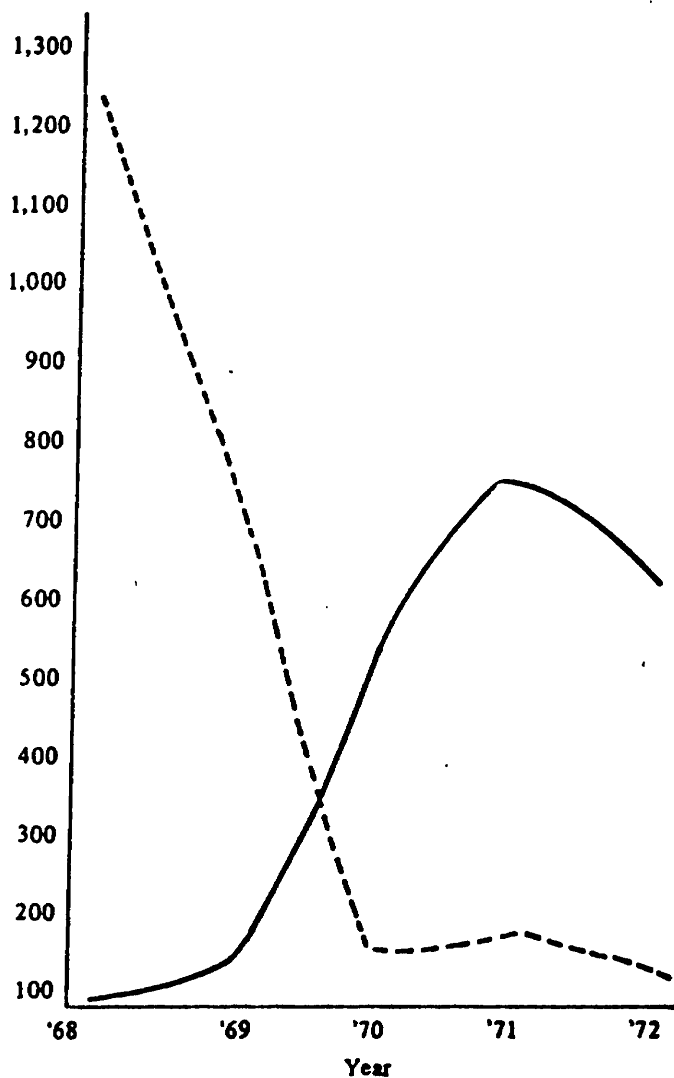
While comprehensive data such as that contained in The Foundation Directory are not available for the period since 1977, data collected by the Council on Foundations in a recent survey of its members indicate that the decline in the real value of foundation assets has continued. From 1977 through 1979 the real value of the assets of the foundations serveyed declined by approximately 11 percent. Thus over the eight year period from 1972 through 1979 the real value of foundation assets fell by almost 40 percent. If the erosion continues at this rate, in twenty years the ability of foundations to support charitable activities will be only a quarter of what it is today.

As these figures suggest, what is at stake is not the continued existence of any particular foundation, but rather the continued ability of foundations as a whole to support important charitable works. Because these figures take into account gifts of additional assets to both existing and newly created foundations, they demonstrate dramatically that the flow of new capital into the foundation sector has been insufficient to offset the erosion of the existing assets of foundations. In fact, as a result of the restrictions imposed on private foundations by the Tax Reform Act of 1969, there has been very widespread termination of foundations while the rate of creation of new foundations has fallen dramatically. This trend has been clearly documented in a study prepared of the National Commission on Private Philanthropy and Public Needs, the results of which are summarized in the chart on page 9. The study examined the rate of creation and dissolution of foundations during the period from 1968 through 1972 in twelve key states, which together account for over 50 percent of all foundations. It demonstrated a sharp decline in the rate of creation of new foundations from 1968 through 1970. Over the same period, dissolutions of private foundations increased dramatically, to a level far in excess of the "birth rate" of new foundations. This data on foundation "birth" and "death" rates, as well as the sharp decline in the real value of total foundtaion assets, clearly show that new money flowing into the foundation sector is insufficient to offset the rapid decline of existing foundation assets.

IV. Congress never intended to reduce foundation capability

The experience of foundations throughout the country indicates that the present requirement that foundations distribute annually all of their income is a major factor contributing to this alarming erosion of foundation grant capability. Indeed, foundations are being forced to spend themselves out of existence by their inability to reinvest any of the income they earn in excess of the 5 percent minimum payout amount. It is absolutely clear that Congress never intended that the payout requirement have this effect. During the decade preceding enactment of the payout requirement in 1969, inflation averaged only 1.9 percent.

Foundations Established/Terminated, 1968 - 1972,
Cumulative of 12 States



From "Analysis of Foundation Center Data on Creation, Dissolution and Reclassification of Private Foundations," Washington, D.C., October 25, 1974, prepared by Caplin & Drysdale and The Foundation Center in Washington, D.C.

It is not surprising, therefore, that in formulating the payout rule neither Treasury nor the Congress devoted significant attention to the effect which the required distribution of all current income would have in a highly inflationary environment. The Congressional debate makes it clear, however, that the Congress did not intend the payout rule to require that foundations distribute at so fast a rate as to erode the real value of foundation assets. Senator Percy, the leading sponsor of the minimum payout provision finally adopted, made this clear in the following statement:

The percentage should not be so high as to amount to a delayed death sentence. A foundation with a well-managed investment portfolio should be able to maintain its size and to stay abreast of changes in the value of the dollar. However, the current needs of our society for philanthropic funds are so great that I consider it inappropriate to permit foundations to grow in size, without making an adequate current contribution to philanthropy. A payout percentage *which will permit a well-managed foundation portfolio to maintain its size while making a productive contribution to charity, represents an equitable balance* between the pressure of society's current needs and the interest of future generations. Cong. Rec., Nov. 24, 1969, S. 15950. (*Emphasis added.*)

Congress has demonstrated a continuing commitment to reevaluate the payout requirement to preserve this principle of "an equitable balance." For example, in 1976 Congress concluded that the 6 percent minimum distribution requirement, coupled with the requirement that this minimum distribution percentage be adjusted annually to reflect any increases in prevailing interest rates, "could have damaging effects on the continuing viability of many foundations." In response, Congress reduced the rate to 5 percent and eliminated the previously required annual adjustment.

Increases in inflation urge the need for a further reevaluation of the payout rule, for under inflationary conditions the total income payout rule now makes it virtually impossible for "a foundation with a well-managed investment portfolio . . . to maintain its size and stay abreast of changes in the value of the dollar." Current inflation rates of 10 percent or more make necessary a revision of the rule to eliminate the requirement that all income be paid out.

V. The effect of the payout requirement in an inflationary environment

It is clear that Congress did not intend by the income payout rule to impose the "delayed death sentence" it specifically renounced in setting the percentage payout. When Congress enacted the income payout rule, current yields on a well-managed, balanced portfolio were significantly below 5 percent; inflation had averaged between 2 percent and 3 percent over the preceding decade; and stocks were growing in value much more rapidly than inflation. Today interest rates on debt securities like Treasury bills and certificates of deposit range from well over 13 percent to almost 17 percent; inflation persists at 10 percent to 12 percent; and real stock values have declined sharply over the last decade. The effect of the income payout requirement has changed radically as the rate of inflation has risen from the 2 percent level prevailing in the 1960's to the 10 percent or higher level of today. This change is attributable to the fact that in a period of high inflation the nominal return on all investments increases. In the case of bonds and other debt securities, this increased nominal return takes the form of higher interest rates. However, only a fraction of this higher nominal return represents real income to the bondholder. The remainder is in fact merely a replacement of that part of the bondholder's capital consumed by inflation. Yet the total income payout rule requires that all this nominal income must be distributed.

When examined in this perspective, it is clear that a payout rule that requires foundations during a period of inflation to distribute the entire nominal return on their assets is the practical equivalent of a requirement that they annually distribute a portion of their corpus. The inevitable effect of such a rule is to reduce their future grant capability and, continued over time, to reduce them to virtual incapacity.

To the extent that foundations hold securities that reflect current high interest rates such as certificates of deposit, the present requirement that they distribute all current income has precisely this effect. The entire nominal return on such debt investments generally comes in the form of current income. Foundations must distribute the entire nominal return and can do nothing to offset the inflationary erosion of their assets and their future grant capabilities.

The manner in which rising inflation rates fundamentally alter the effect of the income payout requirement has been clearly demonstrated in a study prepared by the Charles Stewart Mott Foundation of Flint, Michigan. The Mott Foundation analyzed the effect of the current income payout requirement on the performance of a typical foundation portfolio with initial assets of $1,000,000 under conditions of 2

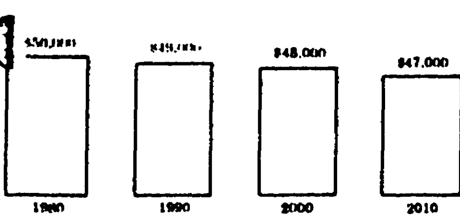
percent inflation and 10 percent inflation. For purposes of the analysis it was assumed that the foundation's assets would be invested 60 percent in common stock and 40 percent in bonds—a portfolio mix reflecting the traditional investment strategy of foundations and other endowed charities—and that the rates of return on these investments would be comparable to historic rates of return over the period from 1926 through 1978.

The results of this analysis are presented in the chart on page 14. (Figures supporting the chart are included as Appendix 1). Example I assumes a 2 percent rate of inflation and depicts the changes in both the purchasing power of the foundation's grants and the real value of the foundation's assets over a 30-year period. This example corresponds roughly to the conditions that prevailed in the period before Congress enacted the 1969 payout requirement. Given this low rate of inflation, under present payout rules the real value of the foundation's grants falls by only $3,000 over 30 years—from $50,000 to $47,000—and the real value of the foundation's assets declines from $1,000,000 to $943,000.

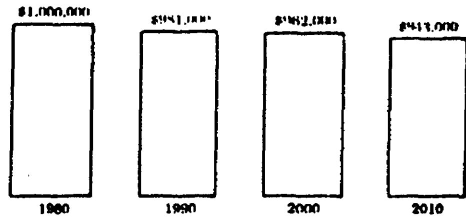
EXAMPLE I

Two Percent Inflation with Current Payout Requirement

Purchasing Power of Income Distributed*



Value of the Securities Portfolio*

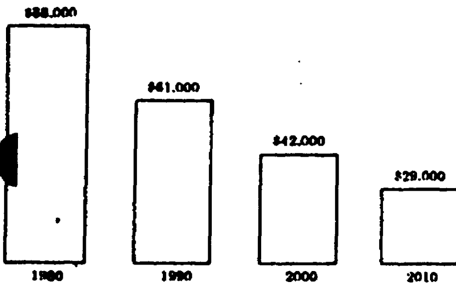


(See Table III • Portfolio II)

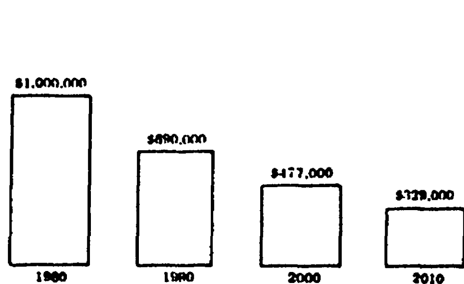
EXAMPLE II

Ten Percent Inflation with Current Payout Requirement

Purchasing Power of Income Distributed



Value of the Securities Portfolio

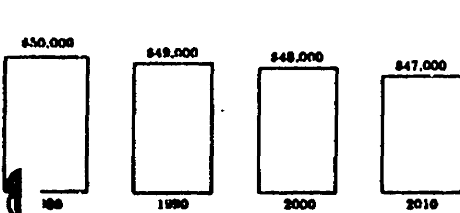


(See Table IV • Portfolio I)

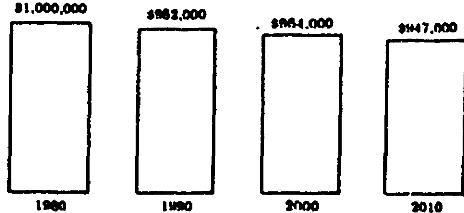
EXAMPLE III

Ten Percent Inflation with Five Percent Straight Payout Requirement

Purchasing Power of Income Distributed



Value of the Securities Portfolio



(See Table IV • Portfolio II)

*Portfolio Composition: 60% stocks, 40% bonds
Initial Portfolio: $1 million

However, as shown by Example II—which more nearly corresponds to today's conditions—this picture changes drastically when the rate of inflation rises to 10 percent. The purchasing power of the foundation's grants is somewhat higher in the early years of the 30-year period—precisely because the foundation is forced by the current income payout rule to distribute part of its corpus. However, because of this erosion of corpus the purchasing power of the foundation's grants falls rapidly. By the end of the 30-year period the real value of these grants is only $29,000. Over the same period, the real value of the foundation's assets has fallen from $1,000,000 to $329,000.

Finally, Example III shows that the proposed modification of the payout requirement would significantly reduce this erosion of foundation grant capability in an inflationary economy. Under the proposed payout requirement the foundation would be required to distribute an amount equal to 5 percent of the value of its investment assets and could use income in excess of 5 percent to preserve the charitable purchasing power of its grants. Under this rule the foundation would be able largely to offset the effect of continued 10 percent inflation. Indeed, the purchasing power of the foundation's grants would be only $3,000 less at the end of the 30-year period than at the beginning, having fallen from $50,000 to $47,000.

It is also important to point out that if, as we all hope, the rate of inflation falls sharply in coming years, the modified payout rule embodied in S. 464 will continue to insure that foundations make substantial current distributions to charity. If inflation falls, data on historic investment returns makes clear that the nominal return on foundation investments will also fall. For example, if inflation falls back to 2 percent per year, the nominal return on the foundation's investments will fall to roughly 6.5 percent, of which approximately 3.5 percent would be in the form of current income. Because the foundation's current income would be well below 5 percent, elimination of the requirement that foundations distribute current income in excess of 5 percent would have absolutely no effect on the foundation's required payout. The foundation would still be required to distribute 5 percent per year—precisely the same result that would obtain under current law.

VI. The income payout rule distorts foundation investment decisions

In inflationary periods, the requirement that foundations pay out their entire current income has another harmful effect not intended by Congress—it distorts foundation investment decisions and encourages foundations to abandon traditional, prudent investment strategies in favor of more risky investments. The mechanism through which this occurs is quite simple. Under current law a foundation that wishes to preserve its future grant capability has a strong incentive to limit its current income to an amount equal to the 5 percent minimum distribution requirement, and to seek to realize the remainder of its total return in the form of long-term capital appreciation. To accomplish this goal; the foundation must invest a greater portion of its total assets in stocks and other assets offering the possibility of capital appreciation. However, it is well established that the risk associated with such equity investments is significantly greater than that associated with bonds and other debt securities. Indeed, a frequently cited historical study of investments compares standard indices and concludes that common stock investments have involved risk four times as great as bond investments.[1] Moreover, there are risks in any long-term investment strategy which forces foundations toward an unbalanced approach. It is better if foundations are free to adopt a prudent balanced strategy combining some fixed income investments and some equity investments.

Statistical data are not available to suggest the extent to which foundations have adopted such higher risk investment strategies. However, it is known that investment advisors are recommending such strategies to their foundation clients; suggesting, for example, such nontraditional investments as call options, deep discount bonds, commodities, timber holdings and foreign equity investments. It is also clear that the present payout rule provides a strong incentive for foundations to accept this advice. By thus encouraging foundations to assume greater risks, the present payout rule is further jeopardizing their future grant capability.

Commenting on this dilemma, Professor of Business Administration, J. Peter Williamson of Dartmouth College and the University of Virginia writes:

"Long-term bonds, and from time to time short-term instruments, offer high current income coupled with declining real capital value. Common stocks offer significantly lower current income coupled with a reduced likelihood of loss of real capital value. The foundation seeking the greatest chance of maintaining the purchasing power of its investments will be driven to the lowest yielding common stocks, which generally constitute the most risky securities available. The founda-

[1] Ibbotson and Sinquefield, "Stocks, Bonds, Bills, and Inflation (1926–1978)," p. 23.

tion choosing a prudent balance between risk and return has been forced in recent years to accept a higher current income and a substantial deterioration in real capital value. What the distribution requirement in Section 4942 has done is to create a situation in which the only chance a private foundation has of minimizing capital depreciation is to pursue an extraordinarily high risk investment strategy. Any reasonable balance between risk and return must lead inevitably to erosion of the real value of the portfolio.

There is no logic in a distribution rule that forces this choice upon a private foundation . . . If the purpose of the legislation is to prevent this imbalance between growth and distribution, then the minimum investment return rule alone would serve that purpose without the perverse results of the requirement that current income be distributed,"

A copy of a recent study by Professor Williamson of the impact of the payout requirement on foundations is attached as Exhibit II

[The study referred to is in the Finance Committee's files:]

While colleges, universities and all other tax-exempt institutions can take advantage of the high yields available on bonds and other similar investments to defend their charitable purchasing power against inflation while still maintaining an adequate current charitable program, foundations cannot. The requirement that all income be distributed has brought about, therefore, an artificial—and wholly unintended—investment constraint which is distorting foundation investment decisions and which should be eliminated.

VII. Effect of the proposed payout rule on foundation grants

Under the payout rule embodied in S. 464 foundations would continue to be required to distribute an amount equal to 5 percent of the value of their investment assets. However, they would not be required to distribute their entire current income. The 5 percent distribution requirement would ensure that foundations continue to make substantial current distributions to charity. Indeed, historically this 5 percent distribution requirement exceeds the average real income which a foundation could have earned over the past 50 years on a balanced well-managed portfolio of stocks and bonds. Professor Williamson's recent study, referred to above, indicates that over the period from 1926 through 1978 the real total return (considering both income and capital appreciation) on a balanced investment portfolio including both equity and debt investments was between 4.0 and 4.5 percent. Whether measured over the past 54 years, 30 years or 5 years the average real return on a well balanced portfolio has been less than 5 percent. Thus, a payout requirement of 5 percent will ensure that foundations distribute to charity the entire real return they can expect from their invested assets—and probably a little more.

The extent to which the proposed payout rate would result in a short-term decline in foundation grants is difficult to predict. Certainly there will be some decline. But the scale of this decline should be seen in perspective. It is clear that certain classes of foundation grants would be unaffected by the change in the payout requirement. Grants by company-sponsored foundations, for example, would be unaffected. These foundations normally hold small endowments and pay grants primarily out of current contributions received from the sponsoring company. There are also substantial amounts distributed by other foundations that are essentially mechanisms for current charitable distributions of individual donations. These will be unaffected.

Some endowed independent foundations may well choose to continue to pay amounts somewhat in excess of 5 percent of the value of their investment assets, either as a matter of program choice or because they are required by their charters to pay out all of their income and/or to pay out principal amounts, as well. In the aggregate, all independent foundations pay out now about 5.7 percent of asset value each year. If all independent foundation giving was reduced to the 5 percent minimum investment return—and, for the reasons stated above, the decline would not be the full amount—the result would be a temporary decrease in grant making. Again this decline would be only temporary. Meanwhile foundation assets would be rebuilt to offset inflation's erosion, and the capital basis for foundation's 5 percent annual grant making would grow. Foundations would be increasing their future grant making potential and ability to fund worthy charitable causes in the decades ahead.

