S. HRG. 103-1025

MISCELLANEOUS FARM-RELATED TAX PROPOSALS

HEARING

BEFORE THE

SUBCOMMITTEE ON
ENERGY AND AGRICULTURAL TAXATION

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

ON

S. 226, S. 531, S. 545, S. 882, S. 1615, S. 1691, and S. 1814

OCTOBER 5, 1994

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

88-740—CC WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-047079-X

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MISCELLANEOUS FARM-RELATED TAX PROPOSALS

WEDNESDAY, OCTOBER 5, 1994

U.S. SENATE,
SUBCOMMITTEE ON ENERGY AND
AGRICULTURAL TAXATION,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 1:05 p.m., in room SD-406, Dirksen Senate Office Building, Hon. Thomas A. Daschle, Chairman of the Subcommittee, presiding.

Also present: Senators Conrad and Roth.

OPENING STATEMENT OF HON. THOMAS A. DASCHLE, A U.S. SENATOR FROM SOUTH DAKOTA, CHAIRMAN OF THE SUBCOMMITTEE

Senator DASCHLE. The hearing will come to order. Let me thank all of those who have agreed to be witnesses today. I want to welcome all of you. This hearing is scheduled to be conducted to examine a number of farm tax bills. We are pleased to have a good number of witnesses today who can help us better appreciate their value.

Periodically the Subcommittee on Energy and Agricultural Taxation holds a hearing on miscellaneous farm tax measures, and it is very important to view the Tax Code's impact on farmers as a whole. Accordingly, it is helpful to discuss farm tax proposals all together in a hearing of this nature.

Farmers often face unique circumstances in their business, and there are a number of provisions in the Internal Revenue Code that recognize this. However, some of those existing provisions need refinement. Moreover, as times change, farmers are subject to increasing legal and regulatory requirements, such as in the environmental area. New tax code provisions may be needed in order to ensure that tax policy goals are consistent with our goals in environmental policy, agricultural policy, and other areas.

The tax bills before us today, sponsored by a number of my colleagues, cover many of these concerns. Two bills relate to the estate tax, which poses significant threats to the continued existence of family farms. IRS interpretation of the estate tax special use valuation for farms has unfairly placed a retroactive tax burden on many inheriting farm families.

Also, the estate tax exemption has not been increased since 1987. And, in a proposal introduced by Senator Durenberger, the exemption would be increased, recognizing the higher value of farm property since that date.

Another couple of bills attempt to refine existing tax code provisions relating to the treatment of disaster-related income. I and many of my colleagues in the Senate, along with Congressman David Minge of the House, have fought to enact a simple change in the timing of recognition of crop disaster payments. Without this change, many farmers will have a bunching of 1993 and 1994 income on their 1994 returns. In addition, many farmers who were forced to sell livestock prematurely as a result of the 1993 floods may not avail themselves of existing disaster tax provisions for livestock because those provisions apply only to drought, and not to floods.

We will also discuss proposals relating to special problems of farmer cooperatives, environmental compliance by farmers, and the ability of farmers to save for retirement.

Senator Boren has introduced legislation to address the proper treatment of gains and losses arising when a farmer cooperative sells assets. Senator Conrad has recognized the need for tax relief for farmers who are forced to purchase special equipment in order to comply with new laws and regulations aimed at environmental protection and soil and water conservation.

Senator Kohl has suggested a new way for farmers to tap the equity of their farm property, often their only pension, to fund their retirement years.

And, finally, we will fulfill a longstanding obligation of the Finance Committee, first extended by former Chairman Lloyd Bentsen, and reaffirmed by Chairman Pat Moynihan, to hold a public hearing on an issue that affects a certain type of export company.

As anyone in this room will attest, exports are the lifeblood of agriculture, and this too is an important part of this hearing.

Without further delay, let us proceed with the testimony. As we have a number of witnesses, I would like to encourage those who have brought written testimony to have it inserted in the record and summarize where possible. We will proceed with the hearing at this time.

I have a letter from Senator Byron Dorgan that I would like to insert in the record with regard to estate tax special use valuation. He has been very active for many years on the issue, and I know that this will be an important contribution to the record.

[The letter from Senator Dorgan appears in the appendix.]

Senator Conrad also is a cosponsor of legislation on this issue that Senator Dorgan and I have introduced, S. 226, and I would note that he is also interested in this issue.

Let me call to the witness stand our first two witnesses. They are colleagues from the House—Congressmen from Delaware and Minnesota—Congressmen Michael Castle and David Minge.

David and Michael, we are very pleased you could be with us this afternoon. Let me call on David for his comments, and then we will ask Michael for his.

STATEMENT OF HON. DAVID MINGE, A U.S. REPRESENTATIVE FROM MINNESOTA

Congressman MINGE. Well, thank you, Mr. Chairman, distinguished guests, and members of the staff. I would like to thank you for the opportunity to testify.

I am here in support of legislation that I introduced in the House of Representatives which would allow farmers who receive disaster aid late—that is, in a calendar year that is different than the year in which the disaster occurred—to carry that income back to the year in which they grew the crop. And before I proceed, I would like to extend my special thanks to Hon. Chairman, who has worked tirelessly with me to try to pass this legislation in Congress.

The need for this legislation was acutely dramatized in the flood of 1993 that devastated tens of thousands of farms throughout the midwest. Those farmers were promised that they would receive payments within approximately ten days after having filed their request for disaster assistance. The tragedy, of course, was that because of the large volume of requests, the U.S. Department of Agriculture was not able to process them as promptly as they had anticipated, and the checks were not cut until 1994 in most cases. Now the difficulty that this posed for farmers is the bunching, which you have already noted in your introductory remarks. Accounting firms have estimated that affected farmers pay as much as $6,000 more in income tax as a result of this bunching.

The situation is really unfair; it is unacceptable. Farmers expected their payments timely but, through no fault of their own, the payments were delayed. They should not suffer because the U.S. Department of Agriculture was unable to administer the program as promptly as it had expected.

The bill that has been introduced on both the House and Senate sides would simply give the farmers the election to take these payments back into the prior year as long as they are operating in a financially consistent way, and their accounting is consistent with their practices for recognition of income from the growth of crops otherwise.

The payment, or the provision in the bill, also introduced symmetry into the Internal Revenue Code because the Internal Revenue Code currently allows farmers to take disaster payments that they receive in a year in which they grew the crop as income in the subsequent year if they normally sell their crops in the subsequent year.

I think that it is important to note that this symmetry is a desirable feature in the tax code and, in fact, the U.S. Congress has previously authorized this type of symmetry in a specific situation when we had crop loss in the late 1970's in the Pacific Northwest.

Unfortunately, it was a temporary fix. What we are attempting to do now is to amend the Internal Revenue Code so that we do not have to again deal with this unfortunate situation.

Mr. Chairman, I have a prepared statement that I will request be inserted in the record, but this is a summary. I appreciate the opportunity to testify.

[The prepared statement of Congressman Minge appears in the appendix.]

Senator DASCHLE. Without objection. We appreciate very much your testimony this afternoon.

Let me just ask you. By now, most farmers have already filed their 1993 tax returns. For these farmers, is there still any benefit to passing the crop disaster tax legislation as you see it, David?

Congressman MINGE. There are two situations in which this legislation would still provide relief. First, farmers can amend their 1993 tax returns and their 1994 tax returns to take advantage of legislation such as this. And that process would save them money because of the progressive nature of the income tax and the fact that they would be in a different tax bracket.

Secondly, there are many farmers who have filed for extensions in anticipation of the enactment of this legislation. The extensions are due to expire on October 15. For those farmers, action by Congress this week would certainly be timely and very welcome.

Senator DASCHLE. Are you aware of farmers who have not yet filed their 1993 returns in hopes that Congress will pass this provision?

Congressman MINGE. Yes, I am. We have received letters from numerous accountants and farmers in my Congressional district indicating that they are awaiting the outcome of this legislation before they actually file their tax returns. They have filed for extensions, and have been granted extensions by the IRS.

Senator DASCHLE. Thank you again.

Congressman MINGE. Thank you.

Senator DASCHLE. I would note the arrival of our colleague, Senator Kohl. Senator Kohl, do you have any comments you wish to make at this time?

Senator KOHL. I am here to introduce one of your witnesses.

Senator DASCHLE. Are you ready? All right.

We are about to hear the testimony of another colleague of ours from Delaware, Michael Castle. Michael, again, welcome.

STATEMENT OF HON. MICHAEL N. CASTLE, A U.S. REPRESENTATIVE FROM DELAWARE

Congressman CASTLE. Well, thank you very much, Mr. Chairman, Senator Kohl. I am very pleased to have the opportunity to appear before you today and make a brief statement.

I am also very pleased that the subcommittee has agreed to review the issue of how export trading companies, known as ETCs, are taxed. This matter is of great importance to Hercules, Inc. and several other companies. I am pleased to see that a number of my constituents, mostly from Delaware, are here today. My constituents are all from Delaware. Hercules people, mostly from Delaware, are here today. They will explain the impact of the changes in the tax regulations for ETCs on their company. In addition, my colleague from Delaware, Senator Bill Roth, has been seeking to address this issue for a number of years, and can share his experience and knowledge with the subcommittee.

In my view, the key questions before the subcommittee are Congressional intent and fairness. Was the intent of Congress in the 1986 Tax Reform Act, to eliminate the favorable tax treatment for the few remaining export trading companies? And, was it fair for these changes to be made through the regulatory process without any review by Congress?

It is my understanding that the 1986 Tax Reform Act intended to end the practice of some financial companies establishing offshore mutual funds to protect them from U.S. taxation. However, when implementing the 1986 Act, the Treasury Department in 1988 established new rules for passive foreign investment companies, PFICs, which also included export trading companies like Hercules and its export trading company, HINTCO.

Prior to this action by the Treasury Department, whenever Congress had modified the law on this subject, it had always given existing ETCs the option to protect or change their status. The 1988 action by Treasury essentially changed the rules in the middle of the game for Hercules and other companies without any review by Congress to determine the fairness of the change.

Obviously, the unexpected change in the tax status of this export trading company has a major financial consequence for Hercules. I am here simply to ask that the committee review how these changes were made, and whether Hercules and other companies were treated fairly.

By holding this hearing, you have already begun this process and we thank you very much.

Senator DASCHLE. Well, Michael, we thank you very much. As you say, this issue has been around for a long time—8 years now—and it would be nice to have it resolved.

You mention other companies. Are you familiar with the names of the other companies for the record?

Congressman CASTLE. No. I am not familiar with the names of the other companies, but there are Hercules people here who, I am sure, could probably give you names, addresses, and telephone numbers of the other companies.

Senator DASCHLE. Well, thank you both for your excellent testimony. Thank you for your attention to these issues and, like you, we hope we can resolve them in the not-too-distant future.

Congressman CASTLE. Thank you, Mr. Chairman.

[The prepared statement of Congressman Castle appears in the appendix.]

Senator DASCHLE. Senator Kohl, there is another panel comprised of the International Tax Counsel of the U.S. Department of Treasury, our friend Norm Richter, who is scheduled to testify, but I know you are here to introduce a constituent. If you wish to do that at this time, it may be appropriate that we go ahead. I know how busy your schedule is. Perhaps we can do that, and then we will take the Treasury testimony.

STATEMENT OF HON. HERB KOHL, A U.S. SENATOR FROM WISCONSIN

Senator KOHL. I thank you very much Mr. Chairman. I am very happy to be here today as you conduct this hearing on farm tax issues.

I am particularly glad that the committee has decided to include a discussion of the Family Farm Retirement Act, S. 882, legislation which I introduced last year.

I am very pleased that Mr. Jim Harris of Racine County, Wisconsin is here today to testify on behalf of S. 882. Jim is here representing the Racine County Farm Bureau.

I remember, shortly after I came to the Senate, Jim came to Washington with a mission. That mission was to talk to everyone in Washington who would listen about the plight faced by American family farmers upon retirement. He talked to me, and I was convinced. Farming, as we all know, is a highly capital intensive business. To the extent that the average family farmer reaps any profits at all, much of that income is directly reinvested into the farm. Rarely are there opportunities for farmers to place money aside in Individual Retirement Accounts. Instead, farmers tend to rely on the sale of their accumulated capital assets to sustain them in their retirement.

All too often, however, farmers find that the lump-sum payments of capital gains taxes levied on those assets leave little room for retirement. S. 882 would address that problem by providing retiring farmers the opportunity to roll over the proceeds of the sale of their farms into a tax-deferred retirement account. Instead of paying a large lump sum capital gains tax at the point of sale, that income would be taxed only as it would be withdrawn from the retirement account. Such a change in method of taxation could help prevent the financial distress that many farmers now face upon retirement.

Certainly another concern that is facing rural America is the diminishing interest in our younger generation in continuing in farming.

In close, this will facilitate the transition of our older farmers into a successful retirement. The Family Farm Retirement Act will also pave the way for a more graceful transition of our younger farmers toward farm ownership. While low prices and low profits in farming will continue to take their toll on our younger farmers, I believe that this will be one tool that we can use to make farming more viable for the next generation.

I thank the committee for its interest in this legislation, and I welcome Mr. Harris here today to offer his testimony on behalf of this legislation.

While I will not be able to stay for the hearing, I will look forward to reviewing the hearing record on this important matter. I thank you for your attention.

Senator DASCHLE. Senator Kohl, thank you very much. Like you, we will welcome Mr. Harris to the panel in just a few minutes. I know the delegation, as well as the members of that particular panel, appreciate your comments, and your welcome contribution to the hearing record.

Senator KOHL. Thank you.

Senator DASCHLE. Prior to the time we bring that panel up, we will invite Norm Richter, the Acting International Tax Counsel, U.S. Department of Treasury, to come to the table. We welcome you, Norm, and appreciate the excellent job you are doing in this capacity. We invite you to proceed with your testimony at this time.

STATEMENT OF NORMAN B. RICHTER, ACTING INTERNATIONAL TAX COUNSEL, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. RICHTER. Thank you, Senator Daschle. I am pleased to present the views of the Administration on the miscellaneous farm tax measures that are the subject of this hearing. I request that my more complete written statement be placed in the record, and I will be happy to answer questions following my statement.

Senator DASCHLE. Without objection.

[The prepared statement of Mr. Richter appears in the appendix.]

I will briefly address each of the eight proposals before the committee, beginning with the one proposal, relating to export trade corporations, which has not been formally introduced as a bill.

Our understanding of this proposal is derived from the testimony to be presented later this afternoon by representatives of the Hercules Corporation.

The background of this particular proposal is somewhat involved. In 1962, in order to promote exports, the Congress allowed taxpayers to establish tax-favored entities called export trade corporations. These corporations were allowed to defer tax on their export related earnings until the earnings were repatriated to the U.S. In 1971, the Congress determined that no more of these entities could be established, but allowed the existing ones to continue to operate. In 1984, the Congress authorized a new category of tax-favored entities to promote exports called foreign sales corporations.

By operating through a foreign sales corporation, U.S. exporters generally could obtain a tax exemption as opposed to the deferral allowed by an export trade corporation for up to 15 percent of the profits on their exports.

In order to encourage the old export trade corporations to convert to the new foreign sales corporation regime, or to dissolve entirely, the Congress at that point offered a special tax incentive. If an export trade corporation elected, within roughly 6 months of the enactment of the 1984 Act, to convert or to dissolve, it could repatriate its accumulated tax-deferred, export-related earnings back to the U.S. completely tax free.

This special window of opportunity closed at the end of 1984. Only a very few export trading corporations declined to take advantage of this incentive during the time period provided, and Hercules one of these few.

In 1986, the Congress then enacted a regime designed to broadly curtail the benefits of tax deferral for certain foreign corporations that were predominately passive in nature. That is to say, most of their income derived from interest, dividends, and similar passive income.

This anti-deferral regime was called the PFIC regime, which stands for the passive foreign investment company regime. This new law made few exceptions, and the application of its rules was to treat the Hercules Corporation as a PFIC, as a passive foreign investment corporation, because of the financing income it earned from financing the exports of unrelated exporters.

We understand that the Hercules Corporation has made several distributions since the PFIC rules went into effect, and it now seeks to have these distributions retroactively treated as tax-free distributions.

The Administration's position is to oppose this proposal. Any export trading company that failed to take advantage of the Congressional incentive provided during a specific time period cannot reasonably claim to have been guaranteed the status quo in perpetuity. Such taxpayers must be seen to have effectively assumed the risk that the law might change to their disadvantage, and should not now be provided retroactive relief from the PFIC rules. I would also note that the proposal would treat as tax free those earnings accumulated since 1984, which, had Hercules or any other ETC in a similar line of business converted or dissolved in 1984, as encouraged by the Congress, would have been currently taxed during the last decade.

As it is, Hercules had three extra years of treatment more favorable than other financing entities before the PFIC rules did come into effect.

The second proposal before the committee is S. 226, a bill to allow real property that is used in farming, and that passes to an heir at death, to be specially valued under the estate tax rules, even though the real property is leased to a member of the decedent's family on a cash basis.

Current law permits a special lower valuation to be used for estate tax purposes if a farm continues to be used in the business of farming. The Administration does not oppose this proposal, provided it is prospective and an acceptable revenue offset is provided. The proposal promotes the intended purpose of the statute's existing relief provision—that is, to keep family property in the family, dedicated to use in the family's farming business.

The third proposal before the committee is S. 531, a bill to increase the unified estate and gift tax credit.

Current law effectively exempts $600,000 of taxable gifts and estate transfers from the estate tax. The bill would take this exemption up to $1 million. The Administration opposes this proposal. The proposed increase in the unified credit is not supported by evidence that the existing threshold is inappropriate. Indeed, approximately 95 percent of decedents have taxable estates below the existing threshold of $600,000.

The fourth proposal before the committee is S. 545, a bill to allow farmers' cooperatives to elect to treat as patronage-sourced income any gain or loss from the sale or disposition of any asset used to facilitate the conduct of business done with or for patrons.

Under current law, non-exempt cooperatives are subject to income tax on taxable income, but may exclude from taxable income those amounts distributed or allocated to patrons as patronage dividends.

Patronage dividends are determined by reference to the net earnings of the cooperative from business done with or for its patrons.

The phrase "from business done with or for patrons" has been interpreted differently by taxpayers, the courts, and the IRS. In some IRS rulings or court decisions, the determination has turned on whether the income is directly related to or facilitates the conduct of business with patrons.

This bill would allow cooperatives to elect to treat as patronage-sourced income any gain or loss from the disposition of assets used to facilitate the conduct of business done with or for patrons.

The Administration does not support this proposal. The characterization of earnings as patronage or nonpatronage effectively determines whether the earnings are subject to tax at the cooperative level.

Providing an election to certain cooperatives to make this characterization exposes the Government to a whipsaw potential because the election may be made at any time, indeed, even after the realization of the gains or losses, and can be revoked at the option of the cooperative.

We do not believe that the 3-year prohibition provided in the bill on subsequent elections will effectively prevent this whipsaw potential, because a cooperative ultimately controls the timing of the realization of its gains and losses, and is in a position in many cases to wait out this period.

It is the Administration's position that the determination of the relationship between a cooperative's earnings and its business with patrons is a factual determination, and that an election is inappropriate. Furthermore, we do not believe there is a policy reason to justify limiting any such favorable treatment of farmer cooperatives alone, to the exclusion of other cooperatives in a similar position.

The fifth proposal before the committee is S. 882, a bill to create a special Individual Retirement Account for the rollover of the proceeds from the sale of farm assets. Under the bill, a farmer could defer recognition of gain up to $500,000.

The Administration opposes this proposal. The proposal would provide tax-favored treatment to farmers over other taxpayers, such as small business owners, whose situations may not be appreciably different.

In addition, the proposal would provide a disincentive for farmers to set up traditional qualified retirement plans covering other workers in addition to themselves.

The sixth proposal before the committee is S. 1615, a bill to expand the existing law regarding elections to defer recognition of income from the sale of livestock in cases of Federally-declared drought.

The bill would extend the opportunity to make these elections to sales of livestock on account of any weather-related condition, such as floods, tornadoes, or hurricanes.

The Administration does not oppose this proposal, provided an acceptable revenue offset is provided.

The proposal would allow the farmer to avoid the bunching of income due to disasters, in circumstances beyond the farmer's control. It allows the taxpayers to take income into account when it would have been taken into account under the taxpayer's normal business practice.

The seventh proposal before the committee is S. 1691, a bill to provide certain taxpayers with a tax credit for expenditures for the purchase of certain pollution control property, as well as for soil and conservation expenditures made for the primary purpose of complying with Federal, state or local environmental laws.

The Administration opposes this proposal. The Administration does not believe that it is appropriate to provide a tax incentive to encourage compliance with environmental laws beyond those provisions already in the tax law.

Moreover, the proposed benefit would again be restricted to one class of taxpayers, to the exclusion of others having to comply with the same environmental laws.

The eighth and final proposal before the committee is S. 1814, a bill to allow taxpayers to elect to include certain disaster payments and crop insurance proceeds in income in the year of the destruction of or damage to crops, even if the payments or proceeds are received in the following year.

The election is permitted only if, under the taxpayer's normal business practice, this income would have been reported in the year of the destruction or damage to the crops.

The proposal is essentially the converse of the existing law's election. Current law allows taxpayers to defer recognition of crop insurance proceeds and disaster payments to the year following receipt, if that is consistent with the taxpayer's normal business practice.

The Administration does not oppose this proposal, again provided an acceptable revenue offset can be provided. The bill would promote the policy of allowing taxpayers engaged in crop farming to avoid unpredictable tax results due to events not within their control, and allows these taxpayers to take income into account when it would have been taken into account under their normal business cycles.

That concludes my oral statement. I will be happy to take any questions members might have.

Senator DASCHLE. Thank you very much for your comprehensive review of the legislation before us.

You mentioned that you do not oppose the two disaster tax bills that we are currently examining. I wonder, however, in spite of the extraordinary difficulty that there has been in passing legislation in both instances, whether you are aware of any relief short of legislation to rectify the problems that the bills attempt to address.

Mr. RICHTER. Unfortunately, I am not. The statute seems to be fairly clear and, in our assessment, it would be beyond the discretion of the Treasury to grant the relief.

Senator DASCHLE. That is my assessment as well—that there really is nothing short of legislative relief in this case to address the problem effectively.

Farmers are not the only businesses that are faced with the costs of complying with new environmental laws and regulations at both the Federal and state level, as you know.

With respect to the proposal that Senator Conrad and I introduced to provide an environmental tax credit for farmers, does the Treasury generally have a problem with using the tax code as an incentive mechanism for encouraging compliance with environmental laws, or is the concern just that it is being offered only for farmers?

Mr. RICHTER. Well, I did note that, obviously, one concern was the restriction of the relief to farmers, but Treasury's concern does go beyond that.

The tax code already provides certain rules that are intended to address the treatment of pollution control and soil and water conservation expenditures properly. For example, Section 175 of the Internal Revenue Code allows a deduction for soil and water conservation expenditures which would otherwise be capitalizable. And Section 169 allows a 5-year amortization of the cost of pollution control facilities, even though they may have recovery periods that might be normally longer. So, the Treasury's view is that these provisions already seek to address these issues in a generic way.

Senator DASCHLE. You indicated in your testimony that Treasury is concerned about the retroactivity of legislation.

Regarding legislation to clarify that, cash leasing of a farm among inheriting family members will not disqualify it for estate tax special use valuation, would you feel differently if the legislation were limited to open cases only?

Mr. RICHTER. Unfortunately not. The issue of "retroactive legislation to clarify a rule" is something that Treasury has supported in the past—for example, technical corrections. In that case, the change alters the statute to implement the intent that had all along been the purpose of the Congress. It is difficult to reach that conclusion in this case, given the 1988 change in the law, which very specifically provided such relief and limited it to the case of the surviving spouse doing a cash lease.

Senator DASCHLE. As you heard, Senator Kohl has introduced a very interesting proposal to provide an IRA type of retirement account into which farmers could roll over the gain from the sale of their farms, and thereby provide for retirement years. I gather from your testimony that Treasury does not support the proposal, but I wonder if you would feel differently about it if it were extended to all taxpayers who do not have other pensions, and whose incomes fall below a specified level.

Mr. RICHTER. The proposal would still raise the concern that it would provide a disincentive for business owners to establish qualified retirement accounts that provide retirement benefits for the rank and file employees of the business as well. So that concern would still remain.

Senator DASCHLE. Let me move to export trading company issues just for a couple of minutes before I call on my colleague.

As I indicated, the last panel of this hearing is scheduled to discuss the current tax status of a number of export trading companies that have concerns about the loss of tax benefits previously afforded to ETCs.

I thought I heard you mention that you thought there were two such companies, but do you have any specific count at this point as to how many companies are affected?

Mr. RICHTER. I actually misspoke. I meant to say a few. We do not have an exact number. The best that the IRS can say is that there are four or fewer.

Senator DASCHLE. Four?

Mr. RICHTER. Four or fewer. And it is not entirely clear whether all of them have the same problem that the Hercules Corporation has.

Senator DASCHLE. One argument that ETCs make is that the passive foreign investment company, rules should not be applied to them. While it has been argued that the PFIC rules were intended to be applied narrowly, there is no question that they have been interpreted broadly to apply to a wide range of companies. Are there other examples of companies that have had the PFIC rules applied to them and have sought relief?

Mr. RICHTER. Yes. And, in fact, there are a number of companies engaged in business not too different from Hercules Corporation's business. That is to say, they are financing entities of U.S. companies and these financing entities have been seeking relief for years as well. In fact, the Congress asked—mandated—that the Treasury study that question and make recommendations as to the appropriate course of action to take.

Another example was, in 1986, when the PFIC rules were enacted, there is evidence of Congressional intent to exempt the securities dealers from the PFIC rules. However, that relief was not provided in the statute, and was not finally provided until last year's budget bill and, in that case, it was provided prospectively.

Senator DASCHLE. What about foreign sales corporations—so-called FSCs? The pending technical corrections legislation would clarify that FSCs are not subject to the PFIC rules. Can we differentiate between FSCs and ETCs?

Mr. RICHTER. I believe you can. The PFIC rules are essentially a regime intended to curtail the benefits of tax deferral in certain cases. Export trading companies, as I described earlier, are an entity whose tax advantage is the ability to defer tax on their income in certain cases, when they operate to finance their own exports.

The Foreign Sales Corporation rules, however, allow actual tax exemption for a certain portion of the foreign sales corporation's rules. What that means, really, is that it is inappropriate to apply an anti-deferral regime to a case where a foreign corporation is earning income which the United States has simply elected not to tax at all. It is just a different category.

Senator DASCHLE. Well, Norm, I have no further questions.

Let me turn to my colleague and friend from North Dakota for any opening remarks he might have, and questions directed to you.

Senator CONRAD. Well, first of all, let me thank Senator Daschle for holding this hearing. I think it is very important that we have this chance to talk to Treasury about the matters that are before the committee.

