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SELECTED REVENUE-RAISING PROVISIONS

HEARING

BEFORE THE

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UNITED STATES SENATE

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SELECTED REVENUE-RAISING PROVISIONS

THURSDAY, APRIL 17, 1997

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to recess, at 10:10 a.m., in room SD–215, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Also present: Senators Grassley, D'Amato, Murkowski, Moynihan, Conrad, Moseley-Braun, and Bryan.

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will please come to order. It is a pleasure to welcome you here today.

The Administration's fiscal year 1998 budget package includes a number of proposals that will cause millions of taxpayers to pay more taxes, and these proposals are listed under the title of unwarranted benefits and other revenue measures. But, of course, one taxpayer's unwarranted benefit is another taxpayer's incentive to achieve a desired result.

We will carefully review the President's revenue-raising proposals. What I am interested in hearing is how these proposals affect jobs and economic growth. A revenue raiser that negatively affects jobs and growth will not pass muster, regardless of what title is attached to it.

But I do look forward to hearing the Administration's perspective, as well as from the second panel of distinguished witnesses representing the private sector.

Pat.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Yes. I would just say it is an honor and pleasure to have Don Lubick before us once again. These are serious proposals from an eminent authority in these matters, and if there are modes in which we can raise revenue and advance some cause or purpose of equity or efficiency, we certainly should take them carefully into consideration, and we will do, sir.

The CHAIRMAN. Thank you.

Senator MOYNIHAN. Could I say, just so our witnesses will know, Mr. Chairman, I will have to leave, at least for a period, at 10:30 for an executive meeting of the Rules Committee.

The CHAIRMAN. I will vote for you in your absence.

Senator MOYNIHAN. You have my vote, sir. [Laughter.]

The CHAIRMAN. Mr. Lubick, as I said, we are delighted to have you here. We look forward to your testimony. Please proceed.

STATEMENT OF HON. DONALD C. LUBICK, ACTING ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. LUBICK. Thank you, Mr. Chairman and Senator Moynihan. I am very pleased to appear before you to discuss the revenue offsets to the tax cut package contained in the President's budget. The cost of the President's proposed tax cuts is offset by cutting spending and extending some preexisting excise taxes, and we believe the subject matter of today's hearing, the reduction of certain unwarranted and unintended tax benefits, mostly corporate.

In particular, the Administration is concerned that corporations and other sophisticated taxpayers engineer transactions in ways that were never anticipated by Congress to exploit gray areas and inconsistencies in the tax law or to take advantage of tax rules that are easy to manipulate without regard to the economic substance of the transactions. We do not believe that the proposals that we have made will adversely affect taxpayers in pursuing normal business pursuits.

These measures, we believe, will improve tax policy, to some extent simplify the tax system, and ensure that the burden of deficit reduction is borne fairly by all sectors. As you are aware, they will produce budget savings that we estimate will amount to $34.3 billion through fiscal 2002.

I will address myself to the policy objectives underlying the four specific groups of proposals that you requested in your letter, the financial transactions, corporate taxes, tax accounting, and international tax proposals.

First, on financial transactions. These proposals relate to the dramatic evolution of the last few years of financial transactions that taxpayers engineer to exploit the gray areas of the tax law.

The tax law has not dealt well with the pace of financial innovation, which is allowing sophisticated taxpayers to obtain different tax characterizations by making small changes in a transaction's terms, but without significantly changing the economics underlying them. Effectively, sophisticated taxpayers can elect the tax treatment that they desire.

As tax engineering of financial transactions has become more aggressive, the tax base has been eroded in a way that was never foreseen or intended by Congress. In part, this is a function of drawing a bright line in the tax law. A bright line may produce some certainty, but it also produces a road map for taxpayers to exploit. I think as we go through this, you will see that this is what has happened.

The developers of financial products have focused their efforts on aspects of the tax system that are particularly vulnerable: the distinction between debt and equity, opportunities for tax arbitrage, obtaining interest deductions to support tax-exempt income, or converting capital gain from ordinary or making losses from capital to ordinary, using opportunities to avoid gain recognition on dispositions of property that are economically the equivalent of sales, and dealing with problems involving the measurement of income. The proposals are in each of these areas.

For example, there are longstanding problems involving the distinctions between debt and equity. In the case of debt at the corporate level, a deduction is allowed for interest paid.

In the case of equity distributions received by corporations there are benefits for a dividend received deduction that is exempt income. So in some situations a corporation will favor debt treatment of financial instruments because it is seeking a corporate interest deduction on payments on the debt.

On the other hand, if a corporation cannot use an interest deduction another corporation may want to make an investment on which it will receive distributions which will be excluded, at least partially, from taxation because of the dividend received deduction.

On the other hand, the corporation in the latter case making the distribution wants to get it as close to the line of debt instruments so that it will not have what is really a true equity investment in the corporation.

So this game can be played both ways. If we allow this to continue, corporations will be able to continue to erode the corporate base basically at will by the design of an instrument around the line currently between debt and equity.

For example, we have seen illustrations where debt instruments are treated as such by banks to obtain interest deductions, but they are recognized by their regulators as equity investment to support the amount of capital they are required to maintain.

In effect, these instruments have, for practical purposes, the treatment as equity in the normal business affairs of the taxpayer, but by framing them in very technical ways around the lines that have grown up they can obtain the tax benefits of deductions as debt.

We are suggesting that, in these gray areas where the only motivation for designing the transaction in this peculiar way, whether it be debt or whether it be equity, we should not allow either the interest deduction if it was more of an equity flavor, but essentially in a debt clothing, if you will, or the reverse, if it is really debt with no investment beyond a fixed term with payments that may be called dividends but are really related to factors that smack of interest, in that situation we don't think the dividend received deduction ought to be available. So, it is essentially game playing.

Another set of problems involves opportunities for arbitrage. Again, as I indicated, interest deductions may be claimed by a corporation and it has become almost impossible to match them to the receipt of dividends so that investments are made in portfolio stock which produce corporate dividends which are eligible currently for a 70 percent divided received deduction.

We have proposed that, to reduce this gaming possibility, that the deduction be reduced to 50 percent. Other areas deal with avoidance of gain recognition on transactions that are economically equivalent to sales.

When a person is not at risk with respect to a particular investment, perhaps by virtue of an equity swap or a sale short against the box, whether or not the shares that he retains go up or down in value he is absolutely protected from any benefit of gain or any risk of loss, we think it is functionally the equivalent of a sale and should be treated that way.

In the case of financial instruments, the standard has been easy to manipulate and taxpayers have engineered financial transactions to get rid of their risks, get rid of the possibility of rewards associated with the owning of their property, but avoiding being characterized as having sold it and, thus, they avoid paying the tax on the gain.

Finally, there are some other proposals in this area that deal with measurement of gain. One of the illustrations involves the question of the use of bases where shares which are exactly identical, are fungible shares, are owned by a taxpayer, acquired at different dates, and by a selective process the taxpayer can minimize gain. Our suggestion is that we use average cost bases in this situation to avoid taxpayers always electing against the revenue, in the same way as insurance companies try to avoid adverse selection.

Let us assume a taxpayer has bought three lots of identical stock, the first one at an average price of 80, the second at an average price of 50, and the third at an average price of 90, and he sells two-thirds of his holding. He can pick the first one and he can pick the third one in order to minimize his gain. We suggest that when you are dealing with completely fungible property, that the average cost basis works better.

The second group of items that we are talking about are corporate provisions that are designed to prevent corporations from exploiting gray areas and inconsistencies in the law. One of them that you will hear about more, I know, on the panel, is the question of whether one can change a disposition that would not be possible under the reorganization provisions.

If a corporation has two businesses and wants to dispose of one in exchange for shares of another corporation, that cannot be done directly under the reorganization provisions.

Indeed, arrangements have been made for the use of Section 355, which allows divisive split-ups of corporate holdings to the shareholders of the corporation. One of those is carried out, and then the shares are immediately disposed of to a third party corporation. In that case, the corporation avoids gain at the corporate level on the disposition of its assets.

A number of other provisions deal with manipulation of these very technical rules that provide for gain and non-recognition on the receipt of preferred stock. But, if the preferred stock is structured very much like debt which would have provided for recognition of gain, those rules are avoided.

Third, we have some problems with the accounting provisions designed to improve the measurement of income, one that has previously been included in the last few years with respect to large farming corporations that were required to switch to the accrual basis but, so far, have been deferring indefinitely the adjustment on their change from the cash method to the accrual method of accounting, we would suggest that it is time to bring that suspended amount of income that has never been recognized gradually into income. That was, I believe, in the Balanced Budget Act that did not pass.

The final group deals with international provisions. Again, we have very, very similar things. We have the use of derivative financial instruments to exploit inconsistencies and to avoid provisions of the law. We have one that I am sure you are familiar with that we think is also an improper benefit, which is the sale source rule, which allows a significant portion of a U.S. exporter's income to be converted from domestic income, which it would be under normal rules, and to foreign source income in order to soak up excess foreign tax credits. At a cost of about $1 billion a year, we believe that this particular benefit could be changed without any significant impact on jobs. There is some economic debate in all of these things, as you are quite aware. As you yourself said in your opening statement, one taxpayer's benefit may be another's—and probably a Treasury Department official's—loophole.

So you will always find advocates, and I have probably been guilty of that myself during private practice, suggesting that the republic will fall if this particular benefit is withheld. Somehow when you get in this seat, I think one acquires an objectivity that one does not necessarily have when one is an advocate for a particular position. But I think that these foreign proposals that we are talking about fall in that category.

One I should mention of more significance is the foreign tax credits that are intended to prevent double taxation of the same income under a foreign income tax and the U.S. income tax.

We are proposing that when you are dealing with companies that are making payments to foreign governments for their extraction of minerals in those countries that are owned by the sovereignty, if there is no generally applicable income tax in that country it is not possible to say that that is an income tax and we should not allow a credit.

Well, that is a quick, bird's eye view, Mr. Chairman. I believe that on examination you will find that most, if not all, of our proposals are aimed at not major restructuring of the Tax Code in order to make some fundamental change, they are more in the nature of repairs than capital improvements.

We are simply trying to get the law back to what it was intended to be, and essentially I do not believe that any of these will prove obstacles to economic growth of this country.

We look forward to working with you on these matters. I see you have already suggested that some portion of them, at least, is in the realm of possibility. I hope to be able to persuade you to move a lot closer to our number than your original starting point.

I will be glad to answer any questions that you have.

The CHAIRMAN. Well, thank you, Senator Lubick.

Mr. LUBICK. Well, thank you for the promotion. I will take a vote. [Laughter.]

The CHAIRMAN. Unfortunately, Mr. Moynihan did not give me his proxy, so we will have to wait on that one.

But I do want to commend you for making your proposals generally prospective. I think that is important. It enables Congress to consider these proposals without disrupting the market business transactions in the interim.

But let me turn to the proposal. The President's fiscal year 1998 budget proposal describes the revenue raising package as follows:

"The President's plan cuts unwarranted corporate tax subsidies, closes tax loopholes, improves tax compliance, and adopts other revenue measures."

My first question is, what is an unwarranted tax subsidy or corporate tax loophole?

Mr. LUBICK. I would say it is a misuse of Code provisions in a way that was never intended. I would say the illustrations of designing financial instruments getting very close to the line without carrying out the purpose that Congress intended to be resolved is an example of an unwarranted benefit or a loophole, if you will.

The CHAIRMAN. For example, the President's budget calls for allowing companies a 50 percent tax credit, or up to $10,000 of wages paid to people who have been long-term welfare recipients. Now, why is that not an unwarranted tax subsidy for those companies? Why is it not corporate welfare, to use another expression that has been floating around?

Mr. LUBICK. I refrain from that phrase, Mr. Chairman.

The CHAIRMAN. Well, let us use unwarranted tax subsidy then.

Mr. LUBICK. It is an incentive to induce employers to hire certain persons that is necessary to make the welfare legislation work in the way that it was intended to, to create more jobs. I think that is a very important goal.

We are not suggesting the elimination of many, many incentives that are in the tax law, whether it be interest deductions to encourage home ownership, or whether it be charitable deductions to encourage charitable giving.

But I think the nature of the provisions that we are discussing are, by and large, a misuse of provisions in the Code, either because they involve new types of instruments that have been designed that were not even in the imagination of Congress at the time it enacted those provisions.

I think basically what we have been concentrating on are those areas in which there has been some subversion of the basic intent. In your illustration, the benefit that we are proposing is one that is being done consciously and with the intention of providing the benefit.

I would say most of the ones we have been talking about are ones that were not thought of when you enacted the legislation that supports them, and if they had been called to your attention you would have written something into the statute to take care of it.

I think one of the difficulties, as I indicated, is when you try to draw these very, very bright lines, there are some very smart tax professionals, some of whom are sitting behind me, among the best, and they can find ways to achieve results that we have not been able to foresee. I think a little grayness around the line is probably a great help in maintaining the integrity of the system.

The CHAIRMAN. Well, I think in many cases this sort of name-calling, whether it is unwarranted tax subsidy, whether it is corporate welfare, or whatever you call it, depends on the eyes of the beholder. I mean, you take your proposal of 50 percent deduction or $10,000 wage, that is pretty nice for the corporation, so it depends a little bit on how you view it.

But let me go on. The Administration proposes to reduce the dividend received deduction to 50 percent. It is argued that that will exacerbate the multiple level of tax on the same income stream and that it will, therefore, increase the cost of capital for corporations that issue the stock and could result in less equity investments by corporations.

Now, the Administration talks about being pro-growth, pro-job. How is this proposal consistent with the Administration's economic theme? How many times should we tax the same income?

Mr. LUBICK. Well, if I had my absolute druthers I would like to see, in an ideal world, a system of corporate shareholder integration, provided we got a full bite one time on all income. We are not operating under that system right now and that is a question for another day. But I think——

The CHAIRMAN. Are you supporting major tax reform?

Mr. LUBICK. I support major tax reform. I think perhaps my definition of it may be different from yours, but I think that is a different issue.

The CHAIRMAN. But a very important one.

Mr. LUBICK. It is certainly very important. I think we should have a Tax Code that raises taxes fairly and one that does not interfere with economic growth and development, and it would even be helpful if we had one that is relatively simple and understandable to apply.

The CHAIRMAN. You are talking my language, Mr. Lubick.

Mr. LUBICK. Well, I think this was first stated on April 20, 1961 by President Kennedy, as the objectives of a sound tax system.

The CHAIRMAN. I have cited that many times.

Mr. LUBICK. Well, that is a good start. At least we are talking the same lingo.

I do think on your basic question you are dealing essentially with portfolio investments rather than direct investment. I think in an ideal system, if we had a corporation that was essentially part of a control group, we would perhaps allow a 100 percent intercorporate dividend deduction.

In the case of portfolio investors, I would suggest that maybe a 0 percent intercorporate dividend might be appropriate because they are investing like every other investor for the yield that is going to be derived from the investment.

We have come up with a 50 percent proposal. Whether you would consider that the wisdom of Solomon or not, I do not know. But essentially this is an area where there is a lot of arbitrage, corporations have large interest deductions that we are not able to associate with these investments, and it seems to us that this is a pretty good solution, at least for the time being, to those type of problems.

The CHAIRMAN. I will ask one more question, then turn it over to Senator Conrad.

It does seem that your package does use a "heads for government win, and a tails the taxpayer loses" approach. For example, the proposals relating to certain debt instruments would deny or defer the interest deductions because they look like equity. But you do not treat them as equity for other purposes, which means no dividends receive deduction.

Then again when you think an equity instrument looks like debt you deny the dividend received deduction, but you do not treat it like debt for other purposes, which means no interest deduction for the corporation. Is this good tax policy?

Mr. LUBICK. Yes.

The CHAIRMAN. What a surprise.

Mr. LUBICK. I think you have put your finger on the reason why we made these proposals, which is, up until now, it has been "heads, I win, tails, you lose." But we have been the losers.

The CHAIRMAN. But it makes sense, in your judgment, in one case to treat something like equity because it means more revenue for the Government, but elsewhere, if it loses revenue, we will treat it otherwise.

Mr. LUBICK. No.

The CHAIRMAN. Do you think inconsistency is a good policy?

Mr. LUBICK. No, that is not my point.

The CHAIRMAN. I think it is.

Mr. LUBICK. We have a very bright boundary line. Taxpayers are able to get, in effect, in these instruments the benefit of equity for business purposes and the benefit of debt for tax purposes, or vice versa. They are able to structure these instruments in abnormal ways that are not necessary for normal business arrangements.

They can structure them as essentially debt, and if they find a person they want to market to who needs a dividend received deduction, it will be equity for that purpose. So I think we are dealing in a very narrow area around the borderline where taxpayers can straddle and play it both ways.

If you are talking about normal business practices, anybody who wants to create a true equity instrument or anyone who wants to create a true debt instrument can do so. These are really hybrids. Hybrids are really good for guidance, but I do not think they are great for the tax system.

The CHAIRMAN. Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman. Thank you, Mr. Lubick, for being here.

I would just make an observation, that to the extent these provisions contribute to balancing the budget, they clearly are pro-growth and pro-jobs. They are pro-growth and pro-jobs because the overall economy gains by our moving to balance the budget. The reason that is the case is because, if you look at non-financial sector debt in this country, it is $14.5 trillion.

The economists tell us if we balance the budget we will see interest rates come down about 1 percent. A 1-percent savings on $14.5 trillion of non-financial sector debt is $145 billion a year in lowered cost to business, to individuals, and to all entities that owe money. That provides an enormous lift to the economy.

One of the reasons the 1993 budget deal has proven so successful is that fact. While some said to us when we were cutting spending—and, yes, raising taxes—on the wealthiest 1 percent—that it was going to crater the economy. I remember those words very well.

They told us that the 1993 plan of deficit reduction would not lower interest rates, would not reduce unemployment and would not reduce the deficit. They were wrong. They were wrong on every single count.

It reduced unemployment dramatically. We have had nearly 12 million jobs created in this economy. The deficit has come down by nearly two-thirds, 5 years in a row now of deficit reduction, if the latest projections on this year's deficit prove to be correct.

All of it happened, in part, and many of us believe in significant part, because we put in place an overall plan of deficit reduction that lowered real interest rates and that led to an economic lift of over $100 billion a year in this economy.

So I believe an overall plan that moves toward balancing the budget is clearly pro-growth and pro-jobs and we have only to look at the 1993 plan which, yes, raised taxes—absolutely it did on the wealthiest 1 percent in income tax—but also cut spending.

It is, I think, imperative that we enact another package of deficit reduction that moves us to balance so that, in fact, we lift this debt burden that overhangs our economy.

With that said, Mr. Lubick, there are provisions here that I question as well. [Laughter.]

Mr. LUBICK. I thought it was too good to be true.

Senator CONRAD. Yes, it was too good to be true.

First, on your net operating loss changes. This is a very small item, but in a State like mine, an agricultural State that has tremendous fluctuations in terms of income, being able to carry back operating losses 3 years rather than what is proposed in this package of 1 year is attractive, much more attractive than going further in carry-forwards, as you proposed. We now can carry forward losses 15 years, carry them back 3 years. You are proposing carrying them back 1 year and carrying them forward, as I understand it, for 20 years.

What is the rationale? It is a small amount of money, $3.5 million, as I read the numbers here. Something more than that, perhaps? Nonetheless, a relatively small amount of money involved. What is the rationale in terms of policy?

Mr. LUBICK. Well, the rationale, Senator, is to obtain a better matching of income. The general tendency of taxpayers is to accelerate deductions and to defer income. If you have these net operating losses, we think they are much more attributable to income that is to be earned in the future rather than to past income.

Senator CONRAD. Let me just say that if you and I went to a town meeting in North Dakota and we had a group of farmers there—and we are in the midst of the worst disaster in 100 years—that explanation would not float very well.

We have just experienced the most severe winter in 100 years. The last blizzard, our eighth of the year on top of 6 winter storms, was the most powerful blizzard in 50 years, all on top of the worst flood threat in 150 years. The economic losses in my State are going to be staggering.

We have already lost, Mr. Chairman, 112,000 head of cattle. We anticipate literally millions of acres will either be severely delayed in planting, or not be planted at all. I really question whether a 1-year carry-back is appropriate.

Mr. LUBICK. Senator, I do not want to inflame you further, but I think this provision raises about $3 billion over the period through 2002.

Senator CONRAD. Three billion dollars.

Mr. LUBICK. It is somewhat more significant than you indicated.

Senator CONRAD. Well, it does further inflame me because that means I have obviously got a misplaced decimal. Three point five billion dollars?

Mr. LUBICK. Three billion dollars.

Senator CONRAD. Three billion dollars.

Mr. LUBICK. I believe that is the number. It is significant.

Senator CONRAD. Well, it just seems to me that that is an inappropriate change and I am not hung up with 3 years necessarily, but I really wonder if we are not going too far.

One other matter, if I might, Mr. Chairman, if I could beg the indulgence of my colleagues, would be on the question of Section 29 credits for biomass and coal facilities. I think everyone here knows that my State is a major coal producer.

The Small Business Job Protection Act of 1996 extended the placed-in-service date to July 1, 1998. The proposal before us would shorten the date to July 1, 1997, repealing 12 months of the 18-month extension. In a March 17 letter signed by myself and 18 of my colleagues, we called for the year extension to be retained. As of yet, we have not had a response.

I would just say to you, this to me is a matter of fairness. It is sort of changing the rules in the middle of the game. I have got companies in my State that have spent hundreds of thousands of dollars, in some cases approaching millions of dollars, on the basis that we were going to have, as the law called for, a window of opportunity to July 1, 1998. When you changed the rules in the middle of the game, it creates problems.

We have already had a major project in my State decide not to go ahead on the basis of this. It is a project that would not only be beneficial to my State, I think it would be beneficial to the Nation, because it was a new method of taking more sulphur out of coal, reducing environmental pollution, and improving the combustibility of that coal.

I will not ask a question because I will not take any more time of my colleagues. I would just say, I think that also is a mistake.

The CHAIRMAN. Senator Bryan.

Senator BRYAN. Thank you very much, Mr. Chairman. Mr. Lubick, welcome to our committee this morning.

I believe that the Administration deserves credit for putting a budget plan out there that balances the budget by the year 2002. There are critics galore, but we have not seen their alternatives. So let me just say as a starting point, I think some credit needs to be given to the Administration for laying out a plan.

My question to you, first, is 2002 is a goal that we have all agreed on, from 1600 Pennsylvania Avenue to Capitol Hill, and both sides of the political aisle, and that is fine.

My question is, what happens in 2003, 2004, 2005?

Because if we do not put the necessary structural changes into this plan, yes we may be able to reach the Holy Grail in the year

2002, but, I mean, it seems to me this is more than just a game as to who can get there to 2002.

I am thinking in terms of, I associate myself with the general observation made by the distinguished Senator from North Dakota. Balancing the budget is the most important thing I think that we can do in terms of strengthening the economy. As you know, Mr. Lubick, that involves some very, very difficult choices, particularly with respect to the entitlement programs.

So if you can just share with me, in general, in 2003, 2004, 2005, if you have got that data before you, what happens if we adopt this plan in its entirety, as proposed by the Administration?

Mr. LUBICK. I am not familiar with the spending side of the budget because my work is essentially on the tax side. You are perfectly right that getting to budget balance in 2002 and then going over the abyss could be, and would be, a catastrophe.

I have attached to my statement the 10-year numbers that have to do with the revenue side of this. Our net revenue reduction, of course, is about $22 billion over a period through 2002, and over the period through 2007, we have a total tax reduction of $225 billion, but we have revenue offsets of $160 billion plus.

So we think it is within the responsible area that will make a contribution to the objective which you are seeking that will be consistent with other savings that will be affected on the other side of the budget that I have no responsibility for. You are perfectly right on your point.

Senator BRYAN. That, to me, is very important. I think 2002 is important and I am pleased that we have all agreed to that. But to hit that number and then go off the chart to the following year, it seems to me we have deceived the American public, that we have really provided another one of these gimmicks. In terms of the long-term prospect, it does not look particularly good.

This may be outside of your bailiwick and portfolio, too, but I think whatever one thinks of the Tax Code, and virtually everybody has much criticism about it—and I join in with much of that criticism—but we have thousands and thousands and thousands of pages of regulations.

We have spawned industries that probably employ millions of people planning, analyzing, evaluating, counseling on this thing. What can you tell us about the Administration's proposal in the context of simplification, will we actually see a reduction in the number of pages of regulation?

That may not be the most perfect criteria, but at least it is an indica that some of us can relate to and say, gosh, if we knock 1,000 pages out of that, somebody is going to have a little less eye strain at the end of the tax season.

Mr. LUBICK. I would like to go, first, to one more comment on your first point, which is that I would hope that in this committee's deliberations, when they are considering the tax questions, that they will look not only within the 2002 budget window, but also look at the out-year consequences of anything that is done.

I think you are perfectly right, one has to consider this in a way that is not gimmicky, by simply doing something that produces one result through 2002 and then the bottom falls out thereafter.

On simplification, we started with a modest collection of proposals which we released this past week. We had not anticipated at the time we first started working on this that simplification was going to be so much front and center. It has always been a concern with me because I guess I am a tax wonk, and I agree with you that we have got to do something to clean this up. I met with some people from the bar association who for years have been saying we have got to do something, we are getting discouraged, we are going to stop. And I said, we will start modestly. We made a proposal.

Senator BRYAN. It is kind of a frightening prospect that we ask the bar association to review this thing in terms of simplifying. I have never been a tax lawyer, but my experience is, giving this to a group of lawyers to work on, simplification may involve another couple, 3,000 pages.

Mr. LUBICK. I will say a word for my brethren in a number of the bar associations that I work for who practice in this area. They will find plenty to do, even if we make massive steps toward simplification.

I think some of the people you are going to hear from in the next panel, in particular, have been active in these associations and have been really setting aside their private and personal concerns in a genuine attempt to deal with the problem.

In many cases, they show a deep concern for the guy who is most troubled by complication, which is the ordinary guy that cannot afford their services. So I think there has been a genuine movement among leaders of the tax bar who have been very responsible to try and deal with these problems.

Our proposals, for example, will eliminate, and I have not got the exact number of pages, but one of the most complicated areas which involves recordkeeping and which involves interpretation of difficult sections of law, has been dealing with taxpayers' reporting of gains on the sale of a house or reinvestment in another house. Our proposal with respect to the capital gains treatment of houses has virtually wiped that out for most taxpayers.

We have done a number of other proposals in there, one, as I remember, involving filing of returns by kids who may get a newspaper route. I think we have eliminated the necessity of filing separate returns for about 1.7 million children that happen to have a small interest savings account and also work for a living.

In another area, on dependency of care, we have eliminated a couple of columns of fine type. I have not measured it in inches or centimeters, but we have made some steps.

Senator BRYAN. I appreciate that.

Mr. LUBICK. They are not dramatic, but I think they are a start and we are going to continue.

Senator BRYAN. I thank you.

Thank you, Mr. Chairman. I apologize to Senator Murkowski that I went over my time.

The CHAIRMAN. Senator Murkowski.

Senator MURKOWSKI. Thank you, Mr. Chairman.

Mr. Lubick, I want to send you these complaints that my office has relative to the complications and complexities of the income tax return, and those of my grandchildren who are having to file now and they cannot figure out why. If you suggest the process is being made simpler, why, I am sitting on the moon right now.

Speaking of simplicity, while we all have this priority, Republican or Democrat, relative to the balanced budget, I assume you agree that reality dictates—and you have been around Washington a long time and have seen the enthusiasm of those of us on this side of the dias relative to the fact that we are going to do something about balancing the budget. Unfortunately, 70 percent or more of deficit reduction in the President's plan is going to be achieved in the year 2001 and 2002. Is that a fair reading, yes, no or maybe?

Mr. LUBICK. You are probably more familiar with that than I am. I think it is probably——

Senator MURKOWSKI. I am talking about the President's budget.

Mr. LUBICK. As I understand it, it is going on a normal curve that would be expected to——

Senator MURKOWSKI. All the tough decisions are in the last couple of years.

Mr. LUBICK. No, I do not think so.

Senator MURKOWSKI. The current occupant of the White House is not going to be here.

Is it not also a fact that CBO suggests that it is not going to be in balance in the year 2002. It is going to be $64 billion out of balance.

Mr. LUBICK. CBO has suggested that.

Senator MURKOWSKI. All right.

Mr. LUBICK. We think our revenue assumptions are——

Senator MURKOWSKI. Well, hopefully you and I will have an opportunity to see each other in the year 2002 and the record will note my curiosity and your response.

Mr. LUBICK. I note the Chairman may be on board with us.

Senator MURKOWSKI. Well, I understand you are old law school affiliates.

Mr. LUBICK. We are classmates.

Senator MURKOWSKI. So you have a special relationship. I am not a lawyer, so I am going to get to the bottom line.

Mr. LUBICK. I do not have that much influence.

Senator MURKOWSKI. I am concerned about the depletion on hard-rock minerals. I am very troubled by the proposal where the suggestion is that we deny depletion for mining activities on Federal land under the excuse that, well, you are getting the land for nothing anyway, so therefore there is justification for the application of the depletion allowance denial.

We have seen the mining industry in this country move offshore. We have seen it move offshore in Mexico, we have seen it move offshore in Canada. Your proposal affects the 1872 mining law. As you know, a mine may have a mixture of types of properties that occurred under the Homestead Act, Mineral Leasing Act, land acquired and swapped, and so forth.

I am just wondering why the Administration seems so hell-bent on driving resource industries that are competitive in a world market offshore and the jobs that go with them. This is what is going to happen, realistically.

I am curious to know if you have looked at the potential loss as associated with denial of the percentage depletion allowance in this regard.

Mr. LUBICK. Well, we do not anticipate that it will be such a loss. We think the incentive in the cost of acquisition of these lands is certainly adequate.

The percentage depletion was originally intended as a substitute for the rather difficult method of computing cost depletion, then it became an incentive. But it was, to my mind, never intended in the situation where there was no significant investment by the taxpayer.

But I am willing to sit down with you, Senator, and explore this question as well.

Senator MURKOWSKI. All right. Well, we would appreciate it if you would be willing to sit down with the industry as well, because you know it takes billions and billions of dollars to develop some of these properties.

Mr. LUBICK. Sure.

Senator MURKOWSKI. It is not sufficient to have them competitive in our domestic market. They are either competitive in the world market where you have a lot of factors, lower labor costs and various other things, and I am very concerned about the implication of this, which leads me into the 50/50 source rule, where I understand it appears that the rule benefits companies who manufacture in the United States and then export, but it only helps those exporters if they have foreign operations and pay more foreign taxes than they can get credit for for their U.S. taxes.

So would it not behoove many of these companies, if we repeal the rule, why will many of these companies not simply move their U.S. production overseas rather than continue exporting from the United States?

Mr. LUBICK. Well, we have had a lot of economic analysis on this and we have actually met with the export coalition that represents these companies. We met just yesterday, actually, with their economist, who happens to be a former colleague of mine and is a very respected economist.

We have some differences on the economics. We are exploring that as well. We certainly do not intend to encourage that and our economic analysis leads us to the conclusion that that is just not going to happen.

Senator MURKOWSKI. Well, an economic conclusion is one thing, and the people that have to compete in the marketplace and their opinion are oftentimes diametrically opposed. I understand the U.S. tax treaty network is limited to about 56 countries, leaving out about 150 other countries with no treaties. The implication of this and firms getting caught in this dilemma are very real.

If I may, one last question relative to foreign oil and gas income. This, again, I gather, is the Administration's proposal, that essentially all foreign oil and gas income be subject to current U.S. tax treatment, which restricts the use of foreign tax credits for oil and gas companies.

As you know, our energy companies are competing around the world to obtain access to new areas for oil and gas development, and this Administration has virtually closed down exploration on public lands in the United States, and certainly in my State of Alaska with regard to ANWAR. So we have got companies that are competing with giant, foreign consortiums.

It seems to me that when we are, what, 52 percent dependent on imported oil at this time, we should not be putting U.S. companies that are active at a competitive disadvantage against their foreign competitors by adding what I am told is about $370 million worth of tax hikes on their foreign operations.

It would seem to me that they do not operate overseas necessarily because they want to, they operate overseas because they have to have a supply in order to stay in business. We are throwing a $370 million tax hike on their foreign operations, which I assume would be a disincentive to some extent.

Mr. LUBICK. I think basically we are only dealing with those countries where there is no income tax and under the foreign tax credit rules. We are trying to avoid double taxation of income.

In other countries where they explore and are subject to an income tax, yes, they continue to get the foreign tax credit. But essentially what they are doing is paying a royalty for the extraction of the mineral to the government that is the owner of the mineral.

That is just not a situation where the foreign tax credit is the device. I do not know that there is any evidence that they are not going to continue to explore these very profitable contracts.

Senator MURKOWSKI. Well, profitability is dependent on a lot of factors, royalty and other agreements, and we are throwing a $370 million tax hike on foreign operations.

The question that I have, and they ask me, is, all right, what does that do to our international competitiveness relative to what a foreign owner, non-United States, can do in the international marketplace. They are looking at an additional tax hit here and you are suggesting they can afford it.

Mr. LUBICK. I think they can and I do not think it is going to affect their competitive position. I do not know who else is going to come in. Certainly if they are extracting oil in these countries, they are doing so on a very profitable basis.

Senator MURKOWSKI. All right. I am told, and I thank my staff, that Joint Tax suggests it is $1.5 billion as a hit, not $370 million. So I would hope that the record would reflect the change relative to my statement and that we could have a response from you, Mr. Lubick, concerning the implications of this because it is a pretty heavy hit, according to Joint Tax. Would you be inclined to do that and let us know?

Mr. LUBICK. We will be glad to, surely. Sure.

Senator MURKOWSKI. So we can feel free to get a response on foreign oil and gas income, the 50/50 source rule, and the depletion on hard-rock minerals and what effect it would have on the domestic mining industry.

Mr. LUBICK. Sure.

Senator MURKOWSKI. I thank you.

Mr. LUBICK. Yes, sir.

Senator MURKOWSKI. I wish you good day, and I hope I see you before the year 2002. But I will not forget our conversation.

Mr. LUBICK. All right.

The CHAIRMAN. Senator Moseley-Braun.

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman Thank you, Mr. Lubick.

Actually, a couple of my questions have been put already, particularly the simplification question. I will never forget a meeting with a woman whose name I do forget, who is tax counsel for a large, multinational corporation.

She had before her about 30 loose-leaf binders that represented the tax filing for that company. She pointed out to me, I have to sign the bottom line of this to swear that everything in here is true and correct.

So simplification in this area, I think, is as desirable as simplifying the taxes paid by individuals.

Senator Bryan and Senator Murkowski both have raised the question, what does this proposal do in that regard.

Mr. LUBICK. Well, we did announce some simplifications yesterday, or this week, in the foreign tax credit area and in these areas, which, again, is a start toward trying to solve those problems which are immensely complex.

In particular, we had a proposal where corporations do not own a majority of the investment, they are in between 10 percent and 50 percent owners because they are in joint ventures, and up until now they have had to make foreign tax credit calculations with respect to each of their separate investments. Some of them may have had 50 different calculations.

We are proposing to combine that all into one, and I think that has been a simplification that has been rather enthusiastically received by the taxpaying public, this particular taxpaying public, in any event.

Senator MOSELEY-BRAUN. Well, I am happy to hear that. I have two specific questions that do not go exactly to simplification, but certainly go to fairness on the one hand, and the objectives of our Tax Code generally.

Were you at the Treasury in 1993?

Mr. LUBICK. No. No, I was not.

Senator MOSELEY-BRAUN. Have you had a chance to examine the Treasury Department's study that was made in 1993 regarding the operation of the export source rule?

Mr. LUBICK. I have been involved in studying the literature on that subject, going all the way back, yes. In fact, we may have here some of the people that worked on it.

Senator MOSELEY-BRAUN. Well, I guess my question, and again following on Senator Murkowski's question to you regarding the effects of the proposed change in the export source rule, in 1993 the Treasury Department ruled that if the 50/50 rule was replaced by an activity-based standard, then goods manufactured here in this country creating jobs for American workers that are exported would decline by a substantial amount.

That was the Treasury's own study, that changing the 50/50 rule to an activity-based rule would diminish export activity. I am just concerned what happened between 1993 and today that would give rise to the proposed change. You mentioned that you were debating with some economists about the economics here. I just wonder, what economics changed between then and now?

Mr. LUBICK. I think, as I understand it, our conclusion was that the amount of exports would be declined by less than the revenue lost on the provision.

Senator MOSELEY-BRAUN. Well, I wish you would take a look at that, because it is my understanding that it was more than an insignificant decline.

Mr. LUBICK. We will be glad to communicate with you on this subject.

Senator MOSELEY-BRAUN. I would appreciate that.

Mr. LUBICK. We will get you the economic material.

Senator MOSELEY-BRAUN. I would very much appreciate that because, again, I share Senator Murkowski's concern in that area.

Another issue, and the Chairman may remember this, when I first got on this committee, and maybe it was a function of naivete or whatever at the time, I was appalled that the Congress moved to retroactively change a tax law in order to catch a particular transaction.

In that case, it was a matter of getting rid of affirmative action in broadcasting. We had had in place a tax certificate program that was being repealed retroactively in response to a particular deal.

Now, while obviously we want to get certainty and regularity and we want to have the objectives of the Code achieved and we want to overcome or be smarter than the smart lawyers that figure out ways to get around the Tax Code—which is kind of tough, actually, when you consider it—at the same time, retroactive repealers just do not sit well with me, retroactive changes to the tax law.

