1981–82 MISCELLANEOUS TAX BILLS, VIII

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

ON

S. 531, S. 805, S. 1214, S. 1304, S. 1320, AND S. 1369

JULY 24, 1981

Printed for the use of the Committee on Finance

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1981-82 MISCELLANEOUS TAX BILLS VIII

FRIDAY, JULY 24, 1981

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

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2221, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood, Durenberger, and Matsunaga.

[Committee press releases, the bills S. 531, S. 805, S. 1214, S. 1304, S. 1320, and S. 1369 and a joint committee discription of these bills follow:]

Press Release No. 81-153

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

FOR IMMEDIATE RELEASE
July 13, 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 FIVE 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 July 24, 1981, on five miscellaneous tax bills.

The hearing will begin at 9:30 a.m. in Room 2221 of the Dirksen Senate Office Building.

The following legislative proposals will be considered at the hearing:

S. 805--Introduced by Senators Durenberger and Mitchell. Would extend the exemption from taxation to dividends received by life insurance companies from subsidiaries.

S. 1214--Introduced by Senator Boschwitz and others. Would repeal the limitation on deduction of investment interest.

S. 1304--Introduced by Senator Chafee and others. Would extend the rules governing regulated investment companies to certain business development companies.

S. 1320--Introduced by Senator Heinz. Would apply the excise tax on trucks and certain truck tires on the sale to the ultimate consumer and provide new rules for the computation of the tax basis.

S. 1369--Introduced by Senator Huddleston. Would eliminate the withholding tax on certain gambling winnings.

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 noon on Monday, July 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 a 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 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) All witnesses must submit written statements of their testimony.

(2) The written statement must be typed on letter-size paper (not legal size) and at least 100 copies must be delivered not later than noon on Thursday, July 23, 1981.

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

(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 of the hearing. 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 Friday, August 7, 1981. On the first page of your written statement please indicate the date and subject of the hearing.

P.R.#81-153

Press Release No. 81-155

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

FOR IMMEDIATE RELEASE
July 21, 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
INCLUDES ADDITIONAL BILL
IN 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 an additional bill will be considered at the Subcommittee's hearing on miscellaneous tax bills scheduled for July 24, 1981.

In addition to bills already scheduled for consideration at the hearing, the following legislative proposal will be considered:

S. 531--Introduced by Senator Heflin. Would provide for a tax credit for certain expenditures incurred in replacing pecan trees destroyed by Hurricane Frederick in 1979.

Written statements--Witnesses who desire to make their views on this additional bill known to the Subcommittee are urged to prepare a written statement for submission and inclusion in the printed record of the hearing. 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 Friday, August 7, 1981. On the first page of your written statement please indicate the date and subject of the hearing.

P.R. #81-155

II

97TH CONGRESS
1ST SESSION

S. 531

To provide a credit against Federal income tax for expenses involved in the planting of pecan trees to replace pecan trees destroyed by Hurricane Frederick.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 24 (legislative day, FEBRUARY 16), 1981

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

---

A BILL

To provide a credit against Federal income tax for expenses involved in the planting of pecan trees to replace pecan trees destroyed by Hurricane Frederick.

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

SECTION 1. CREDIT AGAINST INCOME TAX FOR PLANTING OF CERTAIN PECAN TREES.

(a) ALLOWANCE OF CREDIT.—That notwithstanding any other provision of law, there shall be allowed as a credit against the tax imposed by chapter 1 of the Internal Revenue Code of 1954 an amount equal to the product of—

(1) $10, multiplied by

(2) the number of pecan trees planted by the taxpayer to replace pecan trees destroyed by Hurricane Frederick during September 1979.

(b) LIMITATIONS BASED ON AMOUNT OF TAX.—

(1) IN GENERAL.—The credit allowed by subsection (a) for a taxable year shall not exceed the tax imposed by chapter 1 of such Code for such taxable year, reduced by the sum of the credits allowable under subpart A of part IV of subchapter A of chapter 1 of such Code, other than the credits allowable under sections 31, 39, and 43 of such Code. For purposes of the preceding sentence, the term "tax imposed by chapter 1 of such Code" shall not include any tax treated as not imposed by chapter 1 of such Code under the last sentence of section 53(a).

(2) CARRYOVER OF CREDIT.—If the credit allowable under subsection (a) for any taxable year exceeds the limitation under paragraph (1), such excess shall be carried forward to the succeeding taxable year and added to the credit allowable under subsection (a) for such succeeding taxable year.

SEC. 2. EFFECTIVE DATE.

(a) IN GENERAL.—The provisions of this Act shall apply to taxable years beginning after December 31, 1980, and before January 1, 1986.

(b) PRE-1981 EXPENDITURES ALLOWED FOR 1981.—In the case of the taxpayer's first taxable year beginning after December 31, 1980, this Act shall be applied by taking into account the period beginning on August 31, 1979, and ending on the last day of such first taxable year.

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II

97TH CONGRESS
1ST SESSION

S. 805

To amend the Internal Revenue Code of 1954 relating to certain dividends received by life insurance companies.

IN THE SENATE OF THE UNITED STATES

MARCH 26 (legislative day, FEBRUARY 16), 1981

Mr. DURENBERGER (for himself and Mr. MITCHELL) 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 relating to certain dividends received by life insurance companies.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) the second sentence of paragraph (1) of subsection (a) of section 804 of the Internal Revenue Code of 1954 (relating to exclusion of policyholders' share of investment yield) is amended to read as follows: "For purposes of the preceding sentence, the policyholders' share of any item shall be that percentage obtained by dividing the policy and other contract liability requirements by the sum of the investment yield and any dividends excluded from gross investment income under subsection (b); except that if the policy and other contract liability requirements exceed the sum of the investment yield and any dividends excluded from gross income under subsection (b), then the policyholders' share of any item shall be 100 percent.".

(b) Subsection (b) of section 804 of the Internal Revenue Code of 1954 (relating to gross investment income) is amended by adding at the end thereof the following new sentence: "For purposes of this subsection, dividends shall not include qualifying dividends (as defined in section 243(b) received by an includible corporation within the meaning of section 504(a), as modified by section 243(b)(5).".

(c) Subparagraph (a) of paragraph (2) of subsection (b) of section 805 of the Internal Revenue Code of 1954 (relating to current earnings rate) is amended to read as follows:

"(A) the sum of the taxpayer's investment yield and any dividends excluded from gross investment income under section 804(b) for the taxable year, by".

(d) The second sentence of paragraph (1) of subsection (a) of section 809 of the Internal Revenue Code of 1954 (relating to amount) is amended to read as follows: "For purposes of the preceding sentence, the share of any item set aside for policyholders shall be that percentage obtained by dividing the required interest by the sum of the investment yield and any dividends excluded from gross investment income under section 804(b), except that if the required interest exceeds the sum of the investment yield and any dividends excluded from gross investment income under section 804(b), then the share of any item set aside for policyholders shall be 100 percent.".

(e) The amendments made by this Act shall apply with respect to dividends received in taxable years beginning after December 31, 1980.

O

II

97TH CONGRESS
1ST SESSION

S. 1214

To amend the Internal Revenue Code of 1954 to eliminate the limitation on the interest deduction for interest paid or accrued on investment indebtedness.

IN THE SENATE OF THE UNITED STATES

MAY 18 (legislative day, APRIL 27), 1981

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 to eliminate the limitation on the interest deduction for interest paid or accrued on investment indebtedness.

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

SECTION 1. REPEAL OF LIMITATION ON INTEREST ON INVESTMENT INDEBTEDNESS.

(a) IN GENERAL.—Subsection (d) of section 163 of the Internal Revenue Code of 1954 (relating to limitation on interest on investment indebtedness) is repealed.

(b) CONFORMING AMENDMENTS.—

(1) Subsection (b) of section 703 of such Code (relating to partnership computations) is amended by striking out paragraph (3) and redesignating paragraphs (4) and (5) as paragraphs (3) and (4), respectively.

(2) Paragraph (2) of section 1255(b) of such Code (relating to gain from disposition of section 126 property) is amended by striking out "163(d),".

SEC. 2. EFFECTIVE DATE.

The amendments made by this Act shall apply to taxable years beginning after December 31, 1980.

II

97TH CONGRESS
1ST SESSION

S. 1304

To amend the Internal Revenue Code of 1954 with respect to the tax treatment of business development companies.

IN THE SENATE OF THE UNITED STATES

JUNE 2 (legislative day, JUNE 1), 1981

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

---

A BILL

To amend the Internal Revenue Code of 1954 with respect to the tax treatment of business development companies.

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

(a) IN GENERAL.—Subchapter M (relating to regulated investment companies and real estate investment trusts) of chapter 1 of subtitle A of the Internal Revenue Code of 1954 is amended by adding at the end thereof the following new part:

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"PART IV—PROVISIONS WHICH APPLY TO BUSINESS DEVELOPMENT COMPANIES

"SEC. 860A. TAX TREATMENT OF BUSINESS DEVELOPMENT COMPANIES.

"(a) GENERAL RULE.—Except as otherwise provided in this section, the provisions of parts I and III of this subchapter shall apply to a business development company which would be a regulated investment company but for the requirements of section 851(a). When used other than in this part, the term 'regulated investment company' shall be deemed to include a business development company to which the provisions of parts I and III of this subchapter apply.

"(b) DEFINITION OF BUSINESS DEVELOPMENT COMPANY.—For purposes of this section, the term 'business development company' means any domestic corporation (other than a personal holding company as defined in section 542 without regard to section 542(c)(8))—

"(1) which is a business development company within the meaning of section 2(a)(48) (15 U.S.C. 80a-2(a)(48)) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1—80b-2); or

"(2) which is a small business investment company, licensed before July 1, 1980, under the Small Business Investment Act of 1958, as amended (15 U.S.C. 661-696), or is so licensed on an application filed not more than one month after the date such company is incorporated."

(b) CLERICAL AMENDMENT.—The table of parts for subchapter M of chapter 1 is amended by adding at the end thereof the following new item:

"Part IV. Provisions which apply to business development companies."

(c) EFFECTIVE DATE.—The amendments made by sections (a) and (b) shall apply to taxable years beginning on or after October 21, 1980.

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II

97TH CONGRESS
1ST SESSION

S. 1320

To amend the Internal Revenue Code of 1954 to modify the excise tax on trucks, buses, tractors, etc., and for other purposes.

IN THE SENATE OF THE UNITED STATES

JUNE 3 (legislative day, JUNE 1), 1981

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

---

A BILL

To amend the Internal Revenue Code of 1954 to modify the excise tax on trucks, buses, tractors, etc., and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Motor Vehicle Tax Act of 1981".

SEC. 2. (a) Section 4061 of the Internal Revenue Code of 1954 is amended by inserting the following at the end thereof:

"(c) SALES AFTER ENACTMENT OF MOTOR VEHICLE TAX ACT OF 1981.—The tax imposed by this section shall not apply to articles sold by the manufacturer, producer, or importer after the first day of the first taxable quarter which commences more than 30 days after date of the enactment of the Motor Vehicle Tax Act of 1981."

(b) The chapter heading for chapter 31 of subtitle D of the Internal Revenue Code of 1954 is amended to read as follows:

"CHAPTER 31—RETAILERS EXCISE TAXES"

(c) Chapter 31 of such subtitle D is amended by inserting the following immediately before section 4041:

"Subchapter A—Trucks, Buses, Tractors, Etc.

"SEC. 4001. IMPOSITION OF TAX.

"(a) TRUCKS, BUSES, TRACTORS, ETC.—

"(1) TAX IMPOSED.—There is hereby imposed upon the first sale at retail of the following articles (including in each case parts or accessories therefor sold on or in connection therewith or with the sale thereof) a tax of 10 percent of the wholesale price of the article (determined under subsection (c)), except that on and after October 1, 1984, the rate shall be 5 percent:

"Automobile truck chassis.

"Automobile truck bodies.

"Automobile bus chassis.

"Automobile bus bodies.

"Truck and bus trailer and semitrailer chassis.

"Truck and bus trailer and semitrailer bodies.

"Tractors of the kind chiefly used for highway transportation in combination with a trailer or semitrailer.

A sale of an automobile truck, bus, truck, or bus trailer or semitrailer shall, for the purposes of this subsection, be considered to be a sale of a chassis and of a body enumerated in this subsection.

"(2) EXCLUSION FOR LIGHT-DUTY TRUCKS, ETC.—The tax imposed by paragraph (1) shall not apply to a sale of the following articles suitable for use with a vehicle having a gross vehicle weight of 10,000 pounds or less (as determined under regulations prescribed by the Secretary)—

"Automobile truck chassis.

"Automobile truck bodies.

"Automobile bus chassis.

"Automobile bus bodies.

"Truck trailer and semitrailer chassis and bodies, suitable for use with a trailer or semitrailer having a gross vehicle weight of 10,000 pounds or less (as so determined).

"(b) PARTS AND ACCESSORIES.—

"(1) Except as provided in paragraph (2), there is hereby imposed upon the first retail sale of parts or accessories (other than tires and inner tubes) for any of the articles enumerated in subsection (a)(1) a tax equivalent to 8 percent of the wholesale price of the article (determined under subsection (c)), except that on and after October 1, 1984, the rate shall be 5 percent.

"(2) No tax shall be imposed under this subsection upon any part or accessory which is suitable for use (and ordinarily is used) on or in connection with, or as a component part of, any chassis or body for a passenger automobile, any chassis or body for a trailer or semitrailer suitable for use in connection with a passenger automobile, or a house trailer.

"(c) WHOLESALE PRICE.—For purposes of the tax imposed under this section—

"(1) the wholesale price of an article taxable under subsection (a) shall be deemed to be 90 percent of the actual retail selling price of such article; and

"(2) the wholesale price of an article taxable under subsection (b) shall be deemed to be 75 percent of the actual retail selling price of such article.

"SEC. 4002. ARTICLES CLASSIFIED AS PARTS.

"For the purposes of section 4001, spark plugs, storage batteries, leaf springs, coils, timers, and tire chains, which are suitable for use on or in connection with, or as component parts of, any of the articles enumerated in section 4001(a), shall be considered parts or accessories for such articles, whether or not primarily adapted for such use.

"SEC. 4003. EXEMPTIONS.

"(a) SPECIFIED ARTICLES.—The tax imposed under section 4001 shall not apply in the case of any article specified in section 4063(a).

"(b) EXEMPT PARTS.—Under regulations prescribed by the Secretary—

"(1) the tax imposed under section 4001(b) shall not apply in the case of rebuilt parts or accessories; and

"(2) the tax imposed by section 4001(b) shall not apply to the sale of any article on or in connection with the sale of a light-duty truck as described in section 4001(a)(2) or which is sold for use by the purchaser on or in connection with an automobile bus.

"(c) ARTICLES TAXED UNDER MANUFACTURERS EXCISE TAX.—The tax imposed under section 4001 shall not apply in the case of any article on which a tax was paid under section 4061, as determined under regulations prescribed by the Secretary. Such regulations shall specify methods for identifying the articles which are exempt under this subsection and may include methods for apportioning inventory between articles which are exempt and articles which are not exempt.

"SEC. 4004. DETERMINATION OF PRICE.

"(a) CONTAINERS, PACKING, AND TRANSPORTATION CHARGES.—In determining, for the purposes of section 4001(c), the actual retail selling price for which an article is sold, there shall be included any charge for coverings and containers of whatever nature, and any charge incident to placing the article in condition packed ready for shipment, but there shall be excluded the amount of tax imposed by this subchapter, whether or not stated as a separate charge. A transportation, delivery, insurance, installation, or other charge (not required by the foregoing sentence to be included) shall be excluded from the price only if the amount thereof is established to the satisfaction of the Secretary in accordance with the regulations. There shall also be excluded, if stated as a separate charge, the amount of any retail sales tax imposed by any State or political subdivision thereof, or the

District of Columbia, whether the liability for such tax is imposed on the vendor or the vendee.

"(b) CONSTRUCTIVE SALE PRICE.—If an article is—

"(1) sold on consignment, or

"(2) sold (otherwise than through an arm's length transaction) at less than the fair market price,

the actual retail selling price for purposes of section 4001(c) shall be computed on the basis of the retail price for which such articles are sold, in the ordinary course of trade as determined by the Secretary.

"(c) LEASES, PARTIAL PAYMENTS, INSTALLMENTS, ETC.—The provisions of section subsections (c), (d), and (f) of section 4216 and subsections (a), (b), (c), (d)(1), and (d)(2) of section 4217 shall apply for purposes of this subchapter in the same manner as such provisions apply for purposes of chapter 32.

"SEC. 4005. USE CONSIDERED SALE.

"If any manufacturer, producer, or importer uses an article (otherwise than as material in the manufacture or production of, or as a component part of, another article taxable under this subchapter), then he shall be liable for tax under this subchapter in the same manner as if such article were sold at retail by him. In any such case, the actual retail selling price for purposes of section 4001(c) shall be computed on the basis of the price at which such or similar articles are sold at retail in the ordinary course of trade, as determined by the Secretary.

"SEC. 4006. CERTAIN TAX FREE SALES.

"(a) GENERAL RULE.—Under regulations prescribed by the Secretary, no tax shall be imposed under section 4001 on the sales of an article—

"(1) for export,

"(2) to a State or local government for the exclusive use of a State or local government, or

"(3) to a nonprofit educational organization for its exclusive use,

but only if such exportation or use is to occur before any other use.

"(b) PROOF OF EXPORT.—Where an article has been sold free of tax under subsection (a) for export, or for resale by the purchaser to a second purchaser for export, subsection (a) shall cease to apply in respect of such sale of such article unless, within the 6-month period which begins on the date of the sale (or, if earlier, on the date of shipment), the seller receives proof that the article has been exported.

"(c) DEFINITIONS.—For purposes of this section—

"(1) The term 'export' includes shipment to a possession of the United States.

"(2) The term 'State or local government' means any State, any political subdivision thereof, or the District of Columbia.

"(3) The term 'nonprofit educational organization' means an educational organization described in section 170(b)(1)(A)(ii) which is exempt from income tax under section 501(a). The term also includes a school operated as an activity of an organization described in section 501(c)(3) which is exempt from income tax under section 501(a), if such school normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

"(d) Retail Seller Relieved From Liability in Certain Cases.—In the case of any article sold free of tax under this section (other than a sale to which subsection (b) applies), if the retail seller in good faith accepts a certification by the purchaser that the article will be used in accordance with the applicable provisions of law, no tax shall thereafter be imposed under this subchapter in respect of such sale by such retail seller.

"SEC. 4007. REGISTRATION.

"(a) General Rule.—Except as provided in subsection (b), section 4006 shall not apply with respect to the sale of any article unless the retail seller, the first purchaser, and the second purchaser (if any) are all registered under this section. Registration under this section shall be made at such time, in such manner and form, and subject to such terms and conditions, as the Secretary may by regulations prescribe. A registration under this section may be used only in accordance with regulations prescribed under this section.

"(b) EXCEPTIONS.—

"(1) Subsection (a) shall not apply to any State or local government in connection with the purchase by it of any article if such State or local government complies with such regulations relating to the use of exemption certificates in lieu of registration as the Secretary shall prescribe to carry out the purpose of this section.

"(2) Subject to such regulations as the Secretary may prescribe for the purpose of this section, in the case of any sale or resale for export, the Secretary may relieve the purchaser or the second purchaser, or both, from the requirement of registering under this section.

"(3) Subparagraph (a) shall apply to purchases and sales by the United States only to the extent provided by regulations prescribed by the Secretary.

"(4) The provisions of this section may be extended to and made applicable with respect to, the exemptions provided by section 4003(a) and section 4003(b)(2) to the extent provided by regulations prescribed by the Secretary.

"Subchapter B—Special Rules."

(c) Section 4221(e) of such Code is amended by adding the following new paragraph at the end thereof:

"(7) TIRES AND TUBES SOLD FOR USE ON VEHICLES TAXABLE UNDER SECTION 4001.—Under regulations prescribed by the Secretary, the taxes imposed under section 4071 shall not apply to any article which is sold for use by the purchaser, or by any subsequent purchaser, on any article described in section 4001(a)(1)."

(d)(1) Paragraph (1) of section 6412(a) of such Code (relating to floor stocks refunds) is amended—

(A) by striking out "4061(a)(1),"; and

(B) by striking out "TRUCKS, TIRES" in the paragraph heading and inserting in lieu thereof "TIRES".

(2) Section 6412(c) of such Code is amended by striking out "4061, 4071," and inserting in lieu thereof "4071".

(e)(1) Section 6416 of such Code is amended by striking out "chapter 31 (special fuels)" in paragraph (1) of subsection (a) and substituting "chapter 31 (retailer's excise taxes)".

(2) Section 6416(b)(1) of such Code is amended by inserting "or by section 4001" after "by chapter 32".

(3) Section 6416(b)(2) of such Code is amended by adding the following at the end thereof: "The tax paid by a retail seller under section 4001 in respect of any article shall be deemed an overpayment if the tax did not apply to such article by reason of section 4003 or if such article was sold free of tax by reason of section 4006.

(4) Section 6416(h) is amended by inserting "(or the retail seller in the case of the tax imposed under section 4001)" before "may be identified" and by inserting "(or under section 4001)" after "under chapter 32".

(f)(1) Section 209(c)(1) of the Highway Revenue Act of 1956 is amended by—

(A) inserting "and under section 4001(a)(1) (retailer's excise tax on trucks, buses, etc.)" before the semicolon at the end of subparagraph (C); and

(B) inserting "and 4001(b)" after "4061(b)" in subparagraph (H).

(2) Section 209(c)(3) of such Act is amended by—

(A) striking out "4061(b)" and substituting "4001(b)" in subparagraph (A); and

(B) striking out "4061" and substituting "9001" in subparagraph (B).

(3) Paragraph (4) of section 409(f) of such Act is amended by striking out subparagraph (A) and by redesignating subparagraphs (B) and (C) as subpargraphs (A) and (B), respectively.

SEC. 3. The amendments made by section 2 of this Act shall take effect on the first day of the first taxable quarter which commences more than 30 days after date of the enactment of this Act.

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II

97TH CONGRESS
1ST SESSION

S. 1369

To amend the Internal Revenue Code of 1954 to eliminate the withholding of certain gambling winnings.

IN THE SENATE OF THE UNITED STATES

JUNE 15 (legislative day, JUNE 1), 1981

Mr. HUDDLESTON 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 eliminate the withholding of certain gambling winnings.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subsection (q) of section 3402 of the Internal Revenue Code of 1954 (relating to extension of withholding to certain gambling winnings) is hereby repealed.

(b) The amendment made by this Act shall apply to payments of winnings made after the date of enactment of this Act.

84-805 O—81——3

DESCRIPTION OF TAX BILLS

(S. 805, S. 1214, S. 1304, S. 1320, AND S. 1369)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON JULY 24, 1981

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on July 24, 1981, by the Senate Subcommittee on Taxation and Debt Management.

There are six bills scheduled for the hearing: S. 805 (relating to dividends received by life insurance companies), S. 1214 (relating to repeal of the limitation on the deduction of investment interest), S. 1304 (relating to the tax treatment of business development companies), S. 1320 (relating to imposing the excise tax on trucks at the retail level), S. 1369 (relating to elimination of withholding on certain gambling winnings), and S. 531 (relating to an income tax credit for planting of certain pecan trees).

The first part of the pamphlet is a summary of the bills. This is followed by a more detailed description of the bills, including present law, issues, an explanation of the provisions of the bills, and effective dates. The estimated revenue effects are not yet available.

I. SUMMARY

1. S. 806—Senators Durenberger and Mitchell

Dividends Received by Life Insurance Companies

Under present law, certain dividends from subsidiary members of an affiliated group of corporations may be fully deducted from income by the member corporation receiving the dividend. Otherwise, 85 percent of dividends received by one corporation from another may be deducted (Code sec. 243). Life insurance companies are taxed on that portion of the company's investment income not allocated to policyholders. Dividends constitute investment income subject to this allocation and the company is entitled to a dividend received deduction with respect to that portion of dividends included in taxable investment income (Code secs. 804 and 809).

Under the bill, dividends from a subsidiary corporation received by a life insurance company that are eligible for the 100-percent dividend received deduction would not be subject to the allocation applied to other investment income and would be fully deductible. The amendment would apply to dividends received after December 31, 1980.

2. S. 1214—Senator Boschwitz

Repeal of Limitation on Interest on Investment Indebtedness

Under present law, interest paid or incurred with respect to property held for investment generally may be deducted only to the extent of net investment income plus $10,000 of other income. Net investment income in general consists of income from interest, dividends, rents, royalties, and short-term capital gain from the disposition of investment property, less expenses connected with the production of investment income (Code sec. 163(d)).

The bill would repeal the limitation on the deductibility of investment interest, effective for taxable years beginning after December 31, 1980.

3. S. 1304—Senators Chafee, Durenberger, Sarbanes, and Baucus

Tax Treatment of Business Development Companies

Under present law, regulated investment companies are permitted to deduct dividends paid to their shareholders if they satisfy certain statutory requirements. In general, to qualify as a regulated investment company, a corporation must register under the Investment Company Act, derive its income from dividends, interest and the sale of stocks and securities, and meet certain investment diversification requirements.

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In order to register under the Investment Company Act, a corporation must have more than 100 shareholders or must be making or presently proposing to make a public offering.

Under the Small Business Incentive Act of 1980 (P.L. 96–477), certain investment companies providing capital and managerial assistance to small businesses may elect to be treated as "business development companies" in lieu of registering under the Investment Company Act.

The bill would permit these "business development companies" to qualify for the conduit tax treatment applicable to regulated investment companies. In addition, the bill would permit certain small business investment companies with fewer than 100 shareholders and not proposing to make a public offering to qualify for such treatment. The bill would be applicable to taxable years beginning on or after October 21, 1980.

4. S. 1320—Senator Heinz

Modification of Excise Tax on Trucks and Truck Parts

Under present law, manufacturers excise taxes are imposed at a 10-percent rate on heavy-duty trucks, highway tractors and their related trailers and semitrailers and at an 8-percent rate on truck parts and accessories (Code sec. 4061). A manufacturers excise tax is imposed on tires and tubes (Code sec. 4071).

The bill would impose the excise taxes on heavy-duty trucks, etc., and on truck parts and accessories at the retail level. In addition, the bill would provide for regulations to exclude from the excise tax on tires and tubes articles that are sold for use on trucks, highway tractors and their related trailers and semitrailers. The amendment would apply to sales on and after the first day of the first taxable quarter commencing more than 30 days after enactment.

5. S. 1369—Senator Huddleston

Elimination of Income Tax Withholding on Certain Gambling Winnings

Under present law, proceeds from certain wagers are subject to withholding at a 20-percent rate. Withholding is not imposed with respect to winnings from slot machines, keno, or bingo, and winnings subject to withholding generally must exceed $1,000 and be 300 times the amount wagered (Code sec. 3402(q)).

The bill would repeal the provision for withholding on gambling winnings. It would apply to amounts won after the date of enactment.

6. S. 531—Senator Heflin

Tax Credit for Planting of Certain Pecan Trees

Present law allows taxpayers to take deductions for uninsured business losses and for certain uninsured casualty losses. In general, this deduction cannot exceed the adjusted basis of the property destroyed.

In addition, capital costs incurred in bringing fruit-bearing trees to the income-producing stage have been held to qualify for the investment tax credit.

The bill would provide a $10-per-tree tax credit for planting pecan trees to replace pecan trees that were destroyed, in September 1979, by Hurrican Frederick. The credit would be available for planting expenses incurred after August 31, 1979.

II. DESCRIPTION OF BILLS

1. S. 805—Senators Durenberger and Mitchell

Dividends Received by Life Insurance Companies

Present law

Intercorporate dividends

Under present law, a dividend received by a corporation is generally includible in gross income, but the recipient corporation generally is allowed a deduction for 85 percent of the dividend. If a corporation which is a member of an affiliated group of corporations[1] receives a dividend from another member of the group, the deduction allowed the recipient generally is increased to 100 percent. A member corporation in an affiliated group is eligible for the 100-percent deduction for dividends received only if the affiliated group so elects and certain other requirements are met.

Investment income received by life insurance companies

Present law relating to life insurance companies applies to both a "stock" company (*i.e.*, a corporation owned by its shareholders) and to a mutual life insurance company (i.e., a company is owned by its policyholders). A life insurance company, whether a stock company or a mutual company, is generally taxed on its income at the regular corporate rates. Because of the nature of life insurance, special rules apply in computing life insurance company taxable income.

A life insurance company's taxable income does not include that percentage of the company's investment yield deemed to be set aside to meet policy and other contract liability requirements for policyholders (the policyholders' share of investment yield). The percentage of the total investment yield which is deemed to be set aside to meet policy and other contract liability requirements is applied to each and every item of investment yield, including a dividend. The remainder of the item of investment yield is the company's shares of the item, and is taken into account in determining life insurance company taxable income.

In the case of a dividend, the 85-percent or 100-percent deduction for dividends received is allowed only for the company's share of the dividend. The remainder of the dividend is excluded from life insurance company taxable income as the policyholders' share of the dividend.

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[1] In general, an affiliated group of corporations includes all corporations connected through stock ownership with a common parent corporation if at least 80 percent of the voting stock of each corporation (other than the parent corporation) is owned by other corporations in the group. For certain of the income tax rules, including the determination of the tax rates applied to the taxable income of each member corporation, an affiliated group of corporations is treated as a single taxpayer.

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Dividends paid by insurance companies

Under present law, a dividend paid by a corporation (including a stock life insurance company) to a shareholder generally is not allowed as a deduction to the corporation and is includible in the gross income of the shareholder, subject to the partial dividends-received exclusion for individuals [2] and the dividends-received deduction for corporations. However, a dividend paid by a life insurance company (whether a stock company or a mutual company) to a policy holder generally is allowed as a deduction, within limits,[3] to the company.

Issue

The issue is whether dividends received by a life insurance company from an affiliated corporation should be allocated solely to the company's share of investment yield and deducted in full, so that other income will be allocated to the excludable policyholders' share of investment yield.

Explanation of the bill

The bill provides that if a life insurance company is entitled to the 100-percent deduction for dividends received, dividends received from affiliated corporations will be allocated solely to the company's share of investment yield. Under present law, the life insurance company would be allowed to deduct the full amount of the dividend in computing taxable income.

Under the bill it is intended that the allocation of such dividends only to the company's share of investment yield generally would have the effect of requiring an offsetting reallocation of other investment yield from the company's share to the policyholders' share of investment yield. Under present law, the investment yield so reallocated to meet policyholder requirements would be excluded from life insurance company taxable income.

Effective date

The bill would be effective for qualifying dividends received from affiliated corporations in taxable years beginning after December 31, 1980.

Revenue effect

The estimate of the revenue effect of the bill is not yet available.

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[2] For 1981 and 1982, individuals may exclude from gross income up to $200 ($400 for a joint return) of dividends and interest income received from domestic sources. After 1982, the exclusion reverts to prior law, under which the exclusion applies only to dividends and is limited to $100 ($200 for a joint return).

[3] The deduction for dividends to policyholders is generally allowed against the excess of the company's gain from operations over its taxable investment income, plus $250,000. Taxable investment income is the company's share of investment yield with certain adjustments.

2. S. 1214—Senator Boschwitz

Repeal of Limitation on Interest on Investment Indebtedness

Present law

In the case of individuals, interest paid or accrued on indebtedness incurred with respect to property held for investment may be deducted only to the extent of the taxpayer's net investment income and certain expenses exceeding rental income from a net lease plus $10,000 of other income ($5,000 in the case of a separate return by a married individual). For this purpose, investment income includes dividends, interest, rents, royalties, and net short-term gain attributable to the disposition of investment property. However, it includes no amount derived from conducting a trade or business. For example, salary income from a closely held corporation is not investment income. Before applying the limitation, investment income must first be reduced by expenses (other than interest) directly connected with its production. Disallowed investment interest is carried forward to succeeding taxable years subject to the limitation on deduction in the carryforward year (Code sec. 163(d)).

The limitation on deducting investment interest was originally enacted in the Tax Reform Act of 1969 in order to prevent mismatching of income and deductions and possible conversion of ordinary income into capital gain. For example, an individual could borrow a substantial amount to purchase stock which returned small current dividends but with potential capital appreciation. Income from the investment was deferred and could later be realized as capital gain when the stock was disposed of. Meanwhile, interest on the indebtedness could be deducted currently to offset salary or other income of the taxpayer.

Issue

The issue is whether the limitation on the deductibility of investment interest should be repealed.

Explanation of the bill

The bill would repeal the limitation on the deduction of investment interest.

Effective date

The repeal would apply to taxable years beginning after December 31, 1980.

Revenue effect

The estimate of the revenue effect of the bill is not yet available.

3. S. 1304—Senators Chafee, Durenberger, Sarbanes, and Baucus

Tax Treatment of Business Development Companies

Present law

A regulated investment company is permitted a deduction for capital gain dividends and ordinary income dividends paid to its shareholders if it meets several tests. Among other requirements, a regulated investment company must be a domestic corporation other than a personal holding company. Moreover, it either must be registered with the Securities and Exchange Commission at all times during the taxable year as a management company or unit investment trust under the Investment Company Act of 1940, or it must be a common trust fund or similar fund which is not included in the term "common trust fund" under the Internal Revenue Code and which is excluded by the Investment Company Act from the definition of investment company (Code sec. 851(a)). In order to register under the Investment Company Act of 1940, a corporation must have at least 100 stockholders or must be making or presently proposing to make a public offering.

Under the Small Business Incentive Act of 1980 (P.L. 96-477), certain investment companies providing capital and managerial assistance to small business may elect to be treated as "business development companies" in lieu of registering under the Investment Company Act.

A small business investment company operating under the Small Business Investment Act of 1958 is eligible to be treated as a regulated investment company if it meets the applicable requirements, including the requirement of registering under the Investment Company Act. Thus, it may qualify as a regulated investment company only if it has more than 100 shareholders or is making or presently proposing to make a public offering.

Issue

The issue is whether the provisions applicable to regulated investment companies should be extended to business development companies without having to meet the requirements of registration, as well as to small business investment companies with fewer than 100 shareholders and not proposing to make a public offering.

Explanation of the bill

Under the bill, a "business development company" (as defined in the bill) would not be prevented from qualifying as a regulated investment company by the fact that the company did not register under the Investment Company Act. The bill defines a "business development company" as a domestic corporation other than a personal holding company that is (i) a "business development company" under the Investment Company Act as amended by the Small Business

Incentive Act of 1980 or (ii) a small business investment company licensed before July 1, 1980 under the Small Business Investment Act of 1958 or licensed on an application filed within one month of its incorporation.

The bill would have two main effects. First, it would enable a company electing to be treated as a "business development company" under the Investment Company Act to qualify as a regulated investment company notwithstanding the fact that it does not register under the Investment Company Act.

Second, it would allow certain small business investment companies to qualify as regulated investment companies notwithstanding that such companies did not register under the Investment Company Act and did not have at least 100 shareholders and were not making or presently proposing to make a public offering.

Effective date

The bill would be effective for taxable years beginning on or after October 21, 1980.

Revenue effect

The estimate of the revenue effect of the bill is not yet available.

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[1] Generally, a closed-end company which has elected to be regulated under the Small Business Investment Incentive Act of 1980.

4. S. 1320—Senator Heinz

Modification of Excise Taxes on Trucks and Truck Parts

Present law

Under present law, an excise tax is imposed on heavy-duty trucks, highway tractors and their related trailers and semitrailers sold by the manufacturer or importer (including parts or accessories sold thereon) (Code sec. 4061(a)(1).[1] The tax is 10 percent (5 percent after September 30, 1984) of the manufacturer's or importer's selling price.

Present law imposes an excise tax on parts and accessories (other than tires and inner tubes) sold by the manufacturer or importer for trucks, highway tractors and their related trailers and semitrailers (Code sec. 4061(b)).[2] The tax is 8 percent (5 percent after September 30, 1984) of the manufacturer's or importer's selling price.

Present law also imposes an excise tax on tires and inner tubes sold by the manufacturer or importer. The amount of tax is 9.75 cents a pound for highway tires (4.875 cents a pound after September 30, 1984), 1 cent a pound for laminated nonhighway tires, 4.875 cents a pound for other nonhighway tires, 5 cents a pound for tread rubber (no tax after September 30, 1984), and 10 cents a pound for inner tubes (9 cents a pound after September 30, 1984) (Code sec. 4071).

The revenues from the excise taxes on trucks, truck parts, and tires, tubes, and tread rubber go into the Highway Trust Fund (through September 30, 1984, under present law).

Issues

The main issues presented by the bill are whether the excise taxes on trucks and truck parts should be changed from a manufacturers excise tax to a retailers excise tax and the related tax administrative and collection issues involved in such a change. Another issue is how, in view of the bill's proposed repeal of any excise tax on tires and tubes, the excise taxes on tires and tubes on trucks should apply.

Explanation of the bill

Tax on trucks and truck parts

Under the bill, the present manufacturers excise tax on heavy-duty trucks, highway tractors and their related trailers and semitrailers would be replaced by a retailers excise tax on those articles. Thus, the tax would be collected when an article is first sold at retail rather than

[1] Trucks having a gross vehicle weight of 10,000 pounds or less are exempt from the tax, as are truck trailers, and semitrailers of such weight (Code sec. 4061(a)(2)).

[2] Parts and accessories are exempted if sold for resale by the purchaser on or in connection with the first retail sale of a light-duty truck (Code sec. 4063(e)).

when sold by the manufacturer. The amount of tax would be 10 percent of 90 percent of the actual retail selling price of an article. Actual retail selling price is defined to include any charge for coverings, containers and packing, and to exclude the amount of this tax, the amount of any State or local retail sales tax (if stated separately), and appropriate charges for transportation, delivery, insurance or installation.

Under the bill, the present manufacturers excise tax on truck parts and accessories would be replaced by a retailers excise tax on those articles. The amount of tax would be 8 percent of 75 percent of the actual retail selling price (determined as in the preceding paragraph) of an article.

The bill would not change the reductions in tax rates which are scheduled for these excise taxes under present law. On and after October 1, 1984, the retailers excise tax on heavy-duty trucks, etc., would be 5 percent of 90 percent of the actual retail selling price, and the retailers excise tax on truck parts and accessories would be 5 percent of 75 percent of the actual retail selling price.

Tax on tires and tubes on trucks

The bill provides for regulations under which the manufacturers excise tax on tires and inner tubes would not apply to any tire or inner tube which is sold for use by the purchaser (or any subsequent purchaser) on a truck, highway tractor or a related trailer or semitrailer.

Effective date

The retailer excise taxes provided by the bill would replace the present manufacturers excise taxes on heavy-duty trucks, etc, and on truck parts and accessories beginning on the first day of the first taxable quarter which commences more than 30 days after the date of enactment.

Exemption of certain tires and inner tubes from the manufacturers excise tax on tires and inner tubes would also take effect on the first day of the first taxable quarter which commences more than 30 days after the date of enactment.

Revenue effect

The estimate of the revenue effect of the bill is not yet available.

5. S. 1369—Mr. Huddleston

Elimination of Income Tax Withholding on Certain Gambling Winnings

Present law

In certain circumstances, proceeds from wagers are subject to income tax withholding at a rate of 20 percent (Code sec. 3402(q)). The general rule is that gambling winnings are subject to withholding if the proceeds exceed $1,000 and are at least 300 times as large as the amount wagered. However, special rules apply to winnings from certain types of wagers.

Proceeds of more than $5,000 from wagers placed with State-conducted lotteries are subject to withholding. In addition, proceeds of more than $1,000 from (1) a wager placed in a sweepstakes, wagering pool, or non-State-conducted lottery, or (2) a wagering transaction in a pari-mutuel pool with respect to horse races, dog races, or jai alai, if the amount of such proceeds is at least 300 times as large as the amount wagered, are subject to withholding.

Withholding is not imposed in the case of winnings from a slot machine, keno, or bingo.

Every person who is to receive a payment of gambling winnings subject to withholding is required to furnish the payor with a statement containing his name, address, and taxpayer identification number. The payor of gambling winnings is required to file Form W-2G (reporting of payment of gambling winnings) with the Internal Revenue Service.