If I can go to the environmental tax credit for farmers that Senator Daschle and I have introduced, I find it somewhat curious that Treasury has chosen to oppose this on the grounds that we should not be providing assistance through the tax code for people who comply with the law. I especially find that curious in light of the recommendation we just had from Treasury Department with respect to a similar circumstance that dealt with Superfund. Because, in that circumstance, we were told that it was entirely appropriate to go to people, companies that had no liability, and get them to participate in funding Superfund because there was a societal interest in cleanup.

Now we have a circumstance in which I think there is a clear societal interest in cleanup. This time it is in agriculture. And yet what we are saying to farmers is—you pay the whole cost.

I am just wondering why the difference. When it involves corporations and Superfund, and a cleanup of those sites, why is it appropriate from the Treasury's point of view that we recognize a societal benefit? However, when we come to farmers, and cleanup of those sites, all of a sudden the societal benefit argument is out the window.

Mr. RICHTER. Well, Senator, I do not want to suggest that that societal benefit argument is out the window. I would suggest merely that it is a question of degree.

As with any policy, it is necessary to weigh the tax loss to the FISC against the incentives being considered. In this case, the tax code does provide certain assistance, if you will, for the costs of complying with the environmental laws. I identified them earlier in my answer to Senator Daschle's question.

Senator Conrad. Precisely that same argument applies with respect to Superfund sites. We have those same tax benefits and assistance for those sites but, when it came to Superfund and cleaning up those sites, the Administration, the Treasury Department, came up with a whole new scheme and a whole new regime to pay for it, and cited "societal interests". This was going to benefit the largest society and, therefore, others ought to help fund it.

And now it comes to farmers, who are in a much less favored position, I might add, at least in my State, to achieve the societal benefit of cleaning up the environment. All of a sudden the Treasury turns a blind eye to the need, and says, well, we are not going to help people meet their legal requirements. Why did that same standard not apply to Superfund? Especially because there are hundreds of millions of dollars—billions of dollars. And in this case we are talking about $40 million. You can reverse Treasury policy here.

Mr. RICHTER. As I sit here. [Laughter.]

Well, I have to confess to not being as familiar with the Superfund legislation as I would like to be to give your question a proper answer. I am not entirely sure how different that legislation is since I have not been working on it.

I guess I would just repeat what I said earlier—that there is generic relief in the Code now intended to address these cases. Obviously, a different balance can be struck if the revenue can be found to pay for it.

Senator CONRAD. Let me just say that it looks to an observer and a participant that when it is big corporations who have a lot of power and a lot of clout, their concern and the societal interest in cleaning up their sites is addressed. When it is small fry—farmers with limited incomes, who are also addressing a societal concern—then we have a different standard. That is just the way it looks.

I would hope that the Treasury Department would go back and take a look, and really see if there is an objective standard that is being applied in both these cases, or whether or not this notion, that we should not help farmers clean up the environment because they are required to under the law, is being dealt with in a much different way from large corporations that have Superfund problems.

I would also like to go to the question of the 1984 companies that made a decision to continue to operate with their export trading

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companies. I really want to understand what was done with respect to changing the rules of the game on them. I have not had a chance to study this in depth, but it does look to me like we changed the rules of the game on these folks and left them hanging out there.

As I understand it, in 1984 there were really three options open to companies. One, they could continue to operate; second, they could remain in business and transfer their assets tax free to a foreign sales corporation; and third, they could exit export sales business altogether, and repatriate accumulated export trade income tax free to the United States. Is that a correct summation of the options that were open to them?

Mr. RICHTER. Those options were open to them. Only the first two were actually expressly provided for in the statute, but those three options were——

Senator CONRAD. Those are the options, basically, that they faced?

Mr. RICHTER. That is correct.

Senator CONRAD. And then, as I understand it, all but three corporations exited the export sales business and repatriated accumulated trade income tax free to the United States. Is that true? Three or four companies were in that category?

Mr. RICHTER. I do not know the exact number but——

Senator CONRAD. Small number?

Then, I understand, in 1986, the Tax Code generally ended deferral of taxes on income earned in entities overseas. Is that——

Mr. RICHTER. That is right.

Senator CONRAD. I am trying to get the sequence down correctly.

Mr. RICHTER. That is when the so-called PFIC rules were enacted. It did not do end deferral for all entities. It did it for certain entities that were predominately passive.

Senator CONRAD. And we are again talking about a handful?

Mr. RICHTER. You mean what was done in 1986?

Senator CONRAD. Yes.

Mr. RICHTER. No. The 1986 rules, on the contrary, were drafted extremely broadly with very few exceptions. They applied to any foreign corporation with the requisite level of passive assets and income. The test generally sought only to determine what was predominately passive and what was not.

Senator CONRAD. Well, with respect to the companies that had made the election in 1984 to continue—that handful of companies?

Mr. RICHTER. Yes. They then became subject to these rules——

Senator CONRAD. They became subject to this. So, they were in a situation in which they made a judgment in 1984—this handful that continued. The others repatriated?

Mr. RICHTER. Right.

Senator CONRAD. They brought theirs back tax free.

Now these others—a handful of companies. I do not even know who they are. Perhaps we could get a list of who they are. But I do not think it makes so much difference in terms of who they are as to the principle involved.

They continued on, and then they get caught up in the 1986 rules change that would change their status. So, now they are in a position—in 1984 they made an election to continue on. Now, they are kind of hung out there, it seems to me. They do not have an option to repatriate on a tax-free basis. Is that correct?

Mr. RICHTER. They do not have that option any more. I also should correct what I said before. The advent of the PFIC rules—the 1986 tax change—did not necessarily make export trading companies PFICs. Only passive entities lost the benefits of deferral, which was the principal benefit of export trading companies. Rather, it depended on what sort of business the export trading company was engaged in.

Senator CONRAD. Yes.

Mr. RICHTER. So, some may have been caught, some may not have been caught.

Senator CONRAD. Yes.

Mr. RICHTER. It depended upon the type of business they had. But you are right.

Senator CONRAD. I understand that point. Let me just ask this of you. It just seems to me, in terms of fair treatment, and of treating people similarly situated in the same way——

Mr. RICHTER. Yes.

Senator CONRAD. If we give that handful of companies that in 1984 made an election which we provided for them, you can continue——

Mr. RICHTER. Yes.

Senator CONRAD. You can continue doing business as you have been or you can repatriate tax free. Did we give that handful of companies the same option when we changed the rules of the game?

Mr. RICHTER. We did not.

Senator CONRAD. I just say that I find this troubling as a matter of equity.

Mr. RICHTER. Well, could I put it this way, and see if that affects your reaction to the equities. When Congress provides a limited window of time in which a certain benefit could be taken advantage of—in this case, in 1984, this six-month window is provided for ETCs——

Senator CONRAD. Yes.

Mr. RICHTER. This was in order to encourage them to convert to this new entity that was being created in 1984.

If a taxpayer chooses not to take advantage of such an offer by the Congress, does that somehow implicitly create a guarantee of the law never being changed in the future in perpetuity, as long as they exist?

Senator CONRAD. No. But I would say this to you. Remember how we got onto this in the first place. Believe me, I am someone who believes we should have ended preferential tax treatment for foreign sales corporations sooner than we did. Their treatment turned out to be a mess. I think that is the most fairly stated characterization I can give. So, I do not have trouble with the change in their treatment. I do have a problem just in terms of equitable treatment and fair treatment.

We gave companies an option in 1984. We said, all right, you can continue doing business as you were or you can repatriate tax free at this point. Most people made that election. Remember that the whole reason we established these things was a public purpose of encouraging exports. Right?

Mr. RICHTER. That is right.

Senator CONRAD. That is how we got into this whole thing to begin with. Unfortunately, we did it in a way that probably was not as well designed as it should have been.

But there was a public purpose. The public purpose was to encourage American companies to be export oriented. And then we said in 1984, look, we are going to start to change the rules of the game. You have this choice. And, I would think, we kind of left those few companies who decided to continue doing business as they were with the feeling that they could continue to do that. Then, at some later point, they might be given another option.

And, yet, we did not do that. So this handful of companies that continued to operate overseas, being aggressive on exports, found out that the rules of the game got changed, and they were stuck with that overseas income. The only way to bring it back is on a taxable basis.

Mr. RICHTER. Well, those companies were allowed to continue to do what they were doing for another 3 years before the PFIC rules actually changed the treatment for some of them. And it was a change in law that, I would suggest, created a result no different from any time the Congress changes tax rates, for example.

For example, every time tax rates are changed, the economics of countless transactions are changed.

Senator CONRAD. But then, see, everybody is on the same basis. Everybody has their tax rates changed in the same way.

Here the result is a differential result. The result is that those companies that came back in 1984, they got to do it tax free. That handful of companies that continued to operate overseas wound up being in a taxable position. I must say that my instincts tell me that if I were in their shoes, I would see that as somewhat unfair.

Mr. Chairman, I do not mean to belabor the point. I know we have other business, but I very much appreciate the opportunity to discuss this.

Senator DASCHLE. Senator Roth.

Senator ROTH. Mr. Richter, Senator Conrad has stated my concern very well. I frankly do not understand the policy decision of the Treasury.

I mean we have a basic policy now, do we not, of still trying to encourage exports?

Mr. RICHTER. Its most recent manifestation is in the foreign sales corporation rules. That is correct.

Senator ROTH. And is a foreign sales corporation really the grandchild of export companies?

Mr. RICHTER. That is correct.

Senator ROTH. Are they intended to serve the same purpose?

Mr. RICHTER. As I understand it, they were created to serve the same purpose.

Senator ROTH. As Senator Conrad has so ably stated, there is an inequity, an unfairness here. And I do not understand the justification for it.

Mr. RICHTER. Well, the policy decision you referred to that the Treasury made actually was not a policy decision made by the

Treasury. In 1986, the Congress enacted a new supplemental anti-deferral regime that is causing the difficulties for some of these export trading companies that remain.

Senator ROTH. But that was not directed at this kind of an operation. That was directed at mutual funds, things of that sort, where there was nothing being done.

But the policy, even then, is not the fault of this Administration. It goes back to prior administrations. But the fact is that the policy then, as it is now, is to try to promote exports. An export company, just like the more recent organizations, has the same goals, the same purposes. And it seems to me we have misled business; those who decided to continue the export company. It makes no sense to me.

Mr. RICHTER. But the statute——

Senator ROTH. Unless you look at it from the point of getting every dollar we can for taxpayer's purposes. And I think that is what is behind it.

Mr. RICHTER. Well, Senator, the statute that was enacted provided no exceptions for ETCs. The Treasury was not able to see any authority to provide an exception. It was not provided. And indeed, as I mentioned, I think, before you came, to Senator Daschle, there were other companies that have been arguing for years that they should never have become subject to the PFIC legislation of 1986, and yet have been caught up in that net as well.

Senator ROTH. Well, I guess it comes down to one very simple question. Why should an FSC be treated differently from export companies.

Mr. RICHTER. I think the answer is that there are very different tax benefits associated with them. In the case of FSCs, they get a tax exemption. That is to say that, for 15 percent of their export profits, the Government has decided not to tax that 15 percent of their export profit.

Senator ROTH. Well, the thing that bothers me is that, if you go back, the Government was trying to promote exports under both kinds of institutions. You can make technical arguments, but I could not agree more with Senator Conrad that this seems to be a gross unfairness that needs to be corrected.

Thank you, Mr. Chairman.

Senator DASCHLE. Thank you, Senator Roth.

Norm, thank you very much. We appreciate your willingness to come today, and your answers to all the questions.

Our next panel consists of a number of people representing farm organizations from around the country.

Jim Harris has already been introduced by our distinguished colleague from Wisconsin. Mr. Harris is the Chairman of the National and State Local Legislative Affairs Committees of the Farm Bureau in Racine County. We also have J. Gary McDavid, of McDermott, Will and Emery, on behalf of the National Council of Farmer Cooperatives here in Washington; Alan Sobba, the Director of Tax and Trade of the National Cattlemen's Association; and Barbara Webb, the Associate Director of Government Relations, National Farmers Union.

If all four witnesses could come to the table at this time, we will take testimony from the next panel.

We welcome all of you and appreciate your willingness to come today.

Let me call on Barbara Webb, as the only woman of the panel, for her comments, and we will go on down the table.

STATEMENT OF BARBARA G. WEBB, ASSOCIATE DIRECTOR, GOVERNMENT RELATIONS, NATIONAL FARMERS UNION, WASHINGTON, DC

Ms. WEBB. Thank you, Senator. I appreciate the opportunity to appear today.

My name is Barbara Webb. As you said, I am the Associate Director of Government Relations for National Farmers Union. Our organization has 253,000 farm families that we represent, and we are very cognizant of the fact that this subcommittee and the full Finance Committee make decisions that are very important to our members.

I do want to comment at the outset, before I discuss very briefly some of the bills that are under consideration today, that, despite the importance of discussing these tax matters, what is most important to our members is the issue of farm income.

The impact of income taxes and tax credits are lessened a great deal when you have very little income to begin with. And the most recent figures from USDA—the latest statistics from 1992 that have just been recently reported—indicate that farmers made last year, on the average, $4,337, or about 11 percent of their household income from farming. Most of our members rely a good deal on off-farm income in order to make a living.

With that beginning, let me just address briefly the various bills that are under consideration today.

We support S. 882, the Family Farm Retirement Equity Act of 1993, that has been introduced by Senator Kohl. We believe this could be a very important source of retirement funds for family farmers who, in most instances, are unable to adequately prepare for the future because of low incomes and other reasons.

We are also very supportive of S. 1814, as well as S. 1615, which deal with problems regarding disaster payments and crop insurance payments. Problems have particularly occurred due to last year's flooding and drought payments that are being received by our members.

We are very supportive, as well, of S. 1691, Senator Conrad's legislation, and yours as well, Senator Daschle. You and Senator Conrad have both already addressed this committee at length on this measure which provides a tax credit for paying for machinery, equipment, and other items that are made necessary in order to comply with Federal, state and local environmental laws.

We also support S. 226, the estate tax issue dealing with cash leasing, as well as Senator Dave Durenberger's legislation, S. 531, which would increase the Federal estate tax exemption up to $1 million.

Let me address also, briefly, just two or three other tax matters that are not on the program for today, but are of particular concern to our members.

We have a very strong policy position in favor of the reinstatement of income averaging. Boom and bust cycles in agriculture are nothing new, but farmers and ranchers lost the ability, of course, to use income averaging in 1986. We believe very strongly that reinstating income averaging would help shield family farm income from threats that are being imposed by weather and by various marketing opportunities, or lack thereof.

We would also like to see the full reinstatement of the investment tax credit, and believe that, if it is reinstated, it should also cover used equipment and machinery.

Also, we urge very strongly for Congress, in the remaining days of this session, to look at reinstating the deduction for health care costs for the self-employed at 100 percent on a permanent basis. This would mean a good deal to our members and, of course, as this committee is very well aware, the 25 percent deduction for those purposes expired at the end of 1993. So, if something is not done, there will not be an ability to utilize that deduction in any fashion for 1994. With that I will conclude my remarks. I will be happy to answer any questions or to respond to any questions in writing more fully for the record.

Senator DASCHLE. Thank you very much, Ms. Webb.

[The prepared statement of Ms. Webb appears in the appendix.]

Senator DASCHLE. Alan Sobba?

STATEMENT OF ALAN C. SOBBA, DIRECTOR, TAX AND TRADE, NATIONAL CATTLEMEN'S ASSOCIATION, WASHINGTON, DC

Mr. SOBBA. Thank you, Mr. Chairman. I would first like to thank you, and particularly Tom Bias and Alex Deane of your staff, for your yeoman's work in getting agreements from this Administration so we could take advantage of the GATT appropriately. We hope, in the waning hours of Congress here, that you guys see fit to move the process forward. We think it is in the best interests not only of cattlemen, but of many in agriculture and other businesses. So I do want to thank you for your leadership on that.

I also want to thank you for holding this hearing, because there are a number of tax issues that have been debated in this Congress. Some have been dealt with farther down the line than others.

Estate taxes, for example, have been a priority for our association for a number of years. To just give you a figure to show you why it is so important, nearly 50 percent of the cattle operations in this country have been in the same family for more than 50 years. If you go to a hundred years, it is nearly 15 percent, so you can see that the ability to keep these operations together from generation to generation is a top priority.

So, along those lines, we support both the cash leasing between heirs and the increasing of the unified credit to allow an estate to pass nontaxable from $600,000 to $1 million.

We would also like to encourage you, as you proceed with your investigation of estate taxes into the next Congress, to look at ways of making of making 2032A more user-friendly. There are a number of things that I would like to provide in a letter for the record. But, for example, if you look at areas like California and Florida, where you have a lot of pressure on urban land prices, this $750,000 reevaluation figure is just inadequate. Many times you will end up with a situation where the farm or ranch must be sold to pay the estate taxes. I think that that is not in their best interests, and it is definitely not the spirit of 2032A.

The other issue I would like to mention deals with S. 1615, which expands 451 and 1033, the 1-year deferral of income on livestock sales, and an involuntary conversion. We agree wholeheartedly that those sections should be expanded to include more than drought. This last year, as you recall, there were numerous weather problems in the midwest and some in your State. I think this legislation speaks adequately to it. It is within the spirit of the law, and I think that the Administration earlier mentioned that they had no problem with that also.

As Barbara mentioned too, we fully support the deductibility of health insurance costs for the self-employed. That particular deduction, even if it is at 25 percent, is very valuable. But, obviously, in the spirit of fairness, it should be increased to 100 percent.

And we do also support reinstating of income averaging.

We appreciate the opportunity to testify, and will be happy to answer questions.

Senator DASCHLE. Thank you very much.

Our next witness is Mr. McDavid. Mr. McDavid, thank you for joining us. We will take your testimony at this time.

STATEMENT OF J. GARY McDAVID, McDERMOTT, WILL AND EMERY, ON BEHALF OF THE NATIONAL COUNCIL OF FARMER COOPERATIVES, WASHINGTON, DC

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

My name is Gary McDavid. I serve as the Chairman of the Subcommittee on Tax Legislation for the National Council of Farmer Cooperatives, on whose behalf I appear here today.

I have a written statement that I would ask be included in the record.

Senator DASCHLE. Without objection.

[The prepared statement of Mr. McDavid appears in the appendix.]

We are here because there has been an ongoing controversy between farmer cooperatives and the Internal Revenue Service over the classification of gain or loss on the sale of assets that have been used in the patronage operation. These are such things as grain elevators, warehouses, processing equipment, and other assets that have been used in the marketing and purchasing activities of farmer cooperatives.

The issue is whether gain or loss on the sale of these assets should be treated as patronage or nonpatronage sourced. If it is patronage sourced, the earnings are generally distributed to farmer members pursuant to an agreement between the cooperative and its members. The cooperative can deduct or exclude the amounts distributed from its taxable income and patrons are taxed on these amounts in accordance with Subchapter T of the Internal Revenue Code.

If it is nonpatronage sourced, then the income is taxable to a nonexempt cooperative whether or not it is distributed. Thus, the issue is whether the income is eligible to be included in the patronage refund that is paid to members, or whether it is taxable income to a nonexempt cooperative.

In looking at the distinction between patronage and nonpatronage income, 11 court decisions have applied a relationship test to determine whether particular types of income or loss are patronage sourced. If the activity which produces the income or loss is sufficiently related to the patronage operation, then it is determined to be patronage sourced. This is generally referred to as a directly-related, or actually-facilitated test. The Service does not accept this relationship test in dealing with the sale of assets. When they look at gains and losses from the sale of assets, they simply say that if the asset can be classified as a capital asset, or treated as gain from the sale of a capital asset under section 1231, the gain should be considered to be nonpatronage sourced.

We disagree. We think that the relationship test that has been set out by these 11 court cases dealing with many types of income, including capital gains, should similarly be applied in the case of capital gains.

S. 545 is very important to us for two particular reasons. First, we think that the rules need to be set out in advance. Cooperatives are required to distribute their income within eight and one-half months of the close of the taxable year. If they fail to calculate their patronage sourced income properly, and make a proper distribution within the 8½-month period, they will lose the patronage dividend deduction. We need to know how gains and losses on the sale of these assets are going to be treated, and we think the rules should be clear.

Second, we would like to put an end to this controversy. We would like to save taxpayer cooperatives the expense of litigation, and we think the Internal Revenue Service should also be spared the time and expense of litigating these issues.

Farmers are the ultimate beneficiaries of a resolution of this controversy. Money spent in litigation means less money available for patronage dividends to farmers. Further, clarifying that gain from the sale of an asset may be patronage sourced could mean larger patronage dividends for farmers.

For these reasons the National Council of Farmer Cooperatives strongly supports S. 545. This is the same legislation that passed both Houses of Congress in 1992 as part of H.R. 11, but was subsequently vetoed by President Bush. Legislation has been introduced this year by Senators Boren, Dole and Danforth, along with Senators, Daschle, Baucus, Grassley, Durenberger and Roth of this committee. It has broad bipartisan support in both Houses of Congress.

Thank you very much, Mr. Chairman.

Before I yield the microphone, I do have another matter. I have been asked to submit a written statement on the valuation of farm property for estate tax purposes under 2032A. The statement has been prepared by my law firm, and I would like to submit it for the record as well.

Senator DASCHLE. Without objection.

[The additional statement of Mr. McDavid appears in the appendix.]

Mr. MCDAVID. Thank you.

Senator DASCHLE. Jim Harris. Thank you for coming, Jim.

STATEMENT OF JIM HARRIS, CHAIRMAN, NATIONAL, STATE AND LOCAL LEGISLATIVE AFFAIRS COMMITTEE, RACINE COUNTY FARM BUREAU, UNION GROVE, WI

Mr. HARRIS. Thank you, Mr. Chairman. I appreciate the opportunity to appear in front of you again, as we did 2 years ago for Senator Kasten.

I wish to thank Senator Daschle for the opportunity to testify on behalf of American farmers. We strongly endorse Senator Kohl's bill, S. 882, entitled Family Farm Tax Relief and Savings Act of 1993, and the other similar bills presented by members of the Congress.

S. 882 is very similar to a bill cosponsored by Senator Kohl in 1991, which did obtain 45 votes in the Senate. For brevity, the bill may be referred to as FFRA, standing for Farmers Ranch Retirement Account, in this presentation.

FFRA reestablishes the farm assets as a farmer's retirement fund, correcting the hardships caused by the capital gains tax provision of 1986, and the oversight or failure of the Congress to recognize that the farm investment unit more than satisfies the intent and criteria for investment of funds required of the IRA concept.

The bill is unique in that, in the agricultural economy, it neither advantages nor disadvantages any farm region, product or activity. It will provide great incentive for substantial long-term investment commitment to rural America, and also to the farm unit because the farmer can, without reservation, devote all assets to the farm development, keeping his retirement funds at home, not Texas S&Ls or South African gold mines.

I was rather appalled by the Treasury's suggestion that we should direct our very limited capital into areas where we have no expertise, away from areas where we have much expertise. And, as we all know, the shortage of capital on the farm is very critical.

The bill recognizes the need of the special tenant farming situations which hold little or no real estate, but have large investments in crops, animals and machinery. To date, most long-term tax advantages have been targeted to real estate holdings, not working assets.

Our object here is to treat a portion of the family farm assets as a self-directed IRA, with income tax deferral, rollover and make-up privileges comparable to those granted to other taxpayers' self-directed IRAs.

Farming is an extremely capital intensive profession/occupation. Long-term growth and success of the family farm requires all the farmer's capital resources. One dollar of a farmer's income may yield 10 cents going to the kitchen, 90 cents to the bank, to borrow another $10 for farm operations and expansions, leaving nothing to invest in IRAs. White and blue collar workers, and other professionals, make large incomes that require little to no capital outlay, and they have very substantial retirements. These people are allowed the IRAs, the Keoghs, the 401(k)s. And the other thing along with this is that it is very simple for a person to leave his job and his household and sell this out in parcels. But when one leaves a farming operation, the personal, the capital, and the household is usually wrapped up into one cell. There is no way you can sell a few cows or a tractor out of the lockbox in the bank, but you can share some stocks in the company you work for.

Now when a farmer is forced, or voluntarily sells out at a farm auction when retiring, all proceeds are taxed at a high rate, as if one's lifetime blood and sweat assets were earned that year. There is no consideration for inflation. Paper stock gains are easily held for retirement years, but for agricultural assets it is impossible.

When that farm income is limited or nonexistent due to the combination of persistent low prices and required capital expenditures, by law, no tax-exempt IRAs and only limited Social Security can be funded, and this is the minimum alternative payment.

Thus, the farmer retires with a slim to none retirement. Yet the Government demands their pint of blood through the capital gains area of the farm sale. The typical annual retirement package available to a State of Wisconsin employee—and I am speaking of my wife, who makes roughly $10 to $12 an hour—is a $3,000 per year employer- paid retirement fund, a retirement account, a pension. Then she can put in, or the State puts in, $2,300 for their share of her Social Security. For the self-employed farmer, he pays this himself. Plus, she can put in $7,500 annually into a 401(k)-type plan. Three of her last 4 years she works there, she can double that amount to make up for the years when she had hardships such as a kid in school, college, bought a house, bought a car, and had an operation. We need that same provision for the farmer. She has employer-paid health and, if I was to work there, I could benefit by the same benefits that she can. That would give us a going away party out of the State of Wisconsin with accounts worth close to $1 million. The $500,000 limit of the farm FFRA bill costs $63.80 per month per farm couple, while the $2,000 IRA bills that people usually refer to as nothing but pocket change, cost $333.32 per month.

I have made a chart up for the Senator and for anyone to see. This chart points out the relative expenses of various IRAs. The first account we have is one-half of a farmer's retirement account. The law would let you achieve in the neighborhood of $250,000 after 50 years of farming. This is how you would achieve it. There would be a $32.80 monthly payment into an account paying 8 percent. Now if we compare that, one-half million dollars equal to one inch, that is a farmer's retirement account. Now if we go to one full IRA, which would be $2,000, one full IRA is equivalent to $1.34 million, and that would come out to about this, compared to the one inch of the farmer's IRA.

Then if we go clear out to the SEP IRAs, the SEP IRA is one that allows 15 percent of your net earnings to go into a retirement account, such as an attorney or a doctor might have. And I just keep on pushing out until I reach 80 inches, and that is an account total for a working husband and wife team of $40 million for the same period of time that a farmer is asking sympathy for a one-half million dollars lifetime IRA.

I was appalled by the Treasury's statement. I would think it would be far past time that some of the Treasury people leave the beltway and look at the patches upon patches that we have put on our coveralls, and the rusty boxes we drive down the road that we call our pickups.

Last night I called the local farmers' elevator to get a quote on corn. They were paying $1.92 yesterday. For a share of 22 percent, we would have to correct that price to $1.57 for a pickup. For a pickup in the field, we would be correcting to $1.47 per bushel.

So, Mr. Chairman, I will tell you, I got a considerably better price than that when I was going to the Korean conflict back in the late 1940's, early 1950's. And for many years after that, I could still mail a first-class letter for three cents.

Now, if we were to fair list the price of corn, we would multiply that three cents by 10, and instead of looking at $1.92, I should be looking at $19.20 from a bushel of corn.

I believe I have said enough, so I will cut it off.

[The prepared statement of Mr. Harris appears in the appendix.]