Now, there is a proposal in here regarding the recognition for certain extraordinary dividends. There is a change proposed in the Administration proposal there, a section 1059 change. But the effective date is May 3, 1995. I just do not think it is right.

I mean, if you find something that is an abuse, then you fix it. But to go back to May 1995, and we are now in April 1997, just seems to me to just roil the credibility of our tax-making and tax policy.

I would like your response as to why we could not have just done this within a current effective date and go forward and say, this shall not happen anymore. Not, we are going to go back and try to change the law after the fact.

Mr. LUBICK. Generally speaking, I think we are clearly in agreement with you that retroactive changes, especially retroactive legislative changes, are unfair and undesirable. In this particular case, the transaction engaged in, we think, was particularly abusive and I believe there is a bipartisan consensus on this. This was picked up.

Senator MOSELEY-BRAUN. There was bipartisan consensus to repeal the tax certificates of minority and women broadcast purchasers, too. That did not make it right.

Mr. LUBICK. Well, no. But this was a little different. In this particular situation there was a taking of an advantage which clearly was contrary to the intent of Congress and seems to us——

Senator MOSELEY-BRAUN. It sounds like the same argument that was made about the tax certificates. That is all I am saying. I mean, you are not going to get any violins playing for the people who were involved in that transaction.

You could be right that it was, again, some clever tax lawyers figuring out a way to get around the system, but they operated it based on the law at the time. For us to go back and say, whoops, you did it legally but we are going to change the law after the fact, just does not seem to be right to me.

Thank you, Mr. Chairman.

Mr. LUBICK. Well, I think you are right, generally. But this is not a game of soccer that we are playing here.

The CHAIRMAN. Thank you, Mr. Lubick. We will keep the record open until 5 p.m. for anyone that may want to submit questions in writing.

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

The CHAIRMAN. We appreciate your being here.

At this time I would like to call forward the second panel, a very distinguished group, who will discuss the Administration's revenue raising proposals.

I am pleased and honored to welcome Professor Martin Ginsburg, Hon. Fred Goldberg, Dr. Gary Hufbauer, and Ellen MacNeil.

I know each of you have been asked to discuss several of the proposals. I would ask you to limit your testimony to 5 minutes so there is more time for questions.

Professor Ginsburg, it is a great pleasure to welcome you. We would ask you to begin.

STATEMENT OF MARTIN D. GINSBURG, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER, WASHINGTON, DC

Professor GINSBURG. Thank you, Mr. Chairman, members of the committee. It is very nice to be back here.

If I may, I would just like to pick up on two things Mr. Lubick, who is almost as old a friend of mine as he is of yours, said. In answering your question on what is a loophole, he referred to "the use of a Code provision in a way never intended."

In speaking of what are the objectives of the Administration's proposals in the corporate tax area, Mr. Lubick said, "simply to get the tax law back to what it was intended to be." Taken together, this sounds like the tax lawyers have come up with new, crazy schemes to which the Administration's corporate tax proposals respond. I do not think, in the main, that is true. That is really the theme on which I will speak in the next few minutes.

Of the Administration's six proposals that were referred to me, I think two are commendable, which leaves the other four. The two that I think are commendable are the proposed change in section 1059 that Senator Moseley-Braun referred to.

Senator let me just say that the retroactivity there, which would bother the life out of me in ordinary cases, too, is not retroactive to upsetting the transaction that was done that focused the Administration's attention. The date, I believe, May 3, 1995 is after that proposal. So it is a really a shut-down for the future which, I think, makes us all feel a little bit better.

The other proposal that I think is sensible is the last of the six that were referred to be changed with respect to section 304 of the Code, which is so technical you cannot believe it. Actually, it is the Treasury's third try to fix the same mistake, and they may have it this time.

The other proposals, I think, are very unfortunate. They have something in common. They identify a tax rule that has exhibited great stability in the law. It has been out there a long time.

In application, each of the four tax rules has been accounted sensible by everybody, in and out of the Government, and then to no decent purpose that I can think of, they simply gut the statute.

In my written statement I deal with these at length. Let me deal, very briefly, with three of them and, in whatever time you give me, talk about the fourth, which is the only one I think is interesting.

Let me start with the worst. The Administration amazingly proposes a tax increase limited to corporations and to individuals engaged in any business that is not doing too well.

They propose to accomplish this grand feat and raise thereby something like $3.5 billion over 5 years by throwing out 40 years—40 years—of settled tax law. That is what you do when you say the 3-year net operating loss carry-back, which has been with us since 1958 will, starting next year, become a 1-year carry-back.

The asserted justification for this in fact is not what Mr. Lubick suggested in the colloquy earlier. The asserted justification that we have been given in writing is what I would call a sudden appreciation of efficient government, a sudden concern with "the complexity and administrative burden of carry-backs." This, after 40 years and in the age of computers, is not what I would call a triumph of truth-telling.

Second, the Administration proposes to tax the receipt of preferred stock in certain corporate transactions. In one respect, this is the most extraordinary of the Administration's proposals. It would overturn more than 70 years of uninterrupted, consistent tax law to no sensible purpose, not even a decent revenue estimate. I do not really mean to seem emotional about these. [Laughter.]

The Administration's third proposal that you ought not adopt would treat as a fully taxable, complete liquidation the election to convert a C corporation to an S corporation.

Realistically, as I discuss in the written testimony, it is a proposal simply to repeal subchapter S, effective January 2, 1998 for all C corporations that are worth more than $5 million, and as a practical matter for all new enterprises as well.

It is particularly hard to understand this one. Subchapter S has actually worked well since its introduction in 1958. Last year, this committee and Congress spent a lot of time improving and extending subchapter S. It is hard to believe that you would gut it this year.

The last of the proposals, which unfortunately faces a red light——

The CHAIRMAN. Please proceed.

Professor GINSBURG. Oh, thank you.

Is the Morris Trust transaction proposal. The Morris Trust transaction has been with us over 30 years. It has been tax-free for that entire time.

If you adopt the Administration's proposal, which is really weird, since it would make the taxation hang on whether a subsequent transaction is hostile or friendly—there are days when I cannot figure out if my relationship with my 6-year-old granddaughter is hostile or friendly, but I know it changes regularly—but in any event, you will certainly promote the inefficiency of the system.

I do not want to talk about the technicality of it, but I think it would be useful to the committee to actually know what a Morris Trust transaction is. I would like to give you one from real life, in this case my own, 30 years ago. Here was the situation. X corporation was a moderate-sized, publicly-held company. It had operated for many years two businesses.

One was a commercial business worth about 90 percent of the company, the other was a radio station worth 10 percent. P corporation, a much larger public company, wanted to acquire the commercial business by merging X corporation into P, in a perfectly straightforward, all stock transaction. Everybody was enthusiastic. It made good business sense. There was one problem.

The one problem: if X still owned the radio station on the date of the merger X and P would need advance approval from the Federal Communications Commission, the minimum time for which would have been 18 months. This is a show-stopper; you cannot do the transaction. As a matter of fact, X could not sell the radio station because of the required FCC approval.

The only thing X could do was drop the station into a new subsidiary, Newco, and spin off Newco to the existing shareholders of X corporation. That attracted automatic FCC approval, and that is what we did.

The result was that, when the dust settled on the transaction, anybody who before the deal had owned $100 worth of X corporation stock now owned $10 worth of Newco stock and $90 worth of P stock. That is the transaction that the Administration urges you to tax.

Now, that does not make sense. I appreciate that there is an issue, to my mind a separate and distinct issue, that deals with so-called leveraged Morris Trust transactions, transactions in which substantial amounts of money are borrowed and the cash goes one way and the debt goes another way, and the company with the debt is the one that then is acquired by, in my example, P corporation. That issue, I think, merits serious attention.

You may in the end consider the leveraged spin-off not a great problem, which is my own view of it. You may think there is a problem that should be attended to. I discuss the issue at length in my written testimony, and suggest what I believe to be a coherent approach if the committee wants to address leveraged spin-offs in a focused way.

But to use that issue, the leverage issue, as the Administration would, to throw out all of the absolutely inoffensive Morris Trust transactions, simply makes no sense. To go back to what Mr. Lubick said about loopholes and about the objectives of the proposals, what he said simply does not match what the Administration asks you to do concerning four of these proposals.

The CHAIRMAN. Thank you, Professor Ginsburg. Now we would like to call on Hon. Fred Goldberg.

[The prepared statement of Professor Ginsburg appears in the appendix.]

STATEMENT OF HON. FRED T. GOLDBERG, JR., PARTNER, SKADDEN, ARPS, SLATE, MEAGHER & FLOM, LLP, WASHINGTON, DC

Mr. GOLDBERG. Thank you, Mr. Chairman. It is a pleasure to be back. It is a pleasure to see you shifted seats.

The CHAIRMAN. Thank you.

Mr. GOLDBERG. The Administration's proposals in the area of their capital market revenue raisers are not loophole closers, nor are they a tax on the most recent euphemism, unwarranted tax benefits.

These proposals are tax increases on real people and real businesses. They are tax increases that will discourage and penalize the very activities that are essential to savings, investment, job creation, and economic growth. They also represent major, and in my view ill-advised, changes in long-established tax policy.

They suffer from five defects. First, they represent random, unwarranted and sometimes astonishing changes in how we view the tax law. They are unprincipled in the truest sense of that word.

To prove the point, ask yourselves the following questions: Is there a unifying theme to these proposals; can I take the rationale for one proposal and apply it consistently to other suggested changes; should tax consequences be determined by financial accounting and non-regulatory rules, but only sometimes and only when it raises revenue; should instruments be classified as debt or equity on how they are "viewed," but only sometimes and only when it raises revenue; are we really comfortable with a wholesale departure from symmetry, but only sometimes and only when it raises revenue?

In my opinion, the answer to these questions is no. If the answer is no, you should reject the Administration's proposals out of hand. But, whatever you do, do not kid yourselves. The Administration's proposals in this area embody fundamental changes in tax policy.

Second, the Administration's proposals are contrary to much broader public policy goals. They make it harder, not easier, for everyday Americans to save and invest. They make it harder, not easier, for businesses to compete, create jobs, and meet the needs of their customers. They make it harder, not easier, for State and local governments to assume the responsibilities that the Congress and this Administration have asked them to assume.

Third, several of the Administration proposals are just like the Energizer bunny, they keep taxing, and taxing, and taxing the same income over, and over again.

Fourth, the Administration's proposals are inconsistent with the goals of balancing the budget and tax reform. Finally, the Administration's proposals are fiddling in the capillaries while the tax system requires major surgery.

We have heard talk of corporate integration, we have heard talk of entitlement reform, we have heard talk of simplification. These are important issues. They are issues that matter.

I personally share the view of you and many of your colleagues that the highest tax policy priority is to make it easier for everyday Americans to save and invest. The tax law can play a profound role in helping workers and families create the private wealth that is necessary to meet the individual and collective challenges we face in the 21st century.

I am certain that it is possible, within the current budget framework, to make dramatic strides in that direction. This is where I believe the committee should be spending its time. The Administration's proposals are a needless distraction, proposals that move the tax system in the wrong direction.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Goldberg.

Now I call on Dr. Hufbauer.

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

STATEMENT OF GARY C. HUFBAUER, PH.D., REGINALD JONES SENIOR FELLOW, INSTITUTION FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Dr. HUFBAUER. Thank you, Mr. Chairman.

The U.S. system of taxing international income is incoherent and it needs thorough reform. I have laid out the problem in multiple publications which are available to anyone who cares to read them.

Today, the Administration has offered five proposals for increasing U.S. taxation of international income. Briefly let me just name them and cite the Treasury estimates, which differ somewhat from the JTC estimates: expanding subpart F, $200 million over 5 years, 1998 to 2002; modify taxation of captive insurance companies, $100 million; change foreign tax credit carryover rules, $1.2 billion; tighten foreign oil and gas extraction income rules—the provision that Senator Murkowski referred to—$400 million; then replace the 50/50 export source rule, which is the big one in this pot, $7.5 billion over 5 years.

The first four proposals on this list are a distraction from the much more important task of tax reform. The fifth proposal, the export source rule proposal, would severely damage the outlook for U.S. exports and it would also deprive American workers of billions of dollars of wage premiums in the high-paying U.S. export sector.

Mr. Chairman, in 5 minutes I cannot possibly describe the mind-boggling details of even one of the first four proposals. They are complicated because the U.S. system of taxing international income truly borders on chaos.

Those who believe that the underlying system just needs a little fixing here and there will probably characterize these first four proposals as loophole closers.

But if you accept that characterization, you would have to acknowledge—in the international area—the point that Mr. Goldberg made: there are many areas of reform which would cost revenue which are not on the Administration's list.

Just to tick some of them off: interest allocation rules; consolidating baskets of income; extending the foreign sales corporation to cover all service exports; getting rid of the characterization of domestic losses as foreign losses. All of these provisions are irrational. They would cost money to fix and they are not on the Administration's list.

There is only one revenue loser in the Administration's list and it is very sensible. I think it could have been done by regulation, as I have testified to before. It is the extension of the foreign sales corporation to cover computer software licenses. That will entail a revenue cost of $600 million over the 5 years.

If this is to be a year of repainting the trim on a rotting house, I would say, all right, go for the extension of the FSC to cover computer software licenses and pay for that with items 1, 2, and 4 on the Administration's list. That will not make Senator Murkowski happy, because item 4 is the foreign oil and gas. I would say leave the carryover rules alone, (item 3) for exactly the same reasons which have been touched on earlier by other witnesses.

If you mix that kind of paint, it would pay for itself. But I would much rather see the Treasury—and there are very talented people in the Treasury, Joe Guttentag on the international side is one of the best, and Don Lubick is excellent—and I would much rather see the House Ways and Means Committee and Senate Finance Committee apply their very considerable talents to basic tax reform.

The set of proposals before you is just a waste of time. I know that the political climate in 1997 is not auspicious for basic reform; I read the newspapers, too. But there is no way we are going to deal with our budget deficit problem, our Social Security problem, our National savings problem, and our international competitiveness problem without basic tax reform. So I say, stop this tinkering and go for the fundamentals.

Let me conclude with a short comment on the proposed changes in the export source rule. As a matter of disclosure, I am the consultant referred to, the economist for the Export Source Coalition. I have dealt with this proposal in detail in my testimony before the Ways and Means Committee.

For a 5-year revenue gain of $7.5 billion, that is the Treasury figure, or $8.5 figure, which is the JCT figure, both of which I think are overstated in terms of revenue pickup, this proposal, if enacted, will destroy abcut $170 billion of exports over 5 years.

Even if Alan Greenspan maintains full employment over the next 5 years—and he is another extremely talented person—this proposed change will deprive American workers of about $9.5 billion of wage premiums that are earned in export industries which pay better than alternative work in our economy.

So even if you have full employment, you are going to shift people out of high-paying jobs into lower paying jobs and the average decrease in pay is about $4,500 per worker.

Now, to recall Mr. Lubick's words, the republic will not fall if this happens. We are a big economy, we can take a lot of hits. Also, to recall his words, there are economists and there are economists, and there are others who disagree with me. Frankly, Senator, they are wrong. On this issue, they are wrong. As tax proposals go, this one is pretty bad.

Thank you.

The CHAIRMAN. Thank you, Dr. Hufbauer. Sorry time is so limited, with all of you.

We saved the best for last. Ms. MacNeil, we are looking forward to hearing from you.

[The prepared statement of Dr. Hufbauer appears in the appendix.]

STATEMENT OF C. ELLEN MACNEIL, PARTNER, ARTHUR ANDERSEN, LLP, WASHINGTON, DC

Ms. MACNEIL. Thank you, Senator Roth.

You have asked me to comment on the three tax accounting provisions in the Administration's 1998 budget proposal. I will address each of these provisions separately, however, I would first note that there has been a trend to tinker with tax accounting rules in order to raise revenues.

The result has always been, or has usually been, to widen the gap between tax accounting and financial accounting. These differences will frequently require taxpayers to maintain separate tax-only books and records, with the resulting increase in compliance costs and complexity. These are non-productive costs that impair U.S. competitiveness.

This also means that a taxpayer's regular accounting records and audited financial statements become useless to the IRS. These well-documented records which are relied on by other government agencies and by the public no longer provide a meaningful touchstone to the tax administrator. The Administration of the tax laws is made more difficult, and more controversy arises around tax accounting issues.

While tax accounting and financial accounting do not necessarily have identical goals—and I will agree with Mr. Goldberg that they have identical goals when it tends to raise revenue, they have dissimilar goals when they tend to lose revenue—when it is possible to keep these two accounting systems in concert, that should be considered a desirable goal.

I will, first, address the proposed repeal of components of cost. Manufacturers generally account for inventories in one of two ways, components of cost or total product cost.

Under components of cost, the manufacturer accounts for inventory in units of material, labor, and overhead. Under total product cost, the manufacturer accounts for inventory in units of finished goods.

Components of cost is the predominant and preferable method in industries where specialized and customized products are manufactured, where there is little inventory of finished goods, or where the products change from year to year.

For these taxpayers, the method is the most practical way to record inventories. In 1984, the AICPA issued a LIFO issues paper stating that components of cost is the preferable method, under generally accepted accounting principles, for manufacturers in these circumstances.

Regardless of the outcome of the Administration's proposal, these manufacturers would be obligated to continue to use components of cost for financial reporting purposes.

The explanation and analysis of this proposal prepared by the staff of the Joint Committee acknowledges that it is unclear whether it is possible or practical for some taxpayers to change to the total product cost method. I fully concur with that statement. Repealing components of cost would require affected taxpayers to maintain two separate cost accounting systems for inventories.

Assuming that a change is even possible, this would be enormously expensive and would add no additional value to the enterprise. These are redundant, nonproductive costs that would put American manufacturers at a competitive disadvantage in the world market. For these reasons, I respectfully encourage this committee to oppose the Administration's proposal to repeal components of cost.

The Administration has also proposed to repeal the lower of cost or market method, of inventory accounting. Taxpayers that use FIFO can value their inventory on cost, or lower of cost or market. Lower of cost or market allows the taxpayer to write down goods to market value if that value is below their cost.

The Administration's proposal would accelerate income, but would not change the ultimate amount of income that would be taxed. The cost of this is the additional compliance costs and administrative complexity of creating yet another book tax difference in accounting.

Further, it fails to recognize that a real economic loss has occurred when goods are marked down to less than their cost. For these reasons, I respectfully suggest that the committee also reject this proposal.

The Administration also proposes to terminate suspense accounts for family farm corporations that are required to use the accrual method of accounting. This suspense account was put in place as a transition rule to a provision of the 1987 Act.

The Joint Tax Committee analysis of this proposal notes that opponents argue that Congress has already addressed this issue in the 1987 legislation, and that to trigger the existing suspense accounts would impose liquidity constraints on taxpayers that had relied on present law, and would be retroactive in nature. I strongly agree with this argument.

The transition rules that are applied to legislative accounting method changes are a substantive part of the legislation itself. The suspense account was addressed as part of the legislation and should not now be changed. For these reasons, I also recommend that this proposal be rejected.

Again, I thank you for the opportunity to speak today.

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

The CHAIRMAN. Thank you very much.

Professor Ginsburg, let me go back to the Aministration's proposal to alter the tax treatment of certain preferred stock that is received in tax-free transactions. The argument is that this kind of preferred stock looks like an installment note. How do we respond to that argument?

Professor GINSBURG. Well, I thought in the questioning of Mr. Lubick the response was put very well. If you feel that it looks like an installment note and ought to be viewed as an installment note when it is received by the shareholder in a corporate organization or reorganization or recapitalization, then I guess what we should do is tax the recipient on the installment method, which the proposal says the Treasury should have regulatory authority to do so, and then allow the company to deduct the dividends as interest. But, of course, that is not the proposal at all, and it would cost gigantic amounts of revenue.

The truth is, when you look at the proposal it does not apply to family corporations and it says that if this kind of preferred stock is used, straight, plain, vanilla, debt-like preferred, it will be all right unless it is callable within 20 years, so that if you make it callable by the issuer in the 21st year, well, then it is not subject to this proposal.

But if you want to make it callable earlier, then to get it out from the proposal all you have to do is give it a growth factor, that is, use a convertible preferred, then it is all right. So you have all the options in the world and the taxpayers will, as far as the tax law goes, be able to handle it.

But if you think about it in terms of the economy, it is a genuinely foolish proposal. Companies do not issue convertible preferred stocks if they can help it, because there is a serious economic down side to that.

Why, as a matter of tax law we would want to, tell a company that could issue straight preferred in an economically sensible deal that it must issue convertible preferred, I cannot imagine.

The CHAIRMAN. I am concerned that we are constantly making changes in corporate tax laws to take care of a particular transaction that is not thought to be appropriate. Laws get more of a patchwork, inconsistent pattern. Whatever we do, it does not seem to solve the problem. How do we address this problem of achieving meaningful simplification of these laws without losing too much revenue, do you have any suggestions?

Professor GINSBURG. I think a number of observers, including some on your side of the podium, have made the suggestion that the tax system is not in wonderful shape. I think that is a fair comment.

If there is anything we, taxpayers and the system, would profit from with regard to proposals for change, it is repose. The idea of destabilizing 73 years of tax law seems, to put it mildly, a little unfortunate. What we ought to be doing is trying to reform the system in a much more basic way.

Mr. Lubick, I think, said it very well when, in effect, he said that if he were king, corporate-shareholder integration, which would be an opportunity to eliminate the debt-equity distinction that has so powerful an impact in present tax law. I think it would be enormously worth pursuing.

But if you do not pursue integration, then the idea of further tinkering—to use someone else's term—with the debt-equity rules I believe is just a mad idea.

The CHAIRMAN. Wrong way to go.

Professor GINSBURG. Very much so.

The CHAIRMAN. Mr. Goldberg, I told Assistant Secretary Lubick that I was concerned with "heads, the government wins, tails, the taxpayer loses." As a former IRS commissioner, does this kind of policymake sense?

Mr. GOLDBERG. No, sir, it does not. I think you have laid the question exactly the right way. What Dr. Hufbauer said, what Professor Ginsburg said, I think all of us feel the same. The tax system is in trouble today.

My own judgment is that one of the reasons it is in trouble is, there are all these proposals out there that make no sense. You cannot look the Senator's farmer in the eye. You cannot look the business person in the eye and say, the Red Queen rules; if we make more money we do it one way, and if we lose money, you lose. People lose trust with the system.

I think it is a terrible mistake to go down that road because we are savaging an institution that is already in trouble. My personal view is, we are all going to be forced to spend lots of time on these proposals. I think they ought to be wadded up, and the answer is to start where Professor Ginsburg said, go where Dr. Hufbauer said, and do something right and take the time. That is my own view on the subject. It is frustrating.

The CHAIRMAN. My time is up on the first round.

Senator Moseley-Braun.

Senator MOSELEY-BRAUN. I will be brief, Mr. Chairman.

I serve on both the Banking Committee and the Finance Committee, this one. I am very concerned. Ms. MacNeil, in her testimony talked about the differences that are occasioned between the financial accounting and the tax accounting.

I am concerned that the carry-back rule changes that are proposed will particularly impact on the banking industry that, in many instances, will see the deferred tax assets in the carry-forward, carry-back synergy, I guess is probably the right word.

I am just wondering, the industry is obviously not doing too badly these days, but at the same time, in the event that we saw a downturn, would you comment on the proposal, generally?

Ms. MACNEIL. That is a very good question. The proposal to cut NOL carry-backs down from 3 years to 1 year is, of course, devastating to cyclical businesses. Anybody who has up periods and down periods is very harmed by this provision.

But you are commenting on, I think, the financial accounting aspects of it. In order to reflect a tax loss as a deferred tax asset, there has to be a realistic ability to get the benefit from that, be able to carry it back and recover taxes paid or carry it forward.

The only way really to book it as an asset is when you are able to carry it back. I am simplifying this a great deal, but it will ultimately impair the balance sheet of companies. I think it is kicking companies when they are down.

When they are having losses, they cannot carry them back. A 1-year carry-back is not particularly useful. Giving the additional 5 years, years 16 through 20, if you have not been able to use an NOL in 15 years you are not going to be around in year 16 to use it. So, that is totally useless.

I had not been asked to comment on that provision, but I would oppose that as well.

Senator MOSELEY-BRAUN. Are there any other panelists who would like to comment on that issue?

[No response.]

Senator MOSELEY-BRAUN. No. All right. Thank you. That is all I have, Mr. Chairman. Thank you.

The CHAIRMAN. Thank you.

Dr. Hufbauer, I am a strong believer that to compete effectively in this new emerging global economy, or whatever you want to call it, is critically important to the economic success and creation of jobs of this Nation. Frankly, our current tax laws in this area seem to me to be hopelessly out of date and complex.

What do we do about the problem; how can we address this? What are your recommendations, in 5 minutes?

Dr. HUFBAUER. Even less time than that, Mr. Chairman I totally agree with your diagnosis. When I wrote the 1992 book with this wonderful purple color, I thought that it might be possible to reform the international side just dealing with it alone. I am now convinced, with 5 more years of watching the system evolve, that that is not possible.

I think the international reforms can only be embedded in the kind of reforms that Commissioner Goldberg talked about and Professor Ginsburg talked about, and others have talked about.

So I think you need to go at ???? in the basic tax system, and then international reforms will flow from that. But to just deal with international taxation alone, there will never be the constituency, and it will be an effort to try to fix up something which is a part of this much larger, more troubled system.

The CHAIRMAN. Let me ask you, Ms. MacNeil, one question. Some critics believe that the lower of cost or market is one-sided in that it permits a taxpayer to recognize a decrease in the value of its inventories, a decrease but not an increase.

How do you respond to that comment?

Ms. MACNEIL. That is a frequent criticism of that accounting method. There is a couple of points. First of all, assume a company manufactures widgets and it costs $12 to manufacture a widget, but because of market conditions they can only sell them for $10.

Once they have marked them down for $10, they have recognized a true economic loss. That $2 of cost will never be recovered. So, when you have a lower of cost or market method, it recognizes that a true economic loss has occurred.

First of all, reforming inventory to a mark to market system would be an enormous exercise. It would be mind-boggling because you would have to reflect anticipated profits on inventories and things like that.

I am actually having trouble comprehending how it would be done. I assume anything could be done, but it would not be easy and I do not think it would be very effective.

Almost all of our tax accounting system is based on recording historic events, not projecting the future or what might have been. There are a few exceptions because there are a few mark to market provisions. Only one, actually, that I can really think of.

If you are talking about moving inventory to a mark to market system, you really ought to talk about moving the whole company, the whole balance sheet to a mark to market system, where buildings have appreciated or depreciated.

I do not think you should pick and choose and say, well, this ought to be marked up as well as down. I do not think that would be effective just for inventories. But the mark-down does reflect an actual economic loss.

The CHAIRMAN. Well, I appreciate all of you being here today. I am somewhat a little discouraged, because it seems to me what we are talking about is not really addressing the basic problem.

Yet, the effort to reach a consensus on any overall tax reform has also been eluding us. If I hear what you are saying, however, it is that Congress must address the problem of basic reform and quit nibbling at the problem. Is that a fair statement?

Dr. HUFBAUER. Absolutely.

Mr. GOLDBERG. Yes, sir.

Ms. MACNEIL. Yes.

The CHAIRMAN. Anybody disagree?

[No response.]

The CHAIRMAN. I would ask you to send me a consensus document that will tell us how to reform the tax laws.

We very much appreciate your being here, and I admire each and every one of you for your contribution.

The committee is in recess.

[Whereupon, at 12:04 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF MARTIN D. GINSBURG

Mr. Chairman and Members of the Committee:

My name is Martin D. Ginsburg. I am a Professor of Law at Georgetown University Law Center where I teach various subjects in the field of federal taxation. My principal subject, as a school teacher and earlier as a practitioner, has been corporate tax. Over the past 25 years it has been my privilege to testify before this Committee on a number of occasions, at times at your request, at times on behalf of a bar association group, often simply out of an interest in the subject under review, but never on behalf of a client. At your invitation I appear today as an academic witness, a disinterested witness I like to believe, but certainly not an uninterested one.

As asked to do, I focus my testimony this morning on six of the revenue-raising provisions contained in the President's Fiscal Year 1998 Budget Proposals that fall into the corporate tax area:

1. Require gain recognition for certain extraordinary dividends, in general effective for distributions after May 3, 1995.[1]
2. Modify the net operating loss carryback and carryforward rules.
3. Treat certain preferred stock, received in otherwise tax-free exchanges, as "boot."
4. Treat as a fully taxable complete liquidation the conversion of a "large" C corporation into an S corporation.
5. Require gain recognition by the distributing corporation on certain distributions of controlled corporation stock in so-called "Morris Trust" and similar transactions.
6. Reform the tax treatment of certain related party corporate stock transfers (section 304 transactions).

Proposals 1 and 6 reflect sensible tax policy and merit the Committee's approval. The other four proposals do not reflect sensible tax policy; the proposals occupy the area bounded by very poor and truly awful, and merit the Committee's sincere disapproval.

I. ADMINISTRATION PROPOSALS THAT MERIT THE COMMITTEE'S APPROVAL

The first and last of the 6 Administration proposals under review are best appreciated as targeted corrections of long-standing errors. The corporate tax bar has for decades exploited these and similar mistakes for fun and profit. Publicity has overtaken the two that are now before you.

A. Require Gain Recognition for Certain Extraordinary Dividends, in General Effective for Distributions After May 3, 1995.

The transaction that spawned this retroactively effective legislative proposal was, all know, DuPont's redemption of most of the DuPont stock owned by Seagram coupled with Seagram's acquisition of an option to acquire from DuPont an equal number of DuPont shares. The plan, an aggressive, i.e. "pro-taxpayer," use of the §318 attribution rules—in this case the option attribution rule of §318(a)(4)—had been used, with far less publicity, for many years by subchapter C practitioners to convert proceeds of stock redemptions into dividends eligible for the §243 dividends received deduction. The plan worked particularly well for Seagram because §1059, added to the Code in 1984 to curtail the efficiency of this sort of tax planning, (1) through stock basis reduction restores to income the dividends received deduction but (2) in practical effect postpones forever the date on which the undesirable income inclusion will occur. That legislative error currently is enshrined in §1059(a)(2).

The proposal eliminates the exorbitant deferral opportunity in §1059(a)(2), and calls for an additional acceleration of gain recognition in narrow circumstances when the redemption plan is keyed to pro-taxpayer use of §318(a)(4) option attribution. The first change is entirely appropriate, the second is adequate to its circumscribed purpose, and the proposal as a whole merits your approval.

I would merely add that option attribution is not the only way well-advised taxpayers take what is surely unintended advantage of the §318 attribution rules. Just as a corporate taxpayer seeking the benefit of a dividends received deduction will try to use §318 attribution to convert a stock redemption from "sale" to "dividend" treatment, an individual allowed no dividends received deduction and seeking the rate advantage of long-term capital gain may aggressively employ §318 attribution to convert a stock redemption from "dividend" to "sale" characterization under §302(b).[2]

This is not a suggestion that the Committee at this time address more broadly the unintended consequences of §318 stock attribution. That difficult task seems best left to a time when fundamental rather than stopgap corporate tax reform is on the legislative plate. The points I would make now are, first, that the proposal's particularized response to option attribution simply addresses one problem among many and, second, that the proposal's particularized response to option attribution adequately addresses the problem in the context of the dividends received deduction.

B. Reform the Tax Treatment of Certain Related Party Corporate Stock Transfers (Section 304 Transaction).

The Administration here proposes to cauterize a wound inflicted by a prior Administration more than a quarter-century ago in Rev. Rul. 70-496, 1970-2 C.B. 74. It is a second attempt[3] or perhaps a third.[4] The Administration's proposal responds adequately and practically to cases in which a party to the transaction is a foreign corporation and thus is not included in a U.S. consolidated return, and appears to reach results that are both protective of the revenue and fair to participating taxpayers.

I take advantage of the Administration's proposal to make a broader point. Rev. Rul. 70-496, which generated the problem the Administration seeks finally to resolve, was a foolish pronouncement that applied §304 to prevent a selling taxpayer from ever recovering the basis at which it held the shares sold. A boon, however inappropriate, to the fisc in the specific case. But nothing works one way in our hugely complex tax system. Inevitably, the tax bar found ways to avoid the adverse impact of Rev. Rul. 70-496 and promptly went on to capture for sophisticated corporate clients great and unintended benefits that nestled unperceived by IRS in its foolish 1970 pronouncement. The moral, obvious enough, is that a balanced, fair tax provision works a lot better for everyone than does a provision inappropriately crafted to beat on the taxpayer's head.

II. ADMINISTRATION PROPOSALS THAT MERIT THE COMMITTEE'S DISAPPROVAL

A. Modify the Net Operating Loss Carryback and Carryforward Rules.

The Administration amazingly proposes a tax increase limited to corporations—and individuals—engaged in any business that is not doing too well.

The Administration proposes to accomplish this grand feat, and thereby to raise total taxes an estimated $3.5 billion over 5 years, by destabilizing approximately 40 years of settled tax law: The 3-year net operating loss (NOL) carryback, with us since 1958, commencing 1998 is to become a 1-year carryback.[5]

The Administration does not, however, suggest revenue need as justifying this amazing proposal. Justification is grounded exclusively in a sudden appreciation of efficient government. To quote the Administration in full: I22Because of the increased complexity and administrative burden associated with carrybacks, the carryback period should be shortened.[6]

And this in the age of computers.

Federal income tax law inevitably exhibits a tension between finality and fairness, between the needs of efficient tax administration that are expressed in the concept of annual accounting, and the desire for a true reflection of the taxpayer's income determined, not in a snapshot, but over time. The NOL rules respond to that tension and, until now, have been thought by you and by the rest of us, and by a dozen Administrations, to respond fairly and well.

The Administration's proposal, like the dissembling justification advanced for it, seems to me truly awful. I hope it seems that way to you too.

B. Treat Certain Preferred Stock, Received in Otherwise Tax-Free Exchanges, As "Boot."

For more than 70 years the basic tax law in this area has been in wondrous repose. To no sensible purpose—not even a decently large revenue estimate—the Administration proposes to tear it up, start over, and make the system operate a good deal worse, by taxing as "boot" straight preferred stock received in corporate organizations, reorganizations, and recapitalizations if that preferred stock can be retired at the issuer's option within 20 years.

Here, basically, is how it has worked for more years than any of us has been a taxpayer:

> If in a corporate organization, reorganization, or recapitalization an investor receives preferred stock, the investor is not taxed on that receipt—gain recognition is deferred until the preferred stock is resold—but the issuing corporation is allowed no deduction for the dividends it annually or cumulatively pays on the preferred stock.

In contrast, if in a corporate organization, reorganization, or recapitalization an investor receives debt securities, the investor is taxed on that receipt—in some circumstances the investor can report on the installment method but may then be subject to the offsetting toll charge annually imposed under §453A—and the issuing corporation is allowed a deduction for the interest it annually pays (or under the OID rules promises to pay in the future) on the debt securities.

It currently matters not one tax whit, and never has, that in nontax terms a particular issuer's senior preferred stock might be viewed as "functionally equivalent" to that issuer's junior subordinated debentures. In the tax law preferred stock means tax-free receipt balanced by no yield deduction, and debt means taxable receipt balanced by deductible yield.

In our so-called classical system of corporate taxation, in which dividends are not deductible by the payor, a corporation normally issues straight preferred stock to individual investors (1) in family-owned corporations—which are excluded from the Administration's "boot" recognition proposal—and (2) when the transaction will not efficiently tolerate the issuance of additional growth stock (e.g., of additional common stock or of convertible preferred stock).[8]

Striking a blow for decreased economic efficiency, the Administration exempts from its "tax it now" proposal a preferred stock that participates to any significant extent—including through a conversion privilege—in corporate growth. In other words, precisely what the issuer for sensible commercial reasons does not wish to do the Administration, for no sensible reason, in a tax provision would force the issuer to do.

Surely the Administration has not taken its new appreciation of the "functionally equivalence" of preferred stock and debentures far enough. If we are to treat as debt-boot preferred stock received in corporate transactions, are we not obliged in logic to treat the preferred stock as debt for other tax purposes? The Administration sees the logic and contemplates "installment sale-type rules . . . in appropriate cases," a neat way to further increase the complexity of the tax system, but hides from the obvious corollary that the issuer of such debt-like preferred stock should be allowed to deduct the dividends it pays on that stock.

The nation is not deeply in need of a trifurcated corporate tax regime in which senior securities, received in a corporate transaction, may be either (1) equity for all purposes, (2) equity for no purpose, or (3) debt-like to the holder for some purposes although equity to the issuer for all purposes. This is what the Administration proposes, and you should reject it.

C. Treat as a Fully Taxable Complete Liquidation the Conversion of a "Large" C Corporation into an S Corporation.

In 1982, testifying on the bill that became the Subchapter S Revision Act later that year, I urged that a C corporation's S election should be viewed as a form of complete liquidation of the C corporation and should be taxed in a manner appropriate to that characterization.[9]

It was a feasible suggestion in 1982 because, under the tax law of the time, (1) the C corporation would not recognize gain on its deemed liquidation (old §336) and (2) the shareholder could limit her recognized income on liquidation to her percentage of the C corporation's accumulated earnings and profits (old §333), an amount which for an original shareholder approximated the amount by which her percentage of the C corporation's "inside" net asset basis exceeded her "outside" basis in the corporation's shares.[10] In that long gone tax world the interesting issues mainly were limited to the tax rate to be imposed, and the time over which the shareholder would be allowed to pay her circumscribed tax on the deemed liquidation.

