1981–82 MISCELLANEOUS TAX BILLS, XVI

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

S. 1298, S. 2197, and S. 2498

JULY 19, 1982

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1981-82 MISCELLANEOUS TAX BILLS, XVI

MONDAY, JULY 19, 1982

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

The subcommittee met, pursuant to notice, at 9:33 a.m. in room 2221, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood, Chafee, Symms, and Matsunaga.

[The press release announcing the hearing, description of S. 1298, S. 2197, and S. 2498, the text of the above bills, and the prepared statement of Senator Matsunaga follow:]

Press Release No. 82-147

PRESS RELEASE

FOR IMMEDIATE RELEASE
July 9, 1982

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

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SETS HEARING ON MISCELLANEOUS TAX BILLS

Senator Bob 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 Monday, July 19, 1982, to consider three miscellaneous tax bills.

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

The following proposals will be considered:

S. 2197, introduced by Senator Matsunaga. S. 2197 would make permanent the provision for refund of taxes paid on the sale of fuel for use in a taxicab, and would make certain sales of fuel for use in a taxicab exempt from tax.

S. 2498, introduced by Senator Matsunaga. S. 2498 would provide that certain indebtedness incurred by educational organizations in acquiring or improving real property shall not be treated as acquisition indebtedness for purposes of the tax on unrelated business taxable income.

S. 1298, introduced by Senator Wallop with Senator Packwood, Senator Bradley, Senator Baucus, and others. S. 1298 would extend certain tax provisions to Indian tribes on the same basis as such provisions apply to States.

DESCRIPTION OF TAX BILLS

(S. 1298, S. 2197, and S. 2498)

Scheduled for a Hearing

on July 19, 1982

Before the

Subcommittee on Taxation and Debt Management

of the

Senate Committee on Finance

Prepared by the Staff

of the

Joint Committee on Taxation

July 16, 1982

JCX-32-82

INTRODUCTION

The bills described in this document are scheduled for a hearing on July 19, 1982, before the Senate Finance Subcommittee on Taxation and Debt Management. There are three bills scheduled for the hearing: (1) S. 1298 (relating to tax status of Indian tribes); (2) S. 2197 (relating to excise tax exemption for certain taxicab motor fuels); and (3) S. 2498 (relating to unrelated business income provisions for educational organizations).

The first part of the document is a summary of the bills. This is followed in the second part by a more detailed description of the bills, including present law, issues, explanation of provisions, effective dates, and estimated revenue effects.

I. SUMMARY

1. S. 1298--Senators Wallop, Baucus, Bradley, Packwood, and others

The Indian Tribal Governmental Status Act

S. 1298 would amend the Internal Revenue Code to provide to certain Indian tribal governments generally the same tax treatment in many respects that is now available to States and their political subdivisions. This series of changes would treat Indian tribal governments (the governing bodies of Indian tribes or Alaska Native villages which are recognized by the Treasury Department as exercising sovereign powers) similar to States for the purpose of determining whether they can issue tax-exempt bonds, the same as States for determining whether taxes paid to and charitable contributions made to the Indian tribal government are deductible, and the same as States for certain other income and excise tax purposes.

2. S. 2197--Senators Matsunaga, Roth, Moynihan, and Durenberger

Modification and Expansion of Exemption for Certain Taxicabs from Gasoline and Special Fuels Excise Taxes

Under present law, gasoline and special fuels used in qualified taxicabs are not subject to the general excise taxes imposed on those fuels under Code sections 4081 and 4041 respectively when used in furnishing qualified taxicab services (i.e., service in areas where taxicabs are not prohibited from ride sharing) (sec. 6427(e)). Taxicabs which are manufactured after 1978 must have a fuel economy rating in excess of the average EPA rating for the type of vehicle involved to qualify for this exemption. The exemption for qualified taxicab use is accomplished by means of a refund or credit against income tax claimed for the amount of tax originally paid on the purchase of the fuels. The present exemption is scheduled to expire on January 1, 1983.

Under the bill, the exemption for fuels used in providing qualified taxicab services would be provided at the time the fuels are purchased in the case of registered taxicab operators. In addition, the types of vehicles eligible for the exemption would be expanded to include vehicles with a fuel economy rating in excess of 75 percent of the average EPA rating for the type of vehicle involved. Finally, the bill would make this exemption from tax permanent.

3. S. 2498 - Senators Matsunaga and Durenberger

Exception for Educational Organizations From Certain Unrelated Business Income Provisions

Under present law, generally, any qualified pension trust or organization that is otherwise exempt from Federal income tax is taxed on income from trades or businesses that are unrelated to the organization's exempt purposes. Included in unrelated business income is an exempt organization's income from "debt-financed property," which is not used for its exempt function. Debt-financed property is defined as any property which is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year or during the 12 months prior to disposition if the property is disposed of during the taxable year. With certain exceptions, indebtedness incurred by a qualified pension trust as a result of the acquisition or improvement of real property is not considered "acquisition indebtedness." Thus, income or gain received from a qualified pension trust or with respect to such debt-financed real property is not treated as income from debt-financed property.

The bill would expand the exception for qualified pension trusts from the general definition of acquisition indebtedness to include educational organizations. Thus, income or gain received from or with respect to debt-financed real property owned by educational organizations would not be treated as income from debt-financed property.

II. DESCRIPTION OF BILLS

1. S. 1298--Senators Wallop, Baucus, Bradley, Packwood, and others

The Indian Tribal Governmental Status Act

Present Law

Overview

States (including the District of Columbia) and their political subdivisions generally are exempt from Federal tax. In addition, numerous transactions by private parties with State governments and their political subdivisions result in favorable Federal tax treatment (e.g., exclusion from gross income, tax deductions, or tax credits) for the private parties involved. Under present law, Indian tribal governments are not treated as State and local governments.

Taxation of State and local governments

State and local governments generally are exempt from the Federal income tax (Code sec. 115). In addition, State and local governments are exempt from most Federal excise taxes if an article is used exclusively for the State or local government. Among the excise taxes for which exemptions are provided are the special fuels taxes (chapter 31), the manufacturers excise taxes (chapter 32), the communications tax (chapter 33), and the highway use tax (chapter 36).

Taxation of Indian tribal governments

The Internal Revenue Code does not specifically exempt Indian tribal governments from Federal taxation; however, the Internal Revenue Service has ruled that Indian tribes are not taxable entities.1/ This ruling provides further that tribal income not otherwise exempt from Federal income tax is includible in the gross income of the Indian tribal member when distributed or constructively received by the individual. Since Indian tribal governments are not within the definition of "State" contained in the Code (sec. 7701(a)(10)), the excise tax exemptions provided for States do not apply to the tribal governments.

1/ Rev. Rul. 67-284, 1967-2 C.B. 55.

Special treatment of certain transactions involving State and local governments

Tax-exempt bonds.--Interest on obligations issued by or on behalf of State and local governments generally is exempt from Federal income tax. However, subject to certain exceptions, interest on State and local issues of industrial development bonds (IDBs) is taxable. An obligation is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a governmental unit or tax-exempt organization (described in sec. 501(c)(3)), and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

Present law provides an exception which exempts from tax interest on IDBs that are issued to finance certain types of exempt-purpose facilities. Present law also provides an exception to the general rule of taxability for interest paid on IDBs for certain "small issues." The interest on small issue IDBs is exempt if the proceeds are used for the acquisition, construction, or improvement of land or depreciable property. This exception applies to issues of $1 million or less. At the election of the taxpayer, the limitation may be increased to $10 million, subject to certain restrictions. Finally, tax-exempt financing is permitted for student loans and organizations that qualify for tax exemption under section 501(c)(3), such as private, nonprofit hospitals and private, nonprofit educational institutions.

State and local taxes.--Certain State and local taxes are deductible for Federal income tax purposes whether or not they are paid or incurred in a business context (sec. 164). This provision applies to real property taxes, personal property taxes, income taxes, and general sales taxes. A credit against Federal estate tax is available for limited amounts of State death taxes (sec. 2011). Also, a partial credit against the Federal unemployment tax is allowed for State unemployment tax (secs. 3302-3303).

Charitable contributions.--Charitable contributions generally are deductible for income tax purposes (sec. 170). A contribution to or for the use of a State or political subdivision is a charitable contribution, but only if the contribution is made for "exclusively public purposes" (sec. 170(c)(1)). Similarly, such contributions are deductible for estate tax and gift tax purposes (secs. 2055, 2106(a)(2), and 2522).

Unrelated business income.--A tax is imposed on the unrelated business taxable income of certain types of organizations that generally are exempt from income taxation (sec. 511). Although this tax generally does not apply to State or local governments or their instrumentalities (see sec. 115), the tax does apply to colleges and universities which are agencies or instrumentalities of governments or political subdivisions or which are owned or operated by governments or political subdivisions or by their agencies or instrumentalities (sec. 511(a)(2)(B)).

Excise taxes on prohibited transactions by public charities and private foundations.--An excise tax is imposed on certain public charities that make "excess" expenditures to influence legislation. The term "legislation" is defined to include "action with respect to Acts, bills, resolutions, or similar items by the Congress, any State legislature, any local council, or similar governing body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure" (sec. 4911(e)(2)).

Present law also includes a series of restrictions on activities of private foundations, restrictions on "self-dealing," and on "taxable expenditures." The self-dealing rules generally prohibit payments to government officials, a term which includes anyone holding "elective or appointive public office" in the government of a State, a political subdivision, "or other area of any of the foregoing," if that person is receiving gross compensation at an annual rate of $15,000 or more, and also includes a personal or executive assistant or secretary to any such officeholder. The taxable expenditure rules generally prohibit expenditures to influence legislation. Treasury regulations define "legislation" for purposes of this provision to include "action * * * by any State legislature [or] by any local council or similar governing body * * *" (Treas. Reg. §53.4945-2(a)(2)).

Credit for the elderly.--People who receive retirement income from public retirement systems and have not yet attained age 65 are entitled to credits against income tax under rules different from those applying generally to people 65 or older (sec. 37). A pension, annuity, retirement, or similar fund or system established by a State or political subdivision is a "public retirement system" under these provisions.

Eligibility for certain tax-deferred annuities.--Present law provides that an employee who performs services for an educational institution may exclude from income amounts paid by his or her employer under certain types of annuity arrangements ("tax-sheltered annuities"), if the employer is "a State, a political subdivision of a State, or an agency or instrumentality of one or more of the foregoing" (sec. 403(b)(1)(A)(ii)).

Political campaign contributions.--An individual is allowed a nonrefundable credit (sec. 41) against income tax of 50 percent of his or her political contributions and newsletter fund contributions made during the taxable year, with a maximum credit of $50 ($100 on a joint return). Eligible recipients of political contributions include political parties and individuals who are candidates for nomination or election to any Federal, State, or local elective public office (sec. 41). The Code defines "local" to mean "a political subdivision or part thereof, or two or more political subdivisions or parts thereof of a State."

Scholarship and fellowship grants.--Generally, scholarships and fellowships are excluded from gross income of the recipients (sec. 117). Only a limited exclusion is available in the case of a recipient who is not a candidate for a degree at an educational institution, and even that limited exclusion is available only if the grantor meets one of several tests. A State or political subdivision thereof is an eligible grantor under this provision (sec. 117(b)(2)(A)(iv)).

Special treatment of certain transactions involving Indian tribal governments

Because Indian tribal governments are not treated like State governments for tax purposes, the favorable consequences available to private parties entering into transactions with State governments generally are unavailable for those transactions entered into with the tribal governments. 2/ The excise taxes on certain prohibited transactions dealings by charities with State governments likewise do not apply.

Issues

The first issue is whether Indian tribal governments should be treated as State governments for Federal tax purposes and, if so, shall any exceptions be made.

The second issue is whether transactions involving Indian tribal governments should be treated as transactions involving State governments for Federal tax purposes.

2/ Sec. 4225 of the Code exempts from manufacturers excise tax any article of native Indian handicraft produced by Indians on Indian reservations, in Indian schools, or by Indians under the jurisdiction of the U.S. Government in Alaska.

Explanation of the Bill

Overview

The bill would provide that, for a series of specified purposes under the Internal Revenue Code, Indian tribal governments are to be treated the same as States or similar to States. The bill would define the term "Indian tribal government" to include certain governments of Alaska Natives as well as Indians and would apply whether the entity was characterized as a tribe or as a band, community, village, or group. The rules of the bill would not apply to any Indian tribal government unless it were recognized by the Treasury Department (after consultation with the Interior Department) as exercising sovereign powers. Sovereign powers include the power to tax, the power of eminent domain, and police powers (such as control over zoning, police protection, and fire protection).

The Code provisions amended by this bill generally provide that political subdivisions of States are to be treated essentially the same as the States themselves. Under the bill, a subdivision of an Indian tribal government would be treated as a political subdivision of a State for the purposes specified in the bill if (and only if) the Treasury Department determined (after consultation with the Interior Department) that the subdivision of the Indian tribal government had been delegated the right to exercise one or more of the sovereign powers of the Indian tribal government.

Taxation of Indian tribal governments

Under the bill, most Federal excise taxes would not apply to articles sold for the exclusive use of Indian tribal governments. Among the excise taxes for which exemptions would be provided are the special fuels taxes (chapter 31), the manufacturers excise taxes (chapter 32), the communications tax (chapter 33), and the highway use tax (chapter 36). The bill would not amend the present income tax treatment of Indian tribal governments specified in Rev. Rul. 67-284, *supra*. (i.e., income of the tribe is taxable when distributed to tribe members).

Special treatment of certain transactions involving Indian tribal governments

General rule.--Indian tribal governments would be treated as States in the following transactions involving private parties--

(1) The exclusion from income of interest on certain obligations of State governments (except as set forth below).

(2) The deduction for taxes paid to State and local governments (sec. 164);

(3) The deductions for charitable contributions (secs. 170 (income tax), 2055 and 2106 (estate tax), and 2522 (gift tax));

(4) The tax on unrelated business income of certain types of organizations (sec. 511);

(5) The taxes imposed on certain prohibited transactions by public charities and private foundations (secs. 4911 and 4945);

(6) The credit for individuals who receive retirement income from public retirement systems (sec. 37);

(7) Eligibility for certain tax-deferred annuities (sec. 403(b)(1));

(8) The credit for political campaign contributions (sec. 41); and

(9) The exclusion of certain scholarships and fellowships awarded to students who are not candidates for a degree (sec. 117).

Special rules for tax-exempt bonds.--The bill would permit Indian tribal governments to issue tax-exempt industrial development bonds only where the primary activities of the businesses benefiting from the bonds take place on the reservation and where substantially all of the off-reservation activities are purchasing, marketing, and similar related activities. Additionally, interest on bonds other than IDBs would be exempt from tax only if substantially all of the proceeds of the obligations are used in the exercise of essential governmental functions or for a public utility.

Effective Date

In general, the bill would apply to taxable years beginning after 1979.

The provisions related to tax-exempt bonds would apply to obligations of Indian tribal governments issued after the date of enactment in taxable years ending after that date.

The provisions amending the estate or gift taxes would apply to estates of individuals dying or gifts made after 1979.

The excise tax provisions would be effective on January 1, 1980.

Revenue Effect

It is estimated that this bill would reduce budget receipts by less than $10 million annually.

2. S. 2197--Senators Matsunaga, Roth, Moynihan, and Durenberger

Modification and Expansion of Exemption for Certain Taxicabs from Gasoline and Special Fuels Excise Taxes

Present Law

Under present law, gasoline and special fuels used in qualified taxicabs are not subject to the excise taxes imposed on those fuels under Code sections 4081 and 4041 respectively when used in furnishing qualified taxicab services (sec. 6427(e)). Qualified taxicab services means furnishing of nonscheduled land transportation for a fixed fare by a licensed operator who is not prohibited by law or company policy from furnishing shared transportation (with consent of the passengers). Taxicabs which are manufactured after 1978 must have a fuel economy rating in excess of the average EPA rating for the type of vehicle involved to qualify for this exemption.

The tax on gasoline is 4 cents per gallon and is imposed on the producer or importer of the gasoline. After September 30, 1984, that tax will be 1-1/2 cents per gallon. The tax on special fuels is also 4 cents per gallon, imposed on the retail sale of the fuels. That tax is also scheduled to decrease to 1-1/2 cents per gallon after September 30, 1984.

The exemption for qualified taxicab use is accomplished by means of a refund or credit against income tax claimed for the amount of tax originally paid on purchase of the fuels.

The present exemption is scheduled to expire on January 1, 1983.

Issues

The first issue is whether the exemption from fuels taxes for fuels used in providing qualified taxicab services should be allowed as an exemption when the fuel is purchased or as a credit or refund for tax paid based upon records showing that purchased fuel is actually used for an exempt purpose.

The second issue is whether this exemption should be made permanent.

The third issue is whether the exemption should be allowed where the taxicabs have a fuel economy rating of 75 percent of the average EPA rating.

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Explanation of the Bill

Under the bill, exemption from the excise taxes on gasoline and special fuels used by qualified taxicabs providing qualified taxicab services would be provided to certain taxicab operators at the time the fuels are purchased, rather than by means of a refund or credit as is done under present law. To qualify for exemption at the time the fuels are purchased, taxicab operators would have to register with the Internal Revenue Service as an exempt user. The Service would be authorized to establish registration procedures under which operators would qualify as exempt purchasers. Tax paid on fuels used in providing qualified taxicab services where the taxicab operator was not registered would continue to be refunded or credited as under present law.

In addition, vehicles eligible for the taxicab exemption would be expanded to include vehicles with a fuel economy rating in excess of 75 percent of the average EPA rating for the type of vehicle involved.

Further, the bill would make this exemption from tax permanent.

Effective Date

The provisions of the bill would apply to sales of fuel after December 31, 1981.

Revenue Effect

It is estimated that this bill would reduce fiscal year budget receipts by $5 million for 1983, $8 million for 1984, $9 million for 1985, $10 million for 1986 and 1987. (These revenues would otherwise go into the Highway Trust Fund through September 30, 1984.)

3. S. 2498--Senators Matsunaga and Durenberger

Exception for Educational Organizations from Certain Unrelated Business Income Provisions

Present Law

Under present law (Code sec. 511), generally, any qualified pension trust or organization that is otherwise exempt from Federal income tax is taxed on income from trades or businesses that are unrelated to the organization's exempt purposes; it is not taxed on passive investment income or income from any trade or business that is related to the organization's exempt purposes.

Specifically, present law (sec. 514(a)) provides that an exempt organization's income from "debt-financed property," which is not used for its exempt function, is to be subject to tax as unrelated business income in the proportion in which the property is financed by debt. Debt-financed property is defined as any property which is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year or during the 12 months prior to disposition if the property is disposed of during the taxable year (sec. 514(b)). A debt constitutes acquisition indebtedness with respect to property if the debt was incurred in acquiring or improving the property, or if the debt would not have been incurred "but for" the acquisision or improvement of the property (sec. 514(c)).

With certain exceptions, indebtedness incurred by a qualified pension trust as a result of the acquisition or improvement of real property is not considered "acquisition indebtedness" (sec. 514(c)(9)). Thus, income or gain received from, or with respect to, such debt-financed real property is not treated as income from debt-financed property. However, the special exemption for debt-financed real property for qualified pension trusts does not apply in cases: (1) where the acquisition price is not a fixed amount determined as of the date of acquisition; (2) where the amount of the indebtedness, or the amount payable thereon, or the time for making any payments, is dependent (in whole or in part) or the future revenues derived from the property; (3) where the property is leased by the trust to the seller or a person related to the seller; (4) where the property is acquired by a qualified trust from a person related to the pension plan under which the trust is formed or if such property is leased to such a related person; and (5) where the seller, a person related to the seller, or a person related to the pension plan provides nonrecourse financing for the transaction, and the debt is subordinate to any other indebtedness on the property or the debt bears a less than arm's-length interest rate.

Income of a gratified trust generally is taxable to its beneficiaries upon distribution. Income of an exempt organization is never subject to tax at a later date.

Issue

The issue is whether the exception for qualified pension trusts from the definition of acquisition indebtedness should be expanded to include educational organizations.

Effective Date

The provisions of the bill would be effective for taxable years beginning after December 31, 1982.

Revenue Effect

It is estimated that at the outset this bill would reduce budget receipts by less than $10 million annually. For later years, the revenue effect is indeterminate but could be substantial.

II

97TH CONGRESS
1ST SESSION

S. 1298

To amend the Internal Revenue Code of 1954 to extend certain tax provisions to Indian tribal governments on the same basis as such provisions apply to States.

IN THE SENATE OF THE UNITED STATES

JUNE 2 (legislative day, JUNE), 1981

Mr. WALLOP (for himself, Mr. BRADLEY, Mr. HATFIELD, Mr. PACKWOOD, and Mr. BAUCUS) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to extend certain tax provisions to Indian tribal governments on the same basis as such provisions apply to States.

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

SECTION 1. SHORT TITLE; AMENDMENT OF 1954 CODE.

(a) SHORT TITLE.—This Act may be cited as the "Indian Tribal Governmental Tax Status Act of 1981".

(b) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. INDIAN TRIBAL GOVERNMENTS TREATED AS STATES FOR CERTAIN PURPOSES.

(a) GENERAL RULE.—Chapter 80 (relating to general rules) is amended by adding at the end thereof the following new subchapter:

"Subchapter C—Provisions Affecting More Than One Subtitle

"SEC. 7871. INDIAN TRIBAL GOVERNMENTS TREATED AS STATES FOR CERTAIN PURPOSES.

"(a) GENERAL RULE.—An Indian tribal government shall be treated as a State—

"(1) for purposes of determining whether and in what amount any contribution or transfer to or for the use of such government (or a political subdivision thereof) is deductible under—

"(A) section 170 (relating to income tax deduction for charitable, etc., contributions and gifts),

(B) sections 2055 and 2106(a)(2) (relating to estate tax deduction for transfers of public, charitable, and religious uses), or

"(C) section 2522 (relating to gift tax deduction for charitable and similar gifts);

"(2) for purposes of any exemption from, credit or refund of, or payment with respect to, an excise tax imposed by—

"(A) chapter 31 (relating to tax on special fuels),

"(B) chapter 32 (relating to manufacturers excise taxes),

"(C) subchapter B of chapter 33 (relating to communications excise tax), or

"(D) subchapter D of chapter 36 (relating to tax on use of certain highway vehicles);

"(3) for purposes of section 164 (relating to deduction for taxes);

"(4) subject to section 103(g), for purposes of section 103 (relating to interest on certain governmental obligations);

"(5) for purposes of section 511(a)(2)(B) (relating to the taxation of colleges and universities which are agencies or instrumentalities of governments or their political subdivisions);

"(6) for purposes of—

"(A) section 37(e)(9)(A) (relating to certain public retirement systems), "(B) section 41(c)(4) (defining State for purposes of credit for contribution to candidates for public offices),

"(C) section 117(b)(2)(A) (relating to scholarships and fellowship grants), and

"(D) section 403(b)(1)(A)(ii) (relating to the taxation of contributions of certain employers for employee annuities); and

"(7) for purposes of—

"(A) chapter 41 (relating to tax on excess expenditures to influence legislation), and

"(B) subchapter A of chapter 42 (relating to private foundations).

"(b) TREATMENT OF SUBDIVISIONS OF INDIAN TRIBAL GOVERNMENTS AS POLITICAL SUBDIVISIONS.—For the purposes specified in subsection (a), a subdivision of an Indian tribal government shall be treated as a political subdivision of a State if (and only if) the Secretary determines (after consultation with the Secretary of the Interior) that such subdivision has been delegated the right to exercise one or more of the substantial governmental functions of the Indian tribal government."

(b) CONFORMING AMENDMENTS RELATING TO CROSS REFERENCES.—

(1) Subsection (d) of section 41 is amended to read as follows:

"(d) CROSS REFERENCES.—

"(1) For disallowance of credits to estates and trusts see section 642(a)(2).

"(2) For treatment of Indian tribal governments as States (and the political subdivisions of Indian tribal governments as political subdivisions of States), see section 7871."

(2) Section 164(f) is amended by adding at the end thereof the following new paragraph:

"(3) For treatment of taxes imposed by Indian tribal governments (or their subdivisions), see section 7871."

(3) Section 170(i) is amended by adding at the end thereof the following new paragraph:

"(8) For charitable contributions to or for the use of Indian tribal governments (or their subdivisions), see section 7871."

(4) Section 2055(f) is amended by adding at the end thereof the following new paragraph:

"(11) For treatment of gifts and bequests to or for the use of Indian tribal governments (or their subdivisions), see section 7871."

(5) Subparagraph (F) of section 2106(a)(2) is amended to read as follows:

"(F) CROSS REFERENCES.—

"(i) For option as to time for valuation for purposes of deduction under this section, see section 2032.

"(ii) For exemption of certain bequests for the benefit of the United States and for rules of construction for certain bequests, see section 2055(f).

"(iii) For treatment of gifts and bequests to or for the use of Indian tribal governments (or their subdivisions), see section 7871."

(6) Subsection (d) of section 2522 is amended to read as follows:

"(d) CROSS REFERENCES.—

"(1) For exemption of certain gifts to or for the benefit of the United States and for rules of construction with respect to certain bequests, see section 2055(f).

"(2) For treatment of gifts to or for the use of Indian tribal governments (or their subdivisions), see section 7871."

(7)(A) Section 4227 is amended to read as follows:

"SEC. 4227. CROSS REFERENCES.

"(1) For exemption for a sale to an Indian tribal government (or its subdivision) for the exclusive use of an Indian tribal government (or its subdivision), see section 7871.

"(2) For credit for taxes on tires and tubes, see section 6416(c),"

(B) The table of sections for subchapter G of chapter 32 is amended by striking out the item relating to section 4227 and inserting in lieu thereof the following new item:

"Sec. 4227. Cross references."

(8)(A) Section 4484 is amended to read as follows:

"SEC. 4484. CROSS REFERENCES.

"(1) For penalties and administrative provisions applicable to this subchapter, see subtitle F.

"(2) For exemption for uses by Indian tribal governments (or their subdivisions), see section 7871."

(B) The table of sections for subchapter D of chapter 36 is amended by striking out the item relating to section 4484 and inserting in lieu thereof the following new item:

"Sec. 4484. Cross references."

(9) Sections 6420(h) and 6421(j) are each amended by adding at the end thereof the following new paragraph:

"(4) For treatment of an Indian tribal government as a State (and a subdivision of an Indian tribal government as a political subdivision of a State), see section 7871."

(10) Sections 6424(g) and 6427(j) are each amended by adding at the end thereof the following new paragraph:

"(3) For treatment of an Indian tribal government as a State (and a subdivision of an Indian tribal government as a political subdivision of a State), see section 7871."

(c) CLERICAL AMENDMENT.—The table of subchapters for chapter 80 is amended by adding at the end thereof the following new item:

"SUBCHAPTER C. Provisions affecting more than one subtitle."

SEC. 3. INTEREST ON GOVERNMENTAL OBLIGATIONS.

(a) IN GENERAL.—Section 103 (relating to interest on certain governmental obligations) is amended by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) the following new subsection:

"(g) SPECIAL RULES FOR INDIAN TRIBAL GOVERNMENTS.—

"(1) REQUIREMENTS WITH RESPECT TO INDUSTRIAL DEVELOPMENT BONDS.—An industrial development bond issued by an Indian tribal government (or political subdivision thereof) may be treated as an obligation described in subsection (a)(1) only if—

"(A) the principal activities of the trade or business are to be carried on on the reservation, and

"(B) substantially all of the activities of the trade or business to be carried on off the reservation are purchasing, marketing, or similar activities directly related to the activities described in subparagraph (A).

"(2) APPLICATION OF CERTAIN INDUSTRIAL DEVELOPMENT BOND PROVISIONS.—For purposes of applying subsection (b)(6)—

"(A) if county lines (or lines of incorporated municipalities) established by the State do not exist on the reservation, the Secretary, after consultation with the Secretary of the Interior, may prescribe such maximum and minimum sizes for the geographical areas on the reservation which may be treated as counties (or incorporated municipalities) as may be necessary to ensure that the benefits of subsection (b)(6) for the geographical areas on the reservation shall be approximately equal to the benefits of such provisions for the counties (or incorporated municipalities) in the same general area of the United States as the reservation, and

"(B) if part of a county (or incorporated municipality) is within a reservation and part is not within a reservation, each such part shall be treated as a separate county (or incorporated municipality).

For purposes of applying subsection (b)(4)(E), the rules of subparagraph (A) and (B) of the preceding sentence shall apply.

"(3) Requirements for obligations which are not industrial development bonds.—Subsection (a) shall apply to any obligation issued by an Indian tribal government (or subdivision thereof) which is not an industrial development bond only if such obligation is part of an issue substantially all of the proceeds of which are to be used in the exercise of any essential governmental function or for a public utility.

"(4) RESERVATION DEFINED.—For purposes of this subsection, the term 'reservation' means—

"(A) the area reserved by treaty, Federal statute, or Executive order for the Indian tribe, the government of which is issuing the obligation,

"(B) areas designated by the Secretary of the Interior as a reservation for the Indian tribe the government of which is issuing the obligation, or

"(C) land which—

"(i) is contiguous to a reservation within the meaning of subparagraph (A) or (B),

"(ii) has been acquired in trust for the Indian tribe through consolidation, land exchange or purchase, or

"(iii) is proclaimed by the Secretary of the Interior to be part of such reservation."

(b) CLERICAL AMENDMENT.—Subsection (h) of section 103 (as redesignated by subsection (a)) is amended to read as follows:

"(h) CROSS REFERENCES.—

"For provisions relating to the taxable status of—

"(1) Certain obligations issued by Indian tribal governments (or their subdivisions), see section 7871.

"(2) Exempt interest dividends of regulated investment companies, see section 852(b)(5)(B).

"(3) Puerto Rican bonds, see section 3 of the Act of March 2, 1917, as amended (48 U.S.C. 745).

"(4) Virgin Islands insular and municipal bonds, see section 1 of the Act of October 27, 1919 (48 U.S.C. 1403).

"(5) Certain obligations issued under title I of the Housing Act of 1949, see section 102(g) of title I of such Act (42 U.S.C. 1452(g))."

SEC. 4. DEFINITION OF INDIAN TRIBAL GOVERNMENT.

Subsection (a) of section 7701 (relating to definitions) is amended by adding at the end thereof the following new paragraph:

"(37) INDIAN TRIBAL GOVERNMENT.—The term 'Indian tribal government' means the governing body of any tribe, band, community, village, or group of Indians or Alaska Natives which is determined by the Secretary, after consultation with the Secretary of the Interior, to exercise substantial governmental functions."

SEC. 5. EFFECTIVE DATES.

The amendments made by sections 2, 3, and 4—

(1) insofar as they relate to chapter 1 of the Internal Revenue Code of 1954 (other than section 103 thereof), shall apply to taxable years beginning after December 31, 1979,

(2) insofar as they relate to section 103 of such Code, shall apply to obligations issued after the date of

the enactment of this Act in taxable years ending after such date,

(3) insofar as they relate to chapter 11 of such Code, shall apply to estates of decedents dying after December 31, 1979,

(4) insofar as they relate to chapter 12 of such Code, shall apply to gifts made after December 31, 1979, and

(5) insofar as they relate to taxes imposed by subtitle D of such Code, shall take effect January 1, 1980.

II

97TH CONGRESS
2D SESSION

S. 2197

To amend the Internal Revenue Code of 1954 to make certain sales of fuel for use in a taxicab exempt from tax, to make permanent the provision for refund of taxes paid on the sale of fuel for use in a taxicab, and for other purposes.

IN THE SENATE OF THE UNITED STATES

MARCH 11 (legislative day, FEBRUARY 22), 1982

Mr. MATSUNAGA (for himself, Mr. ROTH, Mr. MOYNIHAN, and Mr. DURENBERGER) 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 make certain sales of fuel for use in a taxicab exempt from tax, to make permanent the provision for refund of taxes paid on the sale of fuel for use in a taxicab, and for other purposes.

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

SECTION 1. EXEMPTION OF TAXICABS FROM TAX ON SALE OF FUEL.

(a) EXEMPTION FROM TAX ON GASOLINE.—

(1) IN GENERAL.—Subpart A of part III of subchapter A of chapter 32 of the Internal Revenue Code

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of 1954 (relating to manufacturer's excise tax on gasoline) is amended by redesignating section 4084 as section 4085 and by inserting after section 4083 the following new section:

"SEC. 4084. EXEMPTION OF SALES FOR TAXICAB USE.

"(a) IN GENERAL.—Under regulations prescribed by the Secretary, the tax imposed by section 4081 shall not apply in the case of gasoline sold for—

"(1) use by the purchaser—

"(A) in a qualified taxicab (as defined in section 6427(e)(2)(B)), and

"(B) while such taxicab is engaged exclusively in furnishing qualified taxicab services (as defined in section 6427(e)(2)(A)), or

"(2) resale by the purchaser for use—

"(A) in a qualified taxicab (as defined in section 6427(e)(2)(B)), and

"(B) while such taxicab is engaged exclusively in furnishing qualified taxicab services (as defined in section 6427(e)(2)(A)).

"(b) REGISTRATION REQUIREMENT.—If any gasoline is sold by any person for use as a fuel in a taxicab, it shall be presumed for purposes of this section that a tax imposed by section 4081 applies to such sale unless the purchaser is registered in such manner (and furnishes such information with respect to the use of the gasoline) as the Secretary shall by regulations provide.".

(2) CLERICAL AMENDMENTS.—The table of sections for subpart A of part III of subchapter A of chapter 32 of such Code is amended by striking out the item relating to section 4084 and inserting in lieu thereof the following:

"Sec. 4084. Exemption of sales for taxicab use.
"Sec. 4085. Cross references.".

(b) EXEMPTION FROM TAX ON DIESEL FUEL AND SPECIAL MOTOR FUELS.—

(1) IN GENERAL.—Subsection (g) of section 4041 of such Code (relating to exemptions from tax on diesel fuel and special motor fuels) is amended by inserting after paragraph (4) the following new paragraph:

"(5) with respect to the sale of any liquid for—

"(A) use by the purchaser—

"(i) in a qualified taxicab (as defined in section 6427(e)(2)(B)), and

"(ii) while such taxicab is engaged exclusively in furnishing qualified taxicab services (as defined in section 6427(e)(2)(A)), or

"(B) resale by the purchaser for use—

"(i) in a qualified taxicab (as defined in section 6427(e)(2)(B)), and "(ii) while such taxicab is engaged exclusively in furnishing qualified taxicab services (as defined in section 6427(e)(2)(A)).".

(2) REGISTRATION REQUIREMENT FOR TAX EXEMPTION.—Subsection (i) of section 4041 of such Code (relating to registration requirement for fuel tax exemption) is amended by inserting "or a taxicab" after "aircraft".