Senator DASCHLE. Well, thank you very much. You have said a good deal. That was a very good demonstration.

Mr. HARRIS. I would like to make one more comment I overlooked here. That is that the lady from NFU referred to, I believe, somewhere around $3,800 as annual farm income. Well, I have taken the liberty of doing some research on this item. A welfare family of four has basic annual income of $7,176; food stamps per month, $278 or $32.40; assistance average per month, $300, $3,600; plus $240. That comes up to an annual income of $14,856. Now that is equivalent to an $18,000 income for a self-employed farmer. But, on top of that, they get the gold card, which is medical services—doctor, hospital, drugs, eye care, dental care. The cost of this insurance policy is over $10,000. Now we have a total of $24,856 for the welfare family. We correct this balance to the 15.3 percent Social Security, the Federal tax and the state tax, and we add on another $9,182. This comes up now that we have a self-employed farmer having to turn out $33,000 of gross taxable earnings to be equivalent to a welfare family.

Now we go one step further. There is only one farmer in eight who has more than this as net. Now, I would like to know how we are supposed to take money out of a fund that is not any greater than what a welfare family gets, and fund our retirement through conventional packages.

The other thing to look at is this. When this was compared to the other types of business—say, a plumber—well, what can a plumber put in his pickup? How many saws and hammers can a carpenter own? Restaurants turn over inventory about every 7 days. A filling station turns over inventory every 3 days. A hardware store turns over inventory every 3 months.

If I wanted to expand my beef operation, from the time I make the decision until I sell my first steer, it is 7 years. There is no comparison between the capital gains, which runs $1 million for many farmers who are serious farmers for each job.

The Wall Street Journal a couple of years back published a study of General Motors. They said that their average investment per employee was $29,000. Now you compare the needs of a $29,000, $100,000 job because $56,000 is for take-home pay, and $30,000 for fringe benefits—compared to a farmer who is a $5,000 a year man, with a $1 million investment. It just does not make sense.

Thank you very much, Mr. Chairman.

Senator DASCHLE. Thank you very much, Mr. Harris.

Let me ask you a question. You make a pretty compelling case for farmers. Can you think of a reason not to expand it as well to small businessmen or to——

Mr. HARRIS. No, there basically is no reason not to. The reason I did not do it is because I felt that when I ran through the budget figures, my budget figures surely come out. I did a very detailed analysis of it. This is going to be around a $15 million credit cost, not the $180 million cost that comes out of the Treasury or the forecasting people. And I can go through that $15 million to substantiate that very closely. But that is all the cost, yes.

Now the other thing is, as it is written, wherever other IRA accounts exist, they are discounted from this. So the people who have this three-to-five-day or two-week turnover of inventory have an ongoing natural payment or salary come in every week. So they can make their payments on an ongoing basis. The farmer simply operates out of the bank and turns all his money back in to the bank, and cannot take ongoing sums out of it.

So It would really have very little value to most businesses. It would have some, but it would have very little value to them.

Senator DASCHLE. Would you means test it or would you give people with seven, eight figure incomes——

Mr. HARRIS. Oh, the means test goes like this. To qualify for this, you have to have been in farming for at least 5 years as a full-time operator. You count those years, and multiply the years by $10,000. So if you farm for 50 years, that gives you $500,000.

The means test is that it has to be an item or product used in your occupation. So, if it is not something that is used in your occupation, take the money from that and rotate it in this. So the cow, the chicken, the combine, the farm qualifies by your means test.

The other thing on this that really cuts it down is, if other IRAs exist, that amount over $100,000 subtracts dollar for dollar from this $500,000 limit.

Subtract that, and the people who have these $1 million or $2 million or $40 million IRAs, Keoghs, 401(k)s. Regardless of what they have, the farmer has no value to them. So with those types of corrections on it, I would have no objection to opening it up to everybody else.

Senator DASCHLE. Thank you very much, Mr. Harris.

Mr. McDavid, you describe in your testimony the test you would suggest for eligibility of gains and losses for special tax treatment. The test applied in legislation is similar to the test applied by the courts. That is, where the assets sold were directly related to, or actually facilitated the patronage or related activities of the coop, they should be accorded pass-through treatment. Wouldn't all asset sales arguably facilitate the activities of the coop, either directly or indirectly?

Mr. MCDAVID. We thought it would be fair and in keeping with the way cooperatives have been taxed generally to say that these assets have to be assets that have been used in the patronage operation.

Some cooperatives have fairly far flung operations, and they can engage in nonpatronage business. So if an asset has been used in the nonpatronage operation, we thought that the gain on the sale of that asset quite logically ought to be considered nonpatronage gain. But, if the asset has been used in the patronage operation—say, for example, a grain elevator or some other property that was a part of the patronage operation—then gain on the sale of that asset, quite logically, ought to be considered to be patronage sourced, or at least be eligible to be treated that way under the election.

Senator DASCHLE. I am not sure I understand that point. Are there examples of sales that would not facilitate the activities of the coop. Give me an example of a sale that would not facilitate the activity. I am sympathetic to what it is we are trying to do here. I wonder whether the generic definition of "sales that facilitate patron activity" is so broad as not to allow us the ability to differentiate between the legitimate activities of a coop for purposes of eligibility for tax benefits and those which are not necessarily in direct support of patron activities.

Mr. MCDAVID. You raise a very good question.

This legislation will focus attention on the way the particular asset has been used. If the asset has been used during its tenure with the cooperative to facilitate its patronage business, the gain on the sale of that asset would be eligible to be treated as patronage sourced.

Now, if I am understanding your question correctly, you are thinking about why the sale might be made. Would the sale itself facilitate the patronage operation? We are focusing on what the asset has been used for as opposed to the purpose for the sale. We think that is a better line to draw. It is pretty clear when you can look at these assets and say, all right, historically, how have they been used? When you begin to get over into the reason for selling it, that raises a lot of questions. What we had hoped to do was to clarify the focus.

Senator DASCHLE. So I assume. Can you think of instances where sales would not facilitate the activities of the coop?

Mr. MCDAVID. Well, I think, in most instances, the sales would facilitate the activities of the coop. I think in almost all instances they would.

Senator DASCHLE. That is my point.

Mr. MCDAVID. Yes.

Senator DASCHLE. Right.

Mr. MCDAVID. Yes, in most instances they would.

Senator DASCHLE. So, in other words, in every instance where they do—we think in most cases they would—that situation would then warrant the applicability of pass-through treatment?

Mr. MCDAVID. Yes.

Senator DASCHLE. I guess that then begs the question. Is there a situation that would not allow for the access to this provision? Could there be a particular case where you would not have a situation where tax treatment would apply as proposed?

Mr. MCDAVID. No. I cannot think of anything.

Senator DASCHLE. Thank you, Mr. McDavid.

Alan Sobba, obviously there are situations we have experienced in years where floods have had a devastating impact on crops. I think the perception is that floods are not as detrimental to livestock as droughts are. Certainly the law currently reflects that.

I think, for the record, it would be helpful for you to share with us, if you can, the degree to which floods are similar to droughts in loss of livestock. It is not always possible, is it, to move livestock out of harm's way as floods come? Did we not also experience a substantial degree of loss along riverbeds in particular?

Mr. SOBBA. Mr. Chairman, I would look at it this way. If you live along a river, or a large body of water that floods like it did this last spring, you normally plan your forage needs. If you have so many head of cattle, you know approximately how much forage it will take, both grass and hay, throughout the year.

If you have a weather pattern that dramatically distorts your ability to graze or make hay on certain property, then it forces you into making a decision that you would not have made under normal circumstances. That same rationale is the rationale that was used to establish both the involuntary conversation of 1033 and also the 1-year rollover in 451. So, I agree wholeheartedly that there is a weather pattern change that dramatically affects what it is that you had planned for. It should not throw you into an income tax situation that you could not foresee.

Senator DASCHLE. Do you recall the legislative consideration of the disaster-related tax relief that is currently available in the law, and why it may be that droughts are the only condition that gives rise to that tax relief?

Mr. SOBBA. I was not here when that was done, but we did look into that earlier last year when all those floods took place and caused the sales to occur. I think it probably was a matter that drought was an overriding factor. I do not know of any other reason. In 1988, Senator Danforth, when we had severe drought, for example, in north central Missouri, changed 451 to allow it to apply to breeding cattle, which previously had only applied to yearling cattle. So I think that is just facts and circumstances.

Senator DASCHLE. Barbara, you were talking about legislation that was introduced having to do with giving farmers a little more flexibility in paying tax on disaster payments, flexibility that is not currently allowed in law.

I assume that you share the view that there are farmers who would be more than happy to file amended returns if legislation were passed this late, but, I guess, I would be interested in your answer to that question. That is, what level of interest is there among your members? And, secondly, to what extent do you think legislation of this kind would be helpful in future years—prospectively?

Ms. WEBB. I think it would be very helpful to take care of future situations by making it permanent. Senator Daschle, I think it is a great concern to our membership, as evidenced by the fact that at our National convention, our delegates who were elected from the grass roots organizations within Farmers Union passed a special order of business concerning this piece of legislation that you had just introduced, I believe, at the time. And there were a number of members who mentioned that, even in the future, it is something that they could use. They were going to look into extensions which Representative Minge addressed earlier, and certainly would hope that it could be done this year. But whenever it was done, they would be willing to amend their returns in order to try to take advantage of the situation.

Senator DASCHLE. Let me ask you a question on an unrelated issue, the same question Senator Conrad asked earlier.

Obviously, we have acquired a number of tools to encourage business and other entities to aggressively undertake activity for cleanup under Superfund. Among those tools are tax provisions that provide incentives for cleanup. The extension of environmental cleanup tax incentives to agriculture seems to me to make a good deal of sense. I think that the inability on the part of Treasury to respond as to why there is a difference between the farm situation and the Superfund situation may reveal that there really is no justifiable rationale for the difference in treatment.

Given the fact that you addressed environmental tax incentives for farmers, perhaps you could elaborate on your own position.

Ms. WEBB. I think our membership which, as you know, is primarily small family farmers, want to comply in every regard with environmental concerns, whether they are imposed on them or not.

In most instances, any problems that they have in doing so are financially driven. We recently had our National Farmers Union fly-in, and we were discussing a number of environmental issues.

We particularly addressed the farm income situation. I know that one member from Oklahoma, which is my home State, got up and stated that he agreed that farmers are the premiere environmentalists. They live on the land. They drink the water. They want to pass it on in a good state to future generations. But when you get down to the situation of whether to build a terrace or feed your family, you have certain lifestyle issues that sometimes take precedence.

This would give farmers in such situations a better ability to comply with the regulations that are imposed on them, that they really want to accomplish on their operations anyway.

I think it would be very helpful and, and as you and Senator Conrad said, it is something that is beneficial to society, as well as to the family farm, and to what we are trying to achieve here.

Senator DASCHLE. Well, Ms. Webb, thank you and all of our panel members

Mr. Harris?

Mr. HARRIS. Yes, I would like to address a couple of other short subjects here, if I may, Mr. Daschle. In Social Security, a typical farmer signs on at the age 62, so he can get his limited Social Security to augment the farm income, so he can stay on the farm in business and, also, possibly work some of the farm family income to his son who may be coming up, or the son's family.

It has been my experience in interviewing farmers lately, that the typical farm income on the Social Security side is between $200 to $400 dollars.

An individual who might have been working for the Federal minimum wage since 1951, his check at this time would be $525 in Social Security. Now when we get back to the estate tax exemption—and, of course, my agent and I are interested in that—I have a story here that says, "Why Lena Quits Milking Cows When Ole Dies".

Mr. and Mrs. Farmer Oleson are retiring due to their advanced age and health.

Their farm auction is to be held Saturday, March 31st. Saturday night after the auction, Lena performs her wifely duties and writes out checks for all outstanding debts. The remaining balance is $100,000. Friendly Joe Shmoe, their accountant, informs Ole and Lena that the Federal and state treasuries desire their share of $42,000 for various taxes.

Monday morning Ole and Lena have but $58,000 to deposit into their taxable savings account for the two of them to live miserly on during their not so golden years.

Now, if Mr. Oleson would have been real considerate of the lovely Lena, he would have passed on by March 30th. Then Lena would have to waltz along through her golden years alone with $100,000, not the $58,000 for the two of them. Does this make sense?

The only chance a farm wife has got is to pray that her husband dies before he retires, so that she will have some money to live the last 7 years after he is gone.

Thank you.

Senator DASCHLE. Mr. Harris, thank you very much.

Senator Roth, do you have any questions?

Senator ROTH. No questions, Mr. Chairman.

Senator DASCHLE. I thank all the panel members. We appreciate your coming this afternoon.

Our final panel is comprised of two people—Thomas G. Tepas, Senior Vice President for Administration for Hercules, and Robert Woodbury, the Vice President of Kollmorgen Corporation. If those witnesses will come forth, we will take their testimony at this time.

Gentlemen, we welcome you, and appreciate your willingness to come this afternoon. Mr. Tepas, let me begin with you.

STATEMENT OF THOMAS G. TEPAS, SENIOR VICE PRESIDENT FOR ADMINISTRATION, HERCULES, INC., WILMINGTON, DE, ACCOMPANIED BY BRUCE W. JESTER, DIRECTOR OF TAXES AND ASSISTANT TREASURER, HERCULES, INC., AND J.D. KNOX (RETIRED), FORMER ASSISTANT TREASURER, HERCULES INC.

Mr. TEPAS. Mr. Chairman, my name is Thomas Tepas. I am the Senior Vice President for Administration at Hercules, Inc. I am joined at this table by Mr. Jim Knox, who was formerly Assistant Treasurer for the Corporation. He retired earlier this year.

I want to thank you and the other members of the committee for the opportunity to testify on a matter of fairness and equity for my company and its nearly 13,000 employees, and over 3,000 shareholders.

While I will speak from a condensed version of our statement, I would appreciate it if the more inclusive and technically-oriented document could be made part of the record.

Senator DASCHLE. Without objection.

[The prepared statement of Mr. Tepas appears in the appendix.]

Mr. TEPAS. Thank you, Mr. Chairman.

By way of background, as you may know, Hercules is a worldwide diversified chemical and aerospace company. Since 1970, we have used our wholly-owned foreign subsidiary, Hercules International Trade Corporation, Ltd., or HINTCO, to distribute and sell our products and those of other U.S. manufacturers and producers to the rest of the world.

Close to 40 percent of approximately $400 million in worldwide sales facilitated by HINTCO was in the business of selling, distributing, financing and providing marketing know how for such U.S. agricultural products as feed grains, soybeans, and energy products, primarily coal.

HINTCO had a worldwide sales force and offices, as well as distributors located throughout Europe and Asia. HINTCO has operated under the ETC program established by Congress in 1962, and authorized again in 1971 and 1984.

In the 1984 Tax Act, after some 20 years of Congressionally authorized export sales, Congress offered existing export trade corporations three choices. They could continue to operate; they could remain in business and transfer their assets tax free to a foreign sales corporation; or they could exit the export sales business altogether and repatriate their accumulated export trade income tax free to the United States.

Hercules chose option number one as the most advantageous business choice for the corporation. We believed, based on the affirmative action of the House Ways and Means and Senate Finance Committees, as well as the full Congress, first in 1971 and then again in 1984, that Hercules would be eligible under the reauthorized ETC program for continued tax deferral on the HINTCO export trade income.

Just 2 years later, however, without consideration by a single member of Congress, or review by any appropriate committees of the Congress, and certainly without an open hearing, tax deferral for ETCs such as ours was, in the Treasury Department's view, effectively halted by the 1986 Tax Act. That position is underscored by the current interpretation of the passive foreign investment company rules issued by the Treasury Department.

Contrary to Mr. Richter's testimony earlier, no ETC had any reason to expect they were at risk if they chose to continue operating after 1984. It is my understanding that the 1986 Tax Act did not specifically address ETCs.

In the last several years, we have pursued this matter in the Congress and at the Treasury. We have been advised that the 1986 provision was specifically aimed elsewhere, and not at export trade corporations.

The 1986 Act's passive provision was directed at ending the deferral of taxes on income earned by passive investment entities located overseas, such as offshore mutual funds.

ETCs are authorized under their own section of the Federal law, and if restrictions had been aimed at this incentive program, we believe that their existence in the 1986 Tax Act would have been specifically noted.

Nevertheless, the Treasury Department's definition of the term "passive income" leaves open the possibility that income derived from the sale of products other than those manufactured by the parent of the ETC would not be eligible for tax deferral.

Accordingly, acting with caution as to the potential and significant tax liabilities, including interest and penalties inherent in the

PFIC rules, HINTCO reluctantly distributed the retained earnings of Hercules, Inc. in 1990 and 1991, including in part those earnings accumulated through December, 1986.

Hercules believes that an equitable resolution of this matter would be for Congress to eliminate the ETC program, make clear that the PFIC provisions do not apply to ETCs, and permit Hercules and other shareholders of ETCs to treat as previously taxed income the export trade earnings of their ETCs, including again export trade earnings distributed after the effective date of the 1986 Act.

It is our understanding, as we heard this afternoon, that Treasury Department will argue against a resolution favorable to us either legislatively or in regulation.

Accordingly, seeking equity, we feel we must return to the legislative process. The Congress is now in possession of knowledge and understanding of this issue and will, hopefully, act on the matter at the appropriate time. In that regard, we believe that the Congress spoke clearly in 1971, and in 1984, to continue the ETC regime and Hercules made a good faith and sound business decision on that basis.

On behalf of my company, its employees and its shareholders, I have an obligation not to stand by idly while an adverse and unintended provision of law prevails that no member of Congress knew would reverse previous commitments. American companies cannot do business with the laws constantly, and without warning, shifting beneath their feet, and with subsequent and unintended interpretations.

After all, when Congress decided to specifically authorize continuance of the ETC program in 1971 and again in 1984, it was a definitive act, forthright and specific, unlike the provisions of the 1986 Act.

Accordingly, Mr. Chairman, it is your judgment on this matter, and that of your colleagues here in the Senate and in the House of Representatives, that we and other ETCs which will testify today or will submit statements for the record, now seek.

Senator DASCHLE. Thank you, Mr. Tepas.

Mr. Woodbury?

STATEMENT OF ROBERT W. WOODBURY, VICE PRESIDENT, KOLLMORGEN CORP., WALTHAM, MA, ACCOMPANIED BY JOSEPH H. NEWBERG, ESQUIRE, COUNSEL TO KOLLMORGEN CORP.

Mr. WOODBURY. Mr. Chairman, my name is Robert Woodbury. I am Vice President and Controller of Kollmorgen Corporation. I am here today to request equitable treatment for my company, Kollmorgen Corporation, and to support other corporations which, like Kollmorgen, had the rules changed on them in the middle of the game.

I am accompanied by my tax counsel, Joseph H. Newberg of Sullivan and Worcester in Boston. We will be happy to answer any questions the committee may have.

By way of background, Kollmorgen is a manufacturer of high performance, motion control analytical instruments and electrical optical systems.

From 1971 to 1991, Kollmorgen used its wholly-owned Swiss subsidiary, Kollmorgen, A.G. ("KAG"), to distribute and sell certain of Kollmorgen's products throughout Europe. Because KAG's business fostered an important goal of U.S. economic policy—that of expanding the sale of U.S. products overseas, KAG was entitled to operate since its formation as an export trade corporation, or ETC, one of the export incentive companies established by Congress.

Presented in 1984 with a Congressionally offered option to: (1) continue as an ETC; (2) to transfer its assets tax-free to a FSC; or (3) to quit the export sales business and repatriate its export trade income tax free to the U.S., Kollmorgen chose to continue operating KAG as an ETC. Even though Kollmorgen could have repatriated all of KAG's accumulated earnings from export sales tax free by terminating its operations, Kollmorgen wanted KAG to continue in its traditional export business with the same tax consequences. Moreover, Kollmorgen had the explicit blessing of Congress to take this route. Certainly Kollmorgen believed, based on the protection of the ETC system by Congress, first in 1971; and then again in 1984, that KAG would be able to continue operating as a tax-deferred ETC as long as it remained in the export business.

Kollmorgen continued to actively operate its ETC and was doing so on April 20, 1990 when the Chief of Staff of the Joint Tax Committee publicly proposed the elimination of the ETC regime as a simplification measure.

When it became likely that the ETC regime would be closed down, and that accumulation of income, even for redeployment in export trade activities, could give rise to PFIC issues, Kollmorgen was forced to reevaluate the economic utility of maintaining its Swiss subsidiary. As a result of this review, Kollmorgen during 1991 withdrew the accumulated export trade income from investment in export assets, in order to redeploy those resources to more productive uses.

Since no relief similar to the 1984, and earlier 1971, relief had been proposed or seemed available, Kollmorgen was required to include such withdrawals in taxable income in accordance with the normal ETC provisions. This has unreasonably affected Kollmorgen and other companies testifying here, compared to all other ETCs which had the opportunity to convert tax free their export trade assets into a FSC, or to withdraw these assets tax free for redeployment. Kollmorgen, therefore, joins with Hercules in requesting relief similar to that contained in the Deficit Reduction Act of 1984, that would allow them to repatriate their earnings tax free.

Certainly, fair relief is warranted, and is not an unreasonable price to ask where the taxpayer has relied on Congressional laws in conducting its export activities, has played by all the applicable rules, and, in the absence of such relief, will have suffered a tax disadvantage not suffered by its competitors who took advantage of the prior relief rules.

In sum, we do not believe it is fair or equitable to deny relief to Kollmorgen, where it had no basis in 1984 to conclude that the Congressionally-mandated and twice- protected ETC regime would lose its viability in the future. Kollmorgen, therefore, joins with Hercules in requesting the ability to repatriate its export trade income tax free.

By way of example, legislative relief that would fairly address the foregoing inequities might include the following elements:

(1) Formal repeal of the ETC regime, effective for years ending on or after December 31, 1990—hereafter the termination date. This approach would be consistent with the public statement by the Chief of Staff of the Joint Tax Committee in 1990, proposing elimination of the ETC regime as a simplification measure.

(2) ETCs in existence as of the termination date would be allowed relief similar to that allowed when the export trade regime was modified in 1971 and again in 1984. Export trade income earned prior to and including the termination date would, when distributed any time after December 31, 1986, be treated as previously taxed income.

We believe this approach would recognize the de facto death warrant for ETCs signed by the Joint Tax Committee in 1990. For reasons more fully addressed by Mr. Tepas from Hercules, this would correct the unfairness suffered by ETCs, which reasonably relied upon Congress by continuing to operate as ETCs after 1984.

Thank you.

Senator DASCHLE. Thank you, Mr. Woodbury, for your statement.

Could either one of you elaborate as to why a company would have chosen to operate as an ETC rather than go to a FSC in 1984 when that opportunity presented itself? What were the factors that one would have weighed in coming to this decision?

Mr. TEPAS. I think, on the part of Hercules, we chose to continue because we had made a significant investment in HINTCO and built it up. We had offices in Europe and the Far East. It was a known entity, successful in what it was doing. It was stimulating U.S. exports. It had grown substantially, and there was just absolutely no incentive, no reason, for us to change to a FSC or to discontinue its operation. It was very good at providing us a competitive advantage.

Mr. WOODBURY. From Kollmorgen's position, we can take an educated guess, since many of the employees who were in the company in 1984 are not in the company today.

The company at that time was losing substantial money, and did not have an in-house tax staff. The management was trying to pay attention to the business, and not worrying about how to handle tax issues, and there was no reason to try to convert to an ETC. It was working for us. It was doing well. Legally, and from a business standpoint, there was no reason to have to undo the ETC.

Senator DASCHLE. But was there not at that point some significant tax advantage?

Mr. KNOX. Tax advantage, Senator, in what respect?

Senator DASCHLE. Was there a decision based upon circumstances at that time, that the tax advantages of an ETC outweighed the advantages of an FSC?

Mr. KNOX. In our judgment, it did. A certain element of our income—financing of third-party business, dealing with third-party business—would not have been subject to this FSC proposal. We would have had to pay tax on it currently, as contrasted by the ETC rules where we had a 100 percent deferral on that income. Deferral certainly had more value to us than the partial exemption of FSC given the nature of our business.

Senator DASCHLE. Is there a way to quantify that value?

Mr. KNOX. I think that the partial exemption, of roughly 70 percent of the income in a FSC, contrasted to 100 percent of the income earned in a deferral situation.

Senator DASCHLE. How would you reply to Counsel Richter's comment in his testimony that, even though you distributed your accumulated export trade income in 1990 and 1991, compared to other companies that went ahead and converted to FSCs in 1984, you enjoyed three extra years of ETC tax benefits from 1984 to 1987? I believe he made that comment in his testimony, and it would be interesting to have your response to it.

Mr. TEPAS. Senator, I think it is clear that we take issue with that statement. But, as to the specifics, Mr. Bruce Jester, currently Tax Director and Assistant Treasurer for Hercules, Incorporated——

Senator DASCHLE. Would you mind introducing everybody on the panel, for purposes of the record.

Mr. TEPAS. I introduce Mr. Jester. He is Director of Tax and Assistant Treasurer for Hercules, Incorporated. I previously identified myself.

Senator DASCHLE. The gentleman representing Kollmorgen?

Mr. WOODBURY. Gentlemen, this is Joe Newberg, Tax Counsel for Kollmorgen.

Mr. TEPAS. And, lastly, at the end of the table is Jim Knox, formerly Assistant Treasurer for the firm.

Mr. JESTER. Senator, in response to the statement made by Treasury, I think that statement is inaccurate because, while we were able to defer taxes for an additional 18 months or 2 years, as a result of the 1986 Act and the 1988 provisions, we then had to repatriate those earnings and pay the tax at that point in time. So there was not really any significant additional benefit obtained during that 18-month, 2-year period.

Senator DASCHLE. No significant benefit?

Mr. JESTER. No. That is correct.

Senator DASCHLE. How would you define significant?

Mr. JESTER. I would define it conversely as insignificant in that the benefit was the time value of the tax payment that was made 2 years later, the time value of that money.

Mr. NEWBERG. Senator, if I might just say, from Kollmorgen's point of view, to respond to that Treasury point, generally, if the taxpayer had elected in 1984 to convert to a FSC, they would not have had a tax deferral of all the income. They would have had a tax exemption, however, of part of that. And by remaining as an export trade corporation, they gave up the right to continue indefinitely into the future and to have a tax exemption on part of their income.

If, on the other hand, they had elected to bring the income—the accumulated export trade assets—back tax free in 1984, they could have then redeployed those assets into other activities with risk and reward ratios known to them.

But export trade corporation status endorsed by Congress in 1984, as it had been in 1971 and 1962, said to people, "This is a good place to invest your money, in export trade activities. We encourage that. Continue to do it. Here are the risk/reward ratios."

Yes, there was continued deferral, but that was part of the game, and there were tradeoffs in making the choice to take that instead of these other things.

Mr. KNOX. One other point, Senator, I would like to make. As was stated in Mr. Tepas' testimony, at least to our knowledge, there was no warning, no advance notice that in 1986 this was going to occur.