Background

The Tax Reform Act of 1976 required the IRS to report to the House Committee on Ways and Means and the Senate Committee on Finance on the operation of the present reporting system as applied to winnings from keno, bingo, and slot machines, and to make a recommendation whether or not such winnings should be subject to withholding. In a report issued in December 1980 ("Compliance in Reporting Gambling Winnings"), the IRS recommended, among other things, that the existing withholding floors be lowered to $600; that withholding be required on winnings of $1,500 or more from keno: and that withholding be required on winnings of $1,200 or more from bingo and slot machines.

Issue

The issue is whether withholding on gambling winnings should be eliminated.

Explanation of the bill

The bill would repeal the provisions for withholding on gambling winnings.

Effective date

The bill would apply to payments of gambling winnings made after the date of enactment.

Revenue effect

The estimate of the revenue effect of the bill is not yet available.

6. S. 531—Senator Heflin

Tax Credit for Planting of Certain Pecan Trees

Present law

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

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

The Internal Revenue Service has held that the costs of trees and other capital costs incurred in their development become eligible for the investment tax credit when they have reached the income-producing stage.[1]

Issue

The issue is whether taxpayers whose pecan trees were destroyed by Hurricane Frederick, in September 1979, should be given a tax credit for replacing those trees.

Explanation of the bill

The bill would provide taxpayers with a nonrefundable tax credit for expenses involved in the planting of pecan trees for the purpose of replacing pecan trees destroyed in September 1979 by Hurricane Frederick. The amount of the credit would be $10 per pecan tree. Excess credits could be carried forward to succeeding taxable years.

Effective date

The credit generally would be available to taxpayers in taxable years beginning after December 31, 1980, and before January 1, 1986. However, in the case of a taxpayer's first taxable year beginning after December 31, 1980, the credit would be available for expenses incurred after August 31, 1979.

Revenue effect

The estimate of the revenue effect of the bill is not yet available.

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[1] Rev. Rul. 65-104, 1965-1 CB28, as clarified by Rev. Rul. 66-183, 1966-2 CB47.

Senator PACKWOOD (chairman), presiding. The hearing will come to order.

We will take S. 531, first, because Senator Heflin has to testify. We will start with S. 531.

Our first witness will be Hon. Howell Heflin.

Senator.

STATEMENT OF HON. HOWELL HEFLIN, U.S. SENATOR, STATE OF ALABAMA

Senator HEFLIN. Mr. Chairman, I appreciate your placing this on the bill and allowing us to go ahead at this time.

I will try to make our testimony short.

The bill I am in support of here today is simple and straightforward. What this bill would do is to allow a credit against income tax for planting pecan trees in south Alabama and in Mississippi and Florida that were destroyed by Hurricane Frederick, in September 1979.

I am sure, Mr. Chairman, that each member of this committee recalls that the gulf coast was devastated by Hurricane Frederick in September 1979, and one group which was particularly hard hit was the Alabama Pecan Growers.

We have explored all possibilities, but we can find no Federal aid program that will enable this industry to get back on its feet.

Accordingly, during the 96th Congress, I introduced a bill, S. 1900 which would have given special tax relief to all fruit and nut growers who suffered damages because of the whims of nature such as floods, fires, or storms.

At a hearing on this measure, the administration spoke in opposition to it basically because it would impact on the symmetry of the tax code.

Thus, because of this problem and because the cost of the bill at that time was estimated at $20 million, per year, that particular measure did not move forward.

In a spirit of compromise, and to provide at least some measure of relief for these small family businesses, I introduced S. 531, this Congress.

Basically, this bill would allow persons who lost pecan trees, a tax credit of $10 for each tree that was destroyed in the hurricane if a tree was planted by the taxpayer to replace the destroyed tree.

The cost of pecan trees in the market around Mobile, in Florida, and Mississippi, and that area is approximately $10 per tree.

Thus, a $10 tax credit will enable the pecan grower to at least recover the cost of initial planting of the tree. It does not even approach the cost to nurture the tree and bring it into full production which takes a period of 8 to 10 years, but at least it would provide some resources to get the trees in the ground at the earliest possible date.

Last year, fewer than 10 percent of the trees that were destroyed were replaced, primarily because the pecan growers, mostly on small family farms, just don't have the funds to purchase new trees to plant.

I understand that still today, there are fewer than 10 percent of those that have replaced their trees. Only 144,000 trees were destroyed by the hurricane. Even if every single tree was replaced and the tax credit claimed, the maximum amount of tax loss under this measure would be about $1.4 million.

In actuality, I would think it would end up being a maximum loss of tax revenues of under $1 million. Most likely, the actual tax loss will be considerably less, as I said. Thus, it is really not a significant amount of money for the National Treasury to absorb.

The bill is significant, however, in that it may enable the crippled pecan industry of south Alabama and Florida and in Mississippi to get back on its feet and once again to be a tax-producing industry.

Mr. Chairman, I hope that the members of this subcommittee will feel compassion for these small business persons and approve this bill.

I might point out, Mr. Chairman, that at the time of this devastating storm, there was no such thing as crop insurance for pecan growers.

Since newly enacted legislation does bring pecan and other fruit and nut trees under the Federal crop insurance programs, this would be a one-time, nonrecurring disaster.

In the future, insurance will be available to offset these kinds of losses. I might say that there was no insurance on the private sector available or in the public sector available.

Because of this special situation, I believe that special legislation is appropriate and I urge my colleagues to support this bill.

I would like to introduce at this time, Hon. Dan Miller, the president of H. M. Tims Pecan Co. of Mobile. He is a member of the Alabama Pecan Growers Association and a member of the board of the Federated Pecan Growers Association and a member of the board of the Pecan Distributors Association and vice president of the National Pecan Shellers and Processors Association.

He has been in the pecan business for over 18 years. It is a pleasure to present Mr. Miller at this time.

STATEMENT OF DAN MILLER, MEMBER OF THE BOARD OF DIRECTORS, ALABAMA PECAN GROWERS ASSOCIATION, BALDWIN COUNTY, ALA.

Senator PACKWOOD. Mr. Miller, it seems to me you wouldn't have time for anything but pecans if you were involved in all of that.

Let me say this to you and to all of the witnesses. Your statements, in their entirety, will be in the record. We are operating under a 5-minute rule for witnesses. I will say quite honestly to you, unless I hold you to that, we will not finish these hearings before we go off for a series of votes that will probably start around 10:30 to 10:45 and we will not be able to keep anybody here to hear witnesses.

Mr. Miller.

Mr. MILLER. Thank you, Mr. Chairman.

I want to personally thank you too, for allowing us to testify this morning. I think you might find, too, that your constitutents in the filbert industry and the lawland industry in Oregon might be supportive of our bill.

Senator PACKWOOD. They were supportive. They have talked to me about this. We have not had the hurricanes you had, but they realize the same type of a thing could happen to them.

Mr. MILLER. Absolutely. Again, thank you very much.

As Senator Heflin told you, we have submitted a lengthy testimony on February 29, 1980. Mr. Tany Brazil, president of the association at that time, gave that testimony. I have a copy of it that I would like to introduce as part of our testimony today.

Senator PACKWOOD. It will appear in the record.

[Material to be inserted.]

84-805 O—81——4

Statement of Mr. Taney Brazeal

Mr. Chairman, Members of this Committee. On behalf of the Alabama Pecan Growers Association, I thank you for the opportunity to provide testimony calling your attention to certain facts and circumstances relevant to your consideration of Senate Bill 1900.

We call you attention specifically to the plight of the pecan growers of South Alabama, Northwest Florida and the Mississippi Gulf Coast who were wiped out by Hurricane Frederic Sept. 12, 1979. However, this legislation would provide similar relief to owners of fruit and nut trees throughout the country who are subject also to becoming victims of natural disasters.

Ice storms could destroy apples, cherries and peaches in such states as Virginia, North Carolina and Georgia. Windstorms could once again destroy the filbert trees in Oregon as they did in the early 1960's. Hail storms and freezes also bring devastation to growers. The pecan growing industry itself spreads along the Gulf Coast, across the south and into the west and central regions of the nation.

Hurricane Frederic swept across this coastal area at recorded winds of up to 150 miles per hour and although fortunately, the deaths were few the devastation was almost beyond belief. Whereas most hurricanes leave a narrow path of severe destruction in the wake of the eye, Hurricane Frederic's eye was flattened to a width of about 50 miles. Along that broad path from Pensacola, Florida to Pascagoula, Mississippi area, the report was the same--destruction that was soon to be valued in the billions of dollars.

It is expected that when the final figures are in months, and perhaps even several years from now, Hurricane Frederic will prove to be the costliest hurricane in history from the standpoint of property damages and cost of cleanup operations.

The damages throughout the path of Hurricane Frederic were so varied, so severe and, in many cases, so long lasting, that we would not begin to cite them all. Neither do we suggest that it was the pecan growers alone who suffered irreparably from the disaster. However, as we shall point out later in this testimony, the pecan growers are unique in that they suffered so much loss of future production and that they found themselves with no compensation for severe lossess, and no means of replacing them.

The damage to the pecan growing industry was both in terms of the dollar value in the area and also the impact on the individual pecan growers. Alabama is the third largest pecan producing state in the nation and 80% of that production is in South Alabama, primarily Baldwin and Mobile County.

First, let us look at the over all economic impact of Hurricane Frederic on the pecan industry in South Alabama. John Boutwell and J. Lavaughn Johnson, economists with the Alabama Cooperative Extension Service, Auburn University prepared just such an assessment in October 1979. Because this is the major known study of the impact available to us and because we are quoting from it so extensively in this testimony, we are attaching to this statement a copy of the complete report.

Boutwell & Johnson assessed the total direct impact of the loss in the two Alabama counties of Baldwin and Mobile at $36.8 million. They assessed the loss of the 1979 pecan crop alone at more than $10.4 million and the cost of the cleanup operation at $7.9 million. Their assessment of loss in property was $18.5 million a figure we consider to be very conservative since it was based on an average value of only $140 per tree which is a low value.

When the value of the trees was approached using real estate appraisal values, the total loss would be much greater. Using average values cited by Larkin H. Harris, a real estate appraiser, and included in Boutwell-Johnson report, the loss of property would be closer to $40 million. That property loss figure would raise the total direct impact to $58.3 million, a substantial impact in such a small geographical area when it is taken into consideration that the figure is only for one phase of the South Alabama economy.

In addition to the direct impact, Boutwell & Johnson found that the disaster had a number of secondary effects.

Because commercial pecan production requires the use of specialized, expensive machinery and equipment both for maintenance and harvest, there is a secondary economic effect on the machinery industry. Farm machinery dealers in the two counties were averaging sales in pecan equipment of $350,000 per year plus an additional $150,000 a year in repair and maintenance of equipment. They report $300,000 of this business lost in 1979 with little or no market for pecan equipment until production is resumed at the earliest in 1987 and more likely in 1991. This secondary effect is greater for following years because of the trend toward use of modern farm machinery.

Boutwell & Johnson report another loss of some $1.7 million in 1980 to the chemical industry because of the loss of sales in chemical insecticides, fungicides and herbicides. They project that chemical sales to the pecan industry will not reach 1979 levels again until the year 2005. Fertilizer and lime sales are expected to slowly increase but since maximum levels of use do not occur until the tree is 15 yo 20 years old, it will remain at low levels also until 2005.

The other secondary economic effect cited by Boutwell & Johnson is labor. The pecan industry uses two types of labor. Production labor during the growing season was valued at $528,000. Harvest labor estimated at $615,000. "More important than the magnitude of this loss is the sector of the economy that it affects.", they reported. "The majority of this hand labor comes from low-income families. Pecan labor income greatly increases their spendable income during the harvest months. The money they earn is spent quickly so it affects an immediate boost to the local economy."

There is also a very significant secondary effect not included in Boutwell & Johnson report. That is the pecan shelling and processing industry which has built up in Mobile and Baldwin County based on the high quality nut general to this area and the early harvest date along the Gulf Coast. Without the source of supply of nuts on which this growing industry was based, there will be a very high secondary effect on this industry. Although it is too early to project accurately the dollar loss, our discussions with leaders in this industry indicate it will be substantial.

Another example of a tertiary effect will be that on some industries based on the pecan industry which then expanded into related fields. One pecan shelling and processing industry located in Baldwin County primarily because of the pecans. From there, it branched out to include a large business of importation of Brazil nuts through the port of Mobile. Without the pecan basis on which this industry was built, we do not yet know what will happen to the import segment of that operation.

The loss of the 1979 crop valued at $10.4 million is a substantial impact alone. In reaching that figure, Boutwell & Johnson found that farmers had already spent $3 million on the 1979 crop, or a total of about $275 an acre. In arriving at those figures, the Auburn economists took into account such items as depreciation and interest on equipment. They concluded that "out-of-pocket costs are higher".

In making their study to assess the loss, Boutwell & Johnson found that Baldwin and Mobile County pecan farmers in general grow a better variety of pecan than in other areas of Alabama. That, coupled with the fact that their pecan crop generally comes in about two weeks ahead of the rest of the state, accounted for an average price in these two counties that was higher than the rest of the state.

Boutwell & Johnson found that clean up costs alone would reach at least $7.9 million. The cost of the clean up per acre ranged from $300 to $600 and depended on whether trees had to be completly removed or cut back.

As we indicated earlier, the damage to pecan orchards was severe and extensive. How severe? Boutwell & Johnson report that 75% of all the pecan trees in Mobile County and 55% of those in Baldwin County were blown down and completely destroyed. The total acres of pecan trees completely destroyed in both counties was 11,050 acres.

Another 4,500 acres in the two counties was so severely damaged as to require heavy pruning which may or may not save those trees. How successful that operation will be cannot be known for perhaps another five years. The percantage of the pecan orchards severely damaged was 30% in Baldwin County and 15% in Mobile County.

The reason for the difference in severely damaged trees is that higher percentage of the trees in Mobile County were completely destroyed.

Only 10% of the trees in Mobile County and only 15% of those in Baldwin County escaped with minor damage. The acreage involved in minor damage was 800 acres in Mobile County and 1650 acres in Baldwin County.

It is the loss of production from the destroyed pecan trees that reflects so well the real casualty to pecan growers. Boutwell & Johnson assessed that loss in these two counties alone at $110.9 million. That is a very conservative estimate. We believe losses are even higher.

The factor which makes this estimate so conservative is use of 70¢ per pound as the value of lost production for all years from 1980 to 2000. The 70¢ per pound represents the five year average for the Alabama Gulfcoast. However, the 1979 prices had already been fairly well established at 85¢ per pound before the hurricane. The last year that prices in Baldwin and Mobile Counties were as low as 70¢ a pound was 1977. With the prevailing inflation rates, the continually healthy demand for pecans, and the unusually high quality of the Gulfcoast pecans it would be reasonable to expect that the price per pound for nuts would have been far greater in the coming years than the old 1977 price.

By simply applying the 1979 value of 85¢ to the years 1980-1999 with no factor for price increases (assuming that operating costs most likely would also rise proportionately) we arrive at anticipated production loss of $134.6 million.

We have discussed here the damage in terms of dollars and the damage in terms of trees and acres. But the greatest impact is that on the individual farmers. The people.

There is not enough time nor space to cite all of the examples of how this disaster has impacted on individual pecan growers. We would like to mention a few random examples.

Attached to this report is a newspaper report of the damage to the pecan orchard of George B. Klumpp of Baldwin County. Total destruction of four orchards containing more than 1,500 mature trees.

18-A—Press Register Mobile, Sunday, Sept. 16, 1979

EXTENSIVE CROP DAMAGE RECORDED — Hurricane Frederic, which left a path of destruction in Baldwin County Wednesday night, took a high toll on area croplands. Pecan grower George B "Bernie" Klumpp said the high winds totally destroyed his four orchards which contained more than 1,500 mature trees. (Mobile Press Register photo by Graham Heath).

Entire pecan groves were destroyed by Hurricane Frederic. The photograph above from the Mobile Press Register, Sunday, Sept. 16, 1979, only four days after the hurricane, tells the story of the plight of one pecan grower.

Leslie Hatchett of Grand Bay in Mobile County owned 3,500 peca. trees ranging in age from 4 to 100 years. He lost 2,255 trees for a real casualty loss to him of some $755,000.

Another pecan grower in Baldwin County recently told of his plight. "For 29 years I've built up my pecan orchards for me and my children. Now it is all gone. Now I've got nothing and no place to go. I'm forced to abandon our life's program." This pecan farmer does not have the funds to replant. Nor does he have the 10, 15 or 20 years to wait to re-establish production.

The loss has been great for pecan growers of all income groups. An older, black farmer in Baldwin County some years ago proudly planted pecan trees. He described his work to another farmer down the road: "Look there young man. See them trees. Me and my boys set them out straight as can be. That's my retirement. The boys can have the farm but those pecan trees are for me in my old age." Now, most of his pecan trees are down and he has no way to recover that loss nor any income to look forward to in the future. Since planting the pecans for his old age, he has since lost his sight adding to the bleak future for this man who had tried to plan ahead.

It is the cost and difficulty of getting back into production, both in terms of dollars and years, that is a major problem in the seemingly hopeless situation of the pecan growers devastated by Hurricane Frederic. Here we are not talking about one year's cash crop--although that was a $10.5 million loss for 1979 alone. There are several factors at work. They include the cost in time and money to replant and re-establish orchards, the inflation factor along with the growing interest rate which severely affects the pecan growers ability to finance this long term operation, and even the availability of nursery stock to replant even if all the other factors were not present.

Boutwell & Johnson project that even if these difficulties were overcome that it would be the year 2000 before pecan production in these two South Alabama counties again reaches the 12.3 million pounds expected to be harvested in 1979. (Incidentally, the estimate for the 1979 crop destroyed can be considered highly accurate because the full grown nuts were well established on the trees and harvest was only a few weeks away so that growers already knew the expected production.)

Boutwell & Johnson's estimate of the year 2000 to regain production was based 2,500 new plantings in 1979, and 5,000 new plantings in 1980 and 5,000 more in 1981. Based on our observation of planting in 1979 and what we have been told to expect for 1980, we are well behind the projected schedule. We will be well in the 21st Century before pre-hurricane Frederic production is reached again in Baldwin and Mobile Counties.

A pecan is not expected to begin production, according to Boutwell & Johnson, until about the eighth year. Some will require up to the twelfth year before reaching full production. This means that pecan growers must plant, maintain, fertilize, spray and, in general, manage a pecan orchard for from eight to twelve years before they may expect a crop. Not only is that cost high, it represents operating funds which must be financed. It represents, pushing off into unknown economic waters with no reliable charts for inflation or interest rates for the years ahead.

The competition for financing today is, perhaps, the major factor in any business enterprise. With increasing pressures for consumer financing and other relatively short-range financing, the pecan grower is at a disadvantage in the money market place. With prime lending rates as of February 22, 1980 at 16.5%, the future for financing a farming operation which requires eight years to begin production is even more bleak. A rate of 18 to 20 percent on a 90-day charge account, high as that is, is one thing. But 18 to 20% a year for eight years for a pecan grower is economically prohibitive. Given those kinds of expectations, today's Baldwin and Mobile County pecan grower might well have a better chance of striking oil or gas on his land than of establishing a profitable pecan orchard.

Boutwell & Johnson have determined that the delay in planting caused by the lack of available transplants makes the re-establishment of the Gulfcoast pecan industry quite costly. They estimate that replanting of the 144,000 destroyed pecan trees cannot be completed before 1985. In fact, we are running behind that schedule already.

They break down costs into establishment (meaning initial planting, etc.) and annual maintenance until nuts are harvested in year eight following planting. Their projected costs per acre for establishment ranges from $511 per acre for 1979 to $823 an acre for 1984 on close spacing of 32' to 40' and from $374 per acre in 1979 to $728 an acre in 1986 for wide spacing of 30' to 60'. Using wide spacing will require two additional years to replant the same number of trees as close spacing.

Maintenance costs are estimated at from $232 per year per acre for the first year for close spacing to $452 for the eighth year or 1986. For wide spacing, they project maintenance costs per acre of from $153 for 1979 to $298 for 1986. The 1979 costs were derived from actual budgets. Costs for following years include anticipated 10% inflation factor.

Projected costs for Mobile and Baldwin Counties for 1980 to 1986 according to Boutwell & Johnson is $24.4 million to restablish 6,135 acres. That cost includes tree replacement and maintenance to bearing age. At the closer spacing anticipated for re-planting, the 6,135 acres would re-establish the 144,000 trees destroyed in the hurricane.

The economists project an average cost per acre of $3979 and an average cost per tree using 24 trees to the acre spacing of $166 per tree. Again, this is a conservative projection because inflation factors raise the cost per acre each year and if planting does not follow the schedule then total costs will rise. For example, the cost per acre rises for $2516 in 1980 to $4452 by 1986. These costs do not include a charge for land or management.

The projected replacement rate, based on maximum availability, ranges from only 100 acres for 1980 to up to 2100 acres in 1986. Replanting of 100 acres in 1980 means in practical terms, that perhaps one of the many pecan growers in Baldwin and Mobile Counties could find enough transplants to replant. Please note, for example, that in this data updated in January 1980, that they now figure replacement on the basis of only 2400 trees for 1980 instead of the 5,000 estimated in October, 1979. The lack of availability of transplants is a serious factor.

(Please note an apparent discrepancy in the number of trees expected to be replanted in the year 1980. Most tables in the Boutwell & Johnson study set that figure at a high of 5,000. However, Table 11 on Page 25, treats the replanting on a more realistic basis of 2,400 for 1980 based on availability. The reason for the apparent discrepancy is that the authors in January updated that table and it has been substituted in the report for the earlier one. To avoid any more confusion than necessary, we have continued to use his 5,000 tree replanting schedule for all other discussions and tables except for the one recently updated on cost of re-establishment. Note general remarks throughout the testimony calling attention to the fact that planting is not on shcedule.

The plight of the South Alabama pecan farmer today is a hopeless one. No trees, no insurance (none was available), no money to replant, in many cases not enough time left in a person's working years to replant, and not enough nursery trees available if growers could afford them.

As this committee meets today, bulldozers are leveling off pecan orchards, families are thrashing about the problems of what to do. For too many of them, the answer is fast becoming that of selling equipment for whatever they can get out of it. The personal impact not only of the loss but of the question of what to do is also taking its toll. Pecan growing is frequently a family operation that spans two or more generations. The distress of one Baldwin County family is multiplied when the sons, who have been doing the pecan growing, decide to sell out the equipment and give it up and the elderly mother still owns the land tries desperately to hold on.

Pecan growing is very much a family operation. We know that from our first hand personal knowledge of the industry and the statistics reaffirm it as well. In fact, Boutwell & Johnson found that in Mobile County there are more acres in home orchards than in commercial pecan production. The economists found approximately 5,000 acres of orchards were home owned and farmed as compared to 3,000 acres of commercial orchards. The ratio of home owned orchards in Baldwin County was less with 3,000 acres of home owned orchards compared to 8,000 acres of commercially grown pecans. The total acreage for both counties shows a very high percentage of home owned with 8,000 of 19,000 acres or 42% of all acres being home owned. (See Table #1, Page 3, Boutwell & Johnson.)

To understand how that high a percentage could be accurate, one must look to the history of the development of the pecan growing industry in South Alabama. Like many farm products, the pecan began with a few trees and a few farmers. Some of the earliest memories of pecan trees in the

South were as yard trees often refered to as "tax trees" because owners sold part of the product for money to pay their yearly property taxes on the home or farm.. There were still enough pecans left for fruit cakes, the legendary Southern pecan pies, candies, and for just cracking and eating either plain or salted, buttered, and roasted in the skillet.

As the pecan flourished, more trees were planted, first a few at a time and then entire orchards. More pecan trees soon brought the need for modern methods of nut production and with it modern equipment, fertilizer and insecticides. Within a few generations, mostly since the early 1900's a backyard "egg money" type operation evolved into a healthy, growing industry still centered for a large part around the family labor and management but increasingly a commercial operation.

It is precisely that growth as a family operation which accounts for the plight of pecan growers such as the man in Baldwin County discussing his loss with the accountant preparing his 1979 income tax. What basis was in the trees? What did they cost to plant? The answer: "Pappa and Mamma put them out. They bought them for 25¢ a piece and I don't even have a record of that." Provable loss under current tax law? None.

The fact that the pecan growing industry in South Alabama is such a family related business means that the average pecan grower does not have readily available, nor affordable business and tax service. The family operated pecan growing business, like the one in Baldwin County operated by a woman and her two sons, finds itself seeking professional assistance only at tax time. That is usually too late and there is not much that can be done except accurately report what has happened on that farm that year. Tax planning is just not practical. How can a 35 year-old pecan farmer make a wise decision about whether or not to incorporate his business, for example, when grandpa still owns the land and may not have decided just yet who is going to inherit it when he dies?

A home operated industry can be a healthy one. The pecan growers are a fine example. While we continually learn of the general difficulties of the farm econcmy and especially that of family operated crop farming, the pecan grower is an exception. His future in South Alabama was bright when the natural disaster of Hurricane Frederic struck last September.

The pecan grower in general, and, as Boutwell & Johnson pointed out, the grower in Baldwin and Mobile Counties particularly, had a ready market at a favorable price. And if the price was not that favorable, he could put his pecans in cold storage and carry them over to the following year for sale.

The pecan market is highly competitive, it is not influenced by speculation such as trading in other commodities; nor is it influenced by government controls. Pecan production is one of the last free markets.

The pecan grower has been doing well with a good, healthy, growing industry. There have been no surpluses, no set asides, no price supports. Unlike other segements of the agricultural industry, pecan growers have never received any specific federal assistance before Hurricane Frederic. It is with a mixture of pride and despair that we report that pecan growers are today receiving their first benefits from federal assistance--the U.S. Army Corps of Engineers is providing some assistance in removing our destroyed pecan trees--part of their general program of debris removal following Hurricane Frederic.

We are here today to request government assistance because it is so badly needed, because it is fair and equitable and, equally important, because we have no place else to go.

Tax law and regulations to the contrary, the loss to a pecan grower of our pecan trees is a very real loss. It is a loss that can be described in fair market value per pecan tree. We are not proposing any formula for arriving at fair market value nor any conclusions as to what that fair market value would be at this time. It is fairly certain that it would be higher than the average per tree value which Boutwell & Johnson used for the purpose of assessing the total economic impact of the loss of pecan trees during the hurricane.

We suggest that the principle of allowing tax losses which reflect the realities of our economic life is fair and equitable. We remind you that the basis of income taxation is profit and that the practice of deductions for casualty loss is long standing. It is the circumstances of a terrible, natural disaster combined with the complexities of a largely family operated farm industry that has left pecan growers bankrupt and hopeless. We can not help but believe that had anyone been able to foresee this situation that the tax law would have already contained some kind of provisions to recognize real loss.

We respectfully request that this Committee give a favorable report on Senate Bill 1900 and that members urge their colleagues in the Congress to give prompt passage. Relief is needed badly and it is needed now. Other industries, small businesses, and home owners are now well on the way to recovering from the disaster of Hurricane Frederic. They have collected their insurance and are re-building.

Pecan growers, however, are in a state of continuing disaster. We have weathered the shock of seeing thousands of tree years of growth flattened like corn stalks. Now, we are in the midst of the secondary shock of learning that we have no means to rebuild.

Passage of Senate Bill 1900 will do at least two very important things. First, and this is no frivolous argument, it will give hope to the despairing pecan grower. It will give the grower, large and small, at least one substantial straw to grasp.

Secondly, and the matter which with you are primarily concerned, Senate Bill 1900 would allow the pecan grower a casualty loss based on fair makdet value. This loss could be carried backward for up to 10 years and, if necessary, forward for 4 years. Through tax adjustments, arrived at through sound, acceptable means of establishing fair market value, it would be possible for the pecan grower to recoup some taxes in order to form a capital reserve to finance the re-establishment of his orchards.

We realize that we are asking for a departure from the established methods of setting casualty loss at fair market value or cost, whichever is lowest. Why should the pecan grower's trees be established at fair market value when the commercial building, for example, lost in the hurricane is set at cost? The answer is insurance. Rather the lack of it. That is the difference. The building owner has available to him insurance at a reasonable cost to protect him from losses usch as those from Hurricane Frederic. The pecan grower has no such insurance. It is not available.

Because so many pecan growing operations are family operations, they have already been somewhat at a disadvantage under tax regulations in that self-labor is not allowable as an expense and also in that practially no family operations are set up to allow depreciation on the trees. Thus we find an apparently inequitable contrast where the city doctor, lawyer or businessman who several years ago purchased a pecan orchard and set up an advantageous bookkeeping system, has been able to depreciate his trees since owning them and now, with the hurricane, is able to deduct the remaining basis as a casualty loss. Many of those type losses which will show up on 1979 tax returns will, in effect, indicate an individual tree value greater than that suggested by Boutwell & Johnson. The pecan grower, on the other hand, whose orchard is his life's work and his family's bread and butter, can not prove, under present regulations, any loss that approaches the fair and realistic value of what was owned by him and is now destroyed.

Even the individual home owner with a pecan tree as a shade tree in the front yard is in a better position under current tax regulations than the pecan grower. If an appraisal indicates that a home in the city is less valuable after the hurricane and the loss of the pecan tree, he can claim that loss. The home owner's loss will be based on current market values of his property, not on the cost of that shade tree.

Viewed from a simple, common sense approach, the pecan grower is asking for a position under tax laws which will treat his losses as fairly as those of the home owner with a shade tree or the recent purchaser of an established pecan orchard. In the case of the pecan grower, that tax situation will, without a doubt, determine whether or not the pecan industry will survive in South Alabama. It will determine whether or not individual pecan growers will continue at their life's work or be forced off the family farm, along with their employees, and into the open job market to swell the unemployment rolls.

Mr. MILLER. Senator, we are requesting today that your subcommittee approve and recommend the passage of Senate bill 531, by Senator Howell Heflin.

It is very simple. It allows a tax credit of $10 per tree, per each tree, for planting, to replace the pecan trees destroyed by the hurricane.

Let me tell you briefly where the pecan industry was in south Alabama in September 1979, before the hurricane.

In 1979, Alabama was the third largest pecan producing State in the Nation. Some 80 percent of that production was in south Alabama, primarily in the two counties of Baldwin and Mobile.

These two counties lie directly on the Gulf of Mexico and were squarely in the 50-mile wide eye of Hurricane Frederick.

In terms of property damage and clean up cost, Hurricane Frederick was the worst hurricane in American history. It flattened a 50-mile path from Pensacola, Fla., Pascagoula, Miss., with general destruction valued at billions of dollars.

This is what it did to the pecan industry in our two counties. The hurricane blew down and completely destroyed 75 percent of all the pecan trees in Mobile County and 55 percent of those in Baldwin County. More than 11,000 acres of pecan trees were completely destroyed. We lost about 144,000 trees.

Another 30 percent of the pecan trees in Baldwin County and 15 percent in Mobile County were so severely damaged as to require heavy pruning. They have not yet recovered and prospects are not good that they ever will.

Only 10 percent of the trees in Mobile County and 15 percent of those in Baldwin County escaped with minor damage. Most of those were young trees that had not yet reached bearing age.

The loss of the 1979 crop alone was valued at over $10 million.

Using conservative projections of loss of crop production for the remaining producing years of those trees destroyed, Auburn University experts tell us the loss is $110 million. That was figured in 1977 pecan prices. Today the loss would be upward of $134 million.

The cost just to clean up was calculated to be almost $8 million with no salvage value for the trees.

It has been almost 2 years since Hurricane Frederick struck. Many areas of our economy are already back on their feet and fine and thriving.

Our Gulf Beach fronts have been built back bigger and better than ever. Businesses, plants, factories, private homes, and public facilties have practically all been rebuilt.

The pecan grower is the sad exception. We had no insurance on the crop or the trees, because it was not available at that time.

We had no Federal assistance. We had no casualty loss beyond the documented original cost of the tree. Many of these were family operated farms with trees 20 or 30 years old and more, bought at low initial cost, sometimes by fathers and grandfathers, and maintained and managed by the farmer and his family. Of course, that self-labor was not deductible as an operating expense.

While the rest of the economy is on the road to recovery, the pecan grower has a different and worse set of problems.

What makes the pecan grower different from other farmers is the many years he must farm before he has a crop. Most of America's farmers have at least one crop a year and many local farmers get two and three crops. But a pecan grower must wait 8 years or more to reach production from his trees.

This means he must plant, maintain, fertilize, spray, and in general, manage a pecan orchard for 8 to 12 years before he——

Senator PACKWOOD. Mr. Miller, let me encourage you not to read your entire statement. I will put it in the record. But we are going to stick to a 5-minute rule and you have 1 minute now to conclude.

Mr. MILLER. Fine. Thank you very much. I had hoped I would be able to read the testimony in that period of time.

Senator, let me just say that most of our people are family farmers. It affected thousands and thousands of small people from 1 and 2 trees up to 5, 10 and up to 500 acres of pecans.

They simply cannot last as pecan farmers. They cannot replace those trees. They cannot get back in the pecan business without some help. They have no source of income until those trees come into production.

I think we will lose a vital industry if we neglect this segment of the population.

Senator PACKWOOD. Let me ask you one question. I neglected to ask it of my Oregon orchardists when they called in support of this.

Was private crop insurance available?

Mr. MILLER. No, sir.

Senator PACKWOOD. You cannot purchase it.

Mr. MILLER. You cannot purchase it. Could not, at that time.

Senator PACKWOOD. Is it even available now, privately? Mr. Miller. We are working on getting it available, yes sir, through this national organization.

Senator PACKWOOD. Mr. Miller, I think you present a very well-documented case. I had a chance to read your testimony previous to your testifying now. I will do what I can to help.

Thank you very much for coming here.

Mr. MILLER. Thank you.

Senator PACKWOOD. Senator Heflin, thank you for taking the time.

Senator HEFLIN. Thank you.

[Senator Heflin's and Mr. Miller's statements follow:]

PREPARED STATEMENT OF SENATOR HOWELL HEFLIN

Mr. Chairman, the bill I am here in support of today is simple and straightforward. What this bill will do is allow a credit against income tax for planting pecan trees in south Alabama which were destroyed by Hurricane Frederick in September of 1979.

I am sure, Mr. Chairman, that each member of this committee will recall that the Gulf Coast was devastated by Hurricane Frederick in September, 1979, and one group which was particularly hard hit was the Alabama pecan growers. We have explored all the possibilities, but we can find no federal aid programs which will enable this industry to get back on its feet. Accordingly, during the 96th Congress, I introduced a bill, S. 1900, which would give special tax relief to all fruit and nut growers who suffer damage because of the whims of nature, such as floods, fires, or storms. At a hearing on this measure, the Administration spoke in opposition to it, basically because it would impact on the symmetry of the Tax Code. Thus, because of this problem and because the cost of the bill is estimated at $20 million per year, that particular measure did not move forward.

In a spirit of compromise and to provide at least some measure of relief for these small family businesses, I introduced S. 531 this Congress. Basically, my bill would allow persons who lost pecan trees a tax credit of $10 for each tree that was destroyed in the Hurricane if a tree was planted by the taxpayer to replace the destroyed tree. The cost of peacn trees in the market in Mobile today is approximately $10 per tree. Thus, a $10 tax credit will enable the pecan growers at least to recover the cost of initial planting of the tree. It does not even approach the cost to nurture the tree and bring it into full production, which takes a period of 8 to 10 years; but at least it would provide some resources to get the trees in the ground at their earliest possible date.

Last year, fewer than 10 percent of the trees that were destroyed were replaced, primarily because the pecan growers, mostly on small family farms, just don't have the funds to purchase new trees to set out.

Over 144,000 trees were destroyed by the hurricane. Even if every single tree were replaced and the tax credit claimed, the maximum amount of tax loss under this measure would be about $1.4 million. Most likely, the actual tax loss will be considerably less than that; and thus, it is really not a significant an amount of money for the national treasury to absorb. It is significant, however, in that it may enable the crippled pecan industry of South Alabama to get back on its feet and once again to be a tax-producing industry.

Mr. Chairman, I hope that the members of this subcommittee will feel compassion for these small businessmen and approve this bill.

I might point out, Mr. Chairman, that at the time of this devastating storm, there was no such thing as crop insurance for pecan growers. Since newly enacted legislation does bring pecan and other fruit and nut trees under the Federal Crop Insurance programs, this should be a one-time, nonrecurring disaster. In the future, insurance will be available to offset these kinds of losses. Because this is a special situation, I think that special legislation is appropriate, and I urge my colleagues to support this bill.

Statement of Dan Miller, Member of the Board of Directors, Alabama Pecan Growers Association

Mr. Chairman, members of the committee, my name is Dan Miller. My place of business is in Mobile, Mobile County, Ala. and I am a resident of Baldwin County, Ala. I am a member of the board of directors of the Alabama Pecan Growers Association and am representing them today in support of Senate bill 531.

We are here to ask your help to relieve a very unique and bad situation peculiar to the pecan growers of the two Gulf Coast counties of Alabama which were devastated by Hurricane Frederick in September 1979.

This same Subcommittee on February 29, 1980 heard testimony from Alabama Pecan Growers and others on a more far reaching measure, Senate Bill 1900.

At that time Mr. Taney Brazeal, president of the Alabama Pecan Growers Association, submitted a lengthy written statement with photographs and a special report from Auburn University. That information documented the economic impact of Hurricane Frederick on the pecan industry in these two counties.

I have here a copy of that testimony before this Subcommittee and with your permission I will incorporate it by reference in our testimony here today. With your permission I will also incorporate a followup statement by Mr. Brazeal to this Subcommittee March 12, 1980.

That testimony in 1980 includes far reaching and detailed data on the need for tax relief.

We are requesting today that your Subcommittee approve and recommend the passage of Senate Bill 531 by Senator Howell Heflin. This bill is very simple. It allows a tax credit of $10 for each pecan tree planted to replace pecan trees completely destroyed by Hurricane Frederick.

Let me tell you briefly where the pecan industry was in South Alabama in September 1979, the destruction by Hurricane Frederick, the cost in time and money to replant and where we are today. I will also call to the attention of this Subcommittee ways in which the pecan industry is different from other farming operations.

In September 1979 Alabama was the third largest pecan producing state in the nation. Some 80 percent of that production was in South Alabama primarily in Baldwin and Mobile Counties. These two counties lie directly on the Gulf of Mexico and were squarely in the 50-mile wide eye of Hurricane Frederick.

In terms of property damage and cleanup costs, Hurricane Frederick, was the worse hurricane in American history. It flattened a 50-mile path from Pensacola, Fla. to Pascagoula, Miss. with general destruction valued at billions of dollars.

This is what it did to the pecan industry in our two counties:

The hurricane blew down and completely destroyed 75 percent of all the pecan trees in Mobile County and 55 percent of all those in Baldwin County.

More than 11,000 acres of pecan trees were completely destroyed.

We lost 144,000 trees.

Another 30 percent of the pecan trees in Baldwin County and 15 percent in Mobile County were so severely damaged as to require heavy pruning. They have not yet recovered and prospects are not good that they ever will.

Only 10 percent of the trees in Mobile County and only 15 percent of those in Baldwin County escaped with minor damage. Most of those were young trees that had not yet reached bearing age.

The loss of the 1979 crop alone was valued at $10.4 million.

Using conservative projections of loss of crop production for the remaining producing years of the 144,000 destroyed trees, Auburn University experts tell us the loss is $110.9 million. That was figures at 1977 pecan prices. Figured at 1979 prices the loss goes up to $134.6 million.

The cost just to clean up was calculated to be $7.9 million with no salvage value for the trees to offset it.

It has been almost two years since Hurricane Frederick struck. Many areas of our economy are already back on their feet and thriving. Our Gulf beach fronts have been built back better and bigger than ever. Businesses, plants, factories, private homes and public facilities have practically all been rebuilt.

The pecan grower is the sad exception.

The pecan grower had no insurance on his crop or his trees because it was not available.

The pecan grower had no federal assistance.

He had no casualty loss beyond the documented original cost of the tree. Many were family operated farms with trees 20 or 30 years old bought at low initial costs and maintained and managed by the farmer and his family. And of course that self labor was not deductible as an operating expense.

While the rest of our economy is on the road to recovery after Hurricane Frederick, the pecan grower has a different and worse set of problems.

What makes the pecan grower different from other farmers is the many years he must farm before he has a crop. Most of America's farmers have at least one crop a year and many of our local farmers get two and three crops per year off the same field.