Deemed liquidation is not a feasible suggestion in 1997: Under post-1986 tax law the C corporation would be taxed, fully and immediately, on all of the gain in its assets, and simultaneously its shareholders would be taxed in full on all of the gain in their shares. This is not an election a sane taxpayer would make. Facing this regime, most "large" C corporations will simply remain C corporations. And if in a given case that is not possible and full tax must be paid, far better to avoid subchapter S and simply convert the enterprise to an LLC taxed as a pass through entity under rules more flexible and more friendly to taxpayers than are the provisions of subchapter S.

The Administration's proposal, realistically viewed, is simply to repeal subchapter S effective January 2, 1998 for C corporations that have a value of more than $5 million. Indeed, now that every state has enacted an LLC statute, if we are going to repeal subchapter S for "larger" C to S conversions the Administration might as well propose the repeal of subchapter S for all newly organized enterprises, large or small, as well.

Incident to the repeal of *General Utilities,* in the period 1986-87 Congress, advised by Treasury and bar groups, crafted a careful, balanced approach to the C to S conversion. Under that approach, which has now persisted for a decade, (1) LIFO inventory benefits are immediately recaptured by the C corporation with the resulting tax payable in four annual installments (§1363(d)), and (2) other built-in gains are subject to corporate tax (as well as to individual shareholder tax on the net) if recognized by the S corporation during the 10 years

following the C to S conversion (§1374).[12]

The C to S conversion regime, like subchapter S overall, has worked well. In the Small Business Job Protection Act of 1996 (Pub. L. 104-188), Congress extended subchapter S to reach corporations with more and different shareholders and, importantly, corporations that operate through subsidiaries. It is difficult to believe that, having expanded subchapter S in 1996, you would for no decent reason reverse field and gut the statute in 1997.

Why does the Administration advance this unfortunate proposal? I honestly cannot imagine, because it is a trivial revenue raiser. According to the Joint Committee Staff's preliminary estimates the proposal would generate between 1998 and 2002 an aggregate $176 million. A poor return on poor policy.[13]

D. Require Gain Recognition by the Distributing Corporation on Certain Distributions of Controlled Corporation Stock in So-Called "Morris Trust" and Similar Transactions.

I address first the proposal the Administration has advanced to tax, for the first time in the Nation's history, a corporation which, solely for good business reasons, (1) distributes to its historic shareholders the stock of a subsidiary operating a long-held business, and (2) as planned, merges tax-free with another corporation that happens to be larger. The only reasons so to tax a *Morris Trust[14]* transaction, as far as I can see, are (1) to destabilize long settled law that was working well, and (2) to make the tax law more intrusive and economically less efficient.

After considering the proposal as the Administration has framed it, I address separately whether, in the context of a *Morris Trust* transaction, threshold shifts of debt between distributing and controlled corporations merit special legislative attention.

1. Integrated divisive/acquisitive transactions involving no threshold shift of debt.

Here is an example from real life of a *Morris Trust* transaction that IRS 30 years ago ruled wholly tax-free, but which under the Administration's proposal would be taxed to the distributing corporation.

Example 1: T corporation, of moderate size and publicly held, for many years had actively engaged in two businesses: manufacturing business X representing approximately 90% of T's value, and radio station R representing the other 10% of T's value. For good business reasons, large unrelated P corporation wished to acquire T and its X business, solely in exchange for P stock in a merger. However, if the P-T merger was to be carried out within a commercially reasonable time, it was necessary that T first dispose of radio station R, because requisite FCC approval of P's acquisition of the radio station as a practical matter could not be obtained in less than 18 months. For the same FCC reasons, the only practical way that T could dispose of radio station R, other than to abandon the station and suffer a huge loss, was for T (1) to transfer R's assets and business to Newco, a new corporation, in exchange for Newco's shares, and (2) to then distribute all of Newco's shares to T's shareholders in a spin-off. This was done and, promptly thereafter, pursuant to the overall plan slimmed-down

T merged into P and the former T shareholders received in the merger solely P stock.

This is the *Morris Trust* transaction. Under §355 and other relevant provisions of the Code, it is now as it long has been a transaction in which (1) T's shareholders are not taxed currently on their receipt of Newco shares and P shares, but will be fully taxed when they later sell those shares, (2) T is not taxed on the formation of Newco and on T's spin-off distribution of Newco's shares to T's shareholders; and (3) in Newco's hands the radio station assets retain the depreciated basis at which T held those assets, so that upon its later disposition of the assets Newco will be fully taxed. In other words, it is an entirely business motivated, economically efficient transaction in which shareholder gain is postponed but preserved, and at the corporate level operating income is taxed to Newco after the spin-off exactly as that operating income would have been taxed to T had there been no spin-off.

If you adopt the Administration's proposal, IRS will hereafter tax T at the time of the spin-off on an amount equal to the value of the radio station in excess of the depreciated basis of the radio station's assets.[15]

And then, when at a subsequent time Newco disposes of the radio station by sale or in liquidation, IRS will tax Newco on the very same gain.[16]

And finally, when Newco's shareholders—who were T's historic shareholders—sell their Newco shares or receive a distribution in Newco's liquidation, IRS will tax those shareholders on a gain that reflects the value of the very same radio station.

The Administration, in short, asks you to adopt an exorbitant regime under which our classical system of double taxation—we tax operating income at the corporate level when the corporation earns it, and we tax investment profit at the shareholder level when the shareholder sells her shares—is converted to a system of triple taxation in which corporations are taxed twice on the same income, once now and once later.

If this indeed were to prove the result of adopting the Administration's proposal, we should rightly deplore it. But in most cases, I think, the results would be worse: Some number of entirely sensible, good business transactions will be abandoned, and some significant number will be reconfigured in ways that promote neither economic efficiency nor anyone's regard for the taxing system.

> **Example 2:** The background facts are the same as in Example 1 but the Administration's proposal has been enacted. Before P approaches T—or perhaps before P has approached T in any manner that subsequently can be traced—T decides that its dominant X business and its R radio business will be better and more profitably conducted by independent managements in separate corporations each of which is public and each of which therefore can compensate management through stock incentives that reflect directly the performance of the particular business. Accordingly, T transfers the radio business to Newco and spins-off Newco's stock. Not long thereafter P formally approaches T with a merger offer and is promptly rebuffed. Having carefully read the Administration's proposal, P commences a hostile tender to acquire all of T's stock. T's management unsuccessfully defends, ultimately caves in, and, in exchange for P stock, P acquires T in a combination of tender offer exchange and last-step merger.[18]

Morris Trust has been good tax law and good tax practice for as long as anyone can remember, embraced by the Treasury in the Johnson Administration and by every treasury in every Administration since, until now. The current Administration has not offered, and I cannot conceive, a good reason now to upset that settled law or, in my example case, either to impose an additional tax on T or to encourage the sort of under-the-table, economically inefficient, planning that promotes the general distaste for the taxing system.[19]

If the Committee is willing to entertain an encompassing revision of the tax law of corporate distributions, I believe you should go in a direction quite different from the Administration's approach.

The Administration's proposal to tax T in some circumstances but not in all circumstances, when T spins off Newco's shares, focuses the larger issue. Prior to the adoption of the 1986 Code which overturned the *General Utilities* doctrine, P was not taxed on its distribution of its subsidiary's shares, whether or not that distribution qualified as a tax-free spin-off or split-off under §355. Nonrecognition of T's gain built in to the shares of its subsidiary was the product, not only of *General Utilities* , but expressly of old §311(d)(2)(B).

The 1986 overturning of *General Utilities* was excellent tax policy to the extent it assured that the basis of a corporation's operating assets will not be stepped-up to fair value unless the corporation recognizes as income the amount of that step-up. But extending *General Utilities* repeal to the stock of a subsidiary corporation, expressly by repealing old §311(d)(2)(B), was not good tax policy because (1) the potential of corporate distributions attracting over time three layers of tax was now assured, and (2) the one escape from that third tax was a spin-off or split-off or split-up qualifying under §355. Beginning in 1987 the tax law thus has placed tremendous and inappropriate pressure on §355, a provision never designed to deal with the tax treatment of the distributing corporation. The Administration's proposal, as Example 2 fairly confirms, will not relieve that pressure. Reenactment of old §311(d)(2)(B) would relieve the pressure on §355[20] in an appropriate way, by limiting the corporate tax on corporate-level gain to one bite and not two bites of the same apple.

2. Integrated divisive/acquisitive transactions that involve a threshold shift of debt.

The use of leverage in a spin-off or split-off is common, and commonly is inoffensive.

> **Example 3:** A and B, unrelated individuals, each owns 50% of T's stock. T has long been engaged in two activities, business X supervised by A and business Y supervised by B. Each business has a net asset basis equal to half its value. For good business reasons, T transfers the Y business and assets to Newco in exchange for Newco's stock, following which T distributes Newco's stock to B in exchange for all of the T stock owned by B.
>
> Because the Y business is worth $400,000 and the X business, which T will retain, is worth $500,000, B will be improperly disadvantaged and A will be improperly advantaged by the split-off plan outlined above. Therefore, as part of the plan T borrows $50,000 from its bank and transfers the $50,000 cash to Newco along with the Y business. T retains responsibility to repay the $50,000 loan to the bank. As a result, at the time of the split-off distribution Newco is worth $450,000 and, immediately after that distribution, T is worth $450,000.

If the corporate division in Example 3 were a pro rata spin-off rather than a non pro rata split-off of Newco, the tax results should be the same. The reason, simply, is that the distribution of Newco will qualify as tax-free under §355 only if the statute's business purpose and non device tests are satisfied. If the divisive transaction inclusive of its threshold cash and debt shifts is found to satisfy the statutory tests of business purpose and non device, that ought to end the matter.

The leveraged transaction that rightly appears inoffensive in Example 3 may present a different appearance in enlarged circumstances.

> **Example 4:** T, a public company, long has been engaged in two activities, business X and business Y. Business Y is worth $400 million and has a net asset basis of $200 million. Business X is worth $500 million and has a net asset basis of $250 million.
>
> For good business reasons, T borrows $300 million, contributes that cash along with the Y business and assets to Newco in exchange for Newco's stock, and distributes Newco's stock to T's public shareholders in a pro rata spin-off. T retains the X business and responsibility to repay the $300 million loan. As a result, at the time of the spin-off distribution Newco is worth $700 million and, immediately after that distribution, T is worth $200 million.
>
> Shortly following the distribution by T of Newco's stock, T merges with and into larger, previously unrelated P corporation. In the T-P merger T's public shareholders exchange their T stock for an aggregate of $200 million P stock.

Under the Administration's proposal T would recognize gain (in the amount of $200 million) if, and only if, the subsequent merger of T into larger P is "pursuant to a common plan or arrangement that includes the distribution" of Newco's shares. That is, a preplanned friendly merger attracts huge corporate tax, an unplanned hostile business combination avoids the tax. It is not a better test applied to leveraged spin-offs than it was when applied to non-leveraged spin-offs, as discussed above.

If the $300 million borrowing in Example 4 concerns us, it ought to be for a reason different from the warmth or hostility of P's embrace of slimmed-down T.

> **Example 5:** The facts are the same as in Example 4 except that, for good business reasons, T transfers business X (rather than business Y) to Newco. Newco borrows $300 million and distributes that cash along with all of Newco's stock to T. T, again for good business reasons, redistributes all of Newco's stock to T's public shareholders. Assume further that neither T nor Newco thereafter merges with or is otherwise acquired by P or by any other corporation.

T's initial basis in Newco's shares would have been $250 million, the net asset basis of business X when T transferred business X to Newco. Newco's distribution of $300 million loan proceeds to T, in advance of T's redistribution of Newco's shares, produces an excess liability gain of $50 million to T. That gain is taxable to T and it is irrelevant that Newco, as well as T, thereafter continues to operate as an independent, stand-alone corporation.

I hold no strong brief for taxing T in Example 4, whether or not T merges with P. The $300 million loan will have to be repaid with after-corporate-tax earnings, whichever corporation is responsible to repay, none of the funds has generated an increased basis in operating assets for any of the corporations, and T's shareholders have received $300 million less P stock then they would have received had there been no borrowing. But if there is felt to be a great need to tax T in Example 4, I believe T's taxable gain should be the same $50 million that would be taxed to T if the distribution transaction were carried out in the manner described in Example 5.[21]

The "excess loss account" approach here suggested—measuring T's leveraged *Morris Trust* gain by the amount, if any, by which (1) the sum of (a) the debt shifted to T plus (b) T's other liabilities exceeds (2)[22] the basis of T's assets (including T's basis in the stock of any T subsidiary)—is not ground breaking. Indeed, it is precisely the approach the Administration endorses to amending §1059(a)(2) in reaction to the Seagram-DuPont extraordinary dividend plan. See part I A, above, recommending the Committee's approval of that Administration proposal. Nor is it novel that, in computing T's gain, we look in practical effect to what the gain would have been, under ordinary tax principles, if the transaction had been structured in a technically different but economically equivalent way.[23] The Treasury embraced that approach in 1990 in (then) Reg. §1.1502-14(g) in which the tax results of a related series of events in a "bump-and-strip" transaction—upstream distribution of a second-tier subsidiary's stock, cash borrowing, and cash distribution—were declared to be the same as those results would have been if the overall transaction had been structured, not as it was in fact carried out, but as it might have been carried out in the absence of tax planning.

ENDNOTES

[1] This proposal is understood to be identical to a provision in the (not enacted) Balanced Budget Act of 1995 (H.R. 2491, 104th Cong.). This and certain other Administrative proposals were ventilated in draft legislative language in March 1996. In addition, I rely mainly upon the Joint Committee Staff's description and analysis of the President's Fiscal Year 1998 Budget Proposal (JCX-10-97, pages 67-77) released March 11, 1997. Estimated budget effects of the provisions are taken from the Joint Committee Staff's document of that title (JCX-8-97) released February 27, 1997.

[2] As an illustration, assume Father, Son, and Daughter each has owned for many years one-third of the stock of X corporation. X redeems all of Father's stock for $10 million, its fair value, and Father severs all employment and other ties with X. Simultaneously, X redeems for $5 million half of Daughter's shares, with the result that Daughter, who before the stock redemptions owned one-third of X's stock, continues to own one-third of X's stock. Without the §318 attribution rules the redemption from Daughter would be treated as a dividend under §302(d). The attribution rules convert the redemption from Daughter to a "sale" under §302(b)(2), allowing her to offset her basis in the shares redeemed and to report the redemption proceeds in excess of basis as long-term capital gain. Under §302(c)(2) Father also receives "sale" treatment. In total, the family has bailed out half the appreciated value of X at capital gain rates.

[3] See §304(b)(4) enacted in 1987, concentrating on a sale of stock of a controlled corporation from one member of a §1504(a) affiliated group to another member of such group; see also H.R. Rep. No. 495 (Conf. Rep.), 100th Cong., 1st Sess. 968-70 (1987).

[4] See Reg. §1.1502-80, effective for stock sales on or after July 24, 1991 between members of an affiliated group of corporations filing a consolidated return, holding §304 inapplicable and characterizing the sale as a deferred intercompany transaction subject to Reg. §1.1502-13.

[5] The Administration proposes an offsetting extension of the NOL carryforward period from the current (since 1981) 15 years to 20 years. The estimates of annual and aggregate revenue increase confirm that the carryforward extension will not offset the tax increase that resides in eliminating 2 years of carryback.

[6] See "Federal Receipts and Collections" in the Administration's Budget of the United States Government—Fiscal Year 1998, Analytical Prospectives page 50.

[7] The Joint Committee Staff tentatively projects $698 million through 2002, but because taxpayers through responsive planning can avoid the added tax burden, actual revenue almost certainly would prove to be only a modest fraction of that estimate.

[8] Preferred stock is issued for cash to corporate investors for a variety of tax-influenced reasons, but the Administration's proposal, because it is limited to preferred

stock issued in corporate organizations, reorganizations, and recapitalizations, would not impact on these transactions.

[9] See Subchapter S Revision Act of 1982: Hearings Before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, House of Representatives, on H.R. 6055, Serial No. 97-64, 97th Cong., 2d Sess. 208 (June 14, 1982). The argument was subsequently expanded in a paper, Subchapter S and Accumulated E&P: A Different View, in 17 Tax Notes 571 (1982).

[10] For example, if the C corporation's total basis in its assets were $3 million and its total liabilities $2 million, its "inside" net asset basis would be $1 million, and a 40% shareholder's percentage of that amount would be $400,000. If the shareholder's "outside" basis in her shares totals $100,000, the difference of $300,000 fairly approximates her part of the C corporation's accumulated e&p if, as one sensibly should, special e&p adjustments relating to accelerated depreciation and the like are ignored.

[11] The Joint Committee Staff in JCX-10-97, pages 48-50, has nicely identified a variety of valuation and step-transaction problems that are inherent in keying the determination, tax or no tax, to a precise $5 million valuation.

[12] If prior to the end of the 10-year recognition period the corporation sells an asset on credit and under §453 defers gain recognition until after the close of the 10-year period, that gain when ultimately recognized is subject to the §1374 corporate-level tax, to the extent the gain would have been subject to that tax if the corporation, at the time it sold the asset, had elected out of installment reporting. See IRS Notice 90-27, 1990-1 C.B. 336.

[13] A C to S proposal grounded in sound policy, I believe, would leave unchanged §1374 but would require each shareholder to recognize gain limited to the amount, if any, by which (1) her proportionate part of the corporation's "inside" net asset basis exceeds (2) her aggregate stock basis measured at the beginning of the first S year. Under this 1997 recast of the 1982 proposal referred to above at n. 10, no corporate level gain would be triggered, beyond that required by §1363(d), and the corporation's accumulated e&p would not be affected.

[14] *Commissioner v. Mary Archer W. Morris Trust*, 367 F.2d 794 (4th Cir. 1966). See also Rev. Rul. 68-603, 1968-2 C.B. 148 (IRS will follow *Morris Trust*); Rev. Rul. 70-434, 1970-2 C.B. 83 (same result in spin-off followed by "B" reorganization); Rev. Rul. 78-251, 1978-1 C.B. 89 (same).

[15] This is the result under the Administration's proposal because, under it, T is treated as having sold Newco's shares at fair value (equal to the value of the radio station) and T's basis in Newco's shares is equal to the basis of the radio station assets less the radio station liabilities.

[16] This is the result under the Administration's proposal because, while T has already been taxed on that same appreciation, nothing in the proposal or elsewhere in the Code awards Newco a correlative upward adjustment in the (low) basis at which Newco received the radio station assets from T.

[17] "[A] hostile acquisition of distributing or controlled commencing after the distribution will be disregarded." JCX-10-97, page 50.

[18] See J. E. Seagram Corp. v. Commissioner, 104 T.C. 75 (1995), holding a similar acquisitive transaction to qualify as a reorganization encompassing the first step tender offer exchange.

[19] The Administration's proposal to tax *Morris Trust* transactions is a last step, not a first step, in its current campaign to upset settled law and impose additional tax when for business reasons a spin-off and a corporate acquisition are combined. As a prime example, in 1975 IRS in Rev. Rul. 75-406, 1975-2 C.B. 125, confirmed that if business X (the business P wishes to acquire) has been long held in public T's subsidiary S rather than in T itself, T can spin-off S tax-free to T's shareholders who then can vote to confirm and carryout a preplanned tax-free merger of S into P. Twenty-one years later, on May 22, 1996, IRS in Rev. Rul. 96-30, 1996-1 C.B. 36, suddenly announcing a change of heart declared that both T and T's shareholders would be immediately taxed on the described transaction. IRS couched this reversal of Rev. Rul. 75-406 as a "modification" of it. A full description of IRS's 1996 destabilization efforts is contained in M. Ginsburg and J. Levin, *Mergers, Acquisitions, and Buyouts* (January 1997 edition) at §1010. Restoration of Rev. Rul. 75-406 would nicely companion a rejection of the Administration's *Morris Trust* proposal.

[20] An exception would be gain recognized to the distributing corporation under current §355(d) if that provision were preserved.

[21] I recognize that if in Example 5 the spin-off were followed by a planned merger of Newco (owning business X) into P, the aggregate tax consequences likely would be horrendously worse than a gain of $50 million charged to T. See Rev. Rul. 70-225, 1970-1 C.B. 80. The fact that no well-advised taxpayer in Example 5 would

go on to the second step merger is not a reason to disregard the tax treatment that would be awarded a stand-alone spin-off in Example 5.

[22] If T is itself a subsidiary (of BigCo), and a third party or the public owns some of T's stock, e.g. up to 20%, T's assets and liabilities properly allocable to that outside ownership should be factored out of the gain recognition equation. If T is a second-tier subsidiary (T's stock is owned by BigCo's wholly-owned subsidiary BigSub) and the BigCo corporate group files a consolidated return, Treasury to make any taxing scheme work ought to reexamine Reg. §1.1502-19(g) Example 3 under which a well-advised taxpayer, in a double-spin transaction (BigSub distributes T's stock to BigCo which spins off T to the public), may be able to make T's excess loss account disappear.

[23] I.e., as if T transferred (Example 5) rather than retained (Example 4) the assets of business X.

Prepared Statement of Fred T. Goldberg, Jr.

Mr. Chairman and Members of the Committee, my name is Fred Goldberg. It is a pleasure to appear before you today to testify on the Administration's capital market revenue raisers.

While I am appearing in my individual capacity, I want to note that I am currently engaged to represent clients regarding certain of the proposals you are considering. I am not being paid for the time I have spent preparing my testimony, and my written statement has not been reviewed or approved by any clients of the firm. I have consulted with both PSA and SIA in preparing my testimony.

Taken as a whole, the Administration's capital market proposals would, if enacted, have a material adverse impact on most of the individuals and businesses we represent. I hasten to point out, however that this should come as no surprise, for they would have a material adverse impact on millions of individual and business taxpayers throughout the country. Indeed, this is the most important point I have to make. These proposals are not "loophole closers" or attacks on "corporate welfare." I implore you and your colleagues to get past the labels. They are tax increases on real people and real businesses. They are tax increases that will discourage and penalize the very activities that are essential to savings, investment, job creation and economic growth. They also represent major changes in long-established tax policy.

I have had the honor and privilege of spending almost seven years in various tax administration and tax policy positions with the IRS and Treasury, including IRS Commissioner and Assistant Secretary for Tax Policy. I have also spent more than 15 years as a tax professional in private practice. Like many others in the private sector, I support your ongoing efforts to address areas of the tax law that confer unwarranted tax benefits. Having "been there and done that," I also empathize with the enormous pressure that Treasury and Congress are under to raise revenue without raising taxes. I have the highest respect for the staff of the tax-writing committees, the Joint Tax Committee, and Treasury's Office of Tax Policy. They are trying to do an extremely difficult job under extremely difficult circumstances.

Based on my experience in government and the private sector, however, it is my judgement that most of the Administration's proposals should be rejected out of hand, and that others must be modified to achieve their stated objectives.

As you requested, I will limit my comments to the following proposals:

- Proposals to recharacterize debt for tax purposes solely to deny interest deductions[1]
- Proposal to defer the interest deduction on OID convertible debt until cash payment[2]
- Proposals to further restrict the dividends received deduction (DRD)[3]
- Proposal to disallow interest deduction on indebtedness allocable to tax exempt obligations[4]
- Proposal to require use of average cost basis in computing gain on sale of securities[5]
- Proposal to require recognition of gain with respect to certain so-called "short-against-the-box" transactions[6] • Proposal to accelerate interest accruals on certain pools of debt[7]
- Proposal to eliminate the "extinguishment doctrine" as it applies to the cancellation, lapse, expiration or other termination of rights that would otherwise be capital assets[8]

For convenience, I will refer to these proposals collectively as the "Administration's Proposals."

Mr. Chairman, I share the policy goals that you and your colleagues have articulated on many occasions. The tax law should help, not punish, everyday Americans who are trying to save and invest. The tax law should facilitate, not undermine, businesses as they respond to competitive pressures, create jobs and meet the needs of their customers. The tax law should support, not stand in the way of, efforts to return power and responsibility to our state and local governments. That is why the Administration's Proposals are so important—and so misguided. They work in exactly the opposite direction. They make it harder, not easier, for everyday Americans to save and invest. They make it harder, not easier, for businesses to compete, create jobs and meet the needs of their customers. They make it harder, not easier, for state and local governments to discharge the responsibilities that the Congress and this Administration have asked them to assume.

The Administration's Proposals suffer from five fundamental defects.

First: the proposals represent ad hoc, random, unwarranted and sometimes astonishing changes in basic tax policy.

- Instruments that are clearly debt under current law are subject to radically different treatment under the Administration's Proposals;[9] the proposal to defer interest deductions on OID convertible debt departs from settled notions of economic accrual. What is particularly troublesome is that there is no coherent reason for these changes. The rationale for any particular proposal is ad hoc, not applied consistently to other instruments, and often justified by anecdote rather than evidence.
- The Administration's Proposals violate long-standing and well accepted notions of symmetry.
  - —For the most part, they would treat the same instrument in entirely different ways—as debt from the holder's perspective and equity from the issuer's perspective.
  - —The OID convertible debt proposal would require investors to accrue interest income currently while denying interest deductions to issuers of the same instrument.
  - —The proposals to further restrict the DRD suffer from a comparable defect—the holder loses a portion of the DRD but the issuer is not given a partial interest deduction.
  - —A similar point applies to the proposal to accelerate interest accruals on certain pools of debt. Why is it that taxpayers should be required to use a method that maximizes income—but not be permitted to use that same method in computing bad debt write-offs?
- Some (but not all) of the Administration's Proposals require treatment of instruments as equity based solely on their treatment for regulatory and/or financial accounting purposes. As a result, two instruments that are identical from the standpoint of their economics and the legal rights and obligations of the parties—two instruments that have always been treated the same for Federal income tax purposes—will be treated differently based on their treatment for regulatory and/or accounting purposes.[10]
- The OID convertible debt proposal alters the tax treatment of a particular instrument solely because it is said to be "viewed as equity."[11] A similar rationale is offered for a number of other proposals recharacterizing debt as equity. This is a dramatic and astonishing departure from current law.

With all due respect, I believe there is simply no tax policy justification for these changes. The proposals are unprincipled in the truest sense of the word. Ask yourselves: Is there a unifying theme to these proposals? Can I take the rationale for one proposal and apply it consistently to other suggested changes? The answer to each of these questions is no.

As a tax policy matter:

- Should tax consequences be determined by financial accounting and non-tax regulatory rules—but only when it raises revenue?
- Should instruments be classified as debt or equity based on how they are "viewed"—but only when it raises revenue?
- Are we really comfortable with a wholesale departure from symmetry—bnt only when it raises revenue?

Maybe some would answer these questions in the affirmative. But don't kid yourselves: these are fundamental changes in policy—changes that I urge you to reject out of hand.

Second: the proposals are contrary to fundamental policy goals—they undermine savings, investment and economic growth.

- Most of the Administration's Proposals are little more than tax increases on savings and investment. Raising taxes is like raising prices. If you increase taxes on savings and investment, you will get less savings and investment. If you get less savings and investment, you will get less economic growth and job creation.
- As a practical matter, these proposals do little more than penalize middle class Americans who work and save, either directly or through mutual funds and retirement plans. The target may be Wall Street, but the victims live on Main Street. For example:

—The Joint Tax Committee has estimated that the average cost basis rule would affect more than 10 million individual taxpayers.

—87.5% of all OID convertible debt is held by individuals. Approximately 43% of these individuals hold this debt through mutual funds, with the remaining 57% holding the debt through retail accounts. With no colorable tax policy justification, the Administration's proposal would deny millions of individual savers this investment opportunity in the future.[12]

- The Administration's average cost basis proposal penalizes long-term investors and reenforces the "lock in" effect of capital gains taxes. The proposal is especially harsh on middle class taxpayers who make and hold modest investments in stocks each year, and workers who retain the stock interests they receive each year by participating in employee stock purchase plans.
- The Administration's proposal to require pro rata allocation of interest expense to tax-exempt obligations will impose additional costs on state and local governments—at the same time that the Congress and this Administration are asking them to shoulder more responsibilities.
- The Administration's proposals to deny interest deductions on certain debt (whether it is because the debt has a maturity in excess of 40 years, is payable in stock of the issuer, or is not shown as debt on the issuer's balance sheet) will make it more difficult and expensive for banks, capital intensive industries and regulated businesses to raise capital—at the same time that the Congress and this Administration expect our financial institutions and manufacturing concerns to compete in global markets, and at the same time that the Congress wants to deregulate electric utilities. And no one should be fooled regarding who will bear the cost. For example, the Administration's proposals in this area are nothing more than a tax increase on utilities and their retail customers.

Third: Several proposals are very much like the Energizer Bunny—they keep taxing, and taxing, and taxing the same income . . . over and over again.

- For example, under our current system (which even the New York Times thinks ought to be changed), we tax income once at the corporate level and again at the shareholder level. The proposal to further restrict the DRD means that we are taxing income at the corporate level more than once, and taxing that same income again at the shareholder level.
- The Administration's Proposals that eliminate the symmetric treatment of certain instruments (i.e., treating the same instrument as equity to the issuer and debt to the holder; deferring the issuer's deduction, but taxing the holder's income currently) are very much like taxing the same income several times.

Fourth: The Administration's Proposals are inconsistent with the goals of balancing the budget and tax reform.

- There is widespread agreement that a balanced budget would be good for the economy because it would increase net national savings and encourage economic growth. As I have already noted, the Administration's Proposals penalize savings and investment.
- Common themes in most tax reform proposals (including proposals for reform within the framework of the current income tax) include: don't tax income more than once; encourage savings and investment; promote economic efficiency; simplify the rules. The Administration Proposals run directly contrary to these goals.

Fifth: The Administration's Proposals fiddle in the capillaries while the tax system requires major surgery.

This is a very troublesome aspect of the Administration's Proposals. You, your colleagues, professional staff and the Treasury Department will spend lots of time and energy on the Administration's Proposals that reflect no coherent policy perspective, and move the system away from where most of us think it ought to go. This time and energy could be far better spent on fundamental tax policy issues that hold far more potential for improving the system.

Rather than fiddling in the capillaries, it would make far more sense to rethink the way we tax income from capital. Short of fundamental tax reform, there are many avenues worth exploring. Above all, I share the view of many on this Committee that the highest tax policy priority is to make it easier for everyday citizens to save and invest. The greatest challenge we face is creating wealth for the workers and families of America. I am quite certain that it is possible, within the current budget framework, to make dramatic strides in that direction. This is where I believe the Committee should be spending its time. The Administration's Proposals are a needless distraction that moves the tax system in the wrong direction.

In sum, the Administration's Proposals fail on two counts. First, they cannot be justified as a matter of tax policy. Quite simply, they have no coherent policy rational. At best, they reflect an arbitrary bias: when in doubt, tax it. If the question is under taxing or over taxing corporate income, over tax it. If the question is under taxing or over taxing investment income, over tax it. If the question is under taxing or over taxing capital gains, over tax it. Those who are wedded to our current income tax system might support this bias as achieving some kind of rough justice. My own view is that it would be a terrible mistake for you and your colleagues to accept that view.

More important, however, is that they run directly contrary to fundamental public policy goals. Savings, investment, the ability to respond to competitive pressures, the restructuring of key industries to create jobs and meet the needs of individual customers, the ability of state and local governments to shoulder additional responsibilities—these goals matter a lot. They will have a big impact on our well-being in the 21st century. It makes no sense to enact tax legislation that moves us away from where we want to go.

In case it's not obvious, I think that most of the Administration's capital market proposals should be rejected by the Congress. They are bad tax policy and bad economic policy. On the other hand, of the proposals you have asked me review, I believe two merit your consideration.

The proposal to "eliminate the extinguishment doctrine" does make sense. In this regard, however, I want to emphasize that the proper forum for any such "elimination" is the Congress, through prospective legislation.

The Administration has proposed taxing so-called short-against-the-box transactions. While there are principled arguments on both sides of this issue, I think this area may warrant your review. In this regard, however, the current Administration proposal is fatally flawed for two reasons. It is far too broad, and will have a material adverse impact on legitimate economic activity that is consistent with sound tax policy. Doing nothing is preferable to the Administration proposal in its current form. If you do move forward in this area, it is imperative that you modify the Administration's Proposal in three respects:

First, any provision should be limited to "extreme" cases. In addition, it should not apply to hedging transactions in the ordinary course of business, hedging transactions of limited duration, and hedging transactions involving caps, floors, and collars.

Second, any provision must be neutral: it should apply equally to gains and losses. This is, of course, the only "fair" answer. If a taxpayer has taken steps that warrant recognition of gain, then those same steps should warrant recognition of loss. Moreover, this rule would have a salutary effect on tax administration. Any time the IRS was tempted to overreach, it would have to live with the consequences on the other side of the table.

Third, any provision should be prospective. Taxpayers are expected to comply with all existing laws and regulations—including many that over tax their income, impose excessive compliance costs, or simply make no sense. For the most part, taxpayers accept their duty to play by the rules and follow the tax laws as they are written. These taxpayers should also be permitted to rely on tax rules that they find beneficial—even if the Treasury is bothered by the consequences.

One of the primary reasons for the widespread distrust of our tax system and the IRS is the perception that they routinely violate basic notions of fair play and common sense. The Administration's Proposals violate these norms in three respects. First, they run roughshod over the notion of symmetry. To take a coin toss analogy, the Administration's Proposals embody the following proposition: if it's heads, the IRS wins; if it's tails, the taxpayer loses. Second, in some cases, they punish taxpayers who relied on existing rules. Finally, they defy common sense. Public policy says: we want to encourage savings, investment and economic growth. We want our institutions to be able to compete in global markets. We want our state and local governments to assume greater authority and responsibility. If this is what we want—indeed, if this is what the Administration says it wants—how can it possibly make sense to pursue tax legislation that moves in the opposite direction?

Once again, I appreciate the opportunity to appear before you today. I would be happy to answer any questions you may have.

ENDNOTES

[1]: Department of the Treasury, General Explanations of the Administration's Revenue Proposals (February 1997) ("Treasury Green Book"), p. 36 (proposal to "deny interest deduction on certain debt instruments").

[2]: Treasury Green Book, p. 38 (proposal to "defer deduction for accrued but unpaid interest on convertible debt").

[3]: Treasury Green Book, p. 40, 41, 42 (proposals to: "reduce dividends-received deduction to fifty percent," "modify holding period for dividends-received deduction," and "deny dividends-received deduction for preferred stock with certain non-stock characteristics").

[4]: Treasury Green Book, p. 44 (proposal to "extend pro-rata disallowance of tax-exempt interest expense to all corporations").

[5]: Treasury Green Book, p. 46 (proposal to "require average cost-basis for securities").

[6]: Treasury Green Book, p. 48 (proposals to: "require recognition of gain on certain appreciated positions in personal property").

[7]: Treasury Green Book, p. 52 (proposal to "require reasonable payment assumptions for interest accruals on certain debt instruments").

[8]: Treasury Green Book, p. 51 (proposal to "eliminate the extinguishment doctrine").

[9]: The Administration's proposal to "deny interest deductions on certain debt instruments" is directly contrary to this Administration's own position regarding the treatment of the instruments in question as debt for Federal income tax purposes. See, Notice 94-47, 1994-1, C.B. 357.

[10]: Why is it that financial accounting treatment should control in some cases, but not control with respect to 41-year debt and OID convertible debt? Why is it that 15 years is a trigger in some cases, but 40 years is a trigger in other cases?

[11]: The Administration's proposal never says who has this "view." The fact that more than 70% of the outstanding issuances are never converted, and the fact that these instruments are treated as debt for financial accounting, rating agency and regulatory purposes, suggest that the Administration's "view" is not widely shared. To the contrary, all of the objective evidence demonstrates that OID convertible debt is "viewed" as debt.

Moreover, if the way an instrument is "viewed" should control its tax treatment, would Treasury recommend that fixed term, investment grade preferred stock be treated as debt?

[12]: The only stated rationale for the proposal, which would deny interest deductions to the borrower while taxing interest income to the investor, is that the instrument is "viewed as equity." As noted above, this assertion is manifestly wrong as a factual matter, and has absolutely no foundation in tax policy.

PREPARED STATEMENT OF GARY C. HUFBAUER

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Mr. Chairman and members of the Committee. My name is Gary Hufbauer, and I am here to comment on the international provisions contained in the Administration's 1998 budget. My views reflect experience and study of international tax issues over the past two decades. As a matter of disclosure, you should know that I have been retained by the Export Source Coalition to analyze the Administration's proposed changes in the Export Source Rule.

The U.S. system of taxing international income is incoherent. It needs thorough reform. I laid out the problems in my 1992 book, published by the Institute for International Economics, *U.S. Taxation of International Income.* In February 1997, at the request of the National Research Council, I revisited the topic in my paper "Directions for International Tax Reform." Between 1992 and 1997, a bad system got marginally worse.

The Administration has offered five proposals for increasing U.S. taxation of international income:

Brief description of proposal	Revenue 1998-2002 ($ billions)
1. Expand Subpart F to cover notional principal contracts and stock lending transactions	$0.2
2. Modify taxation of captive insurance companies	0.1
3. Change foreign tax credit carryover rules	1.2
4. Tighten foreign oil & gas extraction income rules	0.4
5. Replace the 50-50 Export Source Rule with an activity-based test	7.5

The first four proposals are a distraction from the much more important task of tax reform. The fifth proposal, to replace the Export Source Rule with an activity-based test, would severely damage the outlook for U.S. exports. It would also deprive America workers of billions of dollars of wage premiums earned in the high-paying U.S. export sector.

In five minutes, I cannot possibly describe even one of the first four proposals. Some of them are mind-boggling in their complexity. They are complicated because the underlying U.S. system of taxing international income borders on chaos.