Certainly, had we been aware in 1984 that something of this nature would occur within a very short time—18 months or 2 years down the road—we would certainly not have continued on with tax deferral. The value of that deferral was far, far less than the value of bringing back what we had accumulated in 1984 tax free. There would be no comparison. The latter would dwarf the other.

Senator DASCHLE. Mr. Tepas and Mr. Woodbury both mentioned in their statement that HINTCO and KAG distributed their accumulated export trade income in 1991, as was discussed. How does that relate to the choice Hercules and Kollmorgen made in 1984 to continue HINTCO's and KAG's trade export business?

Mr. TEPAS. With regard to Hercules, we felt it prudent, based on the interpretation by Treasury Department that this would be PFIC income. With the interest and penalties associated with it, we really had no other choice but to repatriate as soon as we heard that interpretation.

Mr. WOODBURY. From Kollmorgen's perspective, during 1990, the demand for products in Europe started to decline. This was the first consideration, and we needed to redeploy some of our assets. Most important was, since the Joint Tax Committee in 1990 effectively announced the ETC regime as being killed, it made no sense to leave those assets because accumulating any additional earnings in KAG would have incurred more difficult tax consequences as the company went forward under the PFIC rules.

Senator DASCHLE. In this kind of a situation, are there foreign tax credits that could be used to shelter U.S. income from the tax arising from distribution? What kind of foreign tax credit basket might apply to such income under these circumstances?

Mr. JESTER. There would be some foreign tax credits available to shield some of the income and, to a great extent, the amount of shelter or shielding that would take place would depend on the basket in which the income was allocated.

If the income went into a basket where you had significant tax credits available, then, of course, you could shield that income from U.S. taxation. If it went into a basket where you did not have significant foreign tax credits or had no foreign tax credits available, then there would be no shelter and you would pay U.S. tax currently.

Mr. KNOX. Another aspect, not so much on the foreign tax credits, Senator, but you had inquired about the distributions that Hercules made in 1990 and 1991. A lot of that was precipitated by the interpretation of the PFIC rules that would have effectively denied the deferral to Hercules going out in the future. The price of that deferral, if we continued to defer under the PFIC rules, was very onerous if we took it out over that time horizon. As any business such as ours looks down the road for future planning, that price would have been terribly high.

I think we had a number that went out about 20 years. You were looking at something in the range of a 98 percent effective tax rate on the earnings of the company if we deferred. Caution said to us that we had better make the distribution and proceed ahead with what we had to do.

Senator DASCHLE. Do you know what basket Hercules used in 1990 or 1991?

Mr. JESTER. The income was split among the two baskets. I will refer to the active basket, or the general basket, which is the basket that normally has foreign tax credits available, and the passive basket, which most of the time, at least in our business, does not have significant foreign tax credits available. And, to respond to your question, the income was allocated between both baskets.

Senator DASCHLE. How do you respond to Mr. Richter's point that there is no way Congress could guarantee a taxpayer a special tax status, or guarantee that the rules would not change indefinitely? One has to view all of one's tax benefits in a somewhat prospective way, with almost an anticipation that things are going to change. I think that was the point. How would you respond to that?

Mr. WOODBURY. I will answer that from Kollmorgen's standpoint. As we said in our statement, we had three options in 1984. And, given those three options, we chose option one, as mentioned in my statement. The rules were changed later on, saying that the taxpayer cannot assume that it will go on forever. We had an option which we elected, and other companies made different elections. Changing the rules two to 3 years down the road is not keeping it on an open playing field in that regard. We thought we were targeted, and it was a death warrant only for those continuing as an ETC.

Mr. TEPAS. I would add that, if Congress had made it clear in 1984, or even given some indication that their intention was to terminate ETCs, then, clearly, Hercules would have made a far different choice, made a very different decision than it made. But, in fact, there was no indication of that and, again, we believe that where our company was treated unfairly is that, even in the 1986 Tax Act, the question of ETCs is subject to interpretation, and it is that interpretation that we do not believe Congress intended that has disadvantaged our corporation.

Mr. KNOX. If I might add, Senator, one point on that which we feel is very critical, at least from our analysis of the situation, is that the ETC statutes are very specific. You need to do this, you need to do that, you need to comply with various utilization of your assets. They cannot be employed in things other than the ongoing export activities of the company. You need to comply with rather strict rules within the ETC provision. We were comfortable with these. We knew, or at least we thought we knew, what they meant.

In 1986, what came along in the PFIC was a rather broad and general statutory provision. It did not address ETCs specifically. Had ETCs been addressed, it would have been a different situation, I believe. But we were dealing with the ETC rules, and ETCs got caught up in the PFIC rules, which were rather a broad application to many forms of companies. As Mr. Tepas has mentioned, ETCs were not even mentioned.

[The prepared statement of Mr. Woodbury appears in the appendix.]

Senator DASCHLE. Senator Roth?

Senator ROTH. Thank you, Mr. Chairman and gentlemen, welcome. It is nice to have you here today.

Going along the line of questioning by the Chairman, I expect all you gentlemen agree and understand that any rules or laws can be changed by Congress. But the problem here was that the change that came about was not specific, but as a result of a general provision provided in 1986. In other words, as you have already testified, is it correct that the export trading companies were specifically authorized? Is that correct?

[All responded yes.]

Senator ROTH. And, in 1984, you were given three choices. I want to make sure I understand. You were given three choices. One of them was to continue the export trading corporation. There was no indication then that the rules were going to be changed as to deferral. Is that correct?

Mr. TEPAS. That is correct. Right.

Senator ROTH. Mr. Woodbury?

Mr. WOODBURY. That is correct.

Senator ROTH. So, when the general rule came in 1986 on passive activities, was there any evidence of any type that it was going to apply to export trading companies that you are aware of?

Mr. KNOX. None that we could see, Senator.

Senator ROTH. None whatsoever?

Mr. KNOX. No.

Senator ROTH. So that, in a sense, the rules were changed by the Executive Branch, by the Treasury. Is that correct?

Mr. KNOX. I think the first serious indication we saw, that we had a problem with the PFIC rules, was with the passage of regulations in 1988, which actually dealt with Section 954 of the Revenue Code, dealing with personal holding company income. What had happened was that the PFIC statutory rules were interpreted by Section 954 regulations to define what passive income was.

The PFIC rule said to look to Section 954 for the definition of passive income for purposes of the PFIC rule. But that is the first time that we saw that the issue could apply to our ETC.

Senator ROTH. Well, I have no recollection of the Finance Committee considering the PFIC rules' effect on ETCs or FSCs.

But I do remember talking to the Chief Foreign Counsel at Joint Tax who told me that they just did not consider it at all. No consideration was given of any sort. It seems to me that, if Congress did not think about this issue then, it should reconsider the issue now, especially since the Treasury regulations seem to have been applied broadly.

I assume that you gentlemen would agree that Congress should reconsider the application of the PFIC rules to ETCs.

Mr. WOODBURY. Absolutely, yes.

Senator ROTH. Now let me ask Mr. Tepas. You mentioned in your statement that HINTCO distributed accumulated export trade income in 1990 and 1991. Is this not inconsistent with the choice Hercules made in 1984 to continue HINTCO's export trade business?

Mr. TEPAS. I do not think so. Ideally, HINTCO would have retained these earnings and continued in its efforts to create exports for the U.S. economy.

As I previously mentioned, it was really quite successful at doing that, and we felt that it was providing a competitive advantage to us. We had made certain investments in HINTCO, creating its identity, and leading to its success. I think the decision to bring back retained earnings in 1990 and 1991 were solely a decision really forced upon us by the interpretation in 1988 of the 1986 Tax Act, and one that we believe was an unintended interpretation. So, we really did not feel that we had a viable decision other than to bring back those earnings and pay the taxes on them.

Mr. JESTER. Senator, if I may add to that, I think, as was mentioned earlier, if we had not distributed those funds at that point, and had waited for 15 to 20 years, then the effective tax rate on those earnings would have approached 95 to 98 percent. So we really had no other choice. Senator Roth. You had no real choice?

Mr. JESTER. Right.

Senator ROTH. But Treasury contends, in the case of Hercules, that you are seeking retroactive relief. Do you agree with that?

Mr. TEPAS. I think the ETCs were created to stimulate exports for the U.S. economy. I think we were very successful in doing that. It seems as though, through an interpretation, we are now being disadvantaged. The only difference between now and 1984 is that, because of the uncertain application of the PFIC rules—their interpretation—we have already been forced to repatriate these retained earnings, and have been taxed on those earnings.

I do not believe the retroactivity argument put forth by Mr. Richter is really applicable to us.

Mr. KNOX. If I could add, Senator, I think that we somewhat viewed the 1984 position of the Congress to be saying to ETCs that, if you choose to, we are going to change the way in which you are taxed.

You have been taxed over the past several years on a deferral that said, in effect, that someday those earnings are going to come back and you are going to pay tax on them. We are going to change that retroactively. And we are going to let you take those earnings out in 1984 and treat them as tax exempt.

I do not think we are asking for anything different. I think we are asking for comparable treatment to 1984. But now, in our judgment, the rug was pulled out a short 2 years later. We seek the same type of relief. We think it is comparable relief to what was done in 1984. If it is retroactive, it is retroactive under the same principles that were there in 1984.

Another point Mr. Richter made that, if ETCs are given relief in this situation, we do not think the floodgates will open up. ETCs, as I mentioned earlier, are a specific "animal" provided for under the provisions of a separate statute. Some of the other types of companies who feel they have PFIC problems are general controlled foreign corporations. They are not operating under a specific mandate of Congress, such as ETCs.

Senator ROTH. Thank you. Mr. Woodbury, do you have any further comments?

Mr. WOODBURY. From a retroactive standpoint, what Kollmorgen's relief would be is similar to what Congress gave in 1984. The effective date of export trade earnings through 1990, since the rules were changed by the Congressional committee in 1990, would have similar treatment to what we were offered in the option in 1984, which is consistent.

Senator Roth. Thank you, Mr. Chairman.

Senator DASCHLE. Well, thank you, Senator Roth. Gentlemen, thank you very much for your answers. The hearing record will remain open for five legislative days for any additional comment.

If there are any other remarks that any of you wish to make, and add as an addendum to what you have already said, they would be more than welcome.

[Whereupon, at 3:20 p.m., the hearing was adjourned.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF MICHAEL N. CASTLE

Chairman Daschle, Senator Hatch and members of the subcommittee, I appreciate the opportunity to appear before you today. I am very pleased the subcommittee has agreed to review the issue of how export trading companies, known as ETCs, are taxed.

This matter is of great importance to Hercules Incorporated and several other companies. I am glad to see a number of my constituents from Delaware here today. They will explain the imact the changes in the tax regulations for ETCS have had on their company. In addition, my colleague from Delaware, Senator Bill Roth has been seeking to address this issue for a number of years and can share his experience and knowledge with the subcommittee.

In my view, the key questions before the subcommittee are congressional intent and fairness. Did Congress intend for the 1986 Tax Reform Act to eliminate the favorable tax treatment for the few remaining export trading companies? And was it fair for these changes to be made through the regulatory process without any review by Congress?

It is my understanding that the 1986 Tax Reform Act intended to end the practice of some financial companies establishing off-shore mutual funds to protect them from U.S. taxation.

However, when implementing the 1986 Act, the Treasury Department, in 1988, established new rules for Passive Foreign Investment Companies (PFICS) which also included export trading companies like Hercules Company, HINTCO. Prior to this action by the Treasury Department, whenever Congress had modified the law on this subject, it had always given existing ETCS the option to protect or change their status.

The 1988 action by Treasury essentially changed the rules in the middle of the game on Hercules and other companies—without any review by Congress to determine the fairness of the change. Obviously, the unexpected change in the tax status of its export trading company has a major financial consequence for Hercules.

I am here simply to ask that the committee review how these changes were made, and whether Hercules and other companies were treated fairly by holding this hearing you have already begun this process. Thank you.

PREPARED STATEMENT OF JIM HARRIS

I wish to thank you, Senator Daschle, for the opportunity to testify on behalf of the American farmers. We strongly endorse Senator Kohl's Bill S 882 titled "Family Farm Tax Relief and Savings Act of 1993" and other similar bills that have been presented by members of congress. S 882 is very similar to a bill co-sponsored by Senator Kohl in 1991 which attained 45 votes in the Senate.[1]

For brevity, the bill may be referred to as "F-RA," standing for FARMERS RANCH RETIREMENT ACCOUNT in this presentation.

"F-RA" re-establishes the farm assets as the Farmers Retirement Fund correcting the hardships caused by:

1. The capital gains tax revisions of '86 and

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[1] Similar house bills, Costello HR 1142, Sensenbrenner HR 1747.

2. The oversight or failure of Congress to recognize that the farm investment unit more than satisfies the intent and criteria for investment of funds required of the IRA concept.

LIMITS—There are definitely limits to F-RA. A few follow:

1. Full time farmer for minimum of 5 years to qualify.
2. Maximum of $10,000/year of farming per spouse.
3. Maximum of $500,000 lifetime contribution limit per farm couple.
4. One's ability to-pay—I lost about $30,000 the last three years on the farm and had no significant charges for interest or depreciation because of the good farm economy of the 70's.
5. Any other existing IRA'S which exceeds a $100,000 total. (The 401Ks, Keoughs, IRA's or multi-million dollar accounts which can achieve values of hundreds of millions of dollars.)

The bill is unique in that it neither advantages or disadvantages any farm region, product or activity. It will provide great incentive for substantial long term investment commitment to rural America. Also to the farm unit because the farmer can, without reservation, devote all assets to the farm development, keeping his retirement funds at home! (not Texas S&L's or South Africa gold mines.)

The bill recognizes the need of the special farming (tenant farming) situations which hold little or no real estate but have large investments in crops, animals, machinery, etc. To date most long term tax advantages have been targeted at real estate holdings not working assets.

Object:

Treat a portion of the family farm assets as a "self-directed" IRA with income tax deferral, rollover and make-up privileges comparable to those granted to other tax payers' self-directed IRA's.

FACT—Farming is an extremely capital intensive profession-occupation. Long term growth and success of a family farm requires *all* of the farmer's capital resources. One dollar of farmer income yields $.10 to kitchen, $.90 to bank to borrow $10 more for farm operations and expansion leaving nothing to invest in IRA'S or significant social security.

FACT—White/blue collar workers and other professionals, make large incomes that require little capital outlay.

FACT—These people are allowed generous tax preferential treatment of large sums invested in retirement packages—IRA's, 401K's, Keoughs, Deferred Comps., employer paid retirement funds, etc., which are *invested in commerce. Let the farm be the commerce for the farmer's IRA. It certainly satisfies the intent and purposes of IRA's.* It is simply an investment vehicle like savings, stocks, bonds, mutual funds, etc.

FACT—Throughout history the farmer's capital appreciation was the farmer's retirement fund and was given tax preferential' treatment by means of the previous long term capital gains tax exemption. Capital gains accumulated by a family's dairy herd is family developed from grandparent to grandchild and the farmer is a very active—not passive—risk participator. Plus a major investor in the infrastructure of rural America.

FACT—Now when a farmer is forced or voluntarily sells out (farm auction) when retiring, all proceeds are taxed at a high tax rate, as if ones lifetime—blood and sweat—assets were earned that year (no consideration for inflation.) Paper stocks gains are easily held and averaged for retirement years, agricultural assets—impossible!!!

When net farm income is limited or nonexistent due to the combination of persistent low prices and required capital expenditures, *by law, No Tax Exempt IRA's and Only Limited Social Security can be Funded.* Result—IRA's and meaningful Social Security are inaccessible for many farmers. Thus, the farmer retires with slim retirement funds and a retirement to poverty. YET, the government demands their "PINT OF BLOOD" out of the capital gains area of the farm sale.

A very tiny fraction of the S&L fiasco cost would permanently endow a responsible farm F-RA program!! Agriculture is a most essential "PUBLIC UTILITY" and it's health must be regarded as vital to society. Farmer's capital is invested locally—not Texas S&L's or South Africa—giving a local return of 6 to 1, creating local tax base and jobs.

This in resolution form was passed, or in process by *many farm organizations.*

The typical annual retirement package available of $10/hr. to $12/hr. Wisconsin state employees (my wife's) is (1) $3,000/yr. employer paid retirement; (2) $2,300 employer paid S.S. (7.65% vs. 15.3%); (3) $7,500 shared or self paid 401K (with a $22,500 hardship make up privilege); (4) $2,000 self paid IRA; TOTAL $14,800. (5) + employer paid health insurance (6) + equal spouse's IRA account. The $500,000 limit of Farm F-RA bills cost $63.80 per month, per farm couple, while the $2,000 IRA bills cost $333.32 per month (5 times F-RA cost) per couple and achieve a value of $2,608,000.

I could go on and on about the unfairness issue. If one must, take some away from the over-endowed so the underendowed American farmer who provides the cheapest, most plentiful food supply the world has ever known, can spend a few years in dignity before we turn to the county for support and welfare assistance.

A farmer's social security is much less than one would think. Probably averages in the $300 to $400 per month range. Also, seldom is there a separate Social Security account for the farm wife.

This F-RA concept is of unique value only to those professions which have a huge "RATIO" of required capital assets per dollar of net earned income, particularly where every possible dollar must go back into the business and one absolutely cannot afford a separate retirement fund.

***Presently one spouse almost needs to die so the other can retire comfortably, benefiting by new cost basis established by the spouse's death—SAD!

WHY LENA QUITS MILKING COWS WHEN OLE DIES

Mr. and Mrs. Farmer Oleson are retiring due to their advanced age and health. Their farm auction is to be held Saturday, March 31st. Saturday night after the auction Lena performs her wifely duties and writes out checks for all outstanding debts. The remaining balance is $100,000. Friendly Joe Shmoe, their accountant, informs Ole and Lena that the federal and state treasuries desire their share of $42,000 for various taxes.

Monday morning Ole and Lena have but $58,000.00 to deposit into their taxable savings account for the two of them to live miserly on during their not so golden years.

Now, if Mr. Oleson would have been real considerate of the lovely Lena, he would have passed on by March 30th. Then Lena would have to waltz alone through her golden years. Alone with $100,000.00 where the two of them together have but $58,000.00. Does this make sense? LET'S DO F-RA!!

*Ole & Lena story not in original testimony.

DISCUSSION OF THE SIMPLE LINEAR GRAPH #1

When one reviews Curve #1 of graph I we see that an annual deposit of $1000.00 (1/2 of an IRA) deposited at a monthly rate of $1000/12 months or $83.33/month grows to $652,170.00 in 50 years. A deposit of $766/year—one F-RA equivalent ($63.80 per month) deposited monthly at 8% *1 compounded monthly interest achieves our $500,000 goal. Since we may have a working couple and each contributing to full $2,000 IRA'S ($4,000 total—Curve III), then the combination would grow to $500,000 in a mere 30 years, not 50 as specified in F-RA bill. The data is repeated on semi-log scale graph paper (graph 2 pg. 11) which compresses the huge account totals to a scale of which they can be visualized.

*1—Farmers have commonly paid 12 to 18% interest on their loans for the last 20 years.

Now consider my brother John Harris—a Case I-H Tenneco employee of 31 years and is 59 years old. He has a company package of:

I.	401K—The company and he each contribute 8% of his salary—Input value approximately	$12,000/yr
II.	IRA—$2,000 (self paid)	2,000
III.	Company paid retirement plan—Retirement.	
	At age 57	Per month 1,600
	At age 62	Per month 2,500
IV.	Social Security 1/2 pd by Co.	Approx./yr. 3,200
	(Expected monthly retirement check—$1100 per mo.)	
V.	Deluxe Company paid health insurance throughout working and retirement years (and the government don't even want ours to be deductible.)	$8,000/yr.

This package is worth many, many millions of dollars compared to the pittance of the cost of F-RA'S $383.00 per year per spouse.

ACKNOWLEDGMENTS

I wish to acknowledge and commend Senator Kohl for his leadership on the F-RA legislation and also the support of Racine, Walworth and Kenosha County Farm Bureaus; Jack King of the American Farm Bureau; Darlene Ehrhart of Racine

County Farm Bureau, and most of all my wife Nelda for the support needed to carry this project forward.

Legal consultation provided by Jim MacDonald of MacDonald & MacDonald Law Firm.

Please contact James H. Harris, 4001 67th Drive., Union Grove, WI 53182 for answers to any questions.

Enclosure.

"$500,000 OF FARM ASSETS MAY BE ROLLED OVER INTO THE FARMERS RETIREMENT ACCOUNT, ALL TAXES DEFERRED UNTIL FUNDS WITHDRAWN" UNDER PROPOSED BILLS S882, HR1142 & HR1747

FARMERS TAX EQUALITY,
SAVINGS AND
RETIREMENT SECURITY BILLS

Please contact:
Jim Harris, Chairman
Racine Co. Farm Bureau
National & State Affai
4001 67th Drive
Union Grove, WI 53182
414-878-1661

1-1-94

RACINE COUNTY FARM BUREAU 414-878-21

"FARMERS HAVE NOTORIOUSLY LITTLE SOCIAL SECURITY COVERAGE" *1

FRA - FARMERS RETIREMENT ACCOUNT

- Allows a farm couple to place all proceeds from the sale of qualified farm assets up to maximum of $20,000 per farm couple for each full year of farming into a tax deferred IRA, lifetime maximum of $500,000.
- Instead of paying capital gains tax or ordinary income tax on the proceeds at the time of the farm asset sale, the farmer would only pay taxes on the amount of money drawn out of the account each year.
- Typically farmers and ranchers pour most of their annual income back into the operation, leaving little or no money to salt away into retirement accounts. The public has pension/retirement accounts with employer participation. Their 401s, Keoughs, Sep IRAs are paid with pre-tax dollars, resulting in a huge overall tax break and a $10 for $1 increase in spendable retirement funds.
- A farmers' retirement nest egg typically consists of the after tax equity they have accumulated over the years in their operations, land and land improvements, buildings, livestock, crops and equipment. Under current conditions when they sell out/hold an auction, all sales proceeds are treated as earnings in that given year and taxed at the highest tax rate (28% or more) plus state taxes of up to 12%.
- Before the tax reform act of 1986, long-term capital assets were given preferential tax treatment by means of a long-term capital gains exemption. That ended in 1986 DEVASTATING FARMERS RETIREMENT FUNDS.
- There are several potential advantages to a Farmer Retirement Account:
  - It encourages the timely and orderly transfer of farm property from one generation to another. (It gets dad out of the way).
  - The Farmer-RA investment funds would be available to local institutions for rural investment.
  - It helps farm families to better remain more self-sufficient in their retirement.
  - It gives farmers equal access to tax laws, therefore a matter of tax equity no longer being a second class citizen.
- The Farmer-IRA is not tax avoidance, but rather an aid to tax and retirement planning. TAXES EVENTUALLY WILL BE PAID ON THE RETIREMENT FUNDS!

The Farmer IRA bill S 1130 of 91/92 was 5 votes short March/92 (45 to 53). This was basically the result of one individual's effort - little or no support was contributed by farm organizations.

Sponsors and co-sponsors for this much needed legislation are easy to get. E.g. In '92 I got introduced one Senate bill and 2 house bills. 2 WI Senators and 8 of 9 WI Congressmen were sponsor-co-sponsor. We had over 100 committed House votes for Farmers IRA.

103rd Congress (1993) Farmers Retirement and Security Bills are: Sen Kohl (D-WI) S 882; Congressman Sensenbrenner (R-WI) HR 1747; Congressman Costello (D-IL) HR 1142.

National media coverage has been very easy to get for this much needed legislation as interest is high but <u>action is little</u> by farm organizations.

I testified five times at senate hearings and have met with scores of Senators and Congressmen on this issue. THEY ARE JUST WAITING FOR YOUR CALL ASKING THEM TO SIGN ON.

*1 Statement by Soc. Sec. employee at U of W sponsored Retirement Seminar November '93.

SUPPORT & FINANCI
ASSISTANCE NEEDI

WI AGAIN LEADS FRA FIGHT WITH FIVE BILLS AND UNANIMOUS LEGISLATIVE SUPPORT

The budget impact of the F-RA bill was estimated to be under 200 million dollars a year. This is .2% of the USDA's budget or 2% of the cost of the commodity price support programs - possible sources of off-setting revenue.

Hypothetical savings account paying 8% interest per annum compounded monthly with 1/12th of the annual deposit made monthly:

	1 FRA	1 IRA	2 IRAS	1 401	IRS PUB. 560 SELF-EMPLOYED
Yearly Deposit of:	$766.00	$2000.00	$4000.00	$10,000.00	$30,000
Account Value: (@ 50 years)	$500,000	$1.3 mil.	$2.6 mil.	$6.5 mil.	$19.5 mil.

Current IRA laws (IRA Publication 560) will allow up to $30,000.00 per year per person contributions ($60,000.00 per year per working couple which accumulates to $39 mil. - 80 TIMES THE $.5 MIL. ASKED BY FRA.

State of Wisconsin hourly employees annual tax advantage fringes include but are not limited to: $5,000.00 paid health insurance; $3,000.00 paid pension fund; 1/2 of state paid social security (estimated $1800.00 value); individual paid $7,500.00 tax deferred 401, plus $2,000.00 IRA annually, plus a $22,500.00 401 make-up privilege at retirement time. TOTAL ANNUAL FRINGES OF $19,300 NOT $766.00 asked by FARMERS IRA.

THE FRA BILLS WERE UNIQUE IN THAT THEY NEITHER ADVANTAGED NOR DISADVANTAGED ANY FARM REGION, PRODUCT OR ACTIVITY. THEY WILL PROVIDE GREAT INCENTIVE FOR SUBSTANTIAL LONG TERM INVESTMENT COMMITMENT TO RURAL AMERICA, AND ALSO TO THE FARM UNIT BECAUSE THE FARMER CAN, WITHOUT RESERVATION, DEVOTE ALL ASSETS TO THE FARM DEVELOPMENT, KEEPING HIS RETIREMENT FUNDS AT HOME! (NOT TEXAS S&L'S OR SOUTH AFRICA GOLD MINES.)

The bill recognizes the need of the special farming (tenant farming) situations which hold little or no real estate but have large investments in crops, animals, machinery, etc. To date most long term tax advantages have been targeted at real estate holdings not working assets. Unskilled factory workers with less than an 8th grade education commonly have retirement accounts valued well in excess of $1,000,000.00. They may also have maximum social security coverage, company paid pension and health insurance upon retirement plus personal retirement accounts, etc.

FARM BUREAU, ALONG WITH MANY, MANY OTHER FARM ORGANIZATIONS, SUPPORTS THE ENACTMENT OF TAX DEFERRED CONTRIBUTION TO IRAS AND SUPPORTED THIS LEGISLATION IN THE LAST SESSION OF CONGRESS.

PLEASE SIGN AND ENDORSE THIS DOCUMENT ALONG WITH YOUR FRIENDS, FELLOW FARMERS AND RANCHERS AND MAIL IT TO AND/OR CALL YOUR SENATORS AND CONGRESSMEN URGING THEIR SPONSORSHIP AND SUPPORT OF FARMERS RETIREMENT ROLL-OVER OF FARM ASSETS BILLS. ***THEIR WAITING FOR YOUR CALL***

General Washington D.C. address for your:

Congressman - Honorable Congressman	Honorable Senator
(Name)	(Name)
House Office Bldg.	Senate Office Bldg.
Washington D.C. 20515	Washington D.C. 20510

Phone . . . . 1-202-224-4121 (House & Senate) Cost .11 to .26/minute
1-202-456-1414 (Administration)

Thanks for your help and please call me - grassroots efforts really work.