Thus, a short-term reduction in distributions is clearly justified as a way of insuring that foundations can continue support in the future. Indeed, as we have noted earlier, the philanthropic sector would over time recoup the immediate reductions as payout increased as a result of foundations preserving their endowment value instead of quickly distributing corpus at accelerated rates.

VIII. Technical and administrative amendments

In addition to its principal provision amending the foundation payout requirement, S. 464 contains three technical amendments which will eliminate unnecessary administrative burdens imposed on foundations by current law. The Council on Foundations strongly supports the enactment of each of these amendments.

EXCEPTION TO FOUNDATION RECORDKEEPING REQUIREMENT FOR SMALL GRANTS

Current law requires that a foundation making grants to organizations not recognized as public charities comply with detailed record-keeping and reporting requirements. These so-called "expenditure responsibility" requirements are particularly burdensome for small foundations which often lack the administrative resources to comply with the requirements, and which as a result are simply unable to make many worthwhile grants. Larger foundations also frequently decide to forego small grants to nonpublic charities in order to avoid this burden on their administrative resources.

As a result of this requirement, many small-scale but highly beneficial charitable activities cannot attract the foundation support they need to survive. In practical terms, the cost of this requirement must be measured in terms of the summer youth program, the community cleanup, the local drug abuse prevention effort which never happens because of a lack of foundation support.

To eliminate this clearly unintended result, S. 464 would amend current law to provide a $10,000 de minimis exception under which a foundation would not be required to comply with the expenditure responsibility requirements if its grants, along with those of all related foundations, to a single grantee did not exceed $10,000 in a given year. This amendment would not in any way affect the substantive rules which require that every foundation grant, large or small, go to support a recognized charitable activity. Nor would it relax the expenditure responsibility requirements for large grants, where they are justified by the large amounts of money involved. Instead, this amendment would merely recognize that the record-keeping and reporting requirements which are appropriate for large grants are counterproductive when applied to small grants.

A WORKABLE DEFINITION OF "FAMILY MEMBER"

The private foundation rules impose severe restrictions on the business relationships which may exist between a foundation and its "disqualified persons," and even inadvertent violations of these restrictions trigger substantial penalty taxes. Under current law, "disqualified persons" with respect to a foundation include substantial contributors to the foundation and all of their lineal descendants, regardless of how many generations separate these descendants from the original contributor. This rule can impose a great administrative burden on private foundations, the magnitude of which increases geometrically with each passing generation. For example, many of the country's largest foundations were extablished early in this century, and the managers of these foundations must keep track of hundreds of lineal descendants of substantial contributors in order to avoid inadvertent violations of the foundation rules.

To eliminate this waste of foundation resources without undermining the effectiveness of the foundation rules, S. 464 would amend the definition of "family members," and thus of "disqualified persons," to include only children and grandchildren, rather than all lineal descendants, of substantial contributors. In those few cases in which more remote descendants continue to be actively involved in the operation of the foundation, they will still be treated as disqualified persons by virtue of being foundation managers or the children or grandchildren of such managers. Thus the proposed change will create no potential for abuse, and will increase the amount of foundation resources available to support charitable activities.

ELIMINATION OF UNREASONABLE ADMINISTRATIVE REQUIREMENT

Foundations are required to comply with detailed record-keeping and reporting requirements if they make grants to organizations which are not public charities. In order to determine whether it must comply with these involved and sometimes costly requirements in the case of a particular grant, a foundation must determine whether or not the prospective grantee is a public charity.

The Internal Revenue Service has taken the position that in making this determination a foundation making a substantial grant is not allowed to rely on an official IRS ruling as to the public charity status of the grantee. Therefore, as a practical matter a foundation may feel obliged to make its own detailed investigation of the

grantee's sources of financial support to determine whether the foundation's grant may "tip" the grantee out of public charity status.

The vast majority of such investigations indicate that the foundation's grant will cause no change in the grantee's public charity status. In these cases, the only effect of this investigation is to consume foundation resources which would otherwise be available to support charitable activities. In the small number of cases in which the foundation grant actually causes the grantee to lose its public charity status, there is simply no evidence to suggest that the grant will involve any abuse which justifies this burdensome requirement. Such grants, regardless of the status of the grantee, must comply with strict substantive requirements. Every dollar of the grant must be used for a recognized charitable purpose, and the grant may not result in a private benefit to anyone associated with the foundation.

In light of these safeguards, it is clear that this requirement constitutes an unreasonable and unnecessary drain on foundation resources, the cost of which ultimately falls not on foundations but on the public in the form of reduced foundation support of charitable activities. To eliminate this problem S. 464 would allow foundations to rely on official IRS rulings with regard to the public charity status of potential grantees except in cases in which the IRS has published notice of a change in the grantee's status or the foundation has independently acquired actual knowledge of such a change. I should note that the IRS has recently issued two Revenue Procedures (Rev. Procs. 81-6 and 81-7) which bear on this issue, and the Council is currently studying the extent to which they affect the need for this legislation.

IX. Conclusion

Foundations strongly support the basic objective of the payout rule and they believe that the 5 percent minimum payout requirement should be maintained. In supporting S. 464, foundations seek only the elimination of the requirement that they pay out such income as they receive above 5 percent. The ability of foundations to support vital charitable activities in the future as they have in the past is threatened by the present requirement that foundations distribute their entire current income. Elimination of this requirement would contribute significantly to the preservation of the future grant-making capability of foundations.

APPENDIX I

TABLE I

Total Annual Investment Returns (1926 - 1978)

Security Class	Nominal Annual Return (mean)		Annual Inflation (mean)		Real Annual Returns (mean)
Common Stocks	8.9%	−	2.5	=	6.4%
Long Term Corp. Bonds	4.0%	−	2.5	=	1.5%
Long Term Govt. Bonds	3.2%	−	2.5	=	0.7%
U.S. Treasury Bills	2.5%	−	2.5	=	0.0%

TABLE II

Total Annual Investment Returns (1969 - 1978)

Security Class	Nominal Annual Return (mean)		Annual Inflation (mean)		Real Annual Returns (mean)
Common Stocks	3.2%	−	6.7	=	-3.5%
Long Term Corp. Bonds	5.8%	−	6.7	=	-0.9%
Long Term Govt. Bonds	5.1%	−	6.7	=	-1.6%
U.S. Treasury Bills	5.9%	−	6.7	=	-0.8%

Source: Stocks, Bonds, Bills, and Inflation: Historical Returns (1926-78) Ibbotson & Sinquefield, 1979.

TABLE III

Effect of a 2% Rate of Inflation on 60% Stock — 40% Bond Portfolios with Different Income Payouts

The following tables illustrate the effect of a 2% rate of inflation on the constant dollar portfolio value and the purchasing power of income developed from three 60% stock - 40% bond portfolios. The portfolios are invested to provide a total return of 6.8%, with the bonds returning 5% and the stocks 8% per year. The 8% return from stocks is derived 5% from capital appreciation and 3% from cash income. In the first portfolio, the cash income return of 3.8% is less than the minimum 5% payout requirement. Therefore, some encroachment of the portfolio must occur and the effect of this encroachment is shown in Portfolio II. Portfolio I does not reflect this encroachment.

In the second portfolio, 5% of the value is distributed and 1.8% reinvested 60% stocks - 40% bonds earning at the same rates of return; and in the third, the real return of 4.8% is distributed and 2% is reinvested 60% stocks - 40% bonds earning at the same rates of return.

Assumptions:

(1) All portfolios begin with $1,000,000 invested 60% in stocks to return 8% (6% real return and 2% inflation) and 40% bonds to return 5% (3% real return and 2% inflation).

(2) The rate of inflation is assumed to be 2% per year.

(3) The dividends from stocks provide a cash income yield based on market value of 3% and the interest from bonds provides a cash income yield based on market value of 5% for an overall cash income yield of 3.8% (60% stocks - 40% bonds).

(4) It is assumed that bonds will provide a real return of 3%, although this is somewhat higher than historical returns.

PORTFOLIO I

All Income Distributed[1]

Year	Nominal Value	Value in 1980 Dollars	Income	Income Distributed	Purchasing Power of Income Distributed (1980 Dollars)
1980	$1,000,000	$1,000,000	$38,000	$38,000	$38,000
1990	1,343,916	1,102,480	51,069	51,069	41,894
2000	1,806,111	1,215,461	68,632	68,632	46,187
2010	2,427,303	1,340,081	92,236	92,236	50,921

(1) The capital appreciation from the stocks of 5% per year is assumed to be reinvested: 60% back into stocks and 40% into bonds thereby maintaining the 60% - 40% stock bond ratio.

PORTFOLIO II

5% Distributed, 1.8% Reinvested[1]

Year	Nominal Value	Value in 1980 Dollars	Income	Total Distributed	Purchasing Power of Income Distributed (1980 Dollars)
1980	$1,000,000	$1,000,000	$38,000	$50,000	$50,000
1990	1,196,302	980,544	45,421	59,705	49,088
2000	1,428,748	961,806	54,298	71,437	48,078
2010	1,707,788	942,819	64,896	85,389	47,141

(1) The total return is 6.8% from the portfolio invested 60% in stocks at a 8% return (2% inflation) and 40% in bonds at a 5% return. Of the total return of 6.8%, 5% is distributed, leaving 1.8% to be reinvested.

PORTFOLIO III

Real Return of 4.8% Distributed[1], 2% Reinvested

Year	Nominal Value	Value in 1980 Dollars	Income	Total Distributed	Purchasing Power of Income Distributed (1980 Dollars)
1980	$1,000,000	$1,000,000	$38,000	$48,000	$48,000
1990	1,218,994	1,000,000	46,322	58,512	48,000
2000	1,485,947	1,000,000	56,466	71,325	48,000
2010	1,811,362	1,000,000	68,832	86,945	48,000

(1) The portfolio's real return is 4.8% which is the total return of 6.8% minus 2% inflation. Of the total return of 6.8%, 4.8% is distributed leaving 2% to be reinvested.

TABLE IV

Effect of a 10% Rate of Inflation on 60% Stock — 40% Bond Portfolios with Different Income Payouts

The following tables illustrate the effect of a 10% rate of inflation on the constant dollar portfolio value and the purchasing power of income developed from three 60% stock - 40% bond portfolios. The portfolios are invested to provide a total return of 14.8%, with the bonds returning 13% and the stocks 16% per year. In the first portfolio, all income is distributed; in the second 5% of the value is distributed and 9.8% reinvested 60% stocks - 40% bonds earning at the same rates of return; and in the third, the real return of 4.8% is distributed and 10% is reinvested 60% stocks - 40% bonds earning at the same rates of return.

Assumptions:

(1) All portfolios begin with $1,000,000 invested 60% in stocks to return 16% (6% real return and 10% inflation) and 40% in bonds to return 13% (3% real return and 10% inflation).

(2) The rate of inflation is assumed to be 10% per year.

(3) The dividends from stocks provide a cash income yield based on market value of 6% and the interest from bonds provides a cash income yield based on market value of 13% for an overall cash income yield of 8.8% (60% stocks - 40% bonds).

(4) It is assumed that bonds will provide a real return of 3%, although this is somewhat higher than historical returns.

PORTFOLIO I

All Income Distributed[1]

Year	Nominal Value	Value in 1980 Dollars	Income	Income Distributed	Purchasing Power of Income Distributed (1980 Dollars)
1980	$1,000,000	$1,000,000	$ 88,000	$ 88,000	$88,000
1990	1,790,848	690,449	157,596	157,596	60,760
2000	3,207,136	476,720	282,228	282,228	41,961
2010	5,743,491	329,151	505,427	505,427	28,966

(1) The capital appreciation from the stocks of 10% per year is assumed to be reinvested: 60% back into stocks and 40% into bonds thereby maintaining the 60% - 40% stock bond ratio.

PORTFOLIO II

5% Distributed, 9.8% Reinvested[1]

Year	Nominal Value	Value in 1980 Dollars	Income	Income Distributed	Purchasing Power of Income Distributed (1980 Dollars)
1980	$ 1,000,000	$1,000,000	$ 88,000	$ 50,000	$50,000
1990	2,546,967	981,966	224,133	127,348	49,098
2000	6,487,043	964,256	570,860	324,352	48,213
2010	16,522,289	946,868	1,453,961	826,114	47,343

(1) The total return is 14.8% from the portfolio invested 60% in stocks at a 16% return (10% inflation) and 40% in bonds at a 13% return. Of the total return of 14.8%, 5% is distributed, leaving 9.8% to be reinvested.

PORTFOLIO III

Real Return of 4.8% Distributed[1], 10% Reinvested

Year	Nominal Value	Value in 1980 Dollars	Income	Income Distributed	Purchasing Power of Income Distributed (1980 Dollars)
1980	$ 1,000,000	$1,000,000	$ 88,000	$ 48,000	$48,000
1990	2,593,743	1,000,000	228,249	124,500	48,000
2000	6,727,500	1,000,000	592,020	322,920	48,000
2010	17,449,402	1,000,000	1,535,547	837,571	48,000

(1) The portfolio's real return is 4.8% which is the total return of 14.8% minus 10% inflation. Of the total return of 14.8%, 4.8% is distributed leaving 10% to be reinvested.

We must expect that the needs of the future will be as compelling as are the concerns of today. If we permit foundation endowments to erode, the charitable sector will be unable to call on foundations as alternatives to government at special times of need. American charity then will have lost much of its flexibility and perhaps, over time, some of its freedom. Congress should enact S. 464 to forestall these consequences, which have resulted from inflation and which were completely unforeseen when the payout provision was enacted in 1969.

Senator PACKWOOD. We will hold just a moment until we move onto the last bill of the day, S. 499, while those who are leaving the room clear out as rapidly as possible.

[Brief recess.]

Senator PACKWOOD. Hearing will come to order.

Pat, I might call one thing to your attention before we start this hearing.

The Treasury testified, of course, this morning on all the bills and on this bill, S. 499, which would allow deferral of gain realized on the disposition of broadcast property under the FCC divestiture orders, the Treasury Department does not oppose S. 499.

Senator MOYNIHAN. Oh, I've heard that, Mr. Chairman. I don't believe it. [Laughter.]

Or, at least, that is a historic first, I mean, just——

Senator PACKWOOD. Mr. Johnson.

Hold on. Just get the people to move out and close the door back there, please.

Now, then, Mr. Johnson. Thank you for being so patient.

STATEMENT OF JOHN B. JOHNSON, PUBLISHER AND EDITOR, WATERTOWN DAILY TIMES, WATERTOWN, N.Y.

Mr. JOHNSON. Mr. Chairman, as you know, I am John B. Johnson, and I am president of the Johnson Newspaper Corp. and editor and publisher of the Watertown Daily Times.

I want to just make a few remarks here in support of Senate bill 499.

Our company will be 120 years old on April 21. We began publishing a daily newspaper in 1861 to report the Civil War news. My father became associated with the newspaper in 1904, becoming editor in 1919, and taking on the additional role of publisher in 1934.

Forty years ago, April 29, we began a radio station in Watertown. Then, in 1954, we invested heavily and put on the air the first commercial television station in northern New York, now WWNY television channel 7.

In all the years we operated these stations, there never once was any protest against any of our applications for license renewal. All of our license applications were accepted by the FCC in good order.

In 1975, the Commission ruled that companies holding the only newspaper and only television station in the same market would have to divest themselves of one of these properties by 1980.

There were nine companies affected. All of those companies operated in small cities, such as Watertown, which now has a population of 27,000.

The larger cities, where a single company in many cases owned a television station, they were exempt because there were other television stations on the air in those cities.

We protested that rule in the Federal courts. We lost the protest when the Supreme Court in June 1978 ruled that the FCC's divestiture order was proper. They, in effect, said that the Commission had the right to regulate the newspaper ownership of a broadcast facility.

We promptly applied for a waiver of the rule under provisions provided by the Commission. That was denied in October 1979.

Having lost all appeals, we set about adhering to the Government order and put WWNY-TV up for sale. That sale is about to occur.

In the meantime, we applied for a ruling from IRS, which would have assured us that the proceeds of the sale of WWNY could be reinvested in a newspaper. And, we, at the same time, could defer the taxes. That request was denied.

Our technical submission to you shows that since 1943, it has been the intent of Congress to provide tax relief to firms forced to sell their properties to concur with FCC rules.

That tax regulation was expanded in 1954 to cover television, which by then was actively regulated. Now the Commission with the concurrence of the Supreme Court has expanded its rulemaking to certain classes of newspapers. We feel it is only logical that we should be accorded the same tax relief that has traditionally been provided by the Congress when expansion of this kind of rulemaking has occurred.

What I cannot understand is why we have been told we cannot defer the tax if we invest in a newspaper. The IRS has ruled in another case that a company in the exact same tax position as ours was allowed to sell their newspaper, purchase a television station and defer the tax.

We could invest in television and defer the tax. We could sell the newspaper, invest in a newspaper and defer the tax. But, no, we cannot sell television and invest in a newspaper. Therefore, we support Senate bill 499, and urge its adoption by your committee and the Congress.

And I am very appreciative of being able to testify in this behalf.

Senator PACKWOOD. Quick question: What is the circulation of your newspaper?

Mr. JOHNSON. About 43,000.

Senator PACKWOOD. I serve, Mr. Johnson, on the Congress committee, also, and I am very familiar with the cross-ownership problem and I can assure you that we never had any intent—of course, this was an FCC order—but we never had any intent, in essence, to somehow perpetuate this reverse discrimination. And, in essence, discourage you from owning the newspaper that your family has owned for the better part of a century and a half and force you to buy more tele ision properties and, in essence, to get out of the newspaper business.

And, I apologize if that's been the effect and this bill will have my support.

Mr. JOHNSON. Thank you, sir.

Senator PACKWOOD. Pat.

Senator MOYNIHAN. Well, Mr. Chairman, I just feel exactly the same way.

It is the fact that there is a constitutional infection of the press for the American Government. It is pervasive with that concern.

And there is something repellent about a Federal agency ordering a newspaper to divest itself of a television station and then saying: It must not buy another newspaper. I mean, in no circumstances do we want people buying newspapers. What we need is more rock 'n' roll stations, more sit coms, and—I mean, it just—it offends the spirit of—I don't know what the FCC is—where they got the power to tell a newspaper what to do, anyway. But they did; and they have.

And all that the Watertown Times is asking is equal treatment with an anachronistic provision in the statute that comes from a time that predates television.

The provision assumes that a "property" means a radio broadcasting station and it doesn't——

Now, I am very pleased that the Treasury has said it does not oppose this. I think it ought—I gather there is some question about the date and——

Senator PACKWOOD. Retroactivity.

Senator MOYNIHAN. With your permission, Mr. Chairman, we will sit down with them. But, I think we have a clear case of equity here and it will do us no harm to get it out of the way.

And I thank Mr. Johnson. Thank you for coming and putting this to us.

Thank you, Mr. Chairman.

Senator PACKWOOD. Thank you very much. The hearing is adjourned.

[The prepared statement of Mr. John Johnson follows:]

STATEMENT OF JOHN B. JOHNSON OF JOHNSON NEWSPAPER CORP., ON DEFERRAL OF GAIN REALIZED ON FEDERAL COMMUNICATIONS COMMISSION ORDERED DIVESTITURE

SUMMARY OF COMMENTS

I. Johnson Newspaper Corporation was ordered by the Federal Communications Commission to dispose of either its newspaper operation or its television broadcasting facility.

II. As the Corporation and Johnson Family have been in the newspaper business for 120 and 77 years, respectively, and have developed significant expertise in the profession, it has been decided to dispose of the television broadcasting facility and purchase a new newspaper with the proceeds.