Those who believe that the underlying tax system just needs a little fixing here and there may regard these four proposals as agreeable loophole closers. But if Congress and the Administration are content to be in the fix-up business, there are plenty of international items to fix up that would cost revenue—for example, reforming the interest allocation rules, consolidating the baskets of income, extending the Foreign Sales Corporation (FSC) to cover all service exports, getting rid of the recharacterization of domestic losses as foreign losses. However, among the long list of potential revenue losers involving international income, the Administration has selected just one for reform—extension of the FSC to cover computer software licenses (revenue cost 1998-2002, $0.6 billion).

If this is to be a year of repainting the trim on a rotting house, I would say, "OK, extend the FSC to cover computer software licenses, and pay for that by items 1, 2 and 4 on the Administration's list. Leave the carryover rules alone." That bit of paint would approximately pay for itself.

But I would rather see the Treasury, the House Ways & Means Committee, and the Senate Finance Committee apply their considerable talents to basic tax reform. I realize the political climate in 1997 is not auspicious. But there is no way we are going to deal with our budget deficit problem, our social security problem, our national savings problem, and our international competitiveness problem without basic tax reform. I say, "Stop the tinkering and go to work on the fundamentals!"

Let me conclude with a comment on proposed changes in the Export Source Rule. I dealt with this proposal in detail in my testimony before the Ways & Means Committee (March 12, 1997). For a five-year revenue gain of $7.5 billion, this change, if enacted, will destroy at least $169 billion of potential exports. Even if Alan Greenspan maintains a full employment economy over the next five years, this proposed change would deprive American workers of $9.4 billion of export wage premiums—the higher wages that could be earned in the export sector by comparison with other sectors of the U.S. economy.

As tax proposals go, this one is pretty bad.

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DIRECTIONS FOR INTERNATIONAL TAX REFORM

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OVERVIEW

This short paper is divided into two main parts: first, an examination of the "here and now" of international taxation; and second, prescriptions for the international component of basic tax reform. Between these two main parts, I inquire whether countervailing forces will check the stepwise evolution of the international tax system seen in recent years.

THE "HERE AND NOW" OF INTERNATIONAL TAXATION

The Good Old Days

In the 1950s, 1960s and even the 1970s, the United States entertained a "grand vision" of the international tax system. This vision was built around several foundation facts and assumptions (Hufbauer 1992):

- Countries that were important players in the international economy generally operated "classical" tax systems, consisting of separate corporate and individual income taxes. It was thought that these systems could be satisfactorily meshed, on a bilateral basis, through a series of tax treaties.

- Sales, excise, value added and kindred consumption taxes, were put in a separate conceptual box. Their international aspects -- namely, the extent that they could be adjusted at the border --

were addressed in the General Agreement on Tariffs and Trade (GATT), which has now become the World Trade Organization (WTO).

- Most business and personal income was tightly "linked" to one nation or another, and not easily shifted as a way of avoiding taxes. Most international firms were structured in a hierarchical parent-subsidiary relationship relationship, with capital flowing from the parent to the subsidiary and income flowing in the other direction. Most individuals who earned income abroad did so in the form of wages and salaries.

- The network of purchases and sales of goods and services between related corporate taxpayers was not dense. Most of these transactions could be compared with similar transactions between unrelated parties to determine a fair "arm's length" price, so that income and expense could not be shifted between jurisdictions for the purpose of tax avoidance.

- In this world, the key tasks of international tax officials, acting as revenue collectors, were to determine the "source" of income and the "residence" of the taxpayer. "Source rules" evolved naturally from the links between geography and income. "Residence rules" were built on the place of business organization or the place where the individual spent most of his working time.

● Once source and residence rules were agreed between countries, it was a matter of dickering to establish which country -- the source country or the residence country -- had the primary right to tax the income in question, and which had the secondary right. Most of the dickering was done in bilateral tax treaties. The source country was generally assigned primary taxation rights to the particular stream of income. This primary right was recognized by residence country when it exempted the income from its own tax net, or when it allowed a credit against its own taxes for foreign taxes paid on the income (the foreign tax credit). However, within the treaty framework, source countries usually agreed to cap particular taxes (e.g., a 10 percent limit on withholding taxes imposed on royalty income).

● Up to this point, the conceptual framework had little economic content, except to avoid "double taxation". Double taxation was regarded as a vice, on the argument that it would discourage international trade and investment.

● The United States added two economic doctrines to the picture. The most important was "capital export neutrality". The broad idea (inconsistently applied, even in 1960) was that U.S. firms and residents should not have a tax incentive to operate outside the United States. Latent tax inducements would be offset by the U.S. system of taxing worldwide income: any U.S. firm or resident would eventually pay the same overall rate of tax, no matter where in the world it operated. This would be achieved by taxing the worldwide income of U.S. firms and residents, and allowing a credit for foreign taxes imposed on foreign source income. As the dominant home country for multinational corporations, and as the country with relatively high corporate tax rates (in the 1950s and 1960s), the United States provided an "umbrella" that invited other countries to raise their corporate rates to the U.S. level.

- The second economic doctrine was that foreign countries should not practice tax discrimination against U.S. firms. Taken together, non-distortation and non-discrimination added up to the original "level playing field": U.S. firms should, in the long run, not pay less tax when operating abroad than when operating at home; and foreign governments should not tax U.S. firms more heavily than they taxed their own (or third country) firms. Like all level playing field concepts, this was laden with inconsistencies, which became more apparent over time.

New Realities

By the 1980s, many events had converged to erode these foundation facts and assumptions about the workings of the international economy and the proper role of the international tax system:

- Many industrial countries abandoned their "classical" systems of income taxation for "integrated" systems that gave recognition at the personal level for taxes paid at the corporate level. The proper way to "mesh" classical and integrated systems across international boundaries is not at all obvious.

- Many industrial countries placed more emphasis on the role of sales, excise, value added, and other consumption taxes in their fiscal structures. These taxes have important consequences which are unevenly addressed by the rules of the GATT and the WTO (Hufbauer 1996). Moreever, the doctrine of capital export neutrality cannot be satisfactorily implemented without taking these other taxes (and production subsidies) into account.

- New forms of international income and expense exploded: technology income of various types (from movie royalties to high tech patents); plain vanilla and chocolate sundae portfolio income (interest and dividends; gains and losses from dealing in foreign exchange and derivatives); electronic commerce (both telecommunications transmission services, and all sorts of remote value added services); business, artistic and professional services (Bechtel to Michael Jackson to Arthur Andersen); and huge intracorporate sales of goods and services. Source and residence rules are not obvious for many of these new forms of income and types of expense. In many cases, comparable transactions between unrelated taxpayers do not exist (or are highly idiosyncratic), so there are few ready benchmarks for applying the arm's length pricing standard.

- The combination of global integration, new forms of income and expense, and increasing sophistication among corporate taxpayers loosened the old links between geography and income. Increasingly, firms learned to "game" the tax systems of the world, not only to alter source and residence on paper, but also to change the location of plants, R&D facilities, and headquarters operations.

- Between the 1960s and 1980s, the United States exchanged its position as the high income tax country (in terms of personal and corporate marginal tax rates) for a new position as a low income tax country, relative to other industrial nations. However, since the mid-1980s, the United States has once again drifted up to join the high corporate tax ranks, as established industrial countries and emerging industrial powers have cut their own corporate rates.

- At the same time, multinational corporations based in Europe, Asia and Latin America came to play a much larger role in the world economy.

- This last two fact meant that the U.S. role as disciplinarian of tax distortions and tax discrimination became considerably smaller. And it meant that Treasury revenues from U.S. firms doing business abroad diminished relative to revenues from foreign firms doing business in the United States.

The U.S. Response

What has been the U.S. response to the altered landscape of the global economy? Senator Russell Long (D.-LA) said it all in his famous aphorism, "Don't tax you, don't tax me, tax the fellow behind the tree!" U.S. and foreign multinationals are the quintessential "fellow behind the tree": big, rich, cavalier -- at least in the eyes of tax populists (such as Senator Byron Dorgan, D-N.D.).

The Tax Reform Act of 1986 marked the turning point. The conceptual foundations of U.S. international tax policy, already eroded by global forces, were all but ignored in the search for revenue. In this search, the guiding light had been created years earlier by Stanley S. Surrey, a distinguished professor at the Harvard Law School and Assistant Secretary for Tax Policy during the Kennedy and Johnson Administrations. Surrey's searchlight was his list of "tax expenditures" -- a schedule of revenue lost by departures from an "ideal" tax system. Surrey's ideal basically amounted to a flat rate, broad base, classical tax system.

This ideal is too simplistic for the realities of international taxation. Importantly, it ignores the fact that, whereas the U.S. Congress can (if it wishes) establish uniform taxation across all states and sectors of the U.S. economy, the Congress has no such power for the rest of the world. In a global economy, where the United States is one among several important players, the realities of competition must be taken into account. Tax expenditure estimates ignore this fundamental fact.

Despite this basic flaw, Surrey's ideal tax system has long been used to generate the Treasury's tax expenditure estimates. These numbers were picked up by Congressional tax staff, suitably polished, and became objects of desire in the 1986 tax reform debate. The consequences are described in my book (Hufbauer 1992). Basically, revenue goals were pushed wherever there was a soft spot in the collective armory of multinational firms, and wherever foreign retaliation would not be too severe. The result is a great deal more complexity and somewhat more revenue.

Much the same process has continued to dominate international tax legislation since the Tax Reform Act of 1986. Indeed, as McClure and Ossi (1997) point out, despite widespread recognition that U.S. taxation of international income has become mindlessly complex, and despite many proposals for simplifying the system and giving it direction, only one small reform has been enacted since 1986 (repeal of IRC section 956A).

The year 1997 could see a revival of tax populism, of the 1986 vintage. As before, the search for revenue will be the dominant theme. The big difference between 1997 and 1986 is that the term "tax expenditures" is too dry and technical for present needs, and has come to be replaced by the more emotive term, "corporate welfare". Missing both from the 1986 drive to reduce tax expenditures, and the current drive to cut corporate welfare, is any coherent articulation of the purposes of the tax system in shaping the U.S. role in the international economy.

Instead, the tax writers simply turn to the tax expenditures schedule, and search for pressure points to raise revenue. What's on the list? According to the fiscal year 1997 budget (Office of Management and Budget 1996), here are the corporate items, with figures both for 1997 and the five years 1997-2001 (billions of dollars):

	1997	1997-2001
Exclusion of income of Foreign Sales Corporations	$1.6	$9.0
Inventory property sales source rule exceptions (the Export Source Rule)	1.5	8.5
Interest allocation rules exception for certain financial operations	0.1	0.4
Deferral of income from controlled foreign corporations	2.0	12.1

In 1997, there promises to be an assault on the Export Source Rule, and perhaps another attempt to curb deferral. Some members of Congress may push to replace the arm's length pricing standard by a formula approach, but they are unlikely to make headway. Abroad, some countries may attempt to tax payments for electronic commerce (e.g., payments for seismic analysis done in the United States for drilling operations conducted in the South China Sea). However, new "source" taxes on electronic commerce will be strongly resisted by the U.S. Treasury (1996).

COUNTERVAILING FORCES

What countervailing forces could alter the evolution of the international tax system, which is now decisively shaped by revenue considerations? In my judgment, four forces are working in a more positive direction.

First, many countries have come to see multinational corporations as an ally, not an enemy. The degree of affection differs from country to country and sector to sector. In situations where local firms have a major presence (especially if they are state enterprises), and in situations where economic rents are abundant (which is true both of natural resources and basic telecommunications), the welcome mat may not be fully extended.

But over the last twenty years, more countries have come to see the advantages of an active presence of foreign corporations in more sectors of the domestic economy (Graham 1996a). This trend is almost sure to continue. As it proceeds, more countries will adapt their tax systems to attract firms, especially high-tech firms, corporate headquarters, and R&D facilities.

Among OECD countries, for example, Spain, Canada and Australia have the most attractive R&D packages for large firms, whereas

Germany, Italy and New Zealand have the least generous packages (Organisation for Economic Co-operation and Development 1996). In the next decade, countries such as Brazil, Argentina, Chile, Singapore, China and India are likely to become important competitors for high-tech firms and R&D facilities. Right now, the United States is "king of the mountain" among industrial countries in terms of R&D effort, corporate vitality and economic growth. To keep this position, the United States will need to adapt its tax system to remain at least as friendly as its major competitors.

The second countervailing force is growing recognition of the economic gains associated with larger exports of goods and services. Export growth has contributed about 28 percent of real U.S. GDP expansion in the past four years, even though exports in 1992 accounted for only 10 percent of the U.S. economy. More important, studies by Richardson and Rindal (1996) and the U.S. Department of Commerce (1996) demonstrate that export jobs pay a wage and salary premium of about 15 percent over comparable jobs in other sectors of the economy. These facts, energetically advertised by the Clinton Administration (Magaziner 1996), are gaining acceptance among the American public. Within a few years, tax measures that harm U.S. export capabilities may be regarded with the same disapproval that would be visited on tax measures that discourage education or R&D.

The third countervailing force is the demonstrably strong connection, at least for the United States, between foreign direct investment (FDI) and U.S. exports. Research that I participated in a few years ago shows that U.S. exports to a given country rise by about 2.5 percent for every 10 percent increase in U.S. direct investment in that country (Hufbauer, Lakdawalla and Malani 1994). Graham (1996b) also finds a strong positive correlation between U.S. foreign direct investment and U.S. exports (after allowing for the normal "gravity model" variables -- income per capita, population and distance).

Increasingly, foreign direct investment is an essential component of corporate export efforts. This is especially true for high-tech customized goods and services that require hands-on interaction between seller and buyer, and extensive after-sale maintenance. One reason the United States exports so little to Japan, Korea and China is that local policies in those countries have long kept U.S. multinationals at bay. Those policies are being transformed for reasons already discussed. To expand its export position in Asia and elsewhere, the United States will need to do its part by maintaining a competitive tax climate for U.S. firms that invest abroad.

The fourth countervailing force on my list is the high response rate of production location to corporate tax rates. This is a subject that DeRosa and I recently explored in a report for the

Export Source Coalition (1997). While "older" studies (dating from 1981) surveyed by Hines (1996a) cannot be summarized by a single number, a rough characterization of their results is that a 1 percentage point increase in the effective business tax rate induces a 1 percent decrease in the stock of plant and equipment. In other words, the "modal older study" (to use an unscientific concept) carried out between 1981 and 1995 found an elasticity coefficient of 1.0.

However, recent scholarship has detected significantly larger effects. Grubert and Mutti (1996) estimated an elasticity coefficient of 3.0 for U.S. foreign direct investment placed in various locations. In another paper, Hines (1996b) estimated that a one percentage point increase in a state's corporate tax rate (e.g., from 6 percent to 7 percent) would reduce inward foreign investment in the state by about 10 percent. Finally, in a paper studying the effect of taxation and corruption on direct investment flows from 14 "home" countries to 34 "host" countries, Wei (1997) estimated an elasticity coefficient of 5.0 for the impact of the host country's tax rate.

The recent scholarship uses more sophisticated econometric techniques than the earlier work surveyed by Hines. But more is at work than an improved ability to detect production response rates. With the integration of the world economy, and the sharp decline of major kinds of political risk (communism, socialism, expropriation, protectionism), firms have probably become more responsive to differental tax rates.

The consequences of high response rates can be dramatic. Hufbauer and DeRosa (1997) calculate, for example, that repealing the Export Source Rule -- a leading target on the Administration's 1997 tax agenda -- could ultimately reduce U.S. exports by about $33.5 billion, as firms relocate production abroad, and knock about $2.6 billion off the wage and salary premiums associated with high-paying export jobs, for a revenue gain of only $1.2 billion. Similar adverse consequences might be found for eliminating the Foreign Sales Corporation or repealing the deferral provisions of U.S. tax law.

To summarize, it seems likely that a chain of competitive consequences -- running from friendly tax climates abroad, to wage and salary premiums in U.S. export industries, to the link between U.S. foreign direct investment and U.S. exports, and to the production response of export activities to tax differentials -- will ultimately serve to reverse the present focus on revenue collection as the touchstone of U.S. tax policy. If that happens, then a sensible international component of basic tax reform will be easier to implement.

THE INTERNATIONAL COMPONENT OF BASIC TAX REFORM

The fundamental goals of basic tax reform, along the lines of the flat tax or the Nunn-Domenici USA Tax, are to promote savings and investment and to simplify the tax system. There is little reason to endorse the upheaval and agony of basic tax reform unless you believe three things: savings and investment will rise significantly in response to a consumption-oriented tax system (Hubbard and Skinner 1996); higher savings and investment will augment the long-term rate of U.S. GDP growth from, say 2.5 percent to 3.5 percent; and tax simplification is very desirable, even if some people pay more taxes. In the overall scheme of things, the international aspects of basic tax reform are secondary to these fundamental goals.

That said, the international consequences would be significant. The design of basic tax reform proposals is essentially "territorial": corporate income earned within the United States would be subject to U.S. tax; corporate income earned abroad would not. This basic change would ensure that U.S. firms operating abroad could compete on the samé tax terms as foreign firms. And on balance this feature would not cost revenue, since foreign subsidiaries operating in the United States could no longer deduct interest payments to their overseas parent corporations. The additional revenue collected on the U.S. operations of foreign subsidiaries would make up for any foregone tax on the overseas operations of U.S. subsidiaries.

Once the territorial aspect of the reformed tax system is understood and accepted, that leaves an important international question: what is the proper tax treatment of exports and imports of goods and services? The economic and legal aspects of this question are analyzed in my monograph (Hufbauer 1996). Here I will sketch the central issues that are likely to arise when the debate is joined. For brevity, I list them in the form of political and economic propositions.

Political propositions

- Imported goods and services should be taxed the same as domestically produced goods and services. This will guard against an apparent tax incentive to produce abroad and sell the goods and services back into the U.S. market. Exceptions to symmetrical tax treatment between imports and domestic production should be negotiated country-by-country, or with regional groups such as the European Union or the MERCOSUR, on a reciprocal basis.

- Business profits earned on U.S. export sales should be treated the same as business profits earned on production abroad: in other words, these profits should be excluded from the U.S. tax net. Otherwise there will be an apparent incentive to locate abroad rather than produce in the United States for the export market.

Economic propositions

In addition to these political propositions about basic tax reform, certain less evident economic propostions need to be stated.

- There are two basic principles for making adjustments at the border for domestic taxation: the destination principle and the origin principle. Under the destination principle, domestic taxes are imposed on imports of goods and services, but not imposed on exports. Under the origin principle, just the reverse happens: domestic taxes are not imposed on imports, but they are imposed on exports.

- In theory, exchange rate changes can offset border tax adjustments, both in terms of the overall U.S. trade balance position and in terms of the relative attractiveness of the United States as a place to invest. However, the impact of exchange rate changes will almost certainly differ, sector-by-sector, from the impact of border tax adjustments. Moreover, not one person in ten understands the macro economic equivalence between exchange rate changes and border tax adjustments. Those are two powerful reasons for endorsing the destination principle.

- The impact of basic tax reform on the domestic savings-investment balance will primarily determine the trade balance consequences of tax reform. The presence or absence of border tax adjustments, and changes in the U.S. system of taxing foreign income, are secondary considerations. If basic tax reform increases U.S. savings more than it increases U.S. investment, the U.S. trade balance will "improve"; if tax reform increases U.S. investment more than savings, the trade balance will "worsen".

- That said, the success of basic tax reform will be judged far more by its investment consequences than by its trade balance consequences. The destination principle is more friendly to investment than the origin principle, since it automatically creates tax parity between domestic production both in competition with imports and in export markets.

- However, destination principle adjustments require more administrative machinery, and they create a new form of tax on international transactions. This is particularly troublesome for rapidly growing electronic commerce. Destination principle adjustments would require, for example, U.S. taxation of data analysis in Singapore performed for a U.S. bank, or payments by U.S. firms to France Telecom for the transmission of voice, data or video signals.

Squaring the circle

From these political and economic considerations, I draw a few major conclusions about the international aspects of basic tax reform. First, destination principle border adjustments should be part of basic tax reform legislation. However, the President should be authorized to negotiate origin principal taxation on a reciprocal basis, sector-by-sector, country-by-country. A system of origin principle taxation might be negotiated fairly soon with Canada and Mexico. It might be negotiated globally for electronic commerce, before the European and other countries attach value added taxes to electronic purchases.

Presumably, origin principle taxation would only be negotiated with countries, and in sectors, which implement business tax systems similar to the reformed U.S. system. Presumably origin principle taxation would apply equally to value added, sales and corporate income taxes (otherwise, U.S. firms would still be paying value added taxes on their exports to Europe and elsewhere). And presumably, the origin principle would only be negotiated in contexts where the United States was reasonably assured that it would not lead to tax avoidance (e.g., transhipment of French goods through Canada and then to the United States to avoid U.S. border tax adjustments on direct imports from France). The similarity of tax systems, the comprehensive character of the origin principle (where negotiated), and the anti-abuse provisions, would guard against tax incentives for production relocation.

Under the origin principle, the United States would not collect revenue on imports of goods and services, but it would collect revenue on exports of goods and services. Because bilateral trade would seldom be balanced, one country or the other would collect more revenue from application of the origin principle rather than the destination principle. In some contexts, supplementary provisions might need to be negotiated between the partners to provide for revenue equalization.

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Prepared Statement of Donald C. Lubick

Mr. Chairman and Members of the Committee: I am pleased to appear before you today to discuss certain of the revenue offsets to the tax-cut package contained in the President's Fiscal Year 1998 budget. The President's plan provides tax relief, promotes a fairer tax system and encourages activities that contribute to economic growth, while achieving a balanced budget by Fiscal Year 2002. We look forward to working with this Committee to accomplish these goals.

Yesterday, Deputy Secretary Summers testified before this Committee regarding the several tax proposals in the President's FY 1998 budget plan to encourage higher education and job training. In addition to encouraging investment in education, the President's tax plan would provide much-needed tax reductions for working families, capital gains tax relief and simplification for home ownership, and tax incentives to promote savings and to foster the hiring of the economically disadvantaged. Under the President's plan and Treasury scoring, the gross tax cuts would total $98.4 billion from FY 1998 through FY 2002.

The President's tax plan is fiscally responsible. The cost of these tax cuts is offset by cutting spending, reducing unwarranted and unintended corporate tax benefits, and extending several excise taxes, some of which have recently expired. In particular, the Administration is concerned that corporations and other sophisticated taxpayers engineer transactions in ways never anticipated by Congress. These transactions exploit gray areas and inconsistencies in the tax law or take advantage of tax rules that are easy to manipulate with little or no change in the economic substance of the transactions.

These measures will improve tax policy, simplify the tax system and help ensure that the burden of deficit reduction is borne fairly by all sectors. They produce budget savings of $34.3 billion through FY 2002. Continuance of trust-fund excise taxes, including some that have expired, will provide additional revenues of $36.2 billion through FY 2002. Attached to this testimony is a table showing all the revenue provisions in the President's tax package and their estimated revenue effects. Effective dates of the revenue offsets have generally (with only one minor exception)[1] been made entirely prospective. For instance, all those proposals that were announced by the Administration in December 1995 (and in the FY 1997 budget released in March 1996) with immediate effective dates are now proposed to be made effective as of the date of first committee action.

In the letter of invitation, you have asked that my testimony focus on the policy objectives underlying four groups of revenue-raising proposals: (1) the proposals relating to financial transactions; (2) the corporate tax proposals; (3) the proposals affecting tax accounting rules; and (4) the international tax proposals. To help illustrate the policy objectives, the discussion below highlights certain of the more notable proposals within each group.

1. PROVISIONS RELATING TO FINANCIAL TRANSACTIONS

In general: The provisions relating to financial transactions focus on the dramatic evolution over the last few years of financial transactions that taxpayers engineer to exploit the gray areas of the tax law. The tax law has not dealt well with the incredible pace of financial innovation, which allows a sophisticated taxpayer to obtain different tax characterizations by making small changes in a transaction's terms, but without significantly changing its economics. Effectively, the taxpayer can elect the tax treatment desired. As tax engineering of financial transactions has become more aggressive, the tax base has been eroded in a way never foreseen or intended by Congress.

Developers of financial products have focused their efforts on four areas of the tax system that are particularly vulnerable: distinctions between debt and equity; opportunities for arbitrage[2]; opportunities for avoiding gain recognition on transactions that are economically equivalent to sales; and problems with measurement of gain or income. The President's budget contains proposals to address problems in each of these four areas.

- Maintaining The Distinction Between Debt And Equity

Discussion: The Administration has become increasingly concerned by the blurring of the traditional lines between debt and equity that has occurred in some recently developed financial instruments. Corporations often find it desirable from a non-tax perspective to issue equity, even though it means giving up a tax deduction.[3] Historically, accounting, regulatory, and credit-rating rules and lending practices restrained the amount of debt corporations could issue. In recent years, however, the tension between non-tax rules and tax rules has been significantly eroded. Hybrid instruments have been developed that allow issuers to achieve their business objectives while still maintaining the desirable tax characterization of the instrument as debt. For example, the Federal Reserve recently made it possible for banks to issue instruments that are treated for bank regulatory purposes as equity capital, but can qualify as debt for tax purposes.

In some circumstances, however, corporations favor issuing preferred stock over issuing debt. For example, when the dividends-received deduction (DRD) is worth more to the corporate holder than an interest deduction would be to the issuer (e.g., the issuer has net operating losses and so cannot use an interest deduction), the parties will structure an investment as stock instead of debt.[4] Certain kinds of preferred stock are virtually indistinguishable from debt. Often, debt-like preferred stock is marketed specifically to other corporations, so that the yield on this preferred stock takes into account the DRD available to the holder. In this case the gray area between debt and equity is exploited to obtain a benefit that was intended only to apply when one corporation makes an equity investment in another corporation. This can allow taxpayers to avoid most, if not all, of the corporate-level tax.

The ability of taxpayers to manipulate the terms of financial instruments that fall within the gray area between debt and equity means that the problem of hybrid instruments cannot be solved simply by drawing a sharper line between debt and equity. For example, a rule that required instruments with certain terms to be characterized in all cases as equity for tax purposes would only make it easier for issuers that desired equity treatment of a hybrid instrument to get that result. Thus, the most appropriate way to address the treatment of instruments that cannot clearly be characterized as either debt or equity is to reduce the tax implications of the characterization.

Proposals: The President's tax plan contains several proposals that are designed to reduce inconsistent tax treatment of hybrid financial instruments without generally trying to change the characterization of those instruments. The proposals include:

—A rule that disallows an interest deduction if payments on a debt instrument will be made in the stock of the issuer. If the holder of a debt instrument can be forced to take stock, the holder and the issuer do not have a clear creditor-debtor relationship.

—A rule that disallows an interest deduction if the weighted average maturity of a debt instrument exceeds 40 years.[5] An instrument's term has always been a significant debt/equity factor, but it has never been clear when a term was too long. The proposal provides a clear standard.

—A rule that prevents corporations from treating an instrument as equity for accounting purposes and debt for tax purposes. This rule prevents "regulatory arbitrage" (i.e., getting different treatment from various regulators for the same product).

—A rule that defers an interest deduction until the interest is paid in cash if payments on the debt instrument can, at the holder's option, be made in stock of the issuer.

—A rule that eliminates the 70% and 80% DRD for preferred stock that has an enhanced likelihood of recovery of principal or of maintaining a dividend, or both, or that otherwise has certain non-stock characteristics. The proposal would not apply to preferred stock that participates in corporate growth. Thus, it generally would not apply to preferred stock that can be converted into common stock.

- Curtailing Arbitrage Opportunities: Reduce Minimum Dividends-Received Deduction to 50 Percent

Discussion: Another gray area that corporations have exploited by using sophisticated financial transactions is the limits on the dividends received deduction. A number of rules are intended to prevent corporate taxpayers from creating tax arbitrage using the DRD or from obtaining the benefit of the deduction without bearing the economic burdens of stock ownership. For example, a corporation is required to establish a 46-day (or, in certain cases, 91-day) holding period for the dividend-paying stock before the deduction is available. These holding periods run only while the stockholder is fully subject to the risks of equity ownership. Another set of rules reduces the 70- and 80-percent dividends received deductions to the extent a holder uses debt to finance its investment in the stock.

A classic example of a DRD tax arbitrage is when a corporation buys stock for $100 one day before the ex-dividend date. The corporation receives a dividend of $2.00 and claims a $1.40 DRD. The day after the ex-dividend date, it sells the stock for $98, claiming a $2.00 loss. The net result is the corporation has no economic gain or loss but can claim a $1.40 net loss for tax purposes. Although the holding period rules described above largely prevent taxpayers from using this specific transaction, there are many ways for a corporation to obtain similar results by entering into more complex transactions. These transactions are relatively easy to structure using portfolio stock (i.e., less than 20-percent owned stock). Not only do these transaction have the potential to eliminate tax on corporate income, they encourage corporations to waste resources on developing tax arbitrage schemes.

It is also arguable that a holder of portfolio stock is a passive investor, regardless of whether the holder is an individual or a corporation. Thus, a corporation which owns a small minority interest in another corporation should not qualify for a special tax benefit when individual investors do not.

Proposal: The proposal responds to the arbitrage problems not by creating more complex rules to prevent taxpayers from engaging in dividend arbitrage transactions, but rather by reducing the benefits taxpayers would obtain from engaging in those transactions. The proposal would reduce from 70% to 50% the DRD for stock holdings of corporations that own less than 20% of the dividend-paying corporation. A separate proposal would modify the holding period rules to require corporations to bear the risk of equity ownership near the time a dividend is received in order to obtain the DRD.

- Preventing Avoidance of Gain Recognition on Functional Sales: Require Recognition of Gain on Certain Appreciated Positions in Personal Property

Discussion: A person who sells or exchanges property is generally taxed on any gain from the sale or exchange, and, with certain limitations, can deduct any loss from the sale or exchange. Whether a particular transaction or set of transactions results in a sale or exchange for tax purposes is determined under principles developed in case law, but generally turns on whether the taxpayer has disposed of all the benefits and burdens of ownership. In the case of financial instruments, however, this standard is fairly easy to manipulate. It is clear under current law that taxpayers are able to engineer financial transactions to dispose of all of the economic risk and rewards associated with owning particular property without being treated as selling or exchanging the property, and without being taxed on any gain on the property.

A common example of a gain deferral technique is a so-called "short sale against the box." In that transaction a taxpayer who owns a share of stock borrows an identical share and sells it. At that point the taxpayer has cash from the sale, a share of stock, and an obligation to deliver the share or an identical share to the lender. Because the value of the share of stock is completely offset by the obligation to deliver the share, the taxpayer has disposed of economic ownership of the share. Under current tax law, however, gain or loss on the transaction is not recognized until the taxpayer delivers the share (or an identical share) to the lender. This recognition event can be postponed until long after the sale of the stock has occurred.

An equity swap is another example of a transaction that can be engineered to result in the economic equivalent of a sale without any corresponding gain recognition. In an equity swap a taxpayer agrees to pay to a counterparty dividends and appreciation on a certain number of shares of stock, and the counterparty agrees to pay the taxpayer interest (or some other return), based on a "notional" amount equal to the value of the shares, and any depreciation on the shares.

We believe that economically similar transactions should be taxed similarly, and that taxpayers should not be able to elect dramatically different tax treatments for the same transaction based on the transaction's form. Thus, a person who enters into a transaction that has the same economic effect as a sale of an interest in stock or a bond should be subject to tax in the same way as a person who actually sells the stock or bond. Because that is not how current law works, however, taxpayers have an incentive to undertake complex financial transactions, such as equity swaps, to avoid tax on the sale of stock, bonds and other securities.

Proposal: A taxpayer who enters into a transaction that has the same economic effect as a sale of an interest in stock, a debt instrument or certain other securities would be taxed on any gain as if there had been a sale of the interest. The proposal would treat as constructive sales the types of transactions described above, but only if risk of loss and opportunity for gain is substantially eliminated. Thus, for example, if a taxpayer agrees to sell a particular share of stock he owns to another person in two years for a fixed price, that agreement would cause the taxpayer to recognize any gain on the stock as if he had sold it on the date he entered into the agreement.

- Proper Measurement of Gain/Income: Require Average Cost Basis for Securities

Discussion: Treasury has long been concerned about the ability of sophisticated taxpayers to manipulate the amount of income and gain they recognize in financial transactions. A person who sells property is generally taxed on any gain from the sale, and, with certain limitations, can deduct any loss from the sale. The gain or loss is measured by the difference between the basis of the property, which is often equal to the property's cost, and the amount received from the sale. If a taxpayer holds more than one share of the same stock or more than one of the same bond, and the taxpayer sells less than all of the shares or bonds that he or she holds, the taxpayer can use one of several ways to determine the cost of the shares or bonds sold. The taxpayer may be able to specif:ally identify the securities sold by their cost, for example by simply instructing a broker to sell shares that were acquired at the highest price. Or the taxpayer can determine the cost of securities sold by treating the transaction as a sale of the securities the taxpayer has held the longest (the "first-in first-out" method). Any holder of shares in a mutual fund is also permitted to determine the cost of each share by averaging the cost of all the shares.

Having multiple methods for determining basis and holding periods for securities is complex and difficult to administer. Record keeping for multiple methods is confusing, and mistakes are easy to make. Less sophisticated taxpayers, unaware of their ability to specifically identify securities sold, can be disadvantaged by the default first-in first-out rule. In addition, any third-party record keeping and reporting of basis, such as that increasingly performed by mutual funds for their shareholders, is not as useful as it could be because taxpayers often use a method for calculating their basis that is different from the one used for reporting basis to them.

Further, the current rules give inappropriate results and can lead to abuse. In most cases, and especially when a taxpayer holds stock or securities in "street name," the taxpayer has no way to determine the cost of the actual shares sold. The "specific identification" technique, available under current law, allows taxpayers to avoid tax on true economic gains. This technique invites manipulation by allowing taxpayers to distinguish among fungible securities exclusively by their tax characteristics, even though those tax characteristics have no independent economic significance.

Proposal: The Administration's proposal would simplify and rationalize current law by providing taxpayers with a single method of accounting for their basis in securities and determining holding period. In general, the proposal provides that the basis for fungible securities is the average cost of the securities. In addition, a first-in first-out method would be used for other purposes such as determining the holding period of fungible securities. The proposal would eliminate the specific identification method.[6] Averaging the cost of all the identical shares or securities the taxpayer owns allows a more accurate measurement of the taxpayer's true income from a sale.

- Proper Measurement of Gain/Income: Require Reasonable Payment Assumptions for Interest Income on Certain Debt

Discussion: A person who owns a debt instrument or who lends money must include in income any interest on the debt or loan. In general, a corporation is subject to tax on this interest income as it accrues, rather than when it is actually paid. If a debt can be paid off by the borrower by a specified date without interest (as is the case with certain credit card balances), interest generally does not accrue (and no tax is imposed) under tax rules until the specified date has passed. This is true even though the taxpayer can accurately predict that a certain percentage of borrowers will not pay off the debt by the specified date. Tax rules that apply to pools of mortgages require investors in the pools to use statistical predictions of payment patterns to determine how much interest income to accrue from the mortgages each year.

In many cases receivables have a low interest rate, or a zero interest rate, if they are paid within a certain period. Many credit cards, for example, do not charge a card holder interest if the holder pays the outstanding balance on the card within a grace period. Even though most credit card balances are not paid within this grace period, current tax rules can allow the credit card company to assume the cardholder's balance will be paid off in the period. Since the company assumes that no interest will be incurred by the holder, it accrues no interest income on outstanding balance during the grace period. The treatment allows a permanent deferral of interest income.

Proposal: Rules similar to the rules that apply to pools of mortgages would be applied to pools of credit card receivables and other loans that can be paid by a specified date without interest. This measure would require an investor in such a pool to take into account that many of the borrowers in the pool will owe interest.

2. CORPORATE PROVISIONS

Like the proposals that relate to financial instruments, these provisions prevent taxpayers from exploiting gray areas and inconsistencies in the tax law to manipulate income. The proposals also eliminate unwarranted corporate subsidies. Highlights include:

- Require Gain Recognition for Certain Extraordinary Dividends

Discussion: A redemption of stock by a corporation is sometimes treated like a sale of the stock, and the income is generally treated as capital gain. A corporate shareholder, however, prefers to receive dividends rather than capital gains in order to take advantage of the dividends received deduction. Some corporate taxpayers take the position that certain redemptions of stock that are effectively sales of the stock are treated as dividends. This allows most of the proceeds of the sale to escape taxation because the corporate taxpayer will claim a dividends received deduction.

Proposal: The proposal would eliminate this loophole by eliminating the ability of corporate shareholders to use certain rights to acquire stock as actual stock ownership. This provision has received bipartisan, bicameral support as the appropriate course to halt a current corporate tax loophole. It was included in the Balanced Budget Act of 1995.

- Treat Certain Preferred Stock Like Debt in Reorganizations

Discussion: In mergers and acquisitions, a person receiving stock of the acquiring corporation in exchange for stock of the target corporation generally recognizes no gain. By contrast, if a person receives property (including debt securities) in exchange for stock, gain generally will be recognized. A holder of common stock in the target corporation can receive preferred stock in the acquiring corporation without recognizing gain, even though the preferred stock may be substantially equivalent to a debt security. Similar rules apply to the exchange of assets for stock when a corporation is formed.

Preferred stock can be structured to be economically equivalent to a debt security that does not represent a meaningful equity interest in the issuing corporation. A shareholder receiving this debt-like instrument has effectively sold its interest in the corporation. The tax treatment of this type of transaction should not depend on an arbitrary distinction between debt and equity.