James H Harris 414-878-1663

BEST AVAILABLE COPY

DESCRIPTION OF MISCELLANEOUS FARM-RELATED TAX PROPOSALS (S. 226, S. 531, S. 545, S. 882, S. 1615, S. 1691, AND S. 1814)

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON
ENERGY AND AGRICULTURAL TAXATION

of the

SENATE COMMITTEE ON FINANCE

on October 5, 1994

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

October 3, 1994

JCX-23-94

CONTENTS

INTRODUCTION

The Subcommittee on Energy and Agricultural Taxation of the Senate Committee on Finance has scheduled a public hearing on October 5, 1994, to consider various farm-related tax proposals. These proposals are: (1) S. 226 (estate tax recapture from cash leases of specially valued property); (2) S. 531 (increase the unified estate and gift tax credit); (3) S. 545 (treatment of gains or losses from certain dispositions by farmers' cooperatives); (4) S. 882 (rollover of gain from the sale of farm assets into an asset rollover account); (5) S. 1615 (treatment of livestock sold on account of weather-related conditions); (6) S. 1619 (tax credit for environmental pollution control property and for soil and water conservation expenditures); and (7) S. 1814 (treatment of certain crop insurance proceeds and disaster assistance payments).

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law and the bills (in numerical order) that are the subject of the hearing.

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[1] This document may be cited as follows: Joint Committee on Taxation, Description of Miscellaneous Farm-Related Tax Proposals (JCX-23-94), October 3, 1994.

DESCRIPTION OF BILLS

1. S. 226 (Senators Daschle, Baucus, Boren, Conrad, and Others)

Estate Tax Recapture from Cash Leases of Specially Valued Property

Present Law

A Federal estate tax is imposed on the value of property passing at death. Generally, the value of property is its fair market value, that is, the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

Under section 2032A of the Code, the executor may elect to value certain "qualified real property" used in farming or another qualifying trade or business at its current use value rather than its highest and best use. If, after the special use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years (15 years for individuals dying before 1982) of the decedent's death, an additional estate tax is imposed in order to "recapture" the benefit of the special use valuation (sec. 2032A(c)).

Some courts have held that the cash rental of specially valued property after the death of the decedent is not a qualified use and, therefore, results in the imposition of the additional estate tax. Martin v. Commissioner, 783 F.2d 81 (7th Cir. 1986) (cash lease to unrelated party); Williamson v. Commissioner, 93 T.C. 242 (1989) (cash lease to family member).

Explanation of the Bill

The bill would provide that the cash lease of specially valued real property by a qualified heir to a "member of the family"[2] (who continues to operate the farm or closely held business) does not cause the qualified use of such property to cease for purposes of imposing the additional estate tax under Code section 2032A(c).

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2 A member of the family, with respect to an individual, includes an ancestor, spouse, lineal descendant, lineal descendant of such individual's spouse or parents, and any spouse of any such lineal descendant (sec. 2032A(e)(2)).

Effective Date

The bill would apply to rentals occurring after December 31, 1976.

2. S. 531 (Senators Durenberger and Hatch)

Increase the Unified Estate and Gift Tax Credit

Present Law

The Federal Government imposes a transfer tax on the cumulative property transfers made by gift or at death in excess of an amount exempted by a unified credit. Since 1987, the amount of the unified credit has been fixed at $192,800, which effectively exempts a total of $600,000 in taxable transfers from the estate and gift tax. The benefits of the unified credit are phased out by a 5-percent surtax imposed upon taxable transfers over $10 million and not exceeding $21,040,000.

The unified credit was originally enacted in the Tax Reform Act of 1976. As enacted, the credit was phased in over five years to a level (i.e., a unified credit of $47,000) that effectively exempted $175,625 of taxable transfers from the estate and gift tax in 1981. The Economic Recovery Tax Act of 1981 increased the amount of the unified credit each year between 1982 and 1987, from an effective exemption of $225,000 in 1982 to an effective exemption of $600,000 in 1987. The unified credit has not been increased since 1987.

Explanation of the Bill

The bill would increase the present-law unified credit to an amount (i.e., $345,800) that would effectively exempt $1,000,000 in taxable transfers from the estate and gift tax.[3]

Effective Date

The bill would apply to the estates of decedents dying, and gifts made, after the date of enactment.

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[3] A conforming amendment to the 5-percent surtax would be necessary to permit the increased credit to phase out properly under S. 531. S. 531, as presently drafted, does not contain such a conforming amendment.

3. S. 545 (Senators Boren, Baucus, Danforth, Daschle, Dole, Durenberger, Grassley, Reigle, Roth, and Others)

Treatment of Gains and Losses from Certain Dispositions by Farmers' Cooperatives

Present Law

In general

Unlike other corporations, a cooperative association is allowed to exclude from its taxable income any patronage dividends paid to its members or patrons or amounts paid in redemption of a nonqualified written notice of allocation (sec. 1382).[4] Members of a cooperative association who receive patronage dividends must treat the dividends as income, reduction of basis, or some other treatment that is appropriately related to the type of transaction that gave rise to the dividend. For example, where the cooperative association purchases equipment for its members, patronage dividends attributable to equipment purchases are treated as a reduction in the recipient's basis in the purchased equipment (provided the recipient still owns the equipment).

Definition of patronage dividend

In general, a patronage dividend means an amount paid to a patron (1) on the basis of the quantity or value of business done with or for such patron, (2) under an obligation of the cooperative association to pay such amount, which obligation existed before the association received the amount so paid, and (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons. Such term does not include any amount paid to a patron to the extent that such amount is out of earnings other than from business done with or for patrons, or such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially

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[4] Additionally, cooperative associations may reduce their gross income by the amount of qualified per-unit retain certificates and the amounts paid for redemptions of nonqualifie per-unit retain certificates. A per-unit retain certificate is, in general, a written notice that sets forth the "per-unit retai allocation", that is, the allocation by the cooperative association to a patron with respect to goods marketed by the cooperative association for the patron, which is not determined by reference to the net earnings of the organization.

identical transactions.

<u>Definition of income derived from sources other than patronage</u>

Treasury regulations provide that "...'income derived from sources other than patronage' means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, or from the sale or exchange of capital assets, constitutes income derived from sources other than patronage" (Treas. Reg. sec. 1.1382-3(c)(2)). Notwithstanding the language of the Treasury regulations, both the Internal Revenue Service and the courts have held that, in some cases, income of the types described in the Treasury regulations may constitute income derived from patronage sources.[5]

Also, the Internal Revenue Service has ruled that any gain treated as ordinary income under the depreciation recapture rules of section 1245 is treated as patronage source income in the same portion that the depreciation deductions were taken (Rev. Rul. 74-84, 1974-1 C.B. 244). The ruling further held that any additional gain that is treated as capital gain is not patronage-sourced income.

<u>Explanation of the Bill</u>

<u>In general</u>

Under the bill, a "farmer cooperative" could elect to

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[5] See, e.g., Rev. Rul. 69-576, 1969-2 C.B. 166 (patronage dividend from cooperative bank on loans used for patronage business considered patronage source income because it "...facilitates the accomplishment of the cooperative's marketing, purchasing, and service activities...."); <u>Astoria Plywood Corporation v. United States</u>, 79-1 U.S.T.C. par. 9197 (D. Ore. 1979)(payments for cancellation of a lease on a building used by cooperative for patronage-sourced activities were patronage source income); <u>Land O'Lakes, Inc. v. United States</u>, 675 F. 2d 988 (8th Cir. 1982)(dividends from stock in bank held to be patronage source income where the acquisition of the bank's stock was necessary to receive financing for patronage activities); <u>St. Louis Bank for Cooperatives v. United States</u>, 624 F. 2d 1041 (Ct. Cl. 1980)(interest earned on short-term investment of temporary excess cash of a cooperative bank held to be patronage source income).

include gain or loss on the sale or other disposition of certain assets in the determination of net earnings done with or for patrons. For this purpose, a "farmer cooperative" would be defined as any farmers', fruit growers', or like organization or association to which part I of subchapter T applies.

Assets to which the bill applies

The bill would apply to any asset (including stock or any other ownership or financial interest in another entity), or portion thereof, that is used by the cooperative to facilitate the conduct of business done with, or for, its patrons (herein referred to as a "patronage asset"). Where an asset is not used exclusively to facilitate the conduct of business done with, or for, the farmer cooperative's patrons, the bill would apply only to the extent that the asset is used to facilitate the conduct of business with, or for, its patrons. Allocating the use of the asset between patronage and non-patronage operations could be determined by any reasonable method. The bill also would require that section 1231 be applied separately to patronage gains and losses and nonpatronage gains and losses.

Rules applicable to election

An election made under the bill would apply to all sales (or other dispositions) of patronage assets during the taxable year for which the election is made and all subsequent taxable years until revoked by the farmer cooperative. Following a revocation of its election and absent the consent of the Treasury Department, a farmer cooperative would not be eligible to make an election under this bill until the third taxable year following the taxable year for which the revocation is effective. A revocation would be effective upon the filing of notice with the Treasury Department.

Effective Date

The bill would be effective for sales or other dispositions of property occurring in taxable years beginning after the date of enactment.

4. S. 882 (Senator Kohl)

Rollover of Gain from the Sale of Farm Assets into an Asset Rollover Account

Present Law

Under present law, gain from the sale of farm assets is generally includible in income for the taxable year in which the assets are sold.

Explanation of the Bill

The bill would permit a qualified farmer to defer recognition of a limited amount of net gain from the sale of qualified farm assets to the extent the farmer contributes an amount equal to such gain to one or more asset rollover accounts ("ARAs") in the taxable year in which the sale occurs. An ARA would be an individual retirement arrangement ("IRA") that is designated at the time of establishment as an ARA. Except as provided under the bill, an ARA would be treated in the same manner as an IRA. Thus, amounts contributed to an ARA (and earnings on such amounts) would be includible in income when withdrawn from the ARA. However, unlike IRAs, no deduction would be allowed for contributions to an ARA, and rollover contributions to an ARA could be made only from other ARAs.

Contributions to one or more ARAs (and thus deferral of qualified net farm gain) in any taxable year would be limited to the lesser of (1) the qualified net farm gain for the taxable year, or (2) an amount determined by multiplying the number of years the taxpayer is a qualified farmer by $10,000 ($20,000 for joint filers in each year the taxpayer's spouse also is qualified farmer). In addition, the aggregate amount for all taxable years that could be contributed to all ARAs established on behalf of an individual could not exceed $500,000 ($250,000 in the case of separate return by a married individual), reduced by the amount by which the aggregate value of assets held by the individual and the individual's spouse in IRAs (other than ARAs) exceeds $100,000. A taxpayer would be deemed to have made a contribution to an ARA on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is made not later than the time prescribed by law for filing the individual's Federal income tax return for the year (not including extensions).

Under the bill, qualified net farm gain would be defined as the lesser of (1) the net capital gain of the taxpayer for the taxable year, or (2) the net capital gain for the taxable year determined by taking into account only gain (or loss) in connection with a disposition of a qualified farm asset. A qualified farm asset would be an asset used by a qualified farmer in the active conduct of the trade or business of farming. A qualified farmer would be a taxpayer who during the 5-year period ending on the date of the disposition of a qualified farm asset materially participated in the trade or business of farming, and 50 percent or more of such trade or business is owned by the taxpayer (or spouse) during the 5-year period.

Any individual who made a qualified contribution to, or who received any amount from, an ARA for any taxable year would have to include on the individual's Federal income tax return for such taxable year and any succeeding taxable year (or on such other form as the Secretary may prescribe) information similar to that required in the case of designated nondeductible contributions to an IRA. Excess contributions to an ARA would be subject to the penalties applicable to excess contributions to an IRA.

Effective Date

The bill would apply to sales and exchanges occurring after the date of enactment.

5. S. 1615 (Senators Daschle, Durenberger, Grassley, and Others)

Treatment of Livestock Sold on Account of Weather-Related Conditions

Present Law

In general, taxpayers using the cash method report income in the year it is actually or constructively received. However, present law contains two special rules applicable to livestock sold on account of drought conditions. Code section 451(e) provides that a cash method taxpayer whose principal trade or business is farming and who is forced to sell livestock due to drought conditions may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought conditions that resulted in the area being designated as eligible for Federal assistance. This exception generally is intended to put taxpayers who receive an unusually high amount of income in one year because of a drought in the position they would have been in absent the drought.

In addition, the sale of livestock (other than poultry) that is held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought conditions is treated as an involuntary conversion under section 1033(e). Consequently, gain from the sale of such livestock may be deferred by reinvesting the proceeds of the sale in similar property within a two-year period.

Explanation of the Bill

The bill would amend Code section 451(e) to provide that a cash method taxpayer whose principal trade or business is farming and who is forced to sell livestock due not only to drought (as under present law), but also to floods or other weather-related conditions, may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income would be available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for the drought, flood or other weather-related conditions that resulted in the area being designated as eligible for Federal assistance.

In addition, the bill would amend Code section 1033(e) to provide that the sale of livestock (other than poultry) that is held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought (as under present law), flood or other weather-related conditions is treated as an involuntary conversion.

Effective Date

The bill would apply to sales and exchanges after December 31, 1992.

6. S. 1691 (Senators Conrad, Daschle, Durenberger, Grassley, and Others)

Tax Credit for Environmental Pollution Control Property and for Soil and Water Conservation Expenditures

Present Law

Present law does not provide tax credits for property used to control environmental pollution. However, Code section 48 does provide an energy tax credit for certain energy property (generally, equipment that uses solar energy or energy derived from a geothermal deposit) and a reforestation tax credit for qualified timber property.

In addition, under Code section 175, a taxpayer may deduct certain soil and water conservation expenditures. Such deductions generally cannot exceed 25 percent of gross income derived from farming in the year. Under Code section 169, a taxpayer can elect to amortize certain pollution control facilities over a five-year period. Only "new identifiable treatment facilities" are eligible for five-year amortization. Such facilities generally include only depreciable tangible property (not including a building and its structural components, unless the building is exclusively a treatment facility) that is constructed, reconstructed or erected by the taxpayer after December 31, 1968, or acquired after December 31, 1968, if the original use of the property commences with the taxpayer and commences after such date.

Explanation of the Bill

The bill would provide an "agricultural environmental credit" for property used in certain agriculture-related activities to control environmental pollution and for soil and water conservation expenditures. For any taxable year, the agricultural credit would be equal to the lesser of (1) the sum of (a) 15 percent of the basis of each "agricultural environmental property" placed in service during that year and (b) 15 percent of the amount allowed as a deduction under Code section 175, or (2) the lesser of (a) $15,000 or (b) the excess of $150,000 over the amount of credit previously claimed by the taxpayer in prior taxable years.

To be eligible for the credit, a taxpayer would have to be primarily engaged in a farming-related business, i.e., a farming business (within the meaning of Code sec. 263A(e)(4)), a trade or business of mixing fertilizers from purchased fertilizer materials, or a trade or business of the wholesale distribution of animal feeds, fertilizers, agricultural chemicals, pesticides, seeds or other farm supplies (other than grains).

"Agricultural environmental property" would be defined as any new, identifiable treatment facility (as defined in Code sec. 169(d)(4)(A), substituting December 31, 1993 for December 31, 1968) used in a farming-related business for the primary purpose of complying with Federal, State and local environmental laws dealing with the abatement or control of water, soil or atmospheric pollution or contamination by removing, altering, disposing, storing or preventing the creation or emission of pollutants, contaminants, wastes or heat. "Agricultural environmental property" would not include any expenditure that significantly increases the output, extends the useful life, or reduces the operating costs of the plant or property to which the facility relates or alters the nature of any manufacturing or production process or facility.

The credit could not be claimed on energy property (defined in Code sec. 48(a)(3)) or other property to the extent the basis of such property is attributable to qualified rehabilitation expenditures (defined in Code sec. 47(c)(2)). In addition, the amount that would be allowed as a deduction for soil and water conservation expenditures under Code section 175 would be reduced by the amount of the credit. Finally, no credit would be available for property to the extent an election is made under Code section 169 (amortization of pollution control facilities) with respect to the basis of such property.

Effective Date

The bill generally would be effective for property placed in service after December 31, 1993, subject to transition rules similar to the rules of section 48(m) (as in effect prior to enactment of the Revenue Reconciliation Act of 1990).

7. S. 1814 (Senators Daschle, Boren, Breaux, Conrad, Dole, Durenberger, Grassley, and Others)

Treatment of Certain Crop Insurance Proceeds and Disaster Assistance Payments

Present Law

A taxpayer engaged in a farming business generally may use the cash receipts and disbursements method of accounting ("cash method") to report taxable income. A cash method taxpayer generally recognizes income in the taxable year in which cash is received, regardless of when the economic events that give rise to such income occur. Under a special rule (Code sec. 451(d)), a cash method taxpayer may elect to defer the income recognition of insurance proceeds received as a result of destruction or damage to crops until the taxable year following the year of the destruction or damage, if the taxpayer establishes that, under the taxpayer's usual business practice, income from such crops would have been reported in a following taxable year. For this purpose, certain payments received under the Agricultural Act of 1949, as amended, or title II of the Disaster Assistance Act of 1988 are treated as insurance proceeds received as a result of destruction or damage to crops.

Explanation of the Bill

The bill would amend the special rule of section 451(d) to allow a cash method taxpayer to elect to treat certain disaster-related payments as received in the year of the disaster (even if the payments are received in the year following the disaster) so long as the taxpayer establishes that, under the taxpayer's usual business practice, income from the crops lost in the disaster would have been recognized in that year. The bill would retain the present-law election to defer the recognition of income in applicable situations.

The bill also would expand the payments for which these elections are available to include disaster assistance received as a result of destruction or damage to crops caused by drought, flood, or other natural disaster, or the inability to plant crops because of such a disaster, under any Federal law (rather than only payments received under the Agricultural Act of 1949, as amended, or title II of the Disaster Assistance Act of 1988).

Thus, for example, the bill would allow a calendar-year, cash-method taxpayer who has received disaster assistance payments in 1994 relating to the destruction of crops by a flood in 1993 to elect to treat such payments as received in

1993, so long as the taxpayer establishes that, under the taxpayer's usual business practice, income from such crops would have been reported in 1993.

Effective Date

The bill would be effective for payments received after December 31, 1992, as a result of destruction or damage occurring after such date.

Prior Action

S. 1814 was approved by the Senate Committee on Finance on March 24, 1994, with an amendment relating to the indexation of the threshold applicable to the excise tax on luxury automobiles (S.Rept. 103-244, April 5, 1994).

PREPARED STATEMENT OF J. GARY MCDAVID

INTRODUCTION

I appreciate the opportunity to testify before this subcommittee in support of S. 545, legislation to clarify the tax treatment of asset sales by farmer cooperatives. My name is J. Gary McDavid. I am the Chairman of the National Council of Farmer Cooperative's Tax Legislation Subcommittee and an attorney with the law firm of McDermott, Will & Emery in Washington, D.C.

The National Council of Farmer Cooperatives on whose behalf I appear today, is a nationwide association of cooperative businesses which are owned and controlled by farmers. Its membership includes over 100 agricultural marketing, supply and credit cooperatives, plus 32 state councils. National Council members handle practically every type of agricultural commodity produced in the U.S., market these commodities domestically and around the world, and furnish production supplies and credit to their farmer members and patrons. The National Council represents about 90 percent of the nearly 4,500 local farmer cooperatives in the nation, with a combined membership of nearly 2 million farmers.

The proposed legislation (S. 545) is identical to a provision passed by the 102nd Congress in H.R. 11. It adopts the same test the courts have consistently applied to determine whether income may be treated as patronage sourced. Under this test, a farmer cooperative which is able to demonstrate as a matter of fact that an asset (such as a cotton warehouse, grain elevator or other type of asset) was used to facilitate business done with or for its farmer members could treat the gain or loss from the asset's disposition as patronage sourced. Patronage sourced income may be taxed at either the cooperative or farmer level provided it is distributed in accordance with Subchapter T of the Internal Revenue Code.

Senator David Boren (D–OK) along with Senators Byron Dorgan (D–ND), Bob Dole (R–KS) and John Danforth (R–MO) introduced this legislation (S. 545) on March 11. Co-sponsors include Senators Thomas Daschle (D–SD), Max Baucus (D–MT), Harris Wofford (D–PA), Howell Heflin (D–AL), Bob Kerrey (D–NE), Richard Shelby (D–AL), Bennett Johnston (D–LA), Larry Pressler (R–SD), Charles Grassley (R–IA), Richard Lugar (R–IN), Jim Jeffords (R–VT), Dave Durenberger (MN–R), Slade Gorton (R–WA) and William Roth (R–DE).

OVERVIEW

In recent years, there have been an increasing number of disputes between farmer cooperatives and the Internal Revenue Service over the proper Federal income tax treatment of gain or loss resulting from the sale of assets used by cooperatives in their patronage operations. The issue in controversy is whether gains or losses from such dispositions should be considered to be derived from "patronage" or "nonpatronage" sources. This distinction is important because gain from patronage sources is eligible to be distributed to patrons as a patronage dividend which is deductible to a cooperative (and taxable to the patron). Nonpatronage sourced income is taxable to a nonexempt agricultural cooperative whether or not it is distributed to the farmer patrons.

Over the years, agricultural cooperatives have taken different approaches toward the classification of gain or loss from the sale of assets used in the patronage operation. Some cooperatives, relying on a general standard that has been adopted by both the IRS and the courts, have treated this gain or loss as patronage sourced on the ground that the assets sold were "directly related to" or "actually facilitated" the marketing, purchasing, or service activities of the cooperative. Other cooperatives have treated gain or loss from the sale of assets used in the patronage operation as nonpatronage sourced in reliance on an example in Treasury Regulation Section 1.1382-3(c)(2) and the IRS's administrative position that capital gain (or gain treated as capital gain under section 1231) is automatically nonpatronage sourced.

Recent court decisions have consistently applied a "directly related/actually facilitates" test in distinguishing between patronage and nonpatronage income, finding in one case that gain from the disposition of a capital asset used in the patronage operation was "directly related" to the patronage operation and thus patronage sourced. Notwithstanding these decisions, the IRS has continued to assert deficiencies in such cases based on its administrative position or an overly narrow interpretation of the "directly related/actually facilitates" standard.

The proposed legislation is intended to put an end to this controversy and avoid continuing audit disputes and court proceedings that are burdensome for farmer cooperatives and consume U.S. tax dollars in enforcement activity.

PROBLEMS WITH EXISTING LAW

Generally speaking, a cooperative is a corporation which is required, under its governing corporate documents or by contract, to return its net earnings from patronage sources to its members and other participating patrons on an annual basis. Farmer cooperatives market the production of agricultural producers or purchase supplies and equipment for producers to use in their businesses (*e.g.*, feed, fertilizer, petroleum products).

For federal income tax purposes, so-called "non-exempt cooperatives" are allowed to deduct patronage dividend distributions under subchapter T of the Internal Revenue Code and are thus treated as a "conduit" with respect to patronage operations and earnings. The result of such treatment is that patronage earnings paid out or allocated to members and other participating patrons as "patronage dividends" are not taxed at the cooperative level (but *are* taxable to the patrons).

Section 1388(a) of the Code provides that patronage dividends can be paid only out of cooperative net earnings "from business done with or for its patrons." If a non-exempt cooperative has patronage earnings which are not paid out, or which it is not obligated to pay out, as patronage dividends, it is taxable on such earnings at applicable corporate rates. It similarly is taxable with respect to income from nonpatronage sources.

The term "net earnings from business done with or for its patrons" (i.e., "patronage sourced income") is not defined in the Code. However, the converse term—"income from sources other than patronage" (i.e., "nonpatronage income")—is defined by Treasury regulation as follows:

> "[I]ncome from sources other than patronage" means incidental *income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association.* For example, income derived from the lease of premises, from investment in securities, or from the sale or exchange of capital assets, constitutes income derived from sources other than patronage. [Treas. Reg. Section 1.1382-3(c)(2) (emphasis added).]

This regulation applies specifically to "exempt" cooperatives, which are described in section 521 of the Code and are permitted to deduct distributions from patronage and nonpatronage sources. Nevertheless, the courts and the IRS considered this regulation in developing the basic test for a nonexempt cooperative.

Under the basic test, if the source of the income in question is directly related to or actually facilitates the marketing, purchasing, or service activities of the cooperative, the income is patronage sourced. In a 1969 revenue ruling involving a nonexempt cooperative, the IRS stated the basic test for distinguishing between patronage and nonpatronage income as follows:

> The classification of an item of income as from either patronage or nonpatronage sources is *dependent on the relationship of the activity generating the income of the marketing, purchasing, or service activities of the cooperative.* If the income is produced by a transaction *which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities,* the income is from patronage sources. However, if the trans-

action producing the income does not actually facilitate the accomplishment of these activities but *merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation*, the income is from nonpatronage sources. [Rev. Rul. 69–576, 1969–2 C.B. 166 (emphasis added).]

The courts have consistently applied this basic test, and in particular factual contexts, items of income in the nature of interest, dividends, rentals and capital gains—*i.e.*, the "examples" of nonpatronage income items listed in Reg. Section 1.1382–3(c)(2)—have all been held to constitute patronage sourced income. *See, e.g.*, *CF Industries, Inc.* v. *Commissioner*, 995 F.2d 101 (7th Cir. 1993) (interest); *Dundee Citrus Growers Association*, 62, T.C.M., 879 (1991) (interest); *Illinois Grain Corp.* v. *Comm'r*, 87 T.C. 435 (1986) (interest); *Cotter & Co.* v. *United States*, 765 F.2d 1102 (Fed. Cir. 1985) (interest; rent); *St. Louis Bank for Cooperatives* v. *United States*, 624 F.2d 1041 (Ct. Cl. 1980) (interest; section 1231 asset); Astoria Plywood Corp. v. United States, 79–1 USTC Para. 9197 (D. Ore. 1979) (capital gain); *Linnton Plywood Assoc.* v. *United States*, 410 F. Supp. 1100 (D. Ore. 1976) (dividend). Thus, the courts have not viewed any of the "examples" in Reg. Section 1.1382–3(c)(2) as automatically requiring nonpatronage treatment for the types of income items therein described.