(3) TECHNICAL AND CONFORMING AMENDMENTS.—Subsection (g) of section 4041 of such Code is amended—

(A) by striking out "and" at the end of paragraph (3), and

(B) by striking out the period at the end of paragraph (4) and inserting in lieu thereof "; and".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to sales of fuel after December 31, 1981.

SEC. 2. MAKING PERMANENT THE PROVISION FOR REFUND OF TAXES PAID ON SALE OF FUEL FOR TAXICABS; AMENDING THE DEFINITIONS OF QUALIFIED TAXICAB SERVICES AND QUALIFIED TAXICAB.

(a) MAKING PERMANENT THE PROVISION FOR REFUND OF TAXES PAID ON SALE OF FUEL FOR TAXI-

CABS.—Subsection (e) of section 6427 of the Internal Revenue Code of 1954 (relating to refund of taxes paid on sale of fuel for taxicabs) is amended by striking out paragraph (3).

(b) AMENDING THE DEFINITIONS OF QUALIFIED TAXICAB SERVICES AND QUALIFIED TAXICAB.—

(1) IN GENERAL.—

(A) QUALIFIED TAXICAB SERVICES.— Clause (ii) of section 6427(e)(2)(A) of such Code (defining qualified taxicab services) is amended to read as follows:

"(ii) is not prohibited by company policy from furnishing (with consent of the passengers) shared transportation.".

(B) QUALIFIED TAXICAB.—Clause (iii) of section 6427(e)(2)(C) of such Code (defining qualified taxicab) is amended by striking out "or equal to" and inserting in lieu thereof "75 percent of".

(2) EFFECTIVE DATE.—The amendment made by this subsection shall apply to sales of fuel after December 31, 1981.

II

97TH CONGRESS
2D SESSION

S. 2498

To amend the Internal Revenue Code of 1954 to provide that certain indebtedness incurred by educational organizations in acquiring or improving real property shall not be treated as acquisition indebtedness for purposes of the tax on unrelated business taxable income.

IN THE SENATE OF THE UNITED STATES

MAY 5 (legislative day, APRIL 13), 1982

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

---

A BILL

To amend the Internal Revenue Code of 1954 to provide that certain indebtedness incurred by educational organizations in acquiring or improving real property shall not be treated as acquisition indebtedness for purposes of the tax on unrelated business taxable income.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) paragraph (9) of section 514(c) of the Internal Revenue Code of 1954 (relating to unrelated debt-financed income) is amended to read as follows:

"(9) REAL PROPERTY ACQUIRED BY A QUALIFIED TRUST OR EDUCATIONAL ORGANIZATION.—For purposes of this section—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'acquisition indebtedness' does not include indebtedness incurred by a qualified organization in acquiring or improving any real property.

"(B) EXCEPTIONS.—The provisions of subparagraph (A) shall not apply in any case in which—

"(i) the acquisition price is not a fixed amount determined as of the date of acquisition;

"(ii) the amount of any indebtedness or any other amount payable with respect to such indebtedness, or the time for making any payment of any such amount, is dependent, in whole or in part, upon any revenue, income, or profits derived from such real property;

"(iii) the real property is at any time after the acquisition leased by the qualified organization to the person selling such property to such organization or to any person who bears a relationship described in section 267(b) to such person;

"(iv) the real property is acquired by a qualified trust from, or is at any time after the acquisition leased by such trust to, any person who—

"(I) bears a relationship which is described in section 4975(e)(2) (C), (E), or (G) to any plan with respect to which such trust was formed, or

"(II) bears a relationship which is described in section 4975(e)(2) (F) or (H) to any person described in subclause (I); or

"(v) any person described in clause (iii) or (iv) provides the qualified organization with nonrecourse financing in connection with such transaction and such debt—

"(I) is subordinate to any other indebtedness on such property; or

"(II) bears interest at a rate which is significantly less than the rate available from any person not described in clause (iii) or (iv) at the time such indebtedness is incurred.

"(C) QUALIFIED ORGANIZATION.—The term 'qualified organization' means an organization described in section 170(b)(1)(A)(ii) or a qualified trust.

"(D) QUALIFIED TRUST.—For purposes of this paragraph, the term 'qualified trust' means any trust which constitutes a qualified trust under section 401.".

(b) The amendments made by this section shall apply to taxable years beginning after December 31, 1982.

STATEMENT OF THE HONORABLE SPARK M. MATSUNAGA
ON S. 2197, A BILL FOR THE EXEMPTION OF TAXICABS FROM EXCISE
TAXES ON GASOLINE AND OTHER MOTOR FUELS
BEFORE THE FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
MONDAY, JULY 19, 1982

MR. CHAIRMAN, THANK YOU FOR SCHEDULING THESE HEARINGS ON S. 2197 AND S. 2498, TWO OF THE BILLS WHICH I HAVE INTRODUCED.

THE FIRST BILL S. 2197 ADDRESSES THE PROBLEM RELATED TO THE CURRENT REFUND OF FUEL EXCISE TAX. IN THE SURFACE TRANSPORTATION ASSISTANCE ACT OF 1978, THE CONGRESS ADDED TO THE TAX CODE, SECTION 6427(E), WHICH PROVIDES FOR A REFUND OF THE FEDERAL EXCISE TAX ON GASOLINE, DIESEL AND OTHER FUELS, WHEN USED IN CERTAIN FUEL-EFFICIENT TAXICABS.

IN INITIATING THE TAX EXEMPTION, THE HOUSE OF REPRESENTATIVES OBSERVED THAT TAXICABS ARE THE ONLY AVAILABLE MEANS OF PUBLIC TRANSPORTATION IN MANY SUBURBAN AREAS AND SMALLER TOWNS; IN OTHER AREAS TAXICABS FREQUENTLY COMPETE WITH OTHER FORMS OF PUBLIC TRANSPORTATION WHICH ARE FULLY OR PARTIALLY EXEMPT FROM THE FEDERAL FUEL TAXES. TO ENCOURAGE THE USE OF PUBLIC TRANSPORTATION, THE IMPLEMENTATION OF SHARED-RIDE SYSTEMS, AND THE PURCHASE OF

FUEL-EFFICIENT TAXICABS, THE HOUSE BILL PROVIDED AN EXEMPTION FROM THE FOUR CENTS PER GALLON EXCISE TAX ON GASOLINE AND OTHER MOTOR FUELS USED IN TAXICABS FOR QUALIFIED TAXICAB SERVICES.

TO QUALIFY FOR THIS EXEMPTION, THE HOUSE BILL REQUIRED THAT THE TAXICABS MUST NOT BE PROHIBITED FROM RIDE-SHARING UNDER COMPANY POLICY OR THE RULES OF A FEDERAL, STATE, OR LOCAL AUTHORITY. IT WAS FURTHER REQUIRED THAT WHEN A 1978 OR LATER MODEL TAXICAB WAS ACQUIRED AFTER 1978, THE FUEL ECONOMY OF THE MODEL TYPE OF VEHICLE MUST EXCEED THE FLEET AVERAGE FUEL ECONOMY STANDARD UNDER THE MOTOR VEHICLE INFORMATION AND COST SAVINGS ACT. THE EXEMPTION IN THE ORIGINAL HOUSE BILL WOULD HAVE APPLIED ONLY TO FUEL USED IN FURNISHING PASSENGER TRANSPORTATION FOR A FIXED FARE.

THE FINAL CONFERENCE AGREEMENT DELETED THE HOUSE PROVISION WHICH WOULD HAVE ALLOWED TAX-FREE SALES OF FUEL; INSTEAD, THE CONFEREES AGREED ON A REFUND OR CREDIT PROCEDURE FOR THE TAX PAID ON FUEL USED IN PROVIDING QUALIFIED TAXICAB SERVICES. THUS, TO OBTAIN THE REFUND, A TAXICAB OWNER MUST FIRST PAY THE EXCISE TAX

AND SUBSEQUENTLY FILE FOR A CREDIT OR REFUND.

THE CONFERENCE AGREEMENT ALSO LIMITED THE EXEMPTION TO TWO YEARS, 1979 AND 1980. THE TWO-YEAR PERIOD WAS INTENDED TO PERMIT THE CONGRESS TIME TO DETERMINE THE EFFECTIVENESS OF THE EXEMPTION IN ENCOURAGING THE USE OF MORE ENERGY-EFFICIENT TAXICABS AND RIDE-SHARING. IN AN EXTENSION OF VARIOUS TEMPORARY TAX PROVISIONS IN 1980, THE CONGRESS EXTENDED THE TAXICAB FUEL TAX EXEMPTION FOR TWO MORE YEARS. IT WAS FELT THAT AN ADDITIONAL TWO-YEAR PERIOD WAS NECESSARY TO PROVIDE THE TREASURY DEPARTMENT TIME TO COLLECT THE PERTINENT DATA, AND FOR THE CONGRESS TO EVALUATE THE EFFECTIVENESS OF THIS EXEMPTION.

TO QUALIFY FOR THE EXEMPTION UNDER SECTION 6427(E) OF THE TAX CODE, A PURCHASER WHO USES THE FUEL FOR QUALIFIED TAXICAB SERVICES MUST FIRST PAY THE EXCISE TAX AND SUBSEQUENTLY FILE FOR A REFUND. IF THE REFUND OF TAX DUE IS $50 OR MORE FOR THE CALENDAR QUARTER, THE PURCHASER MAY FILE FOR A REFUND AT THE END OF THE QUARTER. ANY AMOUNTS NOT OTHERWISE REFUNDED MAY BE CLAIMED ON THE PURCHASER'S INCOME TAX RETURN FOR THE YEAR. THE SMALL TAXICAB OPERATORS HAVE COMPLAINED ABOUT THE BURDEN OF THIS

PAYMENT-REFUND PROCEDURE.

S. 2197 SEEKS TO REPLACE THIS CUMBERSOME PROCEDURE WITH THE SIMPLE PROPOSAL FIRST ADOPTED BY THE HOUSE IN ITS VERSION OF THE SURFACE TRANSPORTATION ASSISTANCE ACT. S. 2197 WOULD PROVIDE THAT THE SALE OF FUEL TO TAXICAB OWNERS BE TAX-FREE, IN ORDER TO AVOID THE PRESENT PROCESS OF PAYING THE TAX FIRST AND THEN FILING FOR A REFUND. THE PROPOSED CHANGE WOULD SAVE THE FEDERAL GOVERNMENT THE TIME AND EXPENSE OF PROCESSING AND REFUNDING THE EXCISE TAX. IT WOULD ALSO REDUCE THE TIME-CONSUMING, EXPENSIVE REQUIREMENT FOR TAXICAB OWNERS TO COMPLETE THE NECESSARY REFUND FORMS. THE TAX EXEMPTION WOULD ALSO BE MADE PERMANENT.

THE SECOND BILL, S. 2498, ADDRESSES THE PROBLEM FACED BY EDUCATIONAL INSTITUTIONS WHEN INVESTING IN DEBT-FINANCED REAL ESTATE. UNDER PRESENT LAW, WHEN A TAX-EXEMPT ORGANIZATION BORROWS MONEY TO BUY ANY FORM OF REAL ESTATE, IT MAY INCUR A TAX LIABILITY. IF THE PURCHASED PROPERTY IS SUBSTANTIALLY RELATED TO THE ORGANIZATION'S EXEMPT PURPOSE -- SUCH AS A NEW DORMITORY TO HOUSE STUDENTS ENROLLED AT A COLLEGE -- THERE IS NO ADVERSE TAX EFFECT. BUT IF THE PROPERTY IS ACQUIRED FOR

INVESTMENT PURPOSES AND IS UNRELATED TO THE ORGANIZATION'S EXEMPT PURPOSE, THE ORGANIZATION WILL SUFFER A PENALTY TAX.

THAT PENALTY TAX IS IMPOSED ON A PERCENTAGE OF THE NET INVESTMENT INCOME FROM THE PROPERTY. THIS PERCENTAGE REPRESENTS THE RATIO OF THE OUTSTANDING MORTGAGE TO THE COST BASIS OF THE PROPERTY. THE PENALTY TAX THUS APPLIES TO PROPERTY BOUGHT WITH BORROWED FUNDS. IT ALSO MAY APPLY TO GIFTS AND BEQUESTS OF PROPERTY WHICH THE TAX EXEMPT ORGANIZATION RECEIVES SUBJECT TO AN OUTSTANDING MORTGAGE OR DEBT UNDER CERTAIN CIRCUMSTANCES.

BACKGROUND OF PRESENT LAW

A VARIATION OF THIS PENALTY TAX WAS APPLIED TO CERTAIN TAX EXEMPT ORGANIZATIONS IN 1950, WHEN THE TAX WAS IMPOSED ON RENTAL INCOME FROM DEBT-FINANCED REAL PROPERTY. IN 1969 CONGRESS EXPANDED THE TAX TO APPLY TO ALL EXEMPT ORGANIZATIONS AND TO ALL DEBT-FINANCED PROPERTY UNRELATED TO THE ORGANIZATION'S EXEMPT FUNCTIONS.

THE 1969 TAX REFORM ACT ADDRESSED TAX SHAM TRANSACTIONS. AN OPERATING BUSINESS IN SUCH A TRANSACTION COULD CONVERT ORDINARY INCOME INTO LONG-TERM CAPITAL GAINS BY WAY OF AN INTERMEDIARY

EXEMPT ORGANIZATION. THE EXEMPT ORGANIZATION WOULD EVENTUALLY ACQUIRE THE OPERATING BUSINESS ASSETS WITH LITTLE OR NO PAYMENT OF ITS OWN FUNDS. IN EFFECT, THE TAX BENEFITS PROVIDED THROUGH THE USE OF THE TAX EXEMPT ORGANIZATION PAID FOR THE ACQUISITION.

FOR EXAMPLE, A BUSINESS WOULD SELL ITS OPERATING ASSETS TO A UNIVERSITY ON A DEFERRED PAYMENT BASIS. THE UNIVERSITY WOULD BE OBLIGATED TO MAKE PAYMENT ONLY OUT OF EARNINGS FROM THE ASSETS. THE UNIVERSITY WOULD THEN LEASE THE ASSETS TO A NEW COMPANY FORMED BY THE ORIGINAL BUSINESS. THE COMPANY'S RENTAL PAYMENTS TO THE UNIVERSITY WOULD EQUAL THE UNIVERSITY'S CONTRACT PAYMENT TO THE BUSINESS ON THE DEFERRED PURCHASE.

AS A RESULT OF THIS TRANSACTION, THE BUSINESS EARNINGS FROM THE OPERATING ASSETS BECOMES DEDUCTIBLE AS RENTAL PAYMENTS TO THE UNIVERSITY. THE UNIVERSITY RETURNS THE EARNINGS TO THE BUSINESS IN THE FORM OF MORE FAVORABLY TAXED, LONG-TERM CAPITAL GAINS, THUS PAYING OFF THE PURCHASE COST OF THE BUSINESS ASSET. AN INFLATED PRICE OR AN OPEN END PRICE FOR THE PROPERTY ALSO PROVIDES THE BUSINESS WITH A SIGNIFICANTLY HIGHER RETURN BEFORE ACTUAL OWNERSHIP PASSES TO THE UNIVERSITY.

THE 1969 TAX REFORM ACT ENDED THIS TYPE OF SHAM TRANSACTION BY IMPOSING THE PENALTY TAX ON DEBT-FINANCED INCOME.

1980 EXCEPTION FOR PENSION TRUSTS

THE 1969 TAX REFORM ACT HAD SUCCEEDED IN CONTROLLING THE ACQUISITION OF BUSINESSES BY TAX-EXEMPT ORGANIZATIONS FOR THE PURPOSE OF UTILIZING THEIR TAX-FREE STATUS. BUT THE PENALTY TAX HAS ALSO PREVENTED LEGITIMATE INVESTMENTS IN DEBT-FINANCED REAL ESTATE, THUS HAMPERING INVESTMENT DIVERSIFICATION BY EXEMPT ORGANIZATIONS.

THE SENATE FINANCE COMMITTEE EXAMINED THIS RESTRICTION IN 1980 AND APPROVED A SPECIAL RULE FOR TAX-EXEMPT PENSION PLANS. THE 1980 MISCELLANEOUS REVENUE ACT CREATED AN EXCEPTION FROM THE PENALTY TAX FOR A PENSION PLAN'S PURCHASE OF MORTGAGED REAL ESTATE. TO PREVENT THE PRE-1969 ABUSES FROM RECURRING, THE LEGISLATION IMPOSED CERTAIN SAFEGUARDS:

FIRST, THE PURCHASE PRICE MUST BE A FIXED AMOUNT AND NOT OPEN ENDED.

SECOND, THE DEBT PAYMENT CANNOT BE CONTINGENT ON EARNINGS FROM THE PROPERTY.

THIRD, THE PROPERTY CANNOT BE LEASED BACK TO THE SELLER OR TO A PARTY RELATED TO THE SELLER.

FOURTH, THE PROPERTY CANNOT BE LEASED BACK TO CERTAIN PERSONS DISQUALIFIED UNDER THE PENSION PROVISIONS.

FIFTH, THE PROPERTY CANNOT BE FINANCED BY A NONRECOURSE LOAN FROM A PARTY EITHER RELATED TO THE SELLER OR RELATED TO A PERSON DISQUALIFIED UNDER THE PENSION LAWS, IF THE LOAN IS SUBORDINATE OR IF THE LOAN CARRIES LESS THAN THE GOING INTEREST RATE.

THIS EXCEPTION PRESENTLY APPLIES ONLY TO TAX EXEMPT EMPLOYEE PENSION TRUSTS.

PROPOSAL

EDUCATIONAL INSTITUTIONS, LIKE PENSION PLANS BEFORE BEING EXCEPTED, HAVE BEEN DETERRED BY THE PENALTY TAX FROM INVESTING IN DEBT-FINANCED REAL ESTATE. PRIVATE COLLEGES AND SCHOOLS HAVE THE SAME NEED AS PENSION PLANS TO DIVERSIFY THEIR INVESTMENTS AND MAXIMIZE THEIR INVESTMENT INCOME. THAT NEED HAS BEEN DRAMATICALLY INCREASED IN RECENT YEARS DUE TO RISING COSTS AND CUTS IN FEDERAL ASSISTANCE PROGRAMS. TO MEET THIS NEED THESE

SCHOOLS MUST DIVERSIFY THEIR INVESTMENTS, BUT ARE UNABLE TO BUY SIGNIFICANT REAL ESTATE WITHOUT BORROWING MONEY.

S. 2498 WOULD EXTEND THE PRESENT EXCEPTION ACCORDED PENSION PLANS TO EDUCATIONAL ORGANIZATIONS, INCLUDING COLLEGES AND SCHOOLS. THE SAME SAFEGUARDS APPLICABLE TO PENSION TRUSTS WOULD APPLY TO FORECLOSE ABUSE BY EDUCATIONAL ORGANIZATIONS.

WITNESSES TESTIFYING TODAY ON S. 2498 AND S. 2197 WILL, I AM SURE, SHOW THE CLEAR NEED FOR THEIR ENACTMENT. AGAIN, I THANK YOU, MR. CHAIRMAN FOR SCHEDULING THESE HEARINGS. THANK YOU.

Senator PACKWOOD. The committee will come to order please. As is usual in these hearings, all of your statements will be placed in the record, and we ask the witnesses to hold their statements to 5 minutes so that we have time for questions. That does not apply to the administration; the reason being that the administration has to testify on all of the bills that are before the committee.

We have from the administration today, Bill McKee, the tax legislative counsel for the Department of the Treasury, and Roy Sampsel, an old friend of mine and close acquaintance who is now the Deputy Assistant Secretary for Indian Affairs of the Department of the Interior.

Gentlemen, it is good to have you with us this morning. Mr. McKee, do you want to start?

STATEMENT OF WILLIAM S. McKEE, TAX LEGISLATIVE COUNSEL, U.S. DEPARTMENT OF THE TREASURY

Mr. McKEE. Thank you very much, Mr. Chairman.

I am pleased to present the views of the Treasury Department on the following tax bills: S. 2197, dealing with the exemption from fuel excise taxes for taxicabs, which the Treasury Department opposes; S. 2498, providing an exemption from the unrelated business income tax for debt-financed real property owned by educational organizations, which the Treasury Department opposes; and S. 1298, which would treat certain Indian tribal governments as State governments for certain tax purposes, which the Treasury Department supports.

Senator PACKWOOD. I would like to interject that the last is very unusual. The Treasury Department normally has the position at these hearings of being in opposition to almost all of the bills that are here. So I'm doubly delighted that they are on record in favor of S. 1298.

Mr. McKEE. Thank you, Mr. Chairman. At the morning staff meeting with Mr. Chapoton, I advised him of our position—and his eyebrows did go up quite a bit—that the Treasury was going to support something. He also was delighted that we could take this position.

I would like first to turn to the provisions of S. 2197 dealing with the tax exemption for motor fuels for certain taxicabs. The bill would continue the tax-free status of sales of fuel for taxicab use, would expand the definition of qualified taxicab use, and would make the exemption permanent.

Under present law, which expires at the end of this year, purchasers of gasoline or diesel fuel for taxicabs are eligible for a refund of the Federal excise taxes paid on such fuels. The limitations are that the taxicab, in order to be a qualified taxicab, must be operating in an area in which ride sharing is not prohibited. Moreover, the taxicab must be fuel efficient unless it is made by a small producer. This provision was inserted in 1978 in the Surface Transportation Act, which was designed to encourage ride sharing and thus reduce energy use.

Under the legislation, the Treasury Department was required to study the efficacy of the provision after being provided information by the taxicab industry dealing with the operation of the exemption. The industry has provided us with no information which justifies the exemption. Moreover, they have provided us with no information which would evidence that either lower fares or any more efficient use of transportation facilities, through the use of ride sharing and taxicabs as opposed to single-passenger automobile use, has occurred as a result of this provision.

The one real energy-saving provision that was in the original draft of the bill was the part that was supposed to encourage ride sharing. The bill, as proposed, would emasculate this one energy conservation rule by providing that the fuel exemption would be available if the taxicab company policy was in favor of ride sharing, even though State or local law prohibited ride sharing. In other words, you could have the situation in which local jurisdictions simply prohibited ride sharing, but the fuel tax exemption was nevertheless available because the company voluntarily decided to promote ride sharing, even though it legally could not do so.

The bill, as drafted, also causes some administrative problems for the Internal Revenue Service. The statute, as it is now written, requires operators of qualified taxicabs to file refund claims. Under the bill, as drafted, these taxicabs would be entitled to purchase the fuel tax free once they had registered with the Internal Revenue Service. This tax-free purchase approach was rejected in 1978 when the Surface Transportation Act came in on the grounds that the Internal Revenue Service would have a great deal of difficulty verifying in advance that the fuel purchased tax free would, in fact, be used for qualified purposes.

Should this exemption be extended beyond the end of this year, this provision should be rejected on the grounds that, once again, the Internal Revenue Service simply cannot enforce the provision when the fuel is purchased in advance tax free. We think it is much more appropriate for the taxicab operator to furnish the records and then claim a refund of the tax based on the actual qualified use.

Thus, we oppose both the extension and the expansion of the taxicab exemption provision.

I would now like to turn to S. 2498 dealing with debt-financed real property investments of schools. S. 2498 would exempt income from certain real property investments by schools from the unrelated business income tax imposed on income from certain debt-financed property. The Treasury Department opposes S. 2498.

The general rule in this area, of course, is that exempt organizations pay no tax on investment income. In order to prevent unfair competition with private businesses, however, we tax unrelated business taxable income of these exempt organizations. The unrelated business taxable income, however, generally does not include passive income such as rents. The exception to this exemption is that if the property is debt financed, the Code imposes a tax under usual rules on the share of the income that is attributable to the debt financing. An exception was made to the debt-financed rules in 1980 for real estate investments made by qualified pension trusts.

Thus, the issue that is presented by this bill is whether or not schools should be subject to tax on a portion of their taxable income from real estate investments to the extent that it is debt financed; that is, to the extent that it does not result from contributions, but rather results from the investment of borrowed funds.

The Treasury opposes this provision that would extend the pension plan exception to similar investments made by schools.

The history of the debt-financed exception starts back in 1969 when they were put into the Code as a result of certain abuses dealing with debt-financed acquisitions of operating businesses, through which exempt organizations were utilized—that is, their tax exemption was utilized to convert ordinary business income into capital gain. The famous Supreme Court case of *Clay Brown* illustrates that particular abuse in which an operating business was sold to an exempt organization and then rented back by the previous owner of the business. As a result, at the end of the day, what used to be ordinary income had been magically converted into capital gain.

Nevertheless, in 1969 the debt-financed rules were very broadly drafted to simply prevent the use of debt to enhance the tax-exempt status of these organizations and curtail their ability to use borrowed funds in order to make investments in competition with the private sector.

The proponents of this bill, which would allow schools to make debt-financed real property investments without the imposition of the unrelated business income tax, say that they need these rules in order to be able to make investments in real estate. This is not the case. These organizations can, in fact, invest in real estate on the same terms as any investor in the private sector. The debt-financed property rules simply place the schools or other exempt organizations on the same footing as their private counterparts. Moreover, the Treasury Department has a substantial concern that extending this complete tax exemption for investments in real estate to tax-exempt schools would permit the possibility of the selling of tax benefits into the private sector through partnerships involving exempt organizations and private syndicators.

Although pension trusts are exempted from the debt-financed rules, we think that the situation of pension trusts is distinguishable from schools in general. After all, the purpose of a pension trust is to accumulate funds for a later distribution, and at the time of that distribution, those funds will be taxable.

On the other hand, the exempt purpose of schools is to promote education and the acquiring of funds is ancillary to that exempt purpose. Moreover, the distributions that are made by schools oftentimes are exempt themselves, for example through scholarships, which is not the case with respect to pension plans, the distributions from which are generally taxable.

The history of the 1980 act, which specifically exempted certain pension trusts from the debt-financed rules, expressly states that it is not to be considered as precedent for extending the exemption to other types of exempt organizations.

We are also quite concerned that if this exemption from the debt-financed rules is expanded, there seems to be no logical reason why it should only be expanded to schools rather than to all other worthy and deserving exempt organizations. In other words, we don't see where a line can be drawn for schools as opposed to other types of exempt organizations.

We do believe, however, that the unrelated business income tax rules and the debt-financed rules, which are a part of that statutory scheme, are useful tools in preventing abuses in this area. Therefore, we strongly oppose a piecemeal repeal of the rules of section 514. We would be pleased to join with the subcommittee in an overall examination of the scope and effect of the debt-financed rules of section 514, but, once again, we cannot support, and in fact strongly oppose, any piecemeal repeal of these rules on an, if you will, industry-by-industry or organization-by-organization basis.

Finally, I would like to turn to S. 1298, the Indian Tribal Governmental Tax Status Act, which it gives me great pleasure to be able to say that the Treasury Department supports.

The Indian Tribal Governmental Tax Status Act of 1982 would treat Indian tribal governments as State or local governments under numerous provisions of the Federal tax law. The Internal Revenue Service as a matter of administrative practice currently does not treat Indian tribal governments as either States or political subdivisions for purposes of the Internal Revenue Code.

The bill would reverse this rule for those tribal governments which the Secretary of the Treasury, in consultation with the Secretary of the Interior, determine exercise substantial governmental functions. As a result of the bill, charitable contributions to or for the use of tribal governments would be deductible, taxes imposed by governments would be deductible and contributions to candidates for tribal office would be eligible for the credit for contributions to political candidates. Tribal governments would be exempt from certain excise taxes. Certain employee annuity plans which can be formed by governments would now be available for tribal governments. And finally, and most importantly, interest on tribal government obligations in certain circumstances would be tax exempt. In other words, the present provisions of section 103 dealing with industrial development bonds would be extended to tribal governments and allow them to issue these bonds to obtain financing for certain types of activities carefully defined in the bill.

The taxation of Indian tribes and tribal members is a complex area as a result of the history of the relationship between Indian tribes and the U.S. Government. The Treasury believes, however, that if Indian tribal governments perform the same essential governmental functions for their members as State and local governments perform for their residents, then the fundamental tax policy interest in promoting horizontal equity suggests that tribal governments should be treated for Federal tax purposes in the same manner as State and local governments.

Historically and factually, there is a sufficient analogy between the status of States and Indian tribes to justify this similar tax treatment.

The bill limits carefully these extensions of the Federal tax benefits to those tribal governments, which, in fact, exercise substantial governmental functions. As I noted before, this requires a finding by the Secretary of the Treasury in concert with the Secretary of the Interior that this is, in fact, the case.

In endorsing S. 1298, I would like to emphasize that we neither endorse nor question the desirability of the provisions of tax law whose benefits are extended to tribal governments by this bill. The Treasury does, however, strongly endorse the principle that taxpayers who are similarly situated should be treated alike for tax purposes if the law is to be applied fairly and equitably. That principle underlies our support of this bill.

I now turn the podium over to the Department of the Interior.

[The prepared statement of Hon. William S. McKee follows:]

For Release Upon Delivery
Expected at 9:30 a.m., EDT
July 19, 1982

STATEMENT OF
WILLIAM S. MCKEE
TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the views of the Treasury Department on the following tax bills: S. 2197, dealing with the exemption from fuel excise taxes for taxicabs; S. 2498, providing an exemption from the unrelated business income tax for debt-financed real property owned by educational organizations; and S. 1298, which would treat certain Indian tribal governments as State governments for certain tax purposes.

The Treasury Department opposes the first two of these bills (S. 2197 and S. 2498) and supports the third bill (S. 1298). I will discuss each of the bills in turn.

S. 2197

Excise Tax Exemption for Motor Fuels Used in Certain Taxicabs

S. 2197 would amend the Internal Revenue Code in order to permit certain sales of fuel for use in a taxicab to be made tax-free, to expand the definition of taxicab use which would qualify for the exemption, and to make the exemption permanent.

The Treasury Department strongly opposes enactment of S. 2197.

Under existing law, purchasers of gasoline or diesel fuel for taxicabs providing qualified taxicab services are eligible for a refund of Federal excise taxes paid on such fuels. In general, a taxicab cannot provide qualified taxicab services if Federal, State or local laws or regulations, or if taxicab company policies, prohibit ride-sharing. In addition, to qualify taxicabs must be fuel efficient or be exempt from the fuel efficiency standards because they are manufactured by a small producer. The taxicab exemption provision terminates on December 31, 1982.

The exemption of taxicabs from fuel excise taxes was enacted as part of the Surface Transportation Act of 1978 (P.L. 95-599). Its ostensible purpose was to encourage ride-sharing, thus reducing energy consumption by substituting taxicab use for personal automobile use. Under the legislation, the Treasury Department was required to study the efficacy of the provision after being provided with information by the taxicab industry detailing the operation of the exemption.

The taxicab industry has not provided the Treasury Department with any information which justifies exemption of taxicabs from fuel excise taxes. The industry has not provided any evidence which indicates that the availability of the exemption has reduced taxicab fares to users, nor that it has lured individuals away from their private automobiles into taxicabs for ride-sharing purposes. The revenue loss of approximately $3 million annually could thus be better used in the Highway Trust Fund from which it is excluded by virtue of the exemption.

Indeed, one of the amendments sought under S. 2197 would weaken whatever energy conservation argument remains for extension of the exemption. Although current law requires that qualified taxicab service must be provided in fuel efficient vehicles, and that rule remains unchanged, as a practical matter the exemption for small manufacturers precludes any denial of the exemption to taxicabs on grounds of excessive fuel consumption. Thus, ride-sharing is the one energy saving feature in current law. However, one change under the bill would essentially eliminate the requirement that ride-sharing be available in eligible taxicabs by requiring that only taxicab company policy not prohibit ride-sharing. Thus, for example, the exemption would be available in localities where local ordinances prohibit ride-sharing. In such areas company policy on ride-sharing is irrelevant and clearly no energy conservation can result. Not only would this change undermine the rationale for the provision, it would add significantly to the revenue loss by making more taxicabs eligible for the exemption and would further deprive the Highway Trust Fund of badly needed revenues.

A second change made by the bill would create significant administrative problems. While use of motor fuels in qualified taxicab services is exempt from the Federal excise tax, the fuels cannot be purchased tax-free. Consequently, eligible taxicab operators must currently seek a refund of excise taxes paid. The bill would permit tax-free sales of fuel to purchasers who register with the Internal Revenue Service. A similar provision was rejected by the conference committee which enacted the exemption in the Surface Transportation Act of 1978. The reason for the rejection was the administrative difficulty that such a provision would create for the Internal Revenue Service. It was recognized that the Internal Revenue Service would be unable to verify in advance that the fuel was in fact being purchased for qualified uses. Allowing taxicab operators to purchase fuels tax free would provide significant opportunities for abuse which the Internal Revenue Service is not equipped to monitor. Requiring taxicab operators to maintain records and to claim refunds based on such records, as under current law, is the preferable method for assuring some degree of accountability for fuel use by taxicab owners.

While it is true that under current law operators of intercity, local, or school buses may purchase fuels tax-free, the administrative burden is not significant for the Internal Revenue Service in those cases because of the relatively small number of eligible operators and the relative ease of ascertaining qualified uses. Thus, the same reasons for rejecting tax-free sales of fuel for taxicabs which existed in 1978 exist today.

In conclusion, Treasury opposes both extension and expansion of the taxicab exemption provision. While the revenue losses are relatively minor, the exemption is made available to a very small group of taxpayers who have not established that the exemption is justified either on the basis of energy policy or tax equity.

S. 2498
Debt-Financed Real Property Investments of Schools

S. 2498 would exempt income from certain real property investments by schools from the unrelated business income tax imposed on income from certain debt-financed property. The Treasury Department opposes S. 2498.

Generally, exempt organizations are not taxed on income earned on investments. However, in order to prevent exempt organizations engaged in commercial activities from having a competitive advantage over taxable entities similarly engaged, a tax is imposed on income earned by an exempt organization from business activities that are unrelated to its exempt purpose. Exceptions to this tax on unrelated business income are provided for traditional types of passive investment income (rents, royalties, dividends, and interest) <u>unless</u> the acquisition or improvement of the property producing the income is financed by debt. Under section 514 of the Code, subject to limited exceptions, a share of any income from debt-financed property, proportional to the ratio of debt on the property to the adjusted basis of the property, is (after allowance for a proportionate share of deductions, including straight line depreciation) taxed as income from an unrelated business. An exception to the debt-financed income rules was added by the Miscellaneous Revenue Act of 1980 (P.L. 96-605) for certain debt-financed real property investments of qualified trusts exempt under section 401 of the Code. S. 2498 would extend this exception to similar investments by schools.