Proposal: The proposal would prevent taxpayers from exploiting the gray area between debt and equity and eliminate the inconsistency that exists under current law. The proposal would require shareholders who receive preferred stock that is like a debt security to recognize gain in a merger, acquisition, or corporate formation. In general, the proposal applies to preferred stock that has an enhanced likelihood of recovery of principal or of maintaining a dividend, or both, or that otherwise has certain non-stock characteristics.

- Repeal Section 1374 for Large Corporations

Discussion: Corporate income is generally subject to two levels of tax. The corporation is taxed directly on its income and the shareholders are taxed on any distributions they receive from the corporation. A corporation can avoid this two-tier tax by electing to be an "S corporation" or by converting to a partnership. In both cases, any future income and gain are taxed directly to the shareholders or the partners, and distributions of cash are tax-free. The effects of converting to an S corporation or a partnership, however, are quite different. Under section 1374, a conversion to an S corporation is generally tax-free, except that any built-in gain in the corporation's assets at the time of conversion is triggered if the assets are sold within 10 years of the conversion. By contrast, a conversion to a partnership is a fully taxable transaction in which the corporation is taxed on all of the built-in gain in its assets and the shareholders are taxed on the built-in gain in their stock.

The tax treatment of the conversion of a C corporation to an S corporation generally should be consistent with the treatment of its conversion to a partnership. In particular, any appreciation in corporate assets that occurred during the time the corporation is a C corporation should be subject to the corporate-level tax.

Proposal: An election by a large corporation to be treated as an S corporation will be treated in the same manner as a conversion to a partnership. As a result, a large corporation that elected to be an S corporation would recognize any built-in gain in its assets and the shareholders would recognize any built-in gain in their stock. For this purpose, a large corporation is any corporation with a value of more than $5 million at the time of conversion. The value of the corporation is the fair market value of the stock on the date of the conversion.

- Require Gain Recognition on Certain Distributions of Controlled Corporation Stock

Discussion: Since 1986, most corporate distributions of property (including stock of a subsidiary) cause the corporation to be taxed on the appreciation in the asset distributed, and result in a taxable event to the shareholder receiving the property. Section 355 provides a limited exception to this treatment. If certain statutory requirements are met, a corporation may distribute stock of a controlled subsidiary to its shareholders on a tax-free basis. This treatment is designed to permit corporate structures to be rearranged without tax effect, provided the shareholders continue their investment in the modified enterprise.

Under section 355 of current law, economically identical transactions can be treated as tax-free or taxable depending on the order of the various steps. Transactions that in end result are effectively complete dispositions of a business to new investors presently can qualify for the favorable tax treatment under section 355. These transactions combine a tax-free distribution of the stock of a corporation under section 355 with a tax-free reorganization (such as a merger). These transactions are often referred to as *Morris Trust* transactions.

Proposal: The proposal would eliminate the loophole under current law by limiting the ability of a corporation to avoid recognizing gain when it disposes of a business. A parent corporation would be taxed on the distribution of appreciated stock of its controllėd subsidiary, unless the same shareholders own at least 50 percent of both the parent and the subsidiary throughout the period beginning two years before the distribution and ending two years after it. This modification is intended to limit the favorable tax treatment under section 355 to situations where the shareholders maintain their investment in the existing corporate enterprise, albeit it in modified form. This proposal would not change the treatment of shareholders; they would continue to have neither gain nor dividend income under section 355.

- Reform the Treatment of Certain Corporate Stock Transfers

Discussion: In certain circumstances, a transfer of subsidiary stock between related corporations is treated as a dividend distribution instead of a sale. Inconsistencies in the tax law allow U.S. corporate groups to use this treatment to produce tax losses when no economic loss has occurred. A similar transaction may be available to U.S. subsidiaries owned by a foreign parent corporation. A U.S. corporation receiving a dividend from a fóreign subsidiary that it owns is generally allowed a credit for the foreign taxes paid by the subsidiary because the U.S. corporation has indirectly paid that tax (in other words, the U.S. corporation bears the burden of that tax because it could have received a larger dividend if the tax had not been paid to the foreign government). The special rules for transfers of stock between related parties, however, may treat a U.S. subsidiary as receiving a dividend from a corporation that it does not actually own. In this case, the foreign tax credit is inappropriate because the U.S. corporation did not bear the burden of the foreign taxes.

Proposal: The proposal would prevent the creation of artificial losses and inappropriate tax credits by reforming the treatment of "dividends" deemed to arise from stock transfers between related parties. Specifically, if the purchaser is a domestic corporation, the proposal would treat the transactions with more consistency by clarifying that the deemed dividend from the purchaser would generally be treated as an extraordinary dividend requiring a basis reduction. The proposal would further require gain recognition to the extent the nontaxed portion of the extraordinary dividend exceeds the basis of the shares transferred.

If the purchaser is a foreign corporation, the proposal would limit the amount treated as a dividend (and the associated foreign tax credits) from the purchaser to the amount of the purchaser's earnings and profits attributable to stock owned by U.S. persons related to the seller.

3. ACCOUNTING PROVISIONS

These measures are designed to improve measurement of income by eliminating loopholes and inconsistent treatments.

- Phase out Preferential Tax Deferral for Certain Large Farm Corporations Required to Use Accrual Accounting

Discussion: Corporate taxpayers engaged in a farming business are required to use the accrual method of accounting (i.e., by recognizing revenues when earned and deducting expenses when incurred) rather than the cash method when their annual gross receipts exceed a specified threshold ($25 million in the case of closely held corporations). However, when the method is changed from cash to accrual, income would ordinarily escape taxation if it had been earned in a year in which the cash method is used and received in a year in which the accrual method is used. In the case of any taxpayer other than a farming corporation, a one-time adjustment must be made in order to ensure that income and deductions are not duplicated or omitted. Farming corporations are permitted to place the amount of this adjustment in "suspense," although the adjustment is required to be included in income in whole or in part upon the occurrence of certain subsequent events, such as contraction of the business or a change in its status as a closely held corporation. The suspended adjustment thus represents a potentially indefinite deferral of the recognition of income.

The current-law treatment of the accounting change for large farming corporations, which permits a potentially indefinite deferral of income, is a substantial and inappropriate departure from the policies underlying the rules for accounting method changes generally, in which the cumulative effect of an accounting method change is taken into account generally over a period not exceeding six years. These large farming corporations should be subject to the same rules that apply to all other taxpayers upon a change in their method of accounting.

Proposal: The proposal would eliminate the ability of large farming corporations to defer indefinitely this special adjustment upon a change to the accrual method of accounting. In addition, the proposal would require that any existing "suspense" account created by a farming corporation that has previously changed to the accrual method would be added to taxable income over a 10-year period.

- Repeal Lower of Cost or Market and Subnormal Goods Inventory Accounting Methods

Discussion: Taxpayers are permitted to use a variety of inventory methods in determining their income tax liability. In connection with the first-in, first-out ("FIFO") method or the retail inventory method, taxpayers may reduce the value of their inventories under either the "subnormal goods" method or the "lower of cost or market" method. Under the subnormal goods method, taxpayers may write down, to net realizable value, the value of inventory items that have declined in value due to damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes. Under the lower of cost or market method, taxpayers examine individual inventory items and write down the value of those that have a replacement cost lower than their original cost (i.e., those that have declined in value). These methods generate a tax deduction in the year the write-down is taken, although the deduction is recaptured when the inventory item is sold or otherwise disposed of.

These inventory methods distort income by inappropriately reducing the tax basis, or cost, of ending inventories, thus overstating cost of goods sold and understating taxable income. Allowing write-downs when either the value or replacement cost declines prior to the sale of the goods is an exception to the realization principle of the income tax system and results in costs not being properly matched with revenues. These methods allow write-downs for value decreases, but do not require write-ups for either value increases or recoveries of previous write-downs, resulting in a one-way mark-to-market provision benefitting a small number of taxpayers to the detriment of the taxpaying public. In addition, the methods are complex and require substantial taxpayer and IRS resources for compliance and examination.

Proposal: The proposal would eliminate the ability of taxpayers to use these inventory methods, postponing the recognition of the loss through decline in value of inventory to the year in which the property is sold or otherwise disposed of. The proposal includes an exception for small businesses with average annual gross receipts over a three-year period of $5 million or less.

- Repeal Components-of-Cost Inventory Accounting Method

Discussion: Under current law, taxpayers are permitted to use a variety of inventory methods in determining their income tax liability. One is the last-in, first-out ("LIFO") method. By assuming that the goods sold in any taxable year are the goods most recently purchased or produced, the LIFO method permits taxpayers to factor out the effects of inflation in the cost of their inventories, thus matching current costs of purchase or production against current revenues. One method of determining the extent of inflation in the cost of manufactured inventories is the "components of cost" method, under which taxpayers treat their inventories as consisting of units of raw material and labor and overhead content, rather than as finished products.

The components-of-cost inventory method distorts income by inappropriately reducing the tax basis, or cost, of ending inventories, thus overstating cost of goods sold and understating taxable income. This method can cause inventory expenses to be overstated, because in some cases it will not adequately account for the effects of technological changes in manufacturing processes upon changes in the cost of the inventory items or their components. Due to technological developments, where skilled labor is substituted for less-skilled labor, or where increased overhead due to factory automation is substituted for labor costs, price indexes computed under this method may tend to overstate the actual impact of inflation on inventories.

Proposal: The proposal would eliminate the ability of taxpayers to use the components-of-cost method.

4. FOREIGN PROVISIONS

These provisions measure foreign income more accurately, prevent manipulation and inappropriate use of the foreign tax credit rules, and eliminate the use of derivative financial instruments to exploit inconsistencies and gray areas in current law. Highlights include:

- Replace Sales Source Rules with Activity-based Rule

Discussion: Current law generally allows 50 percent of the income from manufacturing products in the United States and selling them abroad to be treated as foreign income, even if most of the economic activity generating the income takes place in the United States. This treatment is relevant to the computation of a U.S. taxpayer's foreign tax credit limitation, i.e., the limits on the use of foreign tax credits against U.S. tax on foreign income. By having more income treated as foreign, a U.S.-based multinational with excess foreign tax credits is able to use more of its foreign tax credits and reduce its residual income tax liability to the United States.

The treatment of income as foreign or domestic source, and the foreign tax credit limitation, are relevant only to companies that are subject to high foreign taxes on their foreign operations. Export sales income generally is not subject to any foreign tax. Thus, the 50-percent rule benefits only exporters that have multinational operations, not U.S. exporters that keep all their operations within the United States. Different categories of exporters should be treated equally.

The current rule also distorts overseas investment decisions by providing tax encouragement to companies to create operations in high-tax foreign countries and use artificially created foreign income to offset U.S. taxes with these high foreign taxes. This works to the ultimate benefit of high-tax foreign countries.

A recent industry-funded study finds that the present sales source rules have a revenue cost of more than $1 billion each year without affecting the number of people employed in the United States. We agree with these findings. However, we strongly disagree with the study's projections of the extent to which the present sales source rules promote exports. The study's findings are out of line with other economic studies of the price responsiveness of exports. Relying on more mainstream estimates, Treasury believes that the industry study overstates the increase in exports attributable to the present rules by more than twenty fold. Consequently, we believe that the existing rules' effect on wages is dramatically smaller than the estimate in the industry study. However, even accepting the results of the industry study, the reduction in government revenues is nearly equivalent to the projected increase in wages. Regardless of our differences with the industry study, we are agreed on several key economic conclusions: the existing rule does not increase the number of people employed in the United States, and the revenue cost of the existing rule is substantial.

Proposal: The budget would apportion export income between production activities and sales activities, and thus between U.S. and foreign income, on the basis of an objective measure of actual economic activity.

- Reform Treatment of Dual-Capacity Taxpayers and Foreign Oil and Gas Income

Discussion: A foreign levy, to be eligible for the U.S. foreign tax credit, must be the substantial equivalent of an income tax in the U.S. sense, and must not constitute compensation for a specific economic benefit provided by the foreign country. Taxpayers that are subject to a foreign levy and that also receive (directly or indirectly) a specific economic benefit from the levying country are referred to as "dual capacity" taxpayers, and may not claim a credit for that portion of the foreign levy paid as compensation for the specific economic benefit received. Under a regulatory safe-harbor test, the dual-capacity taxpayer may treat as a creditable tax the portion of the foreign levy that does not exceed the amount of a generally imposed income tax in the foreign country. If there is no generally imposed income tax, the regulation treats the payment as a creditable tax up to the amount of the applicable U.S. tax rate applied to net income.

Foreign oil and gas extraction income (FOGEI) and foreign oil related income (FORI) are subject to special foreign tax credit limitation rules. FORI generally is subject to current U.S. tax under subpart F, while FOGEI generally is not.

The purpose of the foreign tax credit is to avoid double taxation of income by both the United States and a foreign jurisdiction. When a payment to a foreign government is made as compensation for a specific economic benefit, that payment should be deducted as an ordinary cost of doing business; there is no double taxation. Current law recognizes the distinction between creditable taxes and non-creditable payments for a specific economic benefit, but fails to achieve the appropriate split between the two in a case where a foreign country imposes a levy on, for example, oil and gas income only, but has no generally imposed income tax.

Proposal: The proposal would treat payments by a dual-capacity taxpayer to a foreign country as taxes only if there is a "generally applicable income tax" in that country. A tax will not qualify as a generally applicable income tax unless it has substantial application both to non-dual-capacity taxpayers and to persons who are citizens or residents of that country. The proposal thus would treat no portion of a foreign levy as a tax if the foreign country has no generally applicable income tax. The proposal generally would retain the rule of present law where the foreign country does generally impose an income tax. In that case, credits would be allowed up to the level of taxation that would be imposed under that general tax, as long as the tax satisfies the statutory definition of a "generally applicable income tax."

The change to the dual-capacity taxpayer rules would permit two additional rationalizing and simplifying changes to related tax rules. The proposal would convert the special foreign tax credit limitation rules of present-law into a new foreign tax credit separate limitation basket for foreign oil and gas income. It also would treat foreign oil and gas income (including both FOGEI and FORI) as subpart F income.

CONCLUSION

In conclusion, the President's FY 1998 budget plan proposes to reach balance by 2002 with prudent tax reductions that are pro-family, pro-education, and pro-economic growth, and that are targeted to those who need them the most, with offsets that emphasize stopping abuses and closing loopholes but that do not raise taxes on legitimate business transactions. We look forward to working with the Committee on these proposals. I would be pleased to answer any questions you might have.

ENDNOTES

[1]: The proposal to require gain recognition for certain extraordinary dividends retains the effective date of a similar provision that was contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

[2]: Arbitrage generally refers to the ability to shift tax deductions and losses (or other income- or tax-reducing items) to high-rate taxpayers and shift tax income and gains (or other income- or tax-increasing items) to low-tax rate taxpayers, without actually shifting economic losses, gains, or income.

[3]: A holder of stock must include dividends in income, but the corporate issuer generally does not receive a tax deduction for the dividend payments. A holder of debt must similarly include interest in income, but the issuer of the debt generally receives a corresponding tax deduction, subject to certain limitations. Because an issuer can deduct interest but not dividends, the tax system generally provides an incentive for companies to use debt rather than equity financing.

[4]: While stockholders must take dividends into income, holders that are domestic corporations can generally offset that income by a tax deduction for 70% of the amount of the dividend. The percentage of this dividends-received deduction (DRD) is generally increased to 80% if the taxpayer owns at least 20% of the stock of the dividend-paying corporation. Whether a particular instrument issued by a corporation is debt or equity is determined under all the facts and circumstances, based on principles developed in case law.

[5]: Because the proposal applies based on weighted average maturity, a debt instrument that paid regular, annual coupons could have a maturity in excess of 40 years without being subject to the proposal.

[6]: Because specific identification is the method that allows a taxpayer to identify a borrowed share as the share delivered on the original sale in a "short sale against the box," the average cost basis proposal would eliminate short-sale-against-the-box transactions. In the absence of the average cost basis proposal, however, a short sale against the box would be a constructive sale.

Effect of Proposals on Receipts
(in billions of dollars)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-2002	1998-2007
Provide tax relief and extend expiring provisions:													
Middle Class Bill of Rights:													
Provide tax credit for dependent children	-0.718	-9.869	-6.806	-8.552	-10.367	-10.369	-10.222	-10.002	-9.789	-10.396	-10.840	-46.003	-97.252
Expand Individual Retirement Accounts (IRAs)	0.000	-1.454	-0.477	-0.753	-1.157	-1.674	-2.662	-2.850	-2.957	-3.209	-3.657	-5.515	-20.860
Provide tax incentive for education and training	-0.084	-4.044	-6.199	-7.848	-8.632	-9.386	-9.649	-9.910	-10.339	-10.537	-11.161	-36.109	-87.706
Subtotal, Middle Class Bill of Rights	-0.802	-15.367	-13.482	-17.153	-20.176	-21.429	-22.533	-22.762	-23.085	-24.142	-25.658	-87.627	-205.807
Provide targeted welfare-to-work tax credit	0.000	-0.068	-0.137	-0.163	-0.122	-0.061	-0.020	-0.005	-0.001	0.000	0.000	-0.551	-0.577
Provide capital gains exclusion on sale of principal residence	-0.071	-0.288	-0.301	-0.284	-0.268	-0.249	-0.228	-0.206	-0.183	-0.158	-0.132	-1.390	-2.297
Establish DC tax incentive program	0.000	-0.024	-0.046	-0.056	-0.066	-0.068	0.000	0.000	0.000	0.000	0.000	-0.260	-0.260
Provide estate tax relief for small business	0.000	-0.001	-0.164	-0.166	-0.174	-0.182	-0.174	-0.166	-0.156	-0.149	-0.142	-0.687	-1.474
Provide tax incentives for distressed areas	-0.040	-0.424	-0.500	-0.502	-0.469	-0.410	-0.355	-0.312	-0.277	-0.251	-0.228	-2.305	-3.728
Provide tax credit for investment in community development institutions (CDFI)	0.000	-0.002	-0.005	-0.007	-0.009	-0.011	-0.013	-0.014	-0.015	-0.009	-0.002	-0.034	-0.087
Toll statute of limitations for incapacitated taxpayers	0.000	0.000	0.000	0.000	-0.006	-0.049	-0.072	-0.099	-0.121	-0.145	-0.164	-0.055	-0.656
Allow Foreign Sales Corporation (FSC) benefits for computer software licenses	-0.010	-0.090	-0.100	-0.110	-0.120	-0.130	-0.145	-0.160	-0.180	-0.200	-0.220	-0.550	-1.455
Extend exclusion for employer-provided educational assistance	-0.062	-0.645	-0.670	-0.758	-0.247	0.000	0.000	0.000	0.000	0.000	0.000	-2.320	-2.320
Extend R&E tax credit	-0.430	-0.787	-0.540	-0.234	-0.111	-0.041	-0.007	0.000	0.000	0.000	0.000	-1.713	-1.720
Extend orphan drug tax credit	-0.008	-0.019	-0.012	-0.003	-0.003	-0.001	0.000	0.000	0.000	0.000	0.000	-0.038	-0.038
Extend work opportunity tax credit	0.000	-0.128	-0.157	-0.093	-0.031	-0.010	-0.001	0.000	0.000	0.000	0.000	-0.419	-0.420
Extend deduction for contributions of appreciated stock	0.000	-0.034	-0.038	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	-0.072	-0.072
Modify phase-out of Puerto Rico economic-activity tax credit	0.000	-0.027	-0.068	-0.091	-0.109	-0.122	-0.128	-0.128	-0.128	-1.050	-2.021	-0.417	-3.872
Subtotal, provide tax relief and extend expiring provisions	-1.443	-17.924	-16.220	-19.820	-21.911	-22.763	-23.676	-23.852	-24.146	-26.104	-28.567	-98.438	-224.783
Eliminate unwarranted benefits and adopt other revenue measures:													
Deny interest deduction on certain debt instruments	0.015	0.052	0.103	0.158	0.213	0.271	0.334	0.393	0.469	0.544	0.623	0.797	3.160
Defer original issue discount deduction on convertible debt	0.000	0.012	0.021	0.032	0.043	0.052	0.060	0.067	0.073	0.078	0.081	0.160	0.519
Limit dividends-received deduction (DRD):													
Reduce DRD to 50 percent	0.000	0.255	0.339	0.354	0.370	0.387	0.404	0.423	0.443	0.466	0.487	1.705	3.928
Eliminate DRD for certain stock	0.000	0.013	0.023	0.036	0.049	0.063	0.077	0.092	0.107	0.124	0.140	0.184	0.724
Modify holding period for DRD	0.000	0.036	0.026	0.027	0.028	0.029	0.030	0.031	0.033	0.034	0.035	0.146	0.309
Interaction	0.000	-0.008	-0.008	-0.008	-0.009	-0.009	-0.009	-0.010	-0.010	-0.011	-0.011	-0.042	-0.093
Extend pro-rata disallowance of tax-exempt interest expense to all corporations	0.000	0.016	0.031	0.045	0.056	0.065	0.074	0.080	0.086	0.090	0.093	0.213	0.636
Require average-cost basis for stocks, securities, etc.	0.000	0.638	0.601	0.594	0.589	0.589	0.595	0.606	0.623	0.644	0.663	3.011	6.142
Require recognition of gain on certain stocks, indebtedness and partnership interests	0.000	0.038	0.061	0.065	0.071	0.076	0.081	0.088	0.094	0.102	0.110	0.311	0.786
Change the treatment of gains and losses on extinguishment	0.000	0.006	0.006	0.006	0.007	0.007	0.008	0.008	0.009	0.009	0.010	0.032	0.076
Require reasonable payment assumptions for interest accruals on certain debt instruments	0.000	0.079	0.234	0.288	0.289	0.207	0.084	0.079	0.071	0.066	0.070	1.097	1.467
Require gain recognition for certain extraordinary dividends	0.401	0.586	0.006	0.011	0.017	0.023	0.029	0.036	0.042	0.050	0.038	0.643	0.837
Repeal percentage depletion for non-fuel minerals mined on Federal and formerly Federal lands	0.008	0.089	0.092	0.094	0.096	0.097	0.099	0.101	0.103	0.105	0.107	0.468	0.983
Modify loss carryback and carryforward rules	0.005	0.144	0.617	0.798	0.690	0.629	0.599	0.603	0.621	0.637	0.653	2.878	5.991
Treat certain preferred stock as "boot"	0.025	0.145	0.163	0.172	0.180	0.144	0.073	0.045	0.047	0.050	0.052	0.804	1.071

Effect of Proposals on Receipts
(In billions of dollars)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-2002	1998-2007
Repeal tax free conversions of large C corporations to S corporations	0.000	0.001	0.012	0.026	0.035	0.045	0.055	0.066	0.078	0.091	0.105	0.119	0.514
Require gain recognition in certain distributions of controlled corporation stock	0.010	0.062	0.067	0.071	0.073	0.076	0.079	0.082	0.086	0.090	0.093	0.349	0.779
Reform treatment of certain stock transfers	0.031	0.114	0.127	0.137	0.146	0.155	0.162	0.170	0.179	0.189	0.197	0.679	1.576
Expand subpart F provisions regarding certain income	0.000	0.019	0.034	0.039	0.044	0.048	0.051	0.054	0.056	0.059	0.061	0.184	0.465
Modify taxation of captive "insurance" companies	0.000	0.026	0.016	0.013	0.007	0.004	0.002	0.000	-0.001	-0.001	-0.001	0.066	0.067
Modify foreign tax credit carryback and carryforward rules	0.000	0.050	0.263	0.340	0.293	0.275	0.255	0.191	0.103	0.074	0.102	1.221	1.946
Replace sales source rules with activity based rules	0.000	0.891	1.474	1.555	1.750	1.856	1.277	2.115	2.270	2.440	2.616	7.525	18.243
Modify rules relating to foreign oil and gas extraction income	0.000	0.004	0.059	0.097	0.104	0.107	0.112	0.118	0.124	0.130	0.136	0.371	0.991
Phase out preferential tax deferral for certain large farm corporations required to use accrual accounting	0.028	0.136	0.121	0.124	0.124	0.124	0.124	0.124	0.124	0.124	0.073	0.629	1.198
Initiate inventory reform:													
Repeal lower of cost or market method	0.020	0.213	0.351	0.372	0.378	0.179	0.048	0.049	0.051	0.052	0.054	1.493	1.747
Repeal components of cost method	0.039	0.130	0.178	0.187	0.196	0.204	0.214	0.224	0.234	0.246	0.258	0.895	2.071
Expand requirement that involuntarily converted property be replaced with property acquired from an unrelated party	0.000	0.002	0.004	0.005	0.008	0.010	0.012	0.014	0.016	0.019	0.021	0.029	0.111
Place further restrictions on like-kind exchanges involving personal property	0.002	0.007	0.012	0.017	0.023	0.029	0.035	0.041	0.047	0.053	0.058	0.088	0.322
Require registration of certain corporate tax shelters	0.000	0.001	0.003	0.002	0.002	0.002	0.002	0.002	0.001	0.001	0.001	0.010	0.017
Require reporting of payments to corporations rendering service to Federal agencies	0.000	0.001	0.007	0.021	0.045	0.077	0.105	0.117	0.129	0.140	0.152	0.151	0.794
Increase penalties for failure to file correct information returns	0.000	0.003	0.016	0.021	0.024	0.026	0.027	0.028	0.029	0.029	0.030	0.090	0.233
Tighten substantial understatement penalty for large corporations	0.000	0.024	0.040	0.041	0.035	0.029	0.015	0.015	0.016	0.016	0.017	0.169	0.248
Repeal exemption for withholding on gambling winnings from bingo and keno in excess of $5,000	0.001	0.017	0.004	0.001	0.001	0.001	0.001	0.001	0.001	0.001	0.001	0.024	0.029
Require tax reporting for payments to attorneys	0.000	0.000	0.003	0.003	0.002	0.002	0.002	0.002	0.002	0.002	0.002	0.010	0.020
Extend oil spill excise tax 1/	0.026	0.222	0.224	0.226	0.230	0.231	0.126	0.000	0.060	0.000	0.061	1.135	1.382
Impose excise taxes on kerosene as diesel fuel 1/	0.004	0.035	0.033	0.031	0.030	0.030	0.031	0.034	0.036	0.039	0.041	0.159	0.340
Limit extension of tax credit for producing fuel from a nonconventional source	0.014	0.064	0.096	0.099	0.101	0.102	0.104	0.106	0.108	0.111	0.113	0.462	1.004
Extend and modify FUTA provisions:													
Extend FUTA surtax 1/	0.000	0.000	0.862	1.218	1.295	1.333	1.417	1.460	1.336	1.226	1.059	4.708	11.206
Accelerate deposit of unemployment insurance taxes	0.000	0.000	0.000	0.000	0.000	1.320	0.036	0.032	0.028	0.033	0.032	1.320	1.481
Subtotal, Eliminate unwarranted benefits	0.829	4.123	6.323	7.320	7.636	8.894	6.230	7.866	7.924	8.152	8.433	34.296	73.320

Effect of Proposals on Receipts
(In billions of dollars)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-2002	1998-2007
Other provisions that affect receipts:													
Extend corporate environmental tax 2/	0.000	1.096	0.732	0.767	0.786	0.803	0.832	0.858	0.894	0.924	0.946	4.182	8.636
Extend Superfund excise taxes 1/	0.110	0.661	0.675	0.687	0.697	0.708	0.717	0.729	0.739	0.749	0.761	3.428	7.123
Extend LUST excise taxes 1/	0.016	0.120	0.126	0.128	0.131	0.134	0.136	0.137	0.139	0.140	0.142	0.639	1.332
Extend aviation excise taxes/new user fees 1/	2.291	5.017	6.678	6.647	6.824	7.007	7.197	7.389	7.589	7.794	8.006	32.173	70.148
Extend GSP and modify other trade provisions 1/	0.000	-0.665	-0.509	-0.648	-0.732	-0.771	-0.829	-0.871	-0.906	-0.453	-0.471	-3.325	-6.855
Assess fees for examination of FDIC-insured banks and bank holding companies (receipt effect) 1/	0.000	0.072	0.075	0.078	0.082	0.086	0.089	0.093	0.097	0.101	0.106	0.393	0.879
Modify method of reimbursing Federal Reserve Banks (receipt effect)	0.000	0.122	0.125	0.129	0.132	0.136	0.140	0.144	0.148	0.152	0.156	0.644	1.384
Establish IRS continuous levy	0.000	0.402	0.398	0.364	0.269	0.212	0.136	0.086	0.065	0.044	0.037	1.645	2.015
Assess fees fro NTSB aviation accident investigation activities 1/	0.000	0.005	0.005	0.005	0.005	0.005	0.005	0.005	0.005	0.005	0.005	0.025	0.050
Establish alien labor certification fee 1/	0.000	0.019	0.037	0.037	0.037	0.037	0.038	0.040	0.041	0.041	0.043	0.167	0.370
Exempt Federal vaccine purchases from the payment of vaccine excise taxes 1/	0.000	-0.072	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	-0.072	-0.072
Extend and increase FDA user fees 1/	0.000	0.178	0.189	0.200	0.211	0.223	0.229	0.234	0.242	0.248	0.254	1.001	2.208
Initiate HFCA medicare survey and certification fee 1/	0.000	0.007	0.007	0.007	0.007	0.007	0.007	0.007	0.007	0.007	0.007	0.035	0.070
Increase employee contributions to CSRS and FERS	0.000	0.000	0.214	0.423	0.571	0.621	0.156	0.000	0.000	0.000	0.000	1.829	1.985
Adjust Federal pay raise (receipt effect)	0.000	-0.164	-0.216	-0.213	-0.212	-0.212	-0.207	-0.201	-0.193	-0.185	-0.176	-1.017	-1.979
Subtotal, Other	2.417	6.797	8.536	8.611	8.807	8.996	8.647	8.650	8.867	9.567	9.816	41.747	87.294
Subtotal, Eliminate unwarranted benefits and other provisions that affect receipts	3.046	10.920	14.859	15.931	16.442	17.890	15.477	16.336	16.791	17.719	18.249	78.042	160.814
Total effect of proposals 1/	1.603	-7.004	-1.361	-3.689	-5.469	-4.873	-8.199	-7.516	-7.356	-8.385	-10.318	-22.396	-64.169
Paygo	1.603	-6.890	-1.270	-3.605	-5.389	-4.797	-8.132	-7.459	-7.310	-8.352	-10.298	-21.951	-63.502
Non-Paygo	0.000	-0.114	-0.091	-0.084	-0.080	-0.076	-0.067	-0.057	-0.046	-0.033	-0.020	-0.445	-0.667

1/ Net of income offsets.
2/ Net of deductibility for income tax purposes.

Department of the Treasury
Office of Tax Analysis

04/16/97

PREPARED STATEMENT OF C. ELLEN MACNEIL

Mr. Chairman and Members of the Committee: Thank you for inviting me to appear before you today to testify on three accounting provisions included in the Administration's fiscal 1998 budget.

While I am appearing here today in my individual capacity, I want to note that I am currently engaged to represent clients regarding certain of the proposals that I will address today. I have not been engaged to prepare or present my testimony, and my written statement has not been reviewed or approved by any clients of my firm.

I am a partner in Arthur Andersen LLP. I am both a CPA and an attorney and have practiced for more than 20 years as a tax professional. I have previously served as Chairman of the AICPA Tax Accounting Committee and the ABA Tax Section's Tax Accounting Committee. I understand the need to balance the budget and I have the highest regard for the taxwriting committees, the Joint Tax Committee, and their staffs, as well as for Treasury's Office of Tax Policy, and the IRS. I recognize that you all have an extremely difficult and frequently thankless job.

The Administration has included three tax accounting provisions in its 1998 budget proposal as potential revenue raisers, on which I have been asked to comment. Based on my experience as a tax professional, and specifically in the tax accounting area, I respectfully encourage this committee not to include these three proposals in any tax legislation.

I will address each of the three provisions separately. However, I would first note that there has been a trend to tinker with tax accounting provisions in order to raise revenue. Whatever the ostensible reason for the change, the result is usually to widen the gap between tax accounting and financial accounting. These differences between tax accounting and financial accounting will frequently require taxpayers to maintain separate tax-only books and records, with a resulting increase in compliance costs and complexity.

When tax accounting differs from financial accounting, a taxpayer's regular accounting records and audited financial statements become useless to the IRS. These well-documented records, which are relied on by other government agencies and by the public, no longer provide a meaningful touchstone to the tax administrator who must instead look to tax-only books and records. Thus, not only must taxpayers incur additional costs for recordkeeping and compliance, but administration of the tax laws is made more difficult and more controversy arises around tax accounting issues.

While I am mindful that financial accounting and tax accounting do not necessarily have identical goals, they share the general objective of fairly presenting the annual income of an enterprise. When it is possible to keep tax accounting and financial accounting in concert, that should be considered a desirable goal.

REPEAL COMPONENTS OF COST INVENTORY ACCOUNTING METHOD

Background

Manufacturers generally maintain their accounting records for inventories in one of two different ways. One is the components of cost method and the other is the total product cost method. Under components of cost, the manufacturer accounts for inventory in terms of units of materials, labor and overhead. Under total product cost, the manufacturer accounts for inventory in units of finished goods. Manufacturers can use either method for both last-in-first-out (LIFO) or first-in-first-out (FIFO) inventory cost accounting purposes.

The components of cost method has been used for over fifty years by large and small manufacturers for internal management, financial statement and tax purposes. It is the predominate and preferable method in industries where specialized and customized products are manufactured, or where products change from year to year. For such taxpayers, this method is the most practical way to record inventories. For most taxpayers, the use of components of cost precedes their adoption of LIFO, and is the underlying methodology on which the business maintains its cost accounting records. It is not a method that was adopted or changed in conjunction with the adoption of LIFO, nor is it a method that is used only for tax purposes.

Quite simply, components of cost is a fundamental method used to maintain cost accounting records for manufacturing operations. It is the way that cost information is gathered, recorded and maintained for management purposes, financial accounting, and tax reporting. It is not limited to LIFO computations, and it is not a function of tax reporting; it is the way in which many manufacturers record their costs to manage their businesses.

Administration Proposal

The Administration would repeal the components of cost method for LIFO inventory accounting. For taxpayers continuing to use a LIFO method of valuing inventory, the proposal would be applied on a cut-off basis. For a taxpayer switching to FIFO or other method of valuing inventory, the proposal would be applied pursuant to the present-law rules governing such changes in methods of accounting.

Discussion

In 1984, the American Institute for Certified Public Accounting (AICPA) issued a LIFO Issues Paper[1] stating, among other things, that components of cost is the preferable method for manufacturers in certain circumstances, including the following situations:

- Manufacturers that use a job order cost system to account for inventories but cannot determine a unit product cost for a comparable product, because products are manufactured to order, not for shelf sale.Manufacturers of products that contain the same or very similar material ingredients, but are heavily influenced by fashion trends, for example, manufacturers of women's clothes.
- Manufacturers whose product lines are based on the same or similar raw materials but constantly evolve to reflect technological changes of various types or changes in customers' requirements, for example, chemical manufacturers.
- Manufacturers that experience continuing evolution as to making versus buying the various material ingredients of their finished products. Manufacturers with substantial work in process inventories in which comparability of unit cost from year to year would be lacking. Manufacturers with significant swings in production volume from period to period.[2]

The accounting staff of the SEC had encouraged the AICPA efforts to develop LIFO accounting guidance. In March 1995, the SEC staff took the unusual step of endorsing the AICPA issue paper and issued Staff Accounting Bulletin (SAB) No. 58. SAB 58 indicated that companies should reexamine their current LIFO practices and compare them to the recommended LIFO methods, such as the components of cost method, in the issues paper.

For many manufacturers, the components of cost method is considered preferable for generally accepted accounting principles. Accordingly, regardless of the outcome of the Administration's proposal, many manufacturers will be obligated to continue to use components of cost for financial reporting purposes.

The Administration's proposal suggests that components of cost is flawed in that it does not appropriately account for labor efficiencies and, therefore, should be repealed. According to the Administration, the components of cost method may not adequately account for technological efficiencies, or situations where overhead costs replace labor costs. The Administration notes that the total product cost method is not affected by these factors. This rationale is not compelling for a number of reasons. Labor efficiency, or inefficiency, and the possible effect on overhead is only one of hundreds of subcomputations within the components of cost method. A taxpayer using components as cost may not have these factors, the factors may not cause the computational problem cited by the Administration, or the taxpayer may adjust its LIFO computations to take into account the effect of these factors. In short, the perceived computational problem does not occur with all users of components of cost, and does not always produce the result described by the Administration.

The Administration has stated that total product cost is not prone to the same problems it perceives exist with components of cost; however, total product cost may have its own anomalies. For example, content changes such as the addition of safety devices would typically be treated as inflation under total product cost and, thus would reduce taxable income. Under components of cost, content changes are not treated as inflation, and therefore, would not artificially lower taxable income.

Virtually any accounting method can be demonstrated to produce unexpected results in particular factual circumstances. That does not make the method itself distortive, and does not warrant repealing the accounting method.

Businesses will strive to use the most accurate and valid information for management purposes; if components of cost produced flawed information, or systematically lowered earnings, businesses would not use it to report to their shareholders or for management purposes. Components of cost is not used by businesses because it produces lower earnings; it is used because it produces a more accurate measure of earnings.