Nonpatronage Treatment of Gain on Sale of Assets Used in Patronage Operation. The IRS has taken the position that, with the exception of depreciation recapture income, gain on the sale of a capital asset (or gain treated as gain from the sale of a capital asset under section 1231) is nonpatronage sourced based on Regulation Section 1.1382–3(c)(2). *See* Rev. Rul 74–160, 1974–1 C.B. 245; Rev. Rul. 74–84, 1974–1 C.B. 244. This position reflects a literal reading of the regulation and has been followed by a number of cooperatives in reporting sales of non-inventory assets. There are practical non-tax reasons why these cooperatives have adopted and need to continue this practice. The proceeds from sales of non-inventory assets are often reinvested in replacement assets with expectation of indefinite retention in the business. In other cases, such proceeds are retained in the business as an important source of equity capital which is used to reduce indebtedness. Allocating gains to patrons in such a case may create an expectation of redemption inconsistent with the need to retain the proceeds in the business. To these cooperatives, the treatment of the gains as nonpatronage income and payment of tax by the cooperative is consistent with the intent to retain the after-tax proceeds in order to continue the operation of the business.

Patronage Treatment of Gain on Sale of Assets Used in Patronage Operation. Other cooperatives have viewed gain on the sale of assets used in the patronage operation as distributable or allocable to members and other participating patrons based on the court decisions applying the basic test (in particular, *Astoria Plywood* and *St. Louis Bank*) and Rev. Rul. 69–576.

Many of these cooperatives customarily pay out only a portion of their patronage refunds in cash, issuing "notices of allocation" to patrons for up to 80 percent of the total patronage refund distribution. The non-cash portion is retained by the cooperative to finance capital expansion or for working capital. However, these allocations cannot be viewed as permanent capital since they are subject to a reasonable expectation of redemption on the part of the patrons. Sales of non-inventory assets provide additional internal funds for these cooperatives, but they generally are required by their governing instrument as well as long-standing custom and practice to treat such sales as patronage sourced.

Apart from its inflexible reliance on the nonpatronage examples in the Treasury regulation, the IRS otherwise tends to take an overly restrictive view of the factors to be considered in determining whether a particular item of income meets the "directly related/actually facilitates" test. In this regard, it often focuses on the particular "transaction" or type of "transaction" that gave rise to the income in question rather than on all facts and circumstances that demonstrate the historical relationship between the source of the income or loss to the overall conduct of the cooperative's patronage business.

The controversies that continue to surface in this area are especially troublesome because of the fact that cooperatives are required by subchapter T of the Code to make patronage dividend distributions within 8-1/2 months of the close of the taxable year. Even though the cooperative may pay a patronage dividend based on a good faith determination of its patronage sourced income under the "actually facilitates" test, an examining IRS agent may attempt to recharacterize part of the income as non-patronage sourced and to tax the cooperative accordingly. If the agent ultimately prevails, the nonpatronage income thus created cannot be offset by the "excess" patronage dividend paid; and no part of that dividend can be recouped by the cooperative in order to fund payment of the increased tax liability. Even where the cooperative ultimately does prevail, the financial and other costs of contesting and perhaps having to litigate the issue can become extremely burdensome.

EXPLANATION OF PROPOSED LEGISLATION

The proposed legislation would provide cooperatives with a mechanism for avoiding the serious administrative uncertainties that continue to exist in connection with the determination of whether gain or loss from the disposition of cooperative assets should be classified as patronage or nonpatronage sourced. Specifically, cooperatives would be able to elect patronage sourced treatment for gain or loss from the sale or other disposition of any asset, provided that the asset in question "was used by the organization to facilitate the conduct of business done with or for patrons." This approach comes directly from the test used by the IRS and the courts for distinguishing between patronage and nonpatronage sourced income generally. As the IRS stated in Rev. Rul 69-576:

> [t]he classification of an item of income as from either patronage or nonpatronage sources is *dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative.* If the income is produced by a transaction *which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities,* the income is from patronage sources. [Emphasis added].

Thus, in the case of an electing cooperative, the IRS could not deny patronage sourced treatment solely on the basis that the asset in question was held, or treated, as a capital asset for federal income tax purposes. The question of whether an asset is a "capital asset" would not be an issue.

For example, under the election the entire gain on the sale of a depreciable "section 1231 asset" that had been used to facilitate the conduct of patronage activities—including any gain over and above depreciation recapture—would qualify as patronage income. Furthermore, the proposed statutory language makes clear that gain from a sale of stock or securities held by an electing cooperative might also qualify as patronage income. That result could follow, for example, where a cooperative sells the stock of a controlled subsidiary corporation the operations and activities of which related and contributed to the cooperative's overall conduct of business with or for the benefit of its member-patrons. In such a case, it is contemplated that the factual determination of whether the subsidiary's stock "was used . . . to facilitate the conduct of business done with or for patrons" would be made with reference to the totality of all facts and circumstances relevant to the historical relationship between the cooperative and the subsidiary—and not solely with reference to the stock sale transaction itself, viewed in isolation.

The proposed legislation would not affect the treatment of nonpatronage sourced capital gains and losses (e.g., from sales of portfolio securities), which are not subject to the special rules governing patronage sourced income. These items would continue to be taxable at the cooperative level as under existing law.

Where an asset has been used for both patronage and nonpatronage purposes, the election to treat gain or loss from the sale of that asset as patronage sourced applies only to the amount of the gain or loss allocable to the patronage use. A cooperative may use any reasonable method for making allocations of income or expenses between patronage and nonpatronage operations.

The statutory election would be available generally with respect to taxable years beginning after the year of enactment and, unless revoked by the cooperative, for all taxable years subsequent to the first taxable year for which the election is made.

An electing cooperative could at any time revoke its election effective for taxable years beginning after the date on which the revocation notice was duly filed with the IRS. Upon revoking an election, however, the cooperative would have to wait at least three (3) taxable years before making another election. It is contemplated that procedural rules relating to the content and filing of revocation notices would be provided by Treasury regulation.

Non-electing cooperatives (including cooperatives which have revoked a prior election) would continue to determine the patronage v. nonpatronage classification of income or loss from asset dispositions as they have under existing law. The proposed legislation expressly provides that no inference could be drawn therefrom regarding the proper application of existing law to non-electing cooperatives in particular factual contexts. Existing law similarly would apply with respect to prior years of cooperatives in particular factual contexts.

COMPELLING REASONS FOR PROPOSED LEGISLATIVE RELIEF

The proposed legislation represents a reasonable approach toward resolving a very significant problem for the cooperative industry. Given the fundamental role of the patronage v. nonpatronage determination in the scheme of cooperative taxation, it is essential that cooperatives be able to know with reasonable certainty the tax consequences of the disposition of assets used in the patronage operation. This simply has not been the case under the conflicting interpretations that now exist.

The electivity feature of the proposed legislation will permit cooperatives to gain assurance that the "actually facilitates" test will govern their determination of patronage sourced gain or loss from the disposition of any asset. In order not to disturb legitimate industry practices, cooperatives that wish to continue relying on the capital gain example in the Treasury regulation will be able to do so by not making an election, as will electing cooperatives whose mode of operations or other business circumstances might change. The proposed 3-year waiting period for re-elections should provide an adequate safeguard against potentially abusive situations.

The ultimate losers in these disputes, of course, are the millions of American farmers who belong to cooperatives. Their livelihoods and ability to operate effectively are inextricably linked to the unique role that cooperatives play in helping to serve the enormous agricultural demands of the country. The proposed legislation will remove a major impediment that cooperatives now face in carrying out this important role. It will do so, moreover, without in any way frustrating the Government's legitimate interest in assuring that the statutory tax benefits enjoyed by cooperatives are not abused. In that regard, it is important to keep in mind that cooperatives will not be relieved from having to establish, on a factual level, a clear "facilitative" relationship between the historical use of the assets sold and the conduct of the cooperative's activities with or for the benefit of its member-patrons. Thus, in appropriate cases the IRS could, and no doubt would, continue to challenge patronage sourced income determinations believed to be erroneous.

CONCLUSION

Legislation is needed to clarify the tax treatment of gains and losses on the sale of assets by farmer cooperatives, eliminate existing uncertainty, and better target the limited resources of the IRS. The proposed legislation will provide such relief in a fair and reasonable manner, and will enable the farmer cooperatives of this nation to continue their critical work more effectively. For these reasons, we strongly support the proposed legislation and urge its enactment.

STATEMENT OF McDERMOTT, WILL & EMERY

Chairman Daschle and Members of the Subcommittee: We greatly appreciate your willingness to consider the proposal to amend Internal Revenue Code section 2032A to clarify that cash rentals of the property by one qualified heir to a member of that person's family will not cause the loss of special use valuation treatment. In addition, we would like to commend the Chairman for his steadfast commitment to enactment of this provision.

SECTION 2032A

Section 2032A was enacted in 1976 to provide relief to estates containing farmland where the heirs continue to farm the land. The intention of the provision was to allow family farms and closely-held businesses to be retained by the family rather than be sold to pay estate taxes.

Section 2032A allows the estate to value the farmland for estate tax purposes at its value for farming purposes rather than at its theoretical highest and best use. To ensure that the farmland continues to be used for farming purposes, section 2032A also provides a recapture tax that is imposed if "qualified use" of the farmland ceases within ten years of the decedent's death. Disagreement over what constitutes cessation of qualified use is the issue with which this Subcommittee is concerned today.

It is acknowledged by all concerned that section 2032A is an exceeding complex statute. That complexity, together with generally restrictive interpretations of the scope of the statute by the Internal Revenue Service throughout the years, has led to numerous disputes over various provisions of the section. Indeed, the Congress has, on several occasions, intervened legislatively in these disputes in order to resolve them. In fact, the issue to which this proposal relates was itself the subject of previous Congressional intervention.

Cessation of qualified use of farmland is defined in section 2032A(c)(6) to be:

(1) cessation of use as a farm for farming purposes; or

(2) cessation of material participation by a qualified heir or any member of the heir's family (defined as an ancestor, spouse, lineal descendant or spouse of a lineal descendant of the qualified heir).

The IRS contends that a qualified heir that rents the farm to other family members on a net cash basis (rather than by means of a crop share lease) is not using the farm in a qualified use even though the other family members continue to farm it. Rather, according to the IRS, the farm is being used in a passive rental activity. This cash rental would, under the IRS view, cause the recapture tax to be imposed even though only family members are operating the farm.

The IRS position is not supported by the language of section 2032A. Indeed, the statute itself states that use of the farm for farming purposes constitutes qualified use. On the other hand, the other requirement—material participation—has always been acknowledged to require direct involvement by the qualified heirs or members of their family. All agree that this requirement would not be met where the farm was cash rented to a non-family members. On the other hand, where the farmland is rented by one qualified heir to another qualified heir or to a family member, the material participation test has been met.

The better interpretation of the statutory scheme is that section 2032A(c)(6) sets out two, non-overlapping requirements to avoid imposition of the recapture tax: (1) the farm must be used as a farm; and (2) the qualified heirs or their families must be directly involved in its operation. Stated another way, if the qualified heirs or their families cease to operate the farm or if they operate the farm as something other than a farm, the recapture tax will be imposed.

The IRS interpretation, in effect, imposes the material participation requirement twice even though the language of the statute only imposes the test once. The IRS position was not asserted until 1981. Until that time, no distinction was made between crop share leases and cash leases of the family farm.

The 1981 IRS position caught many families by surprise since it was not apparent from the language of the statute. Had they known, they could easily have met the requirements by using crop share leases. This is borne out by the fact that since the IRS position became public in 1981, virtually no one has been tripped up by the use of cash leases between qualified heirs and members of their families. It is only those who cash leased before the IRS position became known that were caught unaware and seriously harmed by the IRS position.

The IRS interpretation has been upheld by the courts, primarily on the basis of legislative history written in 1988, twelve years after special use valuation was enacted. However, whether or not the courts should or should not rely on legislative history written twelve years after the fact is not the central issue. The issue really is whether or not farm families who were caught wholly unaware by the IRS position should be made to suffer the penalty of the recapture tax when they have continued to use the farm for farming purposes through means of a cash rental. These are not people who have violated the spirit of the statute. The IRS seeks to impose the recapture tax on the basis of a foot fault.

PROPOSED AMENDMENT

The proposed amendment would clarify that qualified use does not cease merely because a qualified heir cash leases the family farm to another member of that person's family. The amendment is retroactive to 1976 when section 2032A was enacted. This retroactive change is necessary in order that qualified heirs who cash leased before the IRS issued its interpretation in 1981 are not disadvantaged unfairly.

Changing the law to allow qualified heirs to cash lease the family farm to other family members will help preserve family farms. It will allow those families to structure their financial affairs as they see fit without doing any violence to the purposes of special use valuation. Section 2032A was intended to preserve the family farm by valuing it as a farm rather than at its highest and best use. The proposed amendment would only benefit those families who have continued to use the land for farming purposes.

The distinction between a cash lease and a crop share lease is relatively minor and certainly not of a magnitude that should cause the loss of the protection of section 2032A. A cash lease is just what the name implies: the payment of cash by the lessor to the lessee for use of the property. A crop share lease, on the other hand, requires the lessee to share in the costs of producing the crops, as well as the profits therefrom, on a percentage basis. In substance, the distinction is one of protection from loss if the farm is not profitable: cash lease payments would be paid notwithstanding that the farm loses money.

However, this distinction is essentially beside the point in this debate. The real issue is whether the IRS position had any basis when it was announced in 1981 and whether, given that the announcement was not and likely could not have been anticipated by those using section 2032A, it is fair for the IRS position to apply to them.

This proposal is somewhat in the nature of a technical correction. Somehow the statute was interpreted incorrectly; this proposal would fix the statute. In fact, if the Congress were so inclined, it could even prohibit cash leases to family members prospectively so long as the problem for those families who acted before 1981 was fixed retroactively.

Special use valuation was intended to allow families to retain the family farm after the head of the family dies rather than selling the farm to pay estate taxes. It was not intended to be limited by technical distinctions between crop share and cash leases that have virtually no economic effect.

The proposed change was included in the Conference Report on H.R. 11 as section 4707. The estimated revenue loss at that time was $15 million over five years. Thus, Congress is on record as agreeing to overturn the IRS position as overly restrictive.

CONCLUSION

Use of cash leases rather than crop share leases should not result in cessation of qualified use under section 2032A. We urge the Finance Committee to adopt the proposal.

Thank you, Mr. Chairman, and members of the Subcommittee.

SUPPLEMENTAL STATEMENT SHEET

Designated Representatives:
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Statement Summary:

The statement supports the proposal to amend section 2032A to provide that the use of cash leases to family members does not cause the cessation of qualified use under that section.

PREPARED STATEMENT OF HON. DAVID MINGE

Mr. Chairman and distinguished members of the Committee, I would like to thank you for the opportunity to testify today. am here in support of legislation that I introduced in the House which would allow farmers who received disaster aid in 1994 for the floods of 1993 to carry that income back to 1993. Before I proceed, I would like to extend my special thanks to the honorable chairman, who has worked tirelessly to try to pass this legislation.

The need for this legislation arose as a result of the flood of 1993, which devastated tens of thousands of farmers throughout the Midwest. Farmers whose crops were damaged or destroyed applied to receive crop insurance or federal disaster payments. While some farmers received payments in 1993, the majority received them in 1994. At the end of 1993, the Department of Agriculture had only paid approximately one-third of the projected claims. This delay occurred because of the huge volume of farmers who suffered damage from the flooding last year.

During the flooding, the Administration told farmers they would receive the aid within two weeks. Unfortunately, this did not happen. As a result, many farmers who received payments in 1994 will suffer severe and unintended tax consequences. They will have excessively high income in 1994. This income "bunching" will cause farmers to lose standard exemptions for 1993 and move them into higher tax brackets for 1994. One accounting firm in Minnesota estimated that affected farmers would pay as much as $6,000 more in taxes next year.

This situation is completely unfair and unacceptable. Farmers wanted and expected to obtain payments in 1993, but through no fault of their own, they did not receive them until 1994. Farmers should not be punished by.having to pay higher taxes because of the unforeseen yet understandable difficulty in processing so many claims on a timely basis.

To remedy this problem, Senator Daschle and I introduced legislation to allow farmers to carry disaster and crop insurance payments received in 1994 back to

1993. Both the Departments of Treasury and Agriculture have supported these bills as have members of both parties. The House version, H.R. 3757 has 43 cosponsors. The bill is non-controversial. However, according to budget rules, we must find a revenue offset to pay for this bill, which is estimated to cost $10 million over the next five years.

Two problems associated with passing tax legislation have handicapped this effort. First, we needed to find a suitable offset. I am pleased to report that the Committee on Joint Taxation was able to find a revenue offset. Second, we needed to find a moving revenue vehicle to which we could attach the bill. It appears that the only viable vehicle left this session is the Nanny Tax. If this measure is enacted into law this year, farmers will be able to either file amended returns or file their 1993 tax returns under an extension which expires October 15. To me, this issue has illustrated one of the main reasons the public holds Congress in relatively low regard these days—they question our ability to make government work. The Administration told farmers that they would get their payments in ten days. We all know this did not happen, and now the federal government will be making money (tax revenues) because of these delayed payments, unless we pass legislation.

The problem is easy to fix. No one I have spoken with thinks the legislation is bad in concept. Everyone agrees that this is an unfair tax burden for disaster victims. The bottom line, then, is whether Congress is able to act swiftly to solve a simple problem, whether we can make the federal government work. Thank you, Mr. Chairman.

PREPARED STATEMENT OF NORMAN B. RICHTER

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the views of the Administration on the miscellaneous farm-related and other proposals that are the subject of this hearing. One of these proposals, regarding repatriation of earnings of export trade corporations, has not been formally introduced as a bill. Our understanding of the details of this proposal is derived from the testimony to be given later today by representatives of the Hercules Corporation. The remainder of the proposals are described in a summary prepared by the staff of the Joint Committee on Taxation, *Description of Miscellaneous Farm-Related Tax Proposals* (JCX-23-94), October 3, 1994.

A discussion of the proposals is presented below, along with the Administration's positions on the proposals. I will begin with the proposal on export trade corporations, and will address the remaining proposals in the same order as they are presented in the Joint Committee summary. I will be happy to respond to any questions following my statement.

I. PROPOSAL TO ALLOW EXPORT TRADE CORPORATIONS TO REPATRIATE ACCUMULATED EXPORT TRADE EARNINGS TAX-FREE

Current law. U.S. shareholders who own 10 percent or more of the stock of a controlled foreign corporation ("CFC") are subject to tax currently on the CFC's foreign base company income, which includes foreign personal holding company income, including "income equivalent to interest." However, the CFC rules provide that such a U.S. shareholder will not be taxed currently on "export trade income" earned by an export trade corporation ("ETC"). Thus, the principal tax advantage to being an ETC was the deferral of U.S. tax on the export-related earnings until those earnings were repatriated. No new ETCs were permitted to be created after 1971.

ETCs were given the opportunity to become Foreign Sales Corporations ("FSCs") in 1984. Exporters that utilized FSCs generally could obtain a tax exemption for up to 15 percent of their export profits. The incentive offered to ETCs to convert to FSCs (or to dissolve as ETCs) was the opportunity to repatriate tax-free the ETC's accumulated earnings attributable to export trade income. An ETC had to elect to take advantage of this opportunity to repatriate earnings tax-free during a limited period in 1984. However, income earned by a FSC from financing activities generally constitutes "investment income" or "carrying charges" that are treated as "effectively connected income" subject to U.S. tax as earned. Thus, an ETC whose principal activity was financing exports of unrelated sellers may not have found it advantageous to convert to a FSC.

The passive foreign investment company ("PFIC") rules enacted in 1986 provided a new, supplemental anti-deferral regime that applied to any U.S. shareholder of a foreign corporation if 75 percent or more of the foreign corporation's gross income for the tax year was passive, or if 50 percent or more of the average value of its assets for the taxable year produced passive income or was held for the production of passive income. In general, income is passive for purposes of the PFIC rules if the income is foreign personal holding company income for purposes of the CFC rules. As a result, an ETC that is engaged primarily in financing (rather than distribution) activities may be classified as a PFIC because it generates primarily income equivalent to interest even though the U.S. tax on that income is deferred under the CFC rules. If the ETC is a PFIC, any U.S. shareholder of the ETC that does not make an election to be subject to tax currently on all of the ETC's income will be subject to an interest charge when the ETC makes certain "excess distributions" or the shareholder disposes of its interest in the ETC.

Explanation of proposal. We understand the proposal to consist of two parts: (1) The proposal would eliminate the exception from the CFC rules that allows the deferral of tax on "export trade income" of ETCs (presumably prospectively). (2) The proposal would also deem distributions made in taxable years beginning after 1986 of the accumulated and tax-deferred income of ETCs to be previously taxed income and, therefore, exempt from taxation.

Administration position. (1) **Support.** We support the elimination of the exception from the CFC rules for ETCs because the deferral of profits from financing activities provides ETCs with a competitive advantage over other credit subsidiaries that finance U.S. exports. Other finance subsidiaries generally would be subject to tax currently under the CFC, FSC, or PFIC rules on financing income.

(2) **Oppose.** The proposal would provide a retroactive tax exemption for ETC profits distributed since 1986. The result of this proposal would be that income from financing activities accumulated over the past decade would not be taxed by the United States even though all or part of that income would have been subject to U.S. tax currently if the ETC had chosen in 1984 to become a FSC. Moreover, ETCs that elected not to take advantage of the limited incentive to dissolve ETCs provided by the Congress in 1984 effectively assumed the risk that the law might change, and should not now be given retroactive tax relief from the PFIC rules.

II. ESTATE TAX RECAPTURE FROM CASH LEASES OF SPECIALLY VALUED PROPERTY (S. 226)

Current law. Federal estate tax is imposed on the value of property passing at death. Generally, property is valued at fair market value. For this purpose, the Internal Revenue Code provides a special valuation of qualified real property used in the trade or business of farming or used in a trade or business other than farming. In valuing such property for the computation of the estate tax, value can be computed on the basis of the qualified use of the property, rather than its highest and best use. The aggregate reduction in the value of the real property to the estate may not exceed $750,000 for any decedent.

A recapture provision imposes an additional estate tax if within 10 years after the death of the decedent (and before the death of the heir) the property is disposed of in whole or in part (other than to a member of the decedent's family) or is converted to a non-qualified use. Several courts have concluded that the cash rental of specially valued property (that is, where rent is not dependent on the production, or income, from the property) is not a qualified use of the property, thereby subjecting the heir to additional estate tax. See, e.g., *Williamson* v. *Commissioner,* 974 F.2d 1525 (9th Cir. 1992). In 1988, Congress amended the Internal Revenue Code to provide that a surviving spouse will not be considered as using property in a nonqualified use solely because such spouse rents the property to a family member on a net cash basis.

Explanation of proposal. Under the proposal, property would not be considered converted to a nonqualified use solely because the qualified heir rents the property to a member of the decedent's family on a cash basis, but only if the lessee uses the property in a qualified use during the period of the lease. Accordingly, a qualified heir could hold the property for rent, provided the lessee is a member of the decedent's family and uses the property in the business of farming or other trade or business.

The provision would be effective for cash rentals after December 31, 1976. Administration position. Do not oppose, provided the proposal is prospective and an appropriate revenue offset is provided. This proposal promotes the intended purpose of the existing relief provision, that is, to keep family property in the family, dedicated to use in a trade of business of the family or its members.

III. INCREASE IN THE UNIFIED ESTATE AND GIFT TAX CREDIT (S. 531)

Current law. Tax is imposed on the transfer of taxable gifts and the estate of a decedent. The tax is imposed at a graduated rate, ranging from 18 to 55 percent. A nonrefundable credit of $192,800 (unified credit) against the tax is provided. The credit effectively exempts $600,000 of taxable gifts or estate transfers from tax. The benefits of the graduated rates and the unified credit are phased out for cumulative transfers in excess of $10,000,000 (five percent surtax on excess over $10 million, with complete phase-out once the cumulative transfers total $21,040,000).

Explanation of proposal. The proposal would increase the unified credit to $345,800, effectively exempting $1,000,000 in gift and estate transfers from tax. The proposal would apply to estates of decedents dying, and gifts made, after date of enactment.

Administration position. Oppose. An arbitrary increase in the unified credit represents a reduction in the tax base that is not supported by evidence that the existing threshold is inappropriate. We also note that any increase in the credit would require a conforming amendment to the phase-out provisions, which has not been included in this proposal.

IV. TREATMENT OF GAINS AND LOSSES FROM CERTAIN DISPOSITIONS BY FARMERS' COOPERATIVES (S. 545)

Current law. Non-exempt cooperative organizations are subject to income tax on taxable income, but may exclude, in computing taxable income, amounts distributed or allocated to patrons as "patronage dividends." Patronage dividends are allocations or distributions of patronage-sourced earnings. No exclusion is permitted for allocations or distributions of nonpatronage-sourced dividends. Accordingly, an entity-level tax is imposed on nonpatronage-sourced earnings (or on undistributed patronage-sourced earnings). Amounts distributed to a patron (whether patronage- or nonpatronage-sourced) are generally includable in the income of the patron (or may serve to reduce the basis of assets owned by the patron that have been acquired through the cooperative).

The Internal Revenue Code defines a patronage dividend (in relevant part) as an amount paid to a patron that is determined by reference to the net earnings of the cooperative from business done with or for its patrons. Taxpayers, courts, and the Internal Revenue Service have interpreted the meaning of the phrase "from business done with or for patrons" differently, and significant controversies have arisen in cases of characterizing the source of income such as interest, gains, and rental income. Treasury regulations provide that capital gains are always nonpatronage-sourced. The Internal Revenue Service also takes the position that other income (for example, gains and losses on sales of noncapital assets or interest earned on excess funds) must be directly related to or must facilitate the conduct of the business done with or for patrons to be patronage-sourced. The determination of whether income is directly related to or facilitates the conduct of the cooperative business is dependent upon the facts and circumstances of each case. The Internal Revenue Service has issued guidance concluding that particular types of income (e.g., recapture income under section 1245) are per se patronage-sourced. In addition, taxpayers may rely on a number of court decisions to characterize certain types of income as patronage-sourced in particular factual situations.

Explanation of proposal. The proposal would allow a non-exempt "farmer's cooperative" to elect to treat as patronage-sourced income any gain or loss from the sale or disposition of any asset used to facilitate the conduct of business done with or for patrons. If an asset is used for both patronage and nonpatronage business, the amount of gain allocable to patronage sources is determined by the cooperative under some reasonable method.

The election would apply to all sales or other dispositions occurring in the year of the election and all subsequent years, unless it is revoked. After revocation, a new election could not be made before the beginning of the third taxable year after the year in which the revocation is first effective.

A farmer's cooperative is defined to include a farmers', fruit growers' or other like association subject to tax as a non-exempt cooperative. The provision is proposed to be effective for sales or other dispositions in taxable years beginning after the date of enactment.

Administration position. Do not support. The characterization of earnings as patronage or nonpatronage effectively determines whether the earnings are subject to tax only at the patron level or at both the cooperative and the patron levels. Providing cooperatives an election to characterize gains and losses on asset sales as patronage-sourced is especially troublesome because it exposes the government to whipsaw, particularly when the election can be made at any time during the taxable year (e.g., after the realization of gains or losses) and is revocable at the option of the cooperative. The three year prohibition on subsequent elections might be expected to function as an effective backstop to this whipsaw potential, but because the cooperative ultimately controls the timing of realization of the gains and losses, it is in a position to wait out this period.