III. Deferral relief pursuant to IRC Sections 1071 and 1033 was denied by the IRS.

IV. If the Company had reversed the situation and sold the newspaper and invested in a television facility, relief would have been available.

V. The IRS position is not in accord with Congressional intent and Section 1071 should be amended to make it clear that the purchase of a newspaper does qualify for relief.

VI. Senate Bill 499 should be enacted.

TECHNICAL SUBMISSION BY MR. JOHN B. JOHNSON OF THE JOHNSON NEWSPAPER CO.

Introduction

My name is John B. Johnson and I am the President of Johnson Newspaper Company and editor and publisher of the Watertown Daily Times. My father, Harold B. Johnson preceded me in the newspaper business from 1904 to 1949. I began my formal association with the newspaper in 1939 upon graduation from Princeton. My wife, Catherine C. Johnson, my sons, John B. Johnson, Jr. and Harold B. Johnson are both actively involved with the newspaper. My son, John is managing editor and my wife is an officer.

Johnson Newspaper Corporation (the Company) is a New York corporation whose headquarters is located at 260 Washington Street, Watertown, New York 13601. The

Company was organized on March 8, 1892 and has published the Watertown Daily Times since that date. It directly succeeded a partnership which started the newspaper in 1861. In addition the company started and operated two radio stations—WWNY (CBS affiliate in Watertown operated since 1941) and WMSA (ABC affiliate in Massena, New York operated since 1945). In 1954, the Company began the only commercial television in Northern New York. Since then the company has operated television station WWNY-TV (Class B, CBS affiliate) in Carthage-Watertown.

Background

Until the Spring of 1970, the Federal Communications Commission (FCC) permitted common ownership of a station in each of the broadcast services in the same market. On March 25, 1970 the FCC's *First Report and Order* in docket 18110, 22 F.C.C. 2d 306, adopted rules prohibiting common ownership of VHF television stations and aural stations in the same market. Also adopted at that time was a *Further Notice of Proposed Rule Making*, 22 F.C.C. 2d 339, which required divestiture within five years where necessary, in order to reduce one party's holdings in a market to one or more daily newspapers, or to one television station, or to one AM-FM radio combination.

Five years later the FCC issued its *Second Report and Order* in docket 18110, 50 F.C.C. 2d 1046 (1975), formerly requiring divestitures where the common ownership restrictions were violated.

For the next three years, the Company was involved, with other similarly affected companies, in attempting to have the FCC's order set aside. However, in 1978, the U.S. Supreme Court ruled in favor of the FCC and management was forced to decide the company's future.

The company also applied to the FCC for a waiver of its order. That request was denied on October 1979.

In light of the Company's involvement in the newspaper business for 120 years and the expertise developed over those many years, management of the Company decided that it would be best to comply with the order by divesting itself of the television station and continue to operate the newspapers. Furthermore, if possible, management has decided to reinvest the proceeds received from the sale of the television station in another newspaper.

Tax deferral as it relates to involuntary conversions and FCC divestiture orders

Section 1033 of the Internal Revenue Code allows a taxpayer to defer the recognition of gain on the involuntary conversion of property where the taxpayer reinvests the proceeds received within the statutory period of time and where the property obtained is "similar or related in service or use to the property so converted."

In 1943, Congress enacted Section 112(m) of the IRC of 1939, the predecessor of Section 1071(a) of the IRC of 1954. Section 1071(a) provides, in part, that "If the sale or exchange of property . . . is certified by the FCC to be necessary or appropriate to effectuate a change in policy of, or the adoption of a new policy by, the Commission with respect to the ownership and control of radio broadcasting stations, such sale or exchange shall, if the taxpayer so elects, be treated as an involuntary conversion of the property within the meaning of Section 1033 . . ."

The second sentence of Section 1071(a) indicates that for purposes of Section 1033 and the requirement that property be similar or related in service or use to the property converted, ". . . stock of a corporation operating a radio broadcasting station, whether or not representing control of such corporation, shall be treated as . . ." qualifying.

At the time Section 1071 was enacted, television broadcasting was nonexistent. In 1956, the Treasury recognized the need to provide similar relief for forced conversions of television properties and the tax regulations were amended to provide that ". . . the term 'radio broadcasting' includes telecasting". Reg. Sec. 1.1071-(d).

Internal Revenue Service interpretation of Section 1071

The Company submitted a ruling request to the Internal Revenue Service in January 1980 asking that it be allowed to defer gain recognized on the sale of its television property where the proceeds were to be reinvested in a newspaper. On September 16, 1980, a ruling was issued (copy attached) indicating that such relief would not be available to the Company.

On page three of the ruling, it is indicated that Section 1071 entitles a taxpayer to relief under Section 1033 only where the reinvestment is made ". . . in the stock of a radio (or telecast) facility". The ruling also refers to a prior public ruling, Rev. Rul. 78-269, wherein the Internal Revenue Service indicated, in a mirror image of the Company's present situation, that a sale of a newspaper pursuant to an FCC proposal and a purchase of a television station would qualify for relief.

Inconsistencies between FCC and IRS interpretations and need for clarification—Senate bill 499

As indicated in Senator Moynihan's statement introducing Senate Bill 499, ". . . the tax treatment in such cases should not turn on the order in which the assets are exchanged. The test, rather, should be whether the taxpayer has been forced by the FCC to sell and whether the assets he proposes to swap are sufficiently similar in kind."

The purpose of enacting Section 1071 (as originally enacted as Section 112(m) of the 1939 Internal Revenue Code) was stated in Rev. Rul. 73-73, 1973-1 Cum. Bul. 371, 372:

"The purpose of Section 1071 is to provide relief to taxpayers affected by the FCC policy of eliminating common ownership of certain directly *competing communications facilities.* See Senate Finance Committee Report, 1944 C.B. 1013, regarding Section 112 (m) of the 1939 Code, the predecessor of Section 1071 of the 1954 Code." *Emphasis added.*

When originally enacted, Section 1071 applied only to the radio broadcasting industry because at that time the FCC policy was limited to fostering competition in the radio broadcasting area alone. When the FCC expanded its policies to the telecasting industry, as the industry developed, Section 1071 was applied to that industry as well. Treas. Reg. Section 1.1071-1(d) was enacted in 1956 to place into practice comments made by the Senate Committee while it was considering the conversion of Section 112(m) of the 1939 Code to Section 1071 of the 1954 Code. The Senate Committee considered the "established meaning in the industry and in the administration of the Federal Communications Act" in concluding that the term radio broadcasting includes telecasting. See Senate Finance Committee Report 83d Cong., 2d Sess., S. Rept. 1622 (1954) 429. The expansion of Section 1071 to include television was in direct response to the growth in jurisdictional power of the FCC. Although by definition the FCC had jurisdiction over television since the 1934 Federal Communications Act, actual television usage and FCC control over television did not grow until the late 1940's and early 1950's. In 1953, the FCC issued Docket 8967, *Multiple Ownership of AM, FM, and Television Broadcast Stations,* 18 F.C.C. 288 (1953) which directly limited the number of television stations which could be owned by one company. The growth of the television industry and the growth of FCC control over that industry (see F.C.C. Docket 8967 supra.) between 1943 (the original date of enactment of Section 112(m) of the 1939 Code) and 1954 (the date of the Senate Committee Report) was considered by the Senate Committee when the relief provisions of Section 1071 were expanded to include FCC forced television divestitures.

Television stations and newspapers are related in service or usage. Both provide information and entertainment to the public through use of media and generate revenues by selling advertising. Revenue in both industries are based upon the size of the audience attracted. The methods used to reach the audience are quite different, but the basic concept of these two fields of communications is the same. It has been argued before the FCC that television is an entertainment medium while newspaper is a news medium (see *Second Report and Order* supra at 1065), but the FCC has determined that these general differences are of no importance with regard to its goal of promoting a diversity of viewpoints. The FCC has compared an individual local television station and an individual local newspaper and finds them quite similar—both are the primary sources of news, opinion and public affairs programming for a given locality. See *Second Report and Order* supra at 1084. The FCC, in recognizing the great similarities between newspapers and local television stations, has determined that the diversity of viewpoints for a locality would be adversely affected if the only sources of local news is from a local daily newspaper and a local station owned by the same party. The divestiture orders are a demonstration of the FCC's belief that the two media entities are properties similar or related in service and use. It would be unreasonable for the government to take an inconsistent point of view for purposes of the rules set forth in I. R. C. Sections 1033 and 1071.

In order to effectuate the intent of Congress to provide tax relief to taxpayers who are subject to this type of an FCC divestiture, the application of Section 1071 must be expanded consistent with the FCC's expanded policies in this area as was done in 1956 when an expansion of FCC power over television was recognized in the Treasury Regulations. The spirit of 1071 when initially enacted by Congress was to enable the FCC to easily implement its plans of forced divestitures without concern about burdensome tax consequences to the taxpayer. Thus, Section 1071 should be revised to include "newspapers" as qualifying reinvestment property as proposed in Senate Bill 499.

I appreciate the opportunity to submit my views on this matter and urge favorable action by Congress on the Bill.

DEPARTMENT OF THE TREASURY,
INTERNAL REVENUE SERVICE,
Washington, D.C., September 16, 1980.

JOHN B. JOHNSON, *President,*
Johnson Newspaper Corp.,
260 Washington Street, Watertown, N.Y.

DEAR MR. JOHNSON: This is in reply to an updated letter received by the Service on February 6, 1980, and subsequent correspondence submitted on the behalf of X by X's authorized representative. In those letters you ask for rulings under section 1071 of the Internal Revenue Code (the "Code").

The facts and representations submitted with the request are substantially as follows.

X is a domestic corporation which owns and operates radio stations B and C, television station D and one newspaper in or near L.

On January 28, 1975 X was ordered by the Federal Communications Commission (F.C.C.) to divest itself of either its newspaper or television station. This order was issued by the F.C.C. on the basis of the *Second Report and Order in Docket No. 18110;* 50 FCC 2nd 1046 (1975) because X owned the only daily newspaper and only television station within L.

The management of X has determined its expertise lies in the newspaper field, and has decided therefore to sell the assets of the television station. Using the proceeds of the sale, X desires either to purchase stock in a corporation which publishes and operates a newspaper, or to purchase the assets of a newspaper.

Section 1071 of the Code provides, in part, that if the sale or exchange of properties is certified by the FCC to be necessary or appropriate to effectuate a change in policy of or the adoption of a new policy by the FCC with respect to the ownership or control of radio broadcasting stations, such sale or exchange shall, if the taxpayer so elects, be treated as an involuntary conversion of such property within the meaning of Section 1033. For purposes of such section as made applicable by the provisions of this section, stock of a corporation operating a radio broadcasting station whether or not representing control of such corporation, shall be treated as property similar or related in service or use to the property so converted.

Section 1033(a)(2)(A) provides, in part, that if property is involuntarily converted into money, the gain, if any, shall be recognized except that if the taxpayer, during the period specified in Section 1033(a)(2)(B), for the purpose of replacing the property so converted, purchases other property so converted, at the election of the taxpayer, the gain shall be recognized only to the extent the amount realized upon such conversion exceeds the cost of such other property.

Section 1.1071-1(a)(1) and (2)(ii) of the income tax regulations provides, generally, that at the election of the taxpayer, Section 1071 of the Code postpones the recognition of gain upon the sale or exchange of broadcast property after December 31, 1957, if the FCC grants the taxpayer a certificate clearly identifying the property and showing that the sale or exchange is necessary or appropriate to effectuate a change in a policy of, or adoption of a new policy, by such Commission with respect to the ownership and control of radio broadcasting stations.

In Rev. Rul. 76-319, 1976-2 C.B. 242 the test for determining whether two properties are similar or related in service or use is outlined. Rev. Rul. 76-319 refers to Rev. Rul. 64-237, 1964-2 C.B. 319 which states that, with respect to an owner-user, property is not considered similar or related in service or use to the converted property unless the physical characteristics and end uses of the converted and replacement properties are closely similar.

Rev. Rul. 78-269, 1978-2 C.B. 210 provides that where a corporation divests itself of newspaper stock pursuant to a F.C.C. proposal (a F.C.C. "tax certificate" having been granted) the purchase of stock in a television station would cause nonrecognition of any gain realized on the transfer pursuant to sections 1033 and 1071 of the Code.

In the present case, X intends to divest itself of its television station and reinvest the proceeds in the stock of a newspaper. This fact pattern is the opposite of that outlined in Rev. Rul. 78-269 and contrary to the wording of section 1071(a) of the Code in that X will not use the proceeds to reinvest in the stock of a radio broadcast (or telecast) facility. Section 1071(a) provides a limited exception to the provisions of Section 1033 of the Code. That limited exception requires the taxpayer to reinvest in the stock of a radio broadcast (or telecast) facility.

Additionally, Rev. Rul. 76-319 provides that in order for properties to be similar or related in service or use to an owner-user such properties must meet two tests in that both must have similar physical characteristics and the end uses of the converted and replacement properties must be closely similar.

To determine whether a television station and a newspaper have closely similar physical characteristics it is necessary to compare the equipment used to publish a newspaper with the equipment required to operate a television station. We do not believe the equipment used to operate a television station is closely similar to the equipment used to publish a newspaper. Thus, the physical characteristics of the replacement and converted properties in this case are not similar. Consequently, there is no need to discuss whether the "end uses" of the two properties are substantially the same.

Accordingly, based solely on the facts and representations outlined above we make the following findings:

(1) Assuming the F.C.C. issues a certificate as outlined in section 1.1071-1(2)(ii) of the regulations covering the sale of station D, such sale will be considered an involuntary conversion within the meaning of section 1033 of the Code.

(2) As X's replacement of its television station assets with stock in a newspaper meets neither the reinvestment provision outlined in the second sentence of section 1071(a) of the Code, or the similar or related in service or use test outlined in Rev. Rul. 76-319, any gain realized by X on the above transaction may not be deferred under the provisions of sections 1033 or 1071 of the Code.

A copy of this letter should be attached to X's tax return for the tax year in which the transaction covered by this ruling is consummated.

Pursuant to a power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

Sincerely yours,

JOHN L. CRAWFORD,
Chief, Corporation Tax Branch.

[Whereupon, at 12:12 p.m., the hearing adjourned subject to the call of the Chair.]

[By direction of the chairman the following communications were made a part of the hearing record:]

ALDEN, BURNS, HARTEL & PIERCE,
Wayne, Pa., April 13, 1981.

ROBERT LIGHTHIZER, Esq.,
Chief Counsel, Senate Finance Committee,
Washington, D.C. 20510.

DEAR MR. LIGHTHIZER: Encolosed is a statement concerning S. 388 and S. 446 which I submit to the Committee for its record.

I also make the observation that the use of the term "wrap around" was the kiss of death for these forms of annuity because it distorted the Internal Revenue Service's understanding of them. The Service focused on "who" made the investment decision rather than all of the other elements which these annuities have in common with other forms of annuities. Realistically, an annuity is a long-term investment contract which is used when a policyholder is attempting to provide for future needs. In a variable annuity, the investment risk is on the policyowner. The so-called "wrap around" annuities recognized that if the policyowner bore the risk, it made sense to give him a say in investment management. The amount of Federal Tax Revenue is unchanged by "who" makes the investment decision except that better decisions will produce more income to the policyowner and more federal tax dollars.

I appreciate the opportunity to add my voice to a call for corrective legislation.

Very truly yours,

ARTHUR P. HARTEL, Jr.

Enclosure.

STATEMENT OF ARTHUR P. HARTEL, JR.

Mr Chairman and members of the subcommittee: I am an attorney in private practice in Wayne, Pennsylvania and have advised a number of companies concerning the impact of Revenue Ruling 77-85 and Revenue Ruling 80-274. Because of my concern for the adverse impact on the economy caused by the Revenue Rulings, I attended the public hearings held March 30, 1981 by the Subcommittee on Taxation and Debt Management. The testimony of the many witnesses who spoke in favor of

S. 388 and S. 446 makes a compelling argument for Congressional action to restore the investment annuity and savers annuity to the marketplace.

Prior to entering private practice, I was General Counsel of First Investment Annuity Company of America (FIAC) and its parent company, Investment Annuity, Inc. Those companies were the most severely impacted by Revenue Ruling 77-85. I was deeply involved in the discussions and negotiations with the Internal Revenue Service and the Treasury Department which led up to the issuance of Revenue Ruling 77-85. After the ruling was issued, I was part of the litigation team that won the lawsuit against the Internal Revenue Service in the Federal District Court for the District of Columbia. The District Court held unequivocally that the form of variable annuity known in the industry as the investment annuity was legally entitled to be treated as any other annuity under Section 801(g)(1)(b) of the Internal Revenue Code. On the appeal of the Internal Revenue Service, the Court of Appeals ruled that FIAC's suit was barred by the Anti-Injunction Act. The merits of the case were not reached by the Court of Appeals.

The Treasury Department opposes the passage of S. 388 and S. 446. Their principal concern is that Congress should not enact these bills because to do so would "foreclose the Internal Revenue Service from interpreting the law by depriving it of authority to issue a particular ruling." For Congress to refuse to correct the situation caused by the issuance of these rulings would leave the taxpayers without any relief within our system of government. The need for relief is particularly urgent in this case because the Service issued interpretations of the law upon which the taxpayers relied and then reversed those interpretations. The taxpayers and the persons with whom the taxpayers did business in reliance on the original rulings have all been severely harmed by such reversals. Since the Anti-Injunction Act bars the taxpayers from obtaining relief from the courts, the taxpayers are without relief unless that relief is provided by Congress.

Chairman Packwood asked if there is a legislative solution to the problem of the Internal Revenue Service reversing private letter rulings that it has issued. There is a legislative solution. Congress, on a previous occasion in which the taxpayers had no judicial relief and Congressional relief on a case by case basis was impractical, enacted legislation providing access to the courts. The situation involved the qualification of organizations as charitable organizations under Section 501(c)(3) of the Internal Revenue Code. Congress provided for judicial relief in the form of a Declaratory Judgment. This Congressional action has been codified as 26 USC Sec. 7428. This section provides the taxpayer with the opportunity to obtain a Declaratory Judgment with regard to its status as a charitable organization under Section 501(c)(3) of the Code.

A similar statutory procedure could be developed by Congress to provide judicial review in those situations such as faced by Investment Annuity, Inc. and FIAC. Their attempt to review Revenue Ruling 77-85, which reversed over seventy (70) private letter rulings and a prior published Revenue Ruling [issued over a period of some eleven (11) years], was thwarted by the Anti-Injunction Act, even though the only court to rule on the merits of the case upheld the legality of the investment annuity.

The technical aspects of such legislation can be worked out to provide protection to a taxpayer who relied upon private letter rulings and, at the same time, protect the Internal Revenue Service's prerogative to interpret the tax code. The details of such legislation are best left to fuller consideration with respect to a specific legislative proposal. In future cases, the Declaratory Judgment procedure will protect the rights of a taxpayer who has relied upon a private letter ruling if the Internal Revenue Service subsequently reverses the interpretation.

However, such prospective legislation will not restore the investment annuity or the savers annuity to the marketplace. These annuities, like other insurance policies, are approved for sale to the public by the various state insurance departments. While the Treasury Department's objection to the form the legislation encompassed in S. 388 and S. 446 deserves some consideration, the Internal Revenue Service should not have the prerogative to select one or more forms of annuity to which it will extend the tax treatment provided for by Congress and deny that same treatment to other forms of annuities. All annuities which have been approved for sale by a state insurance department should be afforded the same federal tax treatment appropriate for either a fixed or variable annuity.