The explanation and analysis of this proposal, prepared by the staff of the Joint Committee on Taxation, acknowledges that: "It is unclear whether it is possible or practical for some taxpayers to change to the TPC method."[3]

I fully concur with that statement. As previously discussed, repealing components of cost would require affected taxpayers to maintain two separate cost accounting systems for inventories, assuming that a change is even possible. Generally, a cost accounting system is the largest and most complex accounting system maintained by a manufacturer. The establishment and maintenance of such a dual inventory system would be enormously expensive and would take years to design and implement. It would add no additional value to the enterprise. These are redundant, nonproductive costs that would put American manufacturers at a competitive disadvantage in the world market. For all these reasons, I respectfully encourage this Committee to oppose the Administration's proposal to repeal components of costs. This method is the most accurate method for computing LIFO inventories for many manufacturers, and it is effectively required under GAAP. It is the standard industry practice for a substantial number of manufacturers. Its continued availability allows taxpayers to conform tax accounting to financial accounting. Our tax system needs more simplicity, not the increased complexity and unnecessary compliance costs that the repeal of components of cost would impose.

REPEAL LOWER OF COST OR MARKET INVENTORY ACCOUNTING METHOD

Background

Taxpayers that account for inventories on the first-in first-out (FIFO) method may determine the value of their ending inventories based on cost, or on the lower of cost or market method.[4] Under the lower of cost or market method, the value of ending inventory is written down to market value if that value is below cost. In addition, a taxpayer that has subnormal goods in its inventory, including any goods that cannot be sold at normal prices because of damage, changes of style or similar causes, is allowed to write down the carrying value of those goods to their net selling price.[5]

The lower of cost or market method of valuing inventory has long been recognized as in accordance with generally accepted accounting principles, and has been permitted by the income tax regulations for more than fifty years. Generally, the determination of market value that is made for book purposes is also used for tax purposes. The lower of cost or market method has long been recognized as providing a correct reflection of true economic income.

The tax regulations do not allow a write down to market value unless the goods are permanently marked down to that lower value and are offered for sale at that value. Once goods are offered for sale at the marked down price, the taxpayer will never realize more than that price for those goods. Thus, while the mark down is not a sale at a lower price, it is a significant economic event. The taxpayer has recognized that it will never realize more for the goods than the marked down price. It must be recognized that this is not a tax-only adjustment, but rather is a longstanding provision of the income tax regulations that allows tax accounting to be consistent with financial accounting.

Administration Proposal

The Administration proposes to repeal the lower of cost or market method and the subnormal goods method. The proposal would not apply to taxpayers with average annual gross receipts of $5 million or less. The proposal would be effective for tax years beginning after date of enactment and would be applied pursuant to present law rules governing changes of accounting method.

Discussion

The lower of cost or market method has been a part of our tax laws for more than fifty years, and it is used by a broad cross-section of taxpayers in virtually every industry. It is consistent with generally accepted accounting principles and has been specifically permitted by the income tax regulations virtually since their inception. It is not a tax-driven technique.

The lower of cost or market method reflects economic reality. A taxpayer that marks goods down to a price below their cost has experienced a real economic loss. Lower of cost or market recognizes that loss when it occurs.

All accounting method proposals affect timing of income, not the ultimate amount of income that will be reported. The lower of cost or market repeal proposal involves a timing difference only, not a truly substantive change in the amount of income that will be taxed. However, like other tax accounting changes, this proposal will cause tax accounting to differ from financial accounting, and thus will create additional complexities, and administrative burdens on business. The Administration proposal would accelerate income, but would not change the ultimate amount of income that would be taxed. The cost of this is the additional compliance cost and administrative complexity of creating yet another difference between tax accounting and financial accounting. Further, it fails to recognize that a real economic loss has occurred when goods are marked down to less than their cost.

For these reasons I respectfully suggest that this Committee reject the Administration's proposal to repeal the lower of cost or market inventory method.

TERMINATION OF SUSPENSE ACCOUNTS FOR FAMILY FARM CORPORATIONS REQUIRED TO USE NEW ACCRUAL METHOD OF ACCOUNTING

Background

A provision of the Revenue Act of 19876 required family farm corporations with average annual gross receipts in excess of $25 million to change from the cash to the accrual method of accounting. A family farm corporation that is required by this provision to change to the accrual method of accounting is required to establish a suspense account. The suspense account is the cumulative difference in taxable income between the cash and the accrual method at the beginning of the year of change to the accrual method. The amount in the suspense account is included in taxable income if the corporation ceases to be a family corporation or if the gross receipts of the corporation decline below the level that they were at in the year that the taxpayer was required change to its accounting method. As long as the corporation continues to be a family farm, and its operations do not substantially decline, this amount will continue to be deferred.

At the time of its enactment, this provision that required family farms to change to the accrual method was highly controversial and subject to intense scrutiny. All aspects of the provision, including the suspense account, were subject to considerable comment and debate.

Proposal

The Administration's proposal would repeal the ability of a family farm corporation that is required to change to accrual method of accounting to establish the suspense account. Thus, any family farm corporation that is required to change to an accrual method of accounting would be required to include the entire cumulative difference in taxable income between the cash method and the accrual method in income ratably over a ten-year period. The proposal would also require any taxpayer with an existing suspense account to include the amount in the account in income ratably over a ten-year period beginning in the first taxable year after the effective date.

Discussion

Generally, when a taxpayer changes its accounting method the cumulative difference in taxable income under the old method and new method, referred to as a Section 481(a) adjustment, is required to be included in income ratably over a stated period of time. When change is required by legislative action, it is recognized that this transition issue must be addressed as a substantive part of the legislation. It is not unusual for legislation to include a suspense account mechanism or similar approach with regard to implementing a change of accounting method.

For example, Section 458(e) provides for a suspense account in the case of a taxpayer that elects to apply a particular method of accounting for certain returned merchandise. Similarly, Section 808(f) allows a "fresh start adjustment" for insurance companies that are affected by a legislative change in the treatment of certain policyholder dividends. There are other situations where it has been considered appropriate to apply suspense account or similar rules to statutorily required method changes.

The Joint Tax Committee analysis of this proposal notes that opponents of the proposal argue that Congress has already addressed this issue as part of the 1987 legislation and that to now require the restoration of existing suspense accounts would impose liquidity constraints on taxpayers that had relied upon present law and would be retroactive in nature. I strongly agree with this argument.

The transition rules applied to legislative accounting method changes are a substantive part of the legislation itself. The suspense account was addressed as part of the 1987 legislation, and should not be changed.

For these reasons, I respectfully recommend that this proposal be rejected.

Again, I appreciate the opportunity to appear before you today to comment on these important issues. I would be happy to answer any questions you may have.

ENDNOTES

[1] *Issues Paper, Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories;* AICPA Accounting Standards Division; November 30, 1984.

[2] Ibid; Par. 4-41.

[3] Description and Analysis of Certain Revenue-Raising Provisions contained in the President's Fiscal Year 1998 Budget Proposal, Joint Committee on Taxation, March 11, 1997, JCX-10-97, p.75.

[4] Treas. Reg. §1.471-4.

[5] Treas. Reg. §1.471-2(c)

[6] Revenue Act of 1987 (P.L. 100-203), §10205(a), amending Code Sec. 447 to include new subsection (d).

COMMUNICATIONS

The following submissions (listed alphabetically) are in response for comments on the revenue-raising provisions in the Administration's FY 1998 Budget.

Statement
of
The Ad Hoc Coalition
on Intermarket Coordination

Submitted to
The Committee on Finance
U.S. Senate

for the
Hearings on Selected
Revenue-Raising Provisions
in the Administration's Fiscal
Year 1998 Budget Proposal

April 17, 1997

This statement is submitted by the Ad Hoc Coalition on Intermarket Coordination, a coalition of the nation's options exchanges and their clearing firm, in connection with the April 17, 1997 hearing on selected revenue-raising provisions in the Administration's Fiscal Year 1998 Budget. The participants in the Coalition are the American Stock Exchange, the Chicago Board Options Exchange, the Pacific Stock Exchange, the Philadelphia Stock Exchange, and The Options Clearing Corporation. The four exchanges are the only U.S. exchanges on which options on individual equity securities are traded.

OVERVIEW

The Administration's 1998 Budget includes two proposals of concern to the Coalition. One of the proposals, known as the "constructive sale" proposal, is often described as being targeted against the short-against-the box transaction and, specifically, the ability of taxpayers under present law to use that transaction to defer recognition of gain. Press reports have publicized certain specific transactions in which taxpayers have been able to defer gain for long periods of time and ultimately to avoid any income tax on their gain. The legislative proposal included in the Administration's 1998 Budget, however, goes far beyond what is needed to stop such transactions and would fundamentally change long-standing tax principles by requiring recognition of gain (but not loss) on stock, bonds and other financial instruments when taxpayers engage in various risk-reduction (i.e., hedging) strategies, including short-term hedging strategies involving the use of exchange-traded options. The vague language of the proposal also raises significant line-drawing questions, particularly with respect to options transactions.

If Congress decides to enact legislation along the lines of the Administration's proposal, Congress should ensure that the legislation is narrowly crafted so as to affect only those transactions that are determined to be abusive. Otherwise Congress raises the serious risk of adversely impacting legitimate hedging transactions. In other words, Congress must balance the competing concerns of preventing abusive transactions while protecting legitimate hedging activities.

As explained more fully below, the exchanges recommend that if "constructive sale" legislation is enacted, it should include the following provisions:

- The "constructive sale" rule should not apply to short-term hedges that have the potential to defer gain for at most a single taxable year.

- The "constructive sale" rule should be limited to short-against-the-box transactions that would otherwise result in long-term (i.e., more than one year) deferral and other specific transactions that are determined to be close substitutes for such transactions.

- Treasury could be given prospective regulatory authority to apply the "constructive sale" rule to other transactions as long as appropriate guidelines and safe harbors are provided in the statute or committee reports.
- Listed options should be excluded from the definition of "appreciated financial positions" that are subject to the "constructive sale" rule.

The second proposal addressed by these comments is the proposal to deny the dividends received deduction ("DRD") to a corporation that has hedged its risk of loss with respect to dividend-paying stock around the time of the dividend. The proposal appears to reflect a novel view of the function of the DRD that is at odds with the long-standing policy against imposing multiple layers of corporate-level tax on the same income. The Coalition believes that current law adequately prevents "dividend stripping" and other tax-motivated transactions relating to the DRD and that it is inappropriate to impose multiple layers of corporate-level tax on the same income simply because the owner of stock has hedged its risk around the time that a dividend is paid.

BACKGROUND

The options exchanges play an important role in the nation's economy. One of their most important functions is to permit individuals and firms that do not want to bear certain risks -- particularly short-term risks -- to transfer those risks to others who are more willing to bear them. In the words of the Securities and Exchange Commission, exchange-traded options:

> "provide a means for shifting the risk of unfavorable short-term stock price movements from owners of stock who have, but do not wish to bear these risks, to others who are willing to assume such risks in anticipation of possible rewards from favorable price movements."

SEC, Report of the Special Study of the Options Markets, House Committee on Interstate and Foreign Commerce (Committee Print 96-IFC3) 96th Cong. 1st Sess. 1 (1979). See also Miller, "Financial Innovations, Achievements and Prospects," 4 *J. of Applied Corp. Fin.* 4, 7 (1992) (options and futures markets provide "efficient risk sharing").

The existence of options markets also tends to enhance the liquidity of the underlying markets. The options markets afford an efficient and cost-effective means of adjusting an investment's risk/return characteristics and provide market participants with the ability to create more diverse risk/return alternatives. These features tend to make participation in the underlying markets more attractive to a greater number of participants, thus increasing the liquidity in those markets.

The utility of the options markets is evidenced by the substantial volume of transactions on the options exchanges. In 1996, for example, 198.9 million options contracts on individual equities were traded on the options exchanges, with each contract representing 100 shares of stock. The average daily volume for the year was 783,000 contracts. The total option premiums for the year amounted to $67.8 billion.

DISCUSSION

I. The Short-Against-The-Box Proposal

The Administration's proposal would require gain recognition on an "appreciated financial position" held by a taxpayer whenever the taxpayer (i) enters into a transaction with respect to "substantially identical property" that "substantially eliminates the risk of loss and opportunity for gain" on such position "for some period" or (ii) enters into any other transaction that is marketed as being "economically equivalent" to such a transaction. These transactions are referred to as "constructive sales." Under the Administration's proposal, purchasing a put option or writing a call option on substantially identical property constitutes a constructive sale if the option is "substantially certain" to be exercised.[1]

The broad language of the Administration's proposal goes much further than changing the tax treatment of the short-against-the-box transaction. It would appear to reach many risk-reduction transactions -- including short-term hedges -- that are not tax-motivated, are clearly not "abusive," and do not result in long-term deferral of gain. The proposal fails to focus on whether the transaction results in a significant deferral of gain, which is the essence of the transactions that have attracted so much press attention.

In addition, the vagueness of the language used in the Administration's proposal raises significant line-drawing questions for hedging transactions that significantly reduce, but do not eliminate, risk of loss and opportunity for gain. The line-drawing questions are perhaps most significant for transactions involving the use of options, particularly exchange-traded options. The uncertainty created by the proposed language will cause investors and traders to refrain from non-tax-motivated investment and hedging transactions because of the tax risk, leading to costly and undesirable market distortions and inefficiencies. Creating this type of uncertainty in the markets is clearly inappropriate in the absence of some Congressional finding that the options markets are being used by taxpayers to engage in transactions that are determined to be "abusive."

The comments that follow discuss more specifically these and other concerns raised by the Administration's proposal and set forth recommendations for limiting the scope of the proposed legislation.

A. Characteristics of Listed Options -- Exchange-traded options (also known as "listed" options) have a number of characteristics that the Coalition believes should be taken into account in evaluating the potential application of the Administration's proposal to options transactions. In many respects, these characteristics distinguish option transactions from the short-against-the-box transaction.

First, conventional listed options, which represent the vast majority of exchange-traded options, have a maximum term of nine months.[2] These options are generally used to hedge short-term risks or to generate investment income and gains. Since they are of limited duration, these options cannot be used to eliminate risk of loss and/or opportunity for gain for an indefinite period (or until death), as is the case with the short-against-the-box transaction. Thus, even though a taxpayer may reduce his or her risk during the term of the option, entering into the option transaction affords no protection from risks for the period beyond the term of the option.

Although a taxpayer could conceivably enter into a series of options transactions, one after the other as each option expires or is closed out, doing so would not be an efficient means of obtaining tax deferral. This is true for the following reasons:

[1] See section 9512 of the President's 1997 Budget Bill. While legislative language embodying the proposal has not been released this year, the Treasury Department's description of the proposal is the same as last year in all relevant respects. See Department of the Treasury, General Explanations of the Administration's Revenue Proposals (Feb. 1997) at p. 49.

[2] As discussed below, two much more limited categories of exchange-traded options, known as LEAPS and FLEX equity options, have terms of up to three years.

- If the value of the hedged stock declines and the value of the option increases, the gain that was in the stock will essentially shift over to the option, and the gain on the option will be recognized at or before the time the option expires. Thus, the taxpayer cannot have any assurance of deferring gain recognition through a series of option transactions.

- Alternatively, if the value of the stock increases, and the value of the option declines, the taxpayer will have to invest a greater amount of capital to replace the option and maintain the same level of protection.

- Each time the taxpayer entered into a new options transaction, he would create a new straddle under Code section 1092. Gains on any such options would be taxed when the options are closed out or expire, while losses on such options would be deferred under the straddle rules.[3] Thus, over time the taxpayer would be "whipsawed" with respect to gains and losses on the options. In addition, under Code section 263(g) the taxpayer would have to capitalize any interest and carrying charges allocable to the positions in the straddle.

- Each time the taxpayer enters into a new options transaction. he would incur additional transaction costs.

Second, unlike a short-against-the-box transaction, which completely eliminates upside and downside risk, conventional listed options can never completely eliminate such risk. For example, writing a deep-in-the-money call may reduce downside risk (as well as upside potential), but the taxpayer still bears the risk that the stock may drop below the strike price of the option.[4] Even in the recent bull market, one can point to numerous examples of steep declines in the values of individual stocks over relatively short periods of time. Unlike a short-against-the-box transaction, a deep-in-the-money call does not protect an investor against such risks. Similarly, a taxpayer who purchases a deep-in-the-money put with respect to stock that he holds still has an opportunity for gain if the stock price rises above the strike price of the put.

In addition, a taxpayer who hedges a stock with exchange-traded options continues to receive any dividend on the stock and has no obligation to make any comparable payments to another party. Thus, the taxpayer continues to receive the economic return attributable to the dividend, and he bears the risk that the dividend may decrease (as well as the potential benefit from an increase in the dividend).[5]

Third, options transactions that may be covered by the proposal are entered into for non-tax reasons. The options transaction that comes closest to a short-against-the-box transaction is known as a "forward conversion," which consists of (i) long stock and (ii) a long put and a short call with the same strike price and th: same expiration date. A forward

[3] The applicability of the straddle rules is apparently one of the reasons that options are not viewed as an efficient means of deferring gains. See Kleinbard and Nigenhuis. Short Sales and Short Sale Principles in Contemporary Applications, 53d N.Y.U. Institute of Taxation § 17.01(1) n.3. (1995) ("Options transactions seem to be less attractive to investors" as a tax deferral strategy than short-against-the-box and equity swap transactions in part because of the straddle rules). The straddle rules do not apply to a short-against-the-box transaction. See Code § 1092(d)(3).

[4] In addition, the holder of the call may exercise it at any time. Thus, a taxpayer who writes a deep-in-the-money call cannot count on the call remaining outstanding until its expiration.

[5] See J. Hull, Options, Futures and Other Derivative Securities, pp. 140-141 (2d ed. 1993).

conversion comes very close to eliminating downside risk and upside potential during the life of the options. Nonetheless, the principal use of forward conversions is in a non-tax-motivated arbitrage strategy that locks in small profits based on price discrepancies in the stock and options markets.[6] These arbitrage transactions would take place even if there were no tax system.

Similarly, a taxpayer who wants to hedge his stock (whether appreciated, depreciated or flat) may purchase a put to protect against perceived short-term risk. In order to finance the cost of the put, the taxpayer may write a call and use the premium received for the call to pay for the put. For example, if a stock is trading at $42, a taxpayer might purchase a put at $40 for $2 and write a call at $45 for $2. The $2 premium received for the call would pay for the cost of the put. This transaction, which is known as a collar, is engaged in simply to hedge short-term risk at little or no cost and would be utilized even if there were no tax system. Nonetheless, it may be covered by the Administration's Proposal because the taxpayer may be viewed as retaining only limited downside risk and upside potential.

Fourth, exchange-traded options are standardized contracts, and the exchanges specify the strike price of an option and the date of expiration in accordance with their rules. An option is traded on an exchange only if the exchange authorizes trading in that option. Thus, listed options cannot be customized to suit an individual taxpayer's situation.[7]

For example, consider a taxpayer who wants to write a deep-in-the-money call. Under the rules that govern the listing of options, the exchanges do not create deep-in-the-money options. Rather, listed options are created at strike prices that are very close to the current price of the stock.[8] Although options can become deep-in-the-money over time as a result of price movements in the stock, the extent to which a listed option can become deep-in-the-money is limited by the life of the option and the volatility of the stock. For example, for a stock trading at $48 in June, the exchanges might create new options with strike prices of $45 and $50 expiring in February of the following year. If the stock goes up to $100 by the following January, these $45 and $50 February options will still be listed for trading on the exchange. However, a stock whose value has increased by such a great amount in such a short period of time is a very volatile stock, and thus its market value could change so rapidly that deep-in-the-money options may not substantially eliminate risk of loss of opportunity for gain.

Fifth, the vast majority (roughly 90%) of exchange-traded equity options are closed out or expire unexercised. Taxpayers who use options as hedges generally continue to hold their stock after they close out the option or the option expires. Entering into the hedge is not simply a prelude to disposing of the stock. These hedges are thus distinguishable from the types of options transactions apparently envisioned by the Administration's proposal, which consist of selling a call or buying a put that is substantially certain to be exercised. That language seems to reflect the view that such options should be treated as constructive sales because they are in effect a forward sale, i.e., the taxpayer has entered into a transaction that will result in the sale of an asset at a certain price but is able to defer the recognition of the gain for tax purposes. This analysis does not apply to hedges where the taxpayer continues to hold the asset after the option expires or is closed out.

[6] Because of transaction costs, these arbitrage profits can be captured only by large traders, stock specialists and market makers.

[7] The recently introduced FLEX equity options permit the parties to the option contract to specify certain terms.

[8] See, e.g., CBOE Rule 5.5, Interpretations and Policies .02. See generally Hull, supra, pp. 139-140.

Finally, unlike the short-against-the-box transaction, which is a well-defined transaction, the types of options transactions that are potentially subject to the Administration's Proposal are highly uncertain (i.e., the transactions are not well-defined). The Administration's Proposal would apply to certain options if they are "substantially certain" to be exercised or if the options "substantially eliminate" risk of loss and opportunity for gain "for some period." None of these terms has any precise meaning. Moreover, as acknowledged by Treasury representatives in several public presentations, the determination of whether a particular option transaction is covered by the statute may depend on the volatility of the underlying stock, which cannot be determined in advance with any degree of certainty. In addition, since stocks have varying volatility, a transaction might substantially eliminate risk of loss and opportunity for gain on a stock with low volatility but the same transaction would not do so for a stock with higher volatility. Indeed, since the volatility of a stock can vary over time, a transaction might constitute a constructive sale of the stock at one point in time but the same transaction might not be constructive sale of the same stock at a different point in time.

Applying such vague standards to options transactions would create unacceptable uncertainty in the markets.[2] Vague standards will cause taxpayers to refrain from engaging in non-tax-motivated transactions because of a fear that they may unknowingly trigger gain recognition in an appreciated stock position, which will lead to costly and undesirable market distortions and inefficiencies.

B. Application of the Administration's Proposal to Short-Term Hedges. -- Although the Administration's proposal appears to be a response to press reports of transactions that have been entered into to obtain long-term deferral of taxable gain, the proposal is drafted so broadly that it would appear to apply to short-term hedges as well. Indeed, Treasury representatives have stated publicly that a hedge that lasts only one day would be treated as a "constructive sale" under the proposal if the hedge substantially eliminated risk of loss and opportunity of gain for that day. Such an extreme approach is plainly unnecessary in order to prevent taxpayers from obtaining long-term deferral of gain though tax-motivated transactions and it would significantly restrict the ability of taxpayers to engage in legitimate short-term hedging transactions without having to worry about whether they will be deemed to have sold their stock for tax purposes.

Representative Kennelly of the House Ways and Means Committee has introduced a bill (H.R. 846) that while similar in most respects to the Administration's proposal, would not trigger gain in an appreciated position if the taxpayer closes out the "constructive sale" transaction before the end of the taxable year. This change represents a step in the right direction because it properly places the focus on whether there is a deferral of gain, which is the practical issue with which Congress should be concerned. However, while the bill would protect short-term hedges that are closed out within the taxable year, it would trigger gain recognition if the hedge remains open over the end of the year. Yet the types of short-term risks that lead investors to hedge with options (such as an upcoming earnings report) can occur at any time. We fail to see why a short-term hedge that is otherwise legitimate becomes illegitimate simply because it happens to span the end of a single tax year.

[2] The importance of certainty to the markets is illustrated by the existence of the "qualified covered call rules" in section 1092(c)(4), which provide mechanical tests for determining whether writing a covered call creates a straddle. Similarly, Congress clarified the rules for "securities lending transactions" in section 1058 so that taxpayers could have certainty as to whether a transaction would be treated as a sale. Congress provided this clarification because it recognized that securities lending transactions contribute to the liquidity of the securities market. See S. Rep. No. 95-762, 95th Cong. 2d Sess. 5 (1978), reprinted in 1978 U.S.C.C.A.N. 1286, 1290.

Congress can prevent taxpayers from obtaining long-term deferral of gain (and ultimate avoidance of any tax on that gain) while at the same time protecting legitimate short-term hedges by adopting an approach that does not require gain recognition as long as the hedge does not result in a deferral over the end of more than one year. Adopting a rule that triggers gain simply because a hedge spans the end of a single taxable year will unavoidably impact legitimate short-term hedging transactions that are not tax-motivated.

Recommendation: The Coalition believes that any hedging transaction that is closed out in 12 months or less should not be treated as a constructive sale. These hedges cannot result in deferral of taxable gain for more than a single year. Adopting such a rule will protect short-term hedges without permitting taxpayers to obtain long-term deferral of taxable gain.

C. Application of the Administration's Proposal to Longer-Term Hedges With Options. -- Although conventional listed options, which represent the vast majority of all exchange-traded options, can have a life of at most nine months, there are two categories of exchange-traded options, known as LEAPS and FLEX equity options, that can have a life of up to three years. While these options cannot be used to obtain the long-term deferral that can be obtained with the transactions that have attracted so much media attention, they can be used to shift risk for a period of longer than one year.

The vague language in the Administration's proposal could be interpreted to apply to transactions involving these types of options. However, these options transactions are entered into for legitimate risk-shifting purposes and to the best of the knowledge of the exchanges are not being used as substitutes for the short-against-the-box transaction. Moreover, these options cannot be used to completely eliminate risk of loss and opportunity for gain. Rather, they can be used to transfer varying degrees of risk for periods of up to three years, with the taxpayer retaining risk for periods beyond the term of the options.

Recommendation: Because these options are used in legitimate, investment-oriented risk-shifting transactions and because of the potential chilling effect that the proposal's vague language could have on transactions involving these options, the Coalition strongly recommends that any application of the "constructive sale" proposal to these options be addressed through prospective Treasury regulations that could be issued if it becomes apparent that taxpayers begin to use these options to defer gains. Appropriate statutory or committee report language should make clear that only extreme situations closely resembling an actual sale could be subject to the regulations. Appropriate safe harbors should also be specified in the statute or committee reports. These safe harbors should include the following:

- A "collar" would not be treated as a constructive sale if there is at least a 10% spread between the strike price of the put and the strike price of the call.

- A long put or short call would not be treated as a constructive sale if it is not more than 25 percent in the money. Thus, for example, if a stock is trading at $100 per share, a taxpayer could write a call at $75 per share without triggering gain in the stock.

D. Options as Appreciated Financial Positions. -- The Administration's proposal defines an appreciated financial position as including not only direct interests in stock, but also positions with respect to stock, including an option on the stock. If a taxpayer purchases a call option on a stock and the call increases in value, the call would be an appreciated financial position. If a taxpayer then enters into a transaction that substantially eliminates the risk of loss and opportunity for (additional) gain on the call, the gain on the call would be recognized.

As explained above, a listed option has a limited life that is set by the exchange pursuant to its rules. In order for an option to appreciate to any significant extent, some time must pass after it is initially entered into, and thus appreciated options positions will have an even shorter remaining life until expiration. Since any gain on the option will generally be recognized by the time the option is scheduled to expire, it seems unnecessary to treat such options as appreciated financial positions.

The taxpayer will recognize any gain on the option when he closes out the option or the option expires unexercised.[10] The taxpayer cannot avoid recognizing that gain by entering into a new options transaction. There is also no way that the term of an exchange-traded option can be extended.

It is also possible that the option will be exercised. Situations in which the option might be exercised fall into two categories, neither of which would be efficient from a tax-deferral perspective. First, if the appreciated option is a long put or a short call, the exercise of the option would force the taxpayer to sell the stock and any gain on the option would generally be taxed as part of such sale. Second, if the taxpayer's option position consists of a long call or a short put, the taxpayer could either exercise the call or be assigned on the put, with the result that he would have to purchase the underlying stock. While in these situations any gain on the option would effectively be rolled into the stock, a taxpayer would not pursue this strategy to obtain deferral of gain in the option because (i) as compared with the relatively small cost of the option, he would need to make a significant capital investment to acquire the stock, (ii) he would incur additional transaction costs on the purchase of the stock as well as on a subsequent sale of stock, and (iii) he would take on the risks of owning the stock.

Treating exchange-traded options as appreciated financial positions will also create some peculiar and undesirable results. For example, taxpayers holding stock frequently write calls, particularly qualified covered calls,[11] with respect to stock that they hold. Writing covered calls is viewed by many as a conservative investment strategy that entails giving up the opportunity to benefit from an increase in the value of the stock during the life of the option in return for a more predictable return. If a taxpayer writes a qualified covered call and the underlying stock declines in value, the taxpayer will have a gain in the short call position.[12] If the taxpayer then purchases additional shares of the stock, he may be entering into a "constructive sale" of the short call since, depending on the facts, the newly acquired long stock could be viewed as substantially eliminating the risk of loss and opportunity for gain on the short call. This inappropriate treatment could apparently apply even though the taxpayer's motivation was simply to acquire more of the stock (e.g., under a "dollar cost averaging" investment strategy).

A related problem arises from the fact that the Administration's proposal apparently would apply to each separate position regardless of whether that position is part of a larger position. In the above example, the purchase of additional shares actually increases the taxpayer's risk as compared with the original combined position of the long stock and short call. Yet the Administration's proposal would appear to focus only on whether the acquisition of the additional stock reduces risk of loss and opportunity for gain

[10] As noted above, roughly 90% of exchange-traded options are closed out or expire unexercised.

[11] A qualified covered call is an exchange-traded call option that satisfies certain mechanical tests under section 1092. Qualified covered calls are not subject to the general straddle rules.

[12] Even if the stock price stays flat, the passage of time will give rise to gain in the short call position.

on the short call. The fact that the short call was part of a larger position that includes the (original) long stock would apparently be disregarded.

Stating the problem more generically, options strategies generally involve multiple positions. If a taxpayer enters into an options transaction that entails multiple positions and then enters a transaction that could be viewed as substantially eliminating opportunity for gain and risk of loss with respect to one of those positions (assuming that the position, viewed in isolation, has appreciated and ignoring the fact that the position is part of a larger position), the taxpayer would apparently have made a constructive sale of that position and (presumably) could not take into account unrealized losses on other positions that are part of the larger position. Such a fragmented approach to combined positions is clearly inappropriate, yet it is difficult to see how the problem could be addressed without substantial administrative complexity -- both for taxpayers and the IRS.

Treating listed options as within the scope of appreciated financial positions will also create an additional realm of complexity in determining whether one or more options transactions "substantially eliminate" risk of loss and opportunity for gain on other options positions. The combinations of positions that are possible are much greater than when the appreciated financial position is a direct interest in stock, as is the case in the short-against-the-box transaction. In addition, there is a serious risk that the IRS would match up a taxpayer's positions in ways other than the taxpayer intended.

Finally, unlike the case of the short-against-the-box transaction, no tax-motivated transactions have been identified that are being entered into to defer gain on appreciated options positions. In the absence of any perceived abuse, options should not be treated as "appreciated financial positions" under the proposal. To do so would unnecessarily inject uncertainties and a high probability of inappropriate results into the options markets.

Recommendation: For all of the foregoing reasons, the options exchanges believe that listed options, as well as other indirect interests in stock that have limited lives, should be excluded from the definition of an appreciated financial position. Given the limited terms of these instruments and the absence of any perceived abuse in this area, excluding them from the scope of appreciated financial positions should not have any material effect on the revenue expected to be raised by the proposal

II. Holding Period Requirement for the DRD

Under current law, a corporation is not eligible for the DRD with respect to stock unless the corporation holds the stock for at least 46 days.[11] For this purpose, any day that is more than 45 days after the date on which the stock goes ex-dividend is not taken into account. In addition, the corporation's holding period is reduced for periods in which the corporation has reduced its risk of owning the stock by entering into various transactions. See Code § 246(c). Once the corporation has satisfied this holding period requirement, the corporation is eligible for the DRD with respect to dividends on the stock without regard to whether the corporation has reduced its risk of loss with respect to the stock around the time of any particular dividend.

The holding-period requirement of current law is designed to prevent "dividend-stripping" transactions in which a corporation would purchase stock shortly before the ex-dividend date and sell the stock shortly after that date. In the absence of the holding-period requirement, the corporation would receive dividend income eligible for the DRD and generate an offsetting short-term capital loss on the sale of the stock, which (all else being equal) would decline in value by roughly the amount of the dividend. This capital loss could be used to reduce unrelated capital gain. By requiring the corporation to hold the stock for more than 45 days, and by excluding for this purpose any days on which the taxpayer has

[11] The holding period requirement is 91 days in the case of certain preferred stock.

reduced its risk, this rule requires a corporation to bear market risk associated with owning the stock for a sufficiently long period to make dividend stripping unattractive.

Current law also includes various other rules designed to prevent "tax arbitrage transactions" relating to the DRD. For example, no DRD is allowed with respect to a dividend if the corporation has an obligation to make related payments with respect to positions in substantially similar or related property. See Code § 246(c)(1)(B). Thus, a taxpayer that sells short against the box cannot claim the DRD for any dividends it receives during the period of the short sale because it has an obligation to make "in lieu of dividend payments" to the stock lender. Another rule requires basis adjustments in stock when a corporation receives certain extraordinary dividends with respect to that stock unless the corporation has held the stock for a period of two years.[14] See Code § 1059. Yet another restriction is found in section 246A, which denies the DRD for debt-financed portfolio stock in order to prevent taxpayers from both claiming the DRD and deducting interest expense with respect to debt that finances the holding of the dividend-paying stock.

The Administration's proposal would take the current rules that are designed to prevent dividend-stripping and apply them with respect to each dividend. Thus, in order to be eligible for the DRD with respect to a dividend, the corporation would be required to hold the stock -- unhedged -- for at least 46 days around the time of the ex-dividend date.

The proposal represents a policy change that is difficult to justify. It would deny the DRD to a long-term holder of stock simply because it hedged its risks at a time proximate to a dividend payment. Other than as part of a package to reduce the benefits of the DRD, along with the Administration's proposal to reduce the DRD on portfolio stock from 70% to 50%, we see no rationale for the proposal. The effect of the proposal is to exacerbate the triple-tax problem that the DRD is intended to minimize. While the issue of whether to continue the longstanding policies that underlie the DRD is certainly a matter for Congress to decide, we do not believe that the fact that a corporation happens to hedge its risk over a dividend date is a reasonable basis for subjecting the earnings distributed by the dividend to multiple layers of full corporate tax.[15]

The fact that a taxpayer has reduced its risk of loss with respect to a stock does not mean that it is not the tax owner of the stock. Thus, in the absence of some abuse of the tax system or some inappropriate tax arbitrage, the fact that the taxpayer has reduced its risk is not a sufficient reason for denying it the benefits of ownership. This principle is evidenced by the treatment of holders of municipal bonds. The fact that a taxpayer that holds a municipal bond has hedged its risk with respect to the bond, say by purchasing a put on the bond, does not mean the interest that it receives on the bond is no longer tax-exempt.

[14] An amendment included in the Balanced Budget Act of 1995 and in the President's 1998 Budget would require immediate gain recognition with respect to stock in the case of certain extraordinary dividends.

[15] Moreover, the section 246(c) rules apply if a taxpayer has merely diminished its risk of loss. A taxpayer may retain substantial risk and still not acquire holding period in the stock under section 246(c). While such a strict rule may be appropriate to prevent dividend stripping, it seems unduly broad in the context of the current proposal, which applies to taxpayers that have already satisfied the section 246(c) holding period requirement for one or more dividend cycles.

Written Statement

on behalf of the

Airports Council International - North America (ACI-NA)
American Association of Port Authorities (AAPA)
American Public Power Association (APPA)
American Public Works Association (APWA)
Association of Local Housing Finance Agencies (ALHFA)
Association of Metropolitan Sewerage Agencies (AMSA)
Association of Metropolitan Water Agencies (AMWA)
Council of Development Finance Agencies (CDFA)
Council of Infrastructure Financing Authorities (CIFA)
Education Finance Council (EFC)
Government Finance Officers Association (GFOA)
Municipal Treasurers' Association (MTA)
National Association of Counties (NACo)
National Association of Higher Educational Facilities Authorities (NAHEFA)
National Association of State Auditors, Comptrollers and Treasurers (NASACT)
National Association of State Treasurers (NAST)
National Conference of State Legislatures (NCSL)
National Council of Health Facilities Finance Authorities (NCHFFA)
National Council of State Housing Agencies (NCSHA)
National League of Cities (NLC)
National School Boards Association (NSBA)
United States Conference of Mayors (USCM)

concerning

Extension of the *Pro Rata* Disallowance Rule

submitted for the printed record of the

April 17, 1997

Senate Finance Committee Hearing

on

The Administration's Revenue Raising Provisions
in the FY 1998 Budget Proposal

This statement is submitted on behalf of 22 state and local government organizations. We are writing in strong opposition to a tax provision in President Clinton's recent budget proposal that would extend the *pro rata* disallowance of tax-exempt interest expense to all corporations. Our members are elected and appointed state and local government officials who oppose this provision because it would drive up state and local borrowing and lease financing costs for equipment, infrastructure, and other capital facilities and result in tax and fee increases or budget cuts. Last year, Congress rejected a similar proposal in response to concerns raised by state and local governments.

Financing costs would increase because, under current law, nonfinancial corporations are permitted to take a deduction for interest expenses if they can demonstrate that they did not finance their purchases of tax-exempt securities. This tax treatment is advantageous because corporations are not required to reduce their interest deductions on a *pro rata* basis, which is determined by calculating what percentage of their total assets are tax-exempt securities. Furthermore, the Internal Revenue Service (IRS) has established tests to assist taxpayers in complying with current law. The so-called two percent *de minimis* rule simplifies compliance by providing that if an investor's holdings of municipal securities constitutes less than two percent of its total assets, then the IRS generally will not inquire whether any of the borrowings of the investor were incurred for the purpose of purchasing or carrying tax-exempt securities. Current law permits nonfinancial corporations to accept a lower interest rate on the municipal bonds they purchase and the lease purchase or conditional sales agreements they negotiate.