The determination of the source of earnings is an inherently factual one, dependent upon the operations of the cooperative, the use of the asset by the cooperative, and its relationship to the conduct of the cooperative business. Allowing cooperatives to elect the result, rather than having the result follow from the facts and circumstances of the particular situation, is not consistent with the special status of a nonexempt cooperative, i.e., as an entity taxable on nonpatronage sourced earnings. Furthermore, this elective treatment is not consistent with the treatment of other earnings of nonexempt cooperatives, for example, interest, that are factually patronage or nonpatronage, and for which the cooperative may not electively change the characterization.

Even if such an election were to be considered appropriate, there is little policy justification to extend this special treatment only to farmers' cooperatives. It is difficult to distinguish for policy reasons other nonexempt cooperatives that operate under the same tax provisions as farmers' cooperatives. Presumably, these similarly situated cooperatives would seek the same treatment.

V. ROLLOVER OF GAIN FROM THE SALE OF FARM ASSETS INTO AN ASSET ROLLOVER ACCOUNT (S. 882)

Current law. There are two ways in which individuals can contribute amounts to Individual Retirement Accounts or Individual Retirement Annuities ("IRAs"). First, an individual can contribute a limited amount on an annual basis (up to $2,000, or $2,250 for a regular and spousal IRA combined). That annual contribution may be deductible, depending on the individual's income and whether the individual participates in a qualified retirement plan (such as a 401(k) plan). Second, an individual can "rollover" amounts distributed from a qualified retirement plan into the IRA. The amount of the rollover is not taxed until withdrawn from the IRA. Further, regardless of how amounts are contributed to an IRA, the investment earnings are not taxed until withdrawn.

Explanation of proposal. The proposal would create a special type of IRA known as an Asset Rollover Account ("ARA"). A farmer could defer recognition of up to $500,000 in capital gain on the sale of qualified farm assets (such as land, farm equipment, etc.), to the extent the farmer contributes an amount equal to such gain into ARAs for the year in which the sale occurs. In effect, the bill would treat these contributions in a manner similar to rollovers from qualified plans into traditional IRAs. The farmer would not be taxed on the gain realized from the disposition of the farm assets to the extent the amounts are contributed to an ARA, nor would the farmer be taxed on the investment earnings, until these amounts were actually withdrawn from the ARA. The bill imposes certain limits on the amount that can be rolled over, and who is eligible to make a rollover. For example, the $500,000 ceiling is reduced if a farmer or spouse has accumulated more than $100,000 in an IRA. The proposal would apply to sales and exchanges after the date of enactment.

Administration position. Oppose. The proposal would provide tax-favored treatment to farmers over other taxpayers (e.g., other small business owners or homeowners) who are unable to rollover the gain from the sale of their businesses or homes into IRAs. It would be unfair to favor farmers over these other taxpayers.

In addition, the proposal would provide a disincentive to farmers to set up traditional qualified retirement plans covering other workers in addition to themselves. It would allow a farmer to accumulate significant tax-favored retirement benefits without also accumulating retirement benefits for other people working on the farm. This is contrary to long-accepted federal retirement policy, which has been to encourage business owners to establish tax-favored retirement arrangements covering rank and file employees.

VI. TREATMENT OF LIVESTOCK SOLD ON ACCOUNT OF WEATHER-RELATED CONDITIONS (S. 1615)

Current law. A cash method taxpayer generally takes income into account in the year it is received. The Internal Revenue Code allows a cash method taxpayer to elect to include gain from the sale of livestock in taxable income for the year following the year of sale, if the taxpayer can establish that the sale would not have been made but for drought conditions which resulted in the area in which the taxpayer operates being designated as eligible for Federal assistance. The election is available only to a taxpayer whose principal trade or business is farming.

The Internal Revenue Code also allows a taxpayer to treat the sale or exchange of livestock held for draft, breeding or dairy purposes as an involuntary conversion (on which gain is not recognized if the taxpayer purchases similar livestock within two years of the date of sale) if the sale or exchange is made solely on account of drought.

Explanation of proposal. Both the election to defer income and the election to treat a disposition of livestock as an involuntary conversion would be expanded to allow deferral elections by the taxpayer for sales or exchanges made on account of any weather-related condition. Thus, floods, tornadoes, or hurricanes would also permit the elections described. The bill would apply to sales and exchanges after December 31, 1992.

Administration position. Do not oppose, provided an appropriate revenue offset is provided. This provision allows a cash method taxpayer engaged in farming to avoid bunching of income due to disasters beyond the taxpayer's control, and allows the taxpayer to take income into account when it would have been taken into account under the taxpayer's normal business cycle.

VII. TAX CREDIT FOR ENVIRONMENTAL POLLUTION CONTROL PROPERTY AND FOR SOIL AND WATER CONSERVATION EXPENDITURES (S. 1691)

Current law. The Internal Revenue Code allows a current deduction to taxpayers engaged in the business of farming for water and soil conservation expenditures other than expenditures for depreciable property. Without this special provision, these types of expenditures would generally be capitalizable. Aggregate expenses deducted for any year pursuant to this provision may not exceed 25 percent of gross income derived from farming during that taxable year. Any expenses remaining for deduction after the imposition of this limit may be carried forward indefinitely, subject to the 25 percent limit in succeeding years.

The Code also provides taxpayers an election to amortize pollution control facilities over a five-year period. Eligible pollution control facilities include only depreciable tangible property (including a building and its structural components if it is used exclusively as a treatment facility) that is constructed, reconstructed, or erected by a taxpayer after December 31, 1968, or acquired after December 31, 1968 if the original use began with the taxpayer.

Explanation of proposal. The proposal would provide eligible taxpayers a credit equal to the lesser of: (1) the sum of 15 percent of the cost of qualified agricultural environmental property plus 15 percent of water and soil conservation expenditures otherwise deductible; or (2) the lesser of $15,000 or $150,000 minus prior years' credits. Qualified agricultural environmental property is any new treatment facility constructed, reconstructed, or erected after December 31, 1993, or any facility acquired after that date if the original use commenced with the taxpayer, which is used for the primary purpose of complying with Federal, state, or local environmental laws dealing with abatement or control of water, soil, or air pollution or contamination. Qualified agricultural environmental property would not include any expenditure that significantly increases output, extends the useful life, or reduces the operating costs of plant or property to which the facility relates. The deduction otherwise allowable for soil and water conservation expenditures would be reduced by the amount of the credit allowed, and no credit would be provided to the extent that an election to amortize the basis of the property is in effect.

Eligible taxpayers are taxpayers engaged in the business of farming; taxpayers engaged in the business of mixing fertilizers from purchased materials; and taxpayers engaged in the business of wholesale distribution of feed, fertilizer, agricultural chemicals, pesticides, seeds, or other farm supplies (except grains).

The provision would apply to property placed in service after December 31, 1993, with certain transition rules similar to those applicable to certain property eligible for the investment tax credit.

Administration position. **Oppose.** We do not believe it is necessary to provide an additional tax incentive to encourage compliance with environmental laws. Furthermore, to provide a benefit to one arbitrarily-selected class of taxpayers is inappropriate.

VIII. TREATMENT OF CERTAIN CROP INSURANCE PROCEEDS AND DISASTER ASSISTANCE PAYMENTS (S. 1814)

Current law. A cash method taxpayer generally takes income into account in the year received. In the case of insurance proceeds received as a result of destruction of or damage to crops, the Internal Revenue Code allows a cash method taxpayer to elect to include the proceeds in income in the year following the destruction or damage, if the taxpayer can establish that income from the damaged crops would have been reported in that following year under his normal business practice. For purposes of this section, payments received under the Agricultural Act of 1949 and under the Disaster Assistance Act of 1988 as a result of destruction or damage to crops or the inability to plant crops because of a natural disaster are treated as insurance proceeds eligible for the election.

Explanation of proposal. The proposal consists of two parts. First, the election would be expanded to allow a cash method taxpayer to elect to include insurance proceeds in income in the year of the destruction of or damage to crops (though the proceeds are received in the year following the year of destruction or damage) if the taxpayer can establish that, under the taxpayer's normal business practice, income from the damaged crops would have been reported in the year of the destruction or damage. Second, the proposal would provide that any payment of disaster assistance under any Federal law as a result of destruction or damage to crops or an inability to plant crops because of a natural disaster is treated as insurance proceeds subject to either of the elections under this section. The proposal would apply to payments made after December 31, 1992 as a result of destruction or damage occurring after that date.

Administration position. **Do not oppose,** provided an appropriate revenue offset is provided. We believe this provision promotes the policy of allowing taxpayers engaged in crop farming to avoid unpredictable tax results due to events not within their control, and allows these taxpayers to take income into account when it would be taken into account under their normal business cycles.

PREPARED STATEMENT OF ALAN C. SOBBA

Mr. Chairman, thank you for your leadership on agricultural tax issues and for holding this hearing on miscellaneous farm related tax proposals. The National Cattlemen's Association appreciates the opportunity to discuss these issues.

Estate taxes have been a priority issue for the National Cattlemen's Association for many years. Currently, eighty percent of beef cattle operations have remained in one family for 25 years or more, with 42% over fifty years and 12% more than one hundred years. Our members recognize the importance of preserving farms and ranches as financially viable units as the business passes from one generation to the next.

Cattlemen were actively involved in the initial discussions of Section 2032A, special use valuation, which allows farmers and ranchers to value their property based on productive value rather than market value for estate tax purposes. We strongly support this very useful estate tax tool and support S. 226, which amends Section 2032A to allow cash leasing between heirs.

A thorough examination of Section 2032A should be considered in the 104th Congress. There are several changes in the "special use valuation" which would help make the law more user friendly. For example, the $750,000 revaluation limitation is insufficient in many areas. We would like to submit a letter for the record outlining several of these concerns.

We also support S. 531, which increases the estate tax exemption from $600,000 to $1,000,000. This change in the corresponding unified credit is necessary to offset inflation of property values. A permanent solution would be to index the unified credit on an annual basis.

The National Cattlemen's Association encourages further examination of estate-tax laws early next year. There are a variety of proposals being discussed to reduce the estate-tax burden on farmers and ranchers. In addition, several of the business groups we work with, including the National Federation of Independent Businesses, list estate-tax reform as a priority issue. We sense the time is right.

We support S. 882, the asset gain roller bill, as a way to help farmers and ranchers to defer taxes and plan for retirement. The purchase of capital assets and subsequent sale of these assets some 15 to 30 years later is the primary source of retirement funds for many ag producers. This bill would reduce tax liability.

Weather is always an important and uncontrollable factor for farmers and ranchers. We therefore support S. 1615, which amends Section 451, one year deferral of income from livestock sold due to drought and Section 1033 involuntary conversion of livestock sold due to drought. S. 1615 would amend these Sections to include, in addition to drought, flood or other weather related conditions. This change is within the spirit of the law and would alleviate some of the hardships on livestock producers.

Once again, I appreciate the opportunity to speak before this subcommittee. Thank you.

PREPARED STATEMENT OF THOMAS G. TEPAS

Mr. Chairman, I am here today to request equitable treatment for my company, Hercules Incorporated, and to support other exporters which, like Hercules, had the rules changed on them during the middle of the game.

By way of background, Hercules is a manufacturer of aerospace, chemical, and related products. Since 1970, Hercules has used its wholly-owned foreign subsidiary, Hercules International Trade Corporation Limited, or HINTCO, to distribute and sell Hercules products throughout the world. HINTCO has also distributed, financed, and sold the products of other U.S. manufacturers and producers, including large quantities of agricultural grain products. In fact, approximately forty percent of the hundreds of millions of dollars in world-wide sales facilitated by HINTCO were sales of agricultural products, such as seed grains and soybeans. Because HINTCO's business fosters an important goal of U.S. economic policy—that of expanding the sale of U.S. products overseas, HINTCO has been entitled to operate since its formation as an export trade corporation, or ETC, one of the export incentive companies established by Congress.

The export incentive companies specifically authorized by Congress are foreign sales corporations, or FSCs, and ETCs. Export incentive companies have long been granted specific favorable tax treatment because of their unique contribution to the promotion and expansion of U.S. exports. In 1962, Congress established the ETC program and allowed companies that qualified as ETCs to defer tax on profits generated by the sales of U.S. products overseas as long as these profits were retained and used in the U.S. export business. Although Congress generally replaced the ETC with the Domestic International Sales Corporation, or DISC, in 1971, existing ETCs were permitted to continue operating under the same tax-deferral regime. Again in 1984, when the DISC system was replaced with the FSC system, Congress did not allow this transition to its export incentive program to disturb the export activities of existing ETCs or to effect the favorable tax treatment accorded existing ETCs. Instead, Congress offered existing export trade corporations three choices: (1) they could continue to operate as an ETC; (2) they could remain in the U.S. export sales business but transfer their assets, tax-free, to a FSC, or (3) they could exit the export sales business altogether and repatriate their accumulated export trade income tax-free to the U.S.

Presented with these options in 1984, Hercules chose to continue operating HINTCO as an ETC. First, Hercules believed that HINTCO would continue to have an important role to fill as a world-wide distributor of the products of Hercules and other U.S. producers and manufacturers and as a financier of sales of U.S. exports. Therefore, Hercules choose to continue HINTCO's export business as an ETC, the structure under which it had successfully operated for fifteen years. Second, given the nature of HINTCO's traditional export business, Hercules decided that transferring HINTCO's assets to a FSC was not a viable option. The economic consequences of such a transfer did not warrant the reorganization of (and corresponding disruption to) HINTCO's business that would have been required if HINTCO had become a FSC. Finally, Hercules had Congress' explicit blessing to continue its traditional export business under the ETC regime. Certainly Hercules believed, based on Congress' protection of the ETC system first in 1971 and then again in 1984, that HINTCO would be able to continue operating as an ETC eligible for tax deferral on its export trade income as long as it continued to devote that income to the export business.

Just two years later, however, the rug was pulled out from under HINTCO. Despite over twenty years of Congressional support for ETCs, tax deferral on export sales by ETCs was threatened by the adoption in the 1986 Tax Reform Act of the Passive Foreign Investment Company, or PFIC, rules and by the interpretation of those rules in 1988 temporary and proposed regulations issued by the Treasury Department.

The PFIC rules were aimed at ending the deferral of tax on income earned by passive investment entities located overseas, such as offshore mutual funds. This was accomplished either by treating undistributed income of a PFIC as currently taxable or by adding a deferred interest charge to the tax liability that arises when a U.S. shareholder actually receives a distribution from a PFIC or sells his interest in a PFIC. Despite the stated narrow focus of the PFIC rules—ending tax deferral for foreign mutual funds and investment companies, the Treasury Department's definition of the term "passive income" in proposed and temporary regulations left open the possibility that "passive income" could include income from the export activities of export incentive companies. Accordingly, even though they are actively engaged in facilitating the sale of U.S. exports, ETCs and FSCs could be considered "passive" investment companies under the PFIC rules and thus could lose their statutory tax-deferred status.

As soon as Hercules realized that the PFIC rules might effectively eliminate HINTCO's tax-deferred status, Hercules met with Treasury and with staff of various Congressional committees to attempt to clarify, either through legislation or Treasury regulations, that the PFIC rules do not apply to Congress' export incentive programs. To date, however, Hercules has been unsuccessful in its attempts. We have been advised by staff, however, that the actions taken by the Congress in the 1986 Act which impacted on ETCs were done without consideration by a single member of Congress of the potential impact on ETCs, without any mention of export incentive companies, and without an open hearing. Some have gone so far as to advise us that the potential impact of these actions on ETCs was unintentional.

Failing to obtain clarification that HINTCO's tax-deferred status was not threatened by the PFIC rules, Hercules decided that it had no option but to proceed cautiously, as if the PFIC rules did apply to HINTCO, and take defensive steps to avoid the accrual of large PFIC tax liabilities. To this end, HINTCO distributed all of its retained earnings to Hercules in 1990 and 1991, including in part those earnings accumulated through December 31, 1986. The tax consequences of these distributions is dependent on the interaction of many complex foreign tax provisions and can be explored in detail later if, as we request, the Committee decides to proceed with this problem beyond the hearing stage. Nevertheless, the bottom line is that Hercules made several distributions from HINTCO that it would not otherwise have made and paid a substantial amount of taxes on account of these distributions.

In this hearing, Hercules is asking the Committee to address the status of ETCs and to rectify the unfairness caused by the enactment of the PFIC legislation. Hercules believes that an equitable resolution of this matter would be for Congress to eliminate the ETC program and permit Hercules and other shareholders of ETCs to treat as previously taxed income the export trade earnings of their ETCs, including export trade earnings distributed since the effective date of the PFIC legislation, which is when the rules of tax deferral changed for ETCs such as HINTCO. This resolution achieves both tax simplification and tax fairness. It achieves tax simplification because the ETC has become a deferral regime of marginal applicability as a result of the uncertain application of the PFIC rules and the fact that in 1984 many ETCs elected to discontinue operating under the ETC regime. In fact, the elimination of the ETC was proposed by the Chief of Staff of the Joint Tax Committee in an April 20, 1990 letter in response to House Ways of Means Committee Chairman Rostenkowski's call for tax simplification proposals. The resolution also achieves tax fairness because it follows the precedent established by Congress in 1984 when terminated ETCs were allowed to repatriate their accumulated export trade earnings tax-free, while it also recognizes that the ETC ground rules changed in 1986 and that ETCs such as HINTCO were forced after 1986 to make distributions they would otherwise not have made in order to avoid accumulating PFIC tax liabilities.

Hercules is also requesting that Congress clarify that ETCs, like the current generation of export incentive companies, the FSCs, have never been subject to the PFIC rules. Under the tax simplification bill passed by the House, H.R. 3419, this clarification would be made for FSCs, but not for ETCs. This is patently unfair, especially when it is considered that the ETC is the grandparent of the FSC. There is no equitable basis for treating FSCs one way (exempting them from the PFIC rules) and ETCs another. It is also inconsistent with stated goals of tax "simplification" to treat various export incentive corporations differently. In this regard, we would also appreciate the Committee pursuing with the Treasury Department the issue of whether export trade income of an ETC should be viewed as "passive income." Like FSCs, ETCs stand apart in the law as Congressionally-supported export incentive companies, and the income they earn distributing, financing, and selling U.S. exports should be viewed as active, not passive.

Mr. Chairman, in the past, opponents of this relief have argued that Hercules is not fairly entitled to relief. It has been suggested that, in effect, Hercules made its bed in 1984 when it chose to continue operating as an ETC and now, short of legislative clarification, must lie in it. In 1984, however, Hercules made its choice in reliance on Congress' clear indication that the tax-deferred operation of export trade corporations that had been carefully preserved since 1962 would continue to be preserved. If Hercules had been aware that the ETC program as it existed in 1984 might be summarily terminated in 1986, it would not have chosen to continue operating HINTCO as an ETC; rather, it would have terminated HINTCO's status as an ETC and repatriated HINTCO's accumulated export trade income tax-free. Hercules should not be penalized for choosing to continue its traditional export sales business and failing to predict that, between 1984 and 1986, Congress would change the ground rules that formed the basis for Hercules' choice.

In conclusion, the PFIC legislation made the choice offered to Hercules in 1984—a choice between continuing HINTCO as an ETC or terminating it tax-free—a false choice. After 1986, there was no certainty of continuing HINTCO under the tax-deferred ETC regime. Accordingly, the only fair and practical way to resolve the problem caused by the PFIC legislation is to eliminate the ETC, which has little ongoing significance, and give existing ETCs such as HINTCO what we now know was the only "real" option they had in 1984: the ability to close down their operations and to have their export trade income earned through the effective date of any corrective legislation treated, when repatriated any time after the effective date of the PFIC legislation, as previously taxed income.

Addendum to Statement of Thomas G. Tepas

Mr. Chairman, this addendum supplements the oral and written testimony of Hercules, Inc. regarding its proposal for the equitable treatment of export trade corporations ("ETCs") and directly responds to some of the points raised in opposition to Hercules' proposal by Norman B. Richter, acting International Tax Counsel at the Department of Treasury

First, Mr. Richter asserted that Hercules "assumed the risk that the law might change" when it made its choice in 1984 to continue operating HINTCO as an ETC and thus has no right to object to the impact of the PFIC rules on HINTCO. We would like to reiterate that Hercules does not object to the termination per se of the ETC regime. Hercules is just asking for basic fairness in the way the ETC is terminated. Fairness, at a minimum, means treating similarly-situated taxpayers similarly. In 1984, taxpayers whose ETCs were voluntarily terminated were allowed to repatriate their earnings tax-free. On account of the PFIC rules added in the 1986 Act, HINTCO was effectively terminated involuntarily as a ETC, but it was given no relief. Ironically, the effect of this disparate treatment is to penalize those businesses that continued to support the growth of U.S. exports by choosing in 1984 to remain in the export trade business by maintaining their ETCs. Accordingly, what Hercules is requesting is that its terminated ETC, HINTCO, be given the same relief that terminated ETCs received in 1984: tax-free repatriation of export trade earnings.

Second, Mr. Richter characterized Hercules as seeking a "perpetual" guarantee of a certain tax treatment for HINTCO. This is a misstatement of Hercules' position. Hercules does not believe that perpetual guarantees are to be expected. What it does believe, however, is that basic fairness, including notice and due Congressional consideration, is to be expected by taxpayers. The 1984 legislation was carefully crafted, and it was obvious to all parties that the issue of the ETCs and their continuation was the subject of significant Congressional attention. By contrast, as Senator Roth pointed out, in 1986 no member of Congress considered that the treatment of ETCs would be changed by the Tax Reform Act passed that year. Accordingly, Mr. Richter misses the point: it is simply our intention to have members of Congress focus for the first time on the asserted conflict between the ETC provisions contained in the tax code since 1962 and the PFIC provisions added to the tax code in the 1986 Act. Further, we are asking the members to decide what treatment should be provided to ETCs that have been pushed by this conflict towards dissolution and to determine whether such treatment deserves parity with the favorable dissolution provisions that were provided in 1984.

Mr. Richter also made the point that HINTCO obtained the benefit of "three extra years" of tax-deferred earnings that it would not have had if it had elected in 1984 to repatriate its earnings. First, at most, HINTCO only obtained two extra years of tax-deferred earnings—1985 and 1986. By 1987, the PFIC rules were effective. Second, the tax deferral on these two years of earnings is an insignificant benefit. Hercules paid tax on these earnings when they were repatriated in 1987; accordingly, all Hercules obtained was the ability to use, from 1985–86 to 1987, the cash that would otherwise have gone to pay taxes on 1985 and 1986 earnings. If Hercules had known that the PFIC rules would come along in 1 986 and subject HINTCO's income to current taxation, it never would have chosen the relatively minor benefit of 1–2 years of tax deferral on HINTCO's 1985–86 earnings over the substantial benefit of tax-free repatriation of its pre-1985 income. Finally and most importantly, the implication behind Mr. Richter's comment is that, since two years passed before HINTCO was treated unfairly, we have no right to complain of the unfairness. However, under the statutory regime established by Congress, HINTCO deserved tax deferral on 1985 and 1986 income because it was engaged in qualified export trade activities during those and subsequent years. It is simply wrong to suggest that

HINTCO received some extra benefit that balanced out the unfair treatment in years after 1986.

In a similar vein, Mr. Richter suggested that Hercules' proposal should be opposed because it would exempt from taxation financing-related export trade income earned from 1985 through the date the ETC regime is terminated, even though all or part of that income would have been subject to current U.S. taxation if HINTCO had chosen in 1984 to become a FSC. Once again, the assumption underlying Mr. Richter's objection is that Hercules has obtained an unwarranted benefit for the past ten years and thus is not deserving of any relief. This assumption, however, ignores the fact that in 1984 Congress explicitly permitted existing ETCs to continue operating as ETCs and to continue obtaining the tax benefits associated with that status. Hercules did not obtain any "special" benefit by electing to remain an ETC; it has merely obtained the benefits specifically granted by Congress to qualifying export trade corporations.

Hercules also takes issue with Mr. Richter's statement that the relief sought by Hercules should be denied because it "would provide a retroactive tax exemption for ETC profits distributed since 1986." The relief that Hercules is requesting is nothing more than the relief that was provided in 1984 to ETCs who chose to discontinue their operations. In 1984, Congress reclassified the accumulated export trade income that terminated ETCs had earned in prior years from tax-deferred income to tax-exempt income. Presumably, Mr. Richter would also call this a "retroactive tax exemption." Regardless of the label used, Hercules is only asking that similarly-situated taxpayers be treated similarly. More fundamentally, Hercules is now requesting, and has been requesting for years, that the unfairness done to it in 1986 be corrected. The unfairness can only be corrected by changing the post-1986 consequences of that unfairness. If Mr. Richter's argument is accepted, then no wrong can be righted because to do so would produce a "retroactive" result.

Mr. Chairman, you asked Mr. Richter to explain, if he could, the basis for differentiating between FSCs and ETCs with respect to the application of the PFIC rules to these two types of export incentive companies. He answered that the PFIC rules, which are anti-deferral rules, should apply to the ETC regime because the ETC is a tax-deferral regime, but they should not apply to the FSC regime because it is a tax-exemption regime. There is no support for this interpretation of PFIC in the 1986 Act, however. The PFIC rules can be interpreted broadly, to "catch" all controlled foreign corporations that have the stated percentage of passive income, or they can interpreted in a more limited manner not to apply to override unique, Congressionally-authorized tax incentive regimes. If the former is correct, there is no justification for excluding FSCs but not ETCs from the PFIC rules. If the latter is correct (as Hercules believes is the case), there is no justification for including ETCs or FSCs in the scope of the rules. Senator Roth noted at the Subcommittee hearing that, while there are technical differences in the manner in which each export incentive company receives the tax benefits mandated by Congress, the FSC is the grandchild of the ETC, and there is no policy rationale for distinguishing between these two export companies with regard to the application of the PFIC rules, which never dealt explicitly with either FSCs or ETCs. Accordingly, there is no merit to Mr. Richter's suggestion that clarification of the impact of the PFIC rules on ETCs is comparable to clarification of the impact of the PFIC rules on industries such as the securities industry. The ETC regime, like the FSC regime, is in a class by itself, and clarification of the impact of the PFIC rules on these export incentive regimes will not "open the floodgates" to other industries requesting relief from the PFIC provisions.

Finally, Mr. Chairman, you raised a question regarding Hercules' ability to use foreign tax credits to offset the taxes payable on the post-1986 distributions of export trade income made by HINTCO. Although Mr. Jester answered that Hercules had been able to use foreign tax credits to offset some, but not all, of the taxes payable on account of these distributions, we did not have available at the hearing the specific details concerning the taxes paid and foreign tax credits utilized. Accordingly, we would like to supplement our response to your question by providing those details in this addendum. During the period 1987–91, HINTCO made taxable distributions of $250 million to Hercules. As a result of these distributions, Hercules was liable for $93 million in U.S. federal income taxes, which included a $500,000 PFIC penalty. Hercules satisfied $33 million of this liability by making an actual tax payment of $33 million, and it satisfied the remaining $60 million of the tax liability by expending $60 million of its available foreign tax credits. As we discussed at the hearing, as the result of the enactment in 1986 of the PFIC rules, HINTCO was forced to make taxable distributions to avoid accruing large PFIC penalties. These distributions required Hercules to pay $33 million in taxes and to use up $60 million of valuable foreign tax credits which would otherwise have been available to offset other U.S. tax liabilities of Hercules attributable to its overseas operations.