Prior to 1969, sale-leaseback transactions between an exempt organization and a taxable seller of an active business, financed primarily by a contingent, nonrecourse note from the exempt organization to the taxable seller, were used to convert ordinary income of the business to capital gains for the seller. In these transactions, the tax-exempt status of the exempt organization was effectively used to benefit the taxable seller. The current debt-financed income provisions were adopted in 1969 in response to the sale-leaseback abuse. However, the provisions were drafted broadly to reach not only sale-leaseback transactions specifically, but also to ensure that the exceptions to the tax on unrelated business income would not be abused in other ways. Consequently, the 1969 debt-financed income amendments were drafted to apply not only to rental income derived from sale-leasebacks of operating businesses, but also to income from almost all forms of debt-financed investment property, including real property. These broad revisions reflected concern not only for sale-leaseback transactions, but also for the possibility of other abuses through the use of leveraged investments by exempt organizations.

The argument for S. 2498 is that the tax on debt-financed income has inhibited debt-financed investment in real estate, preventing diversification of investments and maximization of investment income by schools. It must be noted, however, that the debt-financed income rules do not preclude leveraged real property investments by schools. They simply subject debt-financed investments to tax on a portion of the income, subject to proportionate allowances for expenses. This tax is intended to prevent the use of an exempt organization's tax exemption in leveraged investments for the benefit of taxable parties (for example, through partnership arrangements employing special allocations), and to remove any competitive advantage the exempt organization may have over a taxable entity engaged in the same activity.

It is also argued that the special exception to the debt-financed income rules available to pension trusts should be extended to schools because schools have the same need as pension trusts to diversify investments and maximize income. However, while the need of schools for investment opportunities may be the same as that of pension trusts, the purpose and effect of the tax exemptions granted to schools and pension trusts are significantly different.

Exemption is accorded to qualified retirement trusts to facilitate the accumulation of funds for nondiscriminatory retirement benefits. Thus, the investment income earned by qualified retirement trusts is not subject to current tax liability. Ultimately, however, the investment income will be taxed when distributed as benefits to plan beneficiaries. On the other hand, unlike a pension trust, schools are granted exemption for the purpose of promoting education, not for the purpose of accumulating funds for future distribution to specific taxable beneficiaries. Moreover, exemption of investment income of a school in many instances results in a permanent exemption rather than a deferral of tax.

Based on these distinctions between pension trusts and other exempt organizations, the Miscellaneous Revenue Act of 1980 amended the debt-financed income rules to allow pension trusts to use borrowed funds to invest in real property without incurring a tax on the investment income. However, as expressly stated in section 110(b) of the Act, the limited exception to the debt-financed income rules for pension trusts was not to be considered precedent for extending the exception to other exempt organizations.

The reasons for applying the debt-financed income rules to tax-exempt organizations in general are fully applicable to schools. No distinction exists between schools and other educational organizations or charitable, scientific or religious organizations which would justify a special exception to the debt-financed income rules for schools. If it is appropriate to consider modifying these rules for schools, consideration should be given to modifying them for all section 501(c)(3) organizations and possibly for all exempt organizations. However, the Treasury Department believes that the debt-financed income rules of section 514 are useful in preventing abuses of tax-exempt status. An exception for investments in real property, even if limited in the same manner as the existing exception relating to investments by qualified trusts, would be a significant reduction in the scope of section 514. While we would be pleased to join with the Subcommittee in an overall examination of the scope and effect of section 514, we oppose piecemeal repeal of this provision.

S. 1298
The Indian Tribal Government Tax Status Act

S. 1298, the Indian Tribal Governmental Tax Status Act of 1982, would treat Indian tribal governments as State or local governments under numerous provisions of the Federal tax law. The Treasury Department supports enactment of S. 1298.

Under current law, developed in a series of revenue rulings, Indian tribal governments are generally not treated as "States" or "subdivisions" thereof for purposes of the Internal Revenue Code. See, e.g., Rev. Rul. 68-231, 1968-1 C.B. 49 (tribal government obligations are not obligations of a "State, Territory or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia" for purposes of section 103; hence, interest on bonds issued by a tribal government is not tax exempt); Rev. Rul. 74-179, 1974-1 C.B. 279 (gifts to tribal governments are not deductible as charitable contributions); Rev. Rul. 58-610, 1958-2 C.B. 610 (tribal governments are not exempt from excise taxes). These rulings have rested on a rationale of strict statutory construction, rather than on other notions of tax policy.

S. 1298 would provide that Indian tribal governments, defined as the governing body of any tribe, band, community, village or group of Indians, determined by the Secretary of the Treasury in consultation with the Secretary of the Interior to "exercise substantial government functions", would be treated as States for certain Federal tax purposes. Additionally, under the bill, subdivisions of tribal governments that have been determined to have been "delegated the right to exercise one or more of the substantial governmental functions" of the tribal government would be treated as subdivisions of a State for certain Federal tax purposes. The bill would have the following effects:

1. Charitable contributions to or for the use of tribal governments or subdivisions would be deductible.

2. Taxes imposed by tribal governments would be deductible.

3. Contributions to candidates for tribal office would be eligible for the credit allowed for contributions to political candidates.

4. Tribal governments and eligible subdivisions would be exempt from the excise tax on special fuels, manufacturers excise taxes, highway vehicle use taxes and the communications excise tax.

5. Contributions to annuities for certain employees of tribal governments or eligible subdivisions would be excluded from the employees' income.

6. Most importantly, interest on tribal government obligations or obligations of eligible subdivisions would in limited circumstances be tax exempt. Interest on otherwise qualifying industrial development bonds (IDBs) issued by a tribal government would be tax exempt only if the principal activities of the trade or business funded with the IDBs are to be carried out on the reservation, except that certain purchasing and marketing activities could be carried on off the reservation. In the case of tribal government obligations that are not IDBs, the interest exemption would be available only if the proceeds are to be used in the exercise of "any essential governmental function" or for a "public utility."

Indian tribes and tribal members occupy a unique role in our scheme of government, and the taxation of Indian tribal members and tribal governments is a matter of some complexity. Treasury believes, however, that if Indian tribal governments perform the same essential governmental functions for their members as State and local governments perform for their residents, then the fundamental tax policy interest in promoting horizontal equity suggests that tribal governments should be treated for Federal tax purposes in the same manner as State and local governments. Although the status of Indian tribes in our scheme of government is unique, there is a sufficient analogy between the status of States and the status of Indian tribes to support treating tribal governments on the same basis as State and local governments.

The Supreme Court has described the status of Indian tribes as follows:

> "[The sovereignty of tribes] exists only at the sufferance of Congress and is subject to complete defeasance. But until Congress acts, the tribes retain their existing sovereign powers. In sum, Indian tribes still possess those aspects of sovereignty not withdrawn by treaty or statute, or by necessary implication as a necessary result of their dependent status."

United States v. Wheeler, 435 U.S. 313, 324 (1978). Thus, like the States, the tribes retained full sovereignty before formation of the United States; like the States, tribal sovereignty was ceded in part to the Federal government, albeit by treaties rather than as a result of the citizens' ratification of a Constitution partially ceding that sovereignty. Although, unlike States, the sovereignty of tribes is subject to the plenary power of Congress to withdraw that retained sovereignty completely, in fact, tribal governments have routinely exercised the powers of sovereigns within the territories over which they have jurisdiction. Thus, tribal governments exercise police powers and have the power to levy taxes, and members of the tribe vote to elect their leaders. Although clearly not "States" within the meaning of the Code provisions extending benefits to States, in fact tribal governments function within the sphere of sovereignty retained by them in much the same manner as States.

Moreover, S. 1298 would extend benefits only to tribal governments which do exercise substantial governmental functions. Thus, insofar as Congress exercised its power to defease tribes of sovereignty, and hence to make those tribes less like States, the tribes so defeased would not be entitled to the bill's benefits. Thus, the principle that similarly situated taxpayers should be treated alike argues strongly in favor of the bill. It should also be noted that the Interior Department, with its special expertise in Indian matters, favors the bill.

In endorsing S. 1298, we neither endorse nor question the desirability of the provisions of the tax law whose benefits are extended to tribal governments by this bill. Treasury does, however, strongly endorse the principle that taxpayers who are similarly situated should be treated alike for tax purposes if the law is to be applied fairly and equitably. That principle underlies our support of this bill.

STATEMENT OF ROY H. SAMPSEL, DEPUTY ASSISTANT SECRETARY FOR INDIAN AFFAIRS, U.S. DEPARTMENT OF THE INTERIOR

Senator PACKWOOD. Mr. Secretary.

Mr. SAMPSEL. Thank you, Mr. Chairman. I am pleased to present the views of the Department of the Interior on S. 1298, the Indian Tribal Government Tax Status Act. We concur with the Department of the Treasury that the bill should be enacted.

The principal reasons include the question of equity, because we believe that the benefits Indian tribes would obtain from this bill would be of little cost to the Federal Government and because the bill is compatible with the administration's policy which furthers the concept of tribal economic self-sufficiency by recognizing and strengthening tribal governments as governments responsible for providing public goods and services to their people.

It was pointed out in the testimony by the Department of Treasury that S. 1298 would remedy the effects of a series of Revenue Service rulings issued during the late 1960's and early 1970's which held that Indian tribes are neither States nor political subdivisions of States under the Internal Revenue Code. Therefore, tribes are not eligible for certain benefits given States and their political subdivisions. As a result, revenue raising and saving mechanisms available to and commonly used by other governments are foreclosed to Indian tribal governments. This policy is particularly unfortunate inasmuch as tribal governments are faced with the task of bringing their people, among some of the poorest in the Nation, into economic prosperity. This task is made more difficult, at least in part, because tribal governments are not allowed the same benefits of other governments under the Internal Revenue Code.

As to the matter of equity, I think that has heen spoken to by the Treasury Department.

Increasing the sovereign powers of the governments, allowing the local economies to provide better services and more services to their people, is one of the other benefits.

I note that this legislation would not empower tribal governments to exercise any governmental power that they do not now have, and I think that is an important consideration. Neither would it extend to tribal governments any benefit now not extended to other governments. It merely would end the discriminating policy of an application of the code toward tribal governments.

Let me address the question of the government to government aspect, because I think it is very important. The administration has consistently talked about the need for this Government to deal with tribal governments on an historic Government to government relationship, and our support of S. 1298 is a natural outgrowth of that policy.

There are a couple of amendments which have been suggested and they are attached for the record, which we would appreciate the committee considering. The first amendment to the legislation deals specifically with the situation that results in terms of the Federal unemployment tax and goes to a situation which exists in the State of Colorado in which the Indian tribes pay taxes under the Federal unemployment tax, but are not eligible to receive unemployment benefits. We recommend that the committee look at that and address that within this piece of legislation.

Also, a rather technical amendment, which deals with section 3(a) of the bill, defining the term "reservation." Obviously, the intent of the subparagraph (B) of the definition on page 10 of the bill asks that the Secretary of the Interior designate reservations. The Secretary does not have that technical authority. I think the proper language to be considered is that the Secretary does have the authority to proclaim reservations under 25 U.S.C. 467 and this appears to be the authority referred to in that subparagraph. It is technical, but I think important for definition purposes.

I thank the committee for its time.

[The prepared statement of Hon. Roy H. Sampsel follows:]

STATEMENT OF ROY H. SAMPSEL, DEPUTY ASSISTANT SECRETARY FOR INDIAN AFFAIRS, DEPARTMENT OF THE INTERIOR, BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT, UNITED STATES SENATE, ON S. 1298, THE "INDIAN TRIBAL GOVERNMENTAL TAX STATUS ACT."

JULY 19, 1982

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE, I AM PLEASED TO PRESENT THE VIEWS OF THE DEPARTMENT OF THE INTERIOR ON S. 1298, THE "INDIAN TRIBAL GOVERNMENT TAX STATUS ACT." WE CONCUR WITH THE DEPARTMENT OF THE TREASURY THAT S. 1298 SHOULD BE ENACTED.

S. 1298 WOULD EXTEND TO TRIBAL GOVERNMENTS THE SAME TAX ADVANTAGES CURRENTLY ENJOYED BY OTHER GOVERNMENTS IN THE UNITED STATES, INCLUDING STATE, COUNTY, AND MUNICIPAL GOVERNMENTS. WE SUPPORT THE BILL FOR THREE REASONS: 1) AS A MATTER OF EQUITY; 2) BECAUSE IT WOULD BENEFIT INDIAN TRIBES AT LITTLE COST TO THE FEDERAL GOVERNMENT; AND 3) BECAUSE THE BILL IS COMPATIBLE WITH THIS ADMINISTRATION'S POLICY OF FURTHERING TRIBAL ECONOMIC SELF-SUFFICIENCY BY RECOGNIZING AND STRENGTHENING TRIBAL GOVERNMENTS AS THE GOVERNMENTS RESPONSIBLE FOR PROVIDING PUBLIC GOODS AND SERVICES FOR THEIR PEOPLE.

AS POINTED OUT IN THE TESTIMONY OF THE DEPARTMENT OF THE TREASURY, S. 1298 WOULD REMEDY THE EFFECTS OF A SERIES OF REVENUE SERVICE RULINGS ISSUED DURING THE LATE 1960'S AND EARLY 1970'S WHICH HELD THAT INDIAN TRIBES ARE NEITHER STATES NOR POLITICAL SUBDIVISIONS OF STATES UNDER THE INTERNAL REVENUE CODE. THEREFORE, TRIBES ARE NOT ELIGIBLE FOR CERTAIN BENEFITS GIVEN STATES AND THEIR POLITICAL SUBDIVISIONS. AS A RESULT, REVENUE RAISING AND SAVING MECHANISMS AVAILABLE TO AND COMMONLY USED BY OTHER GOVERNMENTS ARE FORECLOSED TO INDIAN TRIBAL GOVERNMENTS. THIS DISCRIMINATORY TREATMENT IS PARTICULARLY UNFORTUNATE INASMUCH AS TRIBAL GOVERNMENTS ARE FACED WITH THE TASK OF BRINGING

THEIR PEOPLE, AMONG THE POOREST IN THE NATION, INTO ECONOMIC PROSPERITY. THIS TASK IS MADE MORE DIFFICULT, AT LEAST IN PART, BECAUSE TRIBAL GOVERNMENTS ARE NOT ALLOWED THE SAME BENEFITS AS OTHER GOVERNMENTS UNDER THE INTERNAL REVENUE CODE.

FIRST, AS A MATTER OF EQUITY, TRIBAL GOVERNMENTS SHOULD BE GIVEN THE SAME BENEFITS GIVEN STATE, COUNTY AND MUNICIPAL GOVERNMENTS UNDER THE INTERNAL REVENUE CODE. THE GOVERNMENTS OF FEDERALLY-ACKNOWLEDGED INDIAN TRIBES EXERCISE POWERS OF SELF-GOVERNMENT. THEY HAVE THE RESPONSIBILITY TO PROVIDE A FULL RANGE OF GOVERNMENT SERVICES TO THEIR CITIZENS.

INCREASINGLY, TRIBES HAVE SOUGHT TO EXERCISE THEIR POWERS OF GOVERNMENT TO IMPROVE THEIR LOCAL ECONOMIES AND TO PROVIDE SERVICES TO THEIR PEOPLE. WE BELIEVE IT IS APPROPRIATE THEREFORE TO FACILITATE THESE EFFORTS TO CONFER UPON TRIBAL GOVERNMENTS THE SAME BENEFITS CONFERRED UPON OTHER GOVERNMENTS UNDER THE INTERNAL REVENUE CODE.

WE NOTE THAT THIS LEGISLATION WOULD NOT EMPOWER TRIBAL GOVERNMENTS TO EXERCISE ANY GOVERNMENTAL POWERS THEY NOW DO NOT HAVE, NEITHER WOULD IT EXTEND TO TRIBAL GOVERNMENTS ANY BENEFIT NOW NOT EXTENDED TO OTHER GOVERNMENTS. IT MERELY WOULD END THE DISCRIMINATORY APPLICATION OF THE INTERNAL REVENUE CODE TOWARD TRIBAL GOVERNMENTS.

SECOND, S. 1298 WOULD, AT VERY LITTLE COST TO THE FEDERAL TREASURY, PROVIDE BADLY NEEDED BENEFITS TO INDIAN TRIBES. TRIBAL GOVERNMENTS TODAY ARE MORE DEPENDENT ON FEDERAL FUNDS THAN ARE MOST STATE AND LOCAL GOVERNMENTS. IT

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IS A GOAL OF THIS ADMINISTRATION AND OF MANY TRIBAL LEADERS THAT THIS DEPENDENCY BE LESSENED. AS THE FEDERAL BUDGET BECOMES MORE RESTRICTED, TRIBAL GOVERNMENTS, LIKE STATE AND LOCAL GOVERNMENTS, WILL HAVE TO FIND NEW WAYS TO SUPPORT THE DELIVERY OF ESSENTIAL GOVERNMENT SERVICES. BUT WITHOUT ENACTMENT OF THE BILL, TRIBES WILL BE VERY HARD-PRESSED TO DO THIS. THE POVERTY AND LACK OF ECONOMIC ACTIVITY ON INDIAN RESERVATIONS RENDER LITTLE, IF ANY, TAX BASE. BECAUSE THE INTEREST ON TRIBAL OBLIGATIONS IS NOT GIVEN THE SAME FAVORED TAX TREATMENT AS THOSE OF OTHER GOVERNMENTS, TRIBAL BONDS ARE VIRTUALLY UNMARKETABLE BECAUSE OF THE HIGHER INTEREST RATE REQUIRED.

S. 1298 WOULD DO MUCH TO ALLEVIATE THESE PROBLEMS. IT WOULD PROVIDE TRIBES A MECHANISM TO STIMULATE BUSINESS ACTIVITY, PROVIDE A MEANS TO FINANCE PUBLIC FACILITIES, ENCOURAGE CONTRIBUTIONS TO TRIBAL GOVERNMENTS, EASE THE BURDEN OF TRIBAL TAXATION, AND IN A HOST OF OTHER WAYS ENHANCE THE ABILITY OF TRIBAL GOVERNMENTS TO IMPROVE THE LOT OF THEIR PEOPLE. WE ARE NOT SUGGESTING THAT THIS BILL ALONE WOULD BE A FAST SOLUTION TO THE ECONOMIC PROBLEMS ON INDIAN RESERVATIONS, BUT IT WOULD BE AN IMPORTANT STEP TOWARD REMOVING SOME OF THE IMPEDIMENTS TO TRIBAL ECONOMIC DEVELOPLMENT.

FINALLY, THE BILL IS SUPPORTIVE OF THE ADMINISTRATION'S POLICY OF DEALING WITH INDIAN TRIBES ON A GOVERNMENT-TO-GOVERNMENT BASIS. OUR SUPPORT OF S. 1298 IS A NATURAL OUTGROWTH OF THAT POLICY.

WITH RESPECT TO THE EFFECTIVE DATES FOR THE PROVISIONS OF THE BILL AS PROVIDED IN SECTION 5, WE DEFER TO THE TREASURY DEPARTMENT AS TO THE APPROPRIATENESS OF THOSE DATES. WE ALSO DEFER TO TREASURY ON ANY TECHNICAL AMENDMENTS NECESSARY FOR CONSISTENCY WITH THE INTERNAL REVENUE CODE OF 1954, AS AMENDED.

BASED ON THE FOREGOING, WE STRONGLY RECOMMEND ENACTMENT OF S. 1298.

THIS CONCLUDES MY PREPARED STATEMENT. I WOULD BE PLEASED TO ANSWER ANY QUESTIONS YOU MAY HAVE.

Amendments

1. We recommend that section 3304 of the Federal Unemployment Tax Act (chapter 23, subtitle C, Internal Revenue Code of 1954) be amended to provide that the Secretary of Labor certify a State unemployment tax law only if the employees of Indian tribal governments or their political subdivisions are eligible for benefits under the state unemployment program.

The Federal Unemployment Tax Act (FUTA) provides for grants-in-aid to States for the administration of unemployment compensation laws and imposes a uniform Federal payroll tax on employers. The current FUTA tax rate is 3.4 percent. A credit against this tax of up to 2.7 percent of compensation is allowed for payments made by employers to employment compensation funds set up pursuant to State law.

At least one State, Colorado, does not cover employees of Indian tribal governments under its State unemployment law. Colorado's reason for not covering tribal employees is that it lacks jurisdiction over Indian reservations. Other states have made agreements with Indian tribes to provide unemployment coverage.

Colorado tribes remain liable for the Federal tax even though their employment cannot receive benefits under the State plan. This inequity is only borne by a few tribes in Colorado. This amendment would remove the burden of being subject to the FUTA tax while being unable to benefit under the applicable state unemployment system.

Because the State of Colorado declines to cover Indian tribes, collection has been stayed until an equitable resolution of the issue can be achieved. Since Colorado tribes have been subject to the FUTA tax and have not been eligible for unemployment benefits, we also recommend that the FUTA tax liability be forgiven until the State law is changed to extend unemployment coverage to employees of Indian tribal governments.

2. Section 3(a) of S. 1298 would enact a new Internal Revenue Code section 103(g)(4), which would define "reservation". The intent of subparagraph (B) of the definition on page 10 of the bill is unclear, since the Secretary of the Interior has no present authority to "designate" reservations. The Secretary does have authority to proclaim reservations (25 U.S.C. 467) and this appears to be the authority referred to in subparagraph (C). Accordingly, we recommend that lines 6 through 18, on page 10, be amended to read as follows:

> "(B) areas proclaimed by the Secretary of the Interior as a reservation for the Indian tribe the government of which is issuing the obligation, or
>
> (C) land owned by an Indian tribe which —
>
> > (i) is contiguous to a reservation within the meaning of subparagraph (A) or (B), or
> >
> > (ii) has been acquired in trust for the Indian tribe through consolidation, land exchange or purchase."

Senator PACKWOOD. I am delighted to have the administration supporting this. As you are aware, I introduced the bill in 1975 and it didn't go anywhere. In 1977 it had the opposition of the Treasury and died. At last, I think we are going to treat tribes no different than we treat other municipalities. Although, I think the tribes should be warned, especially in the area of industrial development bonds, of the fact that the Treasury is saying because you may have the same powers as cities have, it doesn't mean they like the powers that cities have. The Treasury, for a number of years, and in many areas with some justification, has attempted to whittle down the power of issuing industrial development bonds. The purposes of the initiatives have grown broader and broader, until they sometimes barely recognize a municipal purpose. It almost becomes a private development purpose.

I am assuming that the tribes would be in the same position if the limitation on the bonds is passed; no better, or no worse than any other municipality. Is that a fair statement, Mr. McKee?

Mr. MCKEE. Yes, sir.

Senator PACKWOOD. I don't want to mislead the tribes. I hope we get this, but I don't want them to think that because the Treasury Department supports this bill that the Treasury Department is on record as loving the expanded use of municipal bonds.

Mr. MCKEE. Absolutely. As I have mentioned, we wanted to be very clear that this did not either endorse or comment upon the provisions of the tax law which these tribal governments would have available. It is simply a matter of tax equity that whatever one governmental unit is entitled to get, other governmental units that are of a similar kind should be entitled to.

Senator PACKWOOD. Senator Matsunaga, do you have some questions.

Senator MATSUNAGA. Thank you, Mr. Chairman.

Mr. McKee, does the Treasury oppose both of my bills now under consideration?

Mr. MCKEE. We oppose the extension of the exemption for the excise tax on fuels for taxicabs and we also oppose the provision which would exempt from the debt-financed rules of section 514 certain schools. That is correct, Senator Matsunaga.

Senator MATSUNAGA. Explain once again the rationale for the Treasury's position.

Mr. MCKEE. With respect to the taxicab provision, there simply is no evidence which would support the need or the desirability of an exemption from the fuel tax for taxicab operators. In the 1978 Surface Transportation Act, the taxicab industry was supposed to come forward to prove that the exemption from the tax had encouraged ride sharing and had promoted the use of fuel-efficient taxicabs. The industry has not done so, and indeed the bill, by its own terms seems to acknowledge that by providing that the exemption from fuel tax would be available even though ride sharing was illegal under local law. Moreover, the fuel efficient requirement is really meaningless as far as we can understand because the small producers are exempted, and, of course, the only other producers of taxicabs are the major automobile producers which are required to meet the fuel efficient standards imposed by the law.

So the bill doesn't appear to be doing what it was supposed to do which the history of the 1978 Act said was to promote ride sharing and then, therefore, take people out of single-passenger, personally owned automobiles, and have them ride, if you will, in a group basis in taxicabs. That simply does not seem to have been the case and does not justify the revenue loss.

Senator MATSUNAGA. Has the study required by the 1978 act on the effectiveness of the fuel tax exemption been completed yet?

Mr. McKEE. The taxicab industry has not submitted anything to the Treasury Department which would support the legislation in question, so we have not received anything which would support their position.

Senator MATSUNAGA. Was not the Treasury Department supposed to conduct a study?

Mr. McKEE. No; the industry was supposed to provide the Treasury Department with the information and then we would analyze it. We have not gotten the information and therefore we have not analyzed anything.

Senator MATSUNAGA. So in fact no study has yet been made?

Mr. McKEE. That is my understanding, Senator.

Senator MATSUNAGA. So you really do not know what the results of fuel tax exemption are?

Mr. McKEE. Well, again, Senator, the industry was supposed to provide us with information and since we have not gotten the information, there is not much we can do.

Senator MATSUNAGA. Isn't it then premature for you to say that the tax exemption hasn't worked when you don't have any data from any study?

Mr. McKEE. Well, I guess we would assume that since the legislation is about to expire—it has been in place since 1978—that if the industry had some strong claims it would come forth with that information. Moreover, Senator, the legislation in and of itself tends to belie the claims that this is going to promote fuel-efficient ride sharing, since the statute, by its own terms, no longer requires that ride sharing even be legally permitted in order to claim the fuel exemption. In other words, the fuel exemption is available under the statute even though State or local law flatly prohibits ride sharing.

Senator MATSUNAGA. What about buses? Buses have a permanent exemption from the fuel excise tax.

Mr. McKEE. That is correct.

Senator MATSUNAGA. What is the rationale for exempting bus fuel and not taxicab fuel.

Mr. McKEE. Senator, perhaps I am wrong, but in my limited experience I have not seen too many buses with just one passenger on them. However, I do notice many taxicabs seem to have only one passenger. Again, the purpose of the statute was to promote ride sharing, and it is the Treasury's position that the industry hasn't shown that ride sharing has been promoted.

Certainly, if the revenue loss is to be justified, it would be that taxicabs are serving a bus-like function by transporting large numbers of individuals in an efficient fashion. But we have not had any evidence that that is occurring. We do not feel that Treasury should be spending the taxpayers' money on the naked assertion that this is, in fact, happening.

Senator MATSUNAGA. When you say that you have not seen buses with but one rider, but you have seen cabs with one, are you basing your statement on any study you have made?

Mr. MCKEE. The legislative history required the industry to come forward with this. We have simply not received anything. It was not up to the Treasury Department, to our understanding, to develop this data.

Senator MATSUNAGA. Well, we will hear from the industry today, but I would think that until such time as a report of that study has been submitted, that it would be premature to end the fuel tax exemption. Would you agree to an extension for a 2-year period rather than a permanent extension?

Mr. MCKEE. No, Senator. We feel that the industry should have presented its data. The bill is now before the subcommittee and the position of the Treasury Department is that in the absence of demonstrable proof, that this is doing what it was supposed to do in producing fuel efficiency, that the Government shouldn't spend the money.

Senator MATSUNAGA. Well, as you know, my bill provides that if the company has no policy against ride sharing, then that company's taxicabs shall be eligible for the fuel tax exemption. Now wouldn't that cause operators in States which do forbid ride sharing to work for the repeal of the restriction?

Mr. MCKEE. It seems to me, Senator, that they would already have done so. Under the bill as now drafted, as long as both the company policy and the State law permitted ride sharing, fuel exemption was available. Whatever pressure the industry could put on State and local governments to promote ride sharing in order to obtain the fuel exemption should have already been put. We certainly see no reason to take that pressure off in the sense that if the bill passes as drafted, it is no longer relevant whether or not ride sharing in fact occurs. State or local law does not have to be changed in order for the taxicab company to be entitled to its fuel exemption. And therefore, I think it will work in exactly the opposite way from which you suggest.

In our testimony, we opposed both the extension of the bill and, as well, the two changes that are made by the bill to current law; that is, the change in the ride sharing requirement and the change in the administrative feature of the bill, which would change the method of obtaining the tax benefit from filing for a refund to an up-front exemption from tax. We oppose both of those provisions, those two changes to present law, and we oppose the extension of the bill.

Senator MATSUNAGA. To your knowledge, how many States forbid share riding?

Mr. MCKEE. I do not know, Senator.

Senator MATSUNAGA. How many municipalities?

Mr. MCKEE. We do not have that information.

Senator MATSUNAGA. So you do not really know whether there is a single State which opposes share riding?

Mr. MCKEE. Again, the Treasury Department with our resources must rely on the affected industry to come forward with the information as the legislative history directs the industry. And we simply have not had that information, Senator.

Senator MATSUNAGA. Well, we will see whether industry has that information. I would think that such information is easy to obtain.

Mr. MCKEE. I am sure the industry is capable of getting that information to us and we would welcome that information. Again, the Treasury was directed to analyze the information that the industry furnished. And we would be more than willing to carry out our obligation in the directions, and work with the industry to develop the analyses required.

Senator MATSUNAGA. If we should amend the bill to provide that where the States forbid share riding, a tax exemption shall not apply, would you then agree to it?

Mr. MCKEE. The Treasury Department will not support any extension of the bill. Again, we do not support the bill itself, the concept of the bill, because we see nothing that justifies the expenditure of taxpayers' money.

Senator MATSUNAGA. Even if the study shows that it has actually worked to save energy?

Mr. MCKEE. If the Treasury is furnished with the appropriate information, then it seems to me appropriate for the Treasury to come back and report to you the analysis of the information. It is very difficult for us to tell you what our conclusions will be before the analysis has been made. I really cannot address the question of what our views would be after we have seen the information. I can only say that absent that information, we are opposed.

Senator MATSUNAGA. You are then saying that your opposition or support would depend upon the results of the study?

Mr. MCKEE. Certainly the absence of information makes it difficult for the Treasury Department to give you its views as to how it thinks the provision should apply.

Senator MATSUNAGA. All right. Now, relative to the second bill—that is the H.R. 2498—what is the rationale for exempting qualified pension trusts from the debt acquisition rule and not extending similar treatment to educational institutions?

Mr. MCKEE. Senator, there are two reasons that we can discern. The first is that pension trusts are subject to a higher fiduciary standard than other exempt organizations. The Treasury Department, as I mentioned in my testimony, is concerned that the exemption of exempt organizations from the rules of section 514 could lead to abusive situations in which exempt organizations form partnerships, for example with taxpayers in the private sector, and through the use of particular partnership allocation provisions, might be able to, if you will, transfer those tax benefits to the private sector.

Pension trusts are subject to certain fiduciary standards which makes the possibility of that abuse somewhat less.

Second, the purpose of the pension plan itself is to accumulate funds for later distribution in a fully taxable fashion. On the other hand, schools which have an exemption which is the purpose of promoting education and the acquiring of funds is ancillary to their basic purpose. Moreover, in many cases, when a school disburses those funds, they are disbursed in a tax-free fashion. So the tax stakes involved between a pension plan as opposed to other exempt organizations is different.

Most importantly, the Treasury is quite concerned about the ability to distinguish schools from other exempt organizations. Admittedly, the line between a pension trust and a school is perhaps not as clear as all of us would like, although we do feel that it is a line that can be drawn. We see no rational distinction between schools and between other equally deserving exempt organizations. And we feel that the passage of this bill would essentially operate as a piecemeal repeal of section 514.

As I told the chairman, the Treasury would be happy to work with the subcommittee to analyze both the scope and effect of section 514 to see if its provisions are working as intended, but we do not believe it should be repealed in a piecemeal fashion for a particular type of investment by a particular type of exempt organization. We note that when the 1980 legislation was put in place, in a very unusual situation or a very unusual piece of legislation, the bill itself, as opposed to the committee reports, specifically stated that the extension or the provision dealing with pension trusts was not to be taken as precedent for any other type of exempt organization. So in 1980, the Congress specifically stated that it did not intend this exemption for pension trusts to be used to support for extending the exemption to other types of organizations.

Senator MATSUNAGA. Is not the educational purpose of the expenditures sufficient reason to justify the exemption?

Mr. McKEE. We do not believe so.

Senator MATSUNAGA. You do not believe so? Where do you rate education?

Mr. McKEE. It is the difference between the notion that a pension trust, whose purpose it is to accumulate money, its sole purpose is to accumulate money for retirement purposes, subject to very strict fiduciary standards. Educational organizations, on the other hand, simply have a tax exempt status to encourage or to develop educational goals and, if you will, the development of its endowment as a secondary fashion. We do not feel that the particular provision of section 514 is necessarily——

Senator MATSUNAGA. I just cannot understand your rationale. I do not know where you place education in your value scale, but I place the highest value on education and believe it warrants the same preferential tax treatment as any other exempt function. As Thomas Jefferson so well observed, the continuance of a democracy, such as ours, depends on an educated populace, and it is the duty of Government to educate its people. That is why we have compulsory education. This is the basic principle of our system, and to implement that policy we encourage education through different programs. In formulating tax policies we therefore exempt educational institutions to realize a desirable social objective. And I really cannot understand your objections.

Mr. McKEE. Senator, I think it is very important to view the particular provision that we are discussing, in light of your remarks. The particular provision we are discussing does not prevent schools from investing in real estate, not at all. It does not impose any special tax upon schools that invest in real estate. Rather, what it simply does is say that the schools which invest in leveraged real estate must pay the same tax burden, to the extent of the leverage, that their counterparts in the private sector do, which in most cases, Senators, is not going to be a significant tax burden.

We are simply concerned that, through no fault of their own, the ability to engage in tax-oriented transactions, using the tax exemptions of these exempt organizations is going to prove a temptation that is too hard to resist.

We do not want to say that schools or education deserves anything but the highest support. We agree with that. But this is a very narrow little provision we are dealing with.

Senator MATSUNAGA. Mr. McKee, what we are proposing here is that educational institutions be permitted to purchase real estate with borrowed money without paying a penalty tax, so that the proceeds of such real estate investment may be used for educational purposes.

Now, on the one hand, the administration today is cutting educational aid everywhere possible. Because of this situation educational institutions are looking towards their own endowments to maintain present programs and to make up for reduced Federal funds. Instead of allowing these institutions to increase their investment income, you limit their income production. You are striking educational institutions at both ends. I really cannot understand the philosophy of this administration.

Mr. McKEE. Senator, I would like to just emphasize again that the particular provision that we are looking at is an extraordinarily narrow provision.

Senator MATSUNAGA. Well, the Treasury ought to broaden it.

I introduced S. 2498 to broaden a narrow provision, so that educational institutions can purchase real estate with borrowed money so long as the proceeds are used for educational purposes.

Mr. Chairman, I have taken too much time already.