Different types of corporations, which would be affected by the proposal, participate in the municipal market in different ways, as described below. With the proposed change, these corporations would be expected to change their investment strategies.

o Traveler's Check and Money Order Companies. These firms invest their reserves in long-term tax-exempt securities. For example, traveler's check and money order companies are required by state money transmitter laws that control their investment options to invest in U. S. Treasuries, municipal bonds and other highly rated securities.

o Freddie Mac, Fannie Mae and Sallie Mae. Federally sponsored corporations such as the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae) have been active in the market for state and local housing bonds, in part, because they are required by federal law to engage in activities relating to mortgages on housing for low- and moderate-income families. The Student Loan Marketing Association (Sallie Mae) purchases tax-exempt student loan bonds.

o Affiliated Companies. The proposal will result in unfair tax treatment for affiliated companies that under current law invest in municipal securities, but are not subject to the *pro rata* rule because they do not borrow to make securities purchases. The new provision that would extend the *pro rata* disallowance of interest on a combined basis to affiliated companies that file consolidated returns would eliminate companies' ability under current law to demonstrate that no borrowing occurred for the purpose of purchasing tax-exempt securities.

- o Bank and Nonbank Leasing Companies. States and localities lease various types of equipment from bank and nonbank leasing companies, including portable classrooms, schools, school buses, software, telecommunications systems, correctional facilities, computers, medical equipment, courthouses and energy management systems. This form of financing is particularly useful to communities that cannot afford to borrow in the bond market, or don't have access to the bond market because of market inexperience or lack of a credit rating.

- o Other Corporations. Many other corporations invest in short-term municipal securities or securities that behave like short-term securities for their own cash management purposes. Their participation in the market is responsible for the stability and low level of short-term rates.

To understand the impact of the President's proposal, we provide information about a leasing transaction. Under current law, a private lessor's cost of funds is 6.2 percent, the lessor's tax rate is 35 percent and the interest rate charged to a government lessee is 5.33 percent. Without the benefit of the two percent *de minimis* rule, a lessor will have to increase the interest rate by 2.17 percentage points (increasing the interest rate charged to the government to 7.5 percent) to earn the same profit on the transaction. This increase represents a 41 percent increase in a government lessee's borrowing rate.

From a technical standpoint, we believe the Administration has provided information about its proposal that downplays its impact. It provides that the rule would not apply to certain nonsaleable tax-exempt bonds acquired by a corporation in the ordinary course of business in payment for goods or services sold to state and local governments. However, what the Administration fails to take into account is that tax-exempt leases are frequently sold to third-party finance companies. Thus, any relief intended by this exception may be meaningless. Additionally, Treasury Secretary Rubin has said that the change in the disallowance rule will not materially affect the cost of borrowing for state and local governments because nonfinancial corporations hold only about five percent of the outstanding tax-exempt securities. This analysis is somewhat misleading because the impact of the proposal is highly concentrated in certain sectors, such as the short-term market and in leasing. Furthermore, as we have shown above, for an individual government, the impact may be devastating.

During the past 11 years, demand for state and local government debt has undergone a dramatic shift in the composition of borrowers. Tax law changes have resulted in large reductions in corporate holdings and increased reliance on individual purchasers. These changes include the application of alternative minimum tax to tax-exempt interest, the denial of the bank interest deduction for most municipal bonds, and a reduction of deductible loss reserves for property and casualty firms that purchase municipal securities. This development causes us concern because it has introduced more volatility into the market. While demand from individuals may be strong now, a shortfall could occur in the future.

The Administration takes the narrow view that this proposal will eliminate inappropriate corporate interest expense deductions. In fact, however, the proposal raises the cost of tax-exempt municipal financing and affects the ability of state and local governments to finance infrastructure, affordable housing, economic development, other facilities and equipment. Accordingly, we are opposed to this effort by the federal government to shift tax burdens to state and local governments.

For more information about the impact of the extension of the *pro rata* disallowance rule or the names and phone numbers of the contact persons for the organizations supporting this statement, please call Catherine L. Spain, Director - Federal Liaison Center, Government Finance Officers Association, 1750 K St., NW, Suite 650, Washington, DC 20006, (202) 429-2750.

April 21, 1997

Statement of the
American Automobile Manufacturers Association
Submitted for the Record

Committee on Finance
United States Senate

April 17, 1997 Hearing on
Revenue Raising Provisions in the Administration's
Fiscal Year 1998 Budget Proposal

The American Automobile Manufacturers Association (AAMA) and its members -- Chrysler Corporation, Ford Motor Company, and General Motors Corporation -- strongly oppose the Administration's proposals to:

- repeal the components of cost (COC) inventory accounting method;
- modify the net operating loss (NOL) carryback and carryforward rules; and
- replace the sales source rule (Export Source Rule) with an activity-based rule.

AAMA believes that these three revenue raising proposals would adversely affect U.S. corporations' ability to compete in the world market.

Repealing COC would require many manufacturing corporations to maintain two separate inventory cost accounting systems, one for financial reporting purposes and another for tax purposes. This would create enormous complexities and could greatly increase accounting costs for U.S. corporations. These are costs that overseas manufacturers will not have to incur. Moreover, it is possible that the Administration's proposal would result in a loss of revenue to the Federal government.

Reducing the carryback period for NOLs would reverse a long established Congressional policy of easing the harshness of annual tax accounting on businesses that, because of their riskiness or cyclical nature, experience sharp fluctuations in income.

Finally, replacing the Export Source Rule with an activity-based rule would raise the cost of manufacturing U.S. goods for export thereby adversely affecting both domestic jobs and the U.S. balance of trade. At a time when everyone acknowledges the importance of exports in sustaining growth in the U.S. economy, elimination of the Export Source Rule runs counter to U.S. trade policy and would be unwise.

The growth markets of the future for manufactured products are overseas. It is imperative that U.S. firms are able to compete with overseas manufacturers for positions in these growth markets. The Administration has stated that it supports the export of U.S. manufactured goods. However, the Administration's proposals to repeal COC inventory accounting, to modify the NOL rules, and to replace the Export Source Rule with an activity-based rule would all add unnecessarily to the cost of U.S manufacturers thereby hindering their ability to compete in the world market, and threatening the loss of U.S. jobs and an increase in our trade deficit.

For these reasons and those listed in the more detailed written material below, AAMA urges rejection of these Administration revenue raisers.

Repeal Components of Cost (COC) Inventory Accounting Method

Background

Manufacturers account for their inventories generally in two different ways. One is the COC method and the other is the Total Product Cost (TPC) method. Under COC, the manufacturer accounts for inventory in terms of units of materials, labor and overhead. Under TPC, the manufacturer accounts for inventory in units of finished goods. Manufacturers can use either method for both last-in-first-out (LIFO) or first-in-first-out (FIFO) inventory cost accounting purposes.

Each of AAMA's member companies has used COC for over fifty years to determine inventories for both internal management and financial statement reporting purposes. The use of COC precedes their adoption of LIFO, and is the underlying method on which our members maintain their cost accounting records. It is not a method that was adopted or changed in conjunction with the adoption of LIFO, nor is it a method that is used only for tax purposes. (For each of our members, the differences between financial statement inventories and tax inventories are differences required by various tax rules. The primary difference is UNICAP. Other minor differences include economic performance and the inability to record reserves for tax purposes. None of the differences between book and tax accounting are specific to or caused by the use of COC.)

It must be emphasized that COC is the fundamental method used by our members to maintain cost accounting records for their manufacturing operations. It is the way that cost information is gathered, recorded and maintained for management purposes, financial accounting, and tax reporting. It is not limited to LIFO computations, and it is not a function of tax reporting. Quite simply, it is the way in which many manufacturers record their costs to manage their businesses.

Administration Proposal

The Administration would repeal the COC method for LIFO inventory accounting. For taxpayers continuing to use a LIFO method of valuing inventory, the proposal would be applied on a cut-off basis. For a taxpayer switching to FIFO or other method of valuing inventory, the proposal would be applied pursuant to the present-law rules governing such changes in methods of accounting.

Discussion

In 1984, the American Institute for Certified Public Accounting (AICPA) issued a LIFO Issues Paper stating that COC is the preferable method for manufacturers in certain circumstances, including situations where:

1. There is very little finished goods inventory;
2. There are substantial work-in-process inventories;
3. Product lines continually evolve;
4. There is a significant shift between purchased and produced materials;
5. There are changes in manufacturing capacity; and
6. Products are not comparable year to year.

All of the factors outlined in the AICPA position paper are applicable to our members' manufacturing operations. In our industry, the COC method is thus considered "preferable" for generally accepted accounting principles (GAAP). Accordingly, regardless of the outcome of the Administration's proposal, our members will be obliged to continue to use COC for financial reporting purposes.

Analyzing just the first two factors demonstrates why COC is generally considered to be more accurate than TPC in our industry, when inventory is composed mainly of work-in-process. This is so because TPC can only be applied to work-in-process amounts by rough estimates (that is, work-in-process will be deemed to equal 50%, or some other specified percentage, of the cost of finished products). Since COC allows for a far more accurate valuation of work-in-process, it is therefore considered preferable under GAAP.

Our members also use COC for internal management reporting purposes. This is their long-standing business practice and will not be changed. For example, it is common for a plant manager to be responsible for labor and overhead, but not for purchasing because purchasing is usually done centrally. Thus, management uses COC for inventory reporting since different individuals and groups have responsibility for different cost elements within the total inventory cost. TPC is essentially meaningless in this context.

It is axiomatic that businesses would strive to use the most accurate and valid information for management purposes; if COC produced flawed information, or systematically lowered earnings, businesses would not use it to report to their shareholders or for management purposes. COC is not used by businesses because it produces lower earnings; it is used because it produces a more accurate measure of earnings.

The Administration's proposal suggests that COC is flawed in that it does not appropriately account for labor efficiencies and, therefore, should be repealed. In particular, the Administration has stated the following:

> The components of cost method, in many cases, does not adequately account for technological efficiencies in which skilled labor is substituted for less-skilled labor or where overhead costs (such as factory automation) replace direct labor costs. The costs of inventories determined by using the total product cost method generally are not affected by such factors.

Although the labor efficiency, or inefficiency, and the possible effect on overhead is only one of hundreds of subcomputations within the COC method, the Administration's proposal focuses only on this narrow aspect. The Administration's position in this regard misses the point to the extent it expresses a concern that a decrease in labor hours could be replaced by an increase in overhead costs. First, labor decreases may occur for a number of reasons, including buying rather than making certain parts or components in-house. Second, labor hours do not consistently decrease. Labor hours may increase, and therefore, have the opposite effect. In any case, not all users of COC will have labor efficiencies and not all such users base their overhead computation on labor. Therefore, the perceived computational problem does not occur with all users of COC, and does not always produce a benefit. Lastly, COC produces a clear reflection of income and the problems discussed in the Administration proposal are not significant.

The Administration has stated that TPC is not prone to the same problems it perceives exist with COC -- that is, that COC artificially understates taxable income. However, TPC has its own anomalies. For example, content changes such as the addition of catalytic converters or safety devices would typically be treated as inflation under TPC and, thus would reduce taxable income. Under COC, content changes are not treated as inflation, and therefore, would not artificially lower taxable income. Forcing taxpayers off COC may well result in less tax revenue for the Federal government.

We do not know how Treasury's revenue estimate for the repeal of COC was developed, but it would be erroneous merely to adjust labor and overhead assumptions. The correct approach would be to recompute the LIFO index for COC taxpayers based on TPC. Several other indicators suggest that the LIFO index would, in fact, be higher rather than lower under TPC. For example, wholesale delivered prices for product groups have shown a greater increase than the COC indexes. In summary, there is a strong likelihood that forcing manufacturers to use TPC could result in a higher inflation index, and thus, a revenue loss.

As previously discussed, repealing COC would require affected taxpayers to maintain two separate cost accounting systems for inventories. The establishment and maintenance of dual sets of inventory records would be enormously expensive and would add no additional value. Due to the size and complexity of our members' business operations. costs related to additional inventory systems could run into hundreds of millions of dollars and take years to design and implement. Indeed. it would place our members and many other U.S. manufacturers at a competitive disadvantage because of such redundant costs and immense recordkeeping burdens.

When President Clinton fitst proposed to repeal COC in 1994 to fund GATT, at least a new simplified alternative inventory price index computation (IPIC) was offered in connection with its elimination. Although current law contains an alternative IPIC, it is generally unworkable and biased against large businesses in its current form. The simplified IPIC offered by the President in 1994 could provide a reasonable alternative if COC must be eliminated. However, no such alternative is offered by the Administration in the fiscal 1998 budget proposal.

Conclusion

For all these reasons, we urge you to oppose repeal of COC. It is the most accurate method for computing LIFO inventories for our members, and it is effectively required under GAAP. It is also the standard industry practice for a substantial number of manufacturers. Moreover, the same COC methodology that is used for financial accounting and internal management is also used for tax purposes. The costs to create a second LIFO cost accounting system solely for tax purposes would be staggering. Finally, we suspect that the end result of such a repeal would be an enormous expense to our member companies in producing less accurate and less meaningful results, all with the likely effect of producing less revenue to the government.

Modify Net Operating Loss (NOL) Carryback and Carryforward Rules

Background

The current three-year carryback period for NOLs has been in place for nearly 40 years, and has served to ease the harshness of annual tax accounting on businesses that, because of their riskiness or cyclical nature, experience sharp fluctuations in income. See e.g., Report of the Committee on Ways and Means, H.R. 8300, 83d. Cong., 2d Sess., at 27 (1954). Moreover, as Congress has emphasized when previously extending the carryback period, the ability to carry losses back rather than forward enables businesses experiencing economic reverses to recover previously paid taxes at the time when losses are incurred, and thus to increase liquid funds at the time they are most needed. See Report of the Committee on Ways and Means, H.R. 13382, 85th Cong., 2d Sess., (1958).

Administration Proposal

The Administration has proposed limiting the carryback period for NOLs from three years to one year, and extending the carryforward period from fifteen to twenty years.

Discussion

The Administration's proposal assertedly would reduce administrative complexity, a rationale that is gossamer thin given the absence of any evidence or testimony of administrative difficulty in connection with NOL carrybacks. Instead, the proposal simply operates as a tax increase on business activity, an increase that is all the more inappropriate because it effectively targets businesses that are engaged in risk-intensive or cyclical activities such as the automotive industry.

Superficially, the Administration's proposal would extend the total period in which NOLs could be used ! ecause of the extended carryforward period. The extension is of virtually no practical significance, however, since a business insufficiently profitable to use a NOL over the present fifteen year carryforward period is unlikely to turn around in an additional five years. In contrast, the reduction in the carryback period has a real and substantial effect. Business cycles often extend for three years or more, leaving cyclical businesses in loss positions for a number of years in succession. Under the Administration's proposal, such businesses will be left having paid tax on income that would have otherwise been offset by losses, at a time when their financial resources are least able to handle an incremental tax burden. The three-year carryback can be crucial to keeping workers employed through a downturn and to funding the eventual recovery.

The rationale for the NOL carryback and carryforward period was recently addressed in 1986 in conjunction with legislation regarding the treatment of NOLs following an ownership change. The General Explanation of the Tax Reform Act of 1986 states:

> Although the Federal income tax system generally requires an annual accounting, a corporate taxpayer was allowed to carry NOLs back to the three taxable years preceding the loss and then forward to each of the 15 taxable years following the loss year (sec 172). The rationale for allowing the deduction of NOL carryforwards (and carrybacks) was that a taxpayer should be able to average income and losses over a period of years to reduce the disparity between the taxation of businesses that have stable income and businesses that experience fluctuations in income.

That rationale continues to be sound today.

Conclusion

There is, in sum, no credible policy justification for shortening the NOL carryback period. To the contrary, the considerable revenue generated by this proposal would, by definition, be a tax on non-existent profits. The practical effect is to force businesses to surrender revenue to the government without regard either to their income or ability to pay. The NOL proposal is simply designed as a revenue raiser without any policy justification.

We strongly urge retention of the three-year NOL carryback period -- a rule that has served its original goals well for nearly 40 years.

Replace Export Source Rule with an Activity-Based Rule

Background

Since 1922, regulations under IRC section 863(b) and its predecessors have included a provision that allows the income from goods that are manufactured in the U.S. and sold abroad (with title passing outside the U.S.) to be sourced as 50% U.S. income and 50% foreign income. This Export Source Rule has been beneficial to U.S. manufacturers that export because it increases their foreign source income and thereby increases their ability to utilize foreign tax credits effectively. Because the U.S. tax law limits the ability of companies to get credit for the foreign taxes which they pay, many U.S. multinational companies face double taxation on their overseas operations -- that is, they are taxed by both the U.S. and the foreign jurisdiction. The Export Source Rule helps reduce this double taxation and thereby encourages U.S. companies to manufacture in the U.S. for export.

Administration Proposal

Under the proposal, income from the sale or exchange of inventory property that is produced in the United States and sold or exchanged abroad would be apportioned between production activities and sales activities on actual economic activity.

Discussion

The Administration contends that its proposal would eliminate an advantage that U.S. multinational exporters that also operate in high tax foreign countries have over U.S. exporters that conduct all their business activities in the U.S. However, the Export Source Rule does not provide a competitive advantage to multinational exporters vis-à-vis exporters with "domestic-only" operations. Exporters with only domestic operations never incur foreign taxes and thus, are not even subject to the onerous penalty of double taxation.

The Export Source Rule, by alleviating double taxation, encourages companies to produce goods in the U.S. and then to export them. A 1993 Treasury Department study found that if the rule had been replaced by an activity-based rule in 1992, goods manufactured in the U.S. for export would have declined by a substantial amount. A recent study of the rule by Gary Hurfbauer of the Institute for International Economics and Dean DeRosa of ADR International. Ldt. estimates that for the year 1999 alone, the Export Source Rule will account for an additional $30.8 billion in exports, support 360.000 jobs, and add $2.3 billion to worker payrolls. According to the Department of Commerce, export related jobs generally provide a wage premium of 13 - 15%. Exports are fundamental to our economic growth and our future standard of living. The U.S. is a mature market. As such, U.S. employers must export to markets overseas in order to expand the U.S. economy.

Contrary to Administration assertions, the U.S. tax treaty network is not a substitute for the Export Source Rule. Moreover, the network is far from complete since it is limited to 56 countries. With or without a tax treaty, the real reason most multinational companies face double taxation is that U.S. tax provisions unfairly restrict corporate ability to credit foreign taxes paid against their U.S. taxes. The Export Sourc.e Rule helps to alleviate this problem.

Conclusion

The Export Source Rule is one of the few WTO-consistent export incentives remaining in our tax code. It is also justified on the basis of administrative convenience. In view of the role of exports in sustaining growth in the U.S. economy, supporting higher paying U.S. jobs, and encouraging exports, any attempt to reduce or eliminate the rule is unwarranted. The Administration's proposed effective repeal of the Export Source Rule is inconsistent with its own trade policy as well as the welfare of the U.S. economy, and should be opposed.

STATEMENT FOR THE RECORD

OF THE

AMERICAN BANKERS ASSOCIATION

ON

REVENUE RAISING PROVISIONS

IN THE

ADMINISTRATION'S FISCAL YEAR 1998 BUDGET PROPOSAL

BEFORE THE

UNITED STATES SENATE

COMMITTEE ON FINANCE

APRIL 17, 1997

The American Bankers Association (ABA) is pleased to have an opportunity to submit this statement for the record on the revenue raising provisions of the Administration's fiscal year 1998 budget proposal.

The ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership -- which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, and savings banks -- makes ABA the largest banking trade association in the country.

The Administration's 1998 budget proposal contains several significant proposals about which we are deeply concerned. Although we support legislative efforts to curtail tax abusive transactions, certain of the corporate reform proposals have been inaccurately and pejoratively categorized as "corporate welfare" and "loophole closers". Some of the revenue-raising proposals are actually across-the-board corporate tax increases rather than "loophole closers." Others involve reductions on tax expenditures that were enacted to achieve a specific social or economic policy objective. In this connection, many of the Administration's corporate revenue raising proposals would be more properly addressed under the rubric of overall tax reform and should not be included in this budget legislation.

We strongly object to the use of the term "corporate welfare." The term "welfare" is generally used to describe governmental assistance given to needy individuals during a difficult period in their lives. It connotes receiving "something in exchange for nothing". The corporate tax law does not contain any analogous provisions. Corporate tax incentives are generally intended to induce or support specific taxpayer actions that achieve specified social and economic policy goals. Accordingly, the term corporate welfare is, at best, misleading. A "loophole" is generally considered to mean a hidden flaw in the tax law the exploitation of which does not reflect the intent of Congress. While we generally support the closing of loophole transactions, many of the Administration's proposals would, in effect, penalize the legitimate business activities of corporations for no other reason than to raise needed revenue.

In this regard, the current corporate reform debate seems to disregard the fact that the corporate income tax is ultimately paid by individuals. It also disregards the vital role played by corporations in our domestic economy. According to New York Stock Exchange statistics, a great many taxpayers have linked their economic futures to that of corporate America. More than one American in three owns stock, much of it through mutual funds and retirement accounts. Corporate America employs over 20 million taxpayers (more than one fifth of all domestic wage and salary workers). Thus, indeed, a hit to corporations will ultimately be felt by individual taxpayers. Given the technological innovations of today's competitive market place, this is not the time for Congress to further disadvantage domestic business entities by curtailing much needed corporate tax incentives. Rather, Congress could better equalize the business playing field by closing genuine loopholes. For example, credit unions that have expanded their membership/customer base far beyond the parameters of their original common bond continue to be exempt from taxation and compete, unfairly, with commercial banks and thrifts. Limiting the proliferation of multiple common bond credit unions is a sorely needed loophole closer, which we would respectfully offer for your consideration.

We support the proposals to expand the availability of individual retirement accounts, to reduce the taxation of capital gains, and to reduce the taxation of estates involving closely held business. However, the Administration's revenue raising proposals are expected to inhibit job creation, inequitably penalize business and lessen the overall economic stimulative impact of the budget proposal. This statement provides additional details on the proposals we find most troubling.

Increased Information Reporting Penalties

The Administration proposes to raise the penalties, under section 6721, for failure to file correct information returns from the current level of $50 per return, not to exceed $250,000 during any calendar year, to the greater of $50 per return or 5 percent of the total amount required to be reported. The ABA strongly opposes the Administration's proposal.

The banking industry prepares and files information returns to report items such as employee wages, dividends, and interest (on Forms W-2, 1099-INT, -DIV, -B, -S, and -MISC) annually, in good faith, for the sole benefit of the IRS. The Administration reasons that the current penalty provisions may not be sufficient to encourage timely and accurate reporting. We disagree. Information reporting penalties were raised to the current levels as part of the Omnibus Budget Reconciliation Act of 1989, P.L. 101-239. The suggestion that this proposal reduces "corporate welfare" or closes a "corporate loophole" presumes that, irrespective of the legislative actions of the one hundred first Congress, corporations are noncompliant, a conclusion for which there is no substantiating evidence.

Further, penalties typically are intended to discourage "bad" behavior and encourage "good" behavior, not to serve as revenue raisers. Let's presume that the new penalty levels achieve the Administration's goal of decreasing the number of taxpayers that incur penalties. In the next budget, will we have another proposed increase in the penalties in order to maintain the revenue flow? Certainly, the proposed increase in penalties is unnecessary and is not a sound tax policy.

Modify Net Operating Loss (NOL) Carry-back and Carry-forward Rules

The ABA opposes the Administration's proposal to limit carry-backs of net operating losses (NOLs) to one year and extend carry-forwards to twenty years. Current law permits NOLs to be carried back three years and carried forward fifteen years to correct income distortions resulting from losses reported at the end of the taxable year. In many instances, NOLs result from general business cycles. This is particularly true for the banking industry, whose performance, over time, tends to mirror the financial ups and downs of its customers. Business cycles often last longer than twelve months and do not necessarily conform to the beginning and end of a taxable year. Accordingly, a one-year carry-back limitation would further distort and prevent accurate reporting of income for the combined period and income of the inidividual taxable years.

In its explanation of the reason for change, the Administration cites the increased complexity and administrative burden associated with carry-backs *vis-a-vis* carry-forwards. This rationale is inconsistent with sound tax policy and is not an adequate justification for so significantly limiting the NOL carry-back period. The notion of a carry-back has always had a quasi-equitable component. That is, it effectively allows a taxpayer who is struggling with a financial downturn to receive a cash infusion from the refund of previously paid taxes. The proposed one-year carry-back tilts the scale to the benefit of the IRS, which will receive a time value of money benefit. Refunds would be paid, if at all, at some point in the future rather than currently.

Additionally, reducing the NOL carry-back period could immediately reduce a bank's regulatory capital since the value of the carry-back for regulatory capital purposes would be limited to the amount of taxes paid in the year prior to the operating loss rather than the total amount of taxes paid in the three previous years. Bank regulatory agencies limit "deferred tax assets" (DTAs). A DTA represents a reduction in the future tax liability. It may result from either (a) NOL carry-forwards and excess credits or (b) a deductible "temporary difference", as defined in the Statement of Financial Accounting Standards No. 109. A "deductible temporary difference" is a tax deduction reported earlier on bank financial statements than on the tax return. The regulatory capital limitation does not apply to net operating loss carry-backs because they are not dependent on future taxable income since DTAs are linked to the carryback period, reducing the period will effectively reduce capital. DTAs that are dependent on future taxable income (such as net operating loss carry-forwards) are limited for regulatory capital to the lesser of the amount that can be realized within one year or 10% of Tier 1 capital.

Increasing the life of a net operating loss carry-forward from fifteen to twenty years is not likely to compensate for the immediate reduction in the value of net operating loss carry-backs. Accordingly, we strongly urge that this proposal not be included in the budget package.

Repeal section 1374 for Large Corporations

The ABA opposes the proposal to repeal Internal Revenue Code section 1374 for large S corporations. The proposal would accelerate net unrealized built-in gains (BIG) and impose a corporate level tax on BIG assets along with a shareholder level tax with respect to their stock. The BIG tax would apply to gains attributable to assets held at the time of conversion, negative adjustments due to accounting method change, intangibles such as core deposits and excess servicing rights, and recapture of the bad debt reserve.

The Small Business Job Protection Act of 1996, P.L. 104-188, allowed financial institutions to elect S corporation status for the first time. Effectively, the Administration's proposal would shut the window of opportunity for those financial institutions to elect S corporation status by making the cost of conversion prohibitively expensive. We believe that such a change would be contrary to Congressional intent.

Indeed, further clarifying legislation is necessary. We note that technical correction legislation is necessary with respect to the treatment of nonfinancial institution S corporations that hold S bank or thrift corporation subsidiaries. Under current law, an S corporation is allowed to own and elect S corporation status for a "qualified subchapter S subsidiary" (QSSS). If a nonfinancial institution parent corporation elects to treat a bank or thrift subsidiary as a QSSS, the QSSS is not treated as a separate corporation and all the assets, liabilities, and items of income, deduction, loss and credit of the subsidiary are treated as the attributes of the nonfinancial institution parent corporation. A technical correction is necessary to allow Treasury regulations to provide that an election to treat a bank subsidiary as a QSSS would not change the status of either the nonfinancial institution parent or the subsidiary for purposes of selected provisions of the Internal Revenue Code applicable to banks and thrifts (such as sections 265(b) interest expense disallowance; 582 bad debts and 6050P returns relating to cancellation of indebtedness).

With respect to thrifts, Section 593(e), as amended by the Small Business Job Protection Act of 1996, provides that distributions by a thrift to its shareholders are taken first out of earnings and profits (E&P) then out of the frozen base year reserves. Moreover, when a C corporation becomes an S corporation, it retains its accumulated C corporation E&P; however, it does not accumulate any additional E&P while it remains an S corporation. According to recent IRS pronouncements, reserve recapture under section

593(e) may be triggered, unintentionally, by the failure to have C corporation E&P. In order to make subchapter S benefits available to all eligible thrifts, S corporation earnings should be counted as E&P for section 593(e) purposes. We urge immediate passage of such technical corrections legislation.

Modify foreign tax credit (FTC) carryover rules

The ABA opposes the Administration's proposal to limit carry-backs of foreign tax credits (FTCs) to one year and extend carry-forwards to seven years. The proposed FTC carryover limitation would further distort and prevent the accurate reporting of income for previous years. The Administration's explanation for the proposed limitation on FTC carry-backs cites the increased complexity and administrative burden associated with carry-backs as opposed to carry-forwards. The Administration's rationale is inconsistent with sound tax policy and is not an adequate justification for so significantly limiting the FTC carry-back period. For the reasons set out above, there is little, if any, justification for making such a significant tax policy change. We suggest that this proposal not be included in the budget package.

Limit Dividends Received Deduction

The ABA strongly opposes the Administration's proposals to reduce the dividends-received deduction (from 70 percent to 50 percent for corporations owning less than 20 percent of the stock of a U.S. corporation), to modify the holding period requirement, and to deny the deduction on limited term preferred stock. In explaining the proposed changes, the Administration states, *inter alia*, that the 70 percent deduction is too generous; that the holding period requirement does not assure that the owner of stock bears sufficient risk of loss; and that the current rules for the deduction are too complex. We disagree. The ABA, along with other members of the financial services community, has steadfastly opposed limitation of the dividends received deduction.

The dividends-received deduction mitigates multiple level taxation of earnings from one corporation paid to another. Originally, "corporations were not taxed on dividends received from other corporations in order to prevent multiple taxation of corporate earnings as the earnings passed from one corporation to another possibly within the same chain of ownership." [1] The deduction was first cut back (to 85 percent) in an attempt to simplify corporate structures and to discourage the use of multiple entities for tax avoidance. However, the deduction remained at 85 percent until 1986, when it was reduced to 80 percent. It was further scaled back in 1987 to 70 percent. In several years

[1] Boris I. Bittker and James S. Eustice, Federal Income Taxation of Corporations and Shareholders, para. 5-05, at 5-38, n. 172 (6th ed. 1996).

since, the deduction has been on the "usual list of suspects" almost any time revenue is needed. Currently, the dividends received deduction is a necessary tool in maintaining corporate viability rather than an implement of tax avoidance. The dividends received deduction does not constitute "corporate welfare", nor should it be considered a "corporate loophole". In effect, cutting back the deduction from 70 percent to 50 percent would not only be a tax increase, it would also be a move closer to imposing a full triple tax on profitable companies.

The Administration has a separate proposal that would deny the interest deduction for certain debt instruments and reclassify certain other debt instruments, because such instruments have "substantial equity features." If the Administration is successful in curtailing the dividends-received deduction to 50 percent (and perhaps even further in the future), we wonder whether such reductions put even greater pressure on issuers to avoid equity instruments and structure debt instruments to achieve their corporate goals.

Reducing the dividends received deduction, as proposed, is also expected to disrupt the preferred stock market with resulting harm to investors, such as IRAs, pensions funds and corporations. The holding period changes would create uncertainty for preferred stock investors as to the availability of the deduction, discourage market-driven hedging practices, and impose significant compliance costs on companies with large portfolios. It would also further erode U.S. competitiveness. We do not believe that tax policy should sacrifice equity in order to achieve simplicity. We urge that this proposal not be included in the 1998 budget package.

Basis of Substantially Identical Securities Determined on an Average Basis

The ABA opposes the Administration's proposal to require taxpayers to determine their basis in substantially identical securities using the average of all of their holdings in securities. We also oppose the proposal to require that taxpayers use a first-in, first-out method for purposes of determining whether gain or loss on the sale of a security is long or short term. These proposals would unnecessarily create additional and complex recordkeeping burdens. Taxpayers would be required to maintain two sets of records for each investment: one for average cost (which must be adjusted at the time of each purchase) and another for acquisition dates (which must be adjusted at the time of each purchase or sale). The burden would be further complicated for taxpayers who maintain computerized records. The programming needed in order to establish, maintain and adjust two sets of records at the time of each transaction, would be substantial. We oppose the significant imposition of costs and compliance burdens associated with the proposal to change the timing aspects of reporting gain or loss from the sale of stock or securities. This proposal is not targeted toward abuse, but is a significant tax policy change with respect to the timing of reporting gain or loss from the sale of stock and is inappropriate for inclusion in the budget.

Require reasonable payment assumptions for interest accruals on certain debt instruments

The ABA opposes the proposal to require prepayment assumptions for interest accruals that would cause credit card issuers to pay tax on grace period interest before having a fixed right to the income. The proposal would require issuers to include in currently taxable income an estimate of the amount of grace period interest that will accrue in the future. This estimate would be based on the credit card issuer's assumptions of the likelihood that its credit card customers will not pay their entire balances before the end of the applicable grace period. This proposal effectively repeals the longstanding and long accepted "all events" standard in this area. It is not a "loophole closer", nor does it constitute "corporate welfare". Moreover, this proposal can only be viewed as a tax increase and an arbitrary departure from well established tax policy.

Other Issues

The Administration's proposal contains a number of other provisions to which we object as being harmful to banks and thrifts, as listed below:

- Extend section 265 pro rata disallowance of tax-exempt interest expense to all corporations;

- Register confidential tax shelters;

- Deny the interest deduction on certain debt instruments; and

- Defer the deduction on certain convertible debt.

CONCLUSION

The ABA appreciates having this opportunity present our views on the revenue raising provisions contained in the President's fiscal year 1998 budget proposal. We look forward to working with you in the future on these most important matters.

Statement Submitted to the Committee on Finance U.S. Senate

Regarding Revenue-Raising Proposals Included in President Clinton's Fiscal 1998 Budget Relating to the Dividends-Received Deduction

April 17, 1997

The undersigned businesses and trade associations appreciate the opportunity to respond to the Chairman's request for testimony to the Finance Committee on the revenue-raising provisions of President Clinton's fiscal 1998 budget plan. Specifically, we are testifying in opposition to the Administration's proposals to reduce, eliminate, or otherwise restrict the availability of the dividends-received deduction.

As the list of signers to this testimony demonstrates, a broad range of trade associations and companies believe that these proposals would exacerbate the multiple taxation of corporate income, penalize investment, and mark a retreat from efforts to develop a more rational tax system for the United States.

Rationale for the dividends-received deduction

The history of the dividends-received deduction (DRD) reflects its purpose and role to eliminate or at least alleviate the impact of potential multiple layers of corporate tax. Without the DRD, income would be taxed ***first*** when it is earned by a corporation, a ***second time*** when the income is paid as a dividend to a corporate shareholder, and finally, a ***third time*** when the income of the receiving corporation is paid as a dividend to an individual shareholder. The DRD serves to mitigate the middle level of taxation.

The DRD has been part of the federal law since 1909, when corporate income first became taxable. The deduction was enacted to provide for full deductibility of intercorporate dividends. This 100-percent deduction ensured that income earned by a corporation was not taxed more than once at the corporate level. Over time, the intended effect of the DRD has been eroded.

The DRD was reduced for the first time in 1935, to 90 percent, and then in 1936 to 85 percent. During this period, the corporate income tax included a surtax applicable to income above a certain level, called the "surtax exemption amount." At the time, there was concern that corporations would attempt to take advantage of multiple surtax exemptions by splitting income among several subsidiaries, each of which would be able to avoid the surtax up to the exemption amount. Subsidiary dividends then could be paid tax-free back to the parent as long as there was a 100-percent DRD. To preclude complete avoidance of the surtax through such "income splitting," the DRD was reduced to 85 percent. The result, for the first time, was a second level of corporate tax imposed on the same earnings (15 percent of intercorporate dividends) before they had left the corporate sector.

Underscoring the rationale that had prompted the earlier cut-back in the deduction, the full 100-percent deduction was restored in 1964 for dividends paid within affiliated groups that elected to use only one surtax exemption. In 1975, the use of a single surtax exemption for an affiliated group became mandatory, so the original rationale for reducing the DRD no longer existed. However, Congress did not act to restore the 100-percent deduction for all corporations. As part of the Tax Reform Act of 1986, Congress reduced the general DRD from 85 percent to 80 percent, a move apparently intended to leave unchanged the effective tax rate on dividends, taking into account the reduced corporate income tax rate under the 1986 Act.

In the Omnibus Budget Reconciliation Act of 1987, the deduction was reduced to 70 percent for dividends received from the stock of corporations in which the receiving corporation owns less than a 20-percent interest. Congress's stated rationale for reducing the deduction was that the prior 80-percent deduction was viewed as "too generous." The legislative history does not explain why precluding a second level of corporate tax (and a third level of tax when the earnings are paid to shareholders) should be viewed as "generous," rather than appropriate tax policy. Of course, the paramount objective of the 1987 Act was to reduce forecasted budget deficits.

The Administration's Proposals

The Administration's FY 1998 budget includes three proposals relating to the DRD:

- The DRD available to corporations owning less than a 20-percent interest in the stock of a corporation would be reduced from 70 percent to 50 percent.

- The DRD would be eliminated for dividends on certain limited-term preferred stock. Many companies issue this type of instrument as an alternative to higher-cost means of financing their operations.

- The DRD would be eliminated if the recipient corporation does not satisfy modified holding period requirements. This proposal generally would affect companies that have in place programs aimed at managing investment risk.

Movement in the Wrong Direction

The undersigned trade associations and companies believe that the Administration proposals run counter to sound tax policy principles:

- ***The proposals would exacerbate multiple taxation of corporate income.*** Most U.S. trading partners have adopted a single level of corporate taxation as a goal and provide some relief from double taxation of corporate income through "corporate integration" rules. Unlike the United States, other G7 countries (Canada, France, Germany, Italy, Japan, and United Kingdom) generally exclude from tax *altogether* dividends received by corporations. Adopting provisions that accentuate the problem of multiple taxation, rather than ameliorating this problem, would harm the international competitive position of U.S.-based corporations.