A pecan grower must wait at least eight years and often as many as twelve before his new tree reaches full production. This means that a pecan grower must plant, maintain, fertilize, spray and, in general, manage a pecan orchard for from 8 to 12 years before he may start bringing in an income. Not only is the annual cost high, and rising, it also represents operation funds which must be financed.

It is that financing—its cost and the competition for loans—that is a major factor in any business enterprise. With the increasing pressures for consumer financing and short-range commercial financing, the pecan grower is at a severe disadvantage in the money market place.

All these factors leave a pecan grower with no funds to replant and no incentive.

Today, only an estimated 10 percent of the pecan trees lost to Hurricane Frederick have been replanted.

Pecan growers badly need the incentive and economic help which would be provided by Senate Bill 531.

Our testimony of a year ago discusses in full some of the secondary effects of the pecan loss. Those are to the farm machinery equipment dealers, fertilizer and chemical sales, labor. One of the hardest high secondary areas was that of the pecan shelling and processing industry. My own family business is that of nut processing and the effect has been severely felt.

Who are these pecan growers?

For the most part they are family farmers. I can tell you that from my first hand knowledge of the industry and from the statistics. Boutwell and Johnson in their Auburn University study, which you have, found that in Mobile County there were more acres in home orchards than in commercial pecan production. Mobile County had about 5,000 acres of family owned orchards as compared to about 3,000 acres of commercial orchards. Nearly half of the acres in pecan trees in our two counties were by family farmers.

Pecan production in the South began as yard trees often referred to as "tax trees" because owners sold part of the pecan crop for money to pay annual property taxes. That was true not only of farmers but other rural and small town home owners. After taxes there were still enough peacans left for the legendary Southern pecan pies, fruit cakes, cookies, candies and just cracking and eating.

It is because the pecan growing industry is a family related business that the average pecan grower does not have the funds to plant back.

The terrible plight of the pecan grower has been brought on by Hurricane Frederick. Before then he had a ready market at a favorable price and was part of a healthy, growing industry.

We ask this Subcommittee and the Congress for its support of Senate Bill 531 realizing that for the pecan grower, the way back is still a long and expensive journey even with the $10 tax credit.

The $10 tax credit is only the cost of the tree itself. That is all. Boutwell and Johnson calculate that it will cost an average of $166 per tree to reestablish the trees destroyed by the hurricane. That is not counting the cost of the land or of management.

They estimate it might be 1987 or 1988 before the trees could all be replanted and that it will be well into the next century before pecan production in our two counties again reaches the 12.3 million pounds of the 1979 crop which was destroyed.

We are appealing to the members of this Subcommittee to give a favorable recommendation to Senate Bill 531 because it will at least give an incentive to pecan growers to start replanting.

We are not asking this committee or the Congress to remove the risk the pecan grower shares with every other farmer. The pecan grower has no set asides, no subsidies, no government controls, no price supports. Ours is one of the last free markets and we are proud of it.

What we are asking is that the concept of a tax credit which is so widely applied in general commerce be allowed in this one instance of an unusual kind of agriculture enterprise.

If it is equitable to allow tax credits for short term new construction, leasehold improvements and purchases of new equipment, just to mention a few instances, then certainly it is equitable to allow a $10 tax credit for a pecan tree which reaches its greatest productive value when it is between 30 and 40 years old. Some of the producing pecan trees destroyed by Hurricane Frederick were well over 50 years old.

That short range cost in terms of lost tax dollars to the U.S. Treasury would probably be less than $1 million over 5 years and might well average only about $250,000 a year. If we were to assume that each and every one of the estimated 144,000 destroyed trees was replanted, the cost would be only $1.4 million. In fact, there will be fewer trees planted back, even with the tax credit, because too few pecan growers have 20 years of their life left to put into developing a new orchard.

After the trees reach bearing age, the short term tax loss to the U.S. Treasury will be overcome by the increase in income tax revenues on the profits earned by these pecan growers.

Meanwhile, even before the trees reach bearing age, the economic impact of the new activities involved in their replanting, fertilizing, spraying and other maintenance, will result in additional tax revenues offsetting the tax credits.

There is an additional benefit to the entire national economy which we respectfully ask this Committee to consider. That is the benefit of providing incentives to small, family farmers to stay on their land and keep producing incomes for themselves and stimulating the local farm economy.

The trend toward urbanization in this country has reached a point of rapidly diminishing returns. There are no jobs in the nation's cities for the small farmer forced off his land whether by a devastating hurricane or by the expenses and complexities of the changing agriculture industry.

Today the problems of unemployment are greater, more complex and more difficult to solve than at any time in the last 50 years. The experiences of the federal government and our state governments have demonstrated how very costly and near impossible it is to solve the pyramiding problems of the unemployed person once that job is lost.

We are urging this Committee to recommend Senate Bill 531 as a sensible, positive means of preventing the unemployment problems which will be created when these small farmers are forced to leave their land.

Pecan growers wiped out by Hurricane Frederick have not planted back. We can not afford to. We have no incentive. But we have not yet given up hope.

We are looking to the Congress for some small act of assistance to aid us in recovering from this terrible natural disaster. Through the U.S. Army Corps of Engineers, the federal government spent more than $100 million just to clean up the debris left by Hurricane Frederick.

We are asking for a very small portion of that amount—no more than $1 million in tax credits—to replant, rebuild our pecan orchards and keep Alabama pecan growers working productively on our own land.

We urge members of this Committee to suport Senate Bill 531 for passage during this session of the Congress so that we can begin the 10 year task of rebuilding our pecan industry in South Alabama.

Senator PACKWOOD. Let me move on for just a moment to S. 1304. Senator Boschwitz wants to testify with the panel of S. 1214, and he cannot be here for another 10 minutes.

So let's take S. 1304 now. Is Mr. Little here?

Do you want to come up and testify now and then we will take S. 1214 next when Senator Boschwitz gets here.

STATEMENT OF ARTHUR D. LITTLE, CHAIRMAN, NARRAGANSETT CAPITAL CORP., PROVIDENCE, R.I., ON BEHALF OF THE NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT CO.

Mr. LITTLE. Thank you, Senator. My name is Arthur Little. I am chairman of Narragansett Capital Corp., a small business investment company located in Providence, R.I.

I also happen to be the immediate past president of the National Association of Small Business Investment Companies and a member of that association's board of governors.

I know, because I have testified before you before, sir, that you are familiar with the venture capital industry and all of the good things it does in terms of supplying financing for the growth of smaller businesses and the effects in terms of both innovation and employment and taxes paid that result from that financing.

So, I won't go through all of that.

Senator PACKWOOD. You were very helpful on the stock options provisions. I appreciate your leadership on that.

Mr. LITTLE. Thank you.

Narragansett was licensed as an SBIC in 1958. Since that time, we have financed 124 companies. However, being a publicly owned corporation, our efforts have been severely impeded by regulation and registration under the Investment Company Act of 1940 which is required since we have more than 100 shareholders.

That statute was enacted primarily to regulate mutual funds and was passed way before the organized venture capital industry was formed and 18 years before SBIC's were created, by law.

As a result, Narragansett and many other companies in our industry got caught in a regulatory web that made it very difficult to go about our business.

However, on October 20, of last year, the Small Business Investment Incentive Act was signed into law. This replaced the outmoded 1940 act with a more appropriate form of regulation for venture capital firms. The firms that are affected and in fact were created by the 1980 act are referred to as business development companies.

Although the SBIC industry is generally delighted with the 1980 act, there is one major hurdle to overcome before that legislation is really useful to us. That hurdle involves the subchapter M amendment which is contained in S. 1304.

The problem really is technical and definitional in nature. Business development companies, by electing to be regulated under the 1980 act, rather than under the 1940 act would not be registered under the 1940 act as required for subchapter M pass through status.

For an SBIC to claim its benefits under the securities laws, but then lose its benefits under the tax laws, while still complying with all of the diversification tests of subchapter M, is a result which certainly is not fair and one which we do not believe that Congress intended.

We therefore strongly urge Congress to change this measure and correct the problem.

If the tax code is amended to make it feasible for Narragansett to convert to a business development company status under the 1980 act, we will indeed do so, and as a matter of fact we have already warranted and guaranteed to the SEC that we will make that step.

We have tried to be very careful in working on the language for S. 1304. We retained Earnie Christian, of the firm of Patton, Boggs and Blow, to research the legislative history and make sure that our requests are properly presented.

As a result, I think you can look through the addenda to the testimony that I present and see that we have done this in such a way that we really keep within the intent of the original legislation.

We do not believe that we step in any way on the—on what the IRS wants. We really think it is a very minimal impact on as far as taxes are concerned.

It really is a technical amendment.

Senator PACKWOOD. Thank you. I can corroborate what you say. I recall, when we passed this, what we intended, and your statement is correct.

Mr. LITTLE. Yes.

Senator PACKWOOD. I believe I see Senator Sarbanes here. I think you are here to testify on the same bill, are you not?

Why don't you come up right now and testify and that will conclude then the hearing on this bill.

NASBIC

NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

618 WASHINGTON BUILDING • TELEPHONE (202) 638-3411
WASHINGTON, D. C. 20005

July 24, 1981

STATEMENT OF

ARTHUR D. LITTLE

Before the

SENATE FINANCE COMMITTEE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

on S. 1304

Good morning Mr. Chairman and Members of the Subcommittee:

My name is Arthur D. Little and I am Chairman of Narragansett Capital Corporation, a Small Business Investment Company (SBIC) located in Providence, Rhode Island. I am also the Immediate Past President of the National Association of Small Business Investment Companies and a member of that Association's Board of Governors.

SBICs and BDCs are part of the venture capital industry, which provides funds for new and growing businesses. Often, venture firms provide small firms with significant managerial assistance in addition to dollars. It is estimated by Stanley Pratt, author of the <u>Venture Capital Journal</u>, that the professional venture capital industry is investing funds at a rate of about $1-billion per year. In an effort to quantify the exciting performance of SBIC portfolio companies, our Association undertook a study which was completed in February of last year. As a result of that study, we found that the firms financed by SBICs had growth rates far in excess of all other small businesses and of business in general. These firms grew faster in all of the key economic impact areas, creating more jobs and paying more taxes than other types of businesses. For your review, I am including a summary of that study for insertion into the record.

Narragansett was licensed as an SBIC under the Small Business Investment Act of 1958 on December 11, 1959. Since that time, we have invested in 124 companies. Narragansett Capital Corporation has been a successful venture capital company and I am proud of its performance. However, our efforts have been severly impeded in the past by registration under the Investment Company Act of 1940, which is required since we have more than 100 shareholders. That statute, enacted primarily to regulate mutual funds, was passed before the organized venture capital industry was formed and 18 years before SBICs were created by law. As a result, Narragansett was caught in a regulatory web that made it extremely difficult to go about our business. On October 20 of last year, the Small Business Investment Incentive Act was signed into law, replacing the outmoded 1940 Act with a lighter and more carefully tailored scheme of regulation for venture capital firms. The firms affected by the 1980 Act are referred to as Business Development Companies.

Although the SBIC industry is generally delighted with the 1980 Act, there is one major hurdle to overcome before the legislation can be generally useful. That hurdle involves the Subchapter M Amendment which is contained in S. 1304, introduced by Senators Chafee, Durenberger, Sarbanes and Baucus. The problem is almost technical in nature. Business Development Companies, by electing to be regulated under the 1980 Act rather than under the 1940 Act, would not be registered under the Investment Company Act of 1940 as required under the tax code for Subchapter M tax pass-through status. For an SBIC to claim its benefits under the securities laws but then to lose its benefits under the tax laws, while still complying with all diversification tests of Subchapter M, is a result which would not be fair and certainly one which Congress did not intend in our opinion. We therefore strongly urge the Congress to correct this problem. If the tax code is amended to make it feasible for Narragansett to convert to Business Development Company (BDC) status under the Small Business Investment Incentive Act of 1980, we intend to do so in the near future.

In our effort to help craft a logical Subchapter M exemption consistent with the intent of Congress both under the securities laws and the tax laws, we retained Ernest Christian of Patton, Boggs and Blow to research the legislative histories and make sure that our requests were properly presented. The results of his efforts are embodied in two memoranda which are attached as addenda to my testimony. The conclusion of the memoranda is that to allow Business Development Companies to claim the tax pass-through under Subchapter M would be clearly consistent with all the tax policy requirements of Subchapter M. S. 1304 would amend Subchapter M to allow companies electing exemption from the 1940 Act as BDCs to be able to elect Subchapter M pass-through provided they otherwise qualify under the tax code.

In the course of investigating Subchapter M it was found that the original relevant section of the tax code granted pass-through to all mutual funds with no reference to number of shareholders. In 1942, in an effort to broaden the class of investment companies which could receive the tax pass-through, the Congress chose to key the tax code into the securities law by allowing pass-through for companies "registered under the Investment Company Act of 1940". Since the Investment Company Act of 1940, however, excludes investment companies with fewer than 100 shareholders from registration (an arbitrary number chosen by the Congress for securities purposes, not for tax purposes), we find that most SBICs which have fewer than 100 shareholders are forced into other types of operations in order to avoid paying capital gains taxes at the corporate level. With this discovery, it became evident that allowing SBICs with fewer than 100 shareholders to also have tax pass-through treatment provided they meet the other tests of Subchapter M would be clearly within the tax policy intentions of the Congress and would have almost no revenue impact. S. 1304 wisely chose to provide the pass-through for those more closely held SBICs along with the Business Development Companies with more than 100 shareholders.

S. 1304 is a well drafted bill in our opinion not only because it provides relief that we favor but also because it has responsible safeguards to prevent abuse of the provisions which were not in the original intention of tax-writing committees of Congress. For example, S. 1304 would not allow a Personal Holding Company to utilize the tax flow-through under Subchapter M since one of the intentions of Congress in drafting Subchapter M was that the pass-through status be allowed for more diversified, professionally managed pools of capital which would not serve as incorporated pocketbooks for wealthy investors. The threshold diversification test of the Personal Holding Company section of the tax code was therefore adopted as the minimum acceptable level of shareholder diversification. S. 1304 also contains a provision favored by the Treasury Department whereby closely-held companies would be prevented from converting their operating assets into Small Business Investment Companies and then obtaining tax flow-through treatment with those assets in addition to federal leverage as SBICs. The Industry supports that provision -- we are certainly not here to suggest overreaching from a tax-paying standpoint.

In conclusion, we would like to reiterate our Association's support for S. 1304 and to commend its sponsors on its introduction. The amendments which S. 1304 would make are extremely necessary and vitally important to a segment of the venture capital community which provides funds for dynamic small and growing businesses. We urge the Congress to enact S. 1304 at the earliest possible opportunity. Mr. Chairman and Subcommittee Members, I would be pleased to answer any questions you may have at this time.

SUMMARY OF
THE ECONOMIC IMPACT OF THE SMALL BUSINESS INVESTMENT COMPANY PROGRAM

A Study Performed By
ARTHUR D. LITTLE, INC.
Data Collection/Processing and
Survey Design Assistance By
DELOITTE HASKINS & SELLS

NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

INTRODUCTION

The Small Business Investment Act was passed in 1958 to establish a new program to help fill the equity gap which Congress had determined to pose a serious threat to the vitality of our free enterprise economy.

The Small Business Investment Company ("SBIC") program was founded on the premise that a partnership between the Federal Government and the private sector could be effective in meeting a public policy goal. SBICs have always been privately capitalized, privately-managed firms licensed and regulated by the Small Business Administration. The particular genius of the program has been the fact that the private owners of SBICs have been exposed to 100% loss on their capital before the Federal Government has stood to lose a penny.

To determine the effectiveness of the SBIC programs, the National Association of Small Business Investment Companies ("NASBIC") sponsored a detailed study that measured the impact of SBIC portfolio companies on the economy. We've summarized the conclusions in this brochure. Copies of the complete report are available from NASBIC. This study was structured and analyzed by the highly respected consulting firm, Arthur D. Little, Inc. The survey was designed and the data were collected and processed by Deloitte Haskins & Sells, the international accounting firm.

The results of this survey prove that this partnership between the Federal Government and the private sector has been extremely effective in bolstering the national economy.

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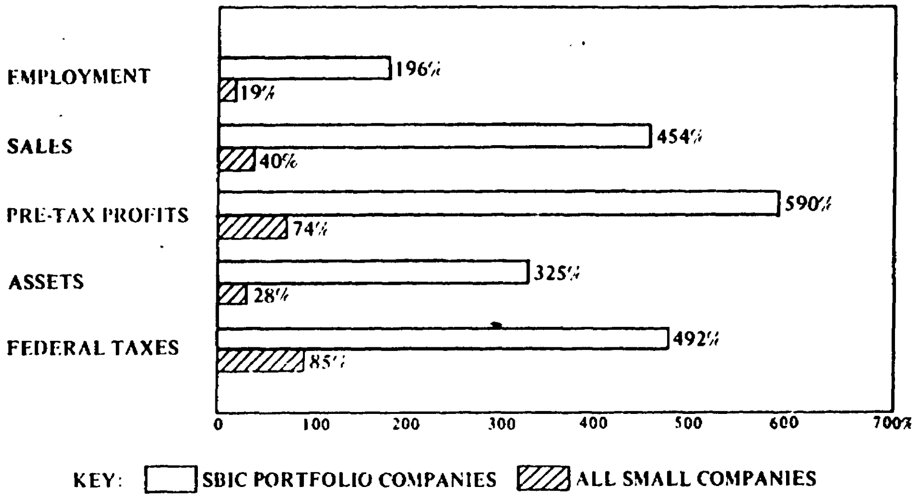
SIGNIFICANT CONCLUSIONS

The results of the NASBIC study accentuate the fact that companies that have received SBIC funds have significantly outperformed other small companies. One need only review the statistics to understand the tremendous impact of SBIC portfolio companies on the nation as a whole. SBIC portfolio companies, as measured by all economic criteria studied, have experienced growth rates that average 8 times as great as those of all small companies (See Figure 1). These statistics alone can serve as a benchmark to demonstrate the compelling success of the SBIC program.

FIGURE 1

AVERAGE GROWTH OF SBIC PORTFOLIO COMPANIES
COMPARED WITH THE AVERAGE GROWTH OF ALL SMALL COMPANIES



The study concludes:

1. Companies financed by SBICs have generated ten times the employment growth of all other small companies (See Figure 1 and 2).
2. These companies produce jobs for $6,463 of one-time investment, whereas various estimates indicate that the government spends at least $25,000 to create a job, and that amount must be spent every year.
3. SBICs are empowered to borrow funds at market rates with the government's guarantee. Only $3,513 of this borrowing creates a job, at no cost to the government.
4. The growth rate of Federal tax payments of companies financed by SBICs is over 5 times that of all small companies.
5. Fully 91% of this impressive performance has come from internal growth, not from mergers and acquisitions.
6. Of all investments made by SBICs, 92% were all or part in the form of equity capital.

FIGURE 2

GROWTH OF SBIC PORTFOLIO COMPANIES VERSUS GROWTH OF ALL SMALL COMPANIES*

Key Economic Impact Measure	Pre-1972 Through Fiscal 78/79		1972/75 Through Fiscal 78/79		1976/77 Through Fiscal 78/79		1978 Through Fiscal 78/79	
	SBIC Portfolio Companies	All Small Companies	SBIC Portfolio Companies	All Small Companies	SBIC Portfolio Companies	All Small Companies	SBIC Portfolio Companies	All Small Companies
Employment	384%	29%	155%	19%	48%	8%	41%	NA
Sales	896%	76%	386%	27%	81%	16%	68%	NA
Profits Before Taxes	1.165%	144%	553%	25%	52%	53%	63%	NA
Assets	694%	48%	188%	24%	92%	13%	60%	NA
Federal Corporate Taxes	739%	135%	652%	63%	85%	57%	101%	NA

* For SBIC's, growth rates are measured from the year prior to SBIC financing to the most recent fiscal year. For all small companies, the comparison is from 1970, 1973 and 1976 to 1978.

Source: Federal Trade Commission, Quarterly Report of Manufacturing Corporations. U. S. Bureau of the Census, County Business Patterns and Arthur D. Little, Inc., estimates.

The most important conclusion of the entire study is that SBIC investments produce jobs. In the companies studied which have been financed by SBIC funds, a job can be created for an investment of $6,463 (See Figure 3). This is not an annual expenditure but instead a one-time investment which need not be repeated

FIGURE 3

EMPLOYMENT INCREASES AND SBIC FINANCING
(Dollar Amounts in Thousands)

Employment Size at Time of Initial Investment	Employment Increase	Total Amount of SBIC Financing	Increase in Employment Per $1 Million of SBIC Financing
0 employees	13,303	$ 53,064	251
1-20 employees	3,413	$ 40,121	85
20-49 employees	5,201	$ 35,586	135
50-99 employees	5,784	$ 49,033	118
100 or more employees	19,224	$125,487	153
TOTAL	46,925	$303,291	155*

*$303,291,000 ÷ 46,925 jobs = $6463 per job.

As of December 31, 1979, the Federal government has lent or guaranteed $649.7 million of loans to SBICs. SBICs have raised $557.7 million in private capital (Source: SBA). For every $3,513 that the government lends or guarantees for the SBIC program, one job is created. The job created does not cost the government anything. In contrast, various estimates indicate that the government must pay at least $25,000 each year for each job it creates

SBICs produce other benefits, too. In every criterion studied — employment, payroll, sales, profits, assets, net worth, taxes, and R&D expenditures — SBICs have been remarkably successful in creating outstanding performance (See Figure 4)

FIGURE 4

SELECTED INDICATORS OF ECONOMIC PERFORMANCE
(Dollar Amounts in Millions)

	Pre-SBIC Financing	Most Recent Fiscal Yr.	Increase
Employment	34,077	81,055	46,928
Payroll	$ 243	$ 752	$ 509
Sales	$ 1,136	$ 4,176	$ 3,040
Pre-Tax Profits	$ 18	$ 206	$ 188
Assets	$ 925	$ 2,760	$ 1,835
Federal Corporation Taxes	$ 21	$ 89	$ 68
State and Local Taxes	$ 7	$ 21	$ 14
R & D Expenditures	$ 32	$ 82	$ 50
Net Worth	$ 171	$ 821	$ 650

The average growth rate of Federal tax payments of SBIC financed companies is over 5 times that of other small companies. SBIC portfolio companies become substantially more efficient and more profitable than other small companies and, accordingly, produce a significantly increasing share of Federal tax revenues.

Although critics may suspect otherwise, SBIC portfolio companies are independent and grow on their own wits, not financial muscle. Fully 91% of the growth of companies that SBICs finance has come from their own internal development. Only 9% of it comes from acquisition. Furthermore, of all SBIC portfolio companies, 92% received a form of equity funds (See Figure 5). Only 8% of the total funds provided consisted of straight debt

FIGURE 5

TYPE OF FINANCING RECEIVED BY
SBIC PORTFOLIO COMPANIES
(Dollar Amounts in 000's)

	Total Amount of SBIC Financing	Percent of Total SBIC Financing
Debt Only	$ 24,617	8%
Equity Only	$ 46,620	15%
Debt & Equity	$242,434	77%
TOTAL	$313,671	100%

SUMMARY

SBICs have had a dramatic impact on the U.S. economy. Companies financed by SBICs have experienced greater employment and government revenue growth rates than other small companies that have not received SBIC funds. SBICs are important to the nation's economic strength. They have played an extremely important role in generating revenues, profits, taxes and jobs in small companies.

Small businesses comprise 97% of all businesses in the United States. They are the backbone of its economy. The success of small businesses has been greatly enhanced by SBICs. Therefore, continued and augmented support of the SBIC program will produce substantial economic benefits to the economy as a whole.

The depth and breadth of the results of SBIC investments can barely be scratched by a short summary and only dented by even so thorough a study as NASBIC has conducted, but the summary conclusion is inescapable - SBICs provide the nation a service which benefits it as no other group can, by providing jobs and tax revenue without threat of monopoly. That is the function of the SBIC program and that is what it has achieved.

July 3, 1980

MEMORANDUM

Re: Proposed Amendment of Section 851(a) to Include in the Definition of Regulated Investment Company Those Small Business Investment Companies Which Are Not Required to Register Under the Investment Company Act of 1940

I. Introduction

Section 851(a) of the Internal Revenue Code should be amended to permit a small business investment company (SBIC) which is not required to register under the Investment Company Act of 1940,[1] but which otherwise meets the requirements of Subchapter M, to elect the conduit tax treatment accorded regulated investment companies. Under present law, a company which satisfies the definition of regulated investment company may elect a type of conduit tax treatment whereby the company pays no corporate tax on income distributed to shareholders. One element of the definition of regulated investment company is that the company must, in general, be registered under the Investment Company Act.

The reference to registration under the Investment Company Act presents two problems for SBICs. First, under present law

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1/ 15 U.S.C. § 80a-1 *et seq.* (1976). The Investment Company Act of 1940 is hereinafter cited as the Investment Company Act.

a company whose outstanding securities are beneficially owned by 100 or fewer persons and which is neither making nor presently proposing to make a public offering of its securities cannot register under the Investment Company Act because it is excluded from the Act's definition of investment company, and only an investment company may register. 15 U.S.C. § 80a-3(c)(1), § 80a-8, George E. Mrosek, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,293. As a result, approximately 90 percent of currently operating SBICs are denied eligibility for conduit tax treatment.[2/] This result is inconsistent with the history and policy of Subchapter M. Furthermore, this result is inconsistent with Congress' goal of stimulating venture capital investment in small business, as expressed in the Small Business Investment Act of 1958 and in pending legislation to reduce the burden which regulation under the Investment Company Act imposes on certain companies which make venture capital investments in small business (including, in general, SBICs).

Second, pending legislation to reduce the burden which regulation under the Investment Company Act imposes on certain companies which make venture capital investments in small business may use the technique of excluding such companies from the Act's definition of investment company. Several bills now pending in Congress employ this technique, and would exempt currently

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2/ Of approximately 350 operating SBICs, only 32 are currently registered under the Investment Company Act.

registered SBICs from the requirement of registration under the Investment Company Act.[3/] If such legislation is enacted, the 10 percent of currently operating SBICs which are registered under the Investment Company Act would lose their eligibility to elect conduit tax treatment, unless the legislation also amends the Investment Company Act to permit those companies which are excluded from the definition of investment company to continue voluntarily their registration. See, e.g., H.R. 7554, § 205; S. 1940, § 204. Even if such a voluntary registration provision is enacted, SBICs which are currently registered would face a dilemma -- the price of reduced regulation under the Investment Company Act would be the loss of conduit tax treatment under Subchapter M. This result is inconsistent with the history and policy of Subchapter M. Furthermore, this result is inconsistent with Congress' goal of increasing venture capital investment in small business because imposition of the corporate tax on SBICs would more than offset the advantages of reduced regulation under the Investment Company Act.

3/ . The bills now pending which would exempt currently registered SBIC's from the requirement of registration under the Investment Company Act are H.R. 3991, H.R. 6723, H.R. 7554, S. 1533 and S. 1940. The Subcommittee on Consumer Protection and Finance of the House Committee on Interstate and Foreign Commerce held two days of hearings (November 7 and 8, 1979) on H.R. 3991, the "Small Business Investment Incentive Act of 1979," which was derived from similar bills introduced in the 95th Congress (H.R. 10717, hearings held September 27, and 28, 1978). Further hearings in the House were held on June 17, 1980. In addition, the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs held hearings on the Senate bills on April 29, May 16, and June 2, 1980.

The proposed amendment of section 851(a)[4/] is presented as Appendix 1. This amendment would include in the section 851(a) definition of regulated investment company any SBIC licensed under the Small Business Investment Act of 1958 even if the SBIC is not required to register under the Investment Company Act. This amendment would have two effects. First, an SBIC which under present law cannot register under the Investment Company Act (because it has 100 or fewer security owners and is neither making nor presently proposing to make a public offering of its securities), but which otherwise meets the requirements of Subchapter M, would be permitted to elect the conduit tax treatment accorded regulated investment companies. Approximately 320 SBICs which are presently ineligible for conduit tax treatment could attempt to qualify as regulated investment companies if this amendment is enacted.[5/] Second, if legislation is enacted which exempts SBICs from the requirement of registration

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4/ Hereinafter all citations to the Internal Revenue Code or the regulations thereunder will consist only of a reference to the appropriate section of the Code or regulations. E.g.: Section 851(a); Reg. § 1.851-1. Citations to other federal statues or regulations will consist of a reference to the appropriate title and section of the United States Code or Code of Federal Regulations. E.g.: 15 U.S.C. § 632; 13 C.F.R. § 121.3-10.

5/ Of these 320 unregistered SBICs, approximately 50 are owned or controlled by banking institutions, 31 by other financial institutions, and 55 by other corporations. For the reasons discussed in Part III.F., *infra*, many of these corporate-dominated SBICs may find conduit tax treatment undesirable.

under the Investment Company Act, the proposed amendment would permit the 32 presently registered SBICs to continue to qualify as regulated investment companies.

This memorandum discusses the history and policy of Subchapter M and demonstrates that the inclusion of unregistered SBICs within the definition of regulated investment company is consistent with congressional intent and the purposes of the special tax treatment accorded regulated investment companies. This memorandum also discusses pending legislation to amend the Investment Company Act in order to stimulate venture capital investment in small business and demonstrates that the availability of conduit tax treatment to SBICs is essential to the success of this effort.

II. Summary of Conclusions

Section 851(a) should be amended to permit SBICs which are not required to register under the Investment Company Act to elect conduit tax treatment, provided they meet the substantive tax criteria set forth in sections 851(b) and 852(a).

Review of the legislative history of section 851(a) indicates that Congress did not intend the reference to registration under the Investment Company Act to operate as a limitation on the availability of conduit tax treatment. The fact that the companies eligible for conduit tax treatment are denominated _regulated_ investment companies may suggest that the consequence of registration under the Investment Company Act -- regulation by the Securities and Exchange Commission (SEC) for the protection of investors -- was intended as a prerequisite to conduit tax treatment. However, prior to the enactment in 1940 of the Investment Company Act, conduit tax treatment was accorded unregulated open-end (_i.e._, redeemable share) investment companies. When the reference to registration under the Investment Company Act was adopted in 1942, closed-end investment companies (_i.e._, those companies whose shares are not redeemable upon demand) first became eligible for conduit tax treatment. Yet the legislative history of the 1942 amendment expresses only an intention to broaden the availability of conduit tax treatment; regulation was not identified as the quid pro quo for the extension of conduit tax treatment to closed-end investment companies. It appears that Congress assumed that essentially all investment companies then in existence were required to register under the Investment Company Act. Therefore, the section 851(a) reference to registration appears to be primarily descriptive, in a general sense, and does not take into account SBICs, which are closed-end investment companies that did not come into existence until 1958.

Even if a purpose of investor protection is implicit in section 851(a), the Small Business Administration (SBA) possesses adequate authority to so regulate unregistered SBICs. For example, the SBA is required by statute to conduct an annual financial examination of every licensed SBIC. Furthermore, adequate investor protection for purposes of Subchapter M is not necessarily equivalent to the strictest possible SEC regulation under the Investment Company Act. The Treasury Department in the past has taken the position that a company which is not subject to the full range of regulatory restrictions under the Investment Company Act is still entitled to elect to be taxed as a regulated investment company. Similarly, pending legislation to provide certain companies which make venture capital investments in small business with relief from the most burdensome provisions of the Investment Company Act reflects a congressional judgment that a lesser degree of regulation is adequate to protect investors in such companies.

Review of the legislative history of section 851(a) indicates that Congress did not, from a tax policy standpoint, ever focus on or intend any requirement that an investment company have more than 100 security owners in order to be eligible for conduit treatment under Subchapter M. This is particulary the case with SBICs. Rather, the 100 security owner limitation on SEC jurisdiction under the Investment Company Act was, essentially, inadvertently incorporated into the tax law by the adoption in 1942 of the reference to registration under the Investment Company Act. Indeed, as initially enacted in 1936, open-end investment companies could qualify for conduit tax treatment regardless of the number of owners of their securities. In an analogous situation, common trust funds were included in the definition of regulated investment company as soon as Congress was informed that such funds are not registered under the Investment Company Act because of securities law reasons which are irrelevant for tax purposes.

The policy which underlies conduit tax treatment for regulated investment companies is that small investors should be permitted to obtain the benefits of professional management, diversification and liquidity intermediation by pooling their resources, without thereby incurring taxes in addition to those which large investors must pay. SBICs pool equity capital supplied by private investors with up to four times as much government supplied capital, in the form of SBA purchased or guaranteed debentures. This pooling of public and private capital, together with a statutory minimum private capital requirement, assures that an SBIC is able to provide its investors with the economic benefits which Congress sought to encourage by enacting the regulated investment company provisions, whether or not the SBIC has more than 100 security owners. Indeed, these economic benefits are essential to the successful operation of SBICs and other companies making venture capital investments.

Congress has previously declared that the operation of SBICs should be encouraged through the provision of additional tax incentives. Current developments in the legislative effort to reduce the burden which the Investment Company Act imposes on companies which specialize in venture capital investments demonstrate the critical importance of Subchapter M tax status to the growth and development of the SBIC industry. Since this vitally important tax incentive could be granted with negligible revenue loss to the Treasury (Part III.F., infra), every consideration supports the prompt elimination of the arbitrary and inequitable distinction between the tax treatment of those SBICs which have more than 100 security owners and those which do not.

Three additional reasons support the amendment of section 851(a) to permit currently registered SBICs to continue to elect conduit tax treatment even if legislation is enacted which exempts these SBICs from the requirement of registration under the Investment Company Act. First, failure to amend section 851(a) would frustrate Congress' purpose to promote venture capital investment, because for SBICs the loss of conduit tax treatment would greatly outweigh the benefits which would result from the elimination of unnecessary securities regulation. Second, Congress has previously expressed its intention that the burden which compliance with the Investment Company Act imposes on SBICs should be reduced without loss of Subchapter M tax status. Third, any requirement of investor protection which may be implicit in Subchapter M will be satisfied notwithstanding the exemption from registration. Any legislation enacted to exempt companies which specialize in venture capital investments from registration under the Investment Company Act is likely to include substantial restrictions on insider transactions in order to protect investors in such companies. Therefore, companies which are not registered under the Investment Company Act will still be regulated under that Act or a similar statute.

III. Discussion

There are several cogent reasons why SBICs which cannot register under the Investment Company Act should be permitted to elect to be taxed as regulated investment companies. Before examining these reasons, however, it will be helpful to clarify the characteristics of SBICs.

SBICs licensed under the Small Business Investment Act of 1958, 15 U.S.C. § 661 et seq. (1976), are predominately engaged in furnishing capital to small business by providing equity capital and long-term loans to small business concerns.[6/]

6/ Small business concerns eligible to receive SBIC financial assistance are defined by 13 C.F.R. § 121.3-11. See 15 U.S.C. § 662(5), § 632. Small business concerns which satisfy four criteria are eligible to receive SBIC financing. These criteria are: (i) the business is independently owned and operated, (ii) it is not dominant in its field of operation, (iii) it does not have a net worth in excess of $6 million, and (iv) it does not have an average net income, after Federal income taxes, for the preceding 2 years in excess of $2 million (computed without regard to loss carryovers). Alternatively, a small business concern is eligible to receive SBIC financing if it meets the first two of the foregoing criteria and also has fewer than a prescribed number of employees or less than a prescribed dollar volume of business. 13 C.F.R. § 121.3-10. The employee number and dollar volume limitations vary according to the industrial classification of the business.

15 U.S.C. §§ 684, 685. The SBA is authorized to purchase or guarantee SBIC debentures up to a maximum amount of 400 percent of the combined private paid-in capital and paid-in surplus of the SBIC. 15 U.S.C. § 683(b). Typically, SBICs make venture capital investments -- that is, high-risk investments in small and unproven but innovative enterprises. Because of inexperience and lack of business sophistication of the existing management of such enterprises, an SBIC often must protect its investments by becoming deeply involved in the management of the enterprises it finances. Because SBICs invest in small innovative enterprises with high growth potential, the return on an SBIC's equity investments generally takes the form of capital gains rather than dividends. SBICs generally invest in highly illiquid assets because the enterprises financed are small, the risk is great, and their securities are unregistered. Finally, SBICs are closed-end investment companies -- that is, their stock is not redeemable upon demand.

A. The Registration Requirement of Section 851(a) Was Apparently Intended Only to Incorporate by Reference the Investment Company Act's Comprehensive Definition of "Investment Company"

Section 851(a) provides:

> For purposes of this subtitle, the term "regulated investment company" means any domestic corporation (other than a personal holding company as defined in section 542)--
>
> (1) which, at all times during the taxable year, is registered under the Investment Company Act of 1940, as amended (15 U.S.C. 80 a-1 to 80 b-2),

> either as a management company or as a unit investment trust, or
>
> (2) which is a common trust fund or similar fund excluded by section 3(c)(3) of such Act (15 U.S.C. 80 a-3(c)) from the definition of "investment company" and is not included in the definition of "common trust fund" by section 584(a).

The legislative history of the regulated investment company provisions of the Code indicates that the section 851(a) reference to registration under the Investment Company Act is primarily descriptive. That is, Congress apparently believed that essentially all investment companies then in existence were registered under the Investment Company Act, and therefore the registration requirement of section 851(a) was adopted as a shorthand specification of the meaning of the term "investment company." It is important to understand that SBICs were not in existence when the reference to registration under the Investment Company Act was adopted.

The forerunner of Subchapter M entered the tax laws in 1936, before the enactment of the Investment Company Act. As originally enacted, conduit treatment was accorded a "mutual investment company." Revenue Act of 1936, Pub. L. No. 74-740, § 13(a)(2), (3).

> (e) Mutual Investment Companies.--
>
> (1) General Definition.--The term "mutual investment company" means any corporation (whether chartered or created as an investment trust, or otherwise), other than a personal holding company as defined in section 351, if --
>
> (A) It is organized for the purpose of, and substantially all its business consists of, holding, investing, or reinvesting in stock or securities; and

(B) At least 95 per centum of its gross income is derived from dividends, interest, and gains from sales or other disposition of stock or securities; and

(C) Less than 30 per centum of its gross income is derived from the sale or other disposition of stock or securities held for less than six months; and

(D) An amount not less than 90 per centum of its net income is distributed to its shareholders as taxable dividends during the taxable year; and

(E) Its shareholders are, upon reasonable notice, entitled to redemption of their stock for their proportionate interests in the corporation's properties, or the cash equivalent thereof less a discount not in excess of 3 per centum thereof.

Revenue Act of 1936, § 48(e)(1). In addition, the corporation was required to meet certain conditions designed to assure diversification of investments and prevent the corporation from being used as a holding company. A requirement of government regulation was not a component of the definition of mutual investment company.7/

Section 48(e)(1)(E) of the Revenue Act of 1936, supra, restricted mutual investment company tax treatment to those companies

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7/ The committee reports on the Revenue Act of 1936 provide no explanation of the mutual investment company provision. In 1936 the only tax on corporations contained in the bill reported by the Ways and Means Committee provided for taxation of the undistributed profits of all corporations. The House bill would have relieved from tax any corporation which annually distributed all of its net income, and therefore special conduit treatment for mutual funds was not required. The Senate Finance Committee retained the separate corporate tax structure but imposed a seven percent surtax on undistributed profits. The mutual investment company provisions were introduced by the Finance Committee as a late amendment to the Senate version of the bill, and were not discussed in the Senate report.

whose shareholders were entitled to redeem their stock. This redemption privilege is the essential characteristic of open-end investment companies. In 1942 section 361(a) of the Internal Revenue Code of 1939 was amended to confer conduit treatment on management companies and unit investment trusts registered under the Investment Company Act and on unregistered common trust funds. The Revenue Act of 1942 dropped the requirement of a redemption privilege and thereby extended conduit tax treatment to registered closed-end companies. Since 1942 the definition of regulated investment company has remained substantially unchanged.

The legislative history of the Revenue Act of 1942 indicates that Congress intended the reference to registration under the Investment Company Act to include essentially all investment companies. "The new provisions enlarge the category of companies entitled to special tax treatment and liberalize the standards required to be met." H. Rep. No. 2333, 77th Cong., 2d Sess. 28 (1942). Moreover, the Senate report states:

> Thus, investment companies known as closed-end companies under the Investment Company Act of 1940 if they meet the requirements of section 361(b), as amended, will come within the definition of the term "regulated investment companies," which has been substituted for the term "mutual investment companies."