Senator PACKWOOD. Sparky, you never take too much time from this committee. You are welcome to all of it you want.

Gentlemen, I have no further questions of you. Again, thank you very much.

Mr. McKEE. Thank you very much.

Senator PACKWOOD. I would like to make a change in order. I have just received a note that I have to go to Howard Baker's office early this morning. I would like to move on to S. 1298 so I can hear all of the testimony before I have to leave.

We will start first with a panel consisting of Ralph Minnick, who is the Warm Springs secretary-treasurer, accompanied by Delbert Frank, Nelson Wallulatum, and Dennis Karnop.

Let me assure you how unusual it is to have the Treasury Department testifying in favor of a bill. It is one of those rare occassions where you can go to court and you almost have a directed verdict.

Ralph, go right ahead.

STATEMENT OF RALPH MINNICK, SECRETARY-TREASURER OF THE TRIBAL COUNCIL OF THE CONFEDERATED TRIBES OF THE WARM SPRINGS RESERVATION OF OREGON

Mr. MINNICK. I have with me, like you pointed out, Mr. Wallulatum of the tribal council; Mr. Delbert Frank, chairman of our tribal council; and Dennis Karnop, our attorney.

Mr. Frank has asked that I present the testimony on his behalf.

[The prepared statement of Delbert Frank, Sr., follows:]

S. 1298

INDIAN TRIBAL GOVERNMENTAL TAX STATUS ACT OF 1981

STATEMENT OF DELBERT FRANK, SR., CHAIRMAN OF THE TRIBAL COUNCIL OF THE CONFEDERATED TRIBES OF THE WARM SPRINGS RESERVATION OF OREGON

Mr. Chairman, Members of the Committee, thank you for this opportunity to testify on behalf of S. 1298, the Indian Tribal Governmental Tax Status Act.

I am presenting this testimony on behalf of the Confederated Tribes of the Warm Springs Reservation of Oregon. The Tribe is most grateful to our Senators from Oregon, Senators Hatfield and Packwood, for cosponsoring this legislation introduced by Senator Wallop of Wyoming.

While each Indian Reservation is unique, we believe this legislation is extremely important to all Indian tribal governments.

Our Reservation is located in the middle of Oregon and consists of approximately 1,000 square miles of land and almost 2,500 members. Virtually all of the land is Indian owned and there are very few non-Indian residents of the Reservation other than employees of the Federal government.

Our Tribe is a totally autonomous government and our Reservation receives virtually no services from state and local government.

Our Tribe spends over five million dollars a year of tribal money on governmental functions. These functions

Statement of Delbert Frank, Sr. - Continued

include law and order, Tribal Court, our community center, juvenile work programs, and other similar activities.

Our Health and Welfare branch operates mental health and alcohol rehabilitation programs, a tribal group home, counseling services, and other social services.

Our Resource branch conducts a range program, fish and wildlife activities, a park system, and other operations.

In short, our tribal government provides substantially all of the governmental functions that any county or municipal operation provides, plus many services beyond the scope of any other municipality.

It comes as a surprise, I think, to most people that Indian Tribes don't already have the status that this bill proposes. Subsequent to the enactment of the Wheeler-Howard Act, the Federal government has placed a heavy emphasis on the governmental role in Indian Tribes. Since that date, Tribes have aggressively sought within the limits of their resources to deal with the governmental problems of their people. Congress has consistently supported this role of tribal governments in recent legislation, most notably, the Indian Self-Determination Act.

Tribal members, like other citizens in the United States, have properly urged aggressive improvements in tribal government.

In many respects, the efforts by tribal governments to perform their functions have been adversely affected by a number of highly arbitrary and discriminatory provisions of

Statement of Delbert Frank, Sr. - Continued

the Internal Revenue Code. These provisions undermine tax initiatives of tribal governmentsand interfere with the ability of tribal leaders to improve conditions within the Reservations.

Tribes are required to pay retailers and manufacturers excise taxes to which non-Indian governments are immune. Gifts to tribal governments are not deductible,although a gift in identical circumstances to a non-Indian city government would be deductible.

Interest on Indian tribal obligations is not tax exempt, even though interest on the obligations of a non-Indian government would be. The existence of this law would greatly aid the financing of projects such as our recently completed hydro-electric generating project. This project was the first of its kind to be undertaken by an Indian Tribe and benefits not only the Tribe, but our state, region, and nation as well.

Taxes paid to Indian tribal governments are not deductible by the individual taxpayer even though similar taxes paid in the same circumstances to a state or non-Indian city government would be deductible.

Congress and the Executive Department have both repeatedly indicated their intention to strengthen and improve tribal governments and to provide the same benefits to tribal governments that are available to state and local governments. S. 1298 would be of tremendous assistance.

Statement of Delbert Frank, Sr. - Continued

While we wholeheartedly support the bill as written, we would like to urge your consideration of adding one further provision in Section 2, where Indian Tribal governments are treated as states for certain purposes. We propose that a new subsection (a)(6)(E) be added to give Tribes the same tax treatment as states for purposes of IRC Section 457, relating to deferred compensation plans for employees. The language we propose would come after Section 2(a)(6)(D) on page 4 of the bill and would read as follows:

"(E) Section 457 (relating to deferred compensation plans with respect to service for state and local governments)"

In summary, passage of S. 1298 will assist tribal governments in the performance of their governmental functions. This assistance will benefit not only tribal members, but also surrounding communities, the states, and the Federal government. Passage will give to tribal governments the same tax status as is now enjoyed by non-tribal governments.

Thank you for the opportunity to submit this testimony.

DELBERT FRANK, SR.
Chairman of the Tribal Council
of the Confederated Tribes of
the Warm Springs Reservation
of Oregon

Mr. MINNICK. Mr. Chairman, members of the committee, thank you for the opportunity to testify on behalf of Senate bill 1298, the Indian Tribal Governmental Tax Status Act.

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Our tribe is a totally autonomous government, and our reservation receives virtually no services from State or local government.

Our tribe spends over $5 million a year of tribal money on governmental functions. These include law and order, tribal court, our community center, juvenile work programs, and other similar activities.

Our Health and Welfare branch operates a mental and alcohol rehabilitation program, a tribal group home, counseling services, and other social services.

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Tribal members, like other citizens in the United States, have properly urged aggressive improvements in tribal government.

In many respects the efforts by tribal governments to perform their functions have been adversely affected by a number of highly arbitrary and discriminatory provisions of the Internal Revenue Code. These provisions undermine tax initiatives of tribal governments and interfere with the ability of tribal leaders to improve conditions within the reservations.

Tribes are required to pay retailers and manufacturers excise taxes to which non-Indian governments are immune. Gifts to tribal governments are not deductible, although a gift in identical circumstances to a non-Indian city government would be deductible.

Interest on Indian tribal obligations is not tax exempt even though interest on the obligations of a non-Indian government would be. The existence of this law would greatly aid the financing of projects such as our recently completed hydroelectric generating plant. This project was the first of its kind to be undertaken by an Indian tribe and benefits not only the tribe but our State, region, and Nation as well.

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Congress and the executive department have both repeatedly indicated their intention to strengthen and improve tribal governments and to provide the same benefits to tribal governments that are available to State and local governments. Senate bill 1298 would be of tremendous assistance.

While we wholeheartedly support the bill as written, we would like to urge your consideration of adding one further provision in section 2, where Indian tribal governments are treated as States for certain purposes. We propose that a new subsection (a)(6)(E) be added to give tribes the same tax treatment as States for the purposes of IRC section 457, relating to deferred compensation plans for employees. The language we propose would come after section 2(a)(6)(D) on page 4 of the bill and would read as follows:

(E) Section 457 (relating to deferred compensation plans with respect to service for State and local governments).

In summary, passage of S. 1298 will assist tribal governments in the performance of their governmental functions. This assistance would benefit not only tribal members but also surrounding communities, the States, and the Federal Government. Passage will give to tribal governments the same tax status as is now enjoyed by nontribal governments.

Thank you for the opportunity to submit this testimony—Delbert Frank, Sr., chairman of the Tribal Council, Confederated Tribes, Warm Springs Reservation of Oregon.

Senator PACKWOOD. I agree with you about deferred compensation. Whether or not it was an oversight when the bill was drafted I am not sure. I will see what I can do to get it in.

I might say for the record, the Warm Springs Confederation has done an exemplary job of self-management. They run one of the best resorts in Oregon, at Kanita. They have a lumber mill; and they have a fairly well-timbered reservation which would make any environmentalist's heart jump with joy. In everything they do and in everything they undertake, they want to assure that they will always be self-sufficient. They do not look to somebody else to take care of them. I cannot tell you how pleased I have been in dealing with all of you over the years. Frankly, you have made it easy, because every time you come you know specifically what you want and you have prepared the facts and the justification. I want to thank you.

Mr. MINNICK. Thank you, Mr. Chairman.

Senator PACKWOOD. Sparky?

Senator MATSUNAGA. I wish to join the chairman in commending you for your presentation. I think the bill proposes something which is long overdue. I am glad that in this instance at least the administration supports you. [Laughter.]

Senator PACKWOOD. Yes.

Mr. MINNICK. Thank you very much.

Senator PACKWOOD. Gentlemen, we have no other questions.

Thank you very much for taking the time to come today.

Next we will hear a panel: Judy Knight, representing the Council of Energy Resource Tribes, the National Congress of American Indians and others; Burton Hutchinson, the chairman of the Arapahoe Tribe, accompanied by Pat Goggles; Alfred Ward, the co-chairman of the Shoshone Tribe of the Wind River Reservation; and Barry Snyder, the president of the Seneca Nation of Indians. The panel is accompanied by Rick West, general counsel, Association on American Indian Affairs.

Ms. Knight, would you like to go first?

STATEMENT OF JUDY KNIGHT, COUNCIL OF AMERICAN INDIANS

Ms. KNIGHT. I thank you for the opportunity of letting us come before you this morning. Mr. de la Cruz was supposed to present a joint statement, but he is at another meeting at the White House this morning pertaining to other tribal matters.

Mr. Chairman and members of the committee, my name is Judy Knight. I am treasurer, council member, and former chairperson of the Ute Mountain Tribe. I am also treasurer of the Board of Directors of the Council of Energy Resource Tribes.

On behalf of my tribe and the 150 tribes composing NCAI, CERT, NTCA, NARF, I would like to thank you for holding these hearings on Senate bill 1298, the Indian Tribal Governmental Tax Status Act, and for allowing me to testify.

As many of you have tribal constituents, you are no doubt well aware of the dire economic conditions with which tribal governments are faced today. As an example, just this past December the Bureau of Indian Affairs reported that unemployment on reservations was averaging 31 to 46 percent annually, nationally. From the reports NCAI, CERT, NTCA, NARF are receiving from member tribes, the last half year has only served to increase that figure. Reports of unemployment of 60 to 70 percent are not uncommon.

Especially in these times when local governments are expected to carry a greater share of financial and administrative responsibility for government programs, one of the major obstacles confronting tribal governments in dealing with these conditions is their inability to generate sufficient revenues is that they do not have a number of Federal tax advantages enjoyed by other governments in the United States including the State, county, and municipal governments. The Indian Tribal Governmental Tax Status Act would remedy this situation.

We support the bill, first, as a matter of equity; second, because the bill would strengthen tribal economic self-sufficiency by strengthening the abilities of tribal governments to provide public goods and services for their people; and, third, because the bill recognizes the appropriate role of tribal governments.

The bill would remedy the effects of a series of Revenue Service rulings issued during the late 1960's and early 1970's that held that, as Indian tribes are neither States nor political subdivisions of States they are not eligible for certain benefits given States and their political subdivisions under the Internal Revenue Code. As a result, revenue raising and saving mechanisms available to and commonly used by other governments are foreclosed to Indian tribal governments. This discriminatory treatment is particularly unfortunate inasmuch as tribal governments are faced with the task of bringing their people, among the poorest in the Nation, into economic prosperity. This task is made more difficult, at least in part, because tribal governments are not given the same benefits as other governments in the Internal Revenue Code.

The act would allow deductions from Federal income taxes for charitable contributions to Indian tribes; allow deductions from Federal income taxes for taxes paid to tribal governments; exempt from Federal income taxes interest paid on bonds issued by tribal governments; allow deductions from Federal income taxes for contributions to tribal political campaigns; exempt tribal governments from certain excise taxes including those on special fuels, manufacturers' excise taxes, highway use taxes, and communications excise tax; and allow tribal governments to offer tax-exempt annuities to certain employees.

Our first point is that as a matter of equity tribal governments should be given the same benefits given State, county, and municipal governments under the Internal Revenue Code.

The governments of federally recognized Indian tribes exercise sovereign powers. They have the ability to provide a full range of government services to their citizens. Increasingly, tribes have sought to exercise their powers of government to improve their local economies and to provide services to their people. We feel it is appropriate, therefore, to facilitate these efforts to confer upon tribal governments the same benefits conferred upon other governments under the Internal Revenue Code.

It should be noted that this legislation would not empower tribal governments to exercise any governmental powers which they now do not have, neither would it extend to tribal governments any benefits now not extended to other governments; it merely would end a discriminatory application of the Internal Revenue Code toward tribal governments.

In that regard, we recognize that this committee has recently reported out legislation that would restrict the use of tax-exempt industrial development bonds.

We are not asking for special favors for tribal governments beyond what other governments are allowed; we are simply asking for the same opportunities to provide for ourselves.

Our second point is that this bill would, at very little cost to the Federal Treasury——

Senator PACKWOOD. Ms. Knight, let me ask that you please abbreviate your statement so that all of the others can testify within the time allotted. Your entire statement will be included in the record.

Ms. KNIGHT. All right.

Senator PACKWOOD. Fortunately, I have had a chance to read the statements that were turned in last night.

Ms. KNIGHT. This bill would, at very little cost to the Federal Treasury provide badly needed benefits to Indian Tribes.

Indian Tribes, like States and localities, are being asked to shoulder an increasing share of the responsibility for providing for the welfare of their people. Unlike State and local governments, we have little opportunity to meet responsibilities because the tax code does not allow tribes the same favorable treatment that it does State and local governments.

This bill would do much to alleviate these problems. It would allow tribes the mechanisms to stimulate business.

If you have read it, I want to put in this final statement:

Finally, we support this bill because it recognizes the appropriate role, status, and responsibilities of tribal governments as governments that represent and are responsible to their people. This bill would allow tribal governments to take an active role in bringing economic well-being to their people.

[The prepared statement of Ms. Knight follows:]

STATEMENT OF JUDY KNIGHT

I am Judy Knight, Tribal Treasurer, Council Member and former Chairperson of the Ute Mountain Tribe. I am also a member of the Board of Directors of the Council of Energy Resource Tribes.

I would like to give you some idea of how S.1298 would help the Ute mountain Tribe. On my reservation we have for many years been very dependent on Federal assistance to provide jobs and services. Last year we sustained a cut in Federal assistance of almost one-third, including an 82% cut back in economic development assistance. The Ute Mountain people as well as the Federal government are looking to the tribal government for help. But we seem to have very few options, in part, because the Internal Revenue Code does not allow us the same mechanisms available to every state and local government in the country.

Let me give you a few examples.

We are badly in need of a new school. Our tribal government buildings are grossly inadequate. Our sewers are in such bad condition that our water has become contaminated. Our roads are in need of repair. Years ago there were Federal grants available to us to cover the costs of such projects. Now, there are not. We are very willing to pay for these facilities ourselves, in fact, we would prefer to do it ourselves rather than rely on Federal largesse. But we have no way of raising the revenue or of obtaining the capital. It is simply impossible for my tribe to raise funds by offering bonds, as the interest on such bonds would not be tax deductible. The interest rate tht we would have to offer would be prohibitive. And how are we to raise money to pay our debts when any taxes that we enact will present harsh burden to those who pay them as they are also are not deductible?

Mr. Chairman, members of the Committee, the government of my tribe wants to provide for the well-being of our people. We believe that our tribal government is the government that is responsible. We do not want to live on Federal assistance alone. But we are not going to be able to effectively provide for ourselves unless you change the inequities that are currently in the tax code. We must have the same opportunity every other government in the country has to provide for ourselves.

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

STATEMENT OF BURTON HUTCHINSON, CHAIRMAN, ARAPAHOE BUSINESS COUNCIL

Mr. HUTCHINSON. Thank you, Mr. Chairman.

I want to thank you for holding these hearings on S. 1298.

My name is Burton Hutchinson, and I am chairman of the Arapahoe Business Council of the Northern Arapahoe Tribe of the Wind River Reservation, Wyo.

On behalf of the Arapahoe Tribe, I am speaking today in support of S. 1298, the Indian Tribal Government Tax Status Act. For many years this proposed legislation has been brought before various Congresses, and though it has always offered a positive benefit to Indian tribal governments by putting them on a par with State and local governments in terms of Federal tax treatment, it has never gained enough votes to win approval. This is so despite the fact that none of the bill's provisions have created an adverse impact on the interests of State and local governments or on individual non-Indian citizens. Because of this history, we in the Arapahoe Tribe were grateful when Senator Malcolm Wallop of Wyoming chose to introduce S. 1298.

All of the bill's provisions would benefit the Arapahoe Tribe as it looks to the future.

We consider two of its features particularly important. One is the allowance of deductions on Federal income taxes for those who make contributions to the tribe. The tribe realizes how important this deduction can be, as evidenced by the recent creation of the Arapahoe educational trust which has obtained a tax exempt status under the Internal Revenue Code and which is now seeking contributions to promote higher education of Arapahoe tribal members. It is time that Congress encouraged such individual contributions to tribal governments in order to assist them in meeting their obligations to people in other areas of government service.

Another important provision of S. 1298 is the allowance of a Federal income tax deduction for taxes paid to tribal governments. This right of tribes to tax has been affirmed very clearly by the U.S. Supreme Court. The feature of S. 1298 that will permit tribal taxpayers to deduct payments to the tribe from their Federal income tax will greatly enhance the acceptability to tribal taxpayers of this important tribal power.

The Arapahoe Tribe strongly supports all of the provisions of S. 1298 but has highlighted these two specific aspects as being of particular importance.

Thank you for the opportunity to testify today.

[The prepared statement of Mr. Hutchinson follows:]

STATEMENT OF BURTON HUTCHINSON
CHAIRMAN, ARAPAHOE BUSINESS COUNCIL
ON S. 1298

July 19, 1982

My name is Burton Hutchinson and I am Chairman of the Arapahoe Business Council of the Northern Arapahoe Tribe of the Wind River Reservation, Wyoming.

On behalf of the Arapahoe Tribe, I am speaking today in support of S. 1298, the Indian Tribal Government Tax Status Act. For many years, this proposed legislation has been brought before various Congresses, and though it has always offered a positive benefit to Indian tribal governments, by putting them on a par with state and local governments in terms of federal tax treatment, it has never gained enough votes to win approval. This is so despite the fact that none of the bill's provisions have created an adverse impact on the interests of state and local governments or on individual non-Indian citizens. Because of this history, we in the Arapahoe Tribe were were grateful when Senator Malcolm Wallop of Wyoming chose to introduce S. 1298.

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The Arapahoe Tribe strongly supports all of the provisions of S. 1298 but has highlighted these two specific aspects as being of particular importance.

Thank you for the opportunity to testify today.

Senator PACKWOOD. Thank you very much.

Mr. Ward?

STATEMENT OF ALFRED WARD, COCHAIRMAN OF THE BUSINESS COUNCIL OF THE SHOSHONE INDIAN TRIBE OF THE WIND RIVER RESERVATION, WYO.

Mr. WARD. Mr. Chairman, members of the committee.

Indian tribes have fought long and hard to have their governments recognized as the real governments of their reservations. The battle has mainly been won. Tribal governmental powers have been upheld over and over by the Supreme Court. Congress has over and over included Indian tribes with State and local governments in acts on revenue sharing, environmental, education, and other matters. With this recognition comes responsibility.

Our attention now is on achieving economic self-sufficiency for our people. We want to be able to supply our own social and economic development services as much as possible. To do this, tribal governments need to have the same tools that State and local governments have. Tribal taxes should be deductible from Federal income tax just as State taxes are. People should be able to give tax-free donations to tribes. Tribes should be able to issue bonds against revenues to finance projects. Tribes should not have to pay Federal taxes that States and cities don't have to pay.

We want Indian governments to continue to grow in services to their people. We need tools to do this. This act will help, not by giving us anything other governments don't have but by providing the same tools State and local governments have.

This is a good bill. It is one Indians have worked for, for years. There is no local opposition to this. It will help us and the Federal Government because the stronger the tribal governments are, the less the United States must do itself. We ask that you do not let this bill die.

Thank you from the Shoshone Tribe.

[The prepared statement of Mr. Ward follows:]

TESTIMONY OF ALFRED WARD, CO-CHAIRMAN OF THE BUSINESS COUNCIL OF THE SHOSHONE INDIAN TRIBE OF THE WIND RIVER RESERVATION, WYOMING

in support of S.1298, the Indian Tribal Governmental Tax Status Act.

MR. CHAIRMAN, members of the committee, Indian Tribes have fought long and hard to have their governments recognized as the real governments of their Reservations. That battle has mainly been won. Tribal governmental powers have been upheld over and over by the Supreme Court. Congress has over and over included Indian Tribes with state and local governments in Acts on Revenue Sharing, Environment, Education, and other matters. With this recognition comes responsibility.

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Senator PACKWOOD. Thank you, Mr. Ward.

Mr. Snyder?

STATEMENT OF BARRY E. SNYDER, PRESIDENT, SENECA NATION OF INDIANS OF NEW YORK

Mr. SNYDER. Mr. Chairman, members of the committee, my name is Barry Snyder. I am the president of the Seneca Nation of Indians of New York.

As I believe the other speakers on this panel have made more than clear, S. 1298, the Indian Tribal Governmental Tax Status Act, enjoys enormous support among Indian tribes all across the Nation—Eastern tribes as well as Western tribes.

The history of the act is indicative of its widespread appeal. S. 1298 was drafted several years ago at the suggestion of the Association on American Indian Affairs, a nationwide organization of some 50,000 non-Indians and Indian taxpayers who believed that such a bill was absolutely essential to providing tax justice for Indian tribes.

Since that time, the bill has been embraced by tribes in all four corners of the Nation as an essential step toward fostering economic self-sufficiency for tribes as well as providing fair treatment under the tax laws. While the Seneca Nation enthusiastically endorses the bill in its entirety, I would like to discuss two provisions of the bill which are particularly important to the Nation.

One such provision is the allowance of a Federal income tax deduction for contributions to Indian tribes. The Seneca Nation has been approached by a private organization which wishes to make a very significant and much needed contribution to the nation. The enactment of S. 1298 will make that contribution clearly eligible for a deduction from Federal income taxes and thus would greatly facilitate this assistance to the Seneca Nation.

A second provision is the exemption of the Seneca Nation from the payment of certain Federal excise taxes. The nation has long believed that these taxes should not properly be charged to tribal governments. The Seneca Nation provides many of the same services on the Allegany and the Cattaraugus Reservations that the State of New York provides off the reservation. It is simply not fair that the Seneca Nation must pay these excise taxes while the State of New York is exempt.

S. 1298 is a good bill. As I think the testimony of our panel has shown, the bill corrects long-standing injustices in our tax laws and will provide substantial financial benefits to Indian tribes at negligible cost to the U.S. Treasury. As I think these hearings also show, there is simply no opposition to the bill from any quarter.

I urge the committee to report this bill favorably to the Senate.

I thank you, Mr. Chairman.

Senator PACKWOOD. Your statement is correct. There is no opposition from any quarter, and that is unusual. Every now and then, even if the Treasury is with you, there is somebody who has some particular reason for objection. To the best of my knowledge, there is no objection, which is a very unusual tribute to the case that you have laid.

Mr. West, would you like to make a comment?

Mr. WEST. Thank you, Mr. Chairman. I am here as General Counsel for the Association on American Indian Affairs and do not have a prepared statement. I am here in the event that questions about particular legal aspects of the bill arose.

If I could just emphasize one point very quickly, and then I will just sit back unless there are questions. As a number of the panel members have pointed out, there are a number of ways in which this bill can be justified: One is that it might contribute in some small way—although I think we all realize much more needs to be done in that area—to promoting the economic self-sufficiency of the Indian tribes. However, I would emphasize, and I'm sure this is the way this committee probably views it, I know this is the way we have viewed it over the years, that this is principally and primarily a measure to correct what I would almost view as an oversight in the Internal Revenue Code that Indian tribes for the past century and a half have functioned as governments and that because of that status, which has been repeatedly confirmed by the Supreme Court and this Congress, they should be treated as governments for purposes of provisions of the Internal Revenue Code.

So I would see this as hopefully a very uncontroversial and quick way of remedying a past tax injustice with respect to American Indian tribes.

I would personally like to thank you for your commitment to the legislation over the years.

Senator PACKWOOD. I am delighted to at last see that the bill has gained what I hope to be sufficient support that will insure its passage.

Let me ask just one question. Do any of you have any objection to the suggestion made by Mr. Minnick about including deferred compensation plans for employees?

[No response.]

Senator PACKWOOD. I don't see any reason why anyone should object to it; it seems to be a good addition. I just wanted to make sure that none of you had any objections.

Senator MATSUNAGA. I have no questions, Mr. Chairman. Everybody appears to be for it; I'm for it, too.

Senator PACKWOOD. Thank you very much for coming.

[The prepared statement of Mr. Snyder follows:]

TESTIMONY OF BARRY E. SNYDER,
PRESIDENT, SENECA NATION OF INDIANS,
IN SUPPORT OF S. 1298
BEFORE THE SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE

July 16, 1982

HIGHLIGHTS

° The Indian Tribal Governmental Tax Status Act enjoys enormous support among Indian tribes nationwide.

° The bill is an essential step toward fostering economic self-sufficiency for tribes, as well as providing fair treatment under the tax laws.

° The Seneca Nation particularly supports the provision allowing a federal income tax deduction for contributions to Indian tribes, which is likely to yield immediate and substantial benefits to the Nation.

° The Seneca Nation also supports in particular the provision for the exemption of Indian tribes from the payment of certain federal excise taxes, an exemption which, in fairness, should apply to tribes just as it applies to state and local governments.

TESTIMONY OF BARRY E. SNYDER,
PRESIDENT, SENECA NATION OF INDIANS,
IN SUPPORT OF S. 1298
BEFORE THE SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT
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July 16, 1982

MR. CHAIRMAN, members of the Committee, my name is Barry Snyder and I am President of the Seneca Nation of Indians of New York. As I believe the other speakers on this panel have made more than clear, S. 1298, the Indian Tribal Governmental Tax Status Act, enjoys enormous support among Indian tribes all across the Nation -- Eastern tribes as well as Western tribes.

The history of the Act is indicative of its widespread appeal. S. 1298 was drafted several years ago at the suggestion of the Association on American Indian Affairs, a nationwide organization of some 50,000 non-Indians and Indian taxpayers, who believed that such a bill was absolutely essential to providing tax justice for Indian tribes.

Since that time, the bill has been embraced by tribes in all four corners of the Nation as an essential step toward fostering economic self-sufficiency for tribes, as well as providing fair treatment under the tax laws. While the Seneca Nation enthusiastically endorses the bill in its entirety, I would like to discuss two provisions of the bill which are particularly important to the Nation.

One such provision is the allowance of a federal income tax deduction for contributions to Indian tribes. The Seneca Nation has been approached by a private organization which wishes to make a very significant and much needed contribution to the Nation. The enactment of S. 1298 would make that contribution clearly eligible for deduction from federal income taxes and thus would greatly facilitate this assistance to the Seneca Nation.

A second provision is the exemption of the Seneca Nation from the payment of certain federal excise taxes. The Nation has long believed that these taxes should not properly be charged to tribal governments. The Seneca Nation provides many of the same services on the Allegany and Cattaraugus Reservations that the State of New York provides off the reservation. It simply is not fair that the Seneca Nation must pay these excise taxes while the State of New York is exempt.

S. 1298 is a good bill. As I think the testimony of our panel has shown, the bill corrects long-standing injustices in our tax laws, and will provide substantial financial benefits to Indian tribes, at negligible cost to the U.S. Treasury. As I think these hearings also show, there simply is no opposition to the bill from any quarter.

I urge the Committee to report the bill favorably to the Senate.

Thank you.

Senator PACKWOOD. We will now move on to S. 2197, and we have Mr. Sigmund Zilber, the President of Metro Taxi Inc., of North Miami. He is speaking on behalf of the International Taxicab Association.

Mr. Zilber, go right ahead.

STATEMENT OF SIGMUND ZILBER, PRESIDENT, METRO TAXI, INC., MIAMI, FLA., ON BEHALF OF THE INTERNATIONAL TAXICAB ASSOCIATION

Mr. ZILBER. Thank you, Mr. Chairman. I am speaking this morning, representing the International Taxicab Association for which I serve as president this year. Our association represents about 55 percent of the taxicabs in the United States. We represent companies from one taxicab all the way up to the largest company, Yellow Cab of Chicago, with 2,100 cabs.

We are in favor of this bill. For the last 4 years we have been enjoying a gas rebate to the industry that has qualified. The reason we are in favor of S. 2197 is that we feel not only does it extend the rebate that we have had for the last 4 years but it also makes it easier for the paperwork for our industry and for the Treasury Department. To continue this rebate would mean an exemption now so that the forms that we have to fill out as an industry, and then mail back to Treasury and then Treasury has to verify and send back to us 2 or 3 months later, would be eliminated.

We also feel that keeping the rebate section of this bill in would help the individual owner and the small operators who buy gasoline at local gas stations. The large fleets, of course, buy gasoline through their own garages. They have their own service areas where gasoline is brought to them, but the smaller fleets and small individual owners buy gas on the street. Keeping the rebate section of the bill would allow them to save up their receipts and continue to qualify for this rebate.

I noticed when Treasury testified before that one of the things brought up was the exemption of not being able to have share-riding. To the best of our knowledge, through a survey we have made countrywide, there is only one community in America that forbids share-riding, and that is New York City.

Senator PACKWOOD. Would you say that again?

Mr. ZILBER. There is only one community in America, to the best of our knowledge, that forbids share-riding, and that is New York City.

Senator PACKWOOD. Do they forbid it, period, or is this with a consent situation?

Mr. ZILBER. They feel it is a safety factor. They don't want the cars stopping, because of the traffic in New York, and picking up more than one party at a time. That is the reason we were told by the New York Taxi Commission, why they have forbidden it for all these years.

Senator Moynihan is one of the cosponsors of this bill and he asked for that provision to be put in because he didn't feel that the taxicabs of New York City should be excluded from this rebate because of a local ordinance that they had no control over.

Our industry in the last 4 or 5 years has increased its share-ride tremendously. There is a new Urban Mass Transit Administration study of our industry that is just being completed, will be out in September. Some of the preliminary facts that we have learned from that study are:

Our industry now handles 40 percent of all total public passengers in America. That means that of all the people who use public transportation in America, 40 percent of them are carried by taxicabs.

There are over 20,000 small communities where there are no buses. There are taxicabs. There may be only one taxicab in that town, or maybe 2. That is the mass transit in those communities.

We have also learned from this new study that 56 percent of our industry is now doing contract work with either mass transit systems, local governments, State governments, welfare boards to handle what we call "group riding," shared-ride. A good portion of our business has now become contract business where we contract with a local agency to do their transportation needs for them. Most of that is shared-ride.

Our industry has progressed rapidly in the last 3 or 4 years into shared-ride—mostly through contract, though, not through street-hails.

Our industry feels that the rebate is needed for 2 reasons: One, our strongest competitor, which is the Intra-City Bus Systems, does get the rebate; they have been getting the rebate for years. We feel that if the bus systems have the tax rebate, we should be allowed to have the tax rebate also.

We are not users of the interstate highway system per se. Very seldom do you see taxicabs on the interstate highway systems outside of the urban area.

Taxicabs are a vital part of transportation in most communities. Most people feel that we are a service for the wealthy. That's not very true. Two-thirds of our business is the elderly, the handicapped, and the transportation-disadvantaged. Very few of what we call the wealthy people use taxicabs. The other third of our business is basically businessman- and tourist-related, but we are mostly transportation for the transportation-disadvantaged and the elderly.

We feel this tax exemption is needed for us. Our business is operating on very marginal profits right now. We are the only nonsubsidized transportation system in America. We feel that this exemption is needed. And, of course, if the present rebate were allowed to lapse without being extended, that could break some of the smaller companies, some of the marginal companies in America.

We do hope that you can pass S. 2197, but if it cannot be passed, that at least an extension of the existing rebate provision that we have had for 4 years, which Congress in its wisdom extended in 1980 for 2 more years, should again be extended for at least 2 more years.

If more information is needed from our industry, we can provide it to you.

I thank you for letting me appear here this morning. I appreciate it, and if there are any questions I would be glad to answer them for you.

[The prepared statement of Mr. Zilber follows:]

STATEMENT OF SIGMUND ZILBER ON BEHALF OF
THE INTERNATIONAL TAXICAB ASSOCIATION
BEFORE THE SENATE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
CONCERNING A LEGISLATIVE PROPOSAL RELATING TO
EXEMPTION OF TAXICABS FROM FUEL EXCISE TAXES

July 19, 1982

Mr. Chairman, my name is Sigmund Zilber. I am President of Metro Taxi, Inc., of Miami, Florida and President of the International Taxicab Association (ITA). I am appearing before you today on behalf of the Association, which is the sole trade association in the taxicab industry, representing taxicab operators in every state and in all major cities of the United States. The members of ITA own or control over half of the principal corporations which operate taxicabs in the United States.

I am here to give you the views of ITA on S.2197, a bill which would amend the Internal Revenue Code to make certain sales of fuel for use in a taxicab exempt from excise tax. The bill applies to sales of fuel for use in qualified taxicabs while engaged exclusively in specified transportation services.

ITA endorses this legislation. It is similar to and a logical extension of section 6427(e) of the Code. That provision was enacted in 1978, and it permitted a refund of the federal excise taxes on gasoline, diesel, and other fuels used in taxicabs. The provision is set to expire on December 31, 1982, and ITA endorses an extension of that date in the event that S. 2197 or similar legislation is not enacted into law.

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In order to obtain the refund under section 6427(e), it is necessary to pay the excise tax and then to file forms with the Internal Revenue Service. The IRS must then process the forms and send out a check. This is an extremely inefficient procedure, and it is particularly burdensome for the owners of small taxicab operations. S. 2197 would replace this cumbersome process by providing that the sale of fuel to taxicab owners would not be subjected to the tax in the first instance, thereby avoiding the costly and time-consuming effort involved in filing and processing refund claims and eliminating the administrative burden and expense to the IRS.