The investment annuity and the savers annuity stimulate capital formation and savings and provide deferral of current income tax only during the period of accumulation. Ultimately, the tax is paid when the income from the annuity is received. These annuities, more than others, specifically fulfill America's current economic needs. Since some form of legislation is needed to restore the investment

annuity and the savers annuity to the marketplace, Congress should take such affirmative action as necessary to accomplish this result.

STATEMENT BY THE AMERICAN BANKERS ASSOCIATION

S. 388 and S. 446 Taxation of annuities

The American Bankers Association is a trade association composed of more than 13,000 banks, over 90 percent of the full service banks in the country. Because "investment annuities" could provide an important incentive to save and because they may provide an important part of the retirement security of many bank customers, the Association supports legislation that would restore the tax treatment afforded these annuities prior to Revenue Rulings 77-85 and 80-274.

In September, 1980, the Internal Revenue Service reversed its ruling position on tax treatment of the income earned by a separate asset account that is invested at the direction of an annuity contract in a deposit account in a financial institution. Prior to the September ruling, the Service had held that the income was taxable to the insurer. Then, in Revenue Ruling 80-274, the Service held that the policyholder is the owner of the deposit account and thus its income is taxable to the policyholder. This holding is contrary to the law and to the facts. An annuity contract requiring the investment of the separate asset account in a deposit at a bank or thrift institution is virtually identical to the more traditional variable annuity contract except that it directs the investment as opposed to giving the insurance company investment discretion over the separate account. The mortality risk assumed by the insurer is similar to that assumed under other forms of annuities, and the policyholder's right to withdraw a part or all of the cash value of the policy prior to the annuity date is the same as in most annuities.

The insurer in the deposit related annuity receives a fee out of the first premium and any subsequent premium and receives an annual fee from the separate asset account. Should there be a withdrawal of the cash value prior to the annuity date, there may be an additional fee. There is no contractual relationship between the policyholder and the financial institution. The policyholder's rights are derived solely from the annuity contract and the insurer may satisfy its obligation to the policyholder using funds derived from sources other than the deposit account. Despite all this the Service held the policyholder to be the owner of the deposit and liable to pay tax currently on its income.

The Service based its holding on Revenue Ruling 77-85, a thoroughly discredited ruling that the Service refuses to abandon. The subject of this ruling which also was a reversal of many prior rulings, was "investment annuities." These annuities also are virtually identical to the traditional variable annuity except for the investment provisions. The contract involved in this earlier ruling gave the policyholder investment discretion over the assets in the separate account. Again the insurer under the investment annuity contract assumed the mortality risk and the policyholder had no direct ownership interest over the separate account assets. Nevertheless, the Service held that the income of the account was currently taxable to the policyholder.

Revenue Ruling 77-85 was challenged in the federal courts. The U.S. District Court for the District of Columbia in a well reasoned and persuasive opinion in *Investment Annuity, Inc.* v. *Blumenthal*, 442 F. Supp. 681 (1977), held the Revenue Ruling "erroneous and unreasonable and, therefore, unlawful and beyond the statutory authority of the IRS." Judge Charles R. Richey initially decided not to grant injunctive relief against the IRS on the assumption that it would proceed appropriately, in good faith, and in a manner fully consistent with the declaratory relief granted without the coercion of a court order. Subsequently, the Court felt compelled to enjoin the Service and the Service appealed the case. On appeal, the U.S. Court of Appeals for the District of Columbia reversed the District Court for lack of jurisdiction without reaching the merits of the case, *Investment Annuity, Inc.* v. *Blumenthal*, 609 F. 2d 1 (1979).

The Congress, by enacting the Anti-Injunction Act and the tax exceptions to the Declaratory Judgment Act prevented the courts in this case from requiring the IRS to comply with the law. Because of actions of other federal and state agencies, the plaintiffs have been unable to relitigate the issue in the tax court or in a refund suit. Therefore, we urge the Congress to take steps to require the Service to comply with the law. The enactment of S. 388 and S. 446 would have this effect. The Association shares the concern expressed by many members of the tax bar, including present and former Treasury and IRS officials, over legislation which directs or forbids a particular interpretation of the Internal Revenue Code of 1954, rather than amending the law. In the case of Revenue Rulings 77-85 and 80-274, however, judicial relief is foreclosed and administrative relief has been denied, even after Revenue Ruling 77-85 was held by the district court to be erroneous. There is no

other, or more appropriate, relief available in this situation. It appears that this type of corrective legislation might have been made unnecessary by better, more informed, and candid consultation with representatives of the affected industry in the formulation of Revenue Ruling 77-85. See Senator Hatch's remarks on pages S17737-S17744, Congressional Record (daily ed.) for October 9, 1978.

Enactment of this legislation is needed not only to put an end to the erroneous interpretation of the law by the IRS but to revitalize the investment annuity, whether related to a separate account invested in bank or savings and loan deposits or a separate account over which the policyholder exercises the investment discretion. These annuities before IRS interference attracted many savers and provided needed capital for housing and other economic growth. We urge the Subcommittee to take action on this legislation at the earliest possible time.

S. 464 Taxation of private foundations

S. 464, which would eliminate the present payout rule that requires foundations to distribute their entire realized income, is a significant step toward providing foundations with the flexibility to continue their important charitable work. The Association is pleased to offer its wholehearted support for this measure. We would like to take this opportunity, however, to bring to your attention an obstacle facing many community bank trust departments in the administration of small charitable trusts. The "private foundation" reporting requirements as they apply to such trusts are an example of regulatory overkill that threaten the ability of civic minded individuals and organizations to support local charitable projects. Until small charitable trust—those with relatively low annual income level—are provided relief from present regulatory requirements, public support for local charitable projects will further diminish.

In the Tax Reform Act of 1969 Congress defined private foundations for the first time for tax purposes. (Section 509 of the Internal Revenue Code). Throughout the 1960's foundations and charitable organizations were the subject of extensive criticisms, including allegations that they furthered various tax inequities, were created for private rather then philanthropic purposes, and did not actually achieve charitable ends. In response to real and perceived abuses by foundations and to assure that charitable institutions that benefitted from preferential tax treatment were answerable to the public and the government concerning their operations, extensive, detailed reporting and regulatory requirements were incorporated in the 1969 Act. It has now become apparent that charitable entities—vehicles for some of man's most humanitarian and progressive acts—are facing an erosion of their funding capability because of the burden of complying with these well-intentioned requirements.

The Tax Reform Act of 1969 extended many of the private foundation rules to non-exempt charitable trusts—which are empowered by their governing instruments to pay or permanently set aside amounts for charitable purposes. Although Congress did not preceive abuses in the use or application of non-exempt charitable trusts (unlike private foundations), it was feared that taxpayers might use such charitable trusts to avoid the restrictions and requirements imposed on private foundations. (Tax Reform Act of 1969, Senate Report, U.S. Code Congressional and Administrative News, 91st Congress, 1st Session. 1969, Vol. 11. page 2123). In its attempt to impose "equal" treatment on entities that provided funds for charitable purposes, Congress did not take into consideration the fact that private foundations and charitable trusts provide different functions, service different constituencies, and do not operate under "equal" conditions or circumstances. The restrictions and requirements imposed by the 1969 Act on private foundations were premised on the theory that the public and the government had the right to know whether funds going to foundations were in fact used for charitable purposes, but there was no comparable concern with respect to the administration of charitable trusts.

Prior to the 1969 Act, trust departments maintaining charitable trusts were required to file an annual Fiduciary Form 1041 and show the charitable recipient of the income. As a result of their classification as private foundations, charitable trusts—Section 4947 trusts—may no longer file information forms that are simple and inexpensive. In order to comply with the private foundation requirements, a trustee of a non-exempt charitable trust must decide whether to seek exempt status as a Section 501 (c) (3) organization, whether to file Form 990—Return of Organization Exempt from Income Tax, Form 990PF—Return of Private Foundation Exempt from Income Tax, Form 990AR—Annual Report of Private Foundation or some combination thereof, and whether the 2 percent excise tax on trust income is applicable or not. (Rev. Proc. 73-29, 1973-2 C.B. 483).

These requirements are particularly onerous in the case of very small charitable trusts administered by community bank trust departments for a nominal fee. Small trust departments have scores of these "mini" trusts established by civic-minded citizens. For example, an individual may establish a $10,000 trust to enable the local

university to offer scholarships to students who could not otherwise afford to go to college. A trust may be created to fund a Symphony Society "chair" so that the community can enjoy local concerts. A resident of a small community may desire to provide funds to the Arts Center through the use of a charitable trust. The trustee of such a small charitable trust which might generate a negligible fee must spend valuable time and resources in deciding which are the appropriate forms for that particular trust and in filling out and filing the forms. If the trustee refers the question to an accounting firm, their charges for the completed forms may be twice the trustee's annual fee, and obviously cannot be absorbed by the trustee. Trust departments which often administered small charitable trusts for local projects out of a sense of civic responsibility can no longer afford to do so. Over the past 10 years we have seen a significant decline in the number of these "mini" trusts established by civic-minded individuals for public benefit purposes. This diminished use of charitable trusts is not for lack of charitable motivation. It is simply the result of too much federal regulation.

Small charitable trusts should be exempt from the reporting requirements of the 1969 Tax Reform Act applicable to private foundations if the trust's annual income is below $20,000. These small charitable trusts should be allowed the option of filing a simple Form 1041 disclosure or an annual statement (under oath) as to the amounts of income generated by the trust and the purposes for which it is expended. Simplification for these lengthy and detailed provisions would enable community bank trust departments to administer these trust in an efficient and inexpensive manner. It would also encourage the establishment of new charitable trusts. Moreover, it would significantly reduce the time and financial resources expended by the Internal Revenue Service in their review of the voluminous paperwork now required. Finally, and most importantly, regulatory reform of this kind will reaffirm the government's support for the public's involvement in local charitable efforts.

COUNCIL OF MICHIGAN FOUNDATIONS,
Grand Haven, Mich., April 15, 1981.

COMMITTEE ON FINANCE, U.S. SENATE,
Subcommittee on Taxation and Debt Management,
Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR PACKWOOD AND GENTLEMEN: The Members of the Council of Michigan Foundations (CMF) wish to go on record in support of S. 464 to eliminate the mandatory dispersal of the entire realized income of a foundation and to keep the requirement to distribute at least five percent of the value of its investment assets.

CMF is an association founded in 1973 of 133 grantmakers including private and community foundations, banks and corporate giving programs. It is the primary objective of CMF members to enhance the human condition, particularly in the state of Michigan. While CMF Members retain over 90 percent of the foundation asset value in the state, more than one-half of the members represent foundations with less than $1 million in assets. These foundations are located in several Michigan communities and are bringing private resources to public needs in the areas of human services, education, health, the environment and the arts in their local communities. The recipients of these funds, both local charitable institutions and individuals, as well as the grantors themselves are most anxious that the grantmaking capability of these resources be available in real terms for the future.

Michigan private foundations have paid out more than 5 percent in several years. According to recent statistics released by the Foundation Center in 1979 Michigan foundations paid out 7.9 percent. (National Data Book 1979)

S. 464 will not change interest in continuing to meet the charitable needs of society, however it will allow for foundations to plan an investment portfolio with the potential to meet future needs. Under current law that insurance is not possible.

Sincerely,

WILLIAM S. WHITE,
Chairman.
DOROTHY A. JOHNSON,
Executive Director.

FEDERAL HOME LOAN BANK BOARD,
Washington, D.C., March 27, 1981.

Hon. ROBERT PACKWOOD,
Chairman, Subcommittee on Taxation and Debt Management,
Committee on Finance, U.S. Senate,
Washington, D.C.

DEAR SENATOR PACKWOOD: We understand that on March 30, 1981, the Senate Finance Subcommittee on Taxation and Debt Management will hold a hearing on S. 446, which provides that the Internal Revenue Code of 1954 is to be applied without regard to Revenue Ruling 80-274. This ruling disallowed the deferral of taxes upon earnings of Federally-insured savings and loan deposit instruments that fund certain annuity programs, holding that the annuitant continues to own the instruments even though they are in the possession and control of the insurance company as payment for the annuity contract. Because enactment of S. 446 could have a significant, positive impact on the thrift industry and, hence, on housing, we wish to take this opportunity to express our support for this legislation. We would appreciate it if this letter would be made part of the official hearing record.

As you may recall, shortly after Revenue Ruling 80-274 was announced, former Bank Board Chairman Jay Janis wrote a letter to former Treasury Secretary William Miller explaining the Bank Board's opposition to the ruling.[1] Specifically, former Chairman Janis noted the fact that strong arguments could be made that the ruling is incorrect as a matter of law, and he expressed his concern about the adverse impact of the ruling on savers' annuities plans because these plans "can be a significant incentive for increased savings by a major segment of the American public, and because these annuity plans have the potential to become a significant source of funds for Federally insured savings and loan associations." In view of these considerations, the Bank Board recommended immediate withdrawal of Revenue Ruling 80-274 and commencement of a rule-making procedure in which interested parties could participate. The Internal Revenue Service, however, has neither withdrawn the ruling nor commenced such a rule-making proceeding.

In our view, the particular importance of savers' annuities plans is that they are generally used as vehicles for retirement savings, and thus could serve as a stable, long-term source of funds for mortgage lending. Having such funds available is extremely important in light of the enormous expected demand for housing in the 1980s. Supplying the mortgage credit needed to satisfy this demand will be an enormous challenge for the thrift industry, which is facing unprecedented competitive pressure for savings—its mortgage lending base—from commercial banks and money market funds. We are seriously concerned that the net result of this situation will be a severe "gap" between our home finance needs and our ability to fund them. Depending on assumptions used, we estimate that over 22 million new homes will be needed in this decade. According to one estimate, by Regional Data Associates, there will be a national shortage of mortgage funds that may reach $390 billion by the end of the decade, a 38 percent short-fall. Savers' annuities plans could help to significantly reduce this long-term gap.

Apart from its long-term potential for assisting attainment of housing goals, S. 446 could provide vital relief for the thrift industry. In our view, savers' annuities plans could provide thrifts with an immediate and helpful influx of lower-cost, longer-term savings deposits. To the extent savers' annuities plans would decrease the long-term cost of such funds to S&Ls, they would relieve somewhat the great pressure on mortgage credit availability and thrift earnings. Thus, for example, one savings institution has informed the Bank Board that pre-Revenue Ruling 80-274 deposits related directly to savers' annuities plans represented 40 percent of the S&L's total savings growth for the first nine months of 1980, and that without these funds the S&L could not have made mortgage credit available to prospective home buyers. Moreover, in a related vein, it is important to note that a primary factor responsible for the current financial difficulty facing the thrift industry is the mismatch between short-term liabilities (deposits) and long-term assets (mortgage loans). Because the retirement-related money they attract is longer-term and less volatile than other savings, savers' annuities plans could help to alleviate this imbalance, thereby relieving long-term financial pressures on both the savings and loan and housing industries.

That current economic conditions, as well as increased competition for savings, are having an adverse impact on thrifts is beyond dispute. For instance, net increase in deposit flows in 1980 for FSLIC-insured institutions totalled only $41.0

[1] The letter (attached) was submitted for the record by Mr. Robert Barrow during this Subcommittee's hearing in the 96th Congress on S. 3082, S. 3094, and H.R. 6806. S. Rep. No. 106, 96th Cong., 2nd Sess. 125-26 (1980).

billion, a mere 5.3 percent increase over 1979's inadequate savings flow of $38.9 billion. The significance of this $41.0 billion amount must be discounted by the fact that approximately three-fourths of this figure represents interest credited to existing accounts. More importantly, virtually all of this increase in deposits is attributable to an increase in accounts offered at market-related interest rates. Consequently, the national cost of funds to associations increased from 7.5 percent in 1979 to 8.9 percent in 1980. This had a dramatic impact on both the total of mortgage loans made by thrifts and thrifts' earnings. Total mortgage loans made by thrifts in 1980 fell to $71.3 billion, 28 percent below the 1979 figure, while thrifts' earnings dropped sharply between 1979 and 1980. Using return on average assets (ROA) as a measure of profitability, the ROA for all FSLIC-insured S&Ls declined from .66 of 1 percent to .13 of 1 percent. About 30 percent of thrifts suffered losses in 1980.

Current indications are that economic difficulties for the thrift industry in 1981 will be even worse than those experienced in 1980. For example, the deposit flow in February, 1981, was 27 percent less than the flow in February, 1980, and the lowest February total since February, 1970. Mortgage loan commitments and closings for February, 1981, fell significantly below their seasonal norm. The number of institutions experiencing losses is increasing. In sum, the need for an immediate infusion of low-cost savings accounts into S&Ls is important to the viability of the thrift industry and the prospect for adequate housing in the future.

In addition to their beneficial impact on the availability of mortgage credit and on the thrift industry in general, there are several other reasons why savers' annuities plans are consistent with public policy. First, savers' annuities plans are beneficial in that they allow individuals to plan for their own retirement. As noted in a recent letter from Congressmen Annunzio, Hyde, and Roth, and Senators Lugar and Symms to Treasury Secretary Regan calling for revocation of Revenue Ruling 80-274, this fact is particularly significant given the finding of a recent study "which indicates that 83 percent of the population is afraid of running out of money before they run out of breath." Thus, savers' annuities plans clearly serve a public purpose to the extent they quell such fears, while at the same time they alleviate pressures on the social security system.

Second, it is also useful to consider the type of person who purchases such plans. Our information is that the majority of savers' annuities plan consumers are older, middle-income citizens who have either attained, or are approaching, retirement age. As a practical matter, then, savers' annuities plans should not be viewed as a tax loophole for the rich, but rather a broad-based program with cross-income appeal.

Finally, it should be noted that the Congress has provided special tax treatment for annuities in Sections 72 and 801(g)(1)(B) of the Internal Revenue Code, 26 U.S.C. §§72, 801(g)(1)(B)(1976). Thus, notwithstanding the question of the legal validity of Revenue Ruling 80-274, permitting tax deferral for savers' annuities plans would constitute at most a mere extension of the degree of tax preference given to annuities rather than the creation of a new class of tax deferrals.

In sum, we believe savers' annuities plans serve significant public policies. Accordingly, we urge the Congress to provide tax deferral treatment for such plans by enacting legislation, such as S. 446, which specifically revokes Revenue Ruling 80-274.

If I or any of my staff may be of any further assistance to you, please feel free to contact us. Please note that, in accordance with 12 U.S.C. § 250 (1976), this letter has not been reviewed outside the Federal Home Loan Bank Board, and does not necessarily reflect the views of the President.

Sincerely,

JOHN H. DALTON,
Chairman.

Attachment.

FEDERAL HOME LOAN BANK BOARD,
Washington, D.C., October 10, 1980.

Hon. G. WILLIAM MILLER,
Secretary, Department of the Treasury,
Washington, D.C.

DEAR MR. SECRETARY: I am writing to express my concern over the recent issuance of Revenue Ruling 80-274. The practical effect of the ruling is to preclude the use of group single premium retirement annuity contracts under which Federally insured savings and loan associations are designated as group contract holders. I believe the Internal Revenue Service should withdraw this recent ruling, and that the Treasury Department and the Internal Revenue Service should reconsider carefully the legal and policy implications of the ruling.

I am concerned about the adverse impact of the ruling on savings account funded annuity plans because these plans can be a significant incentive for increased savings by a major segment of the American public, and because these annuity plans have the potential to become a significant source of stable funds for Federally insured savings and loan associations.