S. Rep. No 1631, 77th Cong., 2d Sess. 158 (1942). This observation reveals that Congress intended that closed-end investment companies should be eligible for conduit tax treatment, provided only that "they meet the requirements of section 361(b)."

Section 361(b) of the Internal Revenue Code of 1939 is substantially equivalent to sections 851(b)-851(d) of the Internal Revenue Code of 1954. Section 851(b) sets forth four substantive limitations on eligibility for conduit tax treatment. First, at least 90 percent of the company's gross income must be derived from dividends, interest, and gains from the sale or other disposition of stock or securities. Section 851(b)(2). This requirement assures that no substantial amount of operating profits will avoid the corporate tax by being commingled with investment income. That is, the company must do more than engage primarily in the investment business (as required by section 3(a) of the Investment Company Act, 15 U.S.C. § 80a-3(a)); rather, the tax law requires that investment must be the substantially exclusive business of the company.

Second, the proportion of the company's gross income derived from the sale or other disposition of stock or securities held for less than 3 months must be less than 30 percent. Section 851(b)(3). This requirement assures that conduit tax treatment is accorded investment companies, not companies specializing in short-swing speculation.

Third, the company's portfolio must meet certain diversification requirements. Section 851(b)(4), (c), (d). This requirement assures that conduit tax treatment accomplishes Congress' purpose -- permitting small investors to pool their resources in order to obtain the benefits of diversification and professional management, without incurring taxes in excess of those which wealthy investors must pay.

Fourth, the company is restricted in its ability to own a controlling interest in its portfolio companies. Section 851(b)(4)(A)(ii).[8/] This requirement assures that conduit tax treatment is not accorded holding companies.

The foregoing requirements of section 851(b) specify the substantive tax policy limitations on the availability of conduit tax treatment. Since the legislative history states that closed-end companies which satisfy these requirements should be eligible for conduit tax treatment, the reference to registration under the Investment Company Act apparently was not intended to restrict the availability of conduit tax treatment. Rather, Congress apparently believed that essentially all companies which engage primarily in investment activities fall within the definition of investment company contained in section 3 of the Investment Company Act and are required to register under Section 8. 15 U.S.C. § 80a-3, § 80a-8. Therefore, the section 851(a) reference to registration appears to be primarily descriptive.

The only indications in the legislative history that Congress may have intended the requirement of registration

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8/ At least 50 percent of a regulated investment company's assets must consist of cash and cash items, Government securities, and securities of issuers not more than 10 percent of whose outstanding voting securities are owned by the regulated investment company.

under the Investment Company Act to impose an independent substantive condition on the availability of conduit tax treatment are founded upon inference and conjecture. The Revenue Act of 1936 accorded conduit tax treatment only to mutual investment companies, which were defined to include only certain open-end (i.e., redeemable share) companies. Revenue Act of 1936, § 48(e)(1)(E), supra. This limitation was assailed as inequitable by the closed-end companies. However, during the 1938 Ways and Means Committee hearings Congressman McCormack emphasized to the representative of the closed-end investment companies that a shareholder's right to redeem his holdings is a "very important right." Revision of the Revenue Laws, 1938: Hearings Before the House Comm. on Ways and Means, 75th Cong., 3d Sess. 843 (1938). Moreover, in 1938 the Treasury resisted the inclusion of closed-end companies in the definition of mutual investment company until the SEC finished its report on investment companies. Id. at 843, 841. Since the redeemable share requirement was removed contemporaneously with the addition of the reference to registration under the Investment Company Act, it might be argued that in 1936 Congress restricted the definition of mutual investment company to open-end companies in order to provide some protection to shareholders of the then-unregulated investment companies.[9] In this view, the

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9/ For example, if the management of a closed-end investment company decided to issue senior securities existing

(footnote continued on next page)

reference to registration under the Investment Company Act would be seen as establishing a requirement of regulation for the protection of investors as a prerequisite to the extension of conduit tax treatment to closed-end investment companies.[10/] SBICs are, in general, closed-end investment companies. Although a relationship between SEC regulation under the Investment Company Act and the extension of conduit tax treatment to closed-end investment companies may be plausible, it is nowhere expressed in the legislative history. Therefore it appears unlikely that Congress intended to implicitly impose a requirement of regulation for the protection of investors by means of the reference to registration under the Investment Company Act.

Further evidence that Congress did not intend regulation under the Investment Company Act to be the quid pro quo for extension of conduit tax treatment to closed-end investment

(Continued from previous page)

shareholders could withdraw only by selling their stock at depressed prices. However, shareholders in an open-end investment company could promptly redeem their shares before issuance of the senior securities, and thereby avoid a loss due to the reduced market value of their shares.

10/ Note also that in 1942 the Senate Finance Committee included common trust funds within the definition of regulated investment company, possibly in response to testimony at the Committee's hearings that common trust funds were "exempted from registration under the Investment Company Act because they are maintained by banks which are already under the supervision of Federal and State authorities...." Revenue Act of 1942: Hearings on H.R. 7379 Before The Senate Finance Comm., 77th Cong., 2d Sess., vol. 2, 2107 (1942) (statement of George A. Wood).

companies is provided by the real estate investment trust provisions of Subchapter M. When in 1960 Congress provided conduit tax treatment for real estate investment trusts, the section 856 definition of real estate investment trust was consciously patterned on the section 851 definition of regulated investment company. H. Rep. No. 2020, 86th Cong., 2d Sess. 4-5 (1960). However, section 856 neither requires that a real estate investment trust be regulated for the protection of its investors, nor that the shares evidencing ownership of the trust be redeemable.

B. Even If Regulation for the Protection of Investors Is a Requirement for Regulated Investment Company Taxation, the Shareholders of SBICs Which Are Not Required to Register Under the Investment Company Act Would Be Adequately Protected By SBA Regulation

Even assuming that closed-end investment companies were included in the definition of regulated investment company only because they are subject to regulation for the protection of investors, it does not follow that the investors in an unregistered SBIC are inadequately protected for purposes of Subchapter M. Even if regulation for the protection of investors is an essential policy, no reason is shown why this protective function must be performed by the SEC, or why it must take the precise form of the restrictions currently imposed by the Investment Company Act.

Although at present the SBA does not regulate SBICs for the express purpose of investor protection, it apparently has adequate statutory authority to do so. Such SBA regulation would apparently be viewed by Congress as an adequate substitute for SEC regulation under the Investment Company Act, since Congress has stated that overlapping jurisdiction between the SEC and the SBA should be eliminated. 15 U.S.C. § 687(g)(2)(H).

There are three sources of statutory authority for SBA regulation of SBICs which may be broad enough to support regulations directed to the protection of SBIC investors:

1. 15 U.S.C. § 682(c) provides: "The aggregate amount of shares in any [small business investment] company or companies which may be owned or controlled by any stockholder, or by any group or class of stockholders, may be limited by the [Small Business] Administration."

2. 15 U.S.C. § 687(c) provides: "The [Small Business] Administration is authorized to prescribe regulations governing the operations of small business investment companies, and to carry out the provisions of this Act in accordance with the purposes of this Act."

3. 15 U.S.C. § 686(a) requires the approval of the SBA before an SBIC may acquire securities of an enterprise with a value exceeding 20 percent of private paid-in capital and paid-in surplus of the SBIC.

Moreover, the SBA has broad investigatory and enforcement powers. The SBA may, upon notice and hearing, issue cease and desist orders or revoke the license of an SBIC, and the SBA may compel attendance and testimony of witnesses and the production of documents at the hearing. 15 U.S.C. § 687a. Note that one of the grounds for license revocation is "any written statement required under this subchapter, or under any regulation issued under this subchapter by the Administrator, fails to state a material fact necessary in order to make the statement not misleading in light of the circumstances under which the statement was made." 15 U.S.C. § 687a(a)(1). Compare SEC Rule 10b-5. Under 15 U.S.C. § 687b(b) each SBIC is subject to examination by the SBA at least annually, and is required to file any reports required by the SBA. Further, the SBA may investigate "whether a licensee or any person has engaged or is about to engage in any acts or practices which constitute a violation of any provision of this chapter, or of any rule or regulation under this chapter, or of any order issued under this chapter." Authority to compel attendance of witnesses and production of documents at such investigations is also provided. 15 U.S.C. § 687b(a).

Furthermore, adequate investor protection for purposes of Subchapter M is not necessarily equivalent to the strictest possible SEC regulation under the Investment Company Act. Thus, existing SBA regulation (such as the prophylactic effects of the annual financial examination and the SBA's investigatory powers) may constitute sufficient investor protection for tax purposes. The Treasury Department has already taken the position that regulated investment company tax treatment is appropriate in circumstances where the SEC does not exercise the full extent of its regulatory authority under the Investment Company Act. In 1969 the National Association of Small Business Investment Companies (NASBIC) instituted a proceeding before the SEC in an attempt to obtain an administrative exemption for SBICs from certain of the requirements of sections 17, 18, 19 and 23 of the Investment Company Act. In re National Association of Small Business Investment Companies, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,076. In conjunction with this administrative proceeding the SBA obtained advice that SBICs registered under the Investment Company Act would, in the opinion of the Treasury Department, be entitled to conduit tax treatment notwithstanding their exemption from the most significant regulatory provisions of the Investment Company Act. Letter of July 15, 1969, from John S. Nolan, Deputy Assistant Secretary of the Treasury, to Arthur H. Singer, Associate Administrator for Investment, SBA, reprinted in Small Business Investment: Hearings on H.R. 10717 Before the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce, 95th Cong., 2d Sess. 221-222 (1978). At a minimum this action indicates that the Treasury has in the past taken the position that whatever regulatory requirements the SEC deems adequate for the protection of investors are sufficient to secure the benefits of regulated investment company tax treatment. Indeed, since the administrative exemption sought by NASBIC involved provisions which are central to the Investment Company Act's scheme of investor protection, the Treasury's opinion that continued registration would be sufficient to secure the benefits of Subchapter M may amount to an administrative interpretation that the section 851(a) reference to registration under the Investment Company Act is primarily descriptive..

It appears likely that before the close of the 96th Congress legislation will be enacted to provide certain companies which specialize in venture capital investments with relief from the most burdensome requirements of the Investment Company Act. The SEC has proposed legislation which would accomplish this result by making specific provisions of the Investment Company Act inapplicable to "business development companies," a term which would include most SBICs.11/ However, such companies would still be required to register and would be subject to other provisions of the Investment Company Act. The SEC approach is a counterproposal to several bills now pending in Congress which would except "venture capital companies" (including all SBICs) from the Investment Company Act's definition of investment company; as a result, these companies would be exempt from the

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11/ H.R. 7491, the draft legislation proposed by the SEC (entitled the "Business Development Company Act of 1980") was introduced on June 4, 1980. This bill was the subject of SEC Commissioner Friedman's testimony at the June 17, 1980 hearing of the Consumer Protection and Finance Subcommittee of the House Committee on Interstate and Foreign Commerce.

requirement of registration and certain of its most onerous regulatory consequences.[12/] The SEC has testified that:

> In our view, the continuing status of venture capital companies as registered investment companies would have several advantages over the exemptive approach of the bills presently before this Subcommittee:
>
> -- as registered investment companies, they would be entitled to pass-through tax treatment under Subchapter M of the Internal Revenue Code. . . .

Hearings on S. 1940 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 96th Cong., 2d Sess. (May 16, 1980) (statement of Stephen J. Friedman, Commissioner, SEC). Thus, continued eligibility for Subchapter M

12/ In general, these bills define "venture capital company" as a company which meets both the following conditions: (i) the company is engaged or proposes to engage primarily in the business of furnishing capital (other than short-term paper) to industry, financing promotional enterprises, purchasing securities of issuers for which no ready market exists, reorganizing companies or similar activities, and (ii) at least 80 percent of the assets of such company, valued at cost, consists of securities which were acquired directly from the issuer in transactions not involving registration of the securities under the Securities Act of 1933, or securities received in a reorganization of the issuer in exchange for such unregistered securities, or securities distributed on or with respect to such unregistered securities. In addition, H.R. 7554 generally requires that the company make available managerial assistance in order to satisfy condition (i); however, H.R. 7554 expressly provides that any SBIC satisfies condition (i). SBICs are predominately engaged in furnishing capital to small business by providing equity capital and long-term loans to small business concerns. 15 U.S.C. §§ 684, 685. These equity investments and long-term loans constitute securities which are acquired directly from the small business concern. Therefore, SBICs are included within the proposed definition of venture capital company, and would be exempted from the registration requirements of the Investment Company Act if a bill similar to those now pending in Congress is enacted.

tax status is an important feature of the SEC's proposed legislation (H.R. 7491) to grant registered investment companies which specialize in venture capital investments relief from specific provisions of the Investment Company Act. If Congress adopts the SEC approach this advantage -- that a conforming amendment of section 851 would not be required -- is likely to be a significant factor motivating the decision. Thus, adoption of the SEC's approach would amount to a congressional interpretation that the section 851(a) reference to registration under the Investment Company Act requires little, if any, regulation.

Whichever approach Congress ultimately adopts, amendment of the Investment Company Act will embody a legislative decision that a lesser degree of regulation is adequate to protect investors in companies which specialize in venture capital investments. Surely Subchapter M does not demand unnecessary regulation. Since SBICs are regulated by the SBA and since there is no indication that investors in SBICs having 100 or fewer security owners are inadequately protected, these SBICs should be allowed to qualify for conduit tax treatment.

C. Including SBICs With 100 or Fewer Security Owners in the Definition of Regulated Investment Company Is Consistent With the Legislative History of Section 851(a)

The inclusion of SBICs with one hundred or fewer security owners in the definition of regulated investment company is consistent with the legislative history of section 851(a). As enacted in 1936, mutual investment company tax treatment was available to any corporation (other than a personal holding company) which met the diversification, income distribution and redemption requirements, without regard to the company's number of shareholders. Revenue Act of 1936, § 48(e), supra. This fact indicates that the 1942 amendment which defined a regulated investment company in terms of investment companies registered under the Investment Company Act merely incorporated securities law limitations in a tax law definition. The 1942 amendment was designed to "enlarge the category of companies entitled to special tax treatment and liberalize the standards required to be met," by including closed-end companies. H. Rep. No. 2333, 77th Cong., 2d Sess. 28 (1942). It is important to understand that SBICs did not exist in 1942 when the reference to registration under the Investment Company Act was adopted. Therefore, Congress was not aware that SBICs, which generally have 100 or fewer security owners, would serve an important function in the investment company industry. Thus, exclusion of companies with 100 or fewer security owners was apparently inadvertent.13/

In an analogous situation, common trust funds were included in the section 851(a) definition of regulated investment company as soon as Congress was informed that these funds are not registered under the Investment Company Act. In 1942 the House

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13/ In 1960 when Subchapter M conduit tax treatment was extended to real estate investment trusts only organizations which are beneficially owned by 100 or more persons were included in the definition of real estate investment trust. This provision was apparently included only to achieve substantial similarity with the definition of regulated investment company. See H. Rep. No. 2020, 86th Cong., 2d Sess. 5 (1960).

bill defined a regulated investment company strictly in terms of those companies registered under the Investment Company Act. This definition excluded common trust funds, which previously had qualified as mutual investment companies. This gap in coverage was pointed out at the Senate hearings on the Revenue Bill of 1942, and the Senate responded by adopting the common trust fund provision. Revenue Act of 1942: Hearings on H.R. 7379 Before the Senate Finance Comm., 77th Cong., 2d Sess., vol. 2, 2106-2107 (1942) (statement of George A. Wood). Similarly, investment companies with 100 or fewer security owners had previously qualified as mutual investment companies. It seems likely that if the issue had been raised in 1942 Congress would have included companies with 100 or fewer security owners in the definition of regulated investment company, notwithstanding their exemption from the Investment Company Act.

D. Permitting SBICs to Elect Subchapter M Tax Treatment Is Consistent With the Policy of the Regulated Investment Company Provisions

The policy which underlies the regulated investment company provisions of the Code is that small investors should be permitted to pool their funds and thereby obtain the benefits of professional management and diversification of investments without incurring taxes in addition to those which large investors must pay. Large investors can afford the services of investment advisers, and have enough capital to invest in a variety of securities. Therefore, the large investor can obtain a professionally managed, diversified portfolio. Small investors must pool their resources in order to secure these benefits, and since small investors require centralized professional management of the pool of investment funds and readily transferrable interests (liquidity), the classical tax system treats this pool as a separate taxable entity. Thus, absent conduit tax treatment for regulated investment companies, small investors would be forced to either suffer a significant reduction in the return on their capital[14/] or forgo the benefits of diversification and professional management.

SBIC's accomplish these same ends. Indeed, the importance of pooling to investments in venture capital is demonstrably greater than the importance of pooling to investments in proven low-risk securities (the so-called blue chip securities). Traditionally mutual funds, which are eligible for Subchapter M tax treatment, invest only in blue chip securities. Diversification of such investments assures a relatively stable rate of return. Individual investments in venture captial, however, tend to be very risky. Diversification of venture capital investments dramatically reduces this risk. That is, many securities in which an SBIC invests will prove worthless, while other investments will result in extraordinarily large capital gains. Thus,

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14/ Assuming a flat 46 percent rate of tax on an investment company's income, the precise reduction in the return on capital would be 46 percent for interest income, 6.9 percent for dividend income (taking into account the 85 percent dividends received deduction of section 243) and 32 percent for capital gains (taking into account the 28 percent corporate capital gains tax and the loss of the individual's 60 percent deduction for capital gains).

for companies which specialize in venture capital investments diversification is not simply a device to assure a constant level of profitability; rather, diversification is essential to survivial.

Similarly, professional management is of even greater importance to SBICs than to traditional mutual funds. The management of an SBIC must provide more than investment evaluation and market expertise. Rather, an SBIC must often protect its capital by becoming deeply involved in the management of the companies in which it invests. Thus, the management of an SBIC must consist of experienced practicing businessmen who can develop some expertise in the lines of business of the investee companies. Compared with investment advisers, managers with these skills are a rare and expensive breed.

In addition to securing professional management and diversification of investments, pooling of funds in an investment company serves a third function of great importance to our economic system. This function is liquidity intermediation. As explained by Professor Clark, individuals prefer to hold liquid assets because of unpredictable and potentially disastrous fluctuations in personal money needs. However, when the assets of many individuals are pooled, in the aggregate these individuals' demands for money become stable.

> By pooling their claims against assets, a group of individuals can take advantage of the law of large numbers, according to which contingencies unpredictable on an individual basis are quite predictable for large numbers. In

> its simplest application, pooling enables financial intermediaries to accomplish liquidity intermediation. Individuals often want to hold liquid assets because they cannot accurately predict future contingencies that will affect their need for cash, whereas users of capital such as corporations, often want capital left with them for long periods of time. An intermediary often issues relatively liquid claims against itself, that is, claims convertible to money within a short time at no or little sacrifice of their full value, and uses the proceeds to invest in fairly illiquid claims. The intermediary can safely invest in illiquid claims, up to a point, because of the relative stability and predictability of the exercise of claims against itself that comes with large numbers of them. Thus, the claim of even the smallest demand deposit account-holder at a commercial bank is, at any given time, quickly convertible into a fixed amount of currency or, indeed, usable as money itself. Otherwise demand deposit accounts would not be as popular as they are. Yet banks in turn do not simply make callable loans or invest in highly liquid securities on the strength of these assets, but make many business loans for which there is no significant secondary market, and which have substantial periods to maturity: 30, 60, and 90 day loans and even term loans for periods longer than a year.

Clark, The Federal Income Taxation of Financial Intermediaries, 84 Yale L.J. 1603, 1610-11 (1975) (footnotes omitted).

Mutual funds which invest in blue chip securities for which a ready market exists perform the function of liquidity intermediation only to a limited extent, because an individual who invests directly in blue chip securities generally suffers little loss in liquidity. SBICs, however, generally invest in securities for which no ready market exists. It might be argued that because SBICs are closed-end investment companies, their significance as liquidity intermediaries is limited.

This argument is without merit for two reasons. First, the stock of SBICs is sometimes registered under the Securities Exchange Act of 1934, and therefore is readily transferable.[15/] Second, banks and insurance companies are often significant investors in SBICs and therefore SBICs interface the liquidity requirements of bank depositors and insurance policyholders with the long term capital needs of new business ventures.

SBICs perform the same economic functions -- professional management, diversification, and liquidity intermediation -- as traditional mutual funds. Therefore there appears to be no justification for denying SBICs the same tax treatement as traditional mutual funds.

It might be argued that the Investment Company Act's 100 security owner requirement serves a function relevant to Subchapter M -- requiring a large number of security owners assures that a company eligible for conduit tax treatment actually represents a pooling of many investors' resources. Remember, however, that a company which makes a public offering of

15/ The stock of closely-held SBICs which are exempt from registration under present law is unlikely to be registered under the Securities Exchange Act of 1934. However, it appears likely that any legislation which may be enacted to exempt currently registered companies from the registration requirement of the Investment Company Act will require, as a prerequisite to the exemption, that such companies have a class of equity security registered under the Securities Exchange Act of 1934. See, e.g., H.R. 7554, § 202.

its securities, however small, must register and may elect to be taxed as a regulated investment company, even if it has fewer than 100 security owners. Furthermore, although a large number of security owners assures that an investment company actually represents a pooling of many investors' resources, such a requirement is unnecessary for SBICs. The economic significance of pooling is that it allows investors to obtain the benefits of professional management, diversification, and liquidity intermediation. These benefits, however, are dependent upon the amount of funds available for investment, not the number of suppliers of funds. An SBIC can provide these benefits to its private investors, however few they may be, because the private equity capital of an SBIC is pooled with three or four times as much government leverage (in the form of SBA purchased or guaranteed debentures). Moreover, a company must meet statutory minimum private capital requirements before it will be licensed to operate as an SBIC. For companies licensed on or after October 1, 1979 the minimum capital requirement is $500,000 (previously $150,000). The combination of pooling private capital with government leverage, and minimum private capital requirements, assures that any SBIC is able to perform the economic functions which Congress sought to encourage by providing conduit tax treatment to regulated investment companies, however few persons may own its securities.

E. Past and Present Congressional Actions Demonstrate an Awareness of the Critical Importance of Conduit Tax Treatment to the Growth and Development of the SBIC Industry

In 1967, Congress expressly recognized the importance of conduit tax treatment to SBICs and the necessity of preserving Subchapter M tax status for SBICs while reducing the burdens of compliance with the Investment Company Act.

> In its annual report for the year ending December 31, 1967, and in each succeeding annual report made pursuant to section 639(a) of this title, the [Small Business] Administration shall include full and detailed accounts relative to the following matters:
>
> * * *
>
> (G) Recommendations of the Treasury Department with respect to additional tax incentives to improve and facilitate the operations of small business investment companies and to encourage the use of their financing facilities by eligible small business concerns.
>
> (H) A report from the Securities and Exchange Commission enumerating actions undertaken by that agency to simplify and minimize the regulatory requirements governing small business investment companies under the Federal securities laws and to eliminate overlapping regulation and jurisdiction as between the Securities and Exchange Commission, the [Small Business] Administration, and other agencies of the executive branch.
>
> * * *
>
> (J) Actions undertaken by the Securities and Exchange Commission to simplify compliance by small business investment companies with the requirements of the Investment

Company Act of 1940 and to facilitate the election to be taxed as regulated investment companies pursuant to section 851 of Title 26.

15 U.S.C. § 687(g)(2). Thus, Congress is already on record in support of encouraging investment in SBICs through additional tax incentives. The annual report of the SBA is required to contain Treasury Department recommendations "with respect to additional tax incentives to improve and facilitate the operations of small business investment companies," and the SEC must describe its actions "to facilitate the election [of SBICs] to be taxed as regulated investment companies." 15 U.S.C. § 687(g)(2)(G), (J). Extending conduit tax treatment to unregistered SBICs with 100 or fewer security owners would accomplish both these objectives. Furthermore, conduit tax treatment will encourage private investment in SBICs and thereby reduce the federal government's role as a substantial investor in SBICs, in conformity with the policy of the Small Business Investment Act of 1958. 15 U.S.C. § 661.

Pending legislation to amend the Investment Company Act in order to eliminate unnecessary restrictions on companies which specialize in venture capital investments also involves a recognition of the importance of Subchapter M tax status to SBICs. Presently there are 32 SBICs registered under the Investment Company Act, all of which elect to be taxed as regulated investment companies. If legislation were enacted to exclude venture capital companies from the Investment Company Act's definition of investment company, these SBICs would be unable to register. Since under present law a company which does not meet the definition of investment company in section 3 of the Investment Company Act cannot voluntarily register under the Act, George E. Mrosek, supra, these companies would lose their conduit tax treatment. Loss of conduit tax treatment would be most harmful to these SBICs, and would greatly outweigh the advantages which relief from the Investment Company Act would provide. Recent versions of bills exempting venture capital companies from the Investment Company Act would amend the Act to provide that a company which would be excluded from the definition of investment company by reason of such legislation may nonetheless voluntarily register as an investment company, thereby preserving its status as a regulated investment company pending an amendment of section 851(a). See H.R. 6723, § 204; H.R. 7554, § 205; S. 1940, § 204. If instead of exempting venture capital companies from registration, Congress decides to grant business development companies relief from specific provisions of the Investment Company Act (the SEC approach, see Part III.B., supra), this decision is likely to be motivated in large part by a desire to preserve the Subchapter M tax status of currently registered SBICs. Therefore, although the final form of legislation to grant companies which specialize in venture capital investments relief from the Investment Company Act cannot be predicted, such legislation is certain to recognize the critical importance of conduit tax treatment to SBICs.

Congress and the Administration 16/ are now firmly committed to stimulating venture capital investment by eliminating unnecessary restrictions on companies which specialize in such investments. SBICs specialize in venture capital investments and are an important segment of the industry. The elimination of unnecessary tax law restrictions on SBICs should be a central component of the present effort to stimulate venture capital investment because Congress recognizes the overwhelming importance of conduit tax treatment to SBICs and is on record in support of promoting SBICs through additional tax incentives. Indeed, the proposed amendment of section 851(a) would not constitute a tax preference for SBICs, because (as the discussion above demonstrates) the present distinction between the tax treatment of those SBICs which have more than 100 security owners and those which do not is an artifact of jurisdictional limitations on the SEC under the Investment Company Act, and cannot be justified by tax policy considerations.

16/ For example, the Department of Labor recently reproposed a section of the regulations (29 C.F.R. § 2550.401b-1(e)) which defines employee benefit plan assets under the Employee Retirement Income Security Act of 1974. 45 Fed. Reg. 38084 (June 6, 1980). This change in the proposed regulations was apparently motivated in part by a memorandum from the White House to the Secretary of Labor which criticized the proposed definition of plan assets because it would severely inhibit pension fund investments in venture capital companies. 1980 Daily Report for Executives, No. 111 (BNA) at G-9 (June 6, 1980).

F. Permitting Unregistered SBICs to Attempt to Qualify for Conduit Tax Treatment Will Cause Negligible Revenue Loss

There are five reasons why the proposed amendment of section 851(a), insofar as it broadens the class of companies which may attempt to qualify as regulated investment companies, will result in negligible revenue loss to the Treasury.

First, many corporate owned or controlled SBICs will not want to elect to be taxed as regulated investment companies. Corporate shareholders of regulated investment companies are not allowed to claim the section 243 deduction for dividends received with respect to capital gain dividends received from the regulated investment company. Section 854(a). Therefore, corporate shareholders must pay a 28 percent rate of tax on the capital gain dividends paid by a regulated investment company. Alternatively, if the investment company does not elect conduit tax treatment and makes in-kind distributions of appreciated stock, corporate shareholders receiving such in-kind dividends will pay a 46 percent rate of tax on only 15 percent of the value of the stock -- an effective rate of tax of 6.9 percent. Hence corporate controlled SBICs which specialize in equity investments may choose not be taxed as regulated investment companies, whether or not they otherwise qualify under Subchapter M. Of approximately 320 presently operating SBICs which are not registered under the Investment Company Act, approximately 135 are corporate controlled.

Second, not all closely-held SBICs could comply with the diversification, income distribution and other tax policy-based requirements of Subchapter M.

Third, many SBICs with 100 or fewer security owners might avoid the corporate tax by selecting the partnership form of organization. In 1976 section 301(a) of the Small Business Investment Act of 1958, 15 U.S.C. § 681(a), was amended to permit limited partnerships to be licensed as SBICs. The SBA's regulations specify that a limited partnership will be licensed as an SBIC only if the sole general partner is a corporation. 13 C.F.R. § 107.4(b). The requirement that the sole general partner of a limited partnership SBIC be a corporation may cause the Internal Revenue Service to take the position that a limited partnership SBIC is in fact a corporation for income tax purposes. See Morrissey v. Commissioner, 296 U.S. 344 (1935); Rev. Proc. 72-13, 1972-1 C.B. 735. Moreover, SBA regulations require that the capital of a corporate general partner which is not invested in the limited partnership SBIC may be invested only in direct obligations of the United States, obligations guaranteed as to principal and interest by the United States, or insured savings accounts. 13 C.F.R. § 107.4(d), 15 U.S.C. § 687(b). Although at present these restrictions may make it difficult for a limited partnership SBIC to qualify for partnership tax treatment, the SBA is presently redrafting its regulations in a way which will assure that a limted partnership SBIC will be able to qualify as a partnership for tax purposes.

Fourth, much of an SBIC's income is shielded from tax by special provisions outside Subchapter M. For example, an SBIC is entitled to a 100 percent dividends received deduction. Section 243(a)(2). Thus, only interest received on long term loans to small business concerns and capital gains on the disposition of securities would be taxable income to SBICs. Furthermore, a portion of this income would be shielded by the operation of section 1243, which permits an SBIC to take an ordinary loss deduction if it incurs a loss on stock of a small business concern received pursuant to the exercise of a conversion privilege of convertible debentures.

Fifth, since corporate SBICs with few security owners are presently taxable, it is likely that many of these companies retain and reinvest their income in order to provide their shareholders with deferred capital gains (on the sale of appreciated SBIC stock or the liquidation of the SBIC) rather than current ordinary income (dividends). Making Subchapter M tax status available to these companies might alter their dividend policy (and prevent premature tax-motivated liquidations), which would substitute a current ordinary income tax on dividend payments to SBIC shareholders for a current corporate tax plus a deferred capital gains tax. It appears unlikely that a large tax differential would result from this substitution.

G. Additional Reasons Support Continued Subchapter M Tax Status for Any SBIC Which May Be Exempted from Registration by Pending Legislation to Amend the Investment Company Act

The final form of legislation to amend the Investment Company Act is still in doubt. Two alternative approaches have received serious consideration: (i) making specific provisions of the Investment Company Act inapplicable to "business development companies," although such companies would still be required to register under the Act (H.R. 7491), or (ii) exempting "venture capital companies" from the registration requirement (*e.g.*, H.R. 7554). The proposed amendment of section 851(a) would permit currently registered SBICs to continue to qualify for conduit tax treatment if Congress decides to exempt venture capital companies from the requirement of registration under the Investment Company Act.[17/] Three reasons in addition to those previously discussed

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17/ The proposed amendment would not permit non-SBIC venture capital companies which may be exempted from registration to qualify for conduit tax treatment. Subchapter M tax status is less important for these companies than it is for SBICs because non-SBIC venture capital companies receive little interest income and can avoid corporate tax on appreciated equity investments by techniques such as dividends in-kind or liquidation. Furthermore, almost all currently operating non-SBIC venture capital companies are partnerships. Thus, exclusion from conduit tax treatment will cause little hardship for those non-SBIC venture capital companies which engage predominately in true venture capital (*i.e.*, high risk equity) investments.

The proposed amendment of section 851(a) does not include non-SBIC venture capital companies in the definition of regulated investment company because of concern expressed by the SEC regarding the breadth of the definition of venture capital company. Even if a company which resembles a mutual fund (*i.e.*, a company which receives significant dividend and interest income and does not make available managerial assistance) could satisfy the definition of venture capital company, it will nonetheless continue to voluntarily register under the Investment Company Act in order to avoid loss of conduit tax treatment.

support continued Subchapter M tax status for any SBIC which may be exempted from the requirement of registration under the Investment Company Act.

First, failure to provide continued Subchapter M tax status for currently registered SBICs would substantially frustrate Congress' purpose in providing an exemption from registration under the Investment Company Act. The disadvantage of liability for corporate taxes would greatly outweigh the advantage of reduced bureaucratic reexamination of business decisions. In recognition of this fact, recent versions of bills to exempt venture capital companies from registration would amend the Investment Company Act to provide that a company which would be excluded from the definition of investment company by reason of such legislation may nonetheless voluntarily register as an investment company, thereby preserving its status as a regulated investment company pending an amendment of section 851(a). See H.R. 6723, § 204; H.R. 7554, § 205; S. 1940, § 204.

Without such a voluntary registration provision, Congress' action in reducing regulation under the Investment Company Act would produce the absurd result of actually decreasing private investors' incentive to provide capital to SBICs for investment in small business. The imposition of the corporate tax on the income of an SBIC would mean a drop of almost 50 percent in the revenues available for distribution as dividends to SBIC shareholders. A loan-oriented SBIC which is subject to the corporate tax and which pays out all of its after-tax earnings as dividends would produce a higher rate of return than the SBIC's stockholders could obtain by making loans to small business concerns directly only if (i) enough SBIC debentures are purchased or guaranteed by the SBA, and (ii) the differential between the rate of interest received by the SBIC on its loans to small business concerns and the rate of interest the SBIC must pay on its debentures is sufficiently large. As Table I (page 43) illustrates, if an SBIC which makes only loans to small business concerns were subject to the 46 percent corporate tax on interest, private investment in the SBIC's stock would be entirely deterred unless the amount of SBA purchased or guaranteed debentures (the so-called government leverage) were greater than 213 percent of the combined private paid-in capital and paid-in surplus of the SBIC (assuming 9 percent interest on SBIC debentures and 15 percent interest on loans to small business concerns). The average government leverage supplied to SBICs (excluding bank-dominated SBICs, which use little government leverage) is considerably less than 200 percent of private paid-in capital and paid-in surplus.

Provision for voluntary registration reveals a congressional expectation that the elimination of unnecessary securities regulation must await a conforming amendment of the tax law. Therefore, Congress' attempt to stimulate venture capital investment by reducing the burden of securities regulation will be in

TABLE 1

Comparison Between Return on Investment in Stock of a Taxable SBIC Which Makes Loans to Small Business Concerns and Return on Investment in Comparable Loans Made to Small-Business Concerns Directly

	Private Capital Investment	SBA Purchased on Guaranteed Debentures */	Total Loan to Small-Business Concerns	Annual 15% Interest Payment by Small-Business Concerns	Annual Net Yield to SBIC After Payment of 9% on Debentures **/	Gross Income to Investor ***/
I. Investment in Stock of SBIC Subject to Corporate Tax	$10,000	$30,000	$40,000	$6,000	$3,300	$1,782
	10,000	21,296	31,296	4,694	2,778	1,500
	10,000	20,000	30,000	4,500	2,700	1,458
	10,000	10,000	20,000	3,000	2,100	1,134
	10,000	0	10,000	1,500	1,500	810
II. Direct Loan to Small-Business Concern	$10,000	N.A.	$10,000	$1,500	N.A.	$1,500

*/ Pursuant to 15 U.S.C. § 683(b)(2) the SBA may not purchase or guarantee SBIC debentures with a value greater than 400 percent of the combined private paid-in capital and paid-in surplus of the SBIC. Furthermore, the SBA may purchase or guarantee SBIC debentures with a value greater than 300 percent of the combined private paid-in capital and paid-in surplus of the SBIC only if 65 percent or more of the SBIC's total funds available for investment is invested in "venture capital." SBA regulations define "venture capital" for this purpose as (i) common or preferred stock of a small business concern, or (ii) debentures or loans which are subordinated to all borrowings by the small business concern from other institutional lenders and no part of the principal of which is repayable during the first three years of the loan. 13 C.F.R. § 107.202(b).

**/ The interest rates on SBIC debentures purchased by the SBA on June 18, 1980 were: (i) 8.685% for debentures with 3 year maturities, (ii) 8.985% for 5 year maturities, (iii) 9.235% for 7 year maturities, and (iv) 9.595% for 10 year maturities.

***/ This column represents the income to the investor prior to taxation of the dividends (SBIC stockholder) or interest (direct loan) at the investor level (assuming a flat 46 percent rate of tax at the SBIC level).

vain if Congress fails to amend section 851(a) to include in the definition of regulated investment company those currently registered SBICs which, by virtue of pending securities legislation, would be exempted from the requirement of registration under the Investment Company Act.

Second, Congress has expressed its intention that administrative actions which provide SBICs relief from the Investment Company Act should not jeopardize SBICs' ability to elect to be taxed as regulated investment companies. 15 U.S.C. § 687(g)(2)(J), supra. In view of this declared congressional policy, it would be extremely inconsistent for Congress to eliminate the requirement that SBICs register under the Investment Company Act and yet fail to provide for their continued Subchapter M tax status.

Third, legislation exempting venture capital companies from the requirement of registration under the Investment Company Act is likely to include significant restrictions designed to protect investors in unregistered venture capital companies. Therefore, even if regulation for the protection of investors is a requirement for Subchapter M tax status, the shareholders of a currently registered SBIC will be protected both by SBA regulation (Part III.B., supra) and by new provisions of the Investment Company Act which are specially adapted to the needs of such a company and its shareholders.

It appears likely that legislation to exempt venture capital companies from registration under the Investment Company Act will require that a majority of the board of directors of an unregistered venture capital company consist of persons who are not interested persons within the meaning of the Investment Company Act. Furthermore, the directors, officers, employees, controlling and affiliated persons of the company would be prohibited from owning or purchasing securities or property from a person controlled by or affiliated with the venture capital company, or from a person to which the company furnishes capital, unless the transaction is approved as fair by a disinterested majority of the board of directors. See H.R. 6723, § 203; S. 1940, § 203. Section 203 of H.R. 7554 contains even more stringent restrictions, including a flat prohibition on the acquisition from any person of securities or property of any investee company by any venture capital company director, officer or employee. H.R. 7554 would also require approval by a disinterested board of insider participation in joint transactions with the venture capital company. Compare Investment Company Act, § 17(a), (d), 15 U.S.C. § 80a-17(a), (d). Notwithstanding the exemption from registration, it appears likely that the SEC will be empowered to enforce these restrictions, in addition to enforcement by private right of action. H.R. 7554, § 203. Enactment of these provisions will constitute a judgment by Congress that such restrictions will assure that the shareholders of an SBIC which claims exemption from registration under the Investment Company Act will be adequately protected. It cannot seriously be contended that a higher standard of investor protection is required to secure the benefits of Subchapter M.

Finally, it should be observed that continued Subchapter M tax status for those currently registered SBICs which are exempted from the requirement of registration under the Investment Company Act will cause no revenue loss.

Appendix 1

96th Congress
2d Session

H.R. __________

To amend the Internal Revenue Code of 1954 with respect to the definition of regulated investment company.

IN THE HOUSE OF REPRESENTATIVES

June ___, 1980

Mr. ____________ (for himself and ____________________) introduced the following bill.

A BILL

To amend the Internal Revenue Code of 1954 with respect to the definition of regulated investment company.

Be it enacted by the Senate and House of Representatives of the United States in Congress assembled, That (a) Section 851(a) (relating to the definition of regulated investment company) of Part I of Subchapter M of Chapter 1 of Subtitle A of the Internal Revenue Code of 1954, is amended to read as follows:

"(a) GENERAL RULE.-- For purposes of this subtitle, the term "regulated investment company" means any domestic corporation (other than a personal holding company as defined in section 542)--

"(1) which, at all times during the taxable year, is registered under the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 to 80b-2), either as a management company or as a unit investment trust; or

"(2) which is a common trust fund or similar fund excluded by section 3(c)(3) of such Act (15 U.S.C. 80a-3(c)(3)) from the definition of "investment company" and is not included in the definition of "common trust fund" by section 584(a); or

"(3) which is a small business investment company licensed under the Small Business Investment Act of 1958, as amended (15 U.S.C. 661 to 696)."

EFFECTIVE DATE.--The amendment made by section (a) shall apply to taxable years beginning after December 31, 1979.