S. 2197 is fully compatible with the purpose of Congress when it enacted section 6427(e) in 1978. As the pertinent House report (for Public Law 95-599) states, taxicabs are the only available means of public transportation in many suburban areas and smaller towns; in other areas, taxicabs frequently compete with other forms of public transportation which are fully or partially exempt from the Federal fuel taxes. It was to encourage public transportation and to encourage the implementation of shared-ride systems and the purchase of fuel-efficient taxicabs, that Congress set up the present procedure for obtaining refunds of the 4 cents per gallon excise tax.

The exemption approach of S.2197 would fully carry out the congressional purpose behind section 6427(e), but in a more efficient manner. In fact, the bill would save money for the government because the time and expense of processing and refunding the excise tax would no longer be necessary. Moreover, the bill would enhance the ability of many small taxicab operations throughout the country to utilize their time in more productive ways.

In addition, S.2197 has certain favorable features which are not present in section 6427(e):

1. Ride-Sharing. The bill retains the ride-sharing requirement of section 6427(e), but with one significant modification. Under the refund provision, the sharing of rides, with the consent of passengers, must not be prohibited either by company policy or by the laws and regulations of a governmental body. Because of unique legal restrictions applicable in New York City, this provision has had the effect of excluding New York taxicabs from the benefits of the statute. This is an inherently unfair situation, and S. 2197 remedies the problem by deleting the reference to governmental prohibitions and requiring only that ride-sharing not be prohibited by company policy.

2. Fuel Economy. Under section 6427(e), there is a requirement that the fuel economy of the model type of the qualifying taxicab exceed the EPA economy standard for the model year. S. 2197 would not require, for purposes of the tax exemption, that taxicabs be held to the strict standard applicable to pleasure vehicles. The bill takes account of

the fact that taxis of necessity must be larger to accomodate luggage and to facilitate the transporting of groups of passengers, the latter being a particularly important consideration in view of the ride-sharing requirement of the legislation. Under the bill, the fuel economy of the model type of the qualifying taxicab would have to be at least 75 percent of the average fuel economy standard established by the EPA for the model year. This 75 percent test would still provide for fuel efficiency, while at the same time reflecting the realities of taxicab operations.

3. <u>Resales By Taxicab Companies</u>. The bill clarifies a matter which has been the subject of some confusion under section 6427(e). It is a common practice in the industry for taxicab companies to purchase fuel in bulk for the purpose of selling the fuel to the drivers to whom they lease their taxis. The application of the refund provision in this circumstance is not clearly spelled out in section 6427(e). S. 2197 eliminates the confusion by applying the exemption to sales of fuel both to taxicab drivers and to companies which purchase the fuel for resale to taxicab drivers.

Mr. Chairman, the use of taxicabs in intracity travel serves to limit substantially the number of private automobiles required, easing congestion and also reducing our national gasoline consumption. The legislation we are endorsing today serves to reduce the burdens on the Internal Revenue Service and on the taxicab industry. I respectfully urge speedy and favorable consideration of this bill.

Senator PACKWOOD. I am frankly surprised by the 40-percent figure. I am perfectly willing to accept it. I just had no idea, when I look at trains full of people and buses full of people, that taxis handled that portion of the people who use mass transit.

Mr. ZILBER. That is the figure that the UMTA study has come out with. There are so many communities in America that don't have any other type of transportation. In the urban areas, no, that is not a true figure. In New York City, that is not a true figure; in Baltimore, Washington, but you go to a lot of your small communities where there are no buses, taxicabs handle all the people who have to move around by any kind of public transportation. And there are lots of communities like that in America.

Senator PACKWOOD. Now I want to make sure I understand this. In New York you want to make sure that you can get the 4-cent exemption even though New York says no ride sharing because that's something beyond your control?

Mr. ZILBER. That's right. The companies do not forbid it, but it is a city ordinance right now that we have not been able to convince the city of New York to change.

Senator PACKWOOD. Thank you.

Sparky?

Senator MATSUNAGA. Thank you, Mr. Chairman.

Mr. Zilber, you heard the representative of the Treasury Department state that the Treasury was awaiting the industry's report on the fuel tax exemption. Are you preparing a report for the Treasury Department?

Mr. ZILBER. Senator, the way we read the original 1978 legislation, we were under the impression the Treasury was going to come to us because it said the Treasury was responsible to find out. We didn't realize that we were supposed to give them a report. We will have the urban mass transit report of our industry. It will be printed in September of this year. We will be glad to deliver it to Treasury with some other information from our industry showing how shared ride has grown in this country in the last 4 years.

Senator MATSUNAGA. Well, I think you ought to expedite that report to the Treasury Department.

Mr. ZILBER. Yes, sir.

Senator MATSUNAGA. I wish the Treasury spokesman Mr. McKee had remained to listen to your testimony; you brought out figures which the Treasury probably does not know. I think the part that the taxicab industry plays in public transportation is sorely underestimated. The sooner you submit the report to the Treasury, the better. And your report ought to include the statistics which you have given in your testimony today.

As you know, Mr. Zilber, the Congress is especially sensitive to potential revenue lost, just as the administration is, because of the budgetary constraints. Do you have any estimate of the revenue effect of the fuel tax exemption?

Mr. ZILBER. Senator, if every cab in the United States qualified, we surmise, my figure is that it would be around $20 million. From past experience we feel about half of the cabs would qualify for it, either by applying for it or getting it through the deduction. So we feel it would be somewhere between $10 and $12 million.

Senator MATSUNAGA. Between $10 and $12 million?

Mr. ZILBER. Yes, sir.

Senator MATSUNAGA. What is the impact of this provision on the finances of the operators?

Mr. ZILBER. Well, our industry like everybody else in this country in the last 2 years has had some very rough times. We have gone from 6,000 cab companies in 1973 down to 3,600 cab companies in this new report that is being finished right now. We feel that there are some marginal companies which, if the tax rebate is not continued and if another five cents tax is added on, will either have to go out to the public and get a meter rate increase through their local governments or go broke.

Senator MATSUNAGA. What would you say would be the benefit of the proposal to taxicab users; that is, the passengers?

Mr. ZILBER. Well, if we can keep our rates down to where people can afford them without having to raise them again, it certainly makes the taxicab more affordable to people. And again, because we are the only form of transportation to so many people in so many areas, we feel that we have to do everything we can to keep the taxicab at least affordable to most of the public. And this would help to keep the rates down.

Senator MATSUNAGA. Thank you very much.

Senator CHAFEE. Thank you very much, and we appreciate your testimony, Mr. Zilber.

Mr. ZILBER. Thank you.

Senator CHAFEE. Now, our final panel will consist of Mr. Storrs, Mr. Farrell, and Mr. Takabuki.

Mr. MORRIS. Senator Chafee, my name is William Morris. I am an attorney with the law firm of Reid & Priest, and I am here to introduce the panel this morning that is appearing on behalf of the Association of American Universities and the Kamehameha Schools from Honolulu, Hawaii.

I want to thank Senator Packwood, Senator Matsunaga and you, Senator Chafee, for holding these hearings and giving us an opportunity this morning to testify on this bill.

On my right is David Storrs, director of investments for Yale University; William Farrell, associate vice president for educational development and research, University of Iowa; and Mr. Matsuo Takabuki, trustee with the Kamehameha Schools, Bishop Estate, from Honolulu, Hawaii.

Senator CHAFEE. Well, I'm familiar with all your institutions. I am glad you are here.

Why don't you start off, Mr. Storrs?

We will put all of the statements in the record. You each have 5 minutes, so you can do as you wish with your statement, Mr. Storrs.

Mr. STORRS. Thank you, sir; I'll go through quickly.

STATEMENT OF DAVID K. STORRS, DIRECTOR OF INVESTMENTS, YALE UNIVERSITY, NEW HAVEN, CONN.

Mr. STORRS. Yale is an independent nonsectarian institution of higher education founded in 1701. We currently educate 5,100 undergraduate students and 4,800 graduate and professional students, both men and women in every department.

We have been under significant financial pressure in recent years which we anticipate will continue, in part as a result of present and contemplated cutbacks in Federal assistance to education.

We therefore are attempting to utilize as productively as possible all our financial resources, of which the largest is the university's endowment fund. That fund currently is worth $740 million, from which we draw about $40 million per year for income for the university budget. That is about 14 percent of the budget. Twelve years ago, by contrast, the endowment provided about 25 percent of our budget. The endowment supported, in other words, almost twice as much educational program.

The reason for this sharp decline is that returns on most endowment investments, for a number of reasons, have fallen far short of inflation. That has led us to diversify the portfolio into other areas, primarily real estate where we are seeking to purchase about $80 million. We currently own about $50 million of real estate, none of which has been leveraged through the use of mortgage debt.

The simple reason that we don't use any leverage is that the unrelated business income tax penalty caused by I. section 514, the subject of this amendment, in most cases causes the net return after tax on leveraged properties to be lower than the unleveraged return, even when the debt is economically favorable and appropriate to assume.

In my example, I cite a $20 million warehouse property on which we expect to earn a 16-percent return. That is the unleveraged return before any debt. If we could purchase that property with an assumable 15-percent mortgage of $10 million, we would only need to provide $10 million of university funds, and we would leverage Yale's return on its own equity investment to 17 percent because the interest rate on the debt is lower than the return on the property being purchased.

Because of the penalty tax, however, caused by section 514 the leveraged return, net of income tax, is lower than the unleveraged return and therefore we would not purchase this property with its existing debt.

In my example I show how the depreciation is an offset against cash income and how the penalty tax results in $161,000 of income tax on that property.

I attach to my statement a completed form 990T, which is the form used to report unrelated business income, showing the calculations, which I don't need to go into here.

A financially attractive investment decision is therefore made unattractive.

In the beginning the effect is not great, and in this case the penalty tax only reduces the return from 17 percent to 15.4 percent. As rents increase, however, and depreciation is used up, a larger and larger part of real estate income is taxed and the reduction in return increases very sharply.

Simply put, in year 16 on this same property the property would have been fully depreciated. The basis of the property would only be the land value, which would be $5 million; the debt would still be about $7 million; and, therefore, 100 percent of the income on this property would be taxable at corporate rates. The leveraged return of 17 percent would be reduced by the penalty tax to 9.2 percent.

The immediate consequence is therefore that universities will not purchase debt-financed properties because of the penalty tax. The second consequence is that when they do, universities will earn lower investment returns than other tax-exempt funds—primarily pension funds—and therefore will be driven out of the real estate market. We don't believe that was the intent of section 514 originally, which was to curb abuses. Those abuses are handled by Senate bill 2498.

The third consequence which we think is unfortunate is the serious reduction in the ability of universities to diversify their portfolio due to their inability to use mortgage indebtedness.

The Treasury arguments against this bill we think are totally inappropriate. The abuses, which they never present in the form of possible examples, we believe are totally cured by S. 2498. We believe that the argument that pension funds have stricter fiduciary standards than universities is incorrect. There are many laws relating to the investment of university investment funds.

We do not believe there was any congressional intent to, as the Treasury puts it, "put university investments under the same standards as other taxable investors." In fact, the history of the country has been exactly the contrary. As Senator Matsunaga pointed out, there has always been the belief that university investments should be tax-exempt as a social objective.

We believe that the argument that the Treasury makes, which is that this bill does not preclude leveraged real estate investments, is totally incorrect. We would never purchase properties with a 46-percent effective tax rate when we could purchase properties with no tax, such as stocks, bonds, and other investments.

We believe this does, contrary to the representation of the Treasury, impose a special tax on universities, and that's because other taxable entities can use the full amount of depreciation and interest deductions as an offset to their income whereas universities can only use the proportion of those deductions equal to the existing debt divided by the basis of the property.

We believe this bill corrects an existing inequity between investments of universities and other tax exempts. The correction results in no cost to the Treasury, because universities do not currently make debt-financed investments. And we therefore support the passage of this bill.

Senator CHAFEE. What do you say, Mr. Storrs, in answer to the argument that you yourself raise in page 3 of your testimony, where you say:

> The second consequence of this tax is that educational institutions will typically earn lower investment returns on real estate than will other tax-exempt funds, primarily retirement funds which are not assessed the penalty tax. If a pension fund will earn a net of 17 percent on a property and Yale will earn 15.4 percent, the pension fund can afford to pay 10 percent more than Yale for the identical property and we cannot compete effectively for investments.

It seemed to me, as I briefly looked over the Treasury's testimony, that what you are asking for is the compounding of something that Treasury seems to object to, namely that if Yale could do this, then the private investor is the one who is damaged; he is the one who cannot compete because you or the pension funds can afford to pay 10 percent more.

Mr. STORRS. Sir, I don't believe that problem would exist, and in fact taxable investors are greatly benefited by investments in real estate through the ability to shelter income. Universities which don't pay tax on their income have no need to shelter their income, and therefore to that extent real estate is less attractive to us than to taxable investors because they can use mortgages and they can use the tax shelter of depreciation for purposes which we cannot.

I would also cite the fact that if we have an existing property which we would like to improve, to the extent that we improve that property through borrowings, because often cash flow from a property is not sufficient to pay for capital improvements, we must pay tax on that income.

Senator CHAFEE. Is that the law now? Do you have to pay a capital gain when you sell it?

Mr. STORRS. Yes, sir, to the extent that it is debt-financed. And S. 2498 would correct that.

Senator CHAFEE. It would eliminate that?

Mr. STORRS. Yes, sir.

Senator CHAFEE. All right.

Mr. Farrell?

STATEMENT OF WILLIAM J. FARRELL, ASSOCIATE VICE PRESIDENT FOR EDUCATIONAL DEVELOPMENT AND RESEARCH AT THE UNIVERSITY OF IOWA

Mr. FARRELL. Thank you, Senator Chafee.

Mr. Storrs has talked about S. 2498 from the point of view of investment, and I would like to summarize a couple of points in my written statement with respect to the use of funds—use of gift funds—from the university's perspective.

First of all, going back to an earlier point that Senator Matsunaga made, because of the decline of Federal and State support today, both public and private institutions need to maximize private support for their institutions.

One great source of support would be mortgaged real estate, but the director of the University of Iowa Foundation tells me that he does not really seek such gifts, and I understand that most development officers do not either, primarily because of the unrelated business income tax on mortgaged real estate income.

So this could be a great source of support for all forms of higher education if indeed the penalty tax did not exist.

Second, we have difficulty in making the most flexible use of our gift revenue. Just to give you one brief example, recently, the University of Iowa Foundation purchased the office part of a building downtown. And they did so at the university's request because basically we needed the office space. We use six-sevenths of that building and the foundation rents out the remaining portion, and because the building is debt ridden, they must pay an unrelated business income tax from 20 to 30 percent on that income.

From the foundation's point of view, this would not be a favorable investment. So there is a tradeoff, really, between the need to meet some of the facility needs of the university on the one hand, and to make good investment decisions on the other.

The third point that I would like to make is that because of the penalty tax, we are not able, really, to invest in our own communities as well as we might. As my statement suggests, we now have 325 acres outside of a small city in Iowa, the city of Muscatine. In order to develop it, we would have to enter into contracts which would be debt-ridden. We are not inclined to do that, or the foundation is not inclined to do that, because there are possibly more favorable courses in the future. At the same time, the community is really losing what would be a great development opportunity.

So, from the point of view of the most flexible use of funds as well as from the point of view of the use of funds which would benefit the general area, we would find that removal of the unrelated business tax on mortgaged real estate a great benefit.

I would like to conclude by saying that we think S. 2498 makes a major leap here in meeting this problem while at the same time preventing some of the abuses which caused the current provisions to be put into effect.

Our principal concern, in a way, is that it does not go far enough. Many public universities, such as the University of Iowa, must rely on a private foundation to raise and to invest funds. We would not benefit from this particular piece of legislation in its present form, though we do support it because we think in principle it is the right thing to do. But we would like to see it expanded, really, to include public as well as private institutions, and that could be done, as I suggest, by including in S. 2498 tax-exempt organizations whose exclusive purpose is the support of public institutions of higher education owned or operated by a State or political subdivision thereof as defined at IRC section 170(b)(1)(A)(iv). We think in this way the bill would serve the greater higher educational community.

Senator CHAFEE. Thank you very much, Mr. Farrell, and that's a good point you make at the end there.

Mr. Takabuki?

STATEMENT OF MATSUO TAKABUKI, TRUSTEE, KAMEHAMEHA SCHOOLS/BERNICE P. BISHOP ESTATE, HONOLULU, HAWAII

Mr. TAKABUKI. Mr. Chairman, I am pleased to be here today. I want to thank you for this opportunity to appear before your subcommittee and for scheduling this hearing.

My name is Matsuo Takabuki. I am one of the five trustees of Kamehameha Schools/Bernice P. Bishop Estate.

In the interests of time I will skip some of the written testimony.

Senator CHAFEE. Well, I am sort of interested in that school. Years ago I was stationed in Hawaii and heard about the school.

As I understood, the original charter of the school provided that you had to have *x* percentage of Hawaiian blood in order to attend the school?

Mr. TAKABUKI. It is not a requirement; it is what we call a preferential admission policy, under which lineal descendents indicate they have some portion of Hawaiian blood. There is no minimum requirement.

Senator CHAFEE. I see. But they must be getting scarcer and scarcer, aren't they?

Mr. TAKABUKI. No; they are not. At Kamehameha Schools today, for each acceptance we have at least nine applicants. In other words, we have an acceptance rate of about 10 percent of the applications made to attend the school.

Senator CHAFEE. I know it is a great school, and I have heard a lot about it, but would that mean that all these applicants can trace themselves back to Princess Bernice?

Mr. TAKABUKI. No, not to Princess Bernice Pauahi Bishop. She is the benefactress of this trust.

Senator CHAFEE. But what is the requirement? Native blood, is that it?

Mr. TAKABUKI. The preference is for the indigenous people of Hawaii, the Native Americans of the United States, if you will.

Senator CHAFEE. Do you have to come in with a genealogy when you apply?

Mr. TAKABUKI. You do have to indicate that you have this preferential admission position.

Senator CHAFEE. What percentage of the admittees now qualify?

Mr. TAKABUKI. Well, you can conceivably have 1 percent Hawaiian blood, 10 percent Japanese, 20 percent Chinese, and 50 percent Caucasian. There is a cosmopolitan population mix in Hawaii. But the common denominator is really having "some," so an applicant can say he is a descendent of the native Hawaiian.

Senator CHAFEE. Do all of the admittees have to have this to qualify?

Mr. TAKABUKI. For preference purposes, yes.

Senator CHAFEE. I see.

Mr. TAKABUKI. Under the census classification, of course, if you say that a person is half or more of one particular ethnic blood, then in the instance of Kamehameha Schools you have many individuals with more Caucasian or more Japanese or more Chinese, or a mixture of these various ethnic ancestries.

Senator CHAFEE. Have you always had girls at the school?

Mr. TAKABUKI. Yes. The Princess' will provided for a school for boys and a school for girls. At that time it was intended to be two separate schools. It is now a coeducational single school.

Senator CHAFEE. Great. All right, why don't you proceed?

Mr. TAKABUKI. Mr. Chairman, I am here today to testify in support of S. 2498. S. 2498, as you are aware, would "amend the Internal Revenue Code to permit tax-exempt educational organizations to borrow money for the purpose of acquiring or improving real property without having to pay the unrelated business income tax on income derived from real property." Under present law, if a tax-exempt educational organization invests in debt-financed property, all or a portion of the income derived from such property is subject to the tax on unrelated business taxable income.

In 1969, the Congress adopted section 514(c), to prevent certain abuses in the *Clay Brown* case, where a taxable corporation was permitted to convert ordinary income into capital gain and a tax-exempt organization eventually acquired the assets of the taxable corporation without any out-of-pocket cost.

S. 2498 contains a number of precisely worded safeguards to prevent the pre-1969 abuses from recurring. S. 2498 would permit tax-exempt educational organizations, if the safeguard requirements are complied with, to finance real property acquisitions and improvements without being subject to the tax on unrelated business taxable income.

Today, more than ever before, many educational organizations are facing a tremendous shortage of funds. This is a result of many factors, not the least of which are the state of our economy and the cutback of many Federal programs. S. 2498 provides a means whereby tax-exempt educational organizations can attempt to meet their own funding needs while still providing protection against the abuses which have occurred in the past.

In considering this legislation it is important to note that the holding and improvement of real estate for the purpose of deriving rental income is not considered an unrelated trade or business for tax-exempt educational organizations. Rental income is generally not taxable as unrelated business taxable income for organizations which are exempt from taxation under section 501(c)(3). The major exception to this rule is for real property financed through borrowing.

Apparently, the concern is not with the ownership of real estate, per se, but with the potential abuses that may occur when the property is financed through borrowing. S. 2498 provides safeguards to avoid past abuses. It also permits debt financing for real property acquisitions and improvements which are otherwise acceptable activities.

I respectfully submit that S. 2498 strikes the necessary balance between the need of educational organizations to finance their legitimate educational activities and the need of the public to be protected against the abusive use of the tax laws.

It should also be noted that this legislation would provide for a more balanced investment portfolio for tax-exempt educational organizations. We are all aware that prudent investment calls for diversification of an investment portfolio. This is especially true for fiduciaries of tax-exempt organizations. An important element in any diversified portfolio is investment in real estate; however, current law severely restricts investment in real estate by tax-exempt educational organizations. Such investments require a very substantial proportion of the available cash of such organizations to be committed to real estate.

If money is borrowed, the return on investment is decreased because a portion of the rents received will become taxable as unrelated business income. Enactment of S. 2498 would correct this problem. It would permit tax-exempt educational organizations to invest a prudent portion of their portfolio in productive, income-producing real estate investments.

In the case of Kamehameha Schools the potential imposition of this tax impedes our efforts to fund a broad range of educational services to the children of Hawaii. We simply must defer or not undertake many important programs because our income cannot be increased quickly enough through more rapid development of our income-producing properties. We are unable to totally finance all of the development projects we could be undertaking to generate the income needed for the expansion of our educational programs without debt financing as permitted under S. 2498.

Lastly, I would like to note, in Public Law 96-605 enacted in 1980, qualified retirement trusts were provided with the opportunity to invest in debt-financed property without being subject to the tax on unrelated business income. The safeguards contained in S. 2498 are identical to those currently in effect with respect to qualified retirement trusts.

If I may, Mr. Chairman—I know my time is up—I would like to comment just briefly on the distinction made by the Treasury regarding qualified pension funds and educational institutions and other section 501(c)(3) organizations.

Senator CHAFEE. Go ahead. Fine.

Mr. TAKABUKI. The distinction, drawn by the Treasury was that pension fund represents an accumulation of funds for future pension payments to beneficiaries in contrast to a tax-exempt educational organization which is a materially different entity.

The purpose for exemption under section 501(c)(3) is the performance of a socially desirable purpose. I think, as Senator Matsunaga pointed out, educational organizations covered under this proposed legislation perform a function that is extremely important for this country—permitting the country to perpetuate itself and to educate its populace.

The Treasury Department has attempted to say that somehow or other pension funds have a higher fiduciary duty than the fiduciaries—trustees or directors—of the universities and schools.

Now, I challenge this statement. I think the fiduciary duty is just as great or greater on those who are responsible for promoting the educational activities of this country than on those who are responsible for the management and custody of pension funds.

The second distinction drawn concerning pension funds, was that somehow the exemption for educational institutions under S. 2498 provides a permanent exemption as compared to a deferral of tax for pension funds. The Treasury seems to say that once the distribution of the pension funds to the beneficiary occurs, it becomes taxable; and if the funds go to an educational institution it is never taxable. In both cases, the first accumulation of funds is not taxable.

In the case of schools however, the use of the funds for educational purposes includes the payment of wages and salaries for teachers, which is probably the biggest portion of the budget, for janitorial and support services, and for books and supplies. All these funds go out to taxable persons, also. I don't see any distinction.

Senator CHAFEE. Well, what do you say, then, about Treasury's point that once you do this for schools then what about hospitals? Where does this end under 501(c)(3)?

Mr. TAKABUKI. I have absolutely no objections to expanding this to all 501(c)(3) organizations.

Senator CHAFEE. Is that what the rest of you gentlemen say? Mr. Storrs?

Mr. STORRS. I don't believe we would have any objection to that.

Senator CHAFEE. Mr. Farrell?

Mr. FARRELL. None at all.

Senator CHAFEE. I was not here for Treasury's testimony. They say, "We would be pleased to join the subcommittee, but we oppose piecemeal repeal of this provision." Do any of you recall what Treasury said about the loss of revenue just under this?

Mr. MORRIS. Senator Chafee, they did not provide a revenue estimate. It is our understanding that it is relatively small, somewhere in the neighborhood of about $10 million.

Senator CHAFEE. I take it that their objections are more to a policing factor than a revenue factor.

Mr. MORRIS. That is one of their basic concerns. But in response to your question about the broadening of the provision, we structured S. 2498 to provide a limited exception to comport with the Congress traditional method of dealing with these kinds of provisions. Traditionally the Congress limits relief to the known problems and does not open up a provision to the world, where there is no possibility of foreseeing the various transactions that may occur in the future.

Senator CHAFEE. But I can't believe that the hospitals aren't going to be in here very quickly. They deal with not as substantial sums as the great universities, but in each city and each community I suppose the hospitals are dealing with as large endowments, or somewhat close to it, as many of the privately supported colleges.

Mr. MORRIS. And we would have no objection to covering them, but we think that a specific case should be made for the appropriateness of extending the exemption to any other entities.

Senator CHAFEE. Senator Matsunaga, I know you have been deeply involved in this. Do you want to ask any questions?

Senator MATSUNAGA. Well, thank you, Mr. Chairman.

First of all, I wish to commend you three gentlemen for your testimonies. I only wish we had the Treasury Department here to listen to you.

Is there anyone here representing the Department of Treasury?

[No response.]

Senator MATSUNAGA. No one, unfortunately. I wish they were here to listen to you, particularly with reference to abuse, which all of you covered, at section 514. It was not to reduce investment returns of universities by taxation, as you all pointed out, or to encourage different investment behavior by universities, but to curb abuses. And as you well know, S. 2498 provides for curbing the abuses.

Mr. Storrs, you did give some figures here relative to the rate of return for real estate investments made by an educational institution in comparison to real estate investments made by a tax-exempt pension plan. I believe that was on page 3.

Now, would you say that the lesser rate of return for leveraged property is due solely to the penalty tax?

Mr. STORRS. In this example, sir, it is the effect of the penalty tax.

Senator MATSUNAGA. It is? All right.

Mr. STORRS. The tax becomes much larger. In the example I gave, in the 16th year, the penalty tax would have reduced the return from 17 percent per year to 9.2 percent per year. So that spread becomes larger and larger—the cost of that penalty tax.

Senator MATSUNAGA. So the penalty tax does amount to a considerable sum.

Mr. STORRS. It amounts to a great deal. And the especially unfortunate aspect is that real estate, over the last 12 years has had an average return of 18 percent compared to stocks which have had an average return of 8 percent per year. When you put a 46-percent tax on even such a wide spread as that, you effectively foreclose yourself from that market, especially with what I think you have to interpret as a congressional disapprobation of entering into "unrelated" areas. We don't believe it is an unrelated investment area to purchase real estate with or without debt, especially since that's the only investment vehicle which carries with it and supports its own purchase indebtedness.

Senator MATSUNAGA. Mr. Farrell, I am glad you are here to represent a State land-grant university. My question to you: Is your problem with the debt acquisition rule shared by other public institutions?

Mr. FARRELL. Yes; most public universities have private foundations, both to raise funds and to invest, generally because under State law, a university would not be permitted to retain assets beyond the fiscal year. So, in effect, these separate entities are really our development office. In the private university, they might well be just part of the operation of the university. But this would be a common pattern in public institutions.

Senator MATSUNAGA. So your proposal is that the public institutions be included in S. 2498?

Mr. FARRELL. Right. And I suggested some specific language which I think would greatly control who would be admitted.

Senator MATSUNAGA. Is there any objection on the part of Mr. Storrs or Mr. Takabuki to the language proposed by Mr. Farrell?

Mr. TAKABUKI. None whatsoever.

Mr. STORRS. None, except that there might be some minor modifications which would accomplish the same essential purpose and include support organizations of private institutions of higher education also.

Senator MATSUNAGA. Do you have that minor change, Mr. Morris?

Mr. MORRIS. Yes, we will supply that, sir.

Senator MATSUNAGA. All right.

Mr. MORRIS. Senator, I think Mr. Storrs has one other comment to make to your first question.

Senator MATSUNAGA. All right. Go ahead.

Mr. STORRS. You asked about the effect of the penalty tax, and I wanted to make clear that the effect of the penalty tax and the reason it increases is that the portion of income on real estate which is subject to the tax increases steadily, and it works out that in about the 11th year, 100 percent of the income is taxable. And this is the reason why the net return declines continuously to that lower level. That is unlike any other form of investment—stocks, bonds, C.D.'s, et cetera—which we make, on which there is no tax at any time.

Senator CHAFEE. Now, let's see—that declines because you have used up your depreciation?

Mr. STORRS. Yes, sir, because the debt in place declines very slowly over time. Typically, mortgage indebtedness is a 25- or 30-year loan, so over, let's say, an 11-year period it would only decline about 30 percent. Well, over an 11-year period, with the new 15-year depreciation rules, you would have written off enough of your property so that the debt in place at that time would equal 100 percent of the depreciated basis of the property, and since that's the basis for the income calculation, 100 percent would be taxable.

Mr. MORRIS. Senator, if I might add to that, the way in which that tax works is really perverse. If on day-one, you buy the property and you have a debt which is equal to 50 percent of the cost of the property, 50 percent of the income will be subject to the penalty tax. After 10 years, as Mr. Storrs has pointed out, as your basis has declined, 100 percent of your income will be subject to tax. The only thing you have done under the statute, which is penalized, is that you have mortgaged the property in year-one, and half of your income is initially subject to tax. The way this penalty tax works, several years down the road, the tax applies to a larger and larger portion of the income from the property until it is fully taxable.

Senator MATSUNAGA. Mr. Takabuki, I wish to commend you, and Mr. Thompson, another trustee who is present here, and the other trustees, for the work which you trustees have done to carry on the educational program at Kamehameha School for Boys and Girls. I think the world doesn't know much about your Bishop Estate and Kamehameha Schools. I am glad that the acting chairman, Senator Chafee, knew something about the Bishop Estate and the Kamehameha Schools.

You have been of the forefront on the fight for this particular bill, and I think your efforts will result in benefits to other institutions, private and public as well. I think you deserve the recognition.

Mr. TAKABUKI. Senator, we appreciate your support. We think this bill will be extremely beneficial to all educational institutions, and also, if you wish to expand it, to all other section 501(c)(3) organizations.

In real estate, of course, one of the things that make it extremely difficult, as compared to stocks and bonds, is that you can buy stocks and bonds in multiples of $1,000. You can't buy any worthwhile real estate unless it is a pretty substantial purchase. In order to make a real estate transaction viable, you may be looking at a $10-$20-$30 million transaction. If that kind of cash is required, without debt financing, it makes it extremely difficult for any public institution to commit itself to a real estate investment.

Senator CHAFEE. What do you say about the concern that once you open the door and you say, all right, take all the 501(c)(3) corporations? I don't think hospitals compare in wealth, say, to churches. Now, what is that going to do to the private investor and his ability to compete—the taxpaying investor—when he is competing against the massive onslaught of 501(c)(3) corporations investing in real estate?

Mr. TAKABUKI. Well, Senator Chafee, I don't want to be misunderstood, but we came here specifically——

Senator CHAFEE. Oh, I know. But this is the very point that Treasury itself raised.

Mr. TAKABUKI. The position Treasury takes is that if we are going to do this for educational institutions, we should expand it to all other 501(c)(3) organizations.

In the private sector, as far as real estate is concerned, it is the private taxable sector that talks in terms of a real estate investment. It represents an investment where a taxpayer can shelter a great deal of income in the initial first 10 years—where there are substantial deductions for depreciation and interest payments on the mortgage—and there may be a substantial cash flow. As distinguished from a stock and bond portfolio, a real estate investment has the tax-shelter aspect for the taxable entity.

Under this legislation we are not asking for greater deductions for interest and depreciation; we are asking that the penalty tax be removed so that, as the years go by, tax-exempt educational organizations do not find themselves subject to an increasing penalty as depreciation reduces the property's basis.

Senator CHAFEE. I appreciate that. I am not arguing with that point, and that, of course, is the point Mr. Storrs made. I guess what I really worry about is what we are doing to the private investor who is competing. Now, you will say they are tax shelters.

I suppose the other side of the argument also is that if we have given this to qualified retirement trusts, the amounts of money that they represent are probably far in excess of all the private charities in the country put together.

Mr. TAKABUKI. Pension funds are able to achieve an accumulation of funds, Senator Chafee. Generally, an educational institution must use most, if not all of its income for educational purposes in the year it receives that income or the following year. Educational organizations don't have a chance to accumulate income because it is utilized immediately.

Senator CHAFEE. Yes.

What would you say if there was a limitation in here to *X* percent of your portfolio?

Mr. TAKABUKI. This would cause a problem for trusts in which land represents the original assets transferred to the trust.

Senator CHAFEE. What do you say to that, Mr. Storrs?

Mr. STORRS. In Europe, typically, funds are much more heavily invested in real estate than they are in this country. Typically, about 25 percent of a long-term fund is in real estate.

Senator CHAFEE. In 501(c)(3) counterparts?

Mr. STORRS. Yes, sir.

In this country about one-half of 1 percent of educational endowment funds are in real estate. I would think that, no matter what happened in the foreseeable future, universities as a group would not put more than about 5 percent of their assets in real estate; leveraged or not. That means about $1½ billion.

Now, pension funds are $800 billion. So it seems to me that it is almost a nonissue with respect to the capital markets and the effects on private capital investors.

Senator CHAFEE. Because the retirement trusts are in it already?

Mr. STORRS. Yes, sir, very heavily.

Mr. TAKABUKI. Senator Chafee, if I may just state, in terms of a limitation of real estate for an educational institution, in the case of the Bishop Estate/Kamehameha Schools the original legacy is real estate, we would have some serious problems under those circumstances.

Senator CHAFEE. This has nothing to do with the overall questions, but how many students do you have in the schools?

Mr. TAKABUKI. We have two kinds of programs: The oncampus program which has about 2,700 students from K through 12.

Senator CHAFEE. 2,700?

Mr. TAKABUKI. 2,700.

Senator CHAFEE. That must be the largest private school in the United States.

Mr. TAKABUKI. Besides that we have what we call the extension program, in which we are undertaking research and development of the educational process in our Kamehameha early education program and other programs of that nature in which the application of our research can be applied to the public schools. That is one aspect of what we call our KERI program—Kamehameha Educational Research Institute.

The third is our extension program in which we participate with the public schools for alienated children in various areas. We have one on the Island of Hawaii near the city of Refuge. We have another at Molokai. We have others on Kauai and Maui. We work together with the public institutions for particular alienated-children problems.

And we have summer fun programs in which Hawaiian culture is taught, and this is given to all students who qualify.