Although Revenue Ruling 80-274 is limited ostensibly to the facts of a specific type of annuity contract involving savings and loan associations, as a practical matter, it raises major policy questions concerning the tax treatment of other types of annuities as well. The ruling fails to provide any reasoned legal analysis for its conclusion. In fact, strong legal arguments and precedent exist for concluding that the ruling is incorrect as a matter of law.

In view of the important policy considerations and the complex legal questions raised by the ruling, I believe it is more appropriate for a decision on the tax treatment of these annuity contracts to be the subject of a proceeding that would provide interested individuals and governmental agencies, including the Bank Board, an opportunity to participate, Therfore. I recommend immediate withdrawal of Revenue Ruling 80-274 and commencement of a rule-making proceeding to consider the important and difficult issues raised by this ruling.

Sincerely,

JAY JANIS, *Chairman.*

INDEPENDENT BANKERS ASSOCIATION OF AMERICA,
Washington, D.C., April 2, 1981.

Hon. ROBERT PACKWOOD,
Chairman, Subcommitte on Taxation and Debt Management,
Dirksen Senate Office, Washington, D.C.

DEAR SENATOR PACKWOOD: On March 30, 1981, the Subcommittee on Taxation and Debt Management conducted a public hearing which included discussions on two Senate bills, S. 388 and S. 446, concerning taxation of annuities. The bills propose to revoke two rulings by the Internal Revenue Service (Revenue Ruling 77-85 and 80-274) which curtail tax saver annuities.

Several insurance companies began offering these tax deferred annuity programs in the 60's with annuity funds invested in certificates of deposit at financial institutions. Approval for the programs was granted by the IRS in private letter rulings.

Since the annuity was owned by the investor and the savings certificate by the insurance company, the owner of a tax saver annuity had taxes deferred until the annuity was withdrawn. Consumers, including small savers, were afforded an opportunity to facilitate personal savings for retirement, education or the purchase of a home. Financial institutions received a stable infusion of new deposits.

The IRS Rulings 77-85 and 80-274 revoke the legality of the annuity contract and place ownership of the savings certificate with the investor rather than the insurance company. This action has resulted in the termination of the tax saver annuity. The U.S. District Court for the District of Columbia has described Revenue Ruling 77-85 as "an erroneous and unreasonable interpretation of the Internal Revenue Code." Both rulings contradict the earlier private letters issued by the IRS. Furthermore, the authority implied in the rulings has been considered by some as an usurpation of the prerogative of Congress to establish rules for annuity contracts and to determine technicalities affecting taxation.

The Independent Bankers Association of America supports S. 388 and S. 446 and views both as highly significant measures directed toward increasing capital formation and encouraging personal saving.

With some minimums as low as $1,000, the tax saver annuities offered an attractive rate of savings to a wide range of consumers. Either as a hedge against the uncertain feasibility of Social Security for retirement protection or as an effective savings plan for the future home buyer, the tax saver annuity provided a viable investment program to help offset inflation.

Currently the rate of personal savings is only 4 percent of disposable income. Over 40 bills have been introduced in Congress for tax exemption on savings to counteract this situation. The tax savers annuity program would provide an important incentive for reversing the present inflation pattern which discourages saving.

Passage of S. 388 and S. 446 rescinding IRS Rulings 77-85 and 80-274 would benefit financial institutions in many ways. Presently commercial banks and especially thrift institutions are experiencing unprecedented outflows of deposits to money market funds. Attempts to compete with the higher rates offered by the money market funds have helped to increase the cost of money to financial institutions. These higher costs have in turn accelerated inflation with higher interest rates and have contributed to an overall shortage of funds available for lending. The

situation is compounded in certain geographic areas where deposit outflows at financial institutions going to money market funds are often reinvested in East Coast money center banks. Tax saver annuity funds placed in certificates of deposits at financial institutions would not only improve capital formation but would also allow the funds to be invested locally.

In conclusion, the Independent Bankers Association of America supports S. 388 and S. 446 and urges the Committee on Taxation and Debt Management to promote passage of the legislation.

Sincerely,

W. C. BENNETT.

LUND LEVIN & O'BRIEN,
Washington, D.C., April 15, 1981.

ROBERT E. LIGHTHIZER, ESQ.,
Chief Counsel, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. LIGHTHIZER: The written statement submitted by Assistant Secretary of the Treasury John E. Chapoton at the hearings on March 30, 1981 referred (at p. 5) to Section 801(g)(1)(A) of the Internal Revenue Code. The statement made no reference to Section 801(g)(1)(B).

However, it is Section 801(g)(1)(B) that is relevant and controlling as regards the tax treatment of the annuity contracts of our client, International General Insurance Corp. These annuity contracts are described in the statement of the company's president, Robert R. Barrow, who testified in support of S. 446.

In 1959, Congress added Section 801(g)(1) to the Code to provide that the term "annuity contract" includes a variable annuity. Congress recognized that since it is the assumption of mortality risk that is at the heart of an annuity contract, it makes no difference whether the annuity contract provides for a fixed annuity payment or a variable annuity payment. S. Rep. No. 291, 86th Cong., 1st Sess. (1959-2 C.B. 770, 795).

In 1962, to accommodate and implement state insurance laws, Section 801(g)(1) was enlarged upon. Congress added a new provision to deal with the many variable annuities that were being issued by companies maintaining one or more separate or segregated asset accounts as provided by state insurance law. S. Rep. No. 2109, 1962-3 C.B. 1180, 1184. Accordingly, Section 801(g)(1) was redesignated Section 801(g)(1)(A) and a new subsection was added dealing with segregated asset accounts.[1]

The new provision, Section 801(g)(1)(B), provides in pertinent part:

"(B) contracts with reserves based on a segregated asset account.—For purposes of this part, a 'contract with reserves based on a segregated asset account' is a contract—

(i) which provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company,

(ii) . . . which provides for the payment of annuities, and

(iii) under which the amounts paid in, or the amount paid out, reflect the investment return and the market value of the segregated asset account."

The Senate Finance Committee stated in this regard, S. Rep. 2109, 87th Cong., 2d Sess. (1962-3 C.B. 1180, 1184-1185):

". . .The segregated asset accounts referred to are those which provide for the payment of annuities where as a result of state law or regulation the amounts received are segregated from the general asset accounts of the life insurance company and where the amounts paid in, or the amounts paid out as annuities, vary with the investment return and market value of the segregated asset account."

The annuity contracts issued by International General Insurance Corp. meet the letter and intent of Section 801(g)(1)(B). Under these contracts, the premium received is allocated to an account which, pursuant to state law, is segregated from the general assets accounts of the company; the contracts provide for the payment of an annuity; and the amounts paid out reflect the investment return and market

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[1] Section 801(g)(1)(A), to which Mr. Chapoton's statement refers, provides:

"(g) Contracts with reserves based on segregated asset accounts.—

"(1) Definitions.—(A) Annuity contracts include contracts.—For purposes of this part, an 'annuity contract' includes a contract which provides for the payment of a variable annuity computed on the basis of recognized mortality tables and the investment experience of the company issuing the contract."

value of the segregated asset account. These annuity contracts thus satisfy the statutory requirements and are, therefore, entitled to annuity tax treatment.

Rev. Rul. 80-274, which was invoked to withdraw the annuity tax treatment previously granted to these annuity contracts, neither considered nor analyzed Section 801(g)(1)(B), the controlling statutory provision. Indeed, Section 801(g)(1) was not even mentioned in Rev. Rul. 80-274.

I would appreciate the inclusion of this statement in the record of the hearings.

Very truly yours,

JOSEPH B. LEVIN.

STATEMENT OF THE EDNA MCCONNELL CLARK FOUNDATION IN CONNECTION WITH S. 464 AND S. 501

We agree wholeheartedly with the idea of setting the minimum annual pay-out requirements for private foundations at a fixed rate.

We agree not because we want to maintain our assets in perpetuity but because we are trying to benefit our grantees in the best way possible. In our case that means working within four tightly targetted program areas where strategies and plans for implementation have been carefully thought out and programmed. It takes time to develop such programs and to implement the strategy constructed for them in what we feel is the most constructive way. We could, of course, in years such as 1979-81, when our income was unusually high, merely distribute general purpose grants to established institutions. But we do not like to make general support grants, nor do we want to make grants which have not been thoroughly researched for their relationship to our program areas. The distribution requirement based on a 6-percent return compared with a 9-percent return on a portfolio such as ours (which totals over $200 million) would range from $12 million to $18 million. This causes very broad fluctuations in distribution requirements and makes sensible contructive program operation in the best interests of our grantees most difficult.

From an investment standpoint it seems to us that when yields in the fixed income market are at double-digit levels, and yields on common stocks are at a high level historically, the value of the stocks and bonds on which this income is yielded is depressed. It is a chicken and egg proposition. Are yields high because prices are depressed or are prices depressed because yields are high? In any event, more often than not the total return would fall someplace between the price action and the income yield. Stabilizing the distribution requirement would enable foundations to construct investment policy based on what we hope are sound investment considerations. Having the distribution requirement necessitate full payout in times of high yielding markets could tend to make tax consequences influence investment policy in a way which would really not be in the best interest of grantees—or of foundations' ability to finance grantees.

STATEMENT OF THE CHARLES STEWART MOTT FOUNDATION

The Charles Stewart Mott Foundation is a private foundation located in Flint, Michigan. The majority of its charitable activities relate to education and community improvement in the Flint area. The Mott Foundation fully supports S. 464, and its companion bill, H.R. 1364. Though not all of the provisions in the bill would have a substantial effect upon the Mott Foundation, we believe that all of the provisions will be good for the charitable community and in the long run for the general public.

In particular, we have been concerned for a number of years with the erosion of private foundation assets which has taken place as a result of inflation and the requirement of the Tax Reform Act of 1969 that foundations pay out all of their income, even if most of that income is illusory rather than real.

In our view, the continued support of charitable activities by foundations is essential to the well-being of this country. Particularly at a time when the administration is seeking drastic cutbacks in the degree of government involvement in education and human resources development, it is essential that foundations be made as strong as possible.

By reducing the amount which foundations are required to distribute to a flat 5 percent of net asset value, S. 464 will help to insure the long-term viability of private foundations. There are those who would say that increases, rather than decreases, in distributions by foundations are required by the government's reduction of services to the public. This is true only if we wish foundations to serve short-term needs while destroying their ability to benefit the public over the long run. If foundations are required to pay out amounts in excess of their real income, while at

the same time suffering restrictions on their ability to attract contributions, also as a result of the Tax Reform Act of 1969, they will eventually be unable to provide the services which the public has come to expect and which have become more and more important with the reduction of government activities.

For these reasons, we believe that the payout reduction is the most important provision of S. 464. The Mott Foundation has prepared a short analysis of the effect of inflation and the payout requirement upon private foundations. This analysis, entitled "Foundations: Scheduled for Extinction?", is attached to our statement and we respectfully request that it be included in the record of these hearings.

The remaining provisions of S. 464 are also useful and necessary changes in the portions of the tax code governing private foundations. The exemption of small grants from expenditure responsibility requirements would remove an unnecessary administrative burden from foundations without creating any potential for abuse.

The change in the definition of family members would relieve foundations of the unnecessary task of keeping constant track of the stockholdings of remote descendants of disqualified persons. Again, this would provide little, if any, potential for abuse.

Finally, the provision of the bill allowing a private foundation to rely upon the determination of the Internal Revenue Service that an organization is a public charity would alleviate a common problem called "tipping", in which the size of a contribution by a private foundation to a public charity in itself results in the loss by the grantee of its public charity status. In most instances there is no reasonable way of determining whether a small foundation will be "tipped" into private foundation status by a private foundation grant. The resulting uncertainty diverts private foundation grants from small charities and there would seem to be no compelling policy justifying such diversion.

In conclusion, the Mott Foundation fully supports all of the provisions of S. 464 and its companion bill. In particular, the section of the bill removing the alternative income payout requirement is essential to the continued financial health of private foundation.

Foundations: Scheduled for Extinction?

An examination of the impact of inflation and the payout requirement on the future of private philanthropy.

Charles Stewart Mott Foundation
Flint, Michigan
January 15, 1981

Inflation and current law threaten to turn the nation's private foundations into an endangered species.

When Congress passed the Tax Reform Act of 1969, it included provisions to require foundations to make an adequate payout — it didn't want them to fade out. But that could happen. Foundations could become in relatively few years so emaciated, so weak financially, that they would no longer have much beneficial effect on this nation's welfare.

The United States is envied abroad for its proliferation of well endowed, non-profit institutions. Foundations and charities have sometimes been called the "third sector" of the economy after the business and government sectors. There are approximately 22,400 active, grant-making, private foundations in the United States. Private foundations, generally established by an individual, come in all sizes and are situated throughout the country. Many foundations are recognized for work that has national and international impact. Foundations were instrumental in developing polio and yellow fever vaccines and for the introduction of new varieties of cereal crops that were part of the so-called "green revolution." However, most people know about foundations because of the work they do in their own communities with local libraries, churches, hospitals and civic organizations.

But now the question must be asked: Are foundations scheduled for extinction?

What has happened is that private foundations are now facing a severe erosion of the real value of their assets and of the grants they make. Three factors work together to create this situation:

- Unprecedented inflation rates have hacked away at foundation investment results.
- The stock and bond markets have performed badly during the last decade. (See Table I and II)[1]
- The federal government requires that private foundations distribute either five percent of their adjusted net asset value or the income on their investments — whichever is larger.

In 1979, private foundations in the United States gave away $2.24 billion. That was a 24 percent increase over the $1.8 billion granted a decade earlier in 1969. However, since the Consumer Price Index increased by 98 percent during that decade, the purchasing value of the 1979 dollars dropped dramatically.

This record contrasts poorly with the experience during the prior decade from 1959 to 1969. In those ten years, foundation giving increased from $702 million to $1.8 billion, an increase of 156 percent. The Consumer Price Index increased by only 26 percent during those years. So foundation giving enjoyed substantial real gains.

Those directly affected by today's decline in purchasing power are the foundations' grantees — the thousands of non-profit organizations that use foundation dollars to provide a range of services and programs benefiting people in communities across the nation, and the world.

On Payouts, Prudence and Private Foundations

Since the 1920's, the motives and operating practices of private foundations have come under periodic Congressional scrutiny. Then in 1969, a series of tax reform hearings resulted in legislation which came to be known as the Tax Reform Act of 1969.

One provision of this act was a payout requirement. This mandated then-existing foundations to pay out either a percentage of the market value of their assets or their net investment income, whichever was larger. The base rate, starting in 1972, was four percent and increased over the next four years in a series of one-half percent annual increments until it reached six percent. Foundations established in 1969 or later were required to distribute the greater of either six percent of the market value of their assets or their net investment income.

In 1976, the law was again changed to reflect the current payout requirement whereby foundations must pay out either a flat five percent of their net asset value or the net income from investments, whichever is larger. The payout provisions were beneficial to charity in that they required all foundations to be responsible for reasonable payouts.

Inflation Makes Things Different

Probably no one in Congress in 1969 envisioned our current inflation rate of more than 10 percent a year. Since the average annual inflation rate was two percent during the 1959-69 decade, double-digit inflation would have been

[1] All tables and supporting material appear in the Appendix at the back of this brochure.

hard to imagine. Today's high inflation has brought high interest rates and dividend yields. Thus foundations must distribute their net income from investments an amount usually larger than the alternative payout requirement of five percent of net asset values. This situation was not anticipated when the payout regulation was adopted.

Since today's higher rates of return are a direct result of higher inflation, they are not all real returns. Rather, they are in great part, merely compensation for inflation. The requirement of total income distribution means the certain erosion of effective grant making in future years because foundations are not allowed to retain this "inflation compensation."

This could be compared to the individual who spends all his interest income from savings today, still expecting that nest egg to support him in future years with a higher cost of living. It can't be done. Part of that income must be reinvested for the time when more dollars will be needed to buy the same amount of goods and services.

The original intent of Congress with the payout requirement was sound. However, conditions have changed and the regulation is now working to rapidly erode charitable giving.

The Mott Foundation believes that a straight five percent payout would better serve the grantee community in the long run. Foundation assets could then be better managed to maintain their purchasing power in the future while still meeting the basic objectives of the payout requirement.

Three Examples

The following three examples will show what happens to foundation giving and portfolio values with inflation at two percent as it had averaged for the ten years preceding the Tax Reform Act of 1969; at 10 percent as it approximates today; and at 10 percent but with a straight five percent payout requirement.

Portfolios consisting of 60 percent stocks and 40 percent bonds have been assumed in the following illustrations. This is very close to the average stock-bond ratio that exists today for many institutional portfolios, including pension plans, managed by fiduciaries responsible for an appropriate balance of risk and return.

The figures used in preparing the bar charts and related tables assume implied-average rates of return that have been available in the security markets during periods of both two percent and 10 percent inflation.

Readers Note: The figures and assumptions underlying these examples can be found in the Appendix at the back of this publication.

Example I: Inflation at Two Percent Annually

The top row of both bar chart series and the supporting figures in Table III show what happens over 30-year period to the purchasing power of grant dollars and the real value of a securities portfolio if inflation had remained at two percent per year. Cash income generated would be less than five percent of the portfolio value (Table III, Portfolio I). So, according to the current legislation, five percent of the portfolio value would be granted each year. (Table III, Portfolio II) This would result in some annual encroachment of the portfolio for distribution. But only a modest erosion of about five percent over the entire 30-year period would occur in both the purchasing power of income granted and the real value of the securities portfolio.

Example II: Inflation at Ten Percent Annually

The middle row in both bar charts and the supporting figures in Table IV-Portfolio I show the far less stable situation now developing for foundations with inflation running at ten percent per year combined with the current payout rule.

With such high inflation, the cash income generated is higher than five percent and therefore all this income must be given away each year. Since no income can be reinvested, both the purchasing power of the income granted and the underlying real value of the securities portfolio will erode. In 30 years, only 33 percent of the original real value will remain.

Example III: A Better Way

The bottom row of both bar charts and the supporting figures in Table IV-Portfolio II show what would result with inflation at ten percent annually but with a change to a straight five percent payout. Foundations would then be permitted to reinvest this additional income over five percent. By doing this, it would be possible to earn additional dollars in future years to help maintain the real value of both the portfolio and the grant making.

This change in the payout requirement would regain the stability for foundations that existed when the legislation was first developed — at a time when inflation was only two percent. Erosion continues with a straight five percent payout, but it is modest.

According to the examples presented, a straight five percent payout, would result in an initial reduction in the amount of funds required for distribution as shown in Bar Chart Example II and III (See Table IV, Portfolio I and II). However, the high income currently experienced is, in part, compensation for high inflation which must be reinvested if foundations and their grantees are to avoid severe reductions in real terms in the coming years.

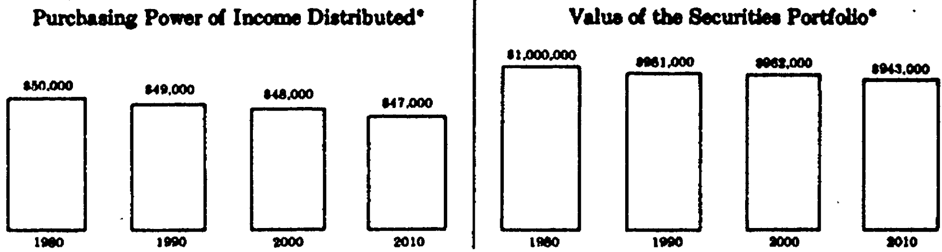
In theory, the only way for investors to remain whole over a long period of time is to pay out only the real return earned (see Tables III and IV-Portfolio III). Examination of Tables I and II shows that real returns can vary significantly over extended periods of time. Consequently, if foundation payout requirements were to be based on real returns, one would have to use very long-term historical records as guidelines. Such a document is the recent research publication, "Stocks, Bonds, Bills, and Inflation: Historical Returns (1926-78)" by Ibbotson and Sinquefield, published in 1979.