August 20, 1980

MEMORANDUM

Re: Proposed Amendment to
Conform Section 851 to
Changes in the Investment
Company Act of 1940

The memorandum entitled "Proposed Amendment of Section 851(a) to Include in the Definition of Regulated Investment Company Those Small Business Investment Companies Which Are Not Required to Register Under the Investment Company Act of 1940," dated July 3, 1980, explained the reasons why pending legislation to amend the Investment Company Act of 1940 in order to encourage the growth and development of companies which make venture capital investments necessitates a conforming amendment of section 851(a) to include small business investment companies (SBICs) in the definition of regulated investment company. At the time that memorandum was written, the precise form of the Investment Company Act amendments could not be predicted. Recent events have clarified the situation. On July 31, 1980 the Senate Banking Committee unanimously ordered S. 2990, the Small Business Securities Acts Amendments of 1980, reported. On August 1, 1980, the Subcommittee on Consumer Protection and Finance ordered H.R. 7554, the Small Business Investment Incentive Act of 1980, reported to the full House Commerce Committee. The provisions of these two bills which would amend the Investment Company Act are identical. Enactment of these amendments to the Investment Company Act is expected shortly.

The purpose of this memorandum is to describe the proposed changes in the Investment Company Act and explain their relationship to the section 851(a) definition of regulated investment company. This memorandum also discusses two issues raised at the meeting held on August 15, 1980 between representatives of the Treasury Department (Mr. John M. Samuels, Tax Legislative Counsel, and Mr. Roger Baneman) and representatives of the National Association of Small Business Investment Companies (Mr. Walter B. Stults, Executive Vice President, Mr. Ernest S. Christian, Jr., and Mr. Peter J. Wiedenbeck). Specifically, these issues concern the possibility that the proposed amendment of section 851(a) might (i) permit an operating corporation to convert its assets (including accumulated earnings and profits) into an SBIC investment portfolio without the imposition of a tax at the shareholder level, and (ii) permit an SBIC to avoid tax due to the exclusion of SBICs from the definition of personal holding company, section 542(c)(8).

I. Description of Pending Legislation <u>to Amend the Investment Company Act</u>

S. 2990 and H.R. 7554 would exempt an electing "business development company" from the most burdensome provisions of the Investment Company Act, including the requirement of registration under section 8 of the Act, 15 U.S.C. § 80a-8. <u>E.g.</u>, S. 2990, §§ 103, 105 (proposed sections 6(f) and 65 of the Investment Company Act). To qualify for this treatment a company (i) must be operated for the purpose of making certain types of investments, and (ii) must make available significant managerial assistance to the issuers of the securities in which it invests. S. 2990, § 101 (proposed section 2(a)(48) of the Investment Company Act). The nature of the eligible investments and the meaning of "making available significant managerial assistance" are so defined that essentially all SBICs would qualify for this treatment.

The eligible investments of a business development company include securities acquired in a nonpublic offering directly from an issuer which is (i) controlled by the business development company, or (ii) does not have any class of securities with respect to which a member of a national securities exchange, broker or dealer may extend or maintain credit pursuant to Federal Reserve Board regulations under section 7 of the Securities Exchange Act of 1934. S. 2990, §§ 105, 101 (proposed sections 61(a)(1) and 2(a)(46)(C) of the Investment Company Act). SBICs are predominately engaged in furnishing capital to small business by providing equity capital and long-term loans to small business concerns. 15 U.S.C. §§ 684, 685. These equity investments and long-term loans constitute securities which are acquired directly from the small business concern. In general, the small business concerns eligible to receive SBIC financing are closely-held businesses whose securities are not registered on a national securities exchange or traded over the counter. Federal Reserve Regulation T provides that members of a national securities exchange, brokers and dealers may not extend or maintain credit on such securities. 12 C.F.R. §§ 220.2(d)-(f), .3(c), .8(a). In consequence, the portfolios of essentially all SBICs will satisfy the investment criteria established for business development companies.

"Making available significant managerial assistance" is defined by proposed section 2(a)(47) of the Investment Company Act. S. 2990,

§ 101. With respect to SBICs, this term includes "making loans to a small business." SBICs could also easily satisfy the managerial assistance requirement with respect to their equity investments. The managerial assistance requirement is satisfied by the exercise of a controlling influence over the management or policies of an eligible portfolio company. Furthermore, "making available significant managerial assistance" includes offers to provide "significant guidance and counsel concerning the management, operations or business objectives and policies of an eligible portfolio company." Id. Regulations of the Small Business Administration (SBA) permit an SBIC to provide advisory management services to the small business concerns it finances without prior approval by the SBA. 13 C.F.R. § 107.601(b)(1). Therefore, there is no limitation on an SBIC's ability to offer to provide significant guidance and counsel.

Although a company which elects to be treated as a business development company would be unable to register under section 8 of the Investment Company Act, it would still be subject to most of the regulatory provisions applicable to registered investment companies. S. 2990, § 105 (proposed section 65 of the Investment Company Act). A business development company would be exempt from several of the most burdensome provisions applicable to registered investment companies, such as sections 17(a) and (d). Id. Even here, however, a company which elects to be exempted from registration would be subject to specialized provisions designed to protect the business development company's investors. Compare Investment Company Act sections 17(a)-(d) with proposed section 63, (S. 2990, § 105).

Because an electing business development company is exempted from registration under the Investment Company Act it cannot qualify as a regulated investment company unless section 851(a) is amended. Therefore, unless a conforming amendment of section 851(a) is enacted, currently registered SBICs will be unable to elect reduced regulation as business development companies without forfeiting their conduit tax treatment under Subchapter M. The reasons set forth in the July 3 memorandum demonstrate the overwhelming importance of conduit tax treatment to these SBICs. Hence, if section 951(a) is not amended currently registered SBICs will not elect to be treated as business development companies and Congress' effort to eliminate unnecessary regulation of these SBICs under the Investment Company Act will be in vain. In summary, although it now appears that the amendment of the Investment Company Act will take the form of an elective exemption of SBICs and other "business development companies" from registration, rather than an exception to the definition of investment company combined with a voluntary registration provision, all the reasons supporting the amendment of section 851(a) continue to apply.

II. Tax Deferred Conversion of Accumulated Operating Profits <u>Into an SBIC Investment Portfolio</u>

Permitting any SBIC which meets the tax policy-based criteria set forth in sections 851(b) and 852(a) to qualify as a regulated investment company would not increase the use of Subchapter M as a device to convert the assets of an operating corporation (including its accumulated earnings and profits) into a diversified investment portfolio without subjecting the corporation's shareholders to tax on the appreciation in their stock.

The concern expressed by the Treasury Department may be explained by reference to the following example. Assume that <u>A</u>, the sole stockholder in Corporation X, paid $100,000 for his shares. For thirty years Corporation X is actively engaged in the manufacture of widgets. At this time the fair market value of Corporation X is $1,000,000, and Corporation X has a basis in its assets of $500,000. A wishes to withdraw from the active management of the business and provide for his retirement. A could liquidate Corporation X and invest the proceeds in a diversified investment portfolio. In this event, A would be subject to tax on the $900,000 long-term capital gain ($1,000,000 value of assets received in exchange for stock having a basis of $100,000). Alternatively, A could have Corporation X sell its assets and cause Corporation X to be licensed as an SBIC. In this event, Corporation X would be subject to tax on its $500,000 long-term capital gain ($1,000,000 received for assets having a basis of $500,000), and under Subchapter M Corporation X could receive conduit tax treatment -- A could receive income from the SBIC's investments as though he owned the securities directly. By means of this device, A has deferred the capital gains tax on $400,000 until he disposes of the Corporation X stock. If A dies while holding the stock this appreciation may escape tax entirely.

The Internal Revenue Service recently issued a proposed regulation under section 368 which would prevent an operating company from obtaining similar results by selling its assets and merging into a regulated investment company in a tax-free reorganization. Prop. Reg. 1.368-1(d), 44 Fed. Reg. 76813 (Dec. 28, 1979) interprets the requirement of continuity of business enterprise. Under the proposed regulation a transaction would be treated as a tax free reorganization only if (i) the transferee continues a significant line of the transferor's historic business, or (ii) there is signigicant use of the transferor's historic business assets in the transferee's business. The following example is set forth in the proposed regulation.

> Example (3). Corporation T is a manufacturer of boys' and men's trousers. On January 1, 1977, as part of an overall plan intended to result in a reorganization, T sold all of its assets to a third party for cash and purchased a highly diversified portfolio of stocks and bonds. On July 1, 1980, T transfers all of its assets to U, a regulated investment company, solely in exchange for U voting stock. The continuity of business enterprise requirements is not met. P's [sic: T's] investment activity is not its historic business, and the stock and bonds are not T's historic business assets.

Prop. Reg. § 1.368-1(d)(5), supra.

The reorganization provisions are exceptions to the general rule that an exchange of securities is a taxable event. This exception is justified where the exchange does not result in a complete change in the nature of the shareholders' investment. Converting an operating corporation into an SBIC would result in a complete change in the shareholders' investment. Therefore, such a conversion might be considered to be an appropriate time to tax the appreciation in the corporation's stock. However, since there has been no sale or exchange by the owners of the corporation's securities, there has been no taxable event.

In considering the potential for abuse of the proposed amendment of section 851(a) it is important to understand that it is possible under present law to accomplish a similar tax deferred conversion of the accumulated profits of an operating corporation into the investment portfolio of a regulated investment company. With reference to the preceding example, A could accomplish the same result under present law by having Corporation X issue 1 share of stock to each of 100 individuals. Then, because Corporation X "proposes to engage primarily, in the business of investing, reinvesting, or trading in securities," Corporation X will be required to register under the Investment Company Act. 15 U.S.C. §§ 80a-3(a)(1), -3(c)(1), -8(a). Consequently, Corporation X will be eligible to elect to be taxed as a regulated investment company.

The possibility of converting an operating corporation into an SBIC rather than into a registered investment company would create no additional potential for tax abuse. Under the proposed amendment of section 851(a) an SBIC which does not have more than 100 security owners could qualify for conduit tax treatment, and such an SBIC would not be subject to the substantial burdens which regulation under the Investment Company Act imposes. These two factors are advantages to using an SBIC rather than a registered investment company as the device to shift profits from an operating corporation into a regulated investment company. However, these advantages are outweighed by an important disadvantage -- the Small Business Investment Act of 1958 (15 U.S.C. § 661 et seq.) and the regulations thereunder (13 C.F.R. Part 107) specify the permissable investments of an SBIC. SBICs cannot invest in blue chip securities; they are limited to investments in small business concerns. 15 U.S.C. §§ 662(5), 632; 13 C.F.R. §§ 121.3-10, -11. SBICs make high risk investments, and the return on an SBIC's capital generally takes the form of capital gains rather than dividends and interest. Furthermore, an SBIC often must become involved in the management and operation of the small business concerns it finances. Thus an SBIC must be an active business enterprise rather than a passive investment manager -- more like a bank than like a traditional mutual fund.

Because of these three factors -- the high risk, the delayed return on investments and the active participation in the management of portfolio companies -- an SBIC is not an attractive investment for the proceeds received on the sale of an operating corporation. Consequently the proposed amendment of section 851(a) would provide no extra incentive to convert the assets (including the accumulated profits) of an operating corporation into the investment portfolio of a regulated investment company.

Furthermore, even if the nature of an SBIC's investments would not be unattractive enough to deter the use of this device, a flood of SBIC conversions would not result. The SBA exercises discretion in the decision whether a license to operate as an SBIC should be granted. In exercising this discretion the SBA is required to

> give due regard, among other things, to the need and availability for the financing of small business concerns in the geographic area in which the proposed company is to commence business, the general business reputation and character of the proposed owners and management of the company, and the probability of successful operations of such company including adequate profitability and financial soundness.

15 U.S.C. § 681(c). Since the availability of small business financing in the geographic area is an important factor in the licensing of SBICs, the number of operating corporations which could convert to SBICs is limited. Moreover, consideration of the probability of successful operation might prevent many closely-held operating corporations from obtaining licenses, because their owners are likely to be inexperienced and unsophisticated in financial affairs.

In summary, even if unjustified tax deferral results from the conversion of operating corporations into regulated investment companies, this deferral is a consequence of present law. Due to the unattractive nature of an SBIC's investments, the opportunity for use of this technique is not enhanced by the proposed amendment of section 851(a). Moreover, even if conversion to an SBIC were attractive, the criteria used to determine whether to grant a license to operate as an SBIC would prevent the widespread use of this technique.

III. Exclusion of SBICs from the Section 542 Definition of Personal Holding Company

Including SBICs with 100 or fewer security owners in the section 851(a) definition of regulated investment company would not result in the avoidance of the personal holding company tax or frustrate the purpose of the personal holding company provisions.

Under present law, personal holding companies (as defined in section 542) are excluded from the section 851(a) definition of regulated investment company.*/ SBICs, however, are excluded by section 542(c)(8) from the definition of personal holding company. Therefore, the proposed amendment of section 851(a) would permit an SBIC, more than 50 percent of the stock of which is owned by five or fewer individuals, to receive conduit tax treatment.

There are two possible reasons why personal holding companies are excluded from regulated investment company tax status under present law. First, the exclusion may result from concern that the personal holding company tax might not apply to regulated investment companies. If not, Subchapter M would provide a limited ability to use a corporation to accumulate ordinary income at the low corporate tax rates. Although the policy of forcing dividend distributions by personal holding companies is similar to the Subchapter M requirement that ordinary income be passed through to shareholders, the equivalence is not exact. Under section 852 (a) only 90 percent of a regulated investment company's ordinary income must be distributed currently; any undistributed income is taxed at the regular corporate rates under section 852(b). A personal holding company, however, is taxed at the 70 percent rate on <u>any</u> undistributed ordinary income. Therefore, the exclusion of personal holding companies from conduit tax treatment may be considered necessary to prevent the use of a regulated investment company as a mechanism to achieve a limited accumulation of investment income at the low corporate tax rates. This rationale is

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*/ Under present law it is possible for a registered investment company to satisfy the definition of personal holding company. Although more than 100 shareholders are required to register under the Investment Company Act, if more than 50 percent of the stock is owned by five or fewer shareholders, a registered investment company would also be a personal holding company.

obviously inapplicable to SBICs, because the exclusion of SBICs from the definition of personal holding company means that SBICs are permitted to accumulate income without limit; therefore, the limited accumulation available under Subchapter M presents no potential for tax avoidance.

It is unclear whether the foregoing reasoning adequately explains the exclusion of personal holding companies from the definition of regulated investment company. Absent this exclusion in section 851(a), it is not clear that the personal holding company provisions would not impose the 70 percent penalty tax on a registered investment company's "investment company taxable income," as defined in section 852(b)(2). Unlike the exception from the regular corporate tax provided by section 11(c)(3), regulated investment companies are not expressly excepted from the definition of personal holding company, and on its face section 852(b) does not indicate that it is the only tax imposed on regulated investment companies. Furthermore, in 1936 when the exclusion of personal holding companies from conduit tax treatment was enacted, personal holding companies were permitted to deduct 20 percent of their "adjusted net income" (i.e., net income less other federal taxes and certain disallowed deductions) from the tax base on which the personal holding company tax was imposed. Revenue Act of 1936, Pub. L. No. 74-740, § 351(b)(2)(A). Therefore, when originally enacted the 10 percent accumulation allowed under Subchapter M was less than the accumulation allowed under the personal holding company provisions.

A second possible reason for the exclusion of personal holding companies from Subchapter M relates to the taxes which would be imposed on the income derived by a company (more than 50 percent of the stock of which is owned by five or fewer individuals) which annually distributes all of its ordinary income. If the personal holding company tax is effective in forcing a complete distribution of a company's undistributed personal holding company income, the ordinary income portion of the company's investment earnings, although exempt from the penalty tax, will be subjected to two current income taxes -- dividends and interest received by the company will be subject to the ordinary corporate income tax, and the after-tax corporate income which is distributed will be taxed again at the shareholders' marginal rates. In contrast, if all ordinary income of a regulated investment company is distributed, the Treasury will receive only the current individual income tax on the dividends received by the shareholders -- no corporate income tax will be imposed because the corporation is granted a dividends paid deduction under Subchapter M. Section 852(b)(2)(D).

Since the most favorable tax consequence available to the shareholders of a personal holding company is to have the company's income taxed both at the corporate and at the shareholder levels, there is a significant disincentive to incorporating an investment portfolio. The exclusion of personal holding companies from Subchapter M assures that this disincentive will apply, even in the case of a registered investment company, if more than 50 percent of the stock of the company is owned by five or fewer individuals.

Including SBICs in the definition of regulated investment company will not permit SBICs to substitute a single current tax (the individual income tax on dividend distributions) for the combination of a current corporate income tax and a current individual income tax. The exclusion of SBICs from the definition of personal holding company means that the relevant choice presented by Subchapter M is between a single current tax (the individual income tax on dividend distribution) and the combination of a current corporate income tax and a deferred capital gains tax on appreciated SBIC stock. Since the theory of the personal holding company provisions is that the single current tax on shareholders is generally greater than the combination of a current corporate tax and a deferred capital gains tax, permitting an SBIC (more than 50 percent of the stock of which is owned by five or fewer individuals) to elect the single current tax on shareholders is unlikely to result in tax avoidance.

In summary, permitting those SBICs which would be treated as personal holding companies absent section 542(c)(8) to elect to be taxed as regulated investment companies would not create any potential for tax avoidance by closely-held SBICs. Although two tax policy-based considerations may justify the exclusion of personal holding companies from Subchapter M, neither of these considerations apply to SBICs, which Congress has previously decided should not be subjected to the personal holding company tax. Furthermore, it should be noted that even under present law an SBIC which would be a personal holding company absent section 542(c)(8) can qualify for conduit tax treatment if it has more than 100 shareholders (*i.e.*, is registered under the Investment Company Act).

STATEMENT OF HON. PAUL SARBANES, U.S. SENATOR, STATE OF MARYLAND

Senator SARBANES. Thank you very much, Mr. Chairman. I will submit the statement for the record and abridge it, because I know you have other legislation to address this morning.

Senator PACKWOOD. I appreciate it very much.

Senator SARBANES. In introducing S. 1304, legislation to amend the code with respect to the tax treatment of business development companies, I was pleased to join with three distinguished members of this committee, the Senator from Rhode Island, Mr. Chafee; the Senator from Minnesota, Mr. Durenberger, and the Senator from Montana, Mr. Baucus.

Mr. Chairman, I should say I am pleased to note the presence of Arthur Little to testify on behalf of the legislation.

Last year he testified before the Securities Subcommittee of the Banking Committee, of which I was then the chairman, before developments overtook us. [Laughter.]

Senator SARBANES. Mr. Little testified on legislation to revise the regulatory framework of the Investment Company Act of 1940, applicable to venture capital companies, which we subsequently enacted in the 96th Congress as the Small Business Investment Incentive Act.

The bill before us is a necessary and logical corollary to that legislation. Mr. Little shared with the subcommittee his extensive experience in raising venture capital, and his knowledge of the problems facing investors who seek to invest in small, untried, and innovative enterprises.

He thereby contributed significantly to the development of the Small Business Investment Incentive Act, which is today Public Law 96-477. I am pleased to see him here this morning.

Mr. Chairman, S. 1304 will correct an anomaly in the tax treatment of venture capital companies which has arisen with the enactment last year of the Small Business Investment Incentive Act.

It will enable business development companies, established pursuant to that act, to qualify for passthrough treatment of corporate earnings.

It will also extend passthrough treatment to bona fide small business investment companies with fewer than 100 shareholders, but not to closely held, personal holding companies.

This legislation has been very carefully crafted in order to address any conceivable problem that anyone might raise with respect to it.

A brief review of the Small Business Investment Incentive Act will make clear the importance of enactment by the Congress of S. 1304.

The purpose of that act was to amend the Investment Company Act of 1940 in order to encourage mobilization of capital for new, small, medium-sized, and independent business by facilitating the activities of venture capital companies and investment advisers, while at the same time maintaining indispensable standards of investment protection.

Recognizing the importance of venture capital for new and untried businesses whose access to conventional capital markets is limited, the Small Business Investment Incentive Act last year established a new regulatory framework which exempts from the registration requirements of the Investment Company Act private and public venture capital companies that meet certain specified criteria and thereby qualify as business development companies. It provides investor protections which are essential to the proper functioning of our capital markets.

Mr. Chairman, it would be illogical and self-defeating if the incentive to venture capital activities provided by the business development company framework which we passed last year were to be nullified by unfavorable tax treatment for the business development company.

Companies regulated under the Investment Company Act of 1940 qualify for passthrough tax treatment of corporate earnings. Such earnings are taxed once to the shareholders in the year they are earned rather than twice, once to the corporation, again when distributed to the shareholders.

However, under current tax law, registration under the 1940 act is the prerequisite for passthrough treatment. A company not so registered is ineligible for it.

Under existing law, a venture capital company seeking to expand its investment activities by qualifying as a business development company not regulated by the 1940 act is therefore penalized with respect to its tax status.

S. 1304 would correct that anomaly.

In other words, we provided a framework to take these companies out of the Investment Company Act for very good reason. I think that legislation is good public policy. We now need to extend the passthrough to these qualified business development companies.

The Small Business Investment Incentive Act was designed to contribute to the capital formation process for a critical sector of the business community. It recognizes the vital importance to our national economy of the small business sector.

It removes unnecessary and antiquated regulatory barriers that have obstructed the direct flow of capital to small and new business enterprises.

S. 1304 is a logical and necessary tax corollary of the Small Business Investment Incentive Act. It will help to translate the promise of that legislation enacted in the last Congress into solid economic reality. I urge the committee to act favorably upon it.

Mr. Chairman, I appreciate your courtesy.

Senator PACKWOOD. Paul, I have no questions. I agree totally with what you say. And, as I indicated to Mr. Little, I know that the result that has happened is not what we intended at the time we were discussing this legislation.

Senator SARBANES. Fine. Thank you very much, Mr. Chairman.

[The statement of Senator Paul S. Sarbanes follows:]

STATEMENT OF SENATOR PAUL S. SARBANES ON S. 1304

Thank you, Mr. Chairman. I appreciate the opportunity to appear this morning before the Subcommittee on Taxation and Debt Management in support of S. 1304, legislation to amend the Internal Revenue Code of 1954 with respect to the tax treatment of business development companies. In introducing this legislation I am very pleased to have joined with three distinguished members of this Committee, the Senator from Rhode Island, the Senator from Minnesota and the Senator from Montana.

I am also pleased to note the presence of Arthur D. Little to testify on behalf of S. 1304. Last year Mr. Little testified before the Securities Subcommittee of the Senate Banking Committee on legislation to revise the regulatory framework of the Investment Company Act of 1940 applicable to venture capital companies—legislation subsequently enacted by the 96th Congress as the Small Business Investment Incentive Act, to which the bill now before us is a logical and necessary corollary. Mr. Little shared with the Subcommittee his extensive experience in raising venture capital and his knowledge of the problems facing investors who seek to invest in small, untried and innovative enterprises. He thereby contributed very significantly to the development of the Small Business Investment Incentive Act, which is today Public Law 96-477.

Mr. Chairman, S. 1304 will correct an anomaly in the tax treatment of venture capital companies which has arisen with the enactment last year of the Small Business Investment Incentive Act. It will enable business development companies established pursuant to that act to qualify for pass-through treatment of corporate earnings. It will also extend pass-through treatment to bona fide small business investment companies with fewer than 100 shareholders, but not to closely held personal holding companies.

A brief review of the Small Business Investment Incentive Act will serve to make clear the importance of enactment by this Congress of S. 1304. The purpose of that Act, briefly put, was to amend the Investment Company Act of 1940 in order to encourage mobilization of capital for new, small, medium sized and independent business by facilitating the activities of venture capital companies and investment advisors while maintaining indispensable standards of investment protection. It is a tribute to the effectiveness of the Investment Company Act that the investment company industry has not experienced a mutual fund and venture capital operations have diverged in very significant ways and the Act had come to restrict unnecessarily venture capital activities. Recognizing the importance of venture capital for new and untried businesses whose access to conventional capital markets is limited, the Small Business Investment Incentive Act last year established a regulatory framework which exempts from the registration requirements of the Investment Company Act private and public venture capital companies that meet certain specified criteria and thereby qualify as business development companies. The Investment Company Act of 1940 and the Small Business Investment Incentive Act of 1980 are alike in assuring the investor protections which are essential to the proper functioning of our capital markets. They differ, however, in certain important respects, for example their provisions governing affiliated person transactions and capital structure; in addition, the new Act places an increased share of the regulatory responsibility on the board of directors of the business development company. The net effect of this Act is to offer apropriate relief from the Federal securities laws for qualifying companies that provide venture capital to small, developing businesses. At the same time, the Act strengthens the investor protection fabric of the securities laws by expressly preserving many safeguards available to investors under existing law and creating new rights and protections for shareholders of venture capital companies. It reflects a significant cooperative effort on the part of members of the Banking Committee without regard to partisanship, of the Securities and Exchange Commission, of representatives of the venture capital industry and of the leadership of the Small Business Committee.

It would be illogical and self-defeating if the incentive to venture capital activities provided by the business development company framework were to be nullified by unfavorable tax treatment for the business development company. Companies regulated under the Investment Company Act of 1940 qualify for passthrough tax treatment of corporate earnings—such earnings are taxed once to the shareholders in the year they are earned rather than twice, once to the corporation and again when distributed to the shareholders. Since registration under the 1940 Act is the prerequisite for passthrough treatment, a company not so registered is ineligible for it. Under existing law a venture capital company seeking to expand its investment activities by qualifying as a business development company not regulated by the 1940 Act is therefore penalized with regard to its tax status. By extending the passthrough to qualified business development companies, S. 1304 would correct that anomaly. It would also extend passthrough treatment to small business investment companies not currently eligible, that is, those with fewer than 100 shareholders, but would not apply such treatment to closely held personal holding companies.

The Small Business Investment Incentive Act was designed to contribute to the capital formation process for a critical sector of the business community. It recognizes the vital importance to our national economy of the small business sector. It removes unnecessary and antiquated regulatory barriers that have obstructed the direct flow of capital to small and new business enterprises. S. 1304 is a logical and necessary tax corollary of the Small Business Investment Incentive Act. It will help to translate the promise of that legislation, enacted in the last Congress, into solid economic reality.

Senator PACKWOOD. I have no questions.

Mr. Little, thank you.

Mr. LITTLE. Thank you.

Senator PACKWOOD. We will now move on to S. 1214. We have Senator Boschwitz with us. We will take Mr. Penick, Mr. Woodbury and Mr. Adams, as a panel.

I might say to Mr. Adams that Senator Armstrong sends his regrets. He wishes he could be here and says that you are related to one of his most able employees.

Mr. ADAMS. I think that's right.

Senator PACKWOOD. But in any event, he is sorry he couldn't be here and he wanted me to say hello.

Mr. ADAMS. Thank you.

STATEMENT OF HON. RUDY BOSCHWITZ, U.S. SENATOR, STATE OF MINNESOTA

Thank you, Mr. Chairman. I want to express my appreciation for holding this hearing and giving me the opportunity to testify in support of S. 1214, a bill that I introduced. It would repeal section 163(d), which limits the deduction for investment interest expense of individuals.

I will try to keep my remarks brief, Mr. Chairman, as we have a distinguished panel here. In the event I do not conclude them, I will insert them for the record, if I may.

Senator PACKWOOD. All of the statements, of course, will be in the record, in their entirety.

Senator BOSCHWITZ. Fine.

Mr. Penick has considerable experience and expertise and will address the technical and historical aspects of the limitation, as well as the overall effect it has on small business.

Mr. Adams will address the negative aspects the limitation has on small businesses in the advertising industry.

By definition, the limitation on the deduction of investment interest expense is a disincentive to investment.

At the outset, I want to emphasize that this limitation only applies to individuals—corporations can deduct their entire interest expense.

As a result, individual investors and entrepreneurs will be the primary beneficiaries of repealing the limitation. An individual is limited to an investment interest expense deduction of $10,000, plus his net investment income, basically his unearned income.

Unfortunately, the vast majority of small businessmen and entrepreneurs do not have unearned income. Profits earned by the business are kept in the business for growth rather than distributed as dividends. Most, if not all of their income is salary from the business. As a result, small businessmen generally are limited to a deduction of $10,000. With interest rates over 20 percent, Mr. Chairman, the limitation affects many small businesses. $50,000 worth of loans is a $10,000 deduction, maximum for an individual.

My legislation would remove those limitations and stimulate investment generally, but would specifically address two types of investments which concern me greatly.

First, individuals who wish to start up a new business often incur substantial interest expense in getting the corporation going. Present law limits the amount of that interest expense that would be deductible.

Repealing the limitation would leave no question that interest expense incurred by an individual starting a new business would be deductible.

Second, the limitation can adversely affect individuals seeking to acquire an interest in an existing business. The limitation compounds the difficulties in transferring small businesses to employees or family members who would become owners or operators.

The problem occurs because the employee or family member seeking to buy an interest receives earned income from the business, which cannot be used to offset the interest expense.

Mr. Chairman, in my particular case, if my four sons who own a share of my business, decided to buy out my share, their mother's share or one another's share, they would have to borrow. Since a reasonable interest in the business is worth more than $50,000, the interest expense would be over $10,000. Since they would have no substantial unearned income, they would be very much affected by this limitation.

So, I can identify very much with the problem that exists.

The Senate is on record twice as favoring the repeal of this limitation, in 1976 and 1979.

The House, however, insisted on a limitation to correct the perceived abuse of tax shelters. I believe, as the Senate did, in 1969 and 1976, that the tax shelter provisions in the Tax Reform Act of 1976, most notably the "at risk" provisions, adequately addressed this issue.

Furthermore, tax shelter abuses should be addressed themselves, rather than dealing with them by limiting legitimate needs.

The many should not suffer for the abuses of a few.

For over a week now, the Senate has been debating the Economic Recovery Tax Act to provide tax incentives to encourage savings and investment.

There are two basic ways to accomplish this goal—create new incentives or remove existing disincentives. The tax cut will provide additional incentives to businesses through a new depreciation system. It will also remove disincentives by reducing tax rates for individuals, making corporate and individual tax rates about equal.

The repeal of the investment interest expense limitation is complementary with reducing tax rates because there are two sides of the same coin.

Reducing the tax rate makes investors more willing to take risks because there is a greater potential for return. Repealing the interest expense limitation removes the barrier to undertake the investment.

Once again, Mr. Chairman, I thank you for holding this hearing so quickly, after the introduction of the bill. I am ready and willing to work with you and others on the Committee to enact this legislation and remove this disincentive to investment.

Senator PACKWOOD. Rudy, you correctly perceived what we tried to do in this Committee in 1976. The purpose of this limitation was to discourage individuals from borrowing money simply to invest it in income-producing property, the tax shelter, if you want to call it that.

At the time we did it, I know the abuse we were trying to correct. Whether we hit the target or not is the purpose of this hearing.

Mr. Penick.

Mr. PENICK. Thank you.

[Senator Boschwitz's statement follows:]

PREPARED STATEMENT OF U.S. SENATOR RUDY BOSCHWITZ

Mr. Chairman, I want to express my appreciation to you for holding this hearing and giving me the opportunity to testify in support of S. 1214, the bill I introduced. My bill would repeal Section 163(d), which limits the deduction for investment interest expense of individuals.

I'll try to keep my remarks brief, so that the other witnesses will have ample time to testify. Mr. Penick has considerable experience and expertise, and will address the technical and historical aspects of the limitation, as well as the overall affect it has on small business. Mr. Adams will address the negative effects the limitation has on small businesses in the advertising industry.

By definition, the limitation on the deduction of investment interest expense is a disincentive to investment. At the outset, I want to emphasize that this limitation only applies to individuals—corporations can deduct their entire interest expense. As a result, individual investors and entreprenuers will be the primary beneficiaries of repealing the limitation. An individual is limited to an investment interest expense deduction of $10,000 plus his net investment income—basically his unearned income. Unfortunately, the vast majority of small businessmen and entrepreneurs do not have unearned income. Profits earned by the business are kept in the business for growth, rather than distributed as dividends. Most, if not all, of their income is salary from the business. As a result, small businessmen are generally limited to a deduction of $10,000. With interest rates over 20 percent, the limitation affects many small businessmen.

My legislation would remove these limitations and stimulate investment generally, but would specifically address two types of investment which concern me greatly. First, individuals who wish to start up a new business often incur substantial interest expense to get the corporation going. Present law would limit the amount of that interest expense which would be deductible. Repealing the limitation would leave no question that the interest expense incurred by an individual starting a new business would be deductible. Second, the limitation can adversely affect individuals seeking to acquire an interest in an existing business. The limitation compounds the difficulties in transferring small businesses to employees or family members who would become owners as well as operators. The problem occurs because the employee or family member seeking to buy an interest in the business (especially less than controlling interest) receivers earned income from the business, which cannot be used to offset the interest expense.

The Senate is on record twice as favoring the repeal of this limitation—both in 1969 and 1976. The House, however, insisted on a limitation to correct perceived abuses of tax shelters. I believe, as the Senate did in 1969 and 1976, that the tax shelter provisions in the Tax Reform Act of 1976, most notably the "at risk" provisions, adequately address this issue. Furthermore, tax shelter abuses should be addressed themselves, rather than dealing with them by limiting legitimate needs. The many should not suffer for the abuses of the few.

For over a week now, the Senate has been debating the Economic Recovery Tax Act to provide tax incentives to encourage savings and investment. There are two basic ways to accomplish this goal—create new incentives or remove existing disincentives.

The tax cut will provide additional incentives to businesses through a new depreciation system. It will also remove disincentives by reducing tax rates for individuals, making corporate and individual rates about equal. The repeal of the investment interest expense limitation is complementary with reducing tax rates, because they are two sides of the same coin. Reducing the tax rate makes investors more willing to take risks, because there is a greater potential for return. Repealing the interest expense limitation removes a barrier to undertake the investment.

Once again, Mr. Chairman, I thank you for holding this hearing. I am ready and willing to work with you and other members of the Committee to enact this bill, and remove this disincentive to investment.

STATEMENT OF WILLIAM C. PENICK, MANAGING DIRECTOR FOR LEGISLATIVE TAX POLICY, ARTHUR ANDERSEN & CO., ON BEHALF OF THE NATIONAL SMALL BUSINESS ASSOCIATION, WASHINGTON. D.C.

Mr. PENICK. My name is Bill Penick. I am the managing director for legislative tax policy with Arthur Andersen. I am appearing this morning on behalf of the National Small Business Association, supporting Senator Boschwitz's bill, No. 1214.

Section 163 was enacted in 1969 primarily to curb perceived abuses in tax shelters. Subsequent legislation, particularly the changes made in 1976, and the adoption of the at risk rules, have essentially eliminated whatever abuses were of concern in 1969.

As Senator Boschwitz has said, the limitation today of $10,000 is particularly harmful to small business owners. Many of them must borrow from banks at very high interest rates to obtain funds to invest in their businesses.

In a period of development or expansion the businesses themselves do not have adequate funds to pay dividends. The owner is caught in a catch 22 situation where he is limited in the deductibility of interest, which in effect increases the cost of the interest that he is paying and has little or no investment income to offset it.

There is of course, an extra $15,000 allowance to cover the situation where a taxpayer owns more than 50 percent of a business and acquires equity in it.

But in many cases, he cannot meet this test. There are many small businesses that are owned by three or more people equally and there is no way they can qualify for this extra $15,000 allowance.

Investment interest limitation creates a real deterrent to the transfer of ownership of small businesses to employees and younger executives.

A very unfortunate consequence of this is increased pressure on older owners who are approaching retirement to sell or merge with larger companies. We see this frequently.

This leads to greater concentration of business in large companies. As our written statement indicates, the small business sector has really been the principal source of new employment in recent years.

In expanding an existing business, aside from transferring ownership, big companies can go out and borrow, if you read the papers recently, billions of dollars for these acquisitions, deduct the interest in full, with no limitation whatever. But the small business owner cannot do that in many cases, because of this limitation under 163(d).

Complexity is certainly not the main consideration in developing our tax laws, but the investment interest limitation provision does create complexity far beyond its benefits.

Attached to our statement, and I know Mr. Woodbury who will testify in a few moments includes the same thing, is a copy of IRS form 4952, which to say the least, will create a few problems for the average taxpayer. It is an incredibly complex document. I really don't blame the Revenue Service for it, it is the complexity of the statute that creates the problem.

Repeal of section 163(d) would clearly simplify tax reporting for thousands of taxpayers. As Senator Boschwitz just said, at a time when we are concerned about capital needs, and particularly in the small business sector, tax disincentives such as those under 163(d) should be closely examined.

In our view, this one should be repealed.

Thank you very much.

[The prepared statement of William C. Penick follows:]

PREPARED STATEMENT OF WILLIAM C. PENICK, ON BEHALF OF THE NATIONAL SMALL BUSINESS ASSOCIATION

My name is William C. Penick and I am the Managing Director for Legislative Tax Policy with Arthur Andersen & Co., an international accounting firm. I appear today on behalf of the National Small Business Association in support of S. 1214. This bill would eliminate the limitation on the deductibility of investment interest now contained in IRC Section 163(d).

The National Small Business Association is a multi-industry trade association representing approximately 50,000 small business firms nationwide. Many of the owners of these small business entities are directly and adversely affected by Section 163(d).

We commend Senator Rudy Boschwitz and others who have expressed concern about this limitation and urge favorable consideration by this Congress of S. 1214.

BACKGROUND OF SECTION 163(D)

The investment interest expense limitation was enacted as part of the Tax Reform Act of 1969 to curb perceived abuses in financing tax shelter investments. Initially, the limitation was $25,000 plus net investment income and net capital gains.

The Tax Reform Act of 1976 continued Congressional concern about abusive tax shelters and enacted a number of provisions that have been effective in curtailing such abuses. These include the so-called "at-risk" provision that generally limits a taxpayer's deductible losses to the actual amount he has invested. The "at-risk" rules have essentially eliminated the major abuse areas toward which the 1969 Act was directed. Furthermore, IRC Sec. 265 remains a very effective deterrent to debt financing for municipal bonds.

Additionally, Section 163(d) was amended to reduce the overall limitation to $10,000 but permitting an additional $15,000 interest deduction for debt incurred to acquire stock in a controlled (50 percent ownership test) corporation by a taxpayer. However, the capital gain income offset to interest expense was eliminated.

Clearly, with today's extremely high interest rates, these limitations are no longer justified and they act as a significant deterrent to many types of investments. When great concern is being shown about the need to encourage savings and investment, a limitation like that contained in Section 163(d) appears completely inappropriate.

SMALL BUSINESS IMPLICATIONS

The importance of small and medium size businesses to the U.S. economy has been well documented. SBA statistics show that small business employs about 60 percent of the U.S. business work force, including farms. Over three-fourths of new jobs generated in recent years have come from the small business sector.

Our tax laws should not create disincentives for the ownership of small businesses, and those that presently exist should be removed. The investment interest limitation under Sec. 163(d) is such a disincentive, and it should be repealed.

The problems created by the existing limitation under Section 163(d) are particularly acute in the small business sector. The Federal Taxation Division of the American Institute of Certified Public Accountants published a booklet last year entitled "Tax Recommendations to Aid Small Business." One of the recommendations contained in that booklet was:

"Interest paid or incurred to purchase or carry debt or equity investments in a Small Business Enterprise (as later defined) should be exempted from the interest expense disallowance rules of Section 163(d)."

The AICPA report properly notes that our present income tax rules place significant restrictions on the small businessman who must borrow funds for entry into a new corporate business activity. Likewise, the investment interest limitations impose a burden on the small business owner who finds it necessary to invest additional funds in an existing corporation.

The interest cost incurred by the small businessman is seldom matched with dividends paid by his company. If the investor does not have substantial outside investment income, a portion of the interest expense paid on his individual loans may be nondeductible under Sec. 163(d).

The existence of the investment interest limitation is particularly ironic at a time when various legislative measures are being considered to encourage investment in business activities. It is also noteworthy that owners of closely-held companies will be under significantly increased pressures to add to the capital of their businesses additional equity, because of the debt/equity rules (Section 385) which are scheduled to be effective the first of next year.

As a partner in a large international accounting firm, I am aware of the extent to which inflation impacts the capital needs of companies of all sizes. Small business has traditionally filled its needs by relying largely upon bank debt—debt which often commands an interest premium of 2 percent to 3 percent over prime rates.