Now, if we include this part of the school—that's the reason I make the distinction between oncampus and offcampus programs.

Senator CHAFEE. How many boarders do you have out of the 2,700?

Mr. TAKABUKI. At the present time boarders from 7 to 12 are children from the neighbor islands of Maui, Kauai, Molokai, and Hawaii. We have about 800, I would say—600 to 800 students.

Senator CHAFEE. You are really running a big operation; no question about it.

Mr. TAKABUKI. An expensive operation, Senator Chafee, where it involves boarding students.

Senator CHAFEE. Well, you have got a great reputation, and some of them attend Mr. Storrs' institution.

Senator MATSUNAGA. That's true, as compared to graduates of the public schools the graduates of Kamehameha schools on the average do much better, which is a good indication of what the institution really could do if it had additional funds such as we now take away by way of penalty.

Senator CHAFEE. Well, I think Mr. Takabuki is indicating that what they are attempting to do is to raise the public schools as well.

Mr. TAKABUKI. That's part of it, because, you see, you were just talking about the common denominator of part-Hawaiian students. Kamehameha takes care of merely 4 percent of the qualified group of school children. There is 2 percent who go to other private schools, but 94 percent of part Hawaiian children are in the public schools, and we have an obligation to them.

Senator CHAFEE. I agree with that.

[The prepared statements of the previous panel follow:]

STATEMENT OF DAVID K. STORRS
DIRECTOR OF INVESTMENTS
YALE UNIVERSITY, NEW HAVEN, CONNECTICUT

Before the Subcommittee on Taxation and Debt Management
Committee on Finance
July 19, 1982

Mr. Chairman, members of the Committee, thank you for the opportunity to explain to you why Yale believes Senate Bill 2498 is an appropriate amendment to the Internal Revenue Code.

Yale University is an independent, non-sectarian institution of higher education founded in 1701. We currently educate about 5,100 undergraduate students and about 4,800 graduate and professional students in eleven programs. Yale educates both men and women in all its academic departments.

Like many universities, Yale has been financially pressed in recent years. We anticipate that financial stringency will continue for the foreseeable future. A part of this financial stringency arises from actual and contemplated cutbacks in federal assistance to education in the form of grants and loans.

We attempt to utilize as productively as possible our financial resources, including Yale's endowment. The endowment, which is made up of capital gifts over many years, is currently worth about $740 million. We draw from that each year about $40 million, or about 14% of the University budget. In 1970, by contrast, the endowment supported 25% of Yale's budget.

The reason for this sharp decline is that returns on endowment investments, primarily stock and bond investments, have, for many reasons, fallen far short of inflation. We have concluded that we should significantly diversify the portfolio into a number of other investment areas, of which real estate is the largest. Our objective is to purchase about $80 million of real estate. We have purchased properties currently worth about $50 million over the last three years. We have not assumed or incurred mortgage debt to leverage our investments.

The simple reason we have not used leverage in our investment program is that the unrelated business income tax penalty caused by Section 514 of the Code typically causes the net return after tax on leveraged properties to be lower than the unleveraged return, even if the leverage is economically favorable.

As an example, consider a $20 million warehouse property on which Yale expected to earn, in the form of rental income net of expenses, 16% per year. This is the unleveraged return.

If that property had an existing assumable 15% mortgage of $10 million, Yale would only need to provide $10 million of equity. The return on Yale's equity would be 17%, as follows:

Gross return (16% on $20 million)	$3.20 million
Interest (15% on $10 million)	$1.50 "
Net cash flow	$1.70 "
Return on $10 million Yale equity	17%

The interest rate is less than the property return, and the economics of buying the property leveraged are clearly better than the economics of buying the property unleveraged.

The penalty tax caused by Section 514, however, lowers the return to 15.4%, as follows:

Gross return	$3.20 million
Interest	$1.50 "
Net cash flow	$1.70 "
Depreciation (75% [assume 25% of value in land] x $20 million over 15 years)	$1.00 "
Net income	$ .70 "
Taxable income (50% of net income)	$ .35 "
Tax (46% of taxable income)	$ .16 "
Net return to Yale (net cash flow minus tax)	$1.54 "
Return on $10 million Yale equity	15.4%

The return on the unleveraged property itself is 16%, the return on the property with its existing financing is 17%, but the return to Yale after paying unrelated business income tax is 15.4%. A financially attractive investment decision, to assume the existing favorable mortgage, is made unattractive by the resulting tax obligation.

Because depreciation and interest reduce taxable income, the effect of the penalty tax is, while significant, not great initially. As rents increase, depreciation is used up and a decreasing portion of loan payments is allocated to interest, a larger and larger portion of real estate income is taxes, and the reduction in return (in this example the drop from 17% to 15.4%) caused by the penalty tax increases steadily.

The immediate effect of the penalty tax is that those universities which choose not to engage in any endeavors unrelated to their educational purpose, whether on the basis of an inferred Congressional disapprobation or for other reasons, will, of course, be totally foreclosed from all leveraged investments, whatever the after-tax return may be. The harmless activity of real estate investment, and not abuses relating to real estate investment, is therefore proscribed by Section 514 for such universities.

The second consequence of this tax is that educational institutions will typically earn lower investment returns on real estate than will other tax-exempt funds, primarily retirement funds, which are not assessed the penalty tax. If a pension fund will earn a net of 17% on a property and Yale will earn 15.4%, the pension fund can afford to pay 10% more than Yale for the identical property and we cannot compete effectively for investments. Especially given that retirement funds assets of about $800 billion dwarf the $30 billion of endowment funds, we see no need to discriminate in this manner against universities and colleges. The intent of Section 514 was not to reduce investment returns of universities by taxation or to encourage different investment behavior by universities, but to curb abuses. Those abuses are handled by S.2498.

The third undesirable consequence of this tax is to reduce the ability of universities to diversify their investment portfolio. If, for instance, a university wants real estate to be no more than 10% of its portfolio through investments of at least $5 million each, and if it needs eight properties for a reasonable level of diversification and to justify the management staff required of such a program, it must have a total fund of $400 million. There are only about ten universities in the country with a $400 million endowment which could gain this minimum level of diversification. Smaller universities would be required to invest their real estate portfolio through partnerships, real estate investment trusts, and other vehicles which are typically both illiquid and not controllable by the institution. If 75% financing could be utilized, on the other hand, universities one quarter as large, or $100 million, could have direct real estate investment programs and resulting greater liquidity.

The $20 million investment I cite above, for example, would be too large for Yale. Using existing financing would put it within our guidelines. The fact is that the penalty tax, by discouraging use of leverage, typically makes universities

1) less able to invest in real estate, 2) less diversified in their portfolio, and 3) less liquid in their investments than would otherwise be the case.

Section 514 was originally written to curb actual abuses by tax-exempt organizations. Those abuses are prevented by the five exceptions enumerated in S.2498 and also, with respect to qualified pension trusts, in existing P.L. 96-605 (the Miscellaneous Revenue Act of 1980). The result of continuing Section 514 in its present, unamended form, is therefore to prevent not abuse by tax exempt organizations, but proper investments in a market, real estate, which has provided and we expect will provide attractive investment returns. S.2498 would permit universities to use more prudently the donated endowment funds entrusted to them in perpetuity by stabilizing and increasing the return on those funds at no cost to the Treasury.

I am not here to ask that universities receive federal subsidies or exemptions from any law, but simply that tax-exempt entities be treated in a manner which does not systematically change their investment opportunities to the detriment of present and future students. I believe S.2498 prevents the abuses originally targeted by Section 514, and eliminates the existing, unintended effect of Section 514 by taxation to discourage universities from making otherwise attractive investments.

Thank you for your consideration.

STATEMENT
of
William J. Farrell

Associate Vice President for
Educational Development and Research

at The University of Iowa

Mr. Chairman and Members of the Subcommittee, my name is William J. Farrell, and I am the Associate Vice President for Educational Development and Research at The University of Iowa. I am testifying today on behalf of the American Association of Universities regarding the unrelated business income tax imposed on the "debt-financed" real estate income of educational institutions.

In 1969, Congress took steps to prevent exempt organizations--including universities--from using tax benefits to pay for the acquisition of operating businesses. The tax-reform act of that year properly brought to an end tax-sham transactions that had no legitimate reason to exist. In the process of accomplishing this reasonable goal, however, it also prevented justifiable investments in debt-financed real estate for such organizations. This has created at least three serious disadvantages for institutions of higher learning.

Because of the penalty tax on debt-ridden real estate, an important source of private gift support is lost to colleges and universities. The director of our University Foundation informs me that his organization makes little or no effort to seek out mortgaged properties as contributions to our University. His practice is commonplace in the country today, even though most development officers regard mortgaged real estate as a potentially major form of assistance. In these days of declining public assistance on both the federal and state level, it is important that every reasonable encouragement is given to both institutions and contributors to increase private, voluntary support to higher education. A significant way in which that encouragement could be granted would be to abolish the unrelated business income tax on debt-financed real estate for universities and colleges.

In the past, this tax has not only restricted private sources of support for institutions of higher education, but it has also discouraged their use of gift revenue in the most flexible and productive ways. Let me give you a couple of examples. In recent years, at the request of the University, the UI Foundation purchased the office section of a large building in downtown Iowa City. Approximately six out of seven offices in this building are used by the University for its own purposes. Nonetheless, under current law, the University of Iowa Foundation had to pay 20 to 30 percent of its net income on the remaining seventh as "unrelated business income tax." A claim for refund was denied by the Internal Revenue Service, because the facility was debt-financed. While the Foundation undertook this course of action in this case, it did so at a real loss to its income, considering other investment alternatives. Sometimes this lack of flexibility in using gift resources for mortgaged real estate results in the abandonment of worthwhile projects. One of the reasons why the UI Foundation was discouraged from undertaking a program to provide housing for young faculty, for example, was precisely because of the penalty tax on debt-ridden property income.

In addition to limiting the universities and colleges in meeting their own needs with gift resources, the current law also restricts the efforts of educational institutions to serve the investment needs of communities in their area. In the recent past, for example, the

University of Iowa Foundation received a gift of 325 acres of land near the city of Muscatine. In the present economy, the Foundation would need to become involved in the development of this land to affect a sale, and, in so doing, it would have to undertake debt-ridden financing. Such real estate investments could greatly serve the interests of both the Foundation and the community. The current tax provisions of debt-financed investments for public charities diminish the incentives of pursuing this course, however. As a result, disposal of this property may have to await other economic conditions and the opportunity for an important development effort in an Iowa community will be lost.

It is our belief that Congress would help both higher education and the general economy by exempting educational organizations and affiliate foundations from the tax provisions that discourage debt-financed investments. Senator Matsunaga's bill, S. 2498, would be a major step toward accomplishing this goal, and it would do so without sacrificing the original legitimate objectives of the current law. In fact, the bill would simply extend to educational institutions an exemption that was granted to tax-exempt pension trusts in 1980. The measure is right in principle, and on that basis alone it has our unqualified support.

Our chief concern is, in its present form, S. 2498 provides the desired benefits only to some educational institutions. Many publicly assisted universities, including The University of Iowa, must rely for practical purposes on an independent private foundation to secure and to invest private contributions. About half of our revenue at The University of Iowa comes from non-state sources, and the UI Foundation plays an important role in contributing to that source. It would be extremely limiting, therefore, to provide the benefits of exemption solely to those educational institutions that directly receive and invest gift revenues on a long-term basis. It is our hope that, when and if S. 2498 is reported out of this subcommittee, it will exclude "debt-financed" real estate income from unrelated business income tax, not only for educational institutions, but also for their fund-raising and investment affiliate organizations as well. Specifically, we would seek the inclusion in S.2498 of tax-exempt organizations whose exclusive purpose is the support of public institutions of higher education, owned or operated by a state or political subdivision thereof, as defined at IRC Section 170 (b)(1)(A)(iv). In this way, S. 2498 will serve the greater higher educational community and not simply a portion of it. Thank you.

SUMMARY OF
STATEMENT OF
MATSUO TAKABUKI
TRUSTEE,
KAMEHAMEHA SCHOOLS/BERNICE P. BISHOP ESTATE
HONOLULU, HAWAII
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
JULY 19, 1982
ON
S. 2498

1. S. 2498 would amend the Internal Revenue Code to permit qualified tax-exempt educational organizations to borrow money for the purpose of acquiring or improving real property without being subject to the tax on unrelated business taxable income on income derived from real property.

2. The provision of law (Section 514(c)) which treats income derived from debt-financed property as unrelated business taxable income was originally enacted in 1950 and broadened by the Tax Reform Act of 1969 to prevent the abusive use of tax-exempt status in the acquisition of debt-financed property (i.e., so-called "sham transactions").

3. S. 2498 contains a series of precisely worded safeguards to prevent the abusive use of tax-exemption in the case of debt-financed real property.

4. Based on the safeguards provided and Congressional approval of a provision permitting qualified pension trusts to invest in debt-financed property without being subject to the tax on unrelated business taxable income on income derived from real property it is entirely appropriate to extend such treatment to qualified educational organizations as provided in S. 2498.

STATEMENT OF
MATSUO TAKABUKI
TRUSTEE,
KAMEHAMEHA SCHOOLS/BERNICE P. BISHOP ESTATE
HONOLULU, HAWAII
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
JULY 19, 1982
ON
S. 2498

Mr. Chairman, I am pleased to be here today and want to take this opportunity to thank you for scheduling this hearing on S. 2498. My name is Matsuo Takabuki. I am a trustee of the Kamehameha Schools/Bernice P. Bishop Estate, Honolulu, Hawaii. The Kamehameha Schools were established under the Last Will and Testament of Princess Bernice Pauahi Bishop, the great-granddaughter of King Kamehameha I. The trustees of her estate were instructed "to erect and maintain in the Hawaiian Islands two schools . . . one for boys and one for girls, to be known as . . . The Kamehameha Schools." The Schools were to provide for the education of native Hawaiian children. The Schools were first opened in 1887 and have been in continuous operation since that date. The legacy to provide for the operation of the Schools were the lands owned by the Princess at the time of her death. These lands represent approximately 10 percent of the land area of the state of Hawaii. Approximately 2 percent of these lands provide most of the revenues for the operation of the Schools.

The remaining 98 percent of the lands are used for agriculture, conservation, and watershed.

I am here today to testify in support of S. 2498 sponsored by Senators Matsunaga, Durenberger, Moynihan and Bentsen.

S. 2498 would amend the Internal Revenue Code to permit tax-exempt educational organizations to borrow money for the purpose of acquiring or improving real property without having to pay unrelated business income tax on income derived from real property. Under present law if a tax-exempt educational organization invests in debt-financed property, all or a portion of the income derived from such property is subject to the tax on unrelated business taxable income.

The provision of law (§514(c)) requiring the taxation of such income was originally enacted in 1950. It was broadened by the Tax Reform Act of 1969. Both the original legislation as well as the 1969 amendments were designed to discourage certain abuses of tax-exempt status. Specifically, the 1969 legislation was intended to prevent sham transactions in which taxable organizations sold assets to a tax-exempt organization at an inflated price and then leased the assets back to the seller. The earnings of the business were used by the seller to meet scheduled rental payments. The tax-exempt organization then returned these funds to the seller as payment for the assets "purchased." In this way, the seller (1) deducted the rental payments as a business expense and (2) upon receipt of purchase payments from the tax-exempt organization, treated them as capital gain. This type of arrangement permitted a taxable corporation to convert ordinary income into capital gain and permitted the tax-exempt organization to eventually acquire assets without any out-of-pocket cost.

S. 2498 contains a number of precisely worded safeguards to prevent the pre-1969 abuses from recurring. S. 2498 would permit tax-exempt educational organizations, if the safeguard requirements are complied with, to finance real property acquisitions and improvements without being subject to the tax on unrelated business taxable income on the income derived from the real property.

Today, more than ever before, many educational organizations are facing a tremendous shortage of funds. This is a result of many factors, not the least of which are the state of our economy and the cutback of many Federal programs. S. 2498 provides a means whereby tax-exempt educational organizations can attempt to meet their own funding needs while still providing protection against the abuses which have occurred in the past.

In considering this legislation, it is important to note that the holding and improvement of real estate for the purpose of deriving rental income is not considered an unrelated trade or business for tax-exempt educational organizations. Rental income is generally not taxable as unrelated business taxable income for organizations which are exempt from taxation under section 501(c)(3) of the Code. The major exception to this rule is for real property financed through borrowing. Apparently, the concern is not with the ownership of real estate, per se, but with potential abuses that may occur when property is financed through borrowing. S. 2498 provides safeguards to avoid past abuses. It also permits debt financing for real property acquisitions and improvements which are otherwise acceptable activities. I respectfully submit that S. 2498 strikes the necessary balance between the need of educational organizations to finance their legitimate activities, and the need of the public to be protected against abusive use of the tax laws.

It should also be noted that this legislation will promote more balanced investment portfolios for tax-exempt educational organizations. We are all aware that prudent investment calls for diversification of an investment portfolio. This is especially true for fiduciaries of tax-exempt organizations. An important element in any diversified portfolio is investment in real estate.

However, current law severely restricts investment in real estate by tax-exempt educational organizations. Such investments require a very substantial proportion of assets to be committed to real estate. If money is borrowed, the return on investment is decreased because a portion of the rents received will become taxable as unrelated business taxable income. Enactment of S. 2498 would correct this problem. It would permit tax-exempt educational organizations to invest a prudent portion of their portfolio in productive real estate investments.

In the case of the Kamehameha Schools the potential imposition of this tax impedes our effort to fund a broad range of educational services to the children of Hawaii. We simply must defer or not undertake many important programs because our income cannot be increased quickly enough through more rapid development of our income producing properties. We are unable to totally finance all of the development projects we could be undertaking to generate the income needed for the expansion of our educational programs.

Lastly, I would note that in Public Law 96-605, enacted in 1980, qualified retirement trusts were provided with the opportunity to invest in debt-financed property without being subject to the tax on unrelated business taxable income on the income derived from real property. The safeguards contained in S. 2498 are identical to the safeguards currently in effect with respect to qualified retirement trusts.

In conclusion, I urge the Senate Finance Committee to act favorably on S. 2498 to permit tax-exempt educational organizations to better provide educational opportunities to our nation's young people.

S. 2498 PANEL

Form 990-T (1981) Page 3

Schedule C—RENT INCOME FROM REAL PROPERTY AND PERSONAL PROPERTY LEASED WITH REAL PROPERTY (See Instructions for Part I, line 6 of page 2)

1. Description of property	2. Rent received or accrued	3. Percentage of rent for personal property
		%
		%
		%
		%
		%

4. Complete for any item if the entry in column 3 is more than 50%, or if the rent is based on profit or income		5. Complete for any item if the entry in column 3 is more than 10% but not more than 50%		
(a) Deductions directly connected (Attach schedule)	(b) Income includable (Column 2 minus column 4(a))	(a) Gross income reportable (Column 2 × column 3)	(b) Deductions directly connected with personal property (Attach schedule)	(c) Income includable (Column 5(a) minus column 5(b))

Add columns 4(b) and 5(c) and enter total here and on line 6, Part I, page 2

Schedule E—UNRELATED DEBT-FINANCED INCOME. (See Instructions for Part I, line 7 of page 2)

1. Description of debt financed property	2. Gross income from or allocable to debt financed property	3. Deductions directly connected with or allocable to debt financed property: (a) Straight line depreciation (Attach schedule)	3. (b) Other deductions (Attach schedule)
1 Warehouse #1	3,200,000	1,000,000	1,500,000

4. Amount of average acquisition indebtedness on or allocable to debt financed property (Attach schedule)	5. Average adjusted basis of or allocable to debt financed property (Attach schedule)	6. Percentage which column 4 is of column 5	7. Gross income reportable (Column 2 × column 6)	8. Allocable deductions (Column 6 × total of columns 3(a) and 3(b))	9. Net income or (loss) includible (Column 7 minus column 8)
10,000,000	20,000,000	50 %	1,600,000	1,250,000	350,000
		%			
		%			
		%			

2 Total (enter here and on line 7, Part I, page 2) 350,000

3 Total dividends-received deductions included in column 8 . . .

Schedule F—INVESTMENT INCOME OF A SECTION 501(c)(7) OR (9) ORGANIZATION (See Instructions for Line 8 of Page 2)

1. Description	2. Amount	3. Deductions directly connected (Attach schedule)	4. Net investment income (Column 2 minus column 3)	5. Set-asides (Attach schedule)	6. Balance of investment income (Column 4 minus column 5)

Total (enter here and on line 8, page 2) . . . . .

Schedule G—INCOME (ANNUITIES, INTEREST, RENTS AND ROYALTIES) FROM CONTROLLED ORGANIZATIONS (See Instructions for Line 9 of Page 2)

1. Name and address of controlled organization(s)	2. Gross income from controlled organization(s)	3. Deductions of controlling organization directly connected with column 2 income (Attach schedule)	4. Exempt controlled organizations: (a) Unrelated business taxable income	4. (b) Taxable income computed as though not exempt ... or the amount in column (a), whichever is more	4. (c) Percentage which column (a) is of column (b)
					%
					%
					%

5. Nonexempt controlled organizations: (a) Excess taxable income	5. (b) Taxable income, or amount in column (a), whichever is more	5. (c) Percentage which column (a) is of column (b)	6. Gross income reportable (Column 2 × column 4(c) or column 5(c))	7. Allowable deductions (Column 3 × column 4(c) or column 5(c))	8. Net income includible (Column 6 minus column 7)
		%			
		%			
		%			

Total (enter here and on line 9, page 2) . . . . .

343-055-1

Form **990-T**
Department of the Treasury
Internal Revenue Service

Exempt Organization Business Income Tax Return

(Under Section 511 of the Internal Revenue Code)

For calendar year 1981 or fiscal year beginning ......, 1981, and ending ......, 19..

OMB No. 1545-0687

1981

Name of organization

Address (number and street)

City or town, State, and ZIP code

A Employer identification number (employees' trust see instruction for Block A)

B Enter unrelated business activity codes from page 11 of instructions

C Check box if address changed ▶ [ ]

D Exempt under section ▶ 501 ( )( )

E Check applicable box ▶ [ ] Corporation [ ] Trust [ ] Section 401(a) trust

F Group exemption number (see instructions for block F) ▶

If the unrelated trade or business gross income is $10,000 or less, complete only page 1, Part III on page 2, and sign the return. Complete all applicable parts of the form (except lines 1 through 4) if unrelated trade or business gross income is over $10,000.

Taxable Income

1 Unrelated trade or business gross income. (State sources ▶	1	350,000
2 Deductions (Complete Part II instead of line 2 if you have gross income over $10 ...	2	
3 Unrelated business taxable income before specific deduction (Subtract line 2 from line 1)	3	
4 Specific deduction (see instructions for line 4)	4	
5 Unrelated business taxable income (subtract line 4 from line 3 or enter amount from line 33, page 2)	5	350,000

Tax Computation

Organizations Taxable as Corporations (See Instructions for Tax Computation)

6 (a) Are you a member of a controlled group? [ ] Yes [ ] No

(b) If Yes, see instructions and enter your share of the $25,000 in each taxable income bracket:

(i) $ ...... (ii) $ ...... (iii) $ ...... (iv) $ ......

7 Income tax on amount on line 5, above. Check here ▶ [ ] if alternative tax from Schedule D (Form 1120) is used. (Fiscal year corporations should use the worksheet in the instructions)	7	161,000

Trusts Taxable at Trust Rates (See Instructions for Tax Computation)

8 Tax: Check applicable block and enter on line 8 whichever is less:

(a) [ ] Tax from tax rate schedule ▶ ......

Multiply the tax by .9875 and enter the result on line 8, or

(b) [ ] Tax from attached Schedule D (Form 1041) 8

Total Income Tax

9 (a) Foreign tax credit (corporations attach Form 1118, trusts attach Form 1116)	9(a)		
(b) Investment credit (attach Form 3468)	9(b)		
(c) Work incentive (WIN) credit (attach Form 4874)	9(c)		
(d) Other credits (see instructions)	9(d)		
10 Total (add lines 9(a) through (d))		10	
11 Subtract line 10 from line 7 or line 8		11	
12 Tax from recomputing prior year investment credit (attach Form 4255)		12	
13 Minimum tax on tax preference items (see instructions for line 13)		13	
14 Alternative minimum tax (see instructions for line 14)		14	
15 Total tax (add lines 11 through 14)		15	
16 Credits and payments: (a) Tax deposited with Form 7004	16(a)		
(b) Tax deposited with Form 7005 (attach copy)	16(b)		
(c) Foreign organizations—Tax paid or withheld at the source (see instructions)	16(c)		
(d) Credit from regulated investment companies (attach Form 2439)	16(d)		
(e) Federal tax on special fuels and oils (attach Form 4136 or 4136-T)	16(e)		
(f) Other credits and payments (see instructions)	16(f)		
(g) Total credits and payments (add lines 16(a) through 16(f))		16(g)	
17 TAX DUE (Subtract line 16(g) from line 15). See instructions for depositary method of payment ▶		17	161,000
18 OVERPAYMENT (subtract line 15 from line 16(g))		18	

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer ...... Date ▶ Title

Paid Preparer's Use Only

Preparer's signature ▶ Date | Check if self-employed ▶ [ ] | Preparer's social security no.

Firm's name (or yours, if self employed) and address ▶ | E.I. No. ▶ | ZIP code ▶

For Paperwork Reduction Act Notice, see page 1 of instructions.

343-055-1

BEST AVAILABLE COPY

Senator CHAFEE. Do you have some of your fellow trustees here that you want to introduce, Mr. Takabuki?

Mr. TAKABUKI. Yes. Mr. Myron Thompson, who is also a trustee of the Kamehameha Schools/Bishop Estate.

Senator MATSUNAGA. Mr. Chairman, I ask unanimous consent that my opening statement be included at the appropriate place in the record in full, as though delivered.

Senator CHAFEE. It certainly will.

Well, thank you all for coming, gentlemen. We appreciate it.

Mr. STORRS. Thank you.

Mr. TAKABUKI. Thank you.

Senator CHAFEE. Mr. Takabuki, I assume that you are not seeking tax credits for your school, are you?

Mr. TAKABUKI. Tax credits?

Senator CHAFEE. Federal tax credits that your parents can take.

Mr. TAKABUKI. No; we are not—at this time. [Laughter.]

Senator MATSUNAGA. I am reminded of the objection of the Treasury that we should not take it piecemeal. But also I am reminded of an incident where there were 10 children, and the father just gave a $100-bill to one of them. The others complained and said, "Well, why didn't you give it to the rest of us?" He said, "Well, he asked." [Laughter.]

Senator CHAFEE. All right. Thank you.

[Whereupon, at 11:42 a.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

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C. MICHAEL DEESE
PAUL H. NETTESHEIM
RICHARD G. FEHRENBACHER
STEVEN D. SIMPSON
JOHN W. HAZARD, JR.*
JAMES C. REED

* NOT ADMITTED IN D. C.

July 20, 1982

Honorable Bob Packwood
United States Senator
145 Russell Senate Office Building
Washington, D.C. 20510

Re: S.2197

Dear Senator Packwood:

We serve as counsel to the International Taxicab Association (ITA) which testified on July 19 before the Subcommittee on Taxation and Debt Management in support of S.2197, a bill involving the fuel excise tax paid by the taxicab industry. The legislation was co-sponsored by Senators Matsunaga, Roth, Durenberger, and Moynihan. As a result of the hearings on this bill, we wish to supply you with the following information.

In testimony given by William S. McKee, Tax Legislative Counsel, Department of Treasury, in opposition to this legislation, he stated:

> "The exemption of taxicabs from fuel excise taxes was enacted as part of the Surface Transportation Act of 1978 (P.L. 95-599). Its ostensible purpose was to encourage ride-sharing, thus reducing energy consumption by substituting taxicab use for personal automobile use. Under the legislation, the Treasury Department was required to study the efficacy of the provision after being provided with information by the taxicab industry detailing the operation of the exemption." (Paragraph 2 on page 2 of his prepared statement.)

Since hearing Mr. McKee's testimony, we have looked at the existing statute relating to this fuel excise tax and the current rebate provided to the taxicab industry and find nothing in the legislation that obligates the taxicab industry to provide information on its own initiative to the Treasury

Department. Nor does the legislation call for any study specifically relating to the taxicab industry. ITA would be more than happy to provide any and all available information to the Department of Treasury if such information would be of assistance.

ITA has developed data involving the utilization of taxicabs by members of the general public, which illustrates that the existing gas tax rebate has served the purpose for which it was originally enacted by encouraging fuel efficiency through shared riding and the purchase of fuel efficient vehicles. A National Taxicab Survey has been conducted by ITA and the analysis has been performed by the University of North Carolina. This survey and analysis has been sponsored by the Urban Mass Transportation Administration of the U.S. Department of Transportation. It has not as yet been published, but is expected to be available in September 1982. Some of the statistical information shown in this study is as follows:

1. For the year 1981:

a.	Total number of taxicabs in U.S.	94,023
b.	Number of taxicab drivers in U.S.	165,867
c.	Number of taxicab passengers in U.S.	1,728,927,623
d.	Vehicle miles per year	6,352,497,804

2. 1981 percentage of taxicab companies which supply shared riding service to the general public - 46.5%. We have no data as to the percentage provided shared rides in 1978 prior to the enactment of the gas tax rebate, but we have reason to believe that the percentage was extremely small.

3. 1981 percentage of taxicab companies offering contract services - 62%.*

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* Contract services involve the utilization of a taxicab company to provide service to a particular organization and almost always entail ride sharing. The organization with whom taxicab companies contract are schools, hospitals, private companies, social service agencies, city agencies, transit authorities, various other public agencies, and private individuals. The percentage of taxicab companies that have contracted with each of these organizations is:

Schools	41.6%	City agencies	28.0%
Hospitals	51.1%	Transit authorities	14.4%
Private companies	66.3%	Other public agencies	12.9%
Social service agencies	56.1%	Private individuals	37.9%

During the testimony of Mr. Zilber, on behalf of ITA in support of S.2197, he advised the Subcommittee that 40% of all passengers using urban mass transportation are transported by taxicabs. This figure is derived from a 1975 study entitled "Taxicab Operating Characteristics" performed by ITA and sponsored by the Urban Mass Transportation Administration of the U.S. Department of Transportation. Additionally, it is significant to note that approximately 60% of all taxicab trips are taken by the transportation disadvantaged, that is, persons with no ready access to other private or public modes of transportation. The transportation disadvantaged include the unemployed, the retired, the elderly, and the handicapped. (This figure comes from a 1970 National Personal Transportation Study sponsored by the Department of Transportation.)

It is our opinion that the gas tax rebate legislation has been the single most influential factor encouraging the taxicab industry to engage in shared riding and to purchase fuel efficient vehicles. Failure of this Congress to enact S.2197 or to grant the taxicab industry an extension of the existing gas tax rebate, which is due to expire December 31, 1982, is certain to have a negative impact on the favorable trends the existing legislation has established.

We seek your assistance in the passage of this most important legislation to the taxicab industry.

Sincerely yours,

Charles E. Chamberlain

CEC/bkc

cc: Honorable Spark M. Matsunaga
Honorable William V. Roth, Jr.
Honorable Daniel Patrick Moynihan
Honorable David Durenberger

STATEMENT OF
DARRELL "CHIP" WADENA
PRESIDENT, MINNESOTA CHIPPEWA TRIBE
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE

July 19, 1982

Mr. Chairman and members of the subcommittee, we thank you for this opportunity to testify in support of S.1298, the Indian Tribal Governmental Tax Status Act, on behalf of the Minnesota Chippewa Tribe, the Ak-Chin Indian Community, the Colville Confederated Tribes, the Papago Tribe and the Tulalip Tribes.

It is our understanding that this legislation is non-controversial. Indian tribes support it. It has strong bipartisan backing in both the House and Senate and is endorsed by the Department of the Treasury and of the Interior. Its budgetary impact is negligible.

S.1298 would grant Indian tribal governments and their subdivisions the same tax treatment under the Internal Revenue Code as state, county, and municipal governments. It would thus remedy an oversight in the Code that has the unintended effect of discriminating against Indian tribes.

The bill provides that -

1. Charitable contributions to or for the use of tribal governments or subdivisions would be deductible.

2. Taxes imposed by tribal governments would be deductible.

3. Contributions to candidates for tribal office would be eligible for the credit allowed for contributions to political candidates.

4. Tribal governments and eligible subdivisions would be exempt from the excise tax on special fuels, manufacturers excise taxes, highway vehicle use taxes and the communications excise tax.

5. Contributions to annuities for certain employees of tribal governments or eligible subdivisions would be excluded from the employees' income.

6. Interest on tribal government obligations or obligations of eligible subdivisions would in limited circumstance be tax exempt.

A number of revenue rulings under the present Code operate against long-standing national policy to respect the unique government-to-government relationship between the United States and the tribes, to promote their economic security and general welfare, and to treat similarly situated tax payers alike.

The importance of the legislation to Indian tribes can be illustrated by its potential impact on Indian housing. Today approximately 50% of Indian housing fails to meet minimum standards. In the past, tribes have had to rely almost entirely on Federal housing subsidies in order to improve their housing stock. With the current severe restraints on Federal funding, efforts to improve Indian housing threaten to come to a virtual standstill. Enactment of S.1298 would enable tribes, through the issuance of tax-exempt mortgage revenue bonds, to attract significant private investment. Today the issuance of taxable housing bonds is not feasible because the tribes cannot afford to pay the high interest rates needed to make these obligations marketable.

Your interest and concern are deeply appreciated.

STATEMENT OF THE
W. RICHARD WEST, JR.,
OFFICE OF GENERAL COUNSEL OF THE
ASSOCIATION ON AMERICAN INDIAN AFFAIRS,
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE
SENATE FINANCE COMMITTEE
REGARDING THE INDIAN TRIBAL GOVERNMENTAL TAX STATUS ACT (S.1298)

July 19, 1982

Mr. Chairman, Members of the Subcommittee, I want to thank you for the opportunity to submit this testimony on behalf of the Association on American Indian Affairs in support of S. 1298, the Indian Tribal Governmental Tax Status Act. I would like to say a few words about the origin of this bill, because I think that history illustrates one of the most important reasons why S.1298 must be enacted.

The Association on American Indian Affairs is an organization composed of some 50,000 Indian and non-Indian citizens from across the nation. They are supporters of the rights of American Indians and taxpayers as well. Some ten years ago, a number of Indian tribes brought to the attention of the Association the fact that the Internal Revenue Code unfairly discriminates against tribal governments.