It should also be noted that a straight payout requirement does not restrict any foundation from implementing a larger payout. However, it would permit the individual trustees of each foundation to better determine whether it is to exist in perpetuity or for a limited time.

(Narrative continued on Page 4)

EXAMPLE I
Two Percent Inflation with Current Payout Requirement

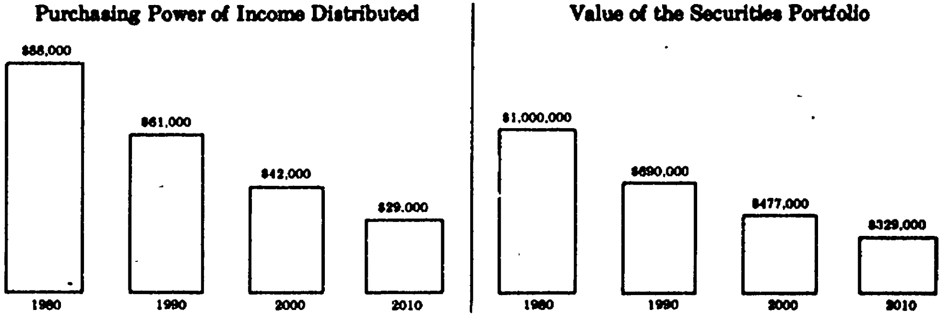
Purchasing Power of Income Distributed* | Value of the Securities Portfolio*



(See Table III • Portfolio II)

EXAMPLE II
Ten Percent Inflation with Current Payout Requirement

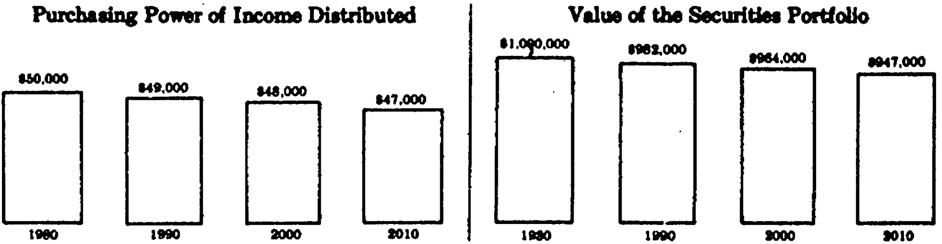
Purchasing Power of Income Distributed | Value of the Securities Portfolio



(See Table IV • Portfolio I)

EXAMPLE III
Ten Percent Inflation with Five Percent Straight Payout Requirement

Purchasing Power of Income Distributed | Value of the Securities Portfolio



(See Table IV • Portfolio II)

*Portfolio Composition: 60% stocks, 40% bonds
Initial Portfolio: $1 million

A Rationale for Existence

Foundations have existed throughout civilized time in many forms and sizes. Every major culture and religion has felt the need to encourage and institutionalize philanthropy in order to promote human welfare.

The accomplishments of foundations and their grantees are a rationale for their continued existence.

Foundations have often served as the social conscience of our society, working to improve the state of the underprivileged and the under-represented. Since the turn of the century, foundations have worked to improve the plight of decaying neighborhoods in our urban centers and have supported the work of historically black colleges and universities.

Foundations have taken the initiative to become more involved in contemporary social issues, putting their resources to work to address the problems of youth unemployment, deterioration of the American family and energy and environmental issues.

During the 1920's when many of the large private foundations were formed, the federal government played a minor role in social programming and education. Today, it has a major role in this area.

While the monetary resources of foundations are small compared to those of the federal government, foundations do have the flexibility to react quickly to developing trends and needs. They can quickly bring together the various sectors, both public and private, to deal with problems.

The flexibility, and willingness to become involved in emerging social issues, are institutional strengths. Foundations can well provide the support for small scale demonstration projects which, if successful, can be replicated on a wider scale.

Many foundations today have reached the point in their giving where the dollars they have granted over the years are greater than their contributed capital — the money given by the original donors for the establishment of the foundation.

But with the current erosion of foundation finances, the prospects for foundation-supported projects to make an impact on our society's problems dim considerably. That would be a shame. The nation needs the strength and depth provided by its large variety of institutions, each trying in its own way to make a constructive contribution to the nation's welfare.

APPENDIX

TABLE I

Total Annual Investment Returns (1926 - 1978)

Security Class	Nominal Annual Return (mean)		Annual Inflation (mean)		Real Annual Returns (mean)
Common Stocks	8.9%	−	2.5	=	6.4%
Long Term Corp. Bonds	4.0%	−	2.5	=	1.5%
Long Term Govt. Bonds	3.2%	−	2.5	=	0.7%
U.S. Treasury Bills	2.5%	−	2.5	=	0.0%

TABLE II

Total Annual Investment Returns (1969 - 1978)

Security Class	Nominal Annual Return (mean)		Annual Inflation (mean)		Real Annual Returns (mean)
Common Stocks	3.2%	−	6.7	=	-3.5%
Long Term Corp. Bonds	5.8%	−	6.7	=	-0.9%
Long Term Govt. Bonds	5.1%	−	6.7	=	-1.6%
U.S. Treasury Bills	5.9%	−	6.7	=	-0.8%

Source: Stocks, Bonds, Bills, and Inflation: Historical Returns (1926-78) Ibbotson & Sinquefield, 1979.

TABLE III

Effect of a 2% Rate of Inflation on 60% Stock — 40% Bond Portfolios with Different Income Payouts

The following tables illustrate the effect of a 2% rate of inflation on the constant dollar portfolio value and the purchasing power of income developed from three 60% stock - 40% bond portfolios. The portfolios are invested to provide a total return of 6.8%, with the bonds returning 5% and the stocks 8% per year. The 8% return from stocks is derived 5% from capital appreciation and 3% from cash income. In the first portfolio, the cash income return of 3.8% is less than the minimum 5% payout requirement. Therefore, some encroachment of the portfolio must occur and the effect of this encroachment is shown in Portfolio II. Portfolio I does not reflect this encroachment.

In the second portfolio, 5% of the value is distributed and 1.8% reinvested 60% stocks - 40% bonds earning at the same rates of return; and in the third, the real return of 4.8% is distributed and 2% is reinvested 60% stocks - 40% bonds earning at the same rates of return.

Assumptions:

(1) All portfolios begin with $1,000,000 invested 60% in stocks to return 8% (6% real return and 2% inflation) and 40% bonds to return 5% (3% real return and 2% inflation).

(2) The rate of inflation is assumed to be 2% per year.

(3) The dividends from stocks provide a cash income yield based on market value of 3% and the interest from bonds provides a cash income yield based on market value of 5% for an overall cash income yield of 3.8% (60% stocks - 40% bonds).

(4) It is assumed that bonds will provide a real return of 3%, although this is somewhat higher than historical returns.

PORTFOLIO I

All Income Distributed [1]

Year	Nominal Value	Value in 1980 Dollars	Income	Income Distributed	Purchasing Power of Income Distributed (1980 Dollars)
1980	$1,000,000	$1,000,000	$38,000	$38,000	$38,000
1990	1,343,916	1,102,480	51,069	51,069	41,894
2000	1,806,111	1,215,461	68,632	68,632	46,187
2010	2,427,363	1,340,021	92,236	92,236	50,921

(1) The capital appreciation from the stocks of 5% per year is assumed to be reinvested: 60% back into stocks and 40% into bonds thereby maintaining the 60% - 40% stock bond ratio.

PORTFOLIO II

5% Distributed, 1.8% Reinvested [1]

Year	Nominal Value	Value in 1980 Dollars	Income	Total Distributed	Purchasing Power of Income Distributed (1980 Dollars)
1980	$1,000,000	$1,000,000	$38,000	$50,000	$50,000
1990	1,196,302	980,564	45,421	59,765	49,029
2000	1,430,748	961,506	54,392	71,437	48,075
2010	1,707,786	942,519	64,896	85,389	47,141

(1) The total return is 6.8% from the portfolio invested 60% in stocks at a 8% return (2% inflation) and 40% in bonds at a 5% return. Of the total return of 6.8%, 5% is distributed, leaving 1.8% to be reinvested.

PORTFOLIO III

Real Return of 4.8% Distributed[1], 2% Reinvested

Year	Nominal Value	Value in 1980 Dollars	Income	Total Distributed	Purchasing Power of Income Distributed (1980 Dollars)
1980	$1,000,000	$1,000,000	$38,000	$48,000	$48,000
1990	1,218,994	1,000,000	46,322	58,512	48,000
2000	1,485,947	1,000,000	56,466	71,326	48,000
2010	1,811,362	1,000,000	68,832	86,946	48,000

(1) The portfolio's real return is 4.8% which is the total return of 6.8% minus 2% inflation. Of the total return of 6.8%, 4.8% is distributed leaving 2% to be reinvested.

TABLE IV

Effect of a 10% Rate of Inflation on 60% Stock — 40% Bond Portfolios with Different Income Payouts

The following tables illustrate the effect of a 10% rate of inflation on the constant dollar portfolio value and the purchasing power of income developed from three 60% stock - 40% bond portfolios. The portfolios are invested to provide a total return of 14.8%, with the bonds returning 13% and the stocks 16% per year. In the first portfolio, all income is distributed; in the second 5% of the value is distributed and 9.8% reinvested 60% stocks - 40% bonds earning at the same rates of return; and in the third, the real return of 4.8% is distributed and 10% is reinvested 60% stocks - 40% bonds earning at the same rates of return.

Assumptions:

(1) All portfolios begin with $1,000,000 invested 60% in stocks to return 16% (6% real return and 10% inflation) and 40% in bonds to return 13% (3% real return and 10% inflation).

(2) The rate of inflation is assumed to be 10% per year.

(3) The dividends from stocks provide a cash income yield based on market value of 6% and the interest from bonds provides a cash income yield based on market value of 13% for an overall cash income yield of 8.8% (60% stocks - 40% bonds).

(4) It is assumed that bonds will provide a real return of 3%, although this is somewhat higher than historical returns.

PORTFOLIO I

All Income Distributed[1]

Year	Nominal Value	Value in 1980 Dollars	Income	Income Distributed	Purchasing Power of Income Distributed (1980 Dollars)
1980	$1,000,000	$1,000,000	$ 88,000	$ 88,000	$88,000
1990	1,790,848	690,449	157,596	157 596	60,760
2000	3,207,138	476,720	282,228	282,228	42,951
2010	5,743,491	329,151	506,427	506,427	28,965

(1) The capital appreciation from the stocks of 10% per year is assumed to be reinvested: 60% back into stocks and 40% into bonds thereby maintaining the 60% - 40% stock bond ratio.

PORTFOLIO II

5% Distributed, 9.8% Reinvested[1]

Year	Nominal Value	Value in 1980 Dollars	Income	Income Distributed	Purchasing Power of Income Distributed (1980 Dollars)
1980	$ 1,000,000	$1,000,000	$ 88,000	$ 50,000	$50,000
1990	2,546,967	981,966	224,133	127,348	49,098
2000	6,487,043	964,258	570,860	324,352	48,213
2010	16,522,269	946,868	1,453,961	826,114	47,343

(1) The total return is 14.8% from the portfolio invested 60% in stocks at a 16% return (10% inflation) and 40% in bonds at a 13% return. Of the total return of 14.8%, 5% is distributed, leaving 9.8% to be reinvested.

PORTFOLIO III

Real Return of 4.8% Distributed[1], 10% Reinvested

Year	Nominal Value	Value in 1980 Dollars	Income	Income Distributed	Purchasing Power of Income Distributed (1980 Dollars)
1980	$ 1,000,000	$1,000,000	$ 88,000	$ 48,000	$48,000
1990	2,593,743	1,000,000	228,249	124,500	48,000
2000	6,727,500	1,000,000	592,020	322,920	48,000
2010	17,449,402	1,000,000	1,535,547	837,571	48,000

(1) The portfolio's real return is 4.8% which is the total return of 14.8% minus 10% inflation. Of the total return of 14.8%, 4.8% is distributed leaving 10% to be reinvested.

STATEMENT OF THE NATIONAL ASSOCIATION OF LIFE COMPANIES IN SUPPORT OF S. 388 AND S. 446

The National Association of Life Companies (NALC) submits this statement for the Committee's hearing record in support of S. 388 and S. 446, bills which would revoke Revenue Rulings 77-85 and 80-274 and reinstate the taxation of annuity contracts with reserves based on a segregated asset savings account as it existed prior to these erroneous IRS rulings.

NALC, headquartered at 3340 Peachtree Road, N.E., Atlanta, Georgia, represents approximately 250 life insurance companies, most of which are small or medium-sized. A number of NALC's member companies offer so-called "invetment" and "wrap around" retirement annuities. Thousands of low and moderate income Americans have purchased these innovative annuity policies as one of the few means available to them for achieving a modest tax deferral while building a personal retirement account. The value of these policies now has been destroyed by the IRS' capricious decisions in Rev. Rul. 77-85 and 80-274.

For over a decade, the IRS has issued over 70 private and public rulings on variable or investment annuities on which insurers, financial institutions, and small savers relied in marketing and purchasing these annuity products. Prior IRS rulings had treated the insurance company as the owner of the savings account which provided the reserve for the annuity. Therefore, the annuity policyowner was not taxed on the interest from the account prior to the annuity starting date. The IRS was fully aware that the annuity industry and countless citizens relied on its prior rulings. Suddenly, in Rev. Rul. 77-85, the IRS reversed its long standing position and now holds that the policyholder, instead of the insurer, is the owner of the savings account, and that interest thereon is includible in the policyholder's yearly gross income. This position, therefore, destroys the tax deferral benefits of the annuity.

NALC strongly objects to the IRS's new position as reflected in Rev. Rul. 77-85 and 80-274. From a public policy point of view, it is unwise to discourage this important savings mechanism. Savings are critically important today for controlling inflation, capital formation (especially for housing purposes) and retirement needs. Small savers should not be denied the opportunity to achieve modest tax deferral, while furthering legitimate public policy goals.

Not only does NALC consider the current IRS position to be unacceptable from a policy perspective, but we also believe that it is arbitrary and erroneous as a matter of law. The U.S. District Court for the District of Columbia has ruled that Rev. Rul. 77-85 on which Ruling 80-274 is based, "is an erroneous and unreasonable interpretation of the Internal Revenue Code." Unfortunately, this decision was overturned on other "jurisdictional" grounds, and therefore this IRS ruling remains in effect.

The IRS's sudden reversal of its long standing interpretation of the Code was not based on any statutory change, and is totally inconsistent with prior interpretations, including those made contemporaneously with the passage of the applicable Code provisions. This is simply an ill-conceived, bureaucratic unsurpation of Congress' authority to make the law. Our democratic system does not provide for changing the law by administrative fiat. This IRS action cannot be tolerated.

Accordingly, the NALC urges the Committee and the Congress to approve promptly the pending legislation to revoke these erroneous IRS rulings and thereby allow tax deferral for interest on these investment and wrap-around annuities.

WISCONSIN EMPLOYERS INSURANCE CO.,
Green Bay, Wis., March 15, 1978.

State of Wisconsin,
Office of the Commissioner of Insurance,
Madison, Wis.
Attn: Mr. L. L. Schlinkert, Insurance Rate and Forms Analyst.

DEAR MR. SCHLINKERT: The above-captioned Forms were submitted to your department on February 17, 1978 and received Tentative Approval on February 20, 1978. We now submit these forms to your department for final approval; they will be issued in the form submitted.

Please note that the Form numbers had been assigned incorrectly (WEG 381, WEG 382 and WEG 383) on these Forms submitted to your department on February 17, and have been changed (WEIC 381, WEIC 382 and WEIC 383).

We will await your response to our request for final approval of these forms. Please feel free to contact me if you have any questions.

Thank you.
Respectfully,

JOHN M. LADWIG, CLU.

Enclosures.

DEPARTMENT OF THE TREASURY,
INTERNAL REVENUE SERVICE,
Washington, D.C., November 3, 1978.

WISCONSIN EMPLOYERS INSURANCE CO.,
Green Bay, Wis.

Gentleman: This is in reply to a request for a ruling submitted on your behalf by your representative concerning the ownership of deposits placed in savings and loans in connection with the insurance of group single premium annuity contracts.

The Company is an insurance company taxable under section 802 of the Internal Revenue Code of 1954.

The Company has developed a group single premium annuity contract to be sold by the Company to depositors of savings and loans. The Company intends to sell annuity certificates to depositors of savings and loans who hold master policies. The savings and loan will act as contractholder and will enroll depositors into the plan just as most employers hold group health policies and enroll their employees into their plans. The Company will reimburse the savings and loan for their expenses associated with the enrollment procedure.

Any premiums received by the Company under the program will be deposited into the savings and loan. These deposits will be segregated accounts with the Company holding legal title to the accounts. The Company will hold the passbooks for the account and each passbook will read, "The insurance company holds this account as agent for annuitant X, subject to the terms of the Annuity Plan." The savings and loan will pay its usual interest on these deposits.

The annuitant's cash value in his Annuity Plan will be the premium paid plus interest accumulated at a guaranteed rate of four percent (4 percent) per year, compounded annually. 100 percent of the premiums paid will be included in the cash value. If the savings and loan only paid three-and-one-half percent (3½ percent) interest on the deposits made by the Company for the benefit of the annuitant involved, the Company would have to make up the extra one-half percent (½ percent). In addition, certain "excess interest" may increase the cash value of the policy, if so determined by the Board of Directors of the Company. In no case can the amount of excess interest credits be less than the interest paid by the savings and loan on the pertinent deposits, diminished by one-half percent (½ percent) and further diminished by the guaranteed rate.

The Annuity Plan provides various options for payment of the benefits, e.g. lump sum, payment over a period of years. The benefits are paid under a permanent purchase rate guarantee.

The annuitant does not have direct access to the interest earned on the deposit in the savings and loan, except as the terms of the Annuity Plan allow him payments of benefits, loans on the cash value of the policy, or surrender of the policy for its cash value less a cash surrender charge. Further, the annuitant has no right or authority to direct the insurance company to cancel any amount or withdraw funds from any account that the Company has with any financial institution. If the annuitant dies prior to the annuity starting date, having designated a contingent payee, the contingent payee will receive in one sum the payment due after the death of the annuitant.

Based on the foregoing, the provisions of the Annuity Plan indicate that the Company will be the recipient of the interest earned on the deposits placed in savings and loans in connection with the Plan. Further, the annuitant has no direct access to the assets in the account, but instead has a right only to receive annuity payments in amounts pursuant to the Company's obligations under the terms of the Annuity Plan.

Accordingly, it is held that the Company will be the owner of the deposits in the savings and loans placed there in connection with the annuity plan, for purposes of determining the Company's gross investment income under section 804(b) of the Code.

This ruling letter is based on the present provisions of the Internal Revenue Code. President Carter, in his special tax message to Congress on January 21, 1978, proposed that taxes be imposed currently on the holders of certain deferred annuities not purchased under qualified retirement plans. The holding of this ruling letter may not be relied upon in the event that legislation affecting the plan described herein is enacted by the Congress.