With today's prime at about 20 percent, let us assume that Mr. Jones is quoted an interest rate of 23 percent from his local bank. This means that a loan to Mr. Jones of $50,000 for an investment in his business would result in annual interest charges of $11,500, a very significant amount in relation to the permissible limits under Sec. 163(d).

While an additional $15,000 is permitted for loans used to finance equity investments in 50 percent owned business entities, many closely-held businesses are owned equally by three or more individuals. In these cases the 50 percent test cannot be met, and the overall $10,000 limitation will apply.

The treatment of most small business enterprises differs from that afforded large publicly-held corporations, which may borrow large amounts to be advanced to or invested in a subsidiary thatr wishes to expand its operations. The large public company need not worry about deducting interest on its loans since Sec. 163(d) does not apply to corporations. Many of us have been shocked by the large amounts of borrowing contemplated in connection with recently announced mergers involving billions of dollars. The cost of carrying this debt will be tax deductible.

OTHER CONSIDERATIONS

The present investment interest limitation discourages individuals from making long-term investments, since the short-term return from such investments is usually small. Interest rates have risen well above average current yields on equity investments and this has worsened the problem. Not only is an individual assuming a personal risk by making an entrepreneurial investment, but he is penalized by Sec. 163(d) if the investment does not yield enough net investment income to offset interest expense.

Congress has appropriately shown great concern about the need to encourage employee ownership of businesses and to retain viable entities in the small business sector.

In many situations, existing owners of small businesses would like to encourage younger employees to acquire equity interests in those businesses. Unfortunately, since such interests normally pay small dividends and employees do not have available funds to purchase stock, they must borrow money at high interest rates. However, having little investment income to offset against interest paid, current tax deductions for the interest will be limited.

In many cases, older owners are approaching retirement but still need income from the businesses to finance their retirement needs if they sell their interests. Succeeding management must rely on borrowed funds to acquire stock either from existing shareholders or from the company. With the very low interest expense limitation under Sec. 163(d), this makes it extremely difficult for an acquiring shareholder to finance the transaction. This creates pressures on existing owners to sell out to larger entities, rather than to continue ownership in the small business sector.

COMPLEXITY

The complexity of tax laws should not by itself dictate tax policy, but taxpayer understanding and acceptance of tax laws are critical to our self-assessment system.

The attached tax form 4952 is required to reflect the limitation on the deductibility of investment interest under Sec. 163(d). Thirty-six lines plus extensive calculations that may be needed to develop data to enter on those lines are provided.

This complex tax form is not the fault of the Internal Revenue Service. It is caused by the statutory provisions contained in Sec. 163(d). Repeal of those provisions should greatly simplify the filing requirements for the thousands of taxpayers who are affected by them.

CONCLUSION

To achieve equity for the small taxpayer who is most affected by Sec. 163(d), the investment interest limitation should be repealed as proposed in S. 1214. Again, we applaud the efforts of Senator Boschwitz to resolve this issue and urge quick action on this proposal by the Congress.

Senator PACKWOOD. Thank you very much.
Mr. WOODBURY.

STATEMENT OF WALLACE R. WOODBURY, CHAIRMAN OF TAX SUBCOMMITTEE OF GOVERNMENT AFFAIRS, COMMITTEE OF THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

Mr. WOODBURY. My name is Wallace R. Woodbury, from Salt Lake City, Utah. I am appearing here as chairman of the Tax Subcommittee of the Government Affairs Committee of the International Council of Shopping Centers.

We urge approval and enactment of Senator Boschwitz's bill, and to undo an ill that has been in the law since 1969 and has never been adequately and properly enforced and creates nothing but inequity where it is enforced.

Senator PACKWOOD. Your microphone has gone off. I don't know if you by chance hit the switch or whether there is something wrong with the controls.

Mr. WOODBURY. Thank you. I am sorry.

Since the enactment in 1969, which disallowed an interest deduction for business interest expenses, since business income property is treated as a business, in addition to the disallowance of interest on investment property, we have had problems, but when in 1976, they created a maximum $10,000 amount of deduction for this interest that is actually paid out, it creates a real problem.

Contrary as to the normal philosophy as to tax shelter, interest paid is a very real cash expense, particularly when you are running a business income property.

So, it doesn't have the traditional identification that you would find with most tax shelters.

The biggest reasons are probably its discriminatory nature. It applies to individuals and not corporations. Moreover, the wealthy individuals who have large amounts of investment income and net lease section 1231 income from other investments, totally avoid the impact.

Unfortunately, the not so wealthy newer entrepreneur, the smaller businessmen, suffer greater development costs and greater capital requirements than their more wealthy competitors or their corporate competitors.

In addition, the interest limitation is difficult to understand and the reason it hasn't been uniformly administered is it can't be uniformly administered.

A significant amount of the investment in shopping centers meets the definition of net lease under this section—under section 163(d), even though, in a normal business contemplation, you wouldn't think of it as net lease property.

The perception—the discriminatory application, some have said, "Well, the reason corporations were left out is because they are not sheltering other income." But through the use of consolidated returns, corporations deduct their investment interest paid with respect to one subsidiary against their income earned by different and wholly unrelated subsidiaries. It has almost an exactly the same effect to a corporation that it has individually.

It discourages new entrepreneurs from coming in to the business. They can't compete on a reasonable basis with others.

So, it discourages competition. We think it thereby increases prices.

Another aspect of it is, if a taxpayer is locked in to a bad investment or if his vacancies increase, the situation is aggravated because he has less investment income and as a consequence, he loses more of his interest deduction.

When you are in trouble, this magnifies the trouble and makes it even worse, which seems like a rather ridiculous type of a tax provision to have that penalizes those that are already being penalized by an unfortunate situation.

So, in order to determine whether a taxpayer has a net lease, he has to do a lot of calculated complicated calculations.

He has to determine first of all, if he pays out in section 162 expenses, 15 percent of his gross revenue.

Then he has to determine what his net investment income is which involves a tax calculation that considers his total income, but his expenses, counts all expenses, except interest, and then recalculates his depreciation, as though it had been straight line.

Then he has to calculate his out-of-pocket expenses on net leased property. If he has it for three different periods, if he acquired the property before 1975, he may have to then recalculate this for three distinct periods.

Needless to say, this is a very complex form. I teach the subject and I can't even get students in 1 hour of work to understand how the form works.

The revenue agents don't understand it. They don't adequately enforce it.

Perhaps the biggest point of all, Senator, is that there is only, the projections of NAR show that there is only $100 million of gross revenue collected from this source. I challenge the Government to administer it for $100 million and I think that the cost to private people far exceeds that and it should be repealed.

Thank you for the opportunity to testify.

[The prepared statement of Wallace R. Woodbury follows:]

Statement of the International Council of Shopping Centers Presented by Wallace R. Woodbury

I. Introduction

My name is Wallace R. Woodbury, Chairman of the Board, Woodbury Corporation, Salt Lake City, Utah. I am Chairman of the Tax Subcommittee of the Government Affairs Committee of the International Council of Shopping Centers (ICSC), and I submit this testimony today on hehalf of the members of the International Council of Shopping Centers.

The ICSC is a business association of approximately 10,000 members consisting of shopping center developers, owners, operators, tenants, lenders and related enterprises. ICSC represents a majority of the 22,000 shopping centers in the United States.

Before turning to an analysis of S. 1214 as introduced by Senator Boschwitz, we think it would be helpful to describe in general terms the role of shopping centers in our economy.

Approximately 5.9 million people are regularly employed in shopping centers and several hundred thousand more people are annually engaged in new construction. These numbers do not include all those people employed in such related businesses as display advertising, maintenance, cleaning and the manufacture of goods sold in the centers who are directly affected by shopping center development.

The 1980 sales data indicates that shopping centers accounted for 41 percent of total U.S. retail sales. By the beginning of the next decade (1990), the shopping center share will likely range between 48 percent and 53 percent. Equally significant is the $386 billion in U.S. shopping center retail sales in 1980.

These numbers demonstrate the significance of shopping center development in the national economy.

II. SECTION 163 (D)

Enacted in 1969, section 163(d) of the Internal Revenue Code provides an exception to the general rule that a taxpayer itemizing his deductions may deduct all the interest paid or accrued within the taxable year on his indebtedness. Section 163(d) was amended further by the Tax Reform Act of 1976 to impose dramatically more significant limitations on the deductibility of interest on investment indebtedness and "net leased" business income property indebtedness by noncorporate taxpayers, by limiting such deductions to $10,000 plus the amount of net investment income and the amount of excess net lease out-of-pocket expense.

III. PROBLEMS WITH SECTION 163 (D)

Section 163(d) works harshly because it operates to deny a deduction for a real cash outlay, which, prior to its enactment, was traditionally recognized as a deductible expense. The harshness has become even more severe because of the present extremely high interest rates. Application of the rule produces a taxable, artificial, paper gain. This adverse and unfair tax effect is a disincentive to investment in the real estate industry.

Section 163(d) is discriminatory in that it applies to individuals, but not to corporations. Moreover, wealthy individuals who have large amounts of investment income and net leased section 1231 income from other investments can avoid its impact.

Unfortunately, not so wealthy, new entrepreneurs cannot avoid the provision's adverse tax effects. Those enterpreneurs consequently suffer greater development costs and greater capital requirements than their more wealthy competitors, and are therefore discouraged or prevented from entering into otherwise economically viable real estate developments.

In addition, the investment interest limitation is difficult to understand and cannot be equitably and uniformly administered.

IV. SUPPORT FOR S. 1214

Because section 163(d) is unfair, complicated, and difficult to administer, it should be repealed as provided for by S. 1214.

There is ample evidence of the need for the legislation introduced by Senator Boschwitz to repeal Section 163(d) of the Internal Revenue Code. We support the legislation because a significant amount of investment in shopping centers is defined as net leased property within the meaning of Section 163(d) which disallows interest expense on net leased business income property in addition to investment property. As a result of this definition, our noncorporate members cannot take a deduction for interest paid with respect to the purchase of property for shopping center development even though all other types of business interest expenses are fully deductible.

V. REASONS FOR REPEAL

A. The deduction of investment interest is not a tax shelter device

The purpose of Section 163(d), first adopted in 1969 and revised in 1976, was to limit the deduction for interest expenses paid or accrued by noncorporate investors on investment indebtedness and net leased business income property indebtedness in order to eliminate what was perceived to be a tax shelter.

We contend that the perception of the deduction of interest on investment indebtedness as a tax shelter device was, and continues to be, wrong.

Unlike a tax shelter, the interest paid on investment indebtedness represents actual cash outlay. The outlay is as real as cash paid in the acquisition of a business asset or the interest paid on borrowed capital. With respect to business income assets, investment interest is a cost of doing business much like the a cost of inventory acquisition. The only difference is that the cost of investment indebtedness is rising much faster than these other business or deductible cost. Noncorporate investors with investment indebtedness who cannot deduct the increasingly onerous interest burden which they carry are currently penalized. Adoption of S. 1214 will not permit the resumption of a tax sheltering device, but it will establish equitable treatment among various types of taxpayers.

B. Ineffectiveness

Section 163(d) does not reach the taxpayers who are the targets of the other code provisions which limit tax shelters. Unlike the smaller, less wealthy entrepreneurs who must borrow to create the asset, the wealthiest taxpayers can borrow on other than net assets and use the borrowed funds to reduce or eliminate indebtedness on net leased assets. Wealthy taxpayers can also avoid the limitation of Section 163(d) by borrowing on an open account in which the indebtedness is difficult to trace to the net leased property. Finally, wealthy taxpayers enjoy other sources of investment income to offset current investment interest indebtedness.

C. Discriminatory application

The discriminatory application of Section 163(d) is further heightened by its application to noncorporate taxpayers only. The effect of this selective application is to permit corporations to deduct investment interest paid with respect to one subsidiary against the income earned by a different and wholly unrelated subsidiary. Thus, corporations are permitted to match interest deductions and investment income in a manner denied to noncorporate taxpayers.

D. Barriers to new entry

Section 163(d) is especially harmful to new and/or not-so-wealthy entrepreneurs who do not have large amounts of capital and who must raise additional capital as a result of this provision. Consequently, these entrepreneurs are discouraged or prevented fromentering into otherwise viable housing and other real estate developments or constructing new or expanded facilities for their businesses. Thus, Section 163(d) discourages competition and increases prices.

E. Negative impact on troubled investments

The inequity of the provision is particularly striking where the investment is unsuccessful. If a taxpayer is trapped into a bad investment, his losses are aggravated by the Section 163(d) disallowance of the actual outlay of cash in investment indebtedness which he made to operate his business. Moreover, if the investment was in real property with a high vacancy rate or high operating expenses, the taxpayer's net investment income will be reduced, which reduction, under the operationof Section 163(d), causes a larger exclusion of investment indebtedness deduction. Thus, the tax code not only favors corporations and wealthy entrepreneurs, but it encourages the failure of a business which is experiencing difficulty. Surely this result is not a wise tax policy goal.

F. Complexity of administration

In addition to all the substantive reasons for repealing Section 163(d), significant practical reasons exist for repeal. As the attached copy of IRS Form 4952, the "Investment Interest Expense Deduction" form, indicates the extremely complex provision requires the taxpayer to make a series of very difficult determinations.

For example, in order to determine whether the taxpayer has a net lease he must calculate whether his deductions are less than 15 percent of his gross revenue. The source of the investment indebtedness must be identified even if the taxpayer has an open line of credit. The taxpayer must make separate calculations of net investment income, investment income (which involves the application of the complicated depreciation and recapture rules), investment expenses and investment interest. Finally, if the investment at issue was made prior to 1975 or prior to 1969, each of the calculations must be made a second or even a third time.

VI. COST

Finally, it cannot be said that the effort required of the taxpayer to comply with Section 163(d) or the efforts of Internal Revenue agents to enforce the provision yields significant revenue. According to data released by the National Association of Realtors in their testimony presented to the House Ways and Means Committee on March 24, 1981, repeal of this disincentive to investment in real estate will reduce revenue by $0.1 billion in each of the next five years, which may be entirely offset by the costs incurred in administration by the government. In addition there are significant taxpayer costs.

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VII. CONCLUSION

We urge the retroactive repeal of Section 163(d). The provision does not address the purposes for which it was adopted, and, by contrast, creates significant inequities among taxpayers.

If the Congress is not ready to enact repeal of Section 163(d) then we strongly urge that the net lease rules of Section 163(d) be repealed and the rules of Section 1231 with respect to property used in a trade or business be applied.

Form **4952** Department of the Treasury Internal Revenue Service

Investment Interest Expense Deduction

▶ See instructions on back.
▶ Attach to return.

1980

Name(s) as shown on return | Identifying number

Kind of return . . . . ▶ Individual Estate Trust

Part I Interest on Investment Debts Incurred Before December 17, 1969

Note: Use Part I only if you have investment interest expense on debts incurred before December 17, 1969, as well as on or after that date.

1 Interest expense on investment debts incurred before December 17, 1969	1	
2 Total net investment income	2	
3 Net investment income allocable to the period before December 17, 1969: $\frac{\text{Line 1}}{\text{Line 1} + \text{Line 7} + \text{Line 15} + \text{Line 28}} \times$ Line 2	3	
4 Subtract line 3 from line 2—Enter here and on line 10(a)	4	

Part II Interest on Investment Debts Incurred After September 10, 1975

5 Interest expense on investment debts incurred after September 10, 1975			5	
6 Carryover—Enter amount from 1979 Form 4952, line 14			6	
7 Total investment interest expense (add lines 5 and 6)			7	
8 (a) Individuals enter $10,000 ($5,000 if married filing separately)	8a			
(b) Additional limitation	8b			
9 Estates enter $10,000; trusts enter zero	9			
10 (a) Total net investment income or line 4 . . . 10a				
(b) $\frac{\text{Line 7}}{\text{Line 7} + \text{Line 15} + \text{Line 28}} \times$ line 10(a)	10b			
11 Excess expenses from "net lease property"	11			
12 Limitation on deduction (add lines 8(a), (b), 9, 10(b) and 11)			12	
13 Allowable investment interest deduction—Enter the smaller of line 7 or line 12			13	
14 Disallowed investment interest to be carried over to 1981 (subtract line 13 from line 7)			14	

Part III Interest on Investment Debts Incurred Before September 11, 1975, and After December 16, 1969

15 Interest expense on investment debts incurred before September 11, 1975, and after December 16, 1969			15	
16 Individuals enter $25,000 ($12,500 if married filing separately)	16			
17 Estates enter $25,000; trusts enter zero	17			
18 Net investment income (subtract line 10(b) from line 10(a))	18			
19 Excess expenses from "net lease property"	19			
20 Excess net long-term capital gain over net short-term capital loss from sale or exchange of property held for investment	20			
21 Tentative limitation (add lines 16 through 20)			21	
22 Capital gain from line 20. (Limit this gain to extent line 15 is more than the sum of lines 16 through 19.) *Note: To adjust this gain on Schedule D or Form 4798, see Schedule D instructions.*			22	
23 Subtract line 21 from line 15. If line 21 is more than line 15, enter zero			23	
24 Additional deduction (50% of line 23)			24	
25 Limitation on deduction (add lines 21 and 24)			25	
26 Allowable investment interest deduction—Enter the smaller of line 15 or line 25			26	
27 Disallowed investment interest to be carried over to 1981 (subtract line 26 from line 15)			27	

Part IV Investment Interest Expense Carryover From Earlier Years—Incurred Before September 11, 1975

28 Carryover—Enter amounts from 1979 Form 4952, lines 27 and 36			28	
29 Enter amount reportable on line 13 plus $25,000*	29			
30 Enter the larger of amount on line 15 or $25,000*	30			
31 Subtract line 30 from line 29. If line 30 is more than line 29, enter zero	31			
32 Enter 50% of line 31			32	
33 Interest deduction limitation (enter the smaller of line 28 or line 32)			33	
34 Interest carryover from earlier years disallowed in 1980 (subtract line 33 from line 28)			34	
35 Enter the 60% capital gain deduction from your 1980 Schedule D or 1980 Form 4798			35	
36 Interest carryover to 1981 (subtract line 35 from line 34)			36	

*$12,500, if married filing separately; zero, if a trust.

313-191-4 Form 4952 (1980)

General Instructions

Purpose of Form.—If you paid or accrued interest during 1980 on debts you incurred to buy or hold certain property, the amount of interest you can deduct may be limited. This applies to investment property and net lease property. Property held for investment includes all investments held for producing taxable income or gain. It does not include property used in a trade or business.

Use Form 4952 to figure your total deduction for investment interest expense if a, b, or d apply.

a. Fill in Part II if in 1980, you paid or accrued more than $10,000 in interest ($5,000 if married filing separately; zero if a trust) on investment debts incurred after September 10, 1975.

b. Fill in part III if in 1980, you paid or accrued more than $25,000 in interest ($12,500 if married filing separately; zero if a trust) on investment debts incurred before September 11, 1975, and after December 16, 1969.

c. Fill in Part I if in 1980, you also paid or accrued interest on investment debts incurred before December 17, 1969.

d. Fill in Part IV if in 1979, you had interest from Parts III or IV not allowed due to the respective limitations.

Source of Amounts to Include.—

a. Your own investment interest expense and offset items.

b. *Partnership.*—Your pro-rata share of partnership's investment interest expense and other items used in the computation, as reported on Schedule K-1 (Form 1065) that you get from the partnership.

c. *Subchapter S Corporation.*—Your pro-rata share of the corporation's investment interest expense and other items used in the computations, as reported on Schedule K-1 (Form 1120S) that you get from the corporation.

d. *Estates and trusts.*—When there is distributable net income, include your share of: (1) the net investment income, and (2) the excess of net long-term capital gain over net short-term capital loss from the sale or exchange of investment property.

Line-By-Line Instructions

Identifying Number.—Individuals enter social security number. Estates and trusts enter employer's identification number.

Preparing Form 4952.—First complete lines 1, 5 through 7, 15 and 28. Then complete form in numerical sequence starting with line 2, if applicable.

Line 1.—Enter your total investment interest expense from all sources, on debts created before December 17, 1969 from a specific item of property for a specified term. Also include debts in existence after December 16, 1969, if a binding contract was in effect on that date. Enter only the interest you paid or accrued in 1980, depending on your method of accounting.

Lines 2, 10 and 18.—Enter your net investment income from all sources required to be reported on your Form 1040 or 1041 for 1980.

If you have an entry on line 1 and had net investment income in 1980, complete lines 2, 3, and 4. Then enter the figure from line 4 on line 10(a). If you do not have an entry on line 1, enter your total net investment income on line 10(a).

Allocate your net investment income for the periods before December 17, 1969, before September 11, 1975 and after December 16, 1969, and after September 10, 1975. The formulas on lines 3 and 10(b) are for this purpose.

Net investment income is the amount by which investment income exceeds investment expenses. Investment income and expenses do not include any amounts connected with a trade or business. (a) Investment income includes the following that are includible in gross income: interest, dividends, rents from net lease property, royalties, net short-term capital gains from investment property, and amounts recaptured as ordinary income from the sale or exchange of investment property subject to sections 1245, 1250 and 1254 provisions. (b) Investment expenses are those deductions directly connected with the production of investment income. Such deductions are those allowable by sections 162, 164(a)(1) or (2), 166, 167, 171, 212, or 611. Depreciation is limited to the amount figured using the straight line method. Depletion is limited to an amount based on cost.

Line 5.—Enter your total investment interest expense from all sources, from obligations incurred after September 10, 1975. Do not include those obligations for which a binding contract was in effect on September 11, 1975. Enter only the interest you paid or accrued in 1980, depending on your method of accounting.

Lines 6 and 28.—Carry to 1980, interest disallowed in 1979 because of the limitations. It retains its same character. For example, treat interest on investment debts incurred after September 10, 1975 when carried over as if it was incurred after that date and subject to the same limitations.

Line 8.—Individuals enter on line 8(a) $10,000 ($5,000 if married filing separately). Enter an additional amount on line 8(b) if you incurred investment interest in connection with acquiring stock in a corporation or partnership interest and you, your spouse and children own 50% or more of the stock or the capital interest in that enterprise. In this case, enter on line 8(b) $15,000 ($7,500 if married filing separately) or the amount of this interest, whichever is less.

Lines 11 and 19.—Excess expenses from net lease property is the amount by which the expenses allowable under sections 162, 163 (without any reduction for the limitations of section 163(d)), 164(a)(1) or (2), and 212 attributable to property subject to a net lease, exceed the income produced by such property.

Property subject to a net lease is rental property that is treated for purposes of computing the limitation as property held for investment. The nature of the income and expenses of this property does not change for figuring the gain or loss for rental property. Rental property is net lease property if either (a) or (b) applies:

(a) You (the lessor) either are guaranteed a specific return of income or are guaranteed in whole or in part against loss of income.

(b) Your 1980 deductions for the property that are allowable only because of section 162 (except rents and reimbursed amounts) equal less than 15% of the income produced by the property. For this 15% test, you may elect to: (a) treat all leased portions of a parcel of real property as subject to a single lease, and (b) exempt real property that has been in use for more than 5 years.

Lines 13 and 26.—This is the allowable investment interest expense. Deduct the nonbusiness part as an itemized deduction on Schedule A (Form 1040). Show the allowable part from rental property on Schedule E (Form 1040), Part II.

Deduct the pro-rata share of allowable investment interest from a partnership on Schedule E (Form 1040), Part III, unless the partnership notifies you that all or part of it relates to nonbusiness property that should be deducted on Schedule A (Form 1040).

Add the pro-rata share of disallowed investment interest from a subchapter S corporation to the distributive share of income as reported on Schedule E (Form 1040), Part III. Do not make an adjustment for the allowable part since the corporation has already deducted it.

Deduct the allowable part of investment interest from estates and trusts on line 11, Form 1041.

Figure the allowable parts for each of the above by the following formula:

$$\frac{\text{Part of investment interest}}{\text{Total investment interest}} \times \text{Total allowable investment interest}$$

All interest on investment debts incurred before December 17, 1969 is allowed without limitation.

Lines 14 and 27.—This is the disallowed investment interest. If you incurred any investment interest from a subchapter S corporation, allocate this amount by using the formula in the instructions for lines 13 and 26. Substitute the amount on lines 14 and 27 for the allowable investment interest in that formula.

Line 15.—Enter your total investment interest expense from all sources, from a specific item of property for a specified term, and from debts incurred before September 11, 1975, and after December 16, 1969. Also include obligations incurred after September 10, 1975, but subject to a written contract or commitment in effect on September 11, 1975. Enter only the interest you paid or accrued in 1980, depending on your method of accounting.

Line 33.—Enter the smaller of lines 28 or 32. This is the investment interest from earlier years that is allowable this year. Allocate this amount according to the formula in the instructions for lines 13 and 26, using percentages obtained in earlier years from which the carryovers resulted.

Senator PACKWOOD. Thank you very much.
Mr. Adams.

STATEMENT OF CHARLES F. ADAMS, EXECUTIVE VICE PRESIDENT, AMERICAN ASSOCIATION OF ADVERTISING AGENCIES, INC.

Mr. ADAMS. Thank you, Senator. What I would like to do is just give an example of the kind Mr. Penick has outlined, the problem, how it impacts on one kind of business.

The American Association of Advertising Agencies represents about 530 advertising agencies, but there are between 6,000 and 8,000 ad agencies across the country.

Most of these, the overwhelming majority of these are privately held companies. Only a handful are publicly held.

Invariably their stock is owned and controlled by full-time employees and very frequently, the bylaws of their corporation will specify that they must be owned and controlled, the stock must be owned by employees.

Now here is how 163(d) impacts on this kind of a business. In a typical advertising agency, when the time comes for a stockholder-manager to retire or to leave his agency, the stock is offered to other employees for purchase. Invariably, those employees have to go out and borrow funds to buy the stock.

While they may be eager and willing to do so, they find it extremely difficult to make that decision when they learn about 163(d). Because by and large, advertising agency employees, as in many small businesses, are essentially wage earners. They do not have any considerable amount of unearned income against which to offset their borrowing.

Therefore, the acquiring employee quickly learns that only a small portion of his interest is going to be deductible on his income tax.

This usually comes as a surprise, because he is accustomed in other circumstances to deducting interest on his income tax.

So, very frequently, the retiring executive, unable to find a satisfactory market for his stock inside of his company, and because of the cost of borrowing and 163(d), will then seek to merge his company or to sell his business to a larger business as the only alternative way to realize the value of his stock.

The evidence of this is clear in our business. Among our members alone, the number of annual sales and mergers has grown from 7, in 1975, which was before 163(d), to 19 last year.

In the last 10 years, our membership has had 100 such mergers and 80 percent of those have come since 163(d).

The negative effect of 163(d) on stock succession is greatly intensified and magnified by the current high interest rates. I think probably the effect of the $10,000 limit would have been $50,000 back in 1976 because you have to almost double it for inflation and interest rates are now three times as high as they were when that bill was passed.

If 163(d) is not eliminated or dramatically altered, it is unlikely that businesses such as advertising agencies will be able to maintain their independence.

The trend toward mergers and sales of companies like ours will continue to grow and the only way that selling principals can realize the value of the stock.

So, we strongly recommend that S. 1214 will be favorably considered for the following reasons.

First, it will remove a major barrier to the entrepreneur who is starting a new business, but who has little hope of early dividends to offset his cost of borrowing.

Second, it will facilitate the transition from first to second generation management and from second to third and so forth.

This will contribute to the stability and business growth in smaller, privately held companies.

Finally, we think it has the potential to benefit the entire free enterprise system in an economy that depends so greatly on small business for growth and for job creations.

For these reasons, we hope that this Senate bill will receive favorable action.

Thank you very much.

Senator PACKWOOD. We have tried to attack this problem over the last dozen years, perhaps unsuccessfully. We have tried it through the at risk provisions. You know the abuse we were trying to get at, and indeed, there were abuses.

I don't have any question, but I might say this. So often when we approach this, trying to correct an abuse, we get no help, and I don't mean this maliciously, you are just not here to testify, from people that are going to be adversely affected who are not abusing it. Whether they don't know we are considering the legislation or not, I am not sure; although my hunch is that all of your different associations are pretty much aware of what this committee is doing.

So, we often draw something well intentioned, unmaliciously, without benefit of any advice except from those critics of the abuses which most of you people would agree on the abuses and you are not the ones who are abusing it.

So, I just might say again, when we get into this so-called second tax bill, if we get into it, there are going to be dozens and dozens of one kind and another, all of them maybe relatively small, that may have unintended consequences. I think we would appreciate your help as we move down that road to try to avoid what we have done in the past.

Senator Durenberger, do you have any questions?

Senator DURENBERGER. I have no questions, Mr. Chairman.

Senator PACKWOOD. Gentlemen, thank you very much.

[The prepared statement of Charles F. Adams follows:]

PREPARED TESTIMONY OF CHARLES F. ADAMS, EXECUTIVE VICE PRESIDENT AND DIRECTOR OF WASHINGTON OFFICE, AMERICAN ASSOCIATION OF ADVERTISING AGENCIES

Thank you, Mr. Chairman. I am delighted to have an opportunity to comment on this matter because of its importance to the people I represent.

The American Association of Advertising Agencies is the national association of the advertising agency business. Its membership includes more than 530 advertising agencies located in virtually every state in the union. These agencies place more than three-fourths of all national advertising in America.

Let me explain why Section 163(d) of the 1976 Tax Reform Act and Senator Boschwitz's bill, S. 1214, are of such great importance to us.

Almost all of our members, except for a handful that are publicly held, are employee-owned businesses. Invariably, their stock is owned and controlled by full-time, active employees. In most instances, the by-laws of their incorporation specify that stock will remain inside the company.

Almost all advertising agencies are small or relatively small businesses. The largest have no more than 2 or 3,000 employees, the smallest just a dozen or so. It is also a highly competitive business. There are some 6,000 ad agencies in the United States, and the largest of these has only 3 percent of the business.

Advertising agencies are typical of many other kinds of service businesses in the country in that they are labor intensive, and are dependent for their survival on the creative talents of their key managers.

Where does 163(d) come into this picture?

In the typical advertising agency, when the time comes for a stockholder manager to retire or leave the agency, his stock is offered to other employees for purchase. Invariably, those employees must borrow funds to purchase that stock. While they may be eager and willing to do so, 163(d) makes it extremely difficult.

By and large, ad agency employees are essentially wage earners, rather than investors. They therefore usually do not have unearend income against which to offset the cost of borrowing.

Therefore, the acquiring employee quickly learns that only a small portion of his interest incurred will be deductible on his income tax. Usually this comes as a surprise, because most taxpayers are accustomed to deducting interest under almost all other circumstances.

Very frequently, in our business, the retiring executive, unable to find a satisfactory market for his stock inside his company, because of the cost of borrowing and 163(d) will then seek to merge his company, or to sell his busines to a larger agency as the only alternative way to realize the value of his stock.

The evidence of the rapid growth in sales and mergers in our industry is clear. Among our members alone, the number of annual agency sales/mergers has grown from 7 in 1975 to 19 last year. There have been more than 100 such mergers among our members over the last 10 years. Eighty percent of these have happened since the creation of 163(d).

The negative effect of 163(d) on stock succession is greatly intensified and magnified by the currently high interest rates. In a larger agency, with a net worth of $20 million and 8 to 15 major shareholders, if one of these buys 4 percent of the agency's stock, the interest at today's rates would be $160,000. If only 10,000, or one-sixteenth of that is deductible, then the incentive to purchase those shares is markedly reduced, if, indeed it is even possible. Even in a much smaller agency, worth $400,000 with four to six major shareholders, if one of them purchases 22 percent of the stock, the interest will be $60,000—and the same burden to the buying shareholder obtains.

If 163(d) is not eliminated or dramatically altered, it is unlikely that businesses such as advertising agencies will be able to maintain their independence—and the trend toward mergers and sales will continue to grow as the only way that selling principals can realize the value of their stock.

We strongly recommend that Bill S. 1214 be favorably considered for the following reasons:

1. It will remove a major barrier to the entrepeneur who must start a new business with little hope of early dividends to offset his cost of borrowing.

2. It will facilitate the transition from first to second generation management, thus contributing to stability and long term business growth in smaller, privately held companies.

3. It has the potential to benefit the entire free enterprise system in a national economy that depends so greatly on small business for growth and job creation.

It is our hope that for all of these reasons, the repeal of 163(d) as outlined in this Senate bill will receive favorable action.

Senator PACKWOOD. Let's move on to S. 1369. I have a statement for the record, from Senator Huddleston, who cannot be here for the hearing this morning.

[The prepared statement of Senator Walter D. Huddleston follows:]

PREPARED STATEMENT OF SENATOR WALTER D. HUDDLESTON

I thank the distinguished Chairman for holding this hearing on S. 1369. At a time when the members of this committee are very much involved in the tax bill which is now on the floor, it is especially generous of you to devote your time to this bill.

I introduced S. 1369 to repeal the withholding on gambling winnings because I am convinced that the adverse effects of this withholding more than offset any increased compliance with the income tax law.

Section 3402 (q) of the Internal Revenue Code, which was added in 1976, requires that a person making payment of certain gambling winnings must deduct and withhold 20 percent of the payment. In determining whether winnings are subject to withholding, winnings are divided into three categories, based on the type of wagering transaction.

Wagers from horseraces and other parimutuel pools are subject to a 20-percent withholding tax if the proceeds from the wager are over $1,000 and at least 300 times as large as the amount wagered. On the other hand, state lottery payoffs are subject to withholding only if the amount exceeds $5,000. Casino gambling has no withholding tax.

This provision was enacted with the purpose of assuring compliance with the tax laws. However, experience has demonstrated that the provision has a number of undesirable effects, and the additional degree of compliance—if any—is probably outweighed by these other considerations.

The IRS estimates that if this provision had been effective for the entire calendar year 1977, approximately $100 million would have been withheld rather than paid over to the winners.

However, this entire amount does not represent a gain to the Treasury. A study conducted by the IRS indicates that compliance rates are increased from about 68 percent without withholding to about 37 percent where the taxpayers were subject to withholding. Even assuming the IRS study to be accurate, only a relatively small fraction of the amount withheld, perhaps 20 percent or $20 million, is a revenue gain to the Treasury.

This small increased Federal revenue is more than offset by the deleterious effects of the proposal. One highly significant effect is the reduction in parimutuel revenues. This means reduced purses for racing owners and also reduced revenues for state and local governments. Another significant effect is that withholding is an additional inducement for individuals to patronize illegal gambling activities whose operators do not comply with the withholding rules.

The effect on parimutuel revenues can be illustrated by examining the parimutuel wagering. Withholding at parimutuel facilities in 1980 amounted to $71.3 million. Statistics indicate that each dollar at a race track is rewagered on the average of 3.5 times. This removal of $71.3 million from the wagering stream means that approximately $250 million less is wagered because of this withholding.

Parimutuel pools are subject to a "takeout"—which generally is approximately 19 percent of the pool. This takeout is used for purses for the contestants, revenues for state and local governments, and amounts paid to the operator of the facility. Consequently, the reduction in wagers due to withholding means reduced revenue totaling about $50 million to state and local governments, horsemen and track operators.

These revenue reductions not only adversely affect governmental revenues in the 30 states which derive substantial revenue from parimutuel activities, but they also reduce the purses available for horsemen and other persons who participate in such sports as greyhound racing and jai alai.

These reductions not only make the horse racing industry less attractive financially, but in the long run I fear that they also will adversely affect the horse breeding industry. This fear is based on the fact sales of thoroughbred and standardbred horses are ultimately dependent upon the potential for the horses to earn money at the track.

In many communities, the horse industry provides significant contributions to the economy. There are 350,000 people licensed to work at race tracks. Also, farms engaged in breeding horses for the race track employed about 80,000 people in 1980 to produce approximately 50,000 foals.

Furthermore, exports of horses during 1980 came to over $200 million, contributing to the vital export balances generated by American agriculture. Many of these exports result from the dominance of the U.S. blood stock industry—a dominance that could well be jeopardized by a declining horse racing industry in this country.

Because the withholding provision only applies to certain types of legalized wagers, it constitutes an additional and unnecessary inducement for individuals to engage in illegal gambling rather than legal gambling. I believe that we would all agree that the tax code should not be used to encourage or promote illegal gambling.

Furthermore, Treasury's view that there are large numbers of individuals who are not paying tax on significant amounts of winnings from parimutuel wagers is not accurate. Since approximately 19 percent of most parimutuel pools is subject to takeout, only about 81 percent of the amounts wagered are normally returned to bettors.

Under this system, it is no surprise that most bettors are net losers at the end of each year. According to a study conducted by the American Horse Council, over 85 percent of bettors receiving payouts subject to withholding reported that they will conclude the year as net losers in their parimutuel transactions.

For these bettors, the withholding tax becomes an exise tax on gross winnings. To obtain return of their money, they must overcome two significant hurdles. First, they must substantiate their losses under a standard which is much more strict than the standard that the IRS applies to most expenses and losses. Second, they may have to forgo the standard deduction to use the losses because the IRS allows gambling losses only as itemized deductions.

In some, a person may even be subject to the "alternative minimum tax" on his wagering transactions even though he can demonstrate that he has no net gambling winnings. Even if the bettor can overcome all of these obstacles and obtain the return of his money, he is still a net loser because the government has had the use of his money from the date of withholding until he receives his refund.

The bettor, at best, suffers from the inappropriate presumption in the withholding law that his winnings from a particular race, not his net winnings, are the measure of his taxable income.

Mr. Chairman, I believe that the basic strength of our tax system is voluntary compliance. Without general cooperation from taxpayers it would be impossible to generate the amount of revenue we do each year.

However, if voluntary compliance is to work, it must be based upon the perception by all taxpayers that tax laws are fair and reasonable. I do not believe that this provision is either fair or reasonable and as a result, the real losers will be the state and local governments and the thousands of people who rely upon the racing industry for their jobs.

It seems to me that the adverse effects of Section 3402(q) far outweigh the convenience to the IRS and the possible minor revenue gains to the Treasury.

Senator PACKWOOD. We have Mr. Drew, Mr. Gannon and Mr. Brown.

I might say to all three of you, this also is an issue with which I am well familiar. It is not new to this committee. It has been kicking around for a fair period of time.

All of your statements will be in the record. Mr. Drew, why don't you go right ahead and start.

Mr. DREW. Thank you, Mr. Chairman.

STATEMENT OF DON DREW, VICE PRESIDENT, NEW YORK RACING ASSOCIATION, NEW YORK, N.Y.

Mr. DREW. My name is Don Drew, vice president of consumer services of the New York Racing Association. NYRA is a nondividend paying private corporation which owns and operates Belmont, Aqueduct and Saratoga Racetracks, three of the largest and most important thoroughbred racing establishments in the country.

I am here on behalf of the New York Racing Association and the parimutuel industry in general to ask for repeal of the highly damaging 20 percent Federal withholding tax on track payouts of $1,000 or more at odds of at least 300 to 1.

I would first like to express my sincere appreciation for this opportunity to present our position on this issue and to describe to you our industry.

Racetracks are at the center of a productivity chain that extends through the entire horse racing industry, one of this country's largest agribusinesses.

That chain encompasses racing patrons; horsemen and backstretch workers, who make the individual races possible; horse owners, fueling the financial base of the industry with their investment dollars; and breeders and farm owners, whose work helps preserve the agricultural green spaces so vital to the country's internal well-being.

In addition to acting as a center piece of this financial structure, racetracks represent in many cases the most important contributors to the economies of their local areas.

The economic impact of a race track involves salaries and purse money distributions spent in that area; payments for goods and services; and substantial tax dollars paid to local and State governments.

There are over 200 parimutuel facilities in the United States and each represent an important, multimillion dollar contributor to its home-area economy.

In an economic study done a few years ago, the thoroughbred racing industry in the State of New York was characterized as a billion-dollar industry embracing approximately 10,000 jobs and contributing some $180 million in cash flow to the economy.

The total annual economic impact of the New York thoroughbred industry was estimated at $430 million at that time.

Nationally, racing's economic impact is estimated conservatively to be $10 billion.

The health of this industry depends in great part on the health of the tracks. Economic problems at the track level have ripple effects throuqhout the rest of the industry which multiply and worsen over time.

I am here to address what is considered to be one of the most harmful developments ever in this area.

I cannot stress strongly enough how seriously the Federal withholding tax impairs our ability to do business with our patrons. The financial side of racing depends on attendance and wagering at the tracks, and because of this, the Federal withholding tax has a uniquely damaging effect on our business relationship with patrons.

These patrons, the 100 million of them who attended parimutuel events last year, expect and demand little more than a fair opportunity in the wagering process.

They know that all things being equal, their winnings and losings will come close to balancing out and they will be most heavily affected by what we call the "takeout"—moneys removed from wagering pools and distributed as revenues among the State treasuries, horsemen and the race tracks.

The racing patron views this as a legitimate and reasonable cost of entertainment.

But due to the Federal withholding tax, which scalps 20 percent from larger payouts, all things are not equal. Under normal circumstances, those dollars would simply help offset the inevitable costs horseplayers incur and, in the course of the year, help balance out the wagering process.

The 20 percent tax interrupts this system in unnecessary, unreasonable and painful fashion.

It is crucial to recognize that the payouts of $1,000 or more do not represent windfall gains, but rather are part of the normal ebb and flow of the wagering process. Removing them through a withholding tax deprives horseplayers of their rightful capital and thereby triggers further serious repercussions for tracks and the industry at large.

The Federal withholding tax removed from racing's wagering stream roughly $71 million in 1980. That figure represents the 20 percent Federal tax assessed on $350 million in payouts.

On average in the parimutuel wagering process, a dollar is churned or rewagered 3.5 times. Removing that $71 million in returns therefore translated into an overall reduction in wagering of $250 million.

Using the "takeout" concept mentioned before, the $250 million would represent $50 million less in revenues to the track and to the States.

As you can see, the Federal tax impacts heavily on the States and their State-regulated businesses. The negative revenue ripples sent through the industry must necessarily reduce employment and racing's overall contributions to the economy.

I know you understand the importance of judging net gains and losses, of balancing positive results against negative impacts.

In this case, we, the parimutuel industry, feel there are no revenue gains made in the area of tax collection and ask you to consider the great costs we have borne. Since the institution of withholding in 1977, the losses have been heavy.

The 20 percent Federal withholding tax is detrimental to every aspect of our industry. It hits us where it hurts most. It reduces attendance by driving away patrons looking for a fairer shake.

It also reduces wagering, the lifeblood of the parimutuel system.

[The prepared statement of Don Drew follows:]

PREPARED STATEMENT OF DON DREW, VICE PRESIDENT, CONSUMER SERVICES, NEW YORK RACING ASSOCIATION

My name is Don Drew, vice president, consumer services of the New York Racing Association. NYRA is a non-dividend-paying private corporation which owns and operates Belmont, Aqueduct and Saratoga Race Tracks, three of the largest and most important thoroughbred racing establishments in the country.

I am here on behalf of the New York Racing Association and the parimutuel industry in general to ask for repeal of the highly damaging 20 percent federal withholding tax on track payouts of $1,000 or more at odds of at least 300-1. I would first like to express my sincere appreciation for this opportunity to present our position on this issue, and describe for you the industry involved.

Race tracks are at the center of a productivity chain that extends through the entire horse racing industry, one of this country's largest agribusinesses. That chain encompasses racing patrons; horsemen and backstretch workers, who make the individual races possible; horse owners, fueling the financial base of the industry with their investment dollars; and breeders and farm owners, whose work helps preserve the agricultural green spaces so vital to the country's internal well-being.

In addition to acting as the centerpieces of the financial structure, race tracks represent in many cases the most important contributors to the economies of their local areas. The economic impact of a race track involves salaries and purse money distributions spent in that area; payments for goods and services; and substantial tax dollars paid to local and state government.

There are over 200 pari-mutuel facilities in the United States and each represents an important, multimillion dollar contributor to its home-area economy. In an economic study done a few years ago, the thoroughbred racing industry in the State of New York was characterized as a billion dollar industry embracing approximately 10,000 jobs and contributing some $180 million in cash flow to the economy. The total annual economic impact of the New York thoroughbred industry was estimated at $430 million. Nationally, racing's economic impact is estimated conservatively at over $10 billion.

The health of this huge industry depends in great part on the health of the tracks. Economic problems at the track level have ripple effects throughout the rest of the industry which multiply and worsen over time. I am here to address what is considered to be one of the most harmful developments ever.

I cannot stress strongly enough how seriously the federal withholding tax impairs our ability to do business with our patronage. The financial side of racing depends on attendance and wagering at the tracks, and because of this the federal withholding tax has a uniquely damaging effect on our business relationship with patrons. These patrons, the 100 million of them who attended pari-mutuel events last year, expect and demand little more than a fair opportunity in the wagering process. They know that, all things being equal, their winnings and losings will come close to balancing out and they will be most heavily affected by what we call the "takeout"—monies removed from wagering pools and distributed as revenues among state treasuries, horsemen (purses) and the tracks. The racing patron views this a a legitimate and reasonable cost of entertainment.

But due to the federal withholding tax, which scalps 20 percent from large payouts, all things are not equal. Under normal circumstances those dollars would simply help offset the inevitable costs horseplayers incur and, in the course of the year, help balance out the wagering process. The 20 percent tax interrupts this system in unnecessary, unreasonable and painful fashion.

It is crucial to recognize that the payouts of $1,000 or more do not represent windfall gains, but rather are part of the normal ebb and flow of the wagering process. Removing them through a withholding tax deprives horseplayers of their rightful capital and thereby triggers further serious repercussions for tracks and the industry at large.

The federal withholding tax removed from racing's wagering stream roughly $71 million in 1980. That figure represents the 20-percent federal tax assessed to over $350 million in payouts. But the effect hardly stops there.

On average, each dollar at a track is rewagered, or churned, 3.5 times. Removing $71 million in returns therefore translates into an overall reduction in wagering at the tracks of nearly $250 million.

Returning to the "takeout" concept mentioned earlier, the reduction of wagering by $250 million in 1980 meant that the state treasuries, horsemen and race tracks received an aggregate $50 million less in revenues. In addition, the tracks were forced to bear the additional costs of an administrative burden.

As you can see, the federal tax impacts heavily on the states and their state-regulated businesses. The negative revenue ripples sent through the industry must necessarily reduce employment and racing's overall contributions to the economy.

I know you understand the importance of judging net gains and losses, of balancing positive results against negative impacts. In this case, we, the pari-mutuel industry, feel there are no revenue gains made in the area of tax collection and ask you to consider the great costs we have borne. Since the institution of withholding in 1977, the losses have been heavy.

The 20-percent federal withholding tax is detrimental to every aspect of our industry. It hits us where it hurts most. It reduces attendance by driving away patrons looking for a fairer shake. It also reduces wagering, the lifeblood of the pari-mutuel system.

The effects are damaging in persistent, long-term fashion. In some cases, withholding serves to drastically reduce the pressured profit margins by which many of our smaller race tracks live. It is fair to say that these tracks may not be able to survive the future damages the tax will inflict.

We ask that you seriously consider these points and the request for repeal we are making.

Senator PACKWOOD. Thank you.

Mr. Gannon.

JOHN J. GANNON, PRESIDENT, NATIONAL ASSOCIATION OF OFF-TRACK BETTING, BATAVIA, N.Y.

Mr. GANNON. Senator, I am John Gannon. I am president of the National Association of Off-Track Betting. It is a trade association of governmental parimutuel off-track betting operations, both in the States of New York and Connecticut.

I am here in support of S. 1369, Senator Huddleston's bill.

At the lead of the chairman I would telescope my statement and merely hit, in summary fashion, a few of the points that I have in that statement.

Senator DURENBERGER (acting chairman), presiding. Without objection, your statement will be made a part of the record.

Mr. GANNON. Thank you.

While the NAOTB joins with the parimutuel horse racing industry, in support of S. 1369, we would like to point out there is a difference in our operations in that we are a governmental operations or public benefit corporations, designed to serve local jurisdictions.

As is true with other segments of the parimutuel industry, OTB operations contribute to the local and national economy through employment and legitimate business activities.

The present tax policy, in our estimation, of withholding on certain gaming payouts is regressive in that the withholding is predicated on a nonexisting tax base, 3402(q) of the code, does not assist OTB in countering illegal wagering since there is no withholding imposed on payouts from an illegal bookie.

In most cases, the amount withheld would be rebet, thus contributing to the legitimate economy. Present tax law does not treat a bettor fairly, in that payouts are subject to withholding.

However, legitimate losses are extremely difficult to document. As I am sure you are aware, most people who take a standard deduction lose the legitimate loss deduction.

Other tax reforms are recommended such as (a), a provision to allow a carryover for losses in succeeding tax years and (b), allowing net legal losses to be deducted from gross income, instead of adjusted gross income, to allow taxpayers who take the standard deduction equity in recognition of a legitimate loss.

In summary, we are very much in favor of the bill as proposed.

Thank you.

[The prepared statement of John J. Gannon follows:]

PREPARED STATEMENT OF NATIONAL ASSOCIATION OF OFF-TRACK BETTING [NAOTB]

Mr. Chairman, members of the subcommittee, the National Association of Off-Track Betting ("NAOTB"), the trade association of governmental parimutuel off-track betting ("OTB") operations in New York and Connecticut, appreciates this opportunity to testify in support of S. 1369, the bill introduced by Mr. Huddleston to repeal the section (3402(q)) of the Internal Revenue Code requiring, under certain conditions, a person making payment of legal gambling winnings to deduct and withhold 20 percent of the payment.

OFF-TRACK BETTING

Off-track betting is the extension of legal commercial horserace betting services to locations outside the racetrack grounds. In New York parimutuel off-track betting was enabled by the State legislature in 1970 following the overwhelming approval of a New York City off-track betting referendum, and is now conducted throughout the State by six independent government entities for the purposes of raising revenue for government and curtailing illegal bookmaking. In Connecticut a State agency established by the legislature conducts parimutuel off-track betting at sixteen separate locations and at a unique New Haven teletrack facility. OTB is not operated for private profit. The revenues OTB generates provide a significant and growing measure of State, municipal, and local tax relief in the form of off-track betting revenue that exceeded $161 million in 1980, an increase of 5.8 percent over 1979. Collectively the New York and Connecticut OTB operations employ 5,150 persons represented by 11 labor unions and contribute more than $150 million in jobs and direct spending to the economies of these States. OTB additionally generates $85 million annually for the racing industry, a major employer and an important source of revenue for State government, and has been effective in reducing illegal bookmaking on horseraces. Off-track betting contributes directly to the economies of a number of States, including the States of Connecticut, Delaware, Florida, Illinois, Kentucky, Maryland, New York, and Pennsylvania, through interstate wagering conducted pursuant to contracts negotiated according to Federal guidelines established in the Interstate Horseracing Act of 1978.

WITHHOLDING ON OTB PAYOUTS

Section 3402(q) of the Internal Revenue Code, which was added by section 1207(d) of the Tax Reform Act of 1976 and amended by section 405 of the Tax Reduction and Simplification Act of 1977, requires OTB operations making a payout of more than $1,000 and at least 300 times the amount wagered to deduct and withhold 20 percent of the payout. Pursuant to an Internal Revenue Service news release, IR-1804, OTB operations commenced withholding on May 18, 1977, and have continued to withhold 20 percent of eligible payouts according to IRS Instructions for Forms W-2G and 5754 (Rev. 1977) since that date.

WITHHOLDING SHOULD BE REPEALED

A Federal Commission charged by Congress with the comprehensive study of gambling condemned withholding in its 1976 Final Report as a counterproductive tax policy that would "increase the advantage of illegal operators, generate minimal revenues to the Government, and unnecessarily increase the administrative burden to the legal gambling business". The Federal Commission recommended Congress to reexamine withholding, and in the event withholding should prove to be destructive of legal gambling industries further recommended that withholding be repealed.

Four years' experience with withholding has confirmed the 1976 warning of the Federal Commission. As the Commission had forseen, withholding has proven to be a strong inducement to illegal gambling and has severely impaired OTB's ability to compete with illegal bookmakers, thereby frustrating one of the statutory purposes of legal off-track betting. By diverting off-track wagers to illegal operators and removing from play winnings that in most cases would otherwise be rebet with OTB, withholding has reduced the flow of off-track betting revenue to State, municipal, and local government and to the racing industry. Finally, withholding has not accomplished the intent of Congress. In enacting section 3402(q) Congress intended to ensure compliance with the tax laws by withholding a percentage of pari-mutual payouts against a bettor's net gains from betting for the tax year. Under the law a bettor may deduct losses to the extent of payouts, and has a tax liability only on his net betting gains. In practice, however, withholding has proven to be an excise tax instead of a genuine withholding against net income from betting. Because OTB operations retain from seventeen to twenty-nine percent of all wagers as pari-mutual revenues, few bettors have net gains over the course of the year. Yet, IRS standards for recording losses are so complex most OTB patrons cannot understand them, and are so cumbersome as to be for all practical puposes inconsistent with the activity of off-track betting. Moreover, many OTB patrons take the standard deduction on their Federal tax return, and bettors cannot deduct even documented losses unless they give up the standard deduction and itemize their losses. In effect, withholding confiscates legal payouts from bettors who in most cases have no tax liability under the law, and who have no real opportunity to obtain tax credit for their losses from pari-mutual off-track betting.

THE NATIONAL ASSOCIATION OF STATE RACING COMMISSIONERS HAS ASKED CONGRESS TO REPEAL WITHHOLDING

The negative effects of withholding on legal off-track betting in New York and Connecticut have been felt by the on-track pari-mutual racing industries of more than 30 States. The National Association of State Racing Commissioners ("NASRC"), the State officials responsible for the regulation of pari-mutual reacing and off-track betting, has condemned withholding as "extremely damaging to all segments of the pari-mutual industry" and the cause of "considerable losses in direct pari-mutual revenue to the States". At its 1981 convention the NASRC resolved to petition the Congress for the repeal of withholding.

NATOB JOINS WITH THE NASRC IN PETITIONING CONGRESS FOR TAX REFORM

The governmental off-track betting operations of New York and Connecticut join with the NASRC in asking Congress to repeal withholding. Further, in view of the demonstrably adverse effects of the present tax treatment of legal pari-mutual payouts NATOB wishes to suggest to the Subcommittee two additional reforms:

*A provision allowing the excess of legal betting losses over legal and net illegal betting gains to be carried over from the taxable year and treated as a legal loss in the succeeding year.

•A redefinition of adjusted gross income to allow taxpayers who take the standard deduction on their Federal tax return to deduct taxable year legal wagering losses to the extent of taxable year legal wagering gains.

Senator PACKWOOD. Thank you.
Mr. Brown.

STATEMENT OF EARLE PALMER BROWN, CHAIRMAN, HARNESS TRACKS OF AMERICA

Mr. BROWN. My name is Earle Palmer Brown. I am the president of Rosecroft Raceway, a Maryland race track; chairman of the board of the Harness Tracks of America, a national trade association representing practically all of the harness tracks in this Nation, and a member of the Executive Committee of the American Horse Council, a national association, representing more than 2.5 million American horsemen and women.

It has been hard for our industry to explain to outsiders why it is so damaging to tell our patrons who are rightly entitled to a payout of $1,000 or more, that they must immediately give 20 percent to the Federal Government.

That is because any accurate explanation must be based on the understanding of the parimutuel process and the very basic fact that few of these patrons will have a net tax liability at the end of the year.

Despite that fact, the way the tax system is set up, it makes it difficult, if not impossible, for them to get their money back.

The net result is that they have had the money confiscated. The withholding actually becomes a penalty.

I would like to take this opportunity to point out why our industry suffers more than others would under a similar burden and why it is so unreasonable to expect that withholding could do anything but damage our industry.

Our operations depend on cash flow, from the patrons and back to them, the turnover. The horsemen, the tracks and the State and local government all receive their revenues through the takeout which, as you know, is a percentage of the wagered dollars that are removed from the betting pool.

When you take money out of circulation as withholding does, you cut directly into the industry's financial lifeline. Not only do you harm the patrons, whose participation in our system depends on their getting their money back, but you also hurt an entire industry which relies on takeout to support the horsemen and the tracks, finance reinvestment, and provide a substantial tax return to local governments.

The best analogy I can think of is to liken the overriding importance of cash flow in our business to that of the country's financial community.

You would not support a 20-percent withholding on a profitable bank or stock market transaction because of the dramatically negative effect the removal of such a large block of money would have on the Nation's economy.

On an obviously smaller scale, our industry depends on its cash flow in much the same way. Withholding affects the entire system, not just the individual taxpayer.

The horse racing industry is an important contributor to national, State and local economies. It might surprise you to learn that a great many race tracks, the focal points of the entire system, the breeders, the horsemen and everyone else are experiencing severe economic problems that seriously threaten their existence.

In my opinion, in the years ahead, many of the small tracks in this Nation are going to go out of business. The majority of the 30 States that have parimutuel racing have been forced in recent years to reduce the revenue to the State, and reinvest those revenues to help preserve what they consider to be a vital, important agricultural industry.

Let me say this about racing: Racing is the only form of gambling that provides open space and green belts around many of our cities. The breeding farms of Florida, California, South Carolina and Maryland are there because they raise the horses that race in our race tracks.

As the senior Senator of my State said in a recent speech to the American Horse Council, when you fly over western Maryland in an airplane and see the dozens of small training tracks on the Eastern Shore of Maryland, Delaware and Virginia, you realize much of that land is being held in open space and farming because of the pari-mutuel racing industry.

Thank you.

Senator PACKWOOD. I am curious about one statement, on page 2, where you say "few of these patrons will have a net tax liability at the end of the year." Is that because they lose more than they gain over the year?

Mr. BROWN. Yes, sir.

Senator PACKWOOD. In bets, they just don't come out even, so consequently, assuming they can prove it, they are entitled to a refund, but as you very correctly say, the difficulty of proving that to the Internal Revenue Service is overwhelming.

Mr. BROWN. The assumption that there is a net income for any more than a small segment of participants in the wagering system is a basic falsehood disproven by a fundamental understanding of our process.

The effect of the takeout process is to leave a lessening amount for redistribution to the patrons. For every dollar wagered at a race track, an average of 81 percent is returned to the bettors.

When spread over time and probability, the result is that the majority of patrons, under normal circumstances, are net losers.

Senator PACKWOOD. Any questions?

Senator DURENBERGER. I have no questions. Thank you, Mr. Chairman.

Senator PACKWOOD. Gentlemen, again, I say it is an issue that has been before us for 4 years. I think we unwisely enacted it. I hope we can help you.

Thank you.

Mr. BROWN. Thank you very much.

Mr. DREW. Thank you.

Mr. GANNON. Thank you.

[The prepared statement of Earle Palmer Brown follows:]

PREPARED STATEMENT OF EARLE PALMER BROWN, PRESIDENT, ROSECROFT RACEWAY, AND CHAIRMAN, HARNESS TRACKS OF AMERICA

My name is Earle Palmer Brown. I am president of Rosecroft Raceway a Maryland race track; chairman of the board of Harness Tracks of America, a national trade association representing the majority of United States harnes tracks; and a member of the executive committee of the American Horse Council, a national association representing some 2.5 million American horsemen and women.

I am here in my capacity as a race track operator and representative of the racing industry in support of Sen. Huddlestion's bill to repeal Federal withholding on race track payouts.

My fellow industry representatives and I are not asking for special treatment for race tracks or their patrons. In fact, we are asking that the special treatment we are enduring be ended because it is so profoundly unfair to our patrons and harmful to the industry.

It has been hard for the industry to explain to outsiders why it is so damaging to tell our patrons who are rightfully entitled to a payout of $1,000 or more that they must immediately give up 20 percent to the Federal Government. That is because any accurate explanation must be based on an understanding of the pari-mutuel process and the basic fact that few of these patrons will have a net tax liability at the end of the year. Despite that fact, the tax system makes it extremely difficult for them to get their tax money back, and in the end their loss of income has severely negative effects for the industry as a whole.

I cannot address all those issues adequately here, but I would direct you to the written statement being filed by the American Horse Council for a complete analysis of the fundamental tax and revenue issues and the problem in general.

I would like to take this opportunity to point out why our industry suffers more than others would under a similar burden and why it is so unreasonable to expect that withholding would have anything but negative effects on the industry.

Pari-mutuel operations depend in cash flow, from their patrons and back to them, for their revenues. Horsemen, tracks and State and local governments receive their revenues through "takeout"—a percnetage of wagered dollars removed from the pari-mutuel pools.

When you take money out of circulation, as withholding does, you cut directly into the industry's financial lifeline. Not only do you harm the patrons, whose participation in the system depends on cash return, but you also hurt an entire industry, which relies on takeout revenue to support its horsemen and tracks, finance reinvestment and provide a substantial tax return to government.

The best analogy I can think of is to liken the overriding importance of cash flow in the pari-mutuel industry to that of this country's financial community. You could not support a 20-percent withholding on profitable bank or stock market transactions because of the dramatically negative effect the removal of such a large block of money would have on the nation's economy. On an obviously smaller scale, the pari-mutuel industry depends on its cash flow in much the same way. Withholding affects the entire system, not just an individual taxpayer.

The horse racing industry is an important contributor to national, state and local economies. Yet it might surprise you to learn that a great many race tracks, the focal points of the system, are experiencing severe economic problems that seriously threaten their existence. A majority of the 30 states that have pari-mutuel racing have been forced in recent years to reduce the government tax on racing and reinvest their revenues to help preserve what they consider to be a vitally important agricultural industry.

The economics of the racing industry are hardly as positive as many believe. Many track operators are struggling, and their problems cast a shadow over the present and future of the industry.

Withholding has made the financial prospects look worse than ever. It has also made the illegal althernatives to race track wagering look better than ever. The excessive tax situation that many of our patrons feel they now face at the track can have the effect of sending them to their local bookmakers, who smile when they think about withholding and happily accept the increased business it channels their way.

If there were a reasonable basis for withholding, a legitimate tax collection premise and documented productiveness, it would be more difficult to argue against its existence.

But pari-mutuel withholding has never been proven to be anything but unjust, confiscatory and unproductive. And it continues to inflict present financial problems and future uncertainties on the intire horse racing industry. Withholding's negative effects are substantial. Its positive effects, if any, come at the expense of this industry and its patrons, and in any event remain unproven and fundamentally questionable.

Given those facts, I hope the committee can understand why my industry feels it has been wronged by withholding and is asking for relief from this unnecessary and unproductive burden. I thank the Committee for this opportunity to present these arguments in favor of S. 1369.

Senator PACKWOOD. Now we have Mr. Pearson and Mr. Stapleton and Mr. Elliott.

Senator DURENBERGER. Mr. Chairman, while they are coming up, I am pleased that you included S. 805 in the hearing today. It is sponsored by Senator Mitchell and myself.

Very simply the amendment would eliminate an unintended double tax burden on certain life insurance companies that they must bear on dividends representing earnings of wholly owned, nonlife company subsidiaries.

I have just met Mr. Stapleton. I will say with regard to Jack Pearson, that he will be able to outline the nature of the uniqueness of this problem better than I, by far.

He is chairman and president and chief executive officer of Northwestern National Life Insurance Co. of Minneapolis, a company that is sort of on what I classify on the cutting edge of a lot of things that the insurance industry is doing differently in this country, starting in the Twin Cities, it is very actively involved in this community.

I am just very pleased and proud that Jack is willing to come here today and speak on behalf of this important issue. I thank you for your consideration.

Senator PACKWOOD. Mr. Pearson, go right ahead.

STATEMENT OF JOHN E. PEARSON, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, NORTHWESTERN NATIONAL LIFE INSURANCE CO., MINNEAPOLIS, MINN.

Mr. PEARSON. Thank you, Mr. Chairman.

I am here to speak in favor of an amendment to the Life Insurance Company Income Tax Act of 1959. This amendment seeks to correct a deficiency never intended wherein earnings of controlled subsidiaries, subsidiaries controlled 80 to 100 percent by the parent are taxed as any other corporation and they are taxed again when the dividends are paid up to the parent.

This deficiency in the act, this problem, initially affects primarily mutual companies which cannot form upstream holding companies, as most stock companies can and have.

The proposed amendment would reestablish neutrality between large segments of our business. From our perspective and I think quite accurately so, it would not result in any significant revenue loss, simply because those of us in this position don't pay any dividends from our subsidiaries to the parent, because of the tax implications.

Finally, there is no adverse impact on other companies, because those without subsidiaries are not affected, certainly, and those stock companies who have holding companies are not affected.

The only effect is that there is an elimination of an unintended, unfair disadvantage.

Interestingly, the Canadian companies, and there are a number of very fine, large life insurance companies in Canada, faced the same problem that we do. The problem we speak to today was corrected under Canadian law, in 1977.

The conclusion of our prepared statement, is that certain life insurance companies with subsidiary corporations are now discriminated against by the 1959 act.

We believe this inequity should be removed. Enactment of the proposal would be consistent with U.S. tax policies applied to all other corporations.

Congress has recognized that the earnings of a controlled subsidiary are in substance the business income of the parent and should not be taxed a second time. Our proposal eliminates the lone exception to this basic tenet of tax policy.

The proposal also supports another fundamental principle of tax policy which is that tax laws should be neutral as to the various corporate forms. It would support the principle of tax neutrality among various types of corporate structures as well as various types of life insurance companies.

I would be happy to answer any questions that you might have relative to this amendment.

Senator PACKWOOD. I am curious. You say this tax can be avoided if you want to convert yourself into a holding company, but one, that may be artificial, in many cases; and two, some companies simply cannot do it.

Mr. PEARSON. Well, primarily the mutual companies cannot. We can form a holding company but it would have to be down stream and we would not achieve the objective.

Senator PACKWOOD. You are in a competitive disadvantage compared to those who can convert themselves into a holding company.

Mr. PEARSON. That's correct, sir.

Senator PACKWOOD. Fine.

Mr. PEARSON. I do represent, and I probably should have said this at the outset, a group of about 16, companies, all of whom have the same basic problem that we have, most of which are mutual life insurance companies. I think you perhaps know that the mutual companies are the biggest segment of the industry.

Senator PACKWOOD. I do not recall the background on this. Would you tell me why we passed this law initially? What were we trying to prevent or prohibit at the time we passed it?

Mr. PEARSON. I think at the outset it was that the industry needed a new tax law. It was, and you are speaking of the 1959 act.

Senator PACKWOOD. I understand the act, but why did we place the tax on the payment of the dividends from the subsidiaries to the parent?

Mr. PEARSON. I don't think it was ever intended. I think it was altogether overlooked. But if you go back 20 or 25 years, there were very few subsidiaries in the first place.

The reason for subsidiaries today is that many life insurance companies have sought to diversify. For example, they are now in the property and casualty business. They have seen fit to get into time sharing with computers. And, in our own case, we have a life insurance subsidiary in New York for specific reasons because we are not licensed there. We have another company out in the west coast that does business in a different distribution system. We have a broker-dealer that enables our agents, our sales people to do mutual fund business.

We, like all these other companies, have subsidiaries that we didn't have back in 1959. That was generally the case in the industry.

With the passage of time and with changes in financial planning and the various things that the life insurance people participate in, it has become desirable to form subsidiaries.

So, it was really a situation that didn't exist then that does today.

Senator PACKWOOD. Senator Matsunaga.

Senator MATSUNAGA. Thank you, Mr. Chairman.

If these questions have already been asked and answered, please say so. There will be no need to respond again. I will check the record later.

Was the American Council of Life Insurance ever involved in drafting the original language of S. 805?

Mr. PEARSON. They were not, sir, that I am aware of. But the American Council of Life Insurance is very aware of our pursuit of this change. They have reviewed the proposal and they do not oppose it.

Senator MATSUNAGA. As I understand it, the American Council of Life Insurance is now working on a comprehensive package of amendments to the 1959 act, subchapter L.

Mr. PEARSON. Yes, sir.

Senator MATSUNAGA. Is this correct?

Mr. PEARSON. Yes, it is.

Senator MATSUNAGA. The ACLI hopes that the final legislative package would be acceptable to all segments of the industry?

Mr. PEARSON. Yes, sir. As a matter of fact, obviously there have been long and arduous negotiations within the industry. That package is in shape so that I think it is ready to begin the process.

I think maybe you are alluding to the question of why we are coming in independently of that effort. I think it is our judgment there are some very, very major issues within that reform of the 1959 act, as the ACLI will present it. It covers substantial other issues.

I think it would be fair to say we look for a fairly long process. We think that S. 805, since it is such a minor issue, does not impact revenue in any substantial form at all.

Perhaps I should address that issue, if I may, for just a second. Right now, because of the impact of double taxation—taxing the sub and then taxing the parent once again when the dividends are brought up—we haven't brought any dividends up from any of our subs, for all the years we have had subsidiaries.

I think that is basically the case with other companies. Since dividends are not being paid to the parent, the bill would have very minimal effect on current tax revenues.

In contrast, the tax package you refer to is one that does have significant revenue impact. It is an attempt to bring us back as an industry to something closer to where we were in 1959. It is just an altogether different issue.

Senator MATSUNAGA. Have you any idea as to how soon this package will be ready to present to the Congress?

Mr. PEARSON. Well, I am not close enough to say, to give you any specifics. I know conversations have begun, and yet, I suspect it will be some time yet.

Senator MATSUNAGA. As you probably have guessed, there have been segments of the industry which say that it is at this time premature to consider S. 805.

Mr. PEARSON. Well, obviously, they are entitled to their judgment. It is my feeling that since this particular issue of double taxation is not addressed in that tax package, it seems appropriate to bring it up at this time.

Senator MATSUNAGA. I have no further questions. Thank you, Mr. Chairman.

Senator DURENBERGER [acting chairman], presiding. Thank you very much, Senator.

I know, Jack, you abbreviated your statement. I don't know whether Mr. Stapleton did. If the chairman did not note it, the statements will be made part of the record in full, as though delivered.

I thank you very much for being here.

Unless there is some other business to come before this hearing, the hearing is adjourned.

[The prepared statement of John E. Pearson follows:]

Statement of

John E. Pearson, Chairman, President and Chief Executive Officer
Northwestern National Life Insurance Company
Minneapolis, Minnesota

Concerning

S. 805

To amend the Internal Revenue Code of 1954 relating
to certain dividends received by life insurance companies.

Before the Subcommittee on Taxation
of the Committee on Finance

July 24, 1981

Thank you Mr. Chairman. I am John E. Pearson, Chairman, President and Chief Executive Officer of Northwestern National Life Insurance Company headquartered in Minneapolis, Minnesota. I am speaking also today for sixteen life insurance companies which do a substantial part of the life insurance business in this country.

The Problem

The companies I represent, and others in the industry, have expanded the services they provide to consumers through the formation and acquisition of wholly owned subsidiaries. For the most part, state laws preclude companies from providing these services through the parent life insurance company.

The Life Insurance Company Tax Act of 1959 (I.R.C. Section 801) does not allow a 100% exclusion of dividends received by a life insurance company from a wholly owned subsidiary. This results in a double tax on such income. The subsidiary, of course, pays the regular corporate tax. Then, because of the proration scheme of the Life Insurance Company Tax Act, another tax is imposed when the subsidiary pays a dividend to the parent life company. In the case of my company, this second tax amounts to approximately 25% of the dividend received from the subsidiary. The amendment we propose would eliminate this second tax.

Diversification of the Life Insurance Business

When the Life Insurance Company Income Tax Act was enacted in 1959, there were very few wholly owned subsidiaries and consequently the double tax that I have described was not specifically addressed. However, during the 1960's and 70's, the life insurance companies began to write other lines of insurance and to provide auxiliary types of business such as computer and financial and administrative services. Separate corporations were created to achieve this diversification and in some cases these new corporations and the life insurance company that organized them became subsidiaries of a holding company. There are a number of reasons for creating such a structure, but one of the effects was to eliminate the double taxation of dividends from these non-life insurance corporations.

The holding company arrangement is not an option open to mutual life insurance nor to some life insurance companies which for business reasons ~~prefer~~ do~~ing~~ business through subsidiaries. Others for legal reasons cannot adopt the holding company structure.

Thus, some life insurance companies have been able to avoid completely this second corporate tax on wholly-owned subsidiary dividends. They are in the position of all other corporations since the 1964 Act (PL 88-272) which totally excluded dividends from controlled subsidiaries. The concept of that Act is that earnings of an 80% owned subsidiary are more directly the earnings of the parent than is the case where one corporation merely derives investment income from an unrelated corporation. Our proposal would extend this tax treatment to life insurers which do not have a holding company organization structure.

The Proposal is Based on Sound Tax Policy

It is widely agreed that the tax laws should be neutral as to corporate form and this proposal would achieve that result. Moreover, it would restore the neutrality between large segments of the life insurance business that existed when the 1959 Act was adopted.

The proposal is consistent with state regulation of insurance. State laws limit the amount of capital a parent life company can invest in subsidiaries. In most states this limit is a lesser of 50% of surplus or 5% of assets. These limits prevent transferring large amounts of assets to subsidiaries in order to achieve a tax advantage.

Moreover, state regulators favor life insurance companies expanding their services through wholly owned subsidiaries instead of through holding company arrangements. We know of no reason why the Federal tax laws should favor the holding company structure over one that is thought to be more in the public interest.

No Revenue Loss

Because of the double taxation of subsidiary dividends, those companies which now have profitable subsidiaries have avoided distributing any earnings to the parent life insurer. Accordingly, there is little if any second tax generated by existing law and the sole effect is to deny the parent life insurer the use of the earnings of the subsidiary. Since there are no taxes being paid on these earnings now, there would be no immediate revenue loss as a result of the enactment of this proposal.

It should be noted, however, that if the legislation were enacted, some of the earnings of the subsidiaries would ultimately be passed along to the parent life insurance companies and less revenue would then be generated than if the law were unchanged. The actual amount of this hypothetical loss will depend on the profitability of the life insurance company subsidiaries and the extent to which management elects to pass profits along to the parent. Even this hypothetical revenue loss would be well within the limits of what has traditionally been considered "negligible" in tax legislation.

No Adverse Impact on Others

Enactment of this proposal would have no adverse effect on any other insurance company. It would have no effect at all on companies which do not have subsidiaries or on those which utilize the holding company arrangement.

Canada Provided Similar Relief

Following enactment of the 1959 Life Insurance Company Tax Act in this country, Canada adopted a tax program for its life insurers that provided for a similar proration of inter-corporate dividends. In 1977 the problem I am presenting today was brought to the attention of the Canadian government and similar relief was requested. The Canadian government granted not only the limited relief of our proposal, but went further to exempt all dividends from the double tax, whether from subsidiaries or unrelated corporations.

Conclusion

Certain life insurance companies with subsidiary corporations are now discriminated against by the 1959 Tax Act. This inequity should be removed.

Enactment of this proposal would be consistent with U.S. tax policies applied to all other corporations.

Congress has recognized that the earnings of a controlled subsidiary are, in substance, the business income of the parent and should not be taxed a second time. Our proposal eliminates the lone exception to this basic tenet of tax policy.

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The proposal would also support another fundamental principle of tax policy, that the tax laws should be neutral as to various corporate forms. It would support the principle of tax neutrality among various types of corporate structures and among various types of life insurance companies.

We hope it will be promptly approved by this Committee and we appreciate your consideration of the proposal.

[Whereupon, at 10:32 a.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:]

COALITION FOR LOW AND MODERATE INCOME HOUSING

Suite 400 South
1800 M Street, N.W.
Washington, D.C. 20036
Telephone: (202) 457-6800

August 7, 1981

WRITTEN STATEMENT OF THE

COALITION FOR LOW AND MODERATE INCOME HOUSING

ON S. 1214

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE

Hearing on July 24, 1981 on Five Miscellaneous Tax Bills

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to present to the Committee the views of the Coalition for Low and Moderate Income Housing with respect to the proposed repeal of the limitation on the deduction of investment interest, as contained in S. 1214, which the Committee is presently considering.

The Coalition for Low and Moderate Income Housing was organized in 1975 to bring together all associations, trade groups, business organizations and individuals who are involved with government-assisted low and moderate income housing. Our members participate in all aspects of this housing, including financing, production, rehabilitation and operation.

The Coalition supports the repeal of Section 163(d) which limits an individual's deduction for interest on investment indebtedness to $10,000 plus the amount of net investment income. This provision discriminates against individuals since there is no similar limitation on corporations. Further, it discriminates in favor of wealthy individuals who, because of the large amount of investment income that they frequently have, have virtually no limit on their interest deductions.

Moreover, in today's climate of high interest rates, the $10,000 limitation is no longer realistic. For example, if an individual borrows only $60,000 at 17% interest to purchase property for investment, he will pay more in interest than he may deduct under current law. Since almost all real estate is financed through substantial borrowing, Section 163(d) thus acts as a severe disincentive to investment in real estate, including low income housing.

STATEMENT OF COALITION FOR LOW AND MODERATE INCOME HOUSING
August 7, 1981
Page Two

If Congress determines for any reason that repeal is impractical, we would urge that the $10,000 limitation be raised to $25,000 which would restore the law as it existed before 1976 when the $10,000 limitation was enacted.

Thank you for this opportunity to submit this written statement.

Herbert F. Stevens

Herbert F. Stevens
Lane and Edson, P.C.
Counsel to the Coalition

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TESTIMONY ON S-1214

MISCELLANEOUS TAX BILLS

BEFORE THE SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT

July 24, 1981

Thank you for this opportunity to express our viewpoints on S-1214 regarding the repeal of the investment interest limitation provision of the Internal Revenue Code of 1954.

Under current provisions of section 163(d) of the Internal Revenue Code of 1954, the total annual deduction for interest expense paid or incurred for investment purposes is limited on a joint income tax return to $10,000 plus the amount of net investment income. It is our belief that this limitation restricts business activity and is counter productive to the creation of jobs and tax revenue in the following ways:

1. The limitation acts as a deterrent to the investment in property and businesses. Business activity is the backbone of a healthy economy. A slow down in activity results in a slow down in the creation of new jobs and new tax revenue.

Interest expense paid or incurred directly in a trade or business is not subject to the investment interest limitation. However, the investment interest limitation creatés a practical prohibition against many individuals acquiring property or businesses. An individual finds that he cannot acquire property because a major portion of the interest expense which he must pay out is not deductible. An individual finds that he cannot buy the corporate stock of an existing business because the interest expense is not deductible. An individual finds that he cannot start a new business in the corporate form because he cannot deduct interest paid on borrowed funds invested in the corporate venture.

New debt-equity regulations issued by the Internal Revenue Service require a high ratio of equity by the shareholder to debt owed by the corporation. An individual finds that tax policy stands as an obstacle to the infusion of his or her ideas and initiative in the acquisiton and revitalization of an existing business or the creation of a new business venture.

2. The limitation on investment interest serves as a penalty on capital formation and the use of capital. An integral part of capital formation is the utilization of capital to acquire businesses and to create new businesses. The failure of individuals to acquire businesses and to create new businesses because interest expense to fund such businesses is not currently deductible will act as a deterrent to capital formation and prohibit many individuals from the ultimate ownership of businesses.

3. The interest expense limitation restricts competition. The limitation acts as a deterrent for the purchase of existing businesses and the creation of new businesses. An individual who does not have substantial funds already on hand is prohibited from entering into new business ventures. The purchase of existing businesses and the creation of new businesses becomes limited to investments by existing businesses without the infusion ~~of~~ new individuals not already established in business.

4. The interest expense limitation provides a premium for investors to invest in income stream investments (dividend income) rather than in growth investments. The economy will be well served by the establishment of many growth risk ventures. Such growth risk ventures cannot pay dividends currently. With the limitation on the deduction of interest expense incurred to fund such growth ventures, individuals refrain from taking the risk.

5. The limitation permits investments by individuals who already are receiving substantial amounts of dividend and interest income while penalizing an individual who has little or no investment income. An individual who already has accumulated substantial investments can continue to utilize borrowed funds to make additional investments. An individual with only salary income is penalized when he attempts to use borrowed funds to generate a business activity.

6. The limitation has not maintained pace with the inflation rate and higher interest rates. Interest rates are approximately three times the rates in effect when the $10,000 limitation was imposed. The amount of funds needed to generate business activity has risen substantially with higher costs of equipment and salaries. At the same time, with higher interest rates, the amount which can be borrowed for an interest cost of $10,000 has decreased.

7. The limitation applies even if the individual sells the asset giving rise to the interest expense and realizes a gain or loss. The limitation operates as a severe penalty when the interest which has been paid out cannot be deducted even against the gain realized on the sale of the asset or against gains realized from the sale of other investments.