This discrimination arises from the fact that Indian tribes, although exercising many of the powers of sovereign nations, are not accorded the same status under the tax laws as other sovereign entities, specifically, state and local governments. Within the boundaries of their reservations, Indian tribes possess the same authority and bear the same responsibilities as state and local governments do within the boundaries of their respective jurisdictions. Indian tribes are responsible for schools, public housing, law and order, child welfare, environmental regulation and, indeed, the entire spectrum of governmental affairs on the reservation. Yet, Indian tribes have continued to shoulder these public responsibilities without any of the tax benefits that are normally enjoyed by sovereign governments.

In response to that inequity, the Association drafted the initial version of the Indian Tribal Governmental Tax Status Act. The goal of the bill, then as now, was to correct this injustice in our tax laws. Reduced to its essential terms, the Tax Status Act provides simply that Indian tribes be accorded the same treatment under the Internal Revenue Code as is now received by state and local governments.

Specifically, the bill would provide as follows:

-- taxes paid to Indian tribal governments would be deductible from taxable income under the Internal Revenue Code;

-- charitable contributions made to Indian tribal governments similarly would be tax deductible;

-- tribes would be exempt from the payment of certain federal excise taxes;

-- tribal governments would be permitted to offer tax-exempt annuities to certain employees;

-- interest on certain tribal obligations would be tax exempt.

In each of these cases, the Tax Status Act does nothing more than correct a long standing imbalance in the tax laws. In each instance, Indian tribes finally would be accorded a tax status which other sovereign governments have enjoyed for many years.

The Tax Status Act has been introduced in every Congress which has convened since the bill was drafted. Twice before the bill has been reported favorably by the House Ways and Means Committee, but each time the House adjourned without bringing the measure to a vote.

These hearings in the 97th Congress make clear what Indian tribes and the Association have long understood: the Tax Status Act is a bill to which there is no opposition, but which must be enacted if there is to be tax justice for Indian tribes. The failure of the Tax Status Act to win enactment is attributable simply to the same inattention which created the need for the bill in the first place.

These hearings are truly gratifying because they indicate that, thanks to Senator Wallop, the sponsor of S.1298, Senator Packwood, the Chairman of this Subcommittee and a cosponsor of the bill, and Senators Andrews, Baucus, Bradley, Cranston, Hatfield, Inouye, and Simpson, also cosponsors of S.1298, the attention of the Senate at long last has turned toward the correction of this error in our tax laws.

The correction of the oversight is long overdue. I say this today on behalf of our 50,000 members and contributors who support this measure, not for what it will do for them, but because they believe that tax justice should not stop at the reservation boundaries.

The discrimination against Indian tribes under the tax laws, from all that appears, has not resulted from any conscious decision concerning the manner in which tribal governments are to be regarded, but rather from a series of discrete and unthinking omissions. The Congress has the means before it now to remedy those mistakes.

You must not allow this legislation to die.

I commend the Subcommittee for this first step and urge you to report S.1298 to the floor for passage.

Thank you very much.

S. 1298, The Indian Tribal Governmental Tax Status Act

Joint Testimony
of

National Congress of American Indians
Council of Energy Resource Tribes
National Tribal Chairmen's Association
Native American Rights Fund
Kickapoo Tribe of Kansas

before the

Subcommittee on Taxation and Debt Management
of the
Senate Committee on Finance

July 19, 1982

Summary of Principal Points

S.1298, The Indian Tribal Governmental Tax Status Act, would give tribal governments equal status with state and local governments for some federal tax purposes.

We support this legislation first, as a matter of equity; second, because the bill would strengthen tribal economic self-sufficiency by strengthening the abilities of tribal governments to provide public goods and services for their people; and third, because the bill recognizes the appropriate role of tribal governments.

1. Federally recognized tribal governments exercise much of the same authority and provide many of the same services as do state and local governments. It is therefore appropriate that tribal governments be granted the same federal tax benefits conferred upon state and local governments.

   This legislation would not give tribal governments additional powers of taxation nor would it give tribal governments any federal tax benefits not already conferred upon state and local governments.

2. Present IRS practice discourages the economic development of Indian reservations, already the poorest regions in the nation. This legislation would provide a means for tribal governments to raise revenues without unduly burdening private enterprises on the reservations.

3. This legislation recognizes the appropriate role, status and responsibilities of tribal governments as governments.

Mr. Chairman and Members of the Committee, my name is Joseph De La Cruz, President of the Quinault Nation and President of the National Congress of American Indians (NCAI). I am here on behalf of the National Congress of American Indians, the Council of Energy Resource Tribes, the National Tribal Chairmen's Association, and the Native American Rights Fund. On behalf of my tribe and the 180 tribes represented by our organizations, I would like to thank you for holding these hearings on S.1298, the Indian Tribal Governmental Tax Status Act, and for allowing me to testify.

As many of you have tribal constituents, you are no doubt well aware of the dire economic conditions with which tribal governments are faced today. As an example, just this past December the Bureau of Indian Affairs reported that unemployment on reservations was averaging 31-46 per cent nationally. From the reports our organizations are receiving from member tribes, the last half year has only served to increase that figure. Reports of unemployment of 60-70 per cent are not uncommon.

Especially in these times when local governments are expected to carry a greater share of financial and administrative responsibility for government programs, one of the major obstacles confronting tribal governments in dealing with these conditions is their inability to generate sufficient revenues. And a major obstacle confronting tribal governments in attempting to generate sufficient revenues is that they do not currently have a number of federal tax advantages enjoyed by every other government in the United States, including the state, county and municipal governments. The Indian Tribal Governmental Tax Status Act would remedy this situation.

We support the bill, first, as a matter of equity; second, because the bill would strengthen tribal economic self-sufficiency by strenghthening the abilities of tribal governments to provide public goods and services for their people; and third, because the bill recognizes the appropriate role of tribal governments.

The bill would remedy the effects of a series of Revenue Service rulings issued during the late 1960's and early 1970's that held that, as Indian tribes are neither states nor political subdivisions of states, they are not eligible for certain benefits given states and their political subdivisions under the Internal Revenue Code. As a result, revenue raising and saving mechanisms available to and commonly used by other governments are foreclosed to Indian tribal governments. This discriminatory treatment is particularly unfortunate inasmuch as tribal governments are faced with the task of bringing their people, among the poorest in the nation, into economic prosperity. This task is made more difficult, as least in part, because tribal governments are not given the same benefits as other governments in the Internal Revenue Code.

The Act would:

- allow deductions from federal income taxes for charitable contributions to Indian tribes;
- Allow deductions from federal incom taxes for taxes paid to tribal governments;
- exempt from federal income taxes interest paid on bonds issued by tribal governments;
- Allow deductions from federal income taxes for contributions to tribal political campaigns;
- exempt tribal government from certain excise taxes including those on special fuels, manufactures excise taxes, highway use taxes and communcations excise tax, and
- allow tribal governments to offer tax-exempt annuities to certain employees.

Our first point is that as a matter of equity tribal governments should be given the same benefits given state, county and municipal governments under the Internal Revenue Code. The governments of federally recognized Indian tribes exercise sovereign powers. They have the responsibility to provide a full range of government services to their citizens.

Increasingly, tribes have sought to exercise their powers of government to improve their local economies and to provide services to their people. We feel that it is appropriate therefore to facilitate these efforts to confer upon tribal governments the same benefits conferred upon other governments under the Internal Revenue Code.

It should be noted that this legislation would not empower tribal governments to exercise any governmental powers which they now do not have, neither would it extend to tribal governments any benefit not now extended to other governments. It merely would end the discriminatory application of the Internal Revenue Code toward tribal governments.

In that regard, we recognize that this Committee has recently reported out legislation that would restrict the use of tax exempt industrial development bonds. We are not asking for special favors for tribal governments beyond what other governments are allowed. We are simply asking for the same opportunities to provide for ourselves.

Our second point is that this bill would, at very little cost to the federal Treasury, provide badly needed benefits to Indian tribes. Indian tribes, like states and localities, are being asked to shoulder an increasing share of the responsibility for providing for the welfare of their people. Unlike state and local governments, however, they have little opportunity to meet these responsibilities, largely because the tax code does not allow tribes the same favorable treatment that it does state and local governments. The poverty and lack of economic activity of Indian reservations render little if any tax base. When tribes do seek to levy taxes they are met with tremendous resistance because taxes paid to tribes are not deductible from federal taxes. In addition, because the interest on certain tribal obligations is not given the same favored tax treatment as those of other governments, tribal bonds are virtually unmarketable.

This bill would do much to alleviate these problems. It would allow tribes a mechanism to stimulate business activity, provide a means to finance public facilities, encourage contributions to tribal governments, ease the burden of tribal taxation, and in a host of other ways enhance the ability of tribal governments to improve the lot of their people. While this bill alone will not be a total solution to the economic problems on Indian reservation, it would be an important step toward removing some of the impediments to tribal economic development.

It should be noted that although the immediate revenue impact of the bill would be negative the total effect on the federal budget could be positive. In 1978, a Ways and Means Committee report estimated and the Treasury agreed that the bill would reduce tax revenues by less than $5 million. This in itself is an extremely small amount. But more significant is the saving that could accrue to the federal Treasury if this bill is passed. Public projects that now are subsidized to a great extent by direct federal assistance would be opened to private financing on the same basis as state, county, and municipal projects. As such it would lessen the dependence of the tribes on federal spending and save dollars for the federal government.

Finally, we support this bill because it recognized the appropriate role, status and responsibilities of tribal governments, as governments, that represent and are responsible to their people. This bill would allow tribal governments to take an active role in bringing economic well-being to their people.

JULY 19, 1982

SENATE FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

STATEMENT OF MALCOLM P. DALTON
GENERAL MANAGER, NAVAJO TRIBAL UTILITY AUTHORITY
CONCERNING S. 1298
THE INDIAN TRIBAL TAX STATUS ACT

The Navajo Tribal Utility Authority, an enterprise created by the Navajo Tribe of Indians to bring modern utility services to the Nation's largest Indian Reservation, supports the approval of legislation to provide the same tax exemptions and general tax treatment for Indian tribes as are applicable to states and other local governmental units. This legislation will provide valuable tools for Indian tribes and nations to use in their efforts to improve living conditions for Indian citizens.

The Navajo Tribal Utility Authority is responsible for electric, natural gas, water and wastewater treatment service to approximately 20,000 service locations in an area covering about 25,000 square miles in three states where the Navajo Indian Reservation is located. The capital investment required for this program has been very difficult to locate and obtain, and has been relatively expensive. It is anticipated that if this legislation is enacted into law that important new sources of capital investment will become available to aid in the necessary task of improving utility services to the Navajo Indian people.

Because the provision of utility services to citizens of a governmental unit has long been regarded as a legitimate municipal funtion, the adoption of S. 1298 would provide treatment for Indian organizations in parity with that of other municipal governmental agencies who have similar responsibilities to their residents. No "special" treatment is sought; merely the opportunity to be treated equally with other governmental units providing similar public services.

While the provisions of S. 1298 regarding tax exemption for interest paid on debt obligations are of primary concern to a capital intensive enterprise such as our Utility, other features of the Bill are of importance also. The Bill would clarify the tax exemption for Indian governments for a variety of excise taxes, including special fuels tax, the manufacturers' excise tax and the tax on the use of certain highway vehicles. From an operational standpoint, these provisions will also assist the Utility Authority in being able to provide utility services on a parity with other municipal utility operations.

On the Navajo Reservation, our Utility Authority anticipates continued growth, and consequently the need for additional facilities to serve the utility needs of the Navajo people. We estimate that, at present, less than one-half of the residents of our Reservation are receiving electric, natural gas, and water service who should be served. We firmly believe that S. 1298, the "Indian Tribal Government Tax Status Act", if enacted, will materially aid in the important and difficult process of providing these services.

The Navajo Tribal Utility Authority supports the enactment of the Bill, S. 1298 and urges the Committee to report favorably thereon.

STATEMENT OF ROBERT SHORTY, JR.
Chairman, Navajo Tax Commission
Before the Senate Finance Subcommittee on
Taxation and Debt Management
July 19, 1982

S. 1298
"The Indian Tribal Tax Status Act"

I am Robert Shorty, Jr. I am and for six years have been the Chairman of the Navajo Tax Commission. Serving in this capacity I have had the opportunity to become closely acquainted with the special financial needs of Indian Tribes. I appreciate the opportunity to express my views on S. 1298, on behalf of the Navajo Tribe.

Few things are more critical to the future well-being of the Indian peoples than a healthy economy. Unfortunately, it is the rare tribe indeed which is not struggling to meet its governmental obligations in these times of national economic recession.

The last decade has been a period of vigorous economic growth on the Navajo reservation. During the 1970's the Navajo government grew to meet the expanding needs of our people. Our police force grew, our court system grew, we took steps to bring the quality of our environment, the use of our land and the right to our water under our control. Social services grew. Medical services expanded. Fire protection was strengthened. The Navajo government serves the basic needs today of over 160,000 people, both members and non-members, on Navajo lands.

Often the powers of our tribal government have been tested in the federal courts and have survived intact. Today all people acknowledged that Indian tribes are here to stay, that tribes <u>are</u> governments capable of providing public services.

Unfortunately, the federal tax law has lagged behind--Indian tribes are not included in the provisions easing the financial difficulties of "federal, state and local governments," perhaps because at the time many viewed tribes as "toy" governments.

The Indian Tribal Tax Status Act is a financial lifesaver. The provisions exempting the interest earned on tribally issued bonds from federal taxes create a new avenue for tribes to pursue finds desperately needed to support government services. We heartily support this measure.

The Navajo Tribe has spoken out formally to endorse S. 1298. A letter from Peter MacDonald, Chairman, Navajo Tribal Council (attached hereto as Exhibit A) to Senator Wallop stresses both tribal support and the urgent nature of this bill. A resolution of the Navajo Tribal Council, CF-10-82, (attached hereto as Exhibit B) sets forth the numerous benefits provided by S. 1298 and provides the endorsement of the tribal government. We urge your favorable consideration of this bill. Thank you.

THE NAVAJO NATION

WINDOW ROCK, ARIZONA 86515

PETER MacDONALD
CHAIRMAN

JUL - 7 1982

Senator Malcolm Wallop
United States Senate
Russell Senate Office Building
Room 204
Washington, D.C. 20510

Re: S. 1298 - Indian Tribal Governmental Tax Status Act

Dear Senator Wallop:

I am writing to you regarding S. 1298, the "Indian Tribal Governmental Tax Status Act." As you know, this salutary legislative proposal, for which you are the prime sponsor, would extend to Indian tribes certain tax benefits which now are enjoyed by state and local governments.

The proposed bill has been strongly supported during the past several years by numerous Indian tribes and national Indian organizations. In addition, the Assistant Secretary for Indian Affairs recently has indicated that the Tax Status Act is his top legislative priority for the current Congress.

I am writing to you because of my deep concern that, while S. 1928 has no opposition from any quarter, it nevertheless has not yet been scheduled for hearings before Senator Packwood's Subcommittee on Taxation and Debt Management. As you certainly must appreciate, S. 1298 must be scheduled for hearings in the very near future if it is to have any realistic chance of enactment during this Congress. Given the entirely noncontroversial nature of this legislation, I anticipate that hearings and mark-up would require very little time, and that the bill should pass easily if we can but schedule it.

In light of the tremendous support which this legislation has in Indian country, I urge you to contact Senator Packwood promptly to schedule a hearing at the earliest possible date.

Sincerely yours,

Peter MacDonald, Chairman
Navajo Tribal Council

xc: Navajo Tax Commission
George P. Vlassis, General Counsel

CF-10-82

Class "C" Resolution
No BIA Action Required.

RESOLUTION OF THE
NAVAJO TRIBAL COUNCIL

Supporting U.S. Senate Bill 1298, Entitled, "Indian Tribal Governmental Tax Status Act"

WHEREAS:

1. The Navajo Tribal Council and other Indian tribes exercise extensive governmental authority within their reservations, to design and implement programs to build healthy economics, capable of providing goods, services and jobs needed by their people; and

2. The Internal Revenue Service affords certain tax benefits to states and their political subdivisions which allows the states and their political subdivisions to build and sustain healthy economics, and provide essential services to their people; and

3. Recent federal cutbacks have placed additional financial burdens on tribal governments and that these tribal governments must find means to sustain their governmental obligations to their members; and

4. Certain revisions to the U.S. Internal Revenue Service, Code of 1954 are needed, to provide equal tax treatment (as afforded to state governments) of Tribal governments and that these revisions will strengthen tribal governments and enable tribal self-determination.

NOW THEREFORE BE IT RESOLVED THAT:

1. The Navajo Tribal Council strongly supports U.S. Senate Bill, S. 1298, entitled, "Indian Tribal Government Tax Status Act", and urges the Congress, and particularly its individual members who represent the various Indian nations, to enact the measure without delay, that this bill would provide equal treatment of Indian tribes by Internal Revenue Service, by allowing that:

A. Any person(s) or business entity paying taxes imposed by the Navajo Nation would be entitled to deduct the sums paid from their federal income tax returns.

B. Any person(s) or other entity who donate gifts of cash and other valuable property to the Navajo Tribal government that this contribution would be deductible for federal income, estate and gift tax purposes.

REID & PRIEST
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202 828-0100

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30 ROCKEFELLER PLAZA
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212 344-2233

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NEW YORK DOWNTOWN OFFICE
40 WALL STREET
NEW YORK, N.Y. 10005
212 344-2233

September 8, 1982

Mr. William S. McKee
Tax Legislative Counsel
U.S. Department of Treasury
Room 3064
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Bill:

On behalf of the Association of American Universities and the Kamehameha Schools/Bernice P. Bishop Estate, I would like to address some of the points you made in your testimony in opposition to S. 2498 on July 19, 1982, before the Senate Finance Committee Subcommittee on Taxation and Debt Management. As you know, S. 2498 would amend the Internal Revenue Code of 1954 (Code) to permit qualified tax-exempt educational organizations to borrow money for the purpose of acquiring or improving real property without being subject to the tax on unrelated business taxable income on income derived from debt-financed real property. S. 2498, is sponsored by Senators Matsunaga, Durenberger, Moynihan and Bentsen.

I would like to first point out that the acquisition indebtedness provisions of section 514 of the Code operate in an illogical manner. The amount of gross income taken into account as unrelated debt-financed taxable income is an amount based on the ratio of average acquisition indebtedness for the year over the adjusted basis of the property for the year. During the early years of a typical real estate investment, the adjusted basis of the property is reduced much more rapidly than the outstanding balance of funds borrowed to finance the investment. This occurs because the period over which real property is depreciated is generally shorter than the amortization schedule for the loan. Additionally, straight-line deprecation reduces the basis of real property improvements ratably while the amortization of a mortgage on the property occurs at a very low rate in the first 5-8 years of a typical 25-30 year loan. A reduction in the principal of the loan at a rate akin to that of depreciation doesn't begin to occur until after the initial 5-8 year period.

Thus, during the first few years of a typical investment in real property, the ratio of the outstanding indebtedness to adjusted basis is increasing and, in many instances, will actually be equal to or in excess of 100 percent. Accordingly, a tax-exempt educational organization undertaking a typical debt-financed real property investment, finds itself in the rather strange position of having its percentage of gross income treated as unrelated debt-financed income increasing at a time when the outstanding amount of borrowed funds is decreasing. This should not be the way this penalty tax provision operates.

It has been suggested that passage of S. 2498 would give tax-exempt educational organizations a competitive advantage over taxable investors. I would suggest that if it is a competitive advantage tax-exempt educational organizations are seeking, investments in real property (regardless of whether the acquisition indebtedness rules are modified) will not be the direction in which they will turn. Investments in stocks and bonds provide tax-exempt educational organizations a much higher return than they do for taxable entities. This is because interest and dividends are not taxable to tax-exempt educational organizations while such income is taxable to taxable organizations. On the other hand, in the early years of an investment in real property, there is no competitive advantage to tax-exempt educational organizations, and this would be so even if the acquisition indebtedness rules are modified in the manner suggested by S. 2498.

During the early years of an investment in real property, a taxable organization is not likely to have any income tax liability from the investment. This is due to the fact that accelerated depreciation and other deductions will generally exceed the revenue from the property. This is also the case for tax-exempt educational organizations, whether or not a bill similar to S. 2498 is enacted. The point is that the modifications proposed in S. 2498 would not increase or provide for any competitive advantage during the early years of a real estate investment. For both tax-exempt and taxable organizations, there is no taxable income from depreciable real property during the early years, and thus, the yield on the investment would be totally dependent on factors other than income tax liability.

On page 5 of your testimony prepared for the Senate Subcommittee, you distinguish the treatment of pension trusts from tax-exempt educational organizations on the grounds that while investment income of a pension trust is accumulated, ultimately it will be taxed when the benefits are distributed to plan beneficiaries, while on the other hand, schools are granted an exemption for the purpose of promoting education and that, in many instances, there will result a permanent exemption rather than simply deferral of tax. I would point out that as a practical matter the investment income realized by tax-exempt educational organizations most often is distributed for wages, salaries, supplies, support services, food, transportation and other services necessary for the operation of the schools. In actuality, investment income received by a tax-exempt educational organization is quickly returned to the market place and used in a manner which generates additional revenue for the government far more quickly than the investment funds that are received by a pension trust. Tax deferrals for investment income in a pension trust can often be for a period of thirty years or longer. On the other hand, investment income earned by tax-exempt educational organizations is very frequently immediately returned in the form of taxable payments for the services necessary to continue the operation of the schools.

You have also suggested that fiduciaries of pension trusts are subject to higher fiduciary standards as a result of the Employee Retirement Income Security Act of 1974 than are fiduciaries of tax-exempt educational organizations. This is simply not true. State imposed fiduciary standards for trustees of tax-exempt educational organizations are general standards which, though less specific than those imposed on fiduciaries of pension trusts under Federal law, are by no means less onerous. In fact, the general standards imposed under state law provide the states and their courts with the ability to impose the most demanding fiduciary standards possible.

The suggestion has also been made that if S. 2498 should become law, it will create potential for abuse through the formation of partnerships consisting of both tax-exempt educational organizations and taxable entities. The potential for abuse is through partnership allocation formulas which would allocate income from debt-financed real estate investments to the tax-exempt educational organizations while allocating the tax deductions to the taxable organizations. The Kamehameha Schools and the Association of American Universities would be willing to consider any proposals the Treasury Department may wish to suggest modifying S. 2498 in order to prevent these types of abuses. We would be more than happy to work with you in developing these modifications.

A suggestion has also been made to apply S. 2498 to all organizations described in 501(c)(3) or all organizations exempt under section 501(a). We would not object to such a proposal. However, on the other hand, we do not possess the necessary information needed to evaluate whether or not the operations of other types of tax-exempt organizations would or could cause potential problems if S. 2498 were so expanded. Tax-exempt educational organizations are not in the position to evaluate the needs and problems of other types of tax-exempt organizations.

We hope you will give the points raised in this letter your serious consideration. We believe they make a persuasive case for Treasury support of S. 2498. We are willing to work with you in any way you feel appropriate to produce legislation which you can support. Please do not hesitate to call on me for any assistance you may require.

Very truly yours,

Bill

William Morris

TOWARD REMOVAL OF THE PENALTY TAX ON DEBT-FINANCED REAL ESTATE INVESTMENT BY EDUCATIONAL INSTITUTIONS

by

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Executive Summary

S. 2498/H.R. 6353 would permit schools exempt from income tax to also be exempt from the tax on unrelated business income earned from real estate investments financed with borrowed funds. Currently, a part of the net income from any investment so financed is subject to corporate income tax according to a prescribed formula.

Enactment of S. 2498/H.R. 6353 would enable educational institutions to diversify their investment portfolios and provide a greater hedge against inflation through investment in real estate. This type investment would enhance the cultural and economic benefits to society which arise from educational activities, and would bring additional funds to the real estate market at a time when the infusion of additional capital may be critical to the vitality of the real estate market.

The exemption proposed in S. 2498/H.R. 6353 is the same as that granted in 1980 by P.L. 96-605 to pension and profit sharing trusts.

Objections to S. 2498/H.R. 6353 have been fourfold:

1) Exemption would give educational institutions a financial advantage over taxable organizations as well as other exempt organizations;

2) Exemption would permit return of the abuses which the tax on unrelated business income was enacted to prevent;
3) Additional income accruing to educational organizations would be accumulated and thus escape the stream of taxable income; and
4) Revenue loss would be substantial.

Such objections are not warranted based on an analysis of available evidence.

1) S. 2498/H.R. 6353 would create no financial advantage. The proposed exemption would merely grant educational institutions the same tax status as pension trusts which are 20 times as important in terms of asset-holdings. It would also ameliorate part of the existing bias in favor of taxable investors who can structure real estate investments to be nontaxable and to generate deductions in excess of costs which can offset tax on other income. Also, after several years of losses the property can then be sold by the taxable investor without ever being effectively taxed on the income.

2) S. 2498/H.R. 6353 would provide appropriate safeguards. The 1980 pension trust legislation provided safeguards by specifically denying tax exemption to transactions arranged to enable the seller to obtain part of the

future profits from the property or the purchaser to bypass the limits on deductions for contributions to a pension fund. To date these safeguards have worked. S. 2498/H.R. 6353 would retain these safeguards with respect to real property investments of educational institutions.

3) Exempting the income received from debt-financed real estate by the endowments of educational institutions would result in earlier taxation of that income than in the case of pension trusts. Ninety percent of the endowment income of educational institutions is spent in the year received for goods and services. About 70-80 percent is spent on faculty and employee compensation because education is a labor intensive industry. These amounts become immediately taxable to the recipients. By contrast, assets and income of pension trusts may be accumulated over the 30-40 year working life of recipients before any distribution occurs and no tax is imposed until such funds are actually distributed.

4) The revenue loss, if any, will be minimal. Funds of educational institutions are currently earning tax-exempt income, so that only the net return on the debt can be considered as exempted from tax. The Treasury currently derives very little revenue from debt

financed income earned by educational institutions because of minimal debt financed investment by such entities. Exemption of this debt-finance income would merely be an alternative to having it earned tax-free by pension trusts or by a taxable entity which reported losses from the property during the first few years of ownership.

The financial squeeze on educational institutions, particularly private institutions, requires opening up real estate as an alternative for their endowment investments. Real estate has provided a greater total return in the last decade than stocks and bonds. Educational institutions have invested little in real estate because the taxation of debt-financed investments generally reduces the net return on the equity below that available if no debt were used. It has also caused them to alter their investment strategies. Unlike stock and bond prices, where debt-financed purchases are not widespread, real estate prices reflect the fact that leverage is customary in real estate purchases. Since many investors, including the financially gigantic pension trusts, can earn income from leveraged real estate free of tax, educational institutions cannot pay competitive prices for debt financed real estate while paying the tax on unrelated business income therefrom. Endowment investment in effect has been limited to stocks and bonds.

I. Why should the penalty tax on debt-financed real estate investment be removed for educational organizations?

The financial welfare of one of the nation's most important industries, education, is encumbered by the restriction on its investment strategy. About 3,000 private and public universities and colleges spent about $64 billion in 1981 to provide educational services to about 11 million students. Many of these institutions also provide important research and other services to government and to business. In addition, over 16,000 private elementary and secondary schools spent about $34 billion in 1981 to provide educational services to over 5 million students.1/

The nation benefits from the productivity of education. Not only do educated individuals derive pecuniary and nonpecuniary benefits, but society generally benefits socially, culturally, and politically from an educated population. But most importantly, education makes an important economic contribution by promoting productivity and growth. Expenditures on education are viewed as human investment which generates greater efficiency in the use of labor, capital, and land and thus yields a return in faster growth of national income. One

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1/ See Statistical Abstract of the United States, 1981, Tables 214, 217, 221 (pages 132, 134, and 137) and Appendix Table 1.

estimate by an authority in the field is that 23 percent of the increase in national income is attributable to the increase in the quality of work promoted by education.[2/]

Higher education and private elementary and secondary education, however, are in a financial crisis. Inflation and student aid requirements have increased operating costs, but social and political constraints limit the oportunity to match rising costs with higher tuition and fees which would be the case if education operated in the normal market place. These constraints are in effect even under good economic conditions. Juanita Kreps, former Secretary of Commerce and now Vice President Emeritus of Duke University has explained that "reluctance to transmit cost increases to the student even in a period of rising income reflects a belief that education should be subsidized if not free and that the return to the society justifies the social expenditure."[3/]

To make up the shortfall between price and cost, higher education has two subsidy sources, that is, two ways by which people contribute to the education of others. One subsidy is financed by compulsory contributions (taxation) and the other by voluntary contributions (donations and endowment income).

2/ Edward F. Denison, The Sources of Economic Growth in the United States, Committee for Economic Development, Supplement Paper No. 13 (New York 1962).

3/ Juanita Kreps, "Higher Education and the Economy" in American Council on Education, Formulating Policy in Postsecondary Education, Washington, D.C. 1970, p. 65.

Tuition levels in effect are determined by the level of these subsidies. Private elementary and secondary schools tend to have little direct government support.

Public institutions depend primarily on the tax-supported subsidy. Private institutions depend on gifts and endowment income but this subsidy has in recent decades financed a declining portion of total costs in higher education. The share of total current revenues coming from endowment earnings dropped sharply from 18 to 8 percent during the 1940s, then fell gradually but consistently to less than 5 percent in the early 1970s, and have held steady at about that level for the past decade.[4/]

One factor in slow endowment growth and poor endowment earnings is the limitation on investment outlets. Even though there has been a strategy of expanding investment in stocks to overcome inflationary pressure on costs, such investment is risky. Fortune Magazine reported in May 1974 (page 230) that the total return to investors (including ordinary income and capital appreciation) for one year in the stocks of the 500 largest U.S. corporations was negative for 385 and the

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4/ Susan C. Nelson, "Financial Trends and Issues" in Public Policy and Private Education, edited by David Breneman and Chester Finn, Jr., Brookings Institution, Washington, D.C., 1978, pp. 69-70 and Appendix Table 1.

median total return was a negative 25.5 percent. Moreover, bonds have not proven to be an attractive investment vehicle over the last decade. (See Appendix Table 5). It is therefore essential for endowments to have the flexibility of real estate investment as an option for greater diversification and yield.

Private institutions cannot be wholly independent of government support. The restriction on investment opportunities in real estate deprives private institutions of an important and strategic investment. By doing so, the restriction not only puts more tax burden on the public to meet the unfinanced cost of higher education, but it also encourages increasing government support and creates concern about public control and attendant constraints on diversity and pluralism and the attainment of quality education.

Certainly, if the level of nontuition revenues are guaranteed by government support with tax monies, it should be the government's obligation to assure the strength of income when government budget deficits limit continuing government support.[5/] The growing probability of declining government support alters the financial balance between current income and costs for many institutions. They must plug the financial gap by seeking funds elsewhere. Pressures are increased to raise tuition, to seek more gifts, to explore more productive investments. In

5/ Federal funds grew from virtually nothing in the 1930s to nearly one-fourth of total income in 1965-1966, and then declined and held steady at 18-20 percent for the past decade. Nelson, Op. cit., p. 72 and Table 2.1. See Appendix Table 2.

the case of endowment income, the adversity of Federal cutbacks is twofold. Not only is higher education faced with less government support but its ability to utilize productive investment strategies which are available to others is significantly restricted by the penalty tax on real estate investment.

II. How widespread is the impact of the debt-financed real estate investment restriction on higher education?

The restriction on debt-financed real estate investment has wide geographical impact and goes far beyond the encumberance of a few universities with large endowments. Tabulations in the 1982 Money Market Directory list 439 endowments, mostly universities and colleges, located in almost all of the 50 states and the District of Columbia. Of these, 227 are located in 40 metropolitan areas shown. See Appendix Table 3.

The need to expand investment opportunities of endowments affects small as well as large universities and colleges. The great majority of private colleges have endowments of less than \$5 million.[6/]

Moreover, the restrictions prevent literally hundreds of local communities from benefiting from debt financed real estate development which would otherwise not be undertaken by endowed schools even if it is in the interest of the communities and the schools to engage in community development.

6/ National Association of Colleges and University Business Officers, Results of the 1981 NACUBO Comparative Performance Study, Washington, D.C. 1982. See Tables 51 and 52.

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III. <u>Why is real estate needed as an investment option?</u>

Educational endowments own very little in the way of real estate. But real estate is one of the three major outlets for investment funds. Real estate and common stock are traditional shelters against inflation, although the situation can vary substantially over time. In some cases real estate is a better shelter than stocks and vice-versa. Bonds are generally the preferred outlet when prices are declining. Well-rounded investment programs therefore seek to utilize all three outlets as judgments on future price and earnings change.

Inflation has made real estate the most profitable investment over the last decade or so. One of the largest available real estate investment programs had an effective annual total rate of return of 12.2 percent for an investment entered on August 1, 1970, and held through July 31, 1981.[7/] By comparison, the annual rate of return was 8.0% for common stocks and 3.5% for long-term bonds during this same period. (See Appendix Table 5). Because of the relatively poor price performance of stocks and bonds during this period (see Appendix Tables 4 and 5), the real value of endowments of educational institutions did not change over the last half of the 1970's even though the nominal value increased by 45 percent (see Appendix Table 6). And between 1973 and 1981 the real value of the endowments

7/ Prudential Insurance Company of American, PRISA 1981 Annual Report, p. 12. See Appendix Table 5.

declined by 24 or 31 percent, depending on the price deflator used (Appendix Table 7).

Yet investment return is not the only reason to remove the tax from debt financed real estate investments. The fact that present law penalizes an investment in debt financed real estate makes it difficult for an educational institution to justify taking on debt to acquire or develop real estate when there is an objective over and beyond the maximum current income. For instance, a college or university may own vacant or agricultural land, perhaps received as a bequest, that could be developed to enhance its gross return with a consequent beneficial result to the community in enhanced employment and tax revenue. However, taking on the necessary debt to carry out the development would lower the net return below that which can be obtained from investments not carried with debt.[8/] As a result, the development is not carried out, or at least is considerably delayed.

Acquisitions for necessary planned development of real estate by a college, university or private school can also be limited by the tax laws. An institution may want to help improve its neighborhood by upgrading the real estate but could only do so by taking on debt. However, to carry the property would require debt-financing and rental of property. In both cases, the

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8/ See, for instance, the testimony of W. J. Farrell of the University of Iowa and M. Takabuki of the Kamehameha Schools before the Subcommittee on Taxation and Debt Management of the Senate Comittee on Finance, July 19, 1982.

return after tax can be such that the investment is noncompetitive with stocks and bonds owned outright.

IV. Does the penalty tax discourage real estate investment?[9]

The penalty tax generally discourages real estate as an investment by tax-exempt entities because the cash flow return on equity invested in a leveraged real estate investment often is less than for a 100 percent equity investment. The following table illustrates why a debt-financed real estate investment can be unattractive vis-a-vis one with 100 percent equity funding.

The table below is based on the following:

(1) Cost of property is $100.

(2) Interest rate on mortgage indebtedness is 15%.

(3) During period covered, there is no reduction in mortgage indebtedness.