  The Treasury Department itself, in 1984, recommended that triple taxation of corporate income be eliminated, and double taxation be halved, as part of its blueprint for an ideal tax system. A subsequent Treasury Department report, released in January 1992, documented the substantial economic benefits of integration and the economic distortions caused by the current multi-tiered system of taxing corporate income. The report concluded that any of three proposed "integration" prototypes would increase investment in capital stock in the corporate sector by $125 billion to $500 billion and would decrease the debt-to-asset ratio in the corporate sector by 1 to 7 percentage points.

  These themes are echoed in recent proposals to restructure the U.S. tax system. While there are considerable differences over how a restructuring of the income tax system should be pursued, there appears to be growing consensus in support of reducing the multiple taxation of corporate income. The various restructuring proposals are grounded in the fundamental rationale that business investment, organization, and financial decisions should be driven by economic and not tax considerations, and that, from a policy perspective, corporate net income should be taxed just like other income – once and only once. Any further erosion of the DRD runs counter to the rationale behind these efforts.

- ***The proposals would penalize investment by corporations and individuals.*** Cutting back on the DRD would increase the cost of equity financing for U.S. corporations, thereby discouraging new capital investment. By contrast, the corporate integration regimes adopted by the other G7 countries do not add to a corporation's cost of financing new investments.

  Individuals also would be affected. Many individuals have invested in perpetual preferred equities, which provide a relatively predictable stream of earnings and stability of principal over time. Preferred equities represent a significant portion of many self-directed individual retirement portfolios. The Administration's proposals would have the effect of depressing the market for perpetual preferred stock, thereby decreasing the value of such shares. Individuals thus would see the value of current holdings and their retirement savings diminished.

- ***A reduction in the DRD would discriminate against particular business sectors and structures.*** The Administration's proposals may have a disproportionate impact on taxpayers in certain *industries*, such as the financial and public utility industries, that must meet certain capital requirements. Certain *types* of business structures also stand to be particularly affected. Personal holding companies, for example, are required to distribute their income on an annual basis (or pay a substantial penalty tax) and thus do not have an option to retain income to lessen the impact of multiple levels of taxation.

- ***Companies should not be penalized for minimizing risk of loss.*** As a result of the Administration's holding period proposal, the prudent operation of corporate liability and risk management programs could result in disallowance of the DRD. Faced with loss of the DRD, companies may choose to curtail these risk management programs.

- ***No tax abuse is targeted by the Administration's proposals.*** The Administration suggests that some taxpayers may be able to take advantage of the 70-percent deduction in a way that "undermines the separate corporate income tax." To the extent Treasury can demonstrate that the deduction may be subject to misuse, targeted anti-avoidance rules can be provided. The indiscriminate approach of sharply cutting back on the DRD goes beyond addressing inappropriate transactions and unnecessarily penalizes legitimate corporate investment activity – simply stated, it's bad tax policy.

- ***The Administration has no convincing defense for such a fundamental change to long-standing tax policy.*** The Administration argues that the current 70-percent deduction, for example, "is too generous." Since Congress already has addressed (in OBRA '87) the argument that an 80-percent deduction was "too generous," and responded by reducing the deduction to 70 percent, it is hard to see why only 10 years later the same deduction could again have become "too generous."

Conclusion

We urge the Committee not to consider the Administration's proposals to reduce the DRD. A more appropriate approach would be to reduce or eliminate the multiple taxation of corporation income, rather than further accentuate the inefficiencies and inequities of the current system.

American Council on Capital Formation
America's Community Bankers
American Insurance Association
American Council of Life Insurance
Edison Electric Institute
Financial Executives Institute
National Association of Manufacturers
PSA The Bond Market Trade Association
Securities Industry Association
U.S. Chamber of Commerce

Aetna Life and Casualty Company
American Bank of Connecticut

American Express Company
American States Financial Corporation
Baltimore Gas & Electric
Bear Stearns & Co., Inc.
B.C. Zieglar & Co.
Chapdelaine Corporate Securities
The Chase Manhattan Corporation
Cinergy Corp.
Citicorp
Colonial Pipeline Co.
Columbia Mutual Insurance Co.
Commonwealth Mortgage Assurance Co.
Cooper Industries Incorporated
Credit Suisse First Boston
Dominion Resources
Entergy Corporation
Erie Insurance Group
Family Farm Insurance Co.
Family Company Group
Flaherty & Crumrine Incorporated
Florida Power & Light Company
Goldman, Sachs & Co.
Household International
Houston Industries Incorporated
J.P. Morgan & Co. Incorporated
Kansas City Power & Light Company
Lehman Brothers Inc.
Lincoln National Corporation
Merchants Insurance Group
Mercury General Corporation
Merrill Lynch & Co., Inc.
MidAmerican Energy Company
Minnesota Power
Morgan Stanley & Co., Inc.
NYSEG (New York State Electric & Gas Corp.)
Northland Insurance Co.
Phoenix Duff & Phelps Investment Advisers
Pitney Bowes Inc.
Progressive Partners
Prudential Securities
Salomon Brothers
Spectrum Asset Management, Inc.
Smith Barney
Texaco, Inc.
The Travelers Group
Twenty-First Securities
Wisconsin Power & Light Company

Comments of the American Financial Services Association on the New Revenue Provision in the President's Fiscal Year 1998 Budget that would "Require Reasonable Payment Assumptions for Interest Accruals on Certain Debt Instruments"

I. Summary of AFSA'S Position

The American Financial Services Association (AFSA) strongly opposes the new revenue proposal titled, "Require Reasonable Payment Assumptions for Interest Accruals on Certain Debt Instruments," which in reality seems to be directed toward unbilled, estimated interest on credit card receivables. The provision is an inappropriate departure from tax accrual standards and there is no basis for extending the prepayment assumptions currently applicable (for only limited purposes) to REMIC interests to credit card receivables in order to "equalize" the two types of significantly different instruments. AFSA is concerned both with the specific impact of the proposal on the credit card industry as well as the precedent it sets for further departures from long-standing tax law accrual standards. This is not an issue of "corporate welfare" or of closing a "loophole," but of whether or not the "all events" test can be selectively ignored in an arbitrary fashion purely to raise tax revenues. The proposal is particularly egregious because affected taxpayers are prevented from using "assumptions" to charge off losses on credit card receivables (See Attachment). A more thorough discussion of the issue is found below followed by a description of AFSA's membership as required by the request for comments.

II. Background

Under present law, holders of credit card receivables recognize credit card interest income for tax purposes under the historic "all events test." Accordingly, any interest income that is both fixed and determinable is accrued currently. Any interest income, however, the right to which is contingent upon events outside the taxpayer's control, is not includable in taxable income until all events occur which eliminate the contingency. This rule applies to interest related to a "grace period" provided to a credit card customer.

Under a typical grace period arrangement (please see the attached chart), a credit card customer can avoid any finance charge on year-end purchases by paying the outstanding balance on or before the payment due date (i.e., through a 25-day grace period). The customer will owe interest related to the period from the billing date through the end of the year only if the customer fails to pay the outstanding balance before the end of the grace period. As the credit card issuer's right to this "grace period interest" is not fixed until the end of the grace period, the issuer is not required to currently accrue any grace period interest which becomes fixed during the subsequent year.

III. The Administration's Revenue Proposal

Simply stated, the provision in President Clinton's Fiscal Year 1998 budget requiring prepayment assumptions for interest accruals would cause credit card issuers to pay tax on grace period interest before having a fixed right to the income. The proposal would require issuers to include currently in taxable income an estimate of the amount of grace period interest that will accrue in the future. This estimate would be based on the credit card issuer's assumptions of the likelihood that its credit card customers will not pay their entire balance before the end of the applicable grace period. If, in the attached example, the taxpayer assumed, based on experience, that 50 percent of all nominal grace period interest becomes fixed, the taxpayer would, under the budget proposal, have to accrue for 1995, 50 percent of the estimated grace period interest on the $1,000 balance outstanding at December 31, 1995, or $3.50.

IV. Why the Revenue Proposal's Departure from Tax Accrual Standards is Inappropriate and Why REMICs are not Comparable Instruments

The Treasury Department claims that prepayment assumptions currently applicable to REMIC interests should be extended to credit card receivables in order to "equalize" the treatment of these two types of instruments. This goal is misplaced, however, because prepayment assumptions are used under present law only for the limited purpose of accruing discount and premiums on REMIC interests, but are not used for accruing stated interest. Instead, stated interest on debt instruments (including credit card receivables) is accrued under the historic "all events test" whereby taxpayers pay federal income tax on taxable income determined by reducing fixed and determinable income by fixed and determinable expenses. A consistent application of the fixed and determinable standard to both income and expenses preserves the integrity and fairness of the system even though some income or expense items may be taken into account at different times for financial statement purposes. Accrual method taxpayers are not entitled to deduct estimates of future expenses (such as bad debts) which, based on experience, are highly likely to be incurred. Predictions of uncertain future events have long been rejected as a basis for tax accounting on both the income and the expense side. In fact, since 1984 the accrual of expenses has been deferred beyond the time that they are fixed and determinable. A further one-sided departure from the historic "all events test" will significantly distort taxable income solely for the sake of a one time revenue raiser.

V. Conclusion

Under no circumstances can present law be viewed as a "loophole" or as providing "corporate welfare." On the contrary, adopting the proposal in question can only be viewed as a tax increase on a selected group of taxpayers. AFSA believes that the proposal is not only an undesirable departure from well established tax policy, but is also inequitable and one-sided.

Statement of Representation

The American Financial Services Association

The American Financial Services Association (AFSA) is the trade association for a wide variety of non-traditional, market funded providers of financial services to consumers and small businesses.

AFSA's members fit into four basic categories:

- Diversified Financial Services Companies — These are companies that offer a broad range of financial services and products to consumers nationwide. Many of these members are affiliated with banks or savings and loans.

- Automotive Finance Companies — These companies, frequently referred to as "captive finance companies," provide financing for customers that purchase the manufacturer's products. In addition, many of the companies or their parents have branched out into a range of other financial services, such as credit cards or mortgage lending.

- Consumer Finance Companies — The core business of this membership segment includes: unsecured personal loans, home equity loans, and sales financing (for retailers' credit customers). This segment includes companies of all sizes.

- Credit Card Issuers — This membership segment offers bank cards, charge cards, credit cards or private label cards. AFSA members include many of the largest credit card issuers in the U.S.

AFSA members are important sources of credit to the American consumer, providing more than 20 percent of all consumer credit. AFSA members are highly innovative and compete at all levels in the financial services markets. Our members have charged AFSA with promoting a free and open financial services market that rewards the highest level of competitiveness.

Attachment

The Administration's proposal is inconsistent with past congressional action affecting credit card receivables. AFSA believes that the logic expressed by the Joint Committee on Taxation in its explanation (see below) of the repeal of the deduction for bad debt reserves in the 1986 Act holds equally to grace period interest. The conclusion of the explanation states that if a deduction is allowed prior to the taxable year in which the bad debt loss actually occurs, the tax liability of the taxpayer is understated. Conversely, if grace period interest must be recognized before the right to receive such income by a credit card issuer is actually fixed, its tax liability will be overstated.

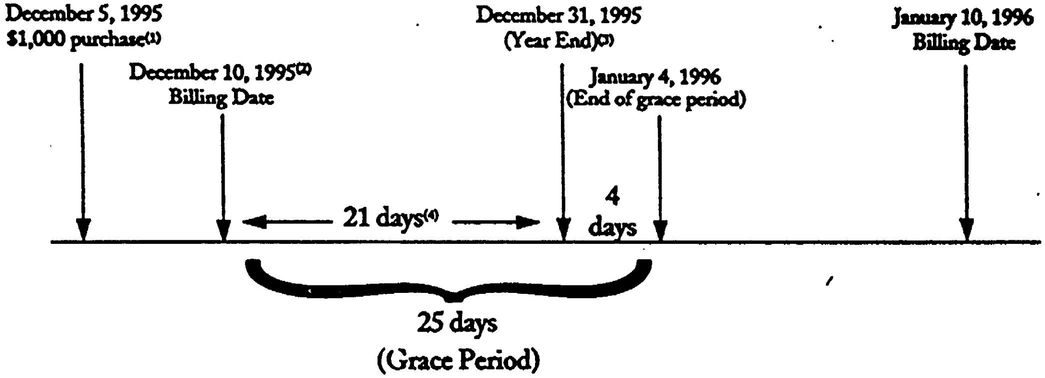
Further, the proposal suffers from the same defects that the staff of the Joint Committee on Taxation relied on as the basis for the repeal of the deduction for bad debt reserves in the 1986 Act:

> **F. Reserve for Bad Debts (Sec. 805 of the Act and sec. 166 of the Code)[73]**
>
> *Prior Law*
>
> Prior law permitted taxpayers to take a deduction for losses on business debts using either the specific charge-off method or the reserve method. The specific charge-off method allows a deduction at the time and in the amount that any individual debt is wholly or partially worthless. The reserve method allows the current deduction of the amount that is necessary to bring the balance in the bad debt reserve account as of the beginning of the year, adjusted for actual bad debt losses and recoveries, to the balance allowable under an approved method as of the end of the year. The deduction taken under the reserve method is required to be reasonable in amount, determined in light of the facts existing at the close of the taxable year.
>
> Worthless debts are charged off, resulting in a deduction under the specific charge-off method, or an adjustment to the reserve account under the reserve method, in the year in which they become worthless. In the case of a partially worthless debt, the amount allowed to be charged off for Federal income tax purposes cannot exceed the amount charged-off on the taxpayer's books. No such requirement is applicable to wholly worthless debts.
>
> Prior law required an actual debt be owed to the taxpayer in order to support the creation of a reserve for bad debts. An exception to this rule was provided for dealers who guarantee, endorse or provide indemnity agreements on debt owed to others if the potential obligation of the dealer arises from its sale of real or tangible personal property.
>
> *Reasons for Change*
>
> The Congress believed that the use of the reserve method for defining losses from bad debts resulted in the deductions being allowed for tax purposes for losses that statistically occur in the future. Thus, the Congress believe that the use of the reserve method for determining losses from bad debts allowed a deduction to be taken to the time that the loss actually occurred. This treatment under prior law was not consistent with the treatment of other deductions under the all events test. If a deduction is allowed prior to the taxable year in which the loss actually occurs, the value of the deduction to the taxpayer is overstated and the overall tax liability of the taxpayer understated. (emphasis added)

"For legislative background of the provision see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 906, H. Rep. 99-426, pp. 638-641, H.R. 3838 as reported by the Senate Committee on Finance on May 29, 1986, sec. 303, S. Rep. 99-313, pp. 153-158 and H. Rep. 99-841 Vol. II (September 18, 1986) pp. 314-316 (Conference Report).

The administration's current revenue proposal applies to credit card issuers' receivables for which the above provision of the 1986 Act repealed the deduction for bad debt reserves. While the repeal of the bad debt deduction in 1986 relied on the "all events'" test to prevent issuers of credit card receivables from using statistical data for purposes of accruing bad debt deductions, for income purposes the Administration is now willing — for income purposes only — to rely on statistics to require income inclusions with respect to the same credit card receivables.

Grace Period Interest Example



December 5, 1995
$1,000 purchase(1)
December 10, 1995(2)
Billing Date
December 31, 1995
(Year End)(3)
January 4, 1996
(End of grace period)
January 10, 1996
Billing Date
21 days(4)
4 days
25 days
(Grace Period)

Assumptions/Notes

[1] Cardmember makes purchase on 12/5 on credit card which provides for 12% interest rate and 25 day grace period.

[2] Cardmember's monthly billing date is 10th.

[3] Card issuer is a calendar year taxpayer.

[4] Grace period interest on a 12% credit card = $1,000 x 12% = $120/12 (months) = $10 x 21/30 = $7.00.

COMMENTS OF THE
AMERICAN PETROLEUM INSTITUTE
ON THE ADMINISTRATION'S REVENUE
RAISERS SUBMITTED FOR THE PRINTED
RECORD OF THECOMMITTEE
ON FINANCE U.S. SENATE.

April 17, 1997

This testimony is submitted by the American Petroleum Institute (API) for the March 12, 1997 Ways and Means hearing on the revenue raising provisions in the Administration's fy 1998 budget proposal. API represents approximately 300 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining, and marketing. The U.S. oil and gas industry is the leader in exploring for and developing oil and gas reserves around the world.

One of the provisions in President Clinton's budget proposal is aimed directly at the foreign source income of U.S. petroleum companies. It seriously threatens the ability of those companies to remain competitive on a global scale, and API strongly opposes it. It is particularly troubling that the Administration would attack the foreign operations of U.S. oil companies in this way, especially when it conflicts with Commerce and State Department initiatives encouraging those same companies to participate in exploration and production ventures in strategic areas around the world.

I. THE PROVISIONS

Specifically, the proposal includes the following provisions:

Effective for taxable years beginning after the bill's enactment, reinvested foreign oil and gas income ("FOGI") earnings would be taxed before being realized through dividend distributions. FOGI would be treated, instead, as Subpart F income as defined under Code Section 952 (i.e., not eligible for deferral), and trapped in a new separate FOGI basket under Code Section 904(d). FOGI would be defined to include both foreign oil and gas extraction income ("FOGEI") and foreign oil related income ("FORI").

In situations where taxpayers are subject to a foreign tax and also receive a so-called "economic benefit" from the foreign country, taxpayers would only be able to claim a credit for such taxes under Code Section 902 if the country has a "generally applicable income tax" that has "substantial application" to all types of taxpayers.

Following is a detailed discussion of these changes and their expected effect on the taxation of FOGI.

II. IMPACT ON GLOBAL COMPETITIVENESS

As noted, the proposed changes to the foreign tax credit ("FTC") rules for FOGI and the current taxation of foreign subsidiary income before distribution conflict with the Clinton Administration's announced trade policy. The Administration has demonstrated an intention to subscribe to the integration of worldwide trade, with a continuing removal of trade barriers and promotion of international investment (e.g., the GATT and NAFTA agreements). Moreover, because of their political and strategic importance, foreign investments by U.S. oil companies have been welcomed by the U.S. government. For example, recent participation by U.S. oil companies in the development of the Tengiz oil field in Kazakhstan has been praised as fostering the political independence of that
newly formed nation, as well as securing new sources of oil to Western nations, which are still too heavily dependent on Middle Eastern imports.

Curiously, given this background, the Administration's proposals will further tilt "the playing field" against the U.S. petroleum industry's foreign exploration and production efforts, and will increase, or make prohibitive, the U.S. tax burden on foreign petroleum industry operations. They will not only stymie new investment in foreign exploration and production projects, but also change the economics of past investments. As illustrated below, the proposed changes in the FTC rules can reduce the return on project investments by approximately one-third.

In the case of natural resource extraction and production, the reason for foreign investment is obvious. If U.S. oil and gas concerns wish to stay in business, they must look to replace their diminishing reserves overseas, since the opportunity to do so in the U.S. has been restricted by both federal and state government policy. If U.S. companies can not legitimately compete, foreign resources will instead be produced by foreign competitors, only then without any benefit to the U.S. economy, and without U.S. concerns or American workers deriving any direct or indirect income from the foreign production activity.

Proposals to increase the taxation of foreign operations, like other barriers to foreign investments by U.S. firms, are based on several flawed premises. There is the perception that foreign investment by U.S. business is responsible for reduced investment and employment in the U.S. These investments are perceived to be made primarily in low wage countries at the expense of U.S. labor; with such foreign investments also including a shift of Research & Development ("R&D") spending abroad. However, studies like the 1995 review by the Economic Strategy Institute (Multinational Corporations and the U.S. Economy [1995]) show these claims to be unfounded. Over a 20-year period, capital outflows from the U.S. averaged less than 1% of U.S. nonresidential fixed investment, which is hardly sufficient to account for any serious deterioration in U.S. economic growth. Instead, affiliate earnings and foreign loans, not U.S. equity, have financed the bulk of direct foreign investment.

The principal reason for foreign investment is seldom cheap labor. Rather, the more common reasons are a search for new markets, quicker and easier response to local market requirements, elimination of tariff and transportation costs, faster generation of local good will, and other deep rooted host country policies. In this regard, the bulk of U.S. foreign investment is in Europe, where labor is expensive, rather than in Asia and Latin America, where wages are low. According to a recent study, almost two-thirds of employment by foreign subsidiaries of U.S. companies was in Canada, Japan, and Europe, all higher wage areas (Sullivan, From Lake Geneva to the Ganges: U.S. Multinational Employment Abroad, 71 Tax Notes 539 [4/22/96]). Although some R&D functions have been moved abroad, they make up only 15 % of domestic R&D, and are primarily in areas aimed at tailoring products to local demands. Moreover, two recent studies of the OECD countries conclude that foreign investment is beneficial to employment and incomes in both the home and host countries. (The OECD Countries, Paris [1994]; Trade and Investment: Transplants, Paris [1994]).

The FTC principle, along with so-called "deferral" of taxation of foreign subsidiary earnings until repatriation, make up the foundation of U.S. taxation of foreign source income. The Administration's budget proposals would destroy this foundation of foreign income taxation on a selective basis for foreign oil and gas income only, in direct conflict with the U.S. trade policy of global integration, embraced by both Democratic and Republican Administrations.

III. FOREIGN TAX CREDIT - BACKGROUND

A. THE FTC IS INTENDED TO PREVENT DOUBLE TAXATION

Since the beginning of Federal income taxation, the U.S. has taxed the worldwide income of U.S. citizens and residents, including U.S. corporations. To avoid double taxation, the FTC was introduced in 1918 to allow a dollar for dollar offset against U.S. income taxes on foreign income for taxes paid to foreign taxing jurisdictions. The need for the FTC is at least as important today as it was 70 years ago. Also under this regime, foreign income of foreign subsidiaries is not immediately subject to U.S. taxation. Instead, the underlying earnings become subject to U.S. tax only when the U.S. shareholder receives a dividend (except for certain "passive" or "Subpart F" income). Any foreign taxes paid by the subsidiary on such earnings is deemed to have been paid by any U.S. shareholders owning at least 10 % of the subsidiary, and can be claimed as FTCs against the U.S. tax on the foreign dividend income (the so-called "indirect foreign tax credit").

Thus, taxing the U.S. shareholder on all or part of the foreign corporation's earnings, before dividends are distributed, is the exception rather than the rule. In the corporate context, the norm is that although U.S. corporations are taxed on their worldwide income, there is no taxation before realization. Accordingly, the earnings of foreign subsidiaries are taxed only when they are received in the form of a dividend, or on disposal of the subsidiary's stock. This is symmetrical with individual shareholders being taxed on earnings from companies in which they own shares when dividends are declared and paid or the stock is sold.

B. BASIC RULES OF THE FTC

The FTC is intended to offset only U.S. tax on foreign source income. Thus, an overall limitation on currently usable FTCs is computed by taking the ratio of foreign source income to worldwide taxable income, and multiplying this by the tentative U.S. tax on worldwide income. The excess of FTCs can be carried back 2 years and carried forward 5 years, to be claimed as credits in those years within the same respective overall limitations.

The overall limitation is computed separately for various "separate limitation categories." Under present law, foreign oil and gas income falls into the general limitation category, i.e., for purposes of computing the overall limitation, foreign oil and gas income is treated like any other foreign active business income. Separate special limitations still apply, however, for income: (1) whose foreign source can be easily changed; (2) which typically bears little or no foreign tax; or (3) which often bears a rate of foreign tax that is abnormally high or in excess of rates of other types of income. In these cases, a separate limitation is designed to prevent the use of foreign taxes imposed on one category to reduce U.S. tax on other categories of income.

C. FTC LIMITATIONS FOR OIL AND GAS INCOME

As discussed in this section and D below, Congress and the Treasury have already imposed significant limitations on the use of foreign tax credits attributable to foreign oil and gas operations. In response to the development of high tax rate regimes by "OPEC" in the early 1970's, taxes on foreign oil and gas income became the subject of special limitations. These changes also addressed Congress's concern over the confusion between taxes and royalties paid to the host country government. For example, each year the amount of taxes on FOGEI may not exceed 35 % (i.e., the U.S. corporate tax rate) of such income. Any excess may be carried over like excess FTCs under the overall limitation. FOGEI is income derived from the extraction of oil and gas, or from the sale or exchange of assets used in extraction activities.

In addition, the IRS has regulatory authority to determine that a foreign tax on FORI is not "creditable" to the extent that the foreign law imposing the tax is structured, or in fact operates, so that the tax that is generally imposed is materially greater than the amount of tax on income that is neither FORI or FOGEI. FORI is foreign source income from (1) processing oil and gas into primary products, (2) transporting oil and gas or their primary products, (3) distributing or selling such, or (4) disposing of assets used in the foregoing activities. Otherwise, the overall limitation (with its special categories discussed above) applies to FOGEI and FORI. Thus, as active business income, FOGEI and FORI would fall into the general limitation category.

D. THE DUAL CAPACITY TAXPAYER SAFE HARBOR RULE

Similar to the treatment of the U.S. Outer Continental Shelf, mineral rights in other countries vest in the foreign sovereign, which then grants exploitation rights in various forms. This can be done either directly, or through a state owned enterprise (e.g., a license or a production sharing contract). Because the taxing sovereign is also the grantor of mineral rights, the high tax rates imposed on oil and gas profits have often been questioned as representing, in part, payment for the grant of "a specific economic benefit" from mineral exploitation rights. Thus, the dual nature of these payments to the sovereign have resulted in such taxpayers being referred to as "dual capacity taxpayers."

To help resolve controversies surrounding the nature of tax payments by dual capacity taxpayers, the Treasury Department in 1983 developed the "dual capacity taxpayer rules" of the FTC regulations. Under the facts and circumstances method of these regulations, the taxpayer must establish the amount of the intended tax payment that otherwise qualifies as an income tax payment but is not paid in return for a specific economic benefit. Any remainder is a deductible rather than creditable payment (and in the case of oil and gas producers, is considered a royalty). The regulations also include a safe harbor election (see Treas. Reg. ° 1.901-2A(e)(1)), whereby a formula is used to determine the tax portion of the payment to the foreign sovereign, which is basically the amount that the dual capacity taxpayer would pay under the foreign country's general income tax. Where there is no generally applicable income tax, the safe harbor rule of the regulation allows the use of the U.S. tax rate in a "splitting" computation (i.e., the U.S. tax rate is considered the country's generally applicable income tax rate).

IV. THE PROPOSAL

A. THE PROPOSAL LIMITS FTCs OF DUAL CAPACITY TAXPAYERS TO THE HOST COUNTRY'S GENERALLY APPLICABLE INCOME TAX

If a host country had an income tax on FOGI (i.e., FOGEI or FORI), but no generally applicable income tax, the Administration's proposal would result in disallowing any FTCs on FOGI. This would result in inequitable and destructive double taxation of dual capacity taxpayers, contrary to the global trade policy advocated by the U.S.

The additional U.S. tax on foreign investment in the petroleum industry would not only eliminate many new projects; but could also change the economics of past investments. In some cases, this could not only reduce the rate of return, but also preclude a return of the investment itself, leaving the U.S. business with an unexpected "legislated" loss. In addition, because of the uncertainties of the provision, it will also introduce more complexity and potential for litigation into the already muddled world of the FTC.

The unfairness of the provision becomes even more obvious if one considers the situation where a U.S. based oil company and a U.S. based company other than an oil company are subject to an income tax in a country without a generally applicable income tax. Under the proposal, only the U.S. oil company would receive no foreign tax credit, while the other taxpayer would be entitled to the full tax credit for the very same tax.

The proposal's concerns with the tax versus royalty distinction were resolved by Congress and the Treasury long ago with the special tax credit limitation on FOGEI enacted in 1975 and the Splitting Regulations of 1983. These were then later reinforced in the 1986 Act by the fragmentation of foreign source income into a host of categories or baskets. The earlier resolution of the tax versus royalty dilemma recognized that (1) if payments to a foreign sovereign meet the criteria of an income tax, they should not be denied complete creditability against U.S income tax on the underlying income; and (2) creditability of the perceived excessive tax payment is better controlled by reference to the U.S. tax burden, rather than being dependent on the foreign sovereign's fiscal choices.

B. THE PROPOSAL LIMITS FTCs TO THE AMOUNT WHICH WOULD BE PAID UNDER THE GENERALLY APPLICABLE INCOME TAX

By elevating the regulatory safe harbor to the exclusive statutory rule, the proposal eliminates a dual capacity taxpayer's right to show, based on facts and circumstances, which portion of its payment to the foreign government was not made in exchange for the conferral of specific economic benefits and, therefore, qualifies as a creditable tax. Moreover, by eliminating the "fall back" to the U.S. tax rate in the safe harbor computation where the host country has no generally applicable income tax, the proposal denies the creditability of true income taxes paid by dual capacity taxpayers under a "schedular" type of business income tax regime (i.e., regimes which tax only certain categories of income, according to particular "schedules"), merely because the foreign sovereign's fiscal policy does not include all types of business income.

For emerging economies of lesser developed countries, as for post-industrial nations, it is not realistic to always demand the existence of a generally applicable income tax. Even if the political willingness exists to have a generally applicable income tax, such may not be possible because the ability to design and administer a generally applicable income tax depends on the structure of the host country's economy. The most difficult problems arise in the field of business taxation. Oftentimes, the absence of reliable accounting books will only allow a primitive presumptive measure of profits. Under such circumstances the effective administration of a general income tax is impossible. All this is exacerbated by phenomena which are typical for less developed economies: a high degree of self-employment, the small size of establishments, and low taxpayer compliance and enforcement. In such situations, the income tax will have to be limited to mature businesses, along with the oil and gas extraction business.

C. THE PROPOSAL INCREASES THE RISK OF DOUBLE TAXATION

Adoption of the Administration's proposals would further tilt the playing field against overseas oil and gas operations by U.S. business, and increase the risk of double taxation of FOGI. This will severely hinder U.S. oil companies in their competition with foreign oil and gas concerns in the global oil and gas exploration, production, refining, and marketing arena, where the home countries of their foreign competition do not double tax FOGI. This occurs where these countries either exempt foreign source income or have a foreign tax credit regime which truly prevents double taxation.

To illustrate, assume foreign country X offers licenses for oil and gas exploitation and also has an 85 % tax on oil and gas extraction income. In competitive bidding, the license will be granted to the bidder which assumes exploration and development obligations most favorable to country X. Country X has no generally applicable income tax. Unless a U.S. company is assured that it will not be taxed again on its after-tax profit from country X, it very likely will not be able to compete with another foreign oil company for such a license because of the different after tax returns.

EXAMPLE

	U.S. OWNED OIL COMPANIES		FOREIGN COMPETITORS
Host Country Taxation			
Taxable profit	100		100
Host Country Tax	-85		-85
After Host Country Tax	15		15
Home Country Taxation	US Present Law	US Proposed	Foreign Competitor's Home Country Tax
Taxable Profit	100	100	Not applicable because foreign income is exempt from taxation if subject to tax in host country.
Foreign Tax deduction	None	-85	
Taxable Income	100	15	
Tentative Tax (e.g., U.S. tax at 35%)	35	5.25	
FTC limited to US tax on foreign source income	-35	N/A	
Home Country Tax payable	0	5.25	
Profit after Tax payments			
Profit before taxes	100	100	100
Tax to Host Country	-85	-85	-85
Tax to Home Country	0	-5.25	0
After Tax Profit	15	9.75	15

Because of the 35 % additional U.S. tax, the U.S. company's after tax return will be more than one-third less than its foreign competitor's. Stated differently, if the foreign competitor is able to match the U.S. company's proficiency and effectiveness, the foreigner's return will be more than 50 % greater then the U.S. company's return. This would surely harm the U.S. company in any competitive bidding.

D. SEPARATE LIMITATION CATEGORY FOR FOGI

To install a separate FTC limitation category for FOGI would single out the active business income of oil companies and separate it from the general business income "basket." There is no legitimate reason to carve out FOGI from the general limitation category or basket. FOGEI is derived from the country where the natural resource is in the ground while FORI is derived from the country where the processing or marketing occurs. Moreover, any FORI that is earned in consuming countries and treated like other business income is very likely taxed currently, before distribution, under the anti-avoidance rules for undistributed earnings of foreign subsidiaries.

V. REPEAL OF SO-CALLED DEFERRAL

A. BACKGROUND

As stated above, the U.S. exercises worldwide taxing jurisdiction over U.S. persons, including U.S. corporations. However, foreign corporations are not creatures of U.S. law and are thus not subject to US income tax. For various reasons, U.S. companies conduct foreign operations through foreign corporations. These corporations are called controlled foreign corporations (CFCs). The earnings of CFCs are taxed currently only by the host country. They are taxed to the U.S. shareholder only if and when distributed as a dividend.

However, if the US shareholder is suspected of using a foreign subsidiary to actively defer U.S. tax, the Code provides for current taxation of such earnings, imputing a constructive distribution. These rules are found in "Subpart F", and the income to the U.S. shareholder from these deemed distributions is conveniently referred to as "Subpart F income." Subpart F income has been viewed by Congress only to exist with respect to passive income or income which can be easily moved to sources with no or low foreign taxes. These rules, referred to as "anti-deferral" rules, are portrayed as denying the "privilege of deferral." However, they operate more in the nature of penalty provisions, rather than by conferring or denying a privilege.

Foreign operations are not placed into foreign subsidiaries merely for tax reasons. Although current taxation of undistributed subsidiary earnings is oftentimes justified by the claim that the taxpayer's choice of operating in the host country through a U.S. company versus a foreign company should not affect the U.S. tax burden, such analysis is flawed. Choice of a foreign corporation as the vessel for doing business in the host country generally is for business reasons, e.g., the utilization of a host country company may be required for natural resources extraction.

B. THE PROPOSAL STATES NO REASON FOR SINGLING OUT FOGI FOR SUBPART F TREATMENT

As stated above, Subpart F treatment is generally limited to passive income that is easily manipulated as to source of income, or that is earned in low or no income tax jurisdictions. The Administration's proposal does not indicate the perceived suspect nature of FOGI. It is clear that none of the typical rationales for Subpart F treatment applies to FOGI For example, FOGI is not passive income but, rather, very active income from the exploration, production, refining, and marketing of petroleum and its primary products.

Undistributed earnings of foreign subsidiaries should only be taxed to the U.S. shareholder where foreign earnings can be manipulated as to source or taxing jurisdiction, with a concomitant potential of U.S. tax avoidance. It is the potential for tax avoidance that calls for an exception from the fundamental principle. As active business income, FOGI is derived where and when the natural resource is extracted, refined and marketed.

Moreover, current taxation of foreign subsidiaries' FOGI will exacerbate the differences between the host country and U.S. tax laws. This may result in double taxation, curtailing or crippling the competitiveness of U.S. oil companies. As a general rule, the host country tax burden on a project is greater than the U.S. tax burden. Thus, in an ideal world, even current taxation of a CFC's earnings would not result in an additional U.S. tax burden. However, differences in the host country and U.S. tax laws, such as the timing of cost recovery, and the many restrictions in the U.S. tax credit mechanism, will frequently result in additional U.S. tax even though the cash flow is reinvested in the host country or region.

VI. OTHER REVENUE PROPOSALS

A. MODIFICATION OF THE FOREIGN TAX CREDIT CARRYOVER RULES

For FTCs in excess of the overall limitation, the proposal would reduce carryback periods from two to one year and extend the carryforward from five to seven years. This is based on the perception that carrybacks were associated with increased complexity and administrative burdens, as compared to carryforwards.

The proposal increases the risk of losing utilization of excess credits effectively due to the reduction of the carryback period; this disadvantage is not offset by the extension of the carryforward period. As a substitute for the proposal, the FTC carryover rules should be aligned with the rules applicable to other tax attributes like Net Operating Losses (NOL) and Business Tax Credits (i.e., 3 years carryback and 15 years carryforward, in total 18 years carryover).

Liberal carryover periods are of even greater importance for FTCs because of variances in foreign and domestic tax rules which result in timing differences of the foreign and domestic tax incidence, with a mismatch of foreign and U.S. tax under the FTC rules. Finally the fragmentation of the foreign income streams in the 1986 Act into nine or more baskets makes a liberalization in an alignment with the carryover rules for other tax attributes even more imperative.

VII. THE PROPOSALS ARE BAD TAX POLICY

Reduction of U.S. participation in foreign oil and gas development because of misguided tax provisions punitively applied to a single U.S. industry will adversely affect the United States. Additional tax burdens will hinder U.S. companies in competition with foreign concerns. Although the host country resource will be developed, it will be done by foreign competition, with the adverse ripple effect of U.S. jobs losses and the loss of continuing evolution of U.S. technology. By contrast, foreign oil and gas development by U.S. companies increases utilization of U.S. supplies of hardware and technology. The loss of any major foreign project by a U.S. company will mean less employment in the U.S. by suppliers, and by the U.S. parent, in addition to fewer U.S. expatriates at foreign locations.

Thus, the questions to be answered are: Would the U.S. (for energy security and international trade reasons, among others) rather be dependent on a competitive U.S.-based petroleum industry for finding and developing foreign oil and gas reserves than on a foreign petroleum industry whose interests are less closely tied to the energy and foreign trade interests of the U.S.? If the answer is "yes", then why would the U.S. government adopt a tax policy that is punitive in nature and lessens the competitiveness of the U.S. petroleum industry? The U.S. tax system already makes it extremely difficult for U.S. multinationals to compete