The above items have become apparent to us in the tax planning for our clients. We have seen business transactions rejected because of the deduction limitation on investment interest. We believe that a tax provision which restricts business activity is detrimental to the economy. We believe that the limitation for the deduction of investment interest set forth in section 163(d) of the Internal Revenue Code should be repealed.

Respectfully submitted,

Harold E. Finch

Harold E. Finch, CPA

Unionmutual

Resend

Portland, Maine 04122
(207) 780-2211

August 4, 1981

Robert E. Lighthizer, Chief Counsel
Committee on Finance, Room 2227
Dirksen Senate Office Building
Washington, D. C. 20510

Re: July 24, 1981 Hearing - S. 805

Dear Mr. Lighthizer:

Thank you very much for the opportunity to comment on S. 805, a bill extending the exemption from taxation to dividends received by life insurance companies from subsidiaries. This bill affects most mutual life insurance companies and some stock life insurance companies.

Union Mutual Life Insurance Company is a mutual life insurance company domiciled in Portland, Maine, which has several stock life insurance company subsidiaries, including Unionmutual Stock Life Insurance Co. of America, Unionmutual Stock Life Insurance Company of New York, and Unionmutual Pension and Insurance Corporation. The problem this bill is intended to correct is of direct concern to us and our policyholders.

Life insurance companies are taxed under a formula which excludes from their taxable income the investment income required to meet policyholder reserve and other interest commitments. This is accomplished by a proration of investment income between a tax-free policyholders' share and a taxable company share. In conformity with this method, present law provides that certain reductions and exclusions that would normally be available to the company, for instance, the exclusion for tax-exempt interest and a deduction for dividends received, must also be prorated between the tax-free policyholders' share and the taxable company's share. This means that the company

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does not receive the full benefit of these items as a reduction of its taxable income but secures only its share of each item.

The following illustration shows how the proration rule cancels part of the dividend-received deduction: Assume a mutual life insurance company has $200 of investment income including $10 of dividend from its wholly owned subsidiary. Assume that the policyholders' share, that is, the amount necessary for policy and other interest requirements, is $120. This is excluded from tax, leaving a company share of $80 of taxable investment income. At this point, a non-life company may elect to take a deduction of 100% of dividends from a wholly owned subsidiary. In this instance, however, the life company may not deduct the full $10 from its taxable income. It must prorate a portion of the $10 to its previously excluded policyholders' share. In this case, the portion would be 60% ($120 divided by $200). After allocating 60% of the $10 in dividends to the policyholders' share, there remains 40% or $4. The company then subtracts $4 instead of $10 from its $80 share of taxable income, leaving taxable income of $76. Had the company been able to eliminate the full amount of the dividend ($10) from its investment income at the outset, it would have been left with taxable income of only $70.

The current law, therefore, for a mutual life insurance company, leads to an inequity as compared to other corporate taxpayers. This special proration formula used to calculate a life insurance company's taxable income results in an increase in its tax when a dividend is received from an 80% owned subsidiary. A stock life insurance company is able to eliminate the inequity through formation of a parent holding company which is a non-life company, and which owns all of the subsidiaries, including the life insurance company. A mutual life insurance company, by its very nature, does not have this alternative.

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We believe that S. 805 eliminates this inequity in the treatment of mutual life insurance companies as compared to other corporations. By doing this, it does not give mutual life insurance companies preferential treatment, but simply puts them in an equal competitive position with other corporations including stock life insurance companies. The benefit of eliminating this inequity would pass directly to the policyholders in the form of dividends, since they are in fact the owners of a mutual life insurance company.

We appreciate the opportunity to inform the committee of our position on this amendment. It is, we believe, a simple technical correction. While we are aware that Congress is under severe time restraints and deals with hundreds of proposed bills, we feel that a knowledge of the effect of this amendment, and its goal will help the committee to react favorably toward the bill's passage.

Sincerely,

Ruth L. Sky

Ruth L. Sky
Governmental Affairs Associate

RLS/kah

STATEMENT OF THE

AMERICAN HORSE COUNCIL

ON

REPEAL OF PARI-MUTUEL WITHHOLDING (S.1369)

Presented to the

Senate Subcommittee on Taxation and Debt Management

of the Senate Finance Committee

The American Horse Council, Inc. is a national association representing approximately 2.5 million American horsemen and women. Its 160 organizational members include most of the major equine and pari-mutuel organizations in this country. While horse industry participants are primarily represented through these groups, AHC membership is also open to individual professional and pleasure horsemen.

The American Horse Council appreciates this opportunity to express its view on S.1369, Sen. Walter Huddleston's proposed legislation to repeal section 3402(q) of the Internal Revenue Code requiring 20% withholding on certain payouts at pari-mutuel operations.

BACKGROUND

On May 18, 1977, pursuant to section 3402(q) of the Internal Revenue Code added by section 1207(d) of the Tax Reform Act of 1976, pari-mutuel operations began withholding 20% of payouts of more than $1,000 at odds of at least 300-1. Withholding on such payouts has continued since that date. Affected are race tracks, off-track betting operations and jai alai frontons.

The imposition of withholding on the pari-mutuel industry and its patrons was an outgrowth of Treasury Department and Internal Revenue Service determinations that such on-site tax collections would ensure compliance with tax laws and generate significant, previously uncollected tax revenues for the federal government.

ISSUE

Based as we believe it was on faulty assumptions and unreasonable claims, withholding has ranged far from its original legislative intent in terms of impact and effect. It has wrongfully collected taxes on transactions that ultimately generate no liability and has had serious and persistently damaging effects on the pari-mutuel industry. It has also reduced state tax revenues and chilled programs such taxes support. Those effects were originally unrecognized or intentionally ignored by Treasury in its impact deliberations.

It is the position of the American Horse Council, speaking for the pari-mutuel horse industry, that withholding has uniquely detrimental effects on pari-mutuel operations and the horse industry at large; that it attempts to enforce by extraordinary means tax compliance in an area where no such unusual measures are necessary; that, by negative corollary, it actually confiscates as tax dollars monies that rightfully should be returned to pari-mutuel patrons but which most cannot retrieve under normal circumstances; that it is unproductive for the Federal Government and seriously counterproductive for States and their pari-mutuel industries; and that it increases the advantages of illegal bookmakers over legal wagering outlets and may accrue to the benefit of organized crime.

This statement outlines those issues and offers what we believe to be reasoned, factual and sharply defined arguments in favor of repeal of section 3402(q) of the Internal Revenue Code.

I. Withholding is based on wrongful assumptions and is unproductive for the Federal Government.

Withholding on pari-mutuel payouts appears to be a derivative of federal withholding on wages, a preliminary tax collection designed to secure tax funds and ensure enforcement of the Internal Revenue Code requirement (Section 61 IRC) that "all income from whatever source derived" be included in gross income and taxed accordingly.

In the case of pari-mutuel payouts, the withholding application is based on assumptions that (1) there is net income and a basis for tax liability; (2) there is a need to ensure compliance; and (3) there are substantial

Federal Government revenues to be gained by such an application.

While those assumptions may apply in other areas, they are seriously inaccurate and misleading in the area of pari-mutuel wagering and have been used indiscriminately to support the claim that withholding is necessary and reasonable.

Income

The assumption that there is net income for any more than a small segment of participants in the pari-mutuel wagering system is a basic falsehood disproven by a fundamental understanding of the pari-mutuel process.

The phrase "pari-mutuel" is itself a French term meaning "among ourselves" as descriptive of the wagering process. Pari-mutuel patrons compete against each other, with the race track or pari-mutuel facility acting as a moneychanger (redistributor). A portion of each wagering pool is removed as "takeout" -- monies divided as revenues among State and local governments, horsemen and tracks -- and the remainder redistributed among the patrons.

The effect of this takeout process is to leave a lessening amount for redistribution to patrons. For every dollar wagered at a race track or pari-mutuel facility, an average 81 cents is returned to bettors. When spread over time and probability, the result is that the majority of patrons under normal circumstances must sustain net losses.

This fact has been borne out repeatedly in examinations of the industry.

By definition, the takeout aspect of pari-mutuel wagering negates the prospect of net winnings for all but a small percentage of participants.

Tax Liability and Compliance

Claims of tax liability and the need to ensure compliance cannot, as shown, be based upon general assumptions of widespread net income in the pari-mutuel area. The majority of pari-mutuel participants cannot and will not generate such a liability, and the question of compliance requirements not being met therefore becomes moot in most circumstances.

The need for extraordinary compliance measures, based on an assumption of non-compliance, has never been demonstrated and cannot be. Moreover, it should be recognized that the payouts in question, those of $1,000 or more at odds of at least 300-1, wrongly characterized as "windfall" profits, are in fact simply part of the normal wagering process and can be expected in most cases to be offset by corresponding losses. (The average patron wagers a total of $150 when attending the races, which when affected by a 19% takeout will generate an average loss of roughly $30. Thus, under normal circumstances, it takes fewer than 34 average race days to offset a $1,000 "windfall." Most regular pari-mutuel patrons easily exceed the three-per-month attendance frequency needed to generate such offsetting losses.)

Tax liability and the need for compliance withholding are faulty assumptions in the pari-mutuel process. This issue is further addressed in Sections II and III.

Revenues

When originally proposed, pari-mutuel withholding was projected by IRS to carry the potential of $500 million in annual revenues for the Federal Government. While that estimate may have fueled Congressional interest in the matter, it was almost immediately reduced to $110 million. Even this figure remains undocumented and misleading.

The assumption of $110 million in Federal Government revenues reflects a raw withholding estimate -- the amount to be collected on-site -- and does not take into account the legitimate offsetting losses generated that significantly reduce the lawful revenue impact.

Withholding at pari-mutuel facilities in 1980 amounted to $71.3 million. Of that amount, it can be estimated that less (possibly much less) than $18 million represented legitimate tax liability for those few patrons who generated net winnings. And there is no evidence to suggest that more than an insignificant portion of this already tiny revenue figure would not have been accounted for under voluntary tax compliance.

The claim of substantial Federal Government revenues from pari-mutuel withholding has not been borne out by the reality of collection. More importantly, IRS efforts to document withholding's effectiveness have consistently failed to address the costs involved for individual tax-payers and the industry at large. Those costs, discussed below, reveal withholding to be seriously counterproductive and a detrimental intervention into the business relationship between the pari-mutuel industry and its customer.

Far from its legislative intent, withholding has not generated formerly uncollected tax revenues for the Federal Government and has instead produced unwarranted and harmful side effects.

II. <u>Withholding is confiscatory and discriminatory.</u>

Based on a series of faulty assumptions involving income, tax liability, compliance and Federal Government revenues, withholding on pari-mutuel payouts has developed not as an effective means of tax collection but rather as a confiscatory and discriminatory excise.

Under current law, a bettor may deduct losses only to the extent that they offset gains. In an industry that by its nature will generate more losses than gains for its patrons, this produces a fundamentally unfair tax situation wherein losses alone receive no tax treatment while gains are fully taxable and must be offset.

In the meantime, IRS standards for substantiation of losses are so difficult to meet that the average pari-mutuel patron cannot or will not be able to produce the necessary documentation. Gains, as reflected by payouts subject to reporting ($600-999) and withholding, are therefore difficult or impossible for the average patron to offset, despite the fact that under normal circumstances his losses in a calendar year will outweigh the value of the gain. American Horse Council studies show that of patrons receiving payouts subject to withholding, over 85% report they will conclude the year as net losers in their pari-mutuel transactions.

In this situation, withholding serves as an excise tax, depriving the patron of a rightful payout and making it exceedingly difficult to retrieve the money through the tax return process. Withholding adds an excise to an already difficult tax situation faced by the average bettor.

The problem of pari-mutuel withholding is compounded by the fact that substantiation of losses for those able to meet IRS standards requires the taxpayer to forfeit use of the standard or zero-bracket deduction. In the common situation where a taxpayer of modest means is affected by withholding on a payout, the forfeiture of the standard deduction in order to claim offsetting losses would most often be a financial disaster. American Horse Council studies have shown that nearly 60% of respondents who were entitled to a refund from 20% withholding either could not give up the standard deduction for financial reasons (they did not have other itemized deductions necesary to make such a move sensible) or were unable to substantiate offsetting losses under difficult IRS standards.

Furthermore, even if the bettor can substantiate and itemize all his gambling losses, he may be subject to the alternative minimum tax on his winnings because the losses are treated as "excess itemized deductions" rather than as proper offsets to those winnings.

The individual attending pari-mutuel events who is affected by withholding at some point is therefore likely to be confronted with these considerations:

-- He will be a net loser for the year, yet is being forced to give up 20% of a payout to early and unwarranted tax collection.

-- In order to gain the rightful refund, he will have to give up the standard deduction and itemize deductions. He will not be able to generate or substantiate enough other itemized deductions to warrant forfeiture of the standard deduction and will therefore find it economically unreasonable to do so. If he does do so, he must meet extremely difficult standards of wagering loss substantiation set by IRS.

In all likelihood, the choice will be to surrender to the Federal Government the amount of the withholding because of the complex and discriminatory recapture process. This amounts to a form of negative taxation that in concept and practice runs counter to the ideals of the tax system.

III. The pari-mutuel industry is uniquely damaged by withholding's incursion into the wagering stream.

Withholding removed $71.3 million from the pari-mutuel process in 1980. Since its inception in 1977, withholding has drained away more than $275 million in collections.

Because the pari-mutuel industry relies on wagering, cash return and rewagering to sustain its financial base, the impact of withholding on pari-mutuel operations is far greater than those numbers would suggest.

To begin with, each dollar at a race track is rewagered an average of 3.5 times. That statistic derives from return of 81% of all wagers to patrons as payouts and the subsequent rebetting of those same dollars. Removal of $1 from the wagering stream by artificial means translates into 3.5 times that amount, or $3.50, in reduced overall wagering due to this "churn" factor. The net effect of the reduced wagering is fewer dollars being subjected to the 19% takeout, and therefore fewer dollars going as revenues to State and local governments, horsemen and race tracks.

In the case of withholding, the toll is dramatic. The subtraction of $71.3 million from the pari-mutuel process in 1980 translated into a huge $250 million reduction in wagering nationwide. The aggregate cost to the revenue partners that depend on wagering for income was at least $50 million last year alone and has totaled over $200 million since inception of the tax.

In order to fully understand this multiplier effect and the net damage inflicted by withholding, it must be recognized that cash flow has the same basic importance for the pari-mutuel industry that it does for the American financial system. Much as dollars flow through Wall Street as a commodity subject to constant transfer and reuse, so dollars at a race track serve to fuel the basic pari-mutuel system. In both worlds, the financial flow in general is more important than the nature of the individual transactions, and any breakdown subjects the entire system to a series of correlated shocks that have a serious effect.

To subject financial markets such as stock exchanges to immediate on-site withholding would be devastating, simply because the effect of removing 20% of profitable transaction values, regardless of overall net profit, would seriously reduce the system's vital cash flow. The impact of withholding on the pari-mutuel system is much the same. Removing dollars as taxes (with or without year-end liability) cuts into the cash flow on which the process is based. The repercussions, as the multiplier effect shows, are much more significant than the raw amount withheld.

Pari-mutuel patrons depend on the return of wagering dollars as payouts to form the base of future wagers. They cannot consistently supply new dollars to the process to replace those removed artificially by the withholding tax. Thus withholding creates a gap in the wagering stream. It subtracts a 3.5 multiple of itself from the system, and thereby interrupts the cash flow that forms the industry's financial base.

Withholding also intervenes in the business relationship between the industry and its patrons, which depends in great part on the general belief of those patrons that they are receiving a fair opportunity in the wagering process. The perception (and reality) of excessive taxation created by withholding acts as a serious disincentive, as does the actual administration of the tax.

IV. <u>Withholding is seriously counterproductive for States and their pari-mutuel industries.</u>

Thirty states conduct pari-mutuel events and derive revenues from the industry. Their interests are directly affected -- negatively and substantially -- by withholding.

The $250 million negative wagering impact of withholding translated in 1980 into an aggregate $50 million reduction in revenues to States and their pari-mutuel industries. As previously noted, withholding has cost these partners over $200 million since 1977, and has had further negative effects on the breeding and related industry segments whose well-being depends on the health of the race tracks.

On the state level, takeout revenues from racing are added to general revenue funds and used accordingly, or in some instances are earmarked for direct use in such areas as education, construction, social programs and so on.

On the industry level, takeout revenues (1) form the base of purse funds, the monies distributed to horsemen and horseowners that represent the heart of the horse business; and (2) provide return on investment and reinvestment capital for track operators. In both areas, the revenues are far from abundant and are the subject of constant concern.

An excellent example of the interplay between State and industry, and the dramatically negative impact withholding can have on that relationship, came in West Virginia recently. Already under extreme hardship to turn a profit from racing operations, Charles Town Race Track saw its bottom line dwindle to desperate levels with the onset of Federal withholding in 1977. In that year, wagering at the track dropped significantly, prompted by withholding's cut from the wagering stream. That development was accompanied by reduced purses, corresponding poor quality racing and the real threat that the thoroughbred operation would be forced to close down -- a disasterous event for the local economy and the thousands of horsemen and employees drawing their livelihoods from the track.

Charles Town was confronted with two alternatives:

obtain tax relief from the State or terminate racing operations. While withholding was not the sole factor which led to this situation, its impact helped necessitate State concessions in order to save the operation. The State agreed to divert a major portion of its revenue from the pari-mutuel takeout to the track to salvage racing at Charles Town. At the first stage, withholding reduced wagering, with a corresponding decrease in revenues for the State, horsemen and the track; at the second stage, it forced the State to redirect its revenues to the industry, thereby further reducing revenue to the State Treasury.

Over the past four years, a majority of States with pari-mutuel industries have been forced to redirect revenues to the tracks to maintain their current financial viability and ensure their future existence. Withholding has been a noted contributor to the difficulties that produced this condition, worsening existing problems and forcing financial commitments to patch them.

Recognizing the State-level impact of withholding, the reduced revenue and the ultimate need for the States to compensate for it in order to preserve their pari-mutuel industries, the national organization representing the State regulatory agencies that govern racing across the nation moved in April, 1981 to formally protest Federal withholding. In resolution form, the National Association of State Racing Commissioners joined with "the Commissions of the respective States which derive substantial economic, social and agricultural benefits from the industry to petition and urge the Congress of the United States to repeal this withholding burden on the millions of people who participate in pari-mutuel sports."

The resolution, drafted and adopted at the annual convention of the NASRC, concluded with the exhortation that "we urge our Governors, our State Legislatures and our U. S. Congressional delegations to join with the racing commissioners in a commitment to insure that the confiscatory and discriminatory tax policy presently applied to the pari-mutuel industry not be permitted to continue to damage the industry and the State revenues derived from it." (A copy of the resolution is attached.)

Withholding has weakened the financial condition of pari-mutuel operations in every State that houses the industry. It has a directly negative effect on State revenues and a secondary impact of requiring State action to alleviate the economic problems it causes for race tracks and other pari-mutuel facilities. Whatever Federal revenues are derived from withholding must necessarily come at the expense of the States and their industry.

V. Withholding's negative impact damages a focal point of a major American agribusiness.

Race tracks are a focal point of the huge American horse agribusiness. Their well-being is of vital importance to an economic chain that includes hundreds of thousands of horsemen and industry employees, horse owners, breeders, farm owners and others whose livelihoods are related to the industry. For example, there are 350,000 people licensed to work at race tracks. Farms engaged in breeding horses for the race track employed about 80,000 people in 1980 to produce approximately 50,000 foals.

Tracks are also key contributors to the economies of their local areas, often generating through employee salaries, horsemen's purses, goods and services purchases and local tax revenues a substantial portion of the local cash flow. The individual economic impacts of race tracks vary, but most can be estimated to generate an impact of at least $30 million on their areas. Larger operations may exceed $100 million.

The national economic impact of the racing industry is difficult to estimate but is thought to exceed $10 billion when calculated to include farmland investment and other related elements. Direct revenue to government approaches $1 billion annually; purse distributions to horsemen account for another $700 million alone. Exports of horses during 1980 came to over $200 million, contributing to the vital export balance generated by American agriculture. Much of this export trade results from the dominance of the U.S. bloodstock industry -- a dominance that could well be jeopardized by a declining horse racing industry in this country.

The substantial horse racing agribusiness keys upon race tracks as the central links in the economic chain, and each segment feels the impact of any financial dislocations at that level.

Withholding's $50 million annual revenue cost to States and their pari-mutuel industries is carried through each level in successively damaging fashion, transmitting potential reductions in employment and salary distributions, lowered investment attractiveness due to downgraded economic prospects, and so forth. The effects may not be immediately evident but must eventually be passed down the line.

As previously noted, the effect of cash removal is uniquely detrimental to the pari-mutuel industry. By the same token, the ripple effects of such a shortfall at the track are substantial as well. Withholding therefore has a serious and pervasive impact on the financial chain of the racing agribusiness, centering on the race tracks. In combination with other economic factors such as inflation, it is eroding the financial underpinnings of the industry and jeopardizing the future of a vibrant and important contributor to the American economy.

VI. <u>Withholding increases the advantages of illegal bookmakers and may accrue to the benefit of organized crime.</u>

There are certain natural advantages which tend to encourage some bettors, particularly those who wager large amounts, to deal with illegal bookmakers. Among these:

- -- Illegal sources accept telephone wagers, whereas the majority of legal sources are prevented by law from doing so;
- -- Illegal sources extend credit to their customers, whereas all pari-mutuel systems are prevented by law from doing so; and
- -- Illegal sources do not report any winnings to the Federal and/or State government, which legal sources must.

One of the primary purposes ascribed to the legalization of State regulated wagering activities is to combat illegal betting operations. As the Commission for the Review of the National Policy Toward Gambling noted in its report to Congress in 1976, "[T]he Commission believes that Congress should take great care in the exercise of its taxing powers so as not arbitrarily to discourage State policies. Not only might the Federal government stifle State initiatives in raising revenues, but Federal taxes on State gambling operations may render State governments incapable of competing with those illegal games they seek as a matter of State policy to eliminate."

By creating and imposing 20% withholding, the Federal Government has provided another incentive for those so inclined to wager with illegal bookmakers. The dollars funneled to these illegal sources may be expected to accrue to the ultimate benefit of organized crime.

In addition to benefiting those least deserving of such benefits, withholding drives to them bettors who would normally make their substantial wagers at the track.

The important point is that withholding cannot serve as an inducement to bring patrons into the legal pari-mutuel system; it can and does drive some of them out of it by adding yet another tax liability to the legal avenue.

<u>SUMMARY</u>

The 20% Federal withholding on pari-mutuel payouts of $1,000 or more at odds of at least 300-1

-- <u>is based on faulty and misleading assumptions</u> of income, tax liability and Federal Government revenues;

-- <u>is confiscatory and discriminatory</u>, most often collecting as tax dollars shares of payouts that do not generate tax liability and making it exceedingly difficult or impossible for the taxpayers to retrieve those monies;

-- <u>has a uniquely damaging effect</u> on the pari-mutuel industry's wagering stream and its vital cash flow;

-- <u>removed $71.3 million</u> from that stream in 1980, translating into a reduction in national wagering of some $250 million;

-- is seriously counterproductive for States and their pari-mutuel industries, which lost an aggregate $50 million in each of the past four years due to the collection;

-- damages the financial underpinnings of the industry and by corollary the economic prospects of one of America's most important agribusinesses; and

-- accrues to the benefit of illegal bookmakers and organized crime by making legal wagering avenues substantially less attractive than illegal ones.

For those reasons, the American Horse Council vigorously supports repeal of section 3402(q) of the Internal Revenue Code as proposed in Sen. Walter Huddleston's S.1369.

NATIONAL ASSOCIATION OF STATE RACING COMMISSIONERS

RESOLUTION OPPOSING WITHHOLDING

WHEREAS, More Than 30 States derive substantial benefits from the pari-mutuel industry, including numerous jobs, stimulus to tourism, agriculture, recreation and both direct and indirect revenues exceeding millions of dollars each year;

WHEREAS, the Federal withholding of taxes on certain pari-mutuel payouts has been extremely damaging to all segments of the pari-mutuel industry, including horse racing, greyhound racing, jai alai and off-track betting;

WHEREAS, that same damage has been reflected in considerable losses in direct pari-mutuel revenue to the States, losses to the States which have approached an estimated $20 million a year;

WHEREAS, in 1977 when withholding was first imposed on pari-mutuel payouts, State revenues from pari-mutuel wagering declined for the first time in 25 years and are now continuing in the same declining trend;

WHEREAS, the withholding of taxes on pari-mutuel payouts is discriminatory in that nothing is withheld from winnings in gambling casinos, and winnings in State lotteries are subject to withholding only if they exceed $5,000, while pari-mutuel entities are required to withhold on payouts of $1,000 when the odds exceed 300-1;

WHEREAS, the reporting level of winnings on pari-mutuel payouts is also discriminatory in that winnings from keno games are reported if they are $1500 or more, winnings from bingo games and from slot machines plays are reported if they are in excess of $1,200, while pari-mutuel entities are required to report payouts of $600 or more when the odds are 300-1;

WHEREAS, it is the nature of pari-mutuel wagering that there is no net year-end real tax liability for the vast majority of its participants, and that for the other participants, the tax liability imposed by the Federal Government in withholding has no relationship to the actual amount of annual net winnings;

WHEREAS, the standards for documenting losses are both inconsistent as applied by IRS and as a practical matter impossible for the vast majority of the patrons of legal pari-mutuel wagering establishments to meet;

WHEREAS, the tax treatment of pari-mutuel betting is unfair and discriminatory in that it prohibits the winning taxpayer from declaring his losses unless he foregoes the use of a standard deduction and itemizes deductions, and further because there is no provision for carryforward of carryback of losses;

WHEREAS, the Federal Government has, in effect, created a 20% excise tax on pari-mutuel wagering through unfair treatment of wagering taxpayers;

WHEREAS, IRS has sought to go beyond the language of the present law by requiring payers of legal pari-mutuel winnings to aggregate identical wagers for the purpose of withholding, notwithstanding that such aggregation was expressly contrary to the intent of Congress and is impossible for pari-mutuel betting establishments to administer; and

WHEREAS, the Federal policy of taxation of pari-mutuel winnings encourages patrons to utilize the services of illegal bookmakers to the detriment of the State regulated and State sanctioned legal pari-mutuel industry and the revenues derived therefrom;

WHEREAS, the Governors of the States have, as a group, formally protested the incursion of the Federal Government into legislative and revenue areas traditionally belonging to those States;

THEREFORE BE IT RESOLVED that the National Association of State Racing Commissioners and the Commissions of the respective States which derive substantial economic, social and agricultural benefits from the industry, hereby petition and urge the Congress of the United States to repeal this withholding burden on the millions of people who participate in pari-mutuel sports.

We also urge an increase in the threshold for reporting legal pari-mutuel winnings from the present $600 to a much higher level; amendment of the present law to make clear that aggregation of identical wagers is not required; amendment of the present law to allow carry forward and carry back of legal pari-mutuel losses; amendment of the present law by redefinition of adjusted gross income to allow the deduction of legal pari-mutuel losses whether or not the taxpayer itemizes deductions; and amendment of the present law and IRS regulations to provide uniform and practical standards for the documentation of legal pari-mutuel losses.

As a unified single organization and as Commissions of the respective States, we urge our Governors, our State Legislatures and our U.S. Congressional delegations to join with the racing commissioners and the pari-mutuel industry in a commitment to insure that the confiscatory and discriminatory tax policy presently applied to the pari-mutuel industry is not permitted to continue to damage the industry and State revenues derived from it. We also urge the Congress to consider the exclusion of legal pari-mutuel winnings from taxable income, as proposed by the Commission on the Review of the National Policy Toward Gambling.

STATEMENT OF CONGRESSMAN JACK EDWARDS

FIRST DISTRICT, ALABAMA

Mr. Chairman, thank you for this opportunity to testify before your Committee today in support of S. 531. I can assure you that this relief is urgently needed for the pecan growers in Alabama whose livelihood was virtually destroyed by Hurricane Frederic in the fall of 1979.

Hurricane Frederic totally destroyed or severely damaged nearly 300,000 pecan trees, just about two-thirds of all the pecan trees in the State of Alabama. The pecan crop was the the largest single crop damaged by Hurricane Frederic. Alabama is the third largest pecan producing state in the nation, with 80 percent of that production in my Congressional District; and in one county alone in my District, $33 million worth of pecan trees were lost. These trees were uninsured because there is no insurance available for them from either governmental or private sources. These losses will be felt not only by the pecan growers who were hit by the hurricane; they will be felt throughout the entire pecan processing industry and in the final price consumers pay for pecans and foods containing pecans.

When a cash crop such as corn or wheat is destroyed by a disaster, the grower usually can replant his crop either that same year or the next season and harvest a new crop in a relatively short time. However, fruit and nut trees are substantially different -- growers must plant new seedlings and bring them to maturity before they begin to bear again, a process which takes up to 12 years at an estimated cost of $20 per tree. The problems of rebuilding the pecan growing industry have been greatly exacerbated by a severe shortage of pecan seedlings throughout the country. Graft wood was injured in the hurricane, and the world's largest pecan nursery in Mississippi was also hit by the hurricane. The Alabama Board of Corrections has initiated a state-funded planting program at the state prison farm in Atmore, Alabama, training inmates to plant pecan seedlings from seed-nuts. I have urged the Board of Corrections and the Horticultural Extension Department at Auburn University to encourage the growing of new varieties of pecan trees in this program which can be brought to bear years earlier than the older varieties. Still, the impact on the pecan industry will be crippling.

These losses to the pecan growers in Alabama represent casualty losses. But the tax law, as you know, limits casualty loss deductions to the owners' cost basis in the property -- the extent of the original investment in the trees. Since most of these pecan trees were planted years, even generations, ago; and since in most cases farmers have already elected to deduct their normal operating expenses, such as fertilizer and fuel; most farmers have little or no technical cost basis in the trees, although they have suffered disastrous economic losses. If a farmer buys land with a grove of pecan trees, of course, he can establish his basis as a percentage of the purchase price of the property. But most of the pecan growers in Alabama have raised their own trees from seedlings, in many cases on land which has been family-owned for years. For many of my constituents, their only deduction for these tremendous losses for the 1979 tax year is that allowed for the appraisal fees for determining the extent of their losses.

I am sure that you know the crippling impact a natural disaster such as this can have on the long-term economic health of a disaster area. For those of us who have a substantial fruit or nut growing industry in our home states, however, the problems are unique. Senator Heflin's bill is the best approach we have seen to providing some relief to the pecan industry which was hit so hard by Hurricane Frederic so that they can be rebuilt and so that the adverse impact on Alabama's economy can be minimized.

I urge you to act timely and favorably on this much-needed legislation. Thank you, Mr. Chairman.

NATIONAL REALTY COMMITTEE INC.
2033 M Street, N.W.
Washington, D.C. 2006

July 24, 1981

Senate Finance Committee
Subcommittee on Taxation
and Debt Management
2227 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Re: S.1214

Gentlemen:

National Realty Committee Inc. is a nonprofit business league whose membership includes owners, operators and developers of all types of real estate throughout the United States.

In connection with your hearings on S. 1214, we desire to strongly endorse passage of the Bill which would repeal the current limitations on the deduction of investment interest.

Code Section 163(d) limiting the deductibility of interest on investment indebtedness in the case of a taxpayer other than a corporation was added to the Code as part of the Tax Reform Act of 1969 but was made applicable to taxable years beginning after December 31, 1971. For years beginning after December 31, 1969 and prior to the effective date of Section 163(d) excess investment interest was treated as a tax preference item under Code Section 57(b).

The proposal to limit the deductibility of so-called excess investment interest was originated by Wilbur Mills, then Chairman of the House Ways and Means Committee. It was not supported by the Treasury Department and, in fact, the then Assistant Secretary of the Treasury for Tax policy opposed the proposal on the ground that the proposed limitation would unfairly discriminate against taxpayers having little or no investment income and that any equitable remedy would be impossible to administer. (Hearings before the Committee on Finance, United States Senate, 91st Congress 1st Session on H.R. 13270, Part 1, pp. 576, 577 (1969)) The validity of the Secretary's position has been borne out by 12 years of experience with the investment interest limitation.

It does indeed unfairly discriminate against individual taxpayers, as opposed to corporate taxpayers, and against taxpayers having little or no investment income, as contrasted with taxpayers having substantial investment income. The latter are not affected by the limitation in any practical way.

Similarly, the limitation obviously discriminates against tax payers who must borrow, as opposed to more afluent individuals who by purchasing investments for all cash simply forego taxable income which could otherwise be earned with the cash so employed.

The problems of administration of the limitation are evidenced by the fact that it has been amended numerous times since its original introduction and, despite the fact that 12 years have elapsed since its enactment, the Treasury has yet to issue Regulations under Section 163(d). "...in the short span of seven years, Congress dealt with investment interest in four different ways, and, while doing so, concocted a multiamended section 163(d) that is frightfully complex." Berger, Simple Interest and Complex Taxes, 81 Col. L. Rev. 217, 251-1 (1981). An additional indication of the difficulties involved in any attempt to rationally administer this provision is reflected in the inability of the Internal Revenue Service to adequately describe, in a manner comprehensible to even a skilled layman, the proper treatment of investment interest in connection with the filing of a partnership income tax return.

A major obstacle in fairly administering any kind of limitation on the deductibility of interest has always been the difficulty in tracing the purpose or use of borrowed funds. Such difficulties have engendered substantial controversies over the years in connection with the limitation on the deductibility of interest incurred to purchase or carry tax exempt securities. This limitation, however, at least has the virtue of a simple legislative structure, a long period of historical interpretation and, most importantly, potential application to a small minority of taxpayers.

The investment interest limitations of Section 163(d), on the other hand, are structurally complex, inadequately understood and have potential application to a broad base of individual taxpayers.

Of particular concern to owners of real property is the fact that for purposes of Section 163(d), interests in real property which would otherwise generally be considered interests in a trade or business, rather than an investment, may by statute be treated as an investment. This confusing result flows from the introduction into Section 163(d) of special rules defining as an "investment" for the purposes of Section 163(d) any leased property treated as being subject to a "net lease" by reason of the so called 15% test.

Under the 15% test, leased property which would for other purposes constitute a trade or business, is treated as an investment, and not as a trade or business, for purposes of Code Section 163(d) for any taxable year in which "the sum of the deductions of the lessor with respect to such property which are allowable solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) is less than 15 percent of the rental income produced by such property . . . ." (Code Section 163(d)(4)(A)(i)).

This test constitutes a very poor measure for distinguishing a truly passive investment from a trade or business.

Under the 15% test of Section 163(d) most shopping centers do not qualify as a trade or business since the landlord's expenses, deductible solely by reason of Section 162 of the Code, often do not exceed 15% of the rental income. In addition, as our inflationary economy results in an increasing tendency by landlords of all types of property to add escalation clauses to leases, a typical office building may or may not, during any particular year, constitute an "investment" or "a trade or business" by virtue of the various lease provisions utilized. Under Section 163(d) as interpreted by the Treasury, it is possible for an office building in which the leases contain escalation clauses covering increases in operating expenses to be treated as an investment while an identical building with leases providing for rent escalations based upon increases in the Consumer Price Index would constitute a trade or business.

This inordinate emphasis on the artificial ratio of a very limited class of expenses to rental income understandably creates artificial results.

The more important consideration of activity as opposed to passivity is not related to the nature of the Landlord's reimbursement arrangements with his tenants. A Landlord running a rooming house with weekly tenants would seem to be clearly engaged in an active trade or business even if his rental arrangements with all of his roomers provided for proportionate reimbursement by each tenant of his or her proportionate share of the total cost of operation.

An additional important consideration in distinguishing property which may legitimately be deemed to be "net leased" and, therefore, subject to treatment as an investment as opposed to a trade or business, is the factor of relevant risk. Code Section 163(d)(4)(A)(ii) treats property as subject to a net lease if "the lessor is either guaranteed a specified return or is guaranteed in whole or in part against loss of income." This statutory test, as contrasted with the 15% test, appears intended to describe a lease which in ordinary real estate trade parlance is referred to as a "net lease." In a true net lease situation, the lessee assumes all of the burdens of ownership and operation including the obligation to maintain and repair the net leased property and to restore such property in the event such restoration becomes necessary as the result of a casualty or other damage. Under a so-called "gross lease", the landlord generally retains the obligation to repair and restore the leased premises, at least to the extent of exterior and structural repairs (tenants are often obligated even under a so-called gross lease to maintain the interior of the leased premises and to make nonstructural repairs).

The risk and activity undertaken by a landlord under a gross lease which requires the landlord to make periodic repairs cannot be adequately reflected by an artificial test such as the 15% formula which measures expenditures only on an annual basis. A landlord under a gross lease may have substantial repair and maintenance expenses only in certain years. Under the 15% test, a building may be an investment for 4 years and a trade or business during the 5th.

The anomaly is exacerbated by the fact that not only are maintenance and repair expenses variable from year to year, but rental income may also vary from year to year. Since the 15% test is based upon an annual ratio of certain expenses to rental income, increases in rental income may convert what had been a trade or business into an investment for purposes of Section 163(d). For example, a shopping center currently satisfying the 15% test as a trade or business may be disqualified by the receipt of percentage rentals from tenants in amounts sufficient to reduce the ratio of qualifying expenses to less than 15% of total rental income.

Additional anomalies and problems with Section 163(d) abound. While Section 163(d)(4)(D) provides that "interest paid or accrued on indebtedness incurred or continued in the construction of property to be used in a trade or business shall not be treated as investment interest", the Treasury apparently views this statutory statement of the obvious fact that construction activity is more akin to a business than an investment as an invitation to prescribe rules determining that construction period interest may indeed constitute investment interest subject to the limtations of Section 163(d) if the taxpayer has a "pattern of constructing net leased buildings" (Proposed Reg. §1.57-2(b)(1) (iv)). Also, since Code Section 189 was introduced as part of the Revenue Act of 1978, the interrelationship between the limitations on construction period interest contained in that section with the limitations of Section 163(d) simply creates additional complexity and uncertainty without any apparent good purpose.

Even an apparent attempt by Congress to alleviate the problems imposed by Section 163(d) upon real property by the inclusion in 1971 of Code Section 163(d)(6) B) which grants the taxpayer an election to eliminate the 15% test "with respect to real property of the taxpayer which has been in use for more than 5 years" has been largely subverted by the issuance of temporary regulations (Reg. §12.8(d)) which provide "for this purpose, real property is in use only during the period that such property is both owned and used for commercial purposes by the taxpayer". These regulations, therefore, add to the statutory requirement that the property be "aged", the further requirement that the particular taxpayer be the owner and user for the required 5 year period.

It has often been suggested that owners of rental real estate should not be overly concerned about characterization of their property as either an investment or as a trade or business under Section 163(d) since the limitation on the deductibility of investment interest does not apply to the extent of the taxpayer's investment income and presumably any property treated as an investment for purposes of characterizing interest paid with respect thereto would in most cases produce investment income sufficient to offset such interest. However, in reality, the offset is often incomplete because of the effects of the depreciation deduction in the calculation of net investment income.

This effect will be exacerbated by the current proposals in Congress to induce increased savings and business investment by providing more rapid capital cost recovery periods for all types of depreciable property, including real estate. Under most of the proposals, both new and used depreciable real property would be given a 15 year capital cost recovery period. If such a relatively rapid capital cost recovery system is in fact enacted, and Section 163(d) is not repealed or the effect thereof substantially ameliorated with respect to real estate by the elimination of the 15% test, the interrelationship between the decline in net income derived from more rapid capital cost recovery periods and the continuing limitation on the deductibility of so-called investment interest will produce even more anomalous results than in the past. In fact, Congress' intention to induce investment by granting more rapid writeoffs will be offset by the increased penalty on investments subject to Section 163(d) limitations.

In conclusion, we strongly urge the repeal of Section 163(d) for the same reasons as motivated the Treasury Department in opposing its original passage. It is unfair and administratively a nightmare for both taxpayers and the Internal Revenue Service. In any event, if Section 163(d) is not completely repealed, the worst aspects of its application to real estate ownership can be eliminated by removing the unnecessary 15% test from the definition of what constitutes real property subject to a net lease.

Respectfully submitted,

NATIONAL REALTY COMMITTEE INC.

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