(4) Depreciation is based on 75% of the cost of the property.

(5) Depreciation, for tax purposes, is based on a 15 year useful life, using the straight line method ($5/yr.).

(6) Rental income from the property is $16.

(7) Assumed income tax rate is 46%.

9/ Holding stocks and bonds on margin also is discouraged by the taxation of the dividends and interest therefrom in the same manner as income from leveraged real estate.

Return before tax on unrelated Business Income

	100% Equity Financing	50% Mortgage Indebtedness	60% Mortgage Indebtedness
Rental income	16.00	16.00	16.00
Interest on debt	-0-	7.50	9.00
Cash flow after interest	16.00	8.50	7.00
Percent return on equity	16.0%	17.0%	17.5%

Percent return on equity after interest and tax on unrelated business income

	100% Equity Financing	50% Mortgage Indebtedness	60% Mortgage Indebtedness
Year 1	16.0%	15.35%	16.08%
Year 2	16.0	15.26	16.01
Year 5	16.0	14.92	15.72
Year 7	16.0	14.62	15.46
Year 8	16.0	14.42	15.42
Year 10	16.0	13.96	15.20

The above table shows that a 16 percent return on a 100 percent equity investment surpasses the return on equity if leverage of 50 or 60 percent is used (with very minor exceptions). In the first year of ownership, with a mortgage equal to 50 percent of the cost of the property, the return on equity is only 15.35 percent. As the investment ages, the return on equity decreases as the proportion of income subject to tax increases. This occurs because the ratio of debt to adjusted basis of the property (the method used under the formula for determining taxable income) increases.[10/] With 50 percent indebtedness, the return on equity in the 10th year of ownership drops to 13.96 percent.

Accordingly, a financial officer for an exempt educational organization will not invest in debt financed real estate if he finds that his net return on equity is expected to be less than on a 100 percent equity investment. As shown in the table above, this disadvantage grows the longer the property is held.[11/]

10/ Percentage of income and expenses (interest and depreciation) used for income tax computation under Section 514(c) of the Internal Revenue Code.

	50% Mortgage Indebtedness	60% Mortgage Indebtedness
Year 1	51.3%	61.5%
Year 2	54.1	64.9
Year 5	64.5	77.4
Year 7	74.1	88.9
Year 8	80.0	96.0
Year 10	95.2	100.0

When the ratio exceeds 100 percent, taxable income is all income less all expenses.

11/ It is noteworthy that with risky high debt financing (70 to 80% or more), it is possible to achieve a greater net return on debt financed real estate than on a 100 percent equity investment. Appendix Table 8 indicates that with 80 percent indebtedness, a 20 percent return can be obtained versus 16 percent on 100 percent equity. But that return is deceptive. To offset the effect of the tax requires moving into a riskier environment. One must recognize that leverage operates on the downside as well as the upside. High per-

(footnote continued on following page)

In addition to a lower rate of return, there is another aspect of the penalty tax that discourages debt financed real estate investment. This is the tax-offset that is available to taxable individuals or partnership investors. Many real estate investments result in losses for tax purposes in the first few years of ownership because interest, allowable depreciation, and other expenses exceed rental income. A taxable individual or partner in the 50 percent bracket can use his proportionate losses to offset tax on other income. When this is done, the actual net cash flow from the investment plus the tax saving can make an investment quite profitable for the investor. An example of this result is shown in Appendix Table 8. Here an individual in the 50 percent bracket with an 80 percent leveraged real estate investment can earn 22.5 percent on his equity during the 15 years of straight line depreciation. By way of contrast, a tax exempt organization could earn only 20 percent on a similar investment (even though

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__/ (footnote continued from previous page)

centage debt financing increases pressure on equity should the investment not work out as planned. For instance, a key store in a shopping center failing to renew its lease can serve to reduce customer traffic enough to harm the whole enterprise. And if the mortgage has to continue to be serviced, the return on equity can be radically reduced. Risks in real estate obviously force a prudent investment officer to require a greater potential return from a real estate investment, especially a leveraged one, than a Treasury bond or a triple A corporate bond. Consequently, a tax on highly leveraged real estate investment tilts the investment flow towards greater equity real estate funding or investment in securities.

non-taxable), if, as is likely, it has no other taxable income against which to offset any losses.12/

The penalty tax also discourages debt financed investment because it distorts investment decisions related to the pricing of real estate. When the educational institution investment officer cannot offset a tax loss against other taxable income, he cannot compete in the marketplace for real estate on a par with taxable investors. Either he has to meet the competitive price and take a lower return on the real estate investment or he must shift endowment funds to stocks and bonds where the use of leverage and an allowance for depreciation do not influence the prices and rates of return.

V. Would the exemption from the penalty tax on debt-financed real estate provide educational institutions with a financial advantage over other exempt organizations?

The answer to this question is obviously no because of the overwhelming size of the pension trust sector vis-a-vis educational institutions. With the passage of Public Law 96-605 which exempts pension and profit sharing trusts from the tax on unrelated business income from leveraged real estate investments, the trusts were given an advantage not available to others exempt under section 501 of the Code, including

12/ In this case interest and depreciation exceed the total rental income. See Appendix Table 8.

educational institutions. Since the assets of pension and profit-sharing funds were $423 billion at the end of 1980 (Appendix Table 9), while the endowments of institutions of higher education were only $21 billion,[13/] the financial strength and advantages of pension trusts are overwhelming. Exempt endowment funds owned by other than educational institutions also are of minor magnitude compared to pension trust assets (See Section XI).

VI. Would removal of the penalty tax provide educational institutions with a financial advantagee to accumulate funds?

When debt financed investment income of exempt organizations became taxable under the Revenue Act of 1950 and the Tax Reform Act of 1969, one reason for taxation was to prevent market distortion that may occur because of the ability of a tax-exempt investor to expand investment faster than a taxable investor, if the former chooses to expand from retained earnings. Alternatively, the tax-exempt organization could choose to pay a higher price for an investment asset than a taxable investor but still obtain a satisfactory rate of return because of the absence of income tax.

13/ U.S. Department of Education, The Condition of Education, 1982 Edition, Washington, D.C., no date, Table 4.13, p. 150.

The situation has changed somewhat in recent years. The deductions that have become available for investments in varied types of real estate, including the accelerated cost recovery system enacted in 1981, have made it possible for real estate investors to report losses for income tax purposes during the initial 5 to 7 years of ownership. These losses can be set-off against other income. Since educational institutions are unlikely to have other taxable income against which to offset losses from real estate investments, they would have no advantage in accumulating income from leveraged real estate during the period when expenses, including depreciation, exceed income. In fact, during this period they have a lower rate of return after taxes. At the point when income from depreciable real property becomes taxable for taxable entities, the strategy is generally to sell the property and pay the capital gains tax.

In the case of a tax exempt entity which holds property subject to an outstanding mortgage, only a portion of the deductions allowable can be taken into account in computing income subject to tax, whereas a taxable entity is allowed the full deduction. Consequently, the exempt entity will have waisted a portion of the attractive benefits of depreciation and yet will pay precisely the same capital gains tax on the same gain as the taxable entity.

When Public Law 96-505 reintroduced income tax exemption for debt financed real property owned by pension or profit sharing plans, the legislation was supported as being a valid enhancement of the function for which the trusts were granted exemption -- i.e., "to accumulate funds to satisfy their exempt purpose -- the payment of employee benefits."[14/] The legislation thus implies that existing exemption for passive investment income of educational institutions is not intended to foster accumulation for future outlays. In addition the legislation implies that permitting receipt of tax-free income from leveraged real estate investments by educational institutions results in accumulations not satisfying their exempt purposes, but merely enhancing their ability to accumulate funds. This is not true.

In actual practice, accumulation is not the objective of educational endowment funds. Income is desired for its availability to meet current expenditures. A survey for fiscal year 1981 of institutions of higher education showed that "the average institution added back to principal 10.3% of interest, dividends, rent and other similar yields."[15/]

14/ Senate Report No. 96-1036, p. 29.

15/ NACUBO, Op. cit., p. 55.

VII. Would removal of the penalty tax still maintain safeguards against abuse?

The tax on unrelated business income from leveraged investment was enacted because tax-exempt organizations had been passing on part of the benefits of the tax exemption to the owners of property and businesses who sold their assets to tax-exempt institutions. When the Congress in 1980 reintroduced exemption for leveraged real estate investments by pension trusts, it added restrictions to the exemption designed to prevent the abuses which had grown up before enactment of the Tax Reform Act of 1969. The law provided that exemption from the penalty tax for income from debt-financed real property will not apply if --

1. The purchase price is not a fixed amount determined as of the date of acquisition;

2. The purchase price (or the amount or timing of any payment) is dependent, in whole or in part, upon the future revenue, income, or profits derived from the property;

3. The property is leased to the transferor (or a party related to the transferor);

4. The property is acquired from or leased to, certain persons who are "disqualified persons" with respect to the pension trust; or

5. The debt is a non-recourse debt owed to the transferor (or a related aprty) which either:

a. is subordinate to any other indebtedness secured by the property, or

b. bears a rate of interest significantly less than that which would apply if the financing had been obtained from a third party.

All of the applicable restrictions are incorporated in S. 2498/H.R. 6353.[16] The restrictions pertinent to educational organizations are addressed to the abuses of the exemption that involve arrangements by the seller of the property with the exempt organization to enhance the sales price (and thus increase the size of the capital gain) by leasebacks, non-recourse loans at below-market interest rates, and variable payout arrangements (which translate into a variable selling price).

It has been suggested that one potential abuse not covered by S. 2498/H.R. 6353 arises when a partnership is formed consisting of both tax-exempt educational organizations and taxable entities. Abuse of the exemption could take the form of a contract which allocates the cash flow from the real estate to the educational organizationa and the tax deductions to the

16/ The criticism has been made that the current law restrictions are so broadly worded as to prevent transactions between independent buyers and sellers that do not constitute abuse of the exemption. See, R.D. Howard and N.G. Blumenfeld, The Journal of Taxation, June 1982.

taxable partner. It may be appropriate to incorporate the requisite restrictions as part of S. 2498/H.R. 6353 to preclude such partnership allocations by pension trusts as well as educational organizations.

VIII. Are endowment earnings ultimately taxable?

It is noteworthy that the elimination of the penalty tax on income from debt-financed real estate held by pension trusts was justified in the Congress and the Executive on the grounds that the exemption of the income was only deferred and that ultimately pension beneficiaries become taxable on such income. The Congressional reports assert that this is not the case with respect to other exempt organizations. The Senate report states that "The investment assets of other organizations under Code Section 501(a) are not likely to be used for the purpose of providing benefits taxable at individual rates."[17] The fact is that higher education endowment income becomes taxable much sooner than pension trust income. Whereas much of endowment income is paid out within a year to taxable recipients, pension trust income is accumulated for employees over their work life (30-40 years) and it is only after the end of the work career that benefit proceeds which represent the pension trust earnings

17/ Senate Report No. 96-1306, p. 29.

become taxable. In fact, it is currently estimateed that the government will lose $28.6 billion in 1983 because of the tax deferral for private pension plan contributions and earnings.[18/] This loss will continue to grow each year reaching nearly $50 billion by 1987. It is noteworthy that the value of the assets of pension funds have been expanding at a rapid pace (the increase between 1970 and 1980 was $285 billion or over 200 percent (Appendix Table 9) which in effect is removed from the tax base.

Endowment earnings of educational institutions become immediately taxable, not as income of the institution but as income to employees and sellers of goods and services to the institutions. Much of the annual endowment earnings is used to pay current costs. The National Association of College and University Business Officers (NACUBO) reports that the distributions from endowment used to meet current expenditures in 1981 was 89.7 percent of the dividends, interest, rents and other yields.[19/] This amounts to $1.2 billion based on 1981 endowment income of $1.4 billion. About 70-80 percent of the operating budgets of educational organizations is for faculty and other employee compensation and the remainder goes for energy costs, maintenance, etc.[20/]

18/ CBO, Tax Expenditure Estimates, Appendix A, Fiscal years 1982-1987, released November 29, 1982.

19/ NACUBO, Op. Cit., p. 55.

20/ From unpublished study by Hans Jenny, Wooster College, Ohio.

IX. Would there be a revenue loss by not imposing a penalty tax on debt-financed real estate investments?

The answer is little or no revenue loss. The endowment funds of educational institutions are equivalent to only about 5 percent of the assets of pension and profit sharing trusts. Any revenue loss attributable to exempting income from debt-financed real property owned by the former can only be a small fraction of the loss resulting from granting the exemption to pension trusts by the 1980 legislation. The Senate report on the 1980 legislation stated that the immediate effect would be a revenue loss of $10 million, but it could be large in the future.[21/] At 5 percent of the pension trust figure, the education endowment revenue loss estimate would be only $500,000 as compared to the $10 million mentioned.

But there is ample reason to believe that any revenue loss would be minimal because of the measurement of income from real estate for Federal income tax purposes. The 15-year useful life standard for measuring depreciation of real estate is generous and, when combined with the interest deduction, shelters for several years after the initial purchase income from real estate financed with a mortgage when owned by a taxable entity. As an example, Appendix Table 10 shows a

21/ Senate Report No. 96-1036, p. 31.

proposed real estate partnership which expects to have losses for tax purposes for 6 years.

Thus, exemption, if ownership is by a pension trust or educational endowment, which would not make the investment except for the exemption, must be considered as a substitute for the situation of a similar investment by a taxable entity. After some time the real estate investment would create taxable income for a taxable owner, so exemption for a section 501 organization could be considered as causing a revenue loss from that point in time forward until the mortgage was paid off. However, if the objective of the taxable investor is to keep his after-tax income reasonably close to the maximum, the taxable investor has the economic encouragement to sell before the 10th year and begin the depreciation process once again. This occurs as the deductible interest factor in a level payment mortgage declines and the non-deductible principal repayment increases. This practice, therefore, limits the extent of revenue loss that could arise from substitution of an exempt trust or fund for ownership by a taxable entity.

Moreover, educational endowments now do not pay any tax (or practically none) on real estate investments simply because it is uneconomic to invest in leveraged real estate because of the penalty tax. Only 2.2 percent of educational endowments at

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the end of fiscal 1981 were in real estate investment.[22] Accordingly, equity investment in leveraged real estate, if the penalty tax were lifted, would almost entirely represent a shift of funds from investments in stocks and bonds, the income from which is now tax-free, because the tax law makes it uneconomic to carry the stocks and bonds on margin.

X. Why not remove the penalty tax on debt-financed investment in outlets rather than real estate?

The great majority (nearly 82 percent) of college endowment funds are invested in stocks and bonds.[23] Income from these securities (and other personal property) also is subject to the unrelated business income tax if debt-financed. While such taxation reduces the net rate of return on equity invested in stocks and bonds carried with debt financing, S. 2498/H.R. 6353 does not provide exemption and we do not recommend that exemption be granted to such investments.

Investment practices are quite different for stocks and bonds. Large holders of stocks and bonds, such as mutual funds, pension trusts and insurance companies, typically own such securities outright. Margin debt on stocks and related equity instruments (essentially convertible bonds) advanced by

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22/ NACUBO, Op. cit., Table 17, p. 23.

23/ NACUBO, Op. cit., p. 25.

broker-dealers at the end of August 1982 was only $11.4 billion.[24] While brokers do not represent the only source for borrowing on stocks and bonds, this lending does provide some indication of the relatively small size of such lending relative to mortgage lending.

Real estate investments are typically financed initially by debt, often 50 percent or more of the cost. In some cases, the property can only be purchased by the buyer assuming an existing mortgage. The amount of mortgages outstanding at the end of June 1982 on multifamily homes and commercial real estate was $435 billion.[25]

Because of the absence of the leverage factor in the pricing of stocks and bonds purchased for investment portfolios, educational institutions can make their purchases on a full equity basis and obtain a net return that is comparable to that obtained by other investors in stocks and bonds. By way of contrast, to match the price for real estate which taxable entities are willing to pay, an educational endowment must be willing to accept a lower net return on the real estate than the other purchasers. This occurs because real estate is priced to reflect the fact that it is customarily acquired with

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24/ Board of Governors of the Federal Reserve System, Federal Reserve Bulletin, October 1982, p. A42.

25/ Ibid, p. A41.

substantial indebtedness. The value of this advantage is realized by the seller through a higher sales price than would otherwise be the case (i.e., this beneit is capitalized by the seller). Thus, a tax exempt entity, competing in the market place for real property, must accept the capitalized price despite the lower rate of return and its inability to absorb the full benefits of debt-financing (i.e., full deduction of interest, taxes, depreciation, etc. for tax purposes). Thus, tax exempt entities must be willing to take a lesser return on debt-financed real estate than can be obtained from stocks and bonds carried without debt.

XI. What would be the revenue loss if extended to other charitable and religious organizations?

Since charitable, religious, and educational organizations ordinarily are viewed as a group, it is only logical to consider the possibility of extending the exemption proposed by S. 2498/H.R. 6353 to these other institutions. No attempt to rank the social benefits from the three categories is warranted. If the other 501(c)(3) institutions feel that exemption of income from debt-financed real estate investment would be useful to them, it should not be considered adverse to the educational institutions request. However, because of problems associated with the operations of private foundations which were addressed by the Tax Reform Act of 1969, separate review of these organizations is warranted.

Exemption of income from debt financed real estate for all section 501(c)(3) organizations would add very little to the possible revenue loss from exemption just for educational institutions. Appendix Table 11 indicates that, exclusive of religious and educational institutions, endowment funds are only about $40 billion, and of this nearly $35 billion is held by private foundations.

Conclusion

In summary, because of governmnt budget stringency in times of inflation and recession, and the pursuit of other pressing national and international problems, government support of private education is waning. Federal funding of higher education is declining in real terms. Within this federal-private partnership in higher education it is surely appropriate to lift the penalty tax on debt-financed real estate investment and afford higher education the opportunity to increase its contribution to educational financing at little or no cost to the Federal fisc.

Given the social and economic benefits that private educational institutions provide, they should not be limited in their investment strategies by tax penalties that have long lost their rationale and have been supplanted by more direct and adequate safeguards that prevent abuse, i.e., recently enacted in the case of pension trusts. S. 2498/H.R. 6535 simply extends these rules to tax exempt educational institutions with little or no revenue loss to the Treasury.

Appendix Table 1

Total current-fund revenues and expenditures, and endowment income, of institutions of higher education 1969-1970 to 1980-1981
($ millions)

	1969-1970	1970-1971	1971-1972	1972-1973	1973-1974	1974-1975	1975-1976	1976-1977	1977-1978	1978-1979	1979-1980	1980-1981 1/
Current fund revenue												
All institutions	$21,515	$23,879	$26,234	$28,606	$31,712	$35,687	$39,703	$43,437	$47,034	$51,838	$58,520	$65,505
Public	13,769	15,527	17,080	18,785	21,206	24,005	26,835	29,255	31,545	34,527	38,824	43,196
Private	7,747	8,352	9,154	9,821	10,506	11,682	12,868	14,181	15,489	17,310	19,691	22,289
Endowment income (earnings)												
All institutions	$ 447	$ 471	$ 481	$ 515	$ 577	$ 718	$ 687	$ 765	$ 802	$ 985	$ 1,177	$ 1,364
Public	57	55	55	65	77	107	97	98	129	154	191	215
Private	390	415	426	450	500	611	590	666	703	832	986	1,150
Current fund expenditures and mandatory transfers 2/												
All institutions	$21,043	$23,375	$25,560	$27,956	$30,714	$35,058	$38,903	$42,600	$45,971	$50,721	$56,914	$64,053
Public	14,250	14,996	16,484	18,204	20,336	23,490	26,184	28,635	30,725	33,733	37,768	42,280
Private	7,794	8,379	9,075	9,752	10,377	11,568	12,719	13,965	15,246	16,988	19,146	21,773

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Source: U.S. Department of Education, Digest of Education Statistics, Washington, D.C. various years.

1/ Unpublished.

2/ Does not include mandatory transfers prior to 1974-1975.

Appendix Table 2

Total current fund revenues, and revenues from the Federal government and endowments, institutions of higher education, 1970, 1975, 1980, 1981
($millions)

	1967 - 1970		1974 - 1975		1979 - 1980		1980 - 1981	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Total current fund revenues	$7,747	100.0%	$11,682	100.0%	$19,696	100.0%	$22,389	100.0%
Federal funds1/	1,438	18.6	2,286	19.6	3,829	19.4	4,207	18.8%
Endowment funds	390	5.0	611	5.2	968	5.0	1,150	5.2

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Source: U.S. Department of Education, The Condition of Education, various years.

1/ Includes Federally-funded research and development centers.

Appendix Table 3

Endowment funds of over $2,000,000 of educational institutions, museums and hospitals by State and metropolitan areas

STATE	ENDOWMENTS #	ENDOWMENTS $ in Mil.
ALABAMA	4	71
ALASKA	—	—
ARIZONA	1	9
ARKANSAS	4	44
CALIFORNIA	21	1,046
COLORADO	4	85
CONNECTICUT	12	1,808
DELAWARE	1	131
DISTRICT OF COLUMBIA	18	363
FLORIDA	5	117
GEORGIA	9	433
HAWAII	2	21
IDAHO	1	34
ILLINOIS	17	1,082
INDIANA	16	645
IOWA	7	108
KANSAS	6	149
KENTUCKY	8	180
LOUISIANA	3	47
MAINE	4	101
MARYLAND	7	301
MASSACHUSETTS	38	2,496
MICHIGAN	12	322
MINNESOTA	9	244
MISSISSIPPI	1	5
MISSOURI	18	451
MONTANA	—	—
NEBRASKA	4	43
NEVADA	1	20
NEW HAMPSHIRE	4	283
NEW JERSEY	8	1,149
NEW MEXICO	3	40
NEW YORK	86	3,208
NORTH CAROLINA	18	364
NORTH DAKOTA	1	6
OHIO	38	860
OKLAHOMA	4	43
OREGON	5	88
PENNSYLVANIA	30	1,131
RHODE ISLAND	3	129
SOUTH CAROLINA	5	56
SOUTH DAKOTA	—	—
TENNESSEE	7	240
TEXAS	18	5,045
UTAH	1	8
VERMONT	4	100
VIRGINIA	16	487
WASHINGTON	5	88
WEST VIRGINIA	2	16
WISCONSIN	6	127
WYOMING	—	—
CANADA	2	84
TOTALS	430	$ 24,785

METROPOLITAN AREAS	1980 CENSUS RANK	ENDOWMENT #	ENDOWMENT $ in Mil.
NEW YORK	1	31	1,686
CHICAGO	3	10	902
STAMFORD	171	—	—
LOS ANGELES—LONG BEACH	2	12	547
DETROIT	5	6	190
PITTSBURGH	13	3	266
SAN FRANCISCO—OAKLAND	6	6	1,117
HOUSTON	9	3	289
ST. LOUIS	12	5	415
DALLAS—FORT WORTH	8	4	191
NEWARK	17	3	85
CLEVELAND	19	7	358
PHILADELPHIA	4	20	551
MINNEAPOLIS—ST. PAUL	15	8	225
HARTFORD	54	5	67
BOSTON	10	26	2,950
WASHINGTON, D.C.	7	12	385
CINCINNATI	27	5	189
SEATTLE—EVERETT	23	2	34
AKRON	57	3	33
ROCHESTER	30	3	554
TULSA	56	2	26
MILWAUKEE	28	2	25
ATLANTA	16	6	301
TOLEDO	61	—	—
MIAMI	21	1	35
SAN DIEGO	20	—	—
GREENSBORO—WINSTON-SALEM	48	4	97
DENVER—BOULDER	22	3	41
KANSAS CITY	29	4	123
PORTLAND	32	3	46
DAYTON	47	3	68
NASSAU—SUFFOLK COUNTY	11	3	27
PHOENIX	26	—	—
PROVIDENCE	41	4	143
BALTIMORE	14	6	283
INDIANAPOLIS	34	4	82
LOUISVILLE	43	3	44
NEW ORLEANS	33	2	55
NEW HAVEN	83	3	833
OTHERS		212	11,340
TOTALS		430	$ 24,785

Source: 1982 Money Market Directory, pp. XIII and XIV.

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Appendix Table 4

Average total return1/ of college and university investment pools2/ for periods ended June 30, 1981, and comparison with other investment and inflation benchmarks

	One year	Three years	Five years	Ten years
Average total return	14.64%	12.49%	9.06%	6.45%
Change in market value	6.94			
Current yield3/	7.70			
Comparative investment indicies :				
Dow-Jones Industrial Average	19.39	12.52	5.10	5.79
Standard and Poor's 500 Index	20.86	17.12	10.01	7.19
Salomón Brothers High Grade Long-term Corporate Bond Index	-14.11	-4.05	.06	3.12
Inflation benchmarks				
Consumer Price Index	9.52	11.59	9.79	8.37
Higher Education Price Index	9.77	9.13	8.10	7.36

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Source: National Association of College and University Business Officers, Results of the 1981 NACUBO Comparative Performance Study, Washington, D.C., no date Table 4, page 9.

1/ Total return is the sum of current cash payments plus any change in market value.

2/ "Investment pool" and "endowment" are not entirely synonomous. All of an institution's endowment funds may not be in its investment pool. Alternatively, other than endowment funds may be included in investment pools. Most of the investment pools as of June 30, 1981, was endowment funds, however.

3/ Assumes reinvestment of income.

Note: Based on investment pools of 209 colleges and universities. As of June 30, 1981, these pools had a market value of $17.8 billion. The estimated market value of endowments for all institutions of higher education at the end of fiscal year 1980 was $20.7 billion (U.S. Department of Education, The Condition of Education, 1982 Edition, Table 4.13, page 150.)

Appendix Table 5

Comparison of annual rate of return from investment in PRISA and representative stocks and bonds 1/, 1971-1981

Effective Annual Rates of Return (for periods from July 31, 1970 to September 30 of year shown)

For a single investment on July 31, 1970:

	Property PRISA	Common Stocks S&P 500	Long-Term Bonds Salomon Bros.	3-Month Treasury Bills	Consumer Index Price
1971	5.7%	26.0%	14.6%	4.9%	4.0%
1972	6.0	21.0	12.1	4.4	3.7
1973	6.9	14.3	10.0	5.0	3.7
1974	7.3	−1.7	4.3	5.7	6.5
1975	7.6	5.1	6.2	5.8	6.8
1976	7.7	8.8	8.4	5.7	6.6
1977	8.0	6.9	8.7	5.6	6.6
1978	8.7	7.5	7.7	5.7	6.8
1979	10.6	8.0	7.1	6.1	7.3
1980	11.8	8.2	5.1	6.6	7.9
1981	12.2	8.0	3.5	7.2	8.1

For a series of equal quarterly investments beginning July 31, 1970: 2/

	Property PRISA	Common Stocks S&P 500	Long-Term Bonds Salomon Bros.	3-Month Treasury Bills	Consumer Index Price
1971	6.0%	14.9%	10.6%	4.7%	3.7%
1972	6.9	14.7	9.0	4.1	3.4
1973	7.6	7.3	7.1	5.4	5.6
1974	8.1	−17.2	−1.5	6.4	8.2
1975	8.3	−0.4	3.6	6.3	8.1
1976	8.2	7.2	7.9	6.0	7.4
1977	8.6	4.6	8.4	5.8	7.2
1978	9.5	5.9	7.0	5.9	7.4
1979	12.0	6.9	6.2	6.4	8.1
1980	13.5	8.8	3.6	7.1	8.4
1981	13.8	7.1	1.3	8.0	9.0

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Source: Prudential Insurance Company of America, PRISA 1981 Annual Report, p. 13.

Note: PRISA - Prudential Property Investment Separate Account.

1/ Investment income plus change in current value.

2/ Made only on dates on which PRISA accepted contributions.

Appendix Table 6

Market value of endowment, in current and constant 1980 dollars, of institutions of higher education, end of fiscal years 1975 to 1980
($ millions)

Type of institutions	1975	1976	1977	1978	1979	1980	Percent change 1975 to 1980
				Current dollars			
All institutions	$14,365	$15,488	$16,304	$16,840	$18,159	$20,743	44.4%
Public	2,615	2,933	3,131	3,271	3,516	3,708	41.8
Private	11,750	12,556	13,174	13,569	14,642	17,305	45.0
				Constant 1980 dollars1/			
All institutions	$20,596	$20,829	$20,590	$19,936	$19,950	$20,743	0.7
Public	3,749	3,944	3,954	3,873	3,863	3,708	-1.1
Private	$16,847	$16,884	$16,636	$16,063	$16,087	$17,035	1.1

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Source: U.S. Department of Education, The Condition of Education, 1982 Edition, Washington, D.C., no date, Table 4.13, p. 150.

1/ Computed by using the Higher Education Price Index.

Appendix Table 7

Relative change1/ in value of college and university endowment funds before and after inflation adjustment, fiscal years 1973-1981

Fiscal year, June 30	Endowment funds nominal value	Real endowment based on CPI	Real endowment based on HEPI2/
1973	100.00%	100.00%	100.00%
1974	83.30	76.49	77.48
1975	91.05	75.19	78.28
1976	98.52	75.96	79.46
1977	102.36	74.60	77.56
1978	103.79	70.82	73.67
1979	112.09	68.94	73.80
1980	122.85	66.11	73.60
1981	139.31	68.46	76.22
Percent change 1981/1978	39.31	-31.54	-23.78

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Source: National Association of College and University Business Officers, Results of the 1981 NACUBO Comparative Performance Study, Washington. D.C., no date, Table 37, page 44.

1/ Change is the result of charge in market value of assets plus new gifts less distributions from current income and any distributions from capital.

2/ Higher Education Price Index.

Appendix Table 8

Cash flow before and after unrelated business income tax on an equity investment in property encumbered by varying percentages of debt

Specifications

1. Cost of property: $100
2. Cash flow before income tax on cost of property: 16 percent or $16
3. Rate of interest on debt: 15 percent
4. Depreciation: 15 years, stright line
5. No reduction of principal of debt during periods in the table
6. Unrelated business income tax rate: 46 percent

	Percent of property financed by debt				
	0	40	50	60	80
Cash flow/rate of return to an exempt organization before imposition of tax on unrelated business income					
Equity investment in property	$100.00	$60.00	$50.00	$40.00	$20.00
Interest on debt	0	6.00	7.50	9.00	12.00
Cash flow on equity after interest	16.00	10.00	8.50	7.00	4.00
Cash flow after interest as a percent of equity	16%	16.67%	17%	17.5%	20%
Cash flow/rate of return to exempt organizations after imposition of tax on unrelated business income 1/					
Cash flow on equity after interest and income tax					
Year 1	$ 16.00	$ 9.06	$ 7.67	$ 6.43	$ 4.00
Year 2	16.00	9.01	7.63	6.40	4.00
Year 5	16.00	8.81	7.46	6.29	4.00
Year 7	16.00	8.64	7.31	6.18	4.00
Year 8	16.00	8.53	7.21	6.12	4.00
Year 10	16.00	8.25	6.98	6.08	4.00
Cash flow after interest and income tax as a percent of equity					
Year 1	16%	15.1%	15.3%	16.1%	20%
Year 2	16%	15.0%	15.3%	16.0%	20%
Year 5	16%	14.7%	14.9%	15.7%	20%
Year 7	16%	14.4%	14.6%	15.5%	20%
Year 8	16%	14.2%	14.4%	15.4%	20%
Year 10	16%	13.7%	14.0%	15.2%	20%
Cash flow/rate of return to a taxable partner in a real estate investment					
Cash flow on equity after interest and income tax offset 2/					
Year 1					$ 4.50
Year 2					$ 4.50
Year 5					$ 4.50
Year 7					$ 4.50
Year 8					$ 4.50
Year 10					$ 4.50
Cash flow after interest and income tax offset 2/ as a precent of equity - For years 1-10					22.5%

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Source: Rudney/Copeland Study, Toward Removal of the Penalty Tax on Debt-Financed Real Estate Investment By Educational Institutions, Washington, D.C.

1/ Amounts subject to tax are computed using the allocation rule in section 514(a) of the Internal Revenue Code and the instructions therefor for Form 990-T, 1981 tax year.
2/ After interest and depreciation, income for tax purposes is minus $1.00. The partner is assumed to be in the 50 percent marginal bracket so the tax offset of $0.50 is added to the net of rentals after interest ($16-$12).

Appendix Table 9

Value1/ of assets of private pension funds
($billions)

Year	Amount
1960	$ 52.0
1970	138.2
1971	152.8
1972	169.8
1973	182.6
1974	194.5
1975	217.4
1976	249.4
1977	283.0
1978	321.2
1979	362.6
1980	422.7

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Source: American Council of Life Insurance, 1981 Pension Facts, Table 2, p. 9

1/ Data are reserves of insured plans plus assets at book value of non-insured plans.

Appendix Table 10

Investor impact summary of a proposed real estate partnership assuming 50% effective tax rate, assuming 44% initial equity

Year	Cash invest- ment	Taxable income (loss)	Cum. taxable (loss)	Tax savings (cost) at 50%	Net investment	Cash distribution	Cash on cash yield
1982 1/	$ 6,000	$ (8,818)	$ (8,818)	$ 4,409	$ 1,591	$ -	-
1983	19,000	(24,307)	(33,125)	12,154	6,846	-	-
1984	19,000	(19,574)	(52,699)	9,787	9,213	-	-
1985	17,000	(16,380)	(69,079)	8,190	8,810	-	-
1986	14,000	(8,092)	(77,171)	4,046	9,954	4,476	6.0%
1987	-	(3,588)	(80,759)	1,794	-	6,022	8.0%
1988	-	1,678	(79,081)	(839)	-	7,266	9.7%
1989	-	3,420	(75,661)	(1,710)	-	8,627	11.5%
1990	-	5,135	(70,526)	(2,568)	-	10,118	13.5%
Total	$75,000	$(70,526)		$35,263	$ 36,414	$36,509	

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1/ Two months.

Appendix Table 11

Endowment funds of organizations exempt under section 501(c)(3)

Institution	Year	Endowment funds ($billions)
Institutions of higher education1/	1980	$20.7
Private foundations2/	1979	34.7
Museums, hospitals, with endowments over $2 million3/		5.0
Religious organizations	Not available	

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Source: Rudney/Copeland Study, Toward Removal of the Penalty Tax on Debt-Financed Real Estate Investment By Educational Institutions, Washington, D.C.

1/ U.S. Department of Education, The Condition of Education, 1982 Edition, Washington, D.C., no date, Table 4.13, p. 150.

2/ Internal Revenue Service, Statistics of Income Bulletin, Fall 1982, Washington, D.C., p. 9.

3/ 1982 Money Market Directory, p. xi. Revised by subtracting the $20.7 billion for education from the figures for education plus museums, etc., in the Directory. A judgment estimate of the relative size of hospital foundations is that they are one tenth that of higher education.