A copy of this letter should be attached to your Federal income tax return.

In accordance with the power of attorney on file, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

JOHN L. CRAWFORD,
Chief, Corporation Tax Branch.

DEPARTMENT OF THE TREASURY,
INTERNAL REVENUE SERVICE,
Washington, D.C., December 3, 1979.

WISCONSIN EMPLOYERS INSURANCE CO.,
277 Ridge Road
Green Bay, Wis.

Attention: Mr. John Ladwig, C.L.U. Manager, Technical Sevices.

DEAR MR. LADWIG: This letter is in reference to your Group Single Premium Retirement Annuity Contracts that were the subject of our letters to you dated November 9, 1978, (Written Determination Number 7906058) and April 3, 1979.

After careful consideration of the matters discussed in our conference with you on May 8, 1979, and your subsequent communications with our office, we have concluded that it will be necessary for us to modify our earlier ruling letter for the following reasons.

If the language on the passbooks representing the deposits held in financial institutions pursuant to the annuity plan refers to any party other than the taxpayer, such language is inconsistent with the actual relationships involved. You have represented that the annuitant derives benefits soley pursuant to the terms of the annuity contract. The taxpayer will be the legal owner of the accounts and will have control, along with the financial institutions, over the investment of the funds in the accounts.

In Revenue Procedure 79-14, 1979-10 I.R.B. 30, the Internal Revenue Service announced, in section 4.01, that it will not issue advance rulings or determination letters as to who is the true owner of property or the true borrower of money in cases in which the formal ownership of the property or liability for the indebtedness is in another party.

Our earlier ruling letter to you involved an arrangement whereby each passbook would state that the taxpayer owned the account as agent for the annuitant. Based on the inconsistency between this language and Rev. Proc. 79-14, we can no longer continue that ruling letter in effect. Moreover, if the taxpayer is to be held to be the owner of the accounts, and to hold them as part of its total reserves, it is inconsistent for the passbooks to note any designation other than that the taxpayer is the owner of the accounts.

Accordingly, our ruling letter to you dated November 9, 1978, cannot be relied upon for any annuity contracts issued subsequent to 90 days after the date of this letter. The prior ruling letter will be valid for contracts issued prior to that date pursuant to section 7805(b) of the Internal Revenue Code.

Pursuant to a power of attorney on file in this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

GERALD FORTNEY,
Assistant Commissioner (Technical).

STATE OF WISCONSIN,
OFFICE OF COMMISSIONER OF SAVINGS AND LOAN,
Madison, Wis., March 28, 1978.

Mr. JOHN M. LADWIG, CLU,
Wisconsin Employers Insurance Co.,
Green Bay, Wis.

DEAR MR. LADWIG: Thank you for your letter of March 15 broadly outling the group and program which Wisconsin Employers Insurance Company plans to implement through savings and loan associations in Wisconsin. As you indicate in your letter, it is the position of this office that no statutory or regulatory obstructions to the plan which you describe exist provided the plan falls within the group exclusion contained in state insurance laws.

I would, however, like to make a couple specific comments concerning the procedure noted in your letter. First, you state "The savings and loan will have the authority to issue individual Certificates to the deposit of that institution." It is my understanding that an association's records in fact would only indicate at most a

beneficial interest on the part of an individual, and that in reality the association would be the depository for Wisconsin Employers Insurance Company. Restated, it is my impression that the association's account would either show Wisconsin Employers as the sole depositor or might indicate Wisconsin Employers the depositor "for the benefit of 'John Jones'". But in any event, it is my understanding that the "retail customer" does not have a direct contractual relationship with the association.

My second comment, again intended to clarify could perhaps best be defined as an amplification of the foregoing thought. You indicate that a savings and loan would be paid an expense allowance for each certificate that is issued. We have no problem with such a procedure, provided the institution's role is in effect that of agent for Wisconsin Employers. My reason for emphasizing this is because as you know Wisconsin state chartered savings and loan association do not have the capacity to act as a trustee for a plan such as that which you describe.

I hope that these comments are of assistance to you in formulating your program. Should you have any additional questions please do not hesitate to contract us at any time.

Sincerely,

BRIAN T. KAYE, CFE,
Deputy Commissioner.

STATE OF WISCONSIN,
OFFICE OF COMMISSIONER OF BANKING,
Madison, Wis., August 30, 1978.

DEAR MS. GRITZMACHER: I have received your letter of August 25, 1978, in which you request an opinion relative to the authority of Wisconsin state banks to participate in the offering and administration of deferred annuity programs.

After reviewing this material and applicable sections of the Banking Code, it is my opinion that Wisconsin state chartered banks may participate in the offering and administration of single premium deferred annuity contracts of the type described by Wisconsin Employers Insurance company.

In order to avoid misunderstandings on the part of your banks' customers, you should, when announcing and promoting the annuity program, distinguish clearly between the bank's functions on the one hand and those of the insurance company on the other hand. It should be pointed out to your customers that the bank is merely accepting deposits and engaging in certain non-discretionary administrative duties and is therefore, not a party to or has any responsibility for the insurance and annuity features of the contract.

These narrowly defined functions would obviate the need for an insurance license or for fiduciary powers on the part of the bank. This approval is conditioned upon your bank's adherence to these functional limitations.

This letter deals exclusively with the regulatory issues pertaining to an annuity program and should not be viewed as a recommendation or endorsement of the plan.

In conclusion, I again emphasize the importance of a full and thorough explanation of the annuity program as well as the bank's limited role to all participants. Should you have any other questions, please contact me.

Yours very truly,

T. E. PEDERSON,
Deputy Commissioner of Banking.

FEDERAL DEPOSIT INSURANCE CORPORATION,
OFFICE OF THE GENERAL COUNSEL,
Washington, D.C., June 4, 1980.

JUDITH A. HASENAUER, Esquire,
Blazzard, Grodd and Hasenauer,
Westport, Conn.

DEAR MS. HASENAUER: This is in response to your inquiry regarding the deposit insurance coverage of certain bank deposits to be held in accordance with an annuity contract plan.

As set forth in your letter of May 27, 1980, the annuity contract plan will operate as follows: The depositor purchases an annuity contract by transferring his or her account with the bank to the Wisconsin Employers Life Insurance Company ("Insurance Company") in exchange for an annuity contract funded by that account. The

account is re-registered in the Insurance Company's name. The bank pays its usual interest on the deposits and receives expense reimbursements for services.

You also noted that: (1) as permitted by Wisconsin Law, the Insurance Company will maintain the deposit instruments in a segregated account; (2) pursuant to Wisconsin law, the assets held in a segregated account may not be charged with liabilities arising out of any other business of the Insurance Company; (3) according to the contract, the annuitant shall have the benefit of the entire principal of and income from the depository account, except that the Insurance company is entitled to receive its service fee from the account; (4) the Insurance company's record will identify each depository account with a particular annuity contract; and (5) according to Wisconsin law, upon liquidation of the Insurance Company, a liquidator may not invade the assets of the segregated account to satisfy claims of other creditors.

As you know, FDIC deposit insurance coverage limitations are a function of the rights and capacities in which deposit accounts are held. Where deposits are held in different and distinct rights and capacities, separate insurance coverage may be warranted with respect to each individual in whose interest the deposits are held. See 12 U.S.C. § 1813(m) and 12 C.F.R. Part 330.

FEDERAL HOME LOAN BANK BOARD,
Washington, D.C., May 5, 1980.

Ms. JUDITH A. HASENAUER,
Blazzard, Grodd & Hasenauer,
Westport, Conn.

DEAR Ms. HASENAUER; This is in response to your two letters of March 26, 1980 in which you advanced your opinion about Wisconsin "segregated account" law, and asked about the insurance of accounts held under an annuity contract offered by Wisconsin Employers Insurance Company (WEIC).

In your letter you describe the WEIC annuity program as follows:

1. Wisconsin Employers proposes to establish one or more [segregated] [1] accounts pursuant to the insurance laws of the State of Wisconsin. Such [segregated] accounts will be used exclusively for the Wisconsin Employers Annuity Contracts described herein.

2. Wisconsin Employers proposes to issue Group Annuity Contracts (the "Annuity Contracts"). Participants under said Annuity Contracts will be certain owners of deposit instruments issued by savings and loan associations ("Member Associations") whose accounts are insured by the FSLIC.

3. Such deposit instruments from the underlying investment for participation under the Annuity Contracts will be held in the name of the Wisconsin Employers [Segregated] Account as the legal owner.

4. The records of the Member Association will reflect that the particular deposit instrument is held by the Wisconsin Employers [Segregated] Account under the Annuity Contract for the ultimate benefit of the Annuitant (Participants under the Group Contract).

5. All deposit instruments held by the Wisconsin Employers [Segregated] Account will be segregated by Pariticipant (Annuitant) and Wisconsin Employers records will clearly reflect the Individual Participant's Certificate under which each deposit instrument is held.

6. Interest credited by Wisconsin Employers on each Annuity Contract will reflect the interest yield in the underlying deposit instrument with a basic minimum guaranteed interest rate. The interet rate actually credited on the Annuity Contract will not be the exact interest credited on the deposit instrument. Wisconsin Employers will retain a portion of the interest yield as its compensation for providing the annuity guarantees contained in the Annuity Contract.

7. At maturity, the proceeds from each deposit instrument held under the Annuity Contract will be re-deposited in a deposit instrument which reflects the investment needs of the Annuitant under the Annuity Contracts.

The WEIC annuity program appears to be substantially similar to other savings account funded annuity programs that we have evaluated in the past. The WEIC program allegedly permits account holders to obtain tax deferred income while maintaining the safety of an investment in an insured savings account.[2] In the earlier annuity programs, the savings accounts were held either by a custodian in trust for the insurance company, or held by the insurance company as agent for the

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[1] You have indicated that since the WEIC annuity is a fixed contract, Wisconsin law (referred to below) requires the use of a "segregated" account.

[2] The tax treatment of such annuities is a matter within the jurisdiction of the Internal Revenue Service; we, therefore, express no opinion on such matters.

annuitant. In the first case the beneficial interest of the insurance company in each account was separately insured at that time for up to $40,000, and in the second case each account was insured for up to $40,000 as an individual account of the annuitant.

You are now asking us to consider a savings account fund annuity in which the underlying deposit is held neither in trust for the insurer, nor as agent for the annuitant. Instead, the underlying savings accounts are placed in a "segregated account" established pursuant to §§ 611.24 (1), (3)(b) and (3)(c) of Wisconsin State. An? (Wisconsin is the domiciliary State of WEIC). Section 611.24 which you have indicated was adopted as part of the Model Variable Contract Law recognized by the National Association of Insurance Commissions provides in relevant part that:

§ 611.24 Segregated accounts in general

(1) Mandatory segregated accounts. A corporation shall establish segregated accounts for the following classes of insurance business, if it also does other classes of insurance business: (a) Mortgage guaranty insurance; and (b) Life insurance including fixed and variable annuities. Disability insurance may be included in a life insurance account.

* * * * * * *

(3)(b) *Identification.* The income and assets attributable to a segregated account shall always remain identifiable with the particular account but unless the commissioner so orders, the assets need not be kept physically separate from other assets of the corporation. The income, gains and losses, whether or not realized, from assets attributable to a segregated account shall be credited to or charged against the account without regard to other income, gains or lesses of the corporation.

(c) *Charges.* Except under par. (e), assets attributable to a segregated account shall not be chargeable with any liabilities arising out of any other business of the corporation, nor shall any assets not attributable to the account be chargeable with any liabilities arising out of it, except under par. (i).[3]

While insurance companies generally lack the authority to act as trustees, we noted in our opinion of January 28, 1980, that as a general principle of insurance law, when an insurance company "is required to create a special fund or to segregate certain assets to secure its performance under certain policies, courts are prone to treat these arrangements as trusts, as contrasted with the debt created by a company's contractual obligation to pay a policy claim out of its general assets." *Rohm and Haas Co.* v. *Continental Insurance Company,* 58 Ill. App. 3rd 378, 374 N.E. 2nd 727 (1978). In that case, the Illinois Court held that under the Illinois version of the above Model Variable Contract Law, a "separate account" is not subject to claims arising out of any other business the insurer may conduct. In our opinion of January 28, 1980, we determined that the relationship between the insurer and the annuitant for whom the company holds this separate account is sufficiently similar to a trust arrangement to qualify as a trust for purposes of § 564.10 of our Insurance Regulations (12 CFR 564.10). In the instant case, Wisconsin law provides for substantially identical insulation of assets with respect to Wisconsin Employers' "segregated account". Accordingly, accounts at insured institutions held by an insurer in a "segregated account" for its annuity policy holders, such as you have described, would be separately insured for up to $100,000 in any one institution (as provided by the new insurance ceiling in P.L. 96-221) with respect to each annuitant interest in such account.

As you may know, while Federal associations have no express or implied power to act as insurance agents, we have long held that such associations may make insurance programs available to their members. Federal associations may aid in the marketing of such insurance programs, as long as they do not act as insurance agents within the purview of applicable state law. Moreover, any commissions recived by such associations which exceed the expenses of administering the program must be proportionately distributed among the participants. If the foregoing criteria are satified, Federals may participate in annuity programs such as the one

[3] In your opinion on Wisconsin "segregated account" law, you indicate that paragraph (e) of § 611.24 provides for liquidation of any general or segregated account without affecting other segregated accounts maintained by the company. Paragraph (i) of the section authorizes the general account of the company to receive "fair consideration" for acting as an insurer for the segregated account (we understand no rules have been adopted implementing this section). Further, you conclude that these provisions do not affect the insulated nature of the segregated account, and therefore should not affect its eligibility for insurance as a trust account.

described above. The extent to which State-chartered associations may participate in such annuity programs, is a question for determination under pertinent state law.

Sincerely yours,

MILAN C. MISKOVSKY,
General Counsel.

FEDERAL HOME LOAN BANK BOARD,
OFFICE OF GENERAL COUNSEL,
Washington, D.C., April 19, 1978.

Mr. W. J. HILLIARD,
President, Wisconsin Employers Insurance Co.,
Green Bay, Wis.

DEAR MR. HILLIARD: This is in response to your letter of March 22, 1978, in which you asked us to review your firm's group annuity contract which will be marketed through savings and loan associations in Wisconsin. Since the annuity plan involves investing in savings accounts on behalf of annuitants, you inquire how such accounts are insured, and the extent to which such associations subject to the Board's jurisdiction may participate in such a program.

In March of 1977, we reviewed a similar group annuity plan. In our letter of March 16, 1977 (copy enclosed), we concluded that since the annuity underwriter holds the accounts as agent for the annuitant, that such accounts are insured in the aggregate with other accounts of the annuitant for up to $40,000.00 as provided in § 564.3(b) of the Insurance Regulations (12 C.F.R. § 564.3(b)). While the Board does not limit the extent to which State-chartered associations may participate in such insurance plans, Federal associations are not authorized to act as insurance agents and may only provide insurance, without profit, as an accommodation for members.

If after reviewing this and the enclosed letter you have further questions, please write to us again.

Sincerely yours,

ANNE P. JONES,
General Counsel.
JEROME S. PLAPINGER,
Associate General Counsel.

FEDERAL HOME LOAN BANK BOARD

DEAR MR. This is in response to your letter of February 1, 1977, in which you asked whether a Federal association would be authorized to "participate" in the manner described below in an annuity program being developed by your client. You also inquired as to the insurance coverage of accounts maintained as part of the program. In your letter you described the annuity program as follows:

In essence, it is proposed that certain insurance companies (hereafter Insurance) sell annuity contracts to depositors of Federal savings and loans in certain states. Insurance is associated with and it will be authorized by the states involved to sell the annuity contacts; is not owned by officers, directors or persons having the power to direct the management of savings and loans. See 12 C.F.R. § 571.9 which impose certain limits on insurance related activities of Federal savings and loan when such relationships exist between the savings and loans and insurance entities.

Insurance proposes to enter with Federal savings and loans whereby the S and L will be the Group Contract Holder. The S and L will be able to enroll its depositors in the program just as most employers enroll employees in health and other insurance plans. The S and L will receive expense reimbursements for their services. Insurance will deposit the premiums paid in the S and L. These deposits will be segregated accounts, each for the benefit of the appropriate annuitant. The S and L will pay its usual interest on these deposits.

The annuitant's cash value in his annuity will be the premium paid plus interest accumulated at three percent (3 percent) per year, compounded annually. See Section 6.1 at Page 6 of the enclosed policy. In effect, the above is the annuitant's minimum interest on this annuity. In other words, if the S and L only paid two and one-half percent (2½ percent) interest on the deposits made by Insurance for the benefit of the annuitant involved, Insurance would have to make up the extra one-half percent (½ percent), in addition, certain "excess interest" can be accrued to the annuitant. See Section 6.2 at Page 6 of the enclosed policy. A review of that provision indicates that a portion of that excess interest paid at the sole discretion of the Board of Directors of Insurance.

As we understand it, Insurance will fund tax deferred annuities by investing monies received as premiums in separate savings accounts, as agent for each annuity purchaser. Section 6 of the annuity policy form, which "guarantees" that interest will accumulate at a rate no lower than 1 percent below the average rate of return on the pre-tax return on an annuity investment may be as much as 1 percent below the rate a saver could obtain by direct investment in savings accounts. You have advised us that Insurance understands that the early withdrawal penalty may not be waived (except in case of death of the annuitant) under any of the Board's present Regulations, and that Insurance will endeavor to manage the accounts so that the program will be arranged as to such annuitants as to avoid withdrawal penalty when benefits begin. It is alleged that the program will be advantageous to the association by helping it to attract long-term deposits, and to the depositor by enabling him to defer taxes on interest income.

While Federal associations have no express or implied power to act as insurance agents, we have long held that such associations may, incidental to the creation of savings accounts, make insurance programs available to their members. We have also said that Federals may aid in the marketing of such insurance programs, as long as they are not acting as insurance agents within purview of applicable State law. Howver, any commissions received by the association which exceed the expenses of administering the insurance plan must be proportionately distributed among the participants. If the foregoing criteria are met, Federals may participate in the annuity program your client proposes.

You have indicated that savings accounts which are part of the program will be held by Insurance as agent for the individual annuity purchasers, and will be so registered. Section 564.3(b) of our Insurance Regulations provides that funds owned by a principal and invested in one or more accounts in the name or names of agents shall be added to any individual accounts of the principal and insured up to $40,000 in the aggregate. Accordingly, each individual's investment in your client's annuity program in a savings account would be insured in the aggregate with any other individual accounts of such individual in any one institution for up to $40,000. In addition, funds of the insurer on deposit in any institution would also be insured up to $40,000 (in response to the question in letter of February 8). It should be clearly understood that neither the Board nor the FSLIC offers any opinion as to whether income under the annuity program referred to above is tax deferred, or that the program has been approved by appropriate insurance authorities.

We trust the foregoing answers your questions.

Sincerely,

DANIEL J. GOLDBERG,
Acting General Counsel.

JEROME S. PLAPINGER,
Associate General Counsel.

VORYS, SATER, SEYMOUR & PEASE, COLUMBUS, OHIO
Washington, D.C., April 6, 1981.

Hon. BOB PACKWOOD,
Chairman, Subcommittee on Taxation and Debt Management,
Senate Committee on Finance, Washington, D.C.