PREPARED STATEMENT OF BARBARA G. WEBB

Mr. Chairman. My name is Barbara Webb, associate director of government relations for the National Farmers Union. I am appearing today on behalf of the over 203,000 farm family members of our organization. The tax decisions of the Senate Finance Committee have an important effect on our membership. We are pleased that your subcommittee is holding a hearing on several bills specifically related to farmers and ranchers.

At the outset, I believe it necessary to stress that tax questions, important as they may be, are secondary to those of earning income in the first place. Around April 15th of every year, my dad always used to tell me to be happy that I owed taxes, because it meant that I was making money! Changes in the tax structure, in particular credits against income taxes, don't help keep family farmers in business if they have little or no income to begin with.

In that regard, recent data from the U.S. Department of Agriculture reports average income from farming was only $4,337 in 1992, or about 11 percent of a farmer's household income. Low commodity prices are driving more and more families from the farm. Continuing the trend of the last decade, the number of U.S. farms dropped another one percent last year, leaving 2.04 million in operation, according to USDA.

Yet, as the most basic of industries, agriculture serves as one of our nation's few sources of renewable wealth. The wealth which is created by production of raw commodities each year multiplies seven or eight times throughout the economy as these same raw commodities are processed, prepared and sold to consumers here and abroad.

With that beginning, let me add that my discussion of some of the bills which are being reviewed today, as well as other tax suggestions which I will make, comes directly from National Farmers Union policy. That policy is advocated and adopted by our producer members at the grassroots county, state and national levels of our organization.

1. S. 882, the "Family Farm Retirement Equity Act of 1993"—For many farmers, equity built up over a lifetime on the family farm can be the primary if not the only source of retirement funds. This also is true in the case of other small business owners. We support efforts by Senator Herb Kohl and others to allow farmers to rollover assets from the sale of their farms into Asset Rollover Accounts (ARA) and defer payment of income taxes until the funds are drawn out of the account.

2. Losses Due to Drought, Floods and Other Disasters—National Farmers Union supports S. 1814, authored by Senator Tom Daschle and others which would allow farmers to choose to include crop insurance proceeds and disaster payments as income either in the year of the disaster or in the year that follows it.

Many farmers and ranchers who applied for disaster or crop insurance payments due to flooding and drought last year received payments in 1993, but the overwhelming majority did not and received them instead during 1994. Payment delays occurred through no fault of the producers, but because of the tremendous volume of farmers and ranchers who suffered from last year's floods and drought. At the end of 1993, USDA had only paid about one-third of the projected claims.

Under current law, farmers must either take these payments as income in 1994 or carry payments forward to 1995. They cannot carry the payments backward to 1993. Farmers receiving payments in 1994 will suffer tax consequences. They will have unusually low income in 1993 and higher income in 1994. One accounting firm in Minnesota estimated that an average farmer who received payments in 1994 could pay as much as $6,000 more in taxes.

Because of their concern about this situation, at our national convention in March National Farmers Union members adopted a "Special Order of Business." The statement reads as follows:

> "Midwestern farmers are deeply appreciative of the substantial improvements in disaster assistance provided in the aftermath of the 1993 floods. However, the scope of the disaster resulted in many county Agriculture Stabilization and Conservation Service (ASCS) offices being unable to keep up. As a result, many farmers did not receive their payments or were even unable to schedule appointments at their ASCS offices until after January 1, 1994. This situation has meant that many disaster victims will have a larger than expected tax liability . . . . Many of these victims may have had no income at all in 1993. We therefore urgently request that Congress move swiftly to approve legislation allowing

disaster victims the option of scheduling payments as income in either 1993 or 1994."

NFU also supports S. 1615, also authored by Senator Daschle, which would expand the definition of disaster used in the case of livestock to cover losses not only from droughts, but also from floods and other weather-related occurrences.

3. **Environmental Tax Credits**—Our membership supports S. 1691, authored by Senator Kent Conrad. This legislation allows a 15 percent income tax credit of up to $15,000 per year or $150,000 over the life of the business or farmer for purchases of machinery and equipment bought primarily to comply with federal, state or local environmental laws.

It will provide the incentive for livestock and crop producers to build or purchase manure handling systems, terraces, filter strips, constructed wetlands and other agricultural systems and machinery that protect the environment. Design, construction and management of these physical structures and equipment will not only help ensure attainment of our nation's soil, water and air quality objectives, but also give rural America a much-needed economic boost. This tax measure will help agriculture producers to develop adequate tools to address new environmental challenges.

4. **Estate Tax Issues**—National Farmers Union supports S. 531 by Senator Daschle. Congress expressed its intent that family farms should remain in the family by passing legislation providing that such property should be valued at its income-producing value rather than its open market value for estate tax purposes. At the time this provision was passed, speculation had driven land values well beyond the farm's ability to produce income in most situations. To prevent abuse, the special use valuation law provided that if the farm was converted to a nonfarm use or sold outside the family within 10 years of the date of the valuation, the heirs would be retroactively liable for estate taxes on the farm's market value at the time of the parent's or grandparent's death. In 1988, Congress passed a technical correction which extended special use valuation of farm property to surviving spouses who continue to cash-rent farm property to their children. Without this change, a recapture tax would have been imposed in such an event. However, no clarification has been made where surviving children cash lease among themselves. Senator Daschle's legislation is needed to eliminate any inequities which might occur in these situations and to further congressional intent that family farms remain in the family.

In addition, National Farmers Union opposes any efforts to reduce the federal estate tax exemption from its current level of $600,000. Because of its potential for facilitating the transfer of a family farm or small business from generation-to-generation, we support S. 531 by Senator Dave Durenberger which would raise this threshold to $ 1 million.

As I mentioned above, many of our nation's farmers are struggling financially and are justifiably concerned about their ability to pass on their operation to a son or daughter. The capital investment required for an average farm can quickly add up to more than the current $600,000 exemption when you consider land, buildings, machinery and livestock. As such, capping the intergenerational tax exempt transfer of assets at $600,000 threatens the ability of some families to transfer a farm or small business. If a family has to sell the farm in order to pay estate taxes, we have destroyed all that the family has worked for many years to achieve.

5. **Other Tax Issues**—National Farmers Union supports a return to income averaging. Boom and bust cycles in agriculture are nothing new, but farmers and ranchers lost the ability to average income over the good and bad years for the purpose of calculating income taxes as a result of the 1986 Tax Reform Act. Reinstating income averaging would help shield family farm income from threats imposed by weather and domestic and global marketing opportunities.

We also request reinstatement of the investment tax credit (ITC). National Farmers Union believes that a properly designed ITC can encourage new enterprises in rural communities and could be a stimulus for encouraging new family farms. Equipment investments in the agricultural sector often consist of used items; therefore, any proposed ITC should include used equipment.

National Farmers Union also urges Congress to reinstate the deduction for health care costs for the self-employed at 100 percent on a permanent basis. The 25 percent deduction level expired at the end of 1993. In the spirit of fairness, the self-employed should receive the same tax treatment as do our nation's corporations and other business entities.

Thank you for this opportunity to express the views of National Farmers Union's members. I would be happy to address any questions you might have either at this time or more fully in writing for the hearing record.

PREPARED STATEMENT OF ROBERT WOODBURY

Mr. Chairman, my name is Robert Woodbury, and I am Vice President and Controller of Kollmorgen Corporation. I am here today to request equitable treatment for my company, Kollmorgen Corporation ("Kollmorgen") and to support other corporations which, like Kollmorgen, had the rules changed on them during the middle of the game. I am accompanied by my tax counsel, Joseph H. Newberg of Sullivan & Worcester in Boston, and we will be happy to answer any questions the Committee may have.

By way of background, Kollmorgen is a manufacturer of high performance motion controls, analytical instruments and electro-optical systems. From 1971 to 1991, Kollmorgen used its wholly-owned Swiss subsidiary, Kollmorgen, A.G. ("KAG"), to distribute and sell certain of Kollmorgen's products throughout Europe. Because KAG's business fostered an important goal of U.S. economic policy—that of expanding the sale of U.S. products overseas, KAG was entitled to operate since its formation as an export trade corporation, or ETC, one of the export incentive companies established by Congress.

Presented, in 1984, with a Congressionally offered option to (i) continue as an ETC, or (ii) to transfer its assets, tax-free, to a FSC, or (iii) to quit the export sales business and repatriate its export trade income, tax-free, to the U.S., Kollmorgen chose to continue operating KAG as an ETC. Even though Kollmorgen could have repatriated all of KAG's accumulated earnings from export sales *tax-free* by terminating KAG's operations, Kollmorgen wanted KAG to continue in its traditional export business with the same tax consequences. Moreover, Kollmorgen had Congress' explicit blessing to take this route. Certainly Kollmorgen believed, based on Congress' protection of the ETC system first in 1971 and then again in 1984, that KAG would be able to continue operating as a tax-deferred ETC as long as it remained in the export business.

Kollmorgen continued to actively operate its ETC and was doing so on April 20, 1990 when the Chief of Staff of the Joint Tax Committee publicly proposed the elimination of the ETC regime as a simplification measure.

When it became likely that the ETC regime would be closed down, and that accumulation of income, even for redeployment in export trade activities, could give rise to PFIC issues, Kollmorgen was forced to reevaluate the economic utility of maintaining its Swiss subsidiary. As a result of this review, Kollmorgen during 1991 withdrew the accumulated export trade income from investment in export assets, in order to redeploy these resources to more productive uses.

Since no relief similar to the 1984 (and earlier 1971) relief had been proposed or seemed available, Kollmorgen was required to include such withdrawals in taxable income in accordance with the normal ETC provisions. This has unreasonably affected Kollmorgen (and the other companies testifying here) compared to all other ETCs, which had an opportunity to convert tax-free their export trade assets into a FSC, or to withdraw these assets tax-free for redeployment Kollmorgen therefore joins with Hercules in requesting relief, similar to that contained in the Deficit Reduction Act of 1984, that would allow them to repatriate their earnings tax-free.

Certainly fair relief is warranted, and is not an unreasonable price to ask where the taxpayer has relied on Congressional laws in conducting its export activities, has played by all of the applicable rules, and in the absence of such relief will have suffered a tax disadvantage not suffered by its competitors who took advantage of the prior relief rules.

In sum, we do not believe it is fair or equitable to deny relief to Kollmorgen, where it had no basis in 198[illegible] to conclude that the Congressionally mandated and twice-protected ETC regime [illegible]ld loose its viability in the future. Kollmorgen therefore joins with Hercules i[illegible] [illegible]questing the ability to repatriate its export trade income tax-free.

EXAMPLE

Legislative relief that would fairly address the foregoing inequities might include the following elements:

1. Formal repeal of the ETC regime, effective for years ending on or after December 31, 1990 (hereafter, the "Termination Date"). This approach would be consistent with the public statement by the Chief of Staff of the Joint Tax Committee in 1990 proposing elimination of the ETC regime as a simplification measure.
2. ETC's in existence as of the Termination Date would be allowed relief similar to that allowed when the export trade regime was modified in 1971 and again in 1984: export trade income earned prior to and including the Termi-

nation Date would, when distributed any time after December 31, 1984, be treated as previously taxed income.

We believe this approach would recognize the *defacto* death warrant for ETC's signed by the Joint Tax Committee in 1990, and would correct the unfairness suffered by ETC's which reasonably relied on Congress in continuing to operate as ETC's after 1984.

COMMUNICATIONS

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION

The American Farm Bureau Federation is the nation's largest general farm organization with a membership of 4.2 million member families in 50 states and Puerto Rico. Farm Bureau members produce virtually every commodity grown commercially in this country. Policy is developed by producer members at the county, state and national levels of the organization. Farm Bureau appreciates the opportunity to comment on farm tax issues important to our member families.

Tax policy and the resulting rules and regulations are very important to our members. Policies that are fair and equitable both promote the economic well being of our nation and provide incentives for citizens to pay their fair share of their respective tax liabilities. With this in mind, Farm Bureau would like to submit the following comments and observations with respect to the farm-related tax proposals under consideration.

ESTATE TAXES

Farming in this country is both a way of life and a way of business for those that cultivate the land and care for animals. Perhaps like no other family business, today's farmers and ranchers owe a great deal to the generations who farmed before them. Most learned how to farm from their parents and most started their careers in production agriculture using assets provided by the previous generation. For this reason, reform of our nation's estate and gift tax laws is a priority for Farm Bureau.

Estate tax laws that govern the transfer of farm family business assets from one generation to the next were last updated in 1981. Due to gradual inflation and pressure from land development, the current $192,800 unified tax credit is no longer sufficient to allow many family farm businesses to pass from one generation to the next. Because more and more farms have assets exceeding the $600,000 exemption, heirs are forced to sell land, equipment and/or buildings to pay estate taxes. When the portion of farm business assets that must be sold is too great, the economic viability of the operation is destroyed and family members are forced to abandon the farm.

S. 226 would expand the definition of land qualifying for "current use value" for estate tax purposes to land leased by an heir to a qualified member of the family who continues to operate the farm. In view that a cash rental/lease arrangement is typical in many farming operations, there is no reason to consider it as an unusual financial arrangement with respect to the leasing arrangement for land that has come through an estate.

Farm Bureau wholeheartedly supports this legislation which clarifies this issue, as it was intended in the original legislation, by specifying that the cash lease of specially valued real property by qualifying heir to a "member of the family" (who continues to operate the farm or closely-held business) does not cause the qualified use of such property to cease for the purposes of imposing an additional estate tax under code Section 20328(c).

S. 531 would increase the present unified tax credit to an amount that would effectively exempt $1 million in taxable transfers from the estate and gift tax. Farm Bureau supports increasing the estate tax exemption to $1 million. This change is necessary to offset the impact of creeping inflation on the unified credit amount that was originally set in 1976 and later revised in 1981.

Additional changes in estate tax law supported by Farm Bureau include indexing the $1 million estate tax exemption. Also the $750,000 limitation on the amount of reduction allowed from fair market value to special use valuation should be eliminated. Finally, the maximum gift tax exemption should be increased from $10,000 to $20,000 per year per recipient.

ASSET ROLLOVER ACCOUNT

Farming and ranching are extremely capital intensive businesses. As such, the long-term growth and success of a family farm often dictates that proceeds be reinvested in the business. While farmers and ranchers understand the importance of planning for retirement, business capital needs frequently supersede retirement savings. To many farmers, investing in farm assets that can be productive now and sold in the future to finance retirement makes sound business and personal sense.

An additional hindrance to regular retirement savings by farmers and ranchers stems from the year-to-year variances in farm income normal to any farming business. Plans currently available for tax sheltered retirement savings, like IRAs and Keoghs, place limits on the amount of funds that can be invested each year. During tough financial years, farmers and ranchers may not have money to invest. Yet in years when they show a profit and could invest, the amount of retirement savings they can shelter from taxes is limited.

S. 882 would provide a qualifying farmer with the option to defer recognition of a limited amount of net gain from the sale of qualified farm assets by allowing farmers Asset Rollover Accounts (ARAs) in the taxable year in which the sale occurs. Using an ARA, farmers and ranchers could defer up to $500,000 in capital gains on the sale of qualified farm assets until the money was withdrawn from the special account.

Farmers hold land an average of 28.6 years over which time period, the value of total farm real estate in the United States has increased 4.27 times. It should be noted that nearly all of this amount is due to nothing more than inflation. Indeed, farmers who sell their farms are often forced to pay a tax rate, on inflated land values, that is double or more of the tax rates paid by people who have access to IRAs and can spread their IRA withdrawals over time.

Farm Bureau supports allowing farmers and ranchers, in preparation for retirement, to invest proceeds from the sale of property and machinery into a special retirement account on which taxes would be due at the time of withdrawal.

TAX TREATMENT OF DISASTER PAYMENTS

A key factor in the profitability of any farming operation is weather, a factor that can't be controlled or even accurately predicted. In years of natural disasters, farm income from the sale of crops may be severely reduced or even eliminated. Livestock producers who face multiplied feed costs may be forced to sell animals prematurely. In addition to problems caused by reduced income, irregular and unexpected cash flows make farm financial planning very difficult.

Fortunately, the federal government provides disaster assistance to farmers and ranchers in these times of need. Unfortunately, disaster assistance payments and income from forced livestock sales are usually received in a different tax year. Receiving extra income in a single year increases taxes paid by farmers and ranchers who are already financially handicapped by natural disaster and negates the benefits of disaster assistance.

S. 1616 would allow farmers and ranchers who are forced by disaster to sell livestock early to include sale proceeds in the following year if that is when the sale would have normally occurred. The measure is retroactive to sales and exchanges after December 31, 1992, making the provision important to producers affected by the very unusual circumstance caused by the 1993 midwestern flood.

Likewise, S. 1814 would allow farmers and ranchers to count disaster payments in disaster years regardless of when the aid is actually received if that is when income from crop sales would normally have occurred. This bill would expand the payments for which these elections are available to include disaster assistance received as a result of destruction or damage to crops caused by drought, flood, or other natural disaster, or the inability to plant crops because of such a disaster, under any Federal law, (rather than only under payments received under the Agricultural Act of 1949, as amended, or title II of the Disaster Assistance Act of 1988).

Again, this bill would be effective for payments received after December 31, 1992, reflecting the need for such action for midwestern farmers who were affected by the flood of 1993. The measure would allow producers to adjust their cash flow in such a way to avoid having no income in the year of a natural disaster, such as a flood, and then subsequently having their income increased in the year after disaster throwing them into a higher tax bracket.

Farm Bureau supports allowing farmers and ranchers to count income from livestock sales and disaster payments in the year that they would normally have occurred so that taxes paid are fair and a true reflection of normal farm income.

TAX CREDIT FOR COMPLIANCE WITH GOVERNMENT MANDATES

Farmers and ranchers are disturbed by the growing trend of government to mandate environmental protection practices on agricultural land. Farm Bureau is opposed to unfunded government mandates and instead supports voluntarily installed conservation measures with technical advice and cost-share assistance from the government. However, Farm Bureau supports tax incentives for producers who are forced to make expenditures in order to comply with environmental laws.

S. 1691, would provide a partial "agricultural environmental credit" for new treatment facilities and for soil and water conservation expenditures necessary to comply with federal, state and local water, soil and air pollution laws. Although AFBF does generally support this concept and most of the specifics of this bill, we have concerns about the section which states "to be eligible for the credit, a taxpayer would have to be primarily engaged in a farming-related business, i.e., a farming business . . . " We suggest that those taxpayers eligible for the credit be expanded to include landowners. Since it is a qualifying "agriculture and environmental property" placed in service, any tax credit should accrue to either the operator or landowner as defined in the lease arrangement.

Another area of concern we have is with the provision that states, "Agricultural and environmental property' would not include any expenditure that significantly increases the output, extends the useful life, or reduces the operating costs of the plant or property to which the facility relates or alters the nature of any manufacturing or production process or facility." As a practical matter, many environmentally sound practices also have the favorable impact of increasing economic productivity. To disallow a credit under these circumstances would seem counterproductive. Consequently, we suggest that this provision be eliminated.

MISCELLANEOUS

Finally, Farm Bureau must stress the urgency of extending the 25 percent deduction for health insurance premiums paid by the self-employed. It is difficult to understand why, during the recent debate about health care, this provision to make health insurance more affordable has not been expanded to 100 percent and made permanent. Farm Bureau urges legislative action to reinstate and expand the deduction for 1994 and to make permanent a 100 percent deduction for health insurance premiums paid by the self-employed.

CONCLUSION

The American Farm Bureau Federation applauds the Senate Finance Subcommittee on Energy and Agricultural Taxation for holding a hearing on these much needed farm tax changes. Thank you again for allowing our comments to be part of the record.

BYRON L. DORGAN,
U.S. Senate, Washington, DC.
October 5, 1994.

Hon. THOMAS A. DASCHLE, *Chairman,*
Subcommittee on Energy and Agricultural Taxation,
Washington, DC.

Dear Mr. Chairman:

I commend you and the other members of the Senate Energy and Agricultural Taxation Subcommittee for holding this hearing to examine several tax relief bills needed to help this nation's family farmers.

For many years in the House of Representatives, I worked on several farm tax proposals to help counter the numerous unreasonable and unfair Internal Revenue Service (IRS) rulings regarding the tax treatment of farmers. One of the proposals, which your Subcommittee is reviewing today, provides tax relief for a number of farm families who risk the loss of their farms.

As you know, Mr. Chairman, the IRS has taken a position that may force many unsuspecting farmers to sell off their family farms because of a glitch in the estate tax laws giving rise to enormous estate taxes, interest and penalties. Under current law, a qualified heir could not benefit from the special valuation for estate tax purposes if he or she cash-rented qualified farm property to another family member after the death of the owner, even where it was clear that the family member continued to actively participate in the farm's operation.

Ironically, this is exactly the problem that Congress tried to address by passing Section 2032A of the Internal Revenue Code. The goal of the section was to keep farms in the family after the death of the owner.

That's why our legislation, S. 226, will amend Section 2032A so that these deserving heirs will also be eligible for special use valuation. Our bill clarifies that cash leasing among inheriting family members will not cause a tax recapture event under Section 2032A. It simply makes clear the original intent of Congress, which was to encourage family farms to remain in the family and operating after the death of the owner. Similar language was included in the Revenue Act of 1992 (H.R. 11) which was passed by Congress, but vetoed by then-President Bush.

I urge you and my colleagues to include this tax fairness proposal in any revenue measure to be passed by Congress this year. We have been working on this particular issue for the past several years, and we ought to correct this matter without further delay.

I look forward to working you and this Subcommittee to pass legislative initiatives to provide much-needed help to our farm communities

Sincerely,

BYRON L. DORGAN, U.S. SENATOR.

STATEMENT OF THE NATIONAL COUNCIL OF FARMER COOPERATIVES

Hon. THOMAS A. DASCHLE,
United States Senate,
Hart Senate Office Building,
Washington, DC.

Dear Senator Daschle: Thank you for allowing the National Council of Farmer Cooperatives to testify in support of S. 545, the cooperative sale of assets legislation, at the hearing of the Senate Finance Subcommittee on Energy and Agricultural Taxation on October 5, 1994. We would like to supplement our testimony at the hearing regarding the means of determining which asset sales qualify to be treated as patronage sourced under the proposed legislation, and we would like to comment on the portion of the written statement submitted by the Department of Treasury pertaining to S. 545. We ask that this letter be included in the hearing record.

DIFFERENTIATING BETWEEN LEGITIMATE PATRONAGE ACTIVITIES OF THE COOPERATIVE AND ACTIVITIES WHICH DO NOT DIRECTLY SUPPORT ITS COOPERATIVE OPERATIONS

At the hearing, you asked for examples of sales by a cooperative that would not facilitate the activities of the coop. You said that you wondered whether the generic definition of "sales which facilitate activity" was so broad as not to allow us the ability to differentiate between the legitimate activities of a coop for purposes of this legislation and those which were not necessarily in direct support of the cooperative's activities.

We do not believe that the legislation as drafted is overly broad. S. 545 provides that a farmer cooperative may elect to include in its patronage net earnings gain or loss from the sale or other disposition of an asset if the asset was "used by the organization to facilitate the conduct of business done with or for patrons. " Under this legislation, asset sales are eligible to be treated as patronage sourced if the asset was used to facilitate the patronage activities of the cooperative.

For example, if a farmer cooperative sold a grain elevator that had been used in the marketing of grain for farmer members of the cooperative, gain or loss on the sale would be eligible to be treated as patronage sourced under this provision. On the other hand, if the cooperative owned a piece of land or equipment that was not used to facilitate its patronage operation, gain or loss on the sale of such asset would not be eligible to be treated as patronage sourced under this provision. If, for example, a grain marketing cooperative owned a commercial apartment building which it held for the purpose of generating rental income and gain on resale, and this building was not used to further the grain marketing activities of the cooperative, gain or loss on the sale of the building would not be eligible to be treated as patronage sourced under S. 545. Similarly, if the grain marketing cooperative operated an automobile repair business that was unrelated to its grain marketing activities, gain or loss on the sale of the automobile repair business, or assets used in that business, would not be eligible to be treated as patronage sourced under this legislation.

This legislation also provides that if an asset has not been used entirely to facilitate the patronage activities of the cooperative, gain or loss on the sale of the asset may be pro rated between patronage and nonpatronage operations using any reasonable method for making allocations of income or expense between patronage and nonpatronage operations.

We submit that the proposed legislation provides a proper basis for determining which asset sales are eligible to be treated as patronage sourced under S. 545, and it further provides that a reasonable allocation will be made in the case of an asset used in both the patronage and nonpatronage operations.

COMMENT ON THE TREASURY DEPARTMENT'S STATEMENT ON S. 545

1. Treasury's Concern That The Election Will Be Used To Whipsaw The Government Is Unfounded.

In its written submission, the Treasury Department stated:

"The characterization of earnings as patronage or nonpatronage effectively determines whether the earnings are subject to tax only at the patron level or at both the cooperative and patron levels. Providing cooperatives an election to characterize gains and losses on asset sales as patronage-sourced is especially troublesome because it exposes the government to whipsaw, particularly when the election can be made at any time during the taxable year and is revocable at the option of the cooperative."

The prohibition on changing an election for a three-year period protects against abusive use of the election, and we submit that three years is sufficiently long for this purpose.

It should also be noted that the characterization of income as patronage or nonpatronage sourced is not only a tax issue. Farmer cooperatives return their patronage sourced earnings to their member/patrons under a contractual obligation with the members. The basic economic relationship the cooperative has with its members will certainly play a role in determining how a cooperative approaches this issue.

2. The Elective Feature Of S. 545 Does Not Undermine The Special Status Of Nonexempt Cooperatives Under Subchapter T Of The Code.

Treasury's written submission includes the following statement:

"The determination of the source of earnings is an inherently factual one, dependent upon the operations of the cooperative, the use of the asset by the cooperative, and its relationship to the conduct of the cooperative business. Allowing cooperatives to elect the result, rather than having the result follow from the facts and circumstances of the particular situation, is not consistent with the special status of a nonexempt cooperative."

Under current tax principles, a cooperative may deduct or exclude from gross income net earnings resulting from business done with or for patrons which are distributed to them pursuant to a pre-existing legal obligation. We do not contend that cooperatives and their members can by making the election turn what is inherently nonpatronage income into patronage income. However, if the asset has been used to facilitate the patronage operation, the gain or loss on sale should be eligible to be treated as patronage sourced. This is not inconsistent with the special status of a nonexempt cooperative.

3. The Decision To Limit S. 545 To Farmer Cooperatives Was Based On Revenue Considerations.

Treasury's written submission says that there is little policy justification for limiting the special treatment of this provision only to farmer cooperatives. Farmer cooperatives do not oppose the expansion of S. 545 to other types of cooperatives. However, Congress restricted the provision to farmer cooperatives when the provision was included in H.R. 11 in order to limit its revenue impact.

Sincerely,

J. GARY MCDAVID.

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