DEAR MR. CHAIRMAN: On March 30, 1981 Norse N. Blazzard, Counsel to the Ad Hoc Committee on Individual Annuity Taxation testified before your Subcommittee on S. 388 and S. 446, bills addressed to aspects of the individual annuity taxation issue.

Because of the limited amount of time to respond to the testimony also given at that hearing by Assistant Secretary of the Treasury for Tax Analysis, John E. Chapoton, Mr. Blazzard subsequently prepared such a response, one which is particularly enlightening as to the policy position taken and the facts relied upon by the Department. That response is submitted herewith with a request that it be made a part of the permanent record of the hearings, preferably immediately following Mr. Blazzard's responses to questions. We believe it is a particularly informative analysis of the conceptual and factual weaknesses in the Administration's position on this issue.

Respectfully requested,

RANDAL C. TEAGUE.

REBUTTAL BY THE AD HOC COMMITTEE ON INDIVIDUAL ANNUITY TAXATION TO THE STATEMENT GIVEN BY HON. JOHN E. CHAPOTON

The Ad Hoc Committee on Individual Annuity Taxation[1] (the "Committee") respectfully submits this rebuttal to the statement given by The Honorable John E. Chapoton on behalf of the United States Treasury Department regarding Senate Bill 388 and Senate Bill 446.

Mr. Chapoton's statement details the Treasury Department's opposition to the Bills which would overturn two Revenue Rulings which deal with the tax treatment of certain annuity contracts which Mr. Chapoton characterizes as "wrap-around" annuities.

The basis for the Treasury Department's opposition to the legislative relief sought is that "an annuity wrapper may not be used to defer tax on otherwise currently taxable dividend and interest income derived from the underlying securities." (Page 2 of Mr. Chapoton's Statement.)

1. The Ad Hoc Committee on Individual Annuity Taxation, Inc. was formed in response to the release of Rev. Rul. 80-274. Its membership encompasses the broad scope of the annuity industry, including life insurance companies, insurance agencies, mutual fund managers, stock brokerage firms and banking institutions.

This position fails to recognize the basic factor inherent in all annuities-that the insurer must make investments in order to meet its obligations under the contracts. The fact that the contract itself specifies what the particular investment will be is merely an effort by the insurer to provide a more appealing product which will better suit the particular retirement needs of each annuitant. Such facts should not, in themselves, detract from the status of such a contract as an "annuity" for tax purposes.

We note that Mr. Chapoton's Statement contains the assertion (on Page 3) that the Treasury has "concluded that [Rev. Rul. 77-85 and Rev. Rul. 80-274] are consistent with the applicable statutory provisions and legislative history." Yet there are no citations of the legal basis for this argument anywhere in Mr. Chapoton's Statement nor in the Rulings themselves! In fact, nowhere in the applicable Statutes, the legislative history, Treasury Regulations nor the previously issued contradictory public and private rulings issued by the IRS, is there any indication that the nature of the investments which underlie an annuity contract will affect its status as an "annuity" for tax purposes! For over a decade, in over 70 different rulings the IRS upheld the position that the nature of an underlying investment did not affect the status of an annuity. The applicable law has not changed! The actions by the Treasury appear to be merely an attempt to subvert the law.

There also remains the uncontroverted fact that the only definition of an annuity contained anywhere in the tax laws or associated rules is contained in the Treasury's own Regulations: The contracts under which amounts paid will be subject to the provisions of Section 72 include those contracts which are considered to be life insurance, endowment and annuity contracts in accordance with the customary practice of life insurance companies." (Treas. Reg. § 1.72-2(a)(1).)

Certainly, the annuity contracts which were the subject of Rev. Ruls. 77-85 and 80-274 satisfy the above definition. It is interesting to note that the above Regulation was adopted in 1956, shortly after enactment of the '54 Internal Revenue Code. No substantive changes have been made in this Treasury Department definition of an annuity in the quarter century since its adoption. Yet, Rev. Ruls. 77-85 and 80-274 specifically contradict the above definition! The annuity contracts which were the subject of the Rulings were "considered to be annuity contracts in accordance with the customary practice of life insurance companies." They were approved by state insurance regulators in accordance with the normal practice in the industry. Under state insurance law the assets underlying the contracts are owned by the insurer, not by the annuitant. The annuitant has no rights with respect to such assets. Such assets are used merely to measure the contract values!

In his Statement (Page 3) Mr. Chapoton specifies that only in the case of series E savings bonds and annuities is tax on current interest deferred until actual receipt. We agree with this conclusion. Apparently Congress, in enacting the laws which provide tax deferral on interest credited to annuity contracts determined that a valid social need supported such an action. It would appear that the Treasury Department, through Rev. Ruls. 77-85 and 80-274 is attempting to frustrate the clear intent of Congress to encourage savings for retirement by permitting such tax deferral. Mr. Chapoton's statement said that:

"The arrangements considered in these rulings represent an attempt to push to an unjustified extreme the special tax treatment accorded deferred annuities under existing law." We respectfully differ with this opinion.

The annuities which were the subject of the Rulings are better for the consumer! They provide an improved investment yield; more security and greater flexibility to

achieve individual retirement goals. They are more attractive, easier to sell and easier to understand. It appears that Treasury's major complaint is that these annuities are more successful at accomplishing the goal for which Congress provided the tax benefit in the first place—they stimulate saving for retirement! Presumably, Mr. Chapoton and the Treasury prefer an annuity which is so unattractive that no one will buy it!

Mr. Chapoton's statement (page 3) acknowledges that:

"The tax laws specifically contemplate the issuance of 'variable annuities,' so-called because the contract purchaser, rather than receiving interest at rates guaranteed by the issuing life insurance company, is entitled to an investment whose results vary with the 'investment experience of the company issuing the contract.' That is, while a 'straight' annuity involves a guarantee by the issuing life insurance company of interest at some contractual rate, the purchaser of a variable annuity assumes the risk of upward or downward fluctuation in the securities in which the premiums paid for the contract are invested."

It would seem that the foregoing portion of Mr. Chapoton's statement specifically acknowledges Congressional intent to permit an annuity with a specific contractual investment orientation. Thus, we fail to understand the attack by Treasury on the annuities which were the subject of Rev. Ruls. 77-85 and 80-274. These products simply permit the annuitant to have his contract values invested in specified types of investments and to have contract benefits measured by the investment experience of such investments.

There is an area of Mr. Chapoton's statement which we believe contains an inaccurate or incomplete statement of the law. The above quotation, as well as footnote 2 on Page 5 state that a variable annuity must have its contract values computed on the basis of "the investment experience of the company issuing the contract." Likewise, the cited footnote states that the legislative history refers to "'variable annuities' as those whose 'benefits . . . vary with the insurance company's overall investment experience.'"

The foregoing appears to be an intentional attempt to distort the law applicable to variable annuities. The provision cited describes only one type of variable annuity, a type which has not been sold in over 15 years! The provision is contained in §801(g)(1)(A) of the Code which was originally enacted in 1959. However, Mr. Chapoton's statement fails to mention the type of variable annuity permitted under §801(g)(1)(B) of the Code, enacted in 1962. Such section reads in pertinent part:

§801(g)(1)(B) Contracts with reserves based on a segregated asset account. For purposes of this part, a "contract with reserves based on a segregated asset account" is a contract

(i) Which provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company,

(ii) Which provides for the payment of annuities, and

(iii) *under which the amounts paid in, or the amount paid out reflects the investment return and the market value of the segregated asset account.* (Italics added)

If a contract ceases to reflect current investment return and current market value, such contract shall not be considered as meeting the requirements of clause (iii) after such cessation.

Thus, a variable annuity can be either a contract whose "benefits vary with the insurance company's overall investment experience" as related in Mr. Chapoton's statement, or a contract whose benefits (the "amounts paid out") vary with the investment experience ("the investment return and the market value") of the segregated asset account. Either type of contract is a "variable annuity" for tax purposes.

The legislative history for the two different types of variable annuities is important. The type of variable annuity described in Mr. Chapoton's statement and the legislation which recognized it (§801(g)(1)(A) of the Code) first appeared as part of the Life Insurance Company Tax Act of 1959. It was originally designated as §801(g)(1) of the Code. This section was the direct result of the decision of the U.S. Supreme Court in *SEC* v. *Variable Annuity Life Insurance Company of America* 359 U.S. 65 (1959) which determined that a variable annuity was a security and the company issuing it was an investment company. The early variable annuity companies were solely in the variable annuity business and therefore the variable annuity contracts reflected the investment experience of the entire insurance company. Therefore §801(g)(1) was appropriate to permit variable annuities which reflected the entire investment experience of the insurer.

In the early 1960's a new development occurred which caused the enactment of §801(g)(1)(B) of the Code which permitted variable annuities to have their benefits reflect the investment experience of a segregated asset account. This new development was the desire of the Prudential Life Insurance Company to sell variable

annuities. Obviously, the variable annuity would be a tiny part of the total asset base of a huge company like the Prudential. To have contract benefits for the small variable annuity element reflect the investment experience of the Prudential's overall assets would defeat the very purpose of the variable annuity. Therefore, Prudential used a segregated asset account to hold the assets underlying its variable annuities and §801(g)(1)(B) was enacted to permit such a procedure.

Since approximately 1965 all variable annuities have been based on segregated asset accounts. To the best of our knowledge, no variable annuities are currently being offered which reflect the investment experience of the entire insurer. All variable annuities presently utilize segregated asset accounts.

It is interesting to note that the rulings given by the IRS on the annuity contract which were the subject of Rev. Rul. 77-85 were contemporary with the enactment of §801(g)(1)(B) of the Code and represented an insistence by the IRS that those annuities were "variable annuities" of the type encompassed by §801(g)(1)(B). It took the IRS over a decade to change its mind!

We believe the foregoing demonstrates that the Treasury Department either does not understand the law applicable to variable annuities or has purposely misstated such law in an attempt to obscure the true legal issues.

Mr. Chapoton's statement contains the assertion (on Page 5) that the "issue raised by the two rulings is whether the tax treatment available to a deferred variable annuity also extends to what is in substance the direct purchase of an investment security." This assertion, as well as the statement contained in Rev. Rul. 80-274 that the annuity is merely a "conduit" for the investment or that the purchaser is in "a substantially identical position" to what he or she would have had without the annuity, fails to consider the costs and limitations which go along with the annuity which would not exist if the investment were owned directly. These are:

1. A sales charge of from 2-5 percent of purchase payments.
2. A premium tax (for instance, in California 2.35 percent of purchase payments).
3. An annual charge which may be as much as 1.5 percent of the total amount held under the contract.
4. In some contracts an annual adminstrative charge.
5. An early surrender charge. In some contracts as much as 5 percent of the amount surrendered.
6. Loss of control of the investments underlying the contracts.

In return for these detriments, the purchaser receives the guarantee of lifetime annuity payments, regardless of longevity of the annuitant or of the population in whole. It is this guarantee which provides the motivation to purchase the annuity. It can hardly be said that the above charges and limitations make the annuity merely a "conduit" or a "paper transaction." It seems obvious that the purchase of the annuity has clearly changed the annuitant's status irrevocably.

Obviously, the purchaser of an annuity must conclude that he or she is better off with the annuity than without! Otherwise, no annuities would be purchased and the Congressional purpose behind the enactment of annuity legislation would be frustrated.

We have been unable to find in the applicable statutes or in the legislative history of such statutes the support referred to in Mr. Chapoton's statement (on Page 5) for the proposition that Congress had any concern for the nature of the investments underlying annuities. On the contrary, we presume that Congress wanted the best investments obtainable to be utilized for retirement programs for our citizens. Certainly, current economic conditions require the utmost in flexibility to meet changing circumstances.

We likewise have been unable to find any support for Mr. Chapoton's assertion (on Pages 5 and 6) that the ability to change underlying investments would affect qualification as an "annuity" for tax purposes. Congress had already spoken when it enacted § 1035(a) of the Code which in pertinent part states: No gain or loss shall be recognized on the exchange of—an annuity contract for an annuity contract.

Thus, any annuitant has the ultimate in investment discretion. If he or she does not like the investment orientation of an annuity, it may be exchanged for a different annuity with a different orientation, with no adverse tax ramifications. We believe Congress, by enactment of § 1035(a), has clearly enunciated the policy that investment control is not relevant to qualification as an annuity. Moreover, we cannot believe Congress would ever intend to lock its citizens into a bad investment, particularly one affecting retirement security.

We believe the IRS was right in the over 70 rulings issued for over a decade on the product which was the subject of Rev. Rul. 77-85. We believe the IRS was right when it issued rulings to six insurers on the type of annuity which was the subject of Rev. Rul. 80-274. The knowledgeable experts in tax law who issued such rulings must have believed they were correct! Certainly, the existence of such a long-term

consistent course of action would seem to support our contention that the recent rulings have no basis in law.

We would like to address Mr. Chapoton's arguments (on Pages 6 and 7) that the type of legislation which was the subject of his statement is inappropriate since it "does not purport to change the underlying substantive law." While we are somewhat sympathetic to this view, we cannot avoid the realization that the substantive law does not need changing. It is already clear! It is the illegal interpretation by the IRS which needs changing, not the substantive law. We want the IRS and the Treasury Department to abide by their own regulations which, as previously cited, state that for tax purposes annuities are "those contracts which are considered to be . . . annuity contracts in accordance with the customary practice of life insurance companies. (Treas. Reg. § 1.72-2(a)(1)).

Moreover, one of the insurers which was put out of business by Rev. Rul. 77-85 attempted to seek redress in the Courts. Although it prevailed on the merits, the IRS opposed the issue on jurisdictional grounds, in effect attempting to deny the insurer any legal redress. The Appellate Court determined that such an insurer has no jurisdiction to question the tax status of one of its products. Despite this bizarre decision the Appellate Court did state:

This is not a situation where there are no remedies, however. Congress keeps a watchful eye on developments in the tax field, and will listen to citizens with a grievance or plea.[2]

Deprived of legal review on the merits due to a technicality, the annuity industry has utilized the only other alternative available—to seek legislative redress. The Treasury Department has refused to discuss the matter of the Rulings with the industry.

Moreover, Rev. Rul 80-274 is so broad in scope and so devoid of legal reasoning or argument that it has had a chilling effect on even traditional variable annuities. It is basic that if the IRS can question the qualification of an annuity merely because of its investment orientation, then there is no safe harbor! Some form of underlying investments are an absolute requirement for any annuity and the IRS can destroy an entire product line which it dislikes, despite clear Congressional legislation to the contrary, merely through the use of the artifice that the underlying investments somehow prevent the product from being an "annuity" for tax purposes.

Respectfully submitted,

BLAZZARD, GRODD & HASENAUER, *Counsel.*

THE FOUNDATION PAYOUT RULE—AMERICAN KIDNEY FUND POSITION

Introduction

The American Kidney Fund is a non-profit health agency dedicated to alleviating the financial burdens caused by renal disease, on a nationwide basis. In addition, the Fund works towards the eradication of the causes of kidney damage.

To achieve these goals the American Kidney Fund provides five areas of program services.

1. Direct Patient Aid Program—Provides grants to patients to assist with the expenses associated with renal disease. These expenses are not covered by any other source; including Medicare.
2. Community Service Program—Provides grants for nationwide programs which will service and benefit victims of renal disease.
3. Research Program—Provides limited grants for research of important studies on renal disease.
4. Public and Professional Education Program—Dissiminates information on renal disease, their causes and treatments, to the public. This is achieved via educational brochures and speaking engagements. The professional element of this program sponsors conferences and symposiums, designed to bring professionals together to discuss important developments in nephrology.
5. Kidney Donor Development Program—Distributes thousands of organ donor cards annually, so that more patients on dialysis can receive transplants.

The role of foundation support at American Kidney Fund and the health field

Foundations have played an important role in the field of health care. Grants to the health field have traditionally been second only to education in dollars received. Within the field of health, grants to health agencies were 1 percent of the total

grant dollars in 1978. The health field in general accounts for 21 percent of the total grant dollars from foundations.[1]

Since the American Kidney Fund is a relatively new organization, foundation support has not been a major element of our fund raising efforts. However, foundation support is playing a more significant role, as the financial needs of our programs develop. In the past year foundation grants to our organization have increased 26 percent; from $7,800 in 1979 to $30,300 in 1980. Many of the grants are unrestricted, allowing us to apply the monies in the program areas where they are most needed. Other grants are project specific, designating a specific program to be funded. Without foundation support some program services we provide to needy kidney patients would not be possible.

The role of foundation support to the nonprofit sector

Private philanthropic giving can be broken down into four categories: individuals, bequests, foundations, and corporations. The total dollars and the percentage of totals for the year 1978 are broken down as follows:

Category	Billions	Percent of total
Individuals	$32.80	82.9
Bequests	2.60	6.6
Foundations	2.16	5.5
Corporations	2.00	5.0
Total	39.56	100.0

Source: American Association of Fund Raising Counsel, Inc. Giving USA Annual Report 1979.

For the nonprofit sector as a whole, foundation giving represented 5.5 percent of the total 40 billion of private contributions in 1978.[2] According to the Foundation Center the value of foundation assets in constant dollars dropped 29.5 percent betwwn 1972 and 1977. This translates to a loss of $7.3 billion in assets. Although grants during this period were up 33.5 percent in current dollars (from $1.5 billion to $2.1 billion), when factored for inflation, grants have actually dropped 8.2 percent to a level of $1.1 billion.

Although foundations provided only 5.5 percent of the total philanthropic dollars contributed in 1978, foundations play a vital role in fulfilling the needs of society. Their uniqueness lies in their ability to react quickly to social concerns, devise creative ways of dealing with peoples needs and provide "seed money" to fund new approaches to new and old problems.

Foundations can be an alternative to government funding for many organizations. The speed in which foundations reply to grant requests makes them an attractive alternative for organizations with growing programs. With the current trend to cut government spending in areas of social concern, the role of foundation funding is becoming even more vital. In the long-run, maintaining or increasing the role foundations play in philantropic giving, is imperative if projects and programs in the non-profit sector are to be continued.

Support for H.R. 1365/S. 464

With double digit inflation and the current requirement that foundations distribute their entire realized income, the ability of foundations to provide support to needed programs and projects is in jeopardy. If inflation persists, which most economists agree it will, the long-term effect of the current law forces foundations to spend themselves out of existence.

The current payout requirement seems to put foundations in a "Catch 22" situation. Foundations can earn high money income in excess of 5 percent, which, in times of inflation really means they are paying out of capital. Or foundations make investment decisions so as to avoid high money return, which also threatens their existence in the long-run. The consequence of either of these investment policies is a threat to a foundation's ability to provide support for the programs of American Kidney Fund and other health agencies in the future.

[1] The Foundation Center, The Foundation Directory, 7th ed., The Foundation Center, New York, N.Y., 1979 p. XXIII *note This sampling accounts for about 35 percent of all foundations and about 65 percent of all grants of $5,000.00 or more in size. It is felt that this sampling provides an accurate representation of the fields of interest by foundations.

[2] Carol M. Kurzig, Foundation Fundamentals: A Guide For Grantseekers, The Foundation Center, New York, N.Y., 1980, pp. 10–11.

It is our feeling that foundations should be preserved as a resource for the future funding of charitable projects and programs. Due to the adverse impact the current payout rule has on the longevity of foundations, the American Kidney Fund supports H.R. 1364/S. 464. These bills would eliminate the requirements that foundations distribute all realized income in excess of 5 percent. These bills would also insure that foundations will continue to support charitable purposes, since they in no way alter the requirement that foundations must pay a minimum of 5 percent of their asset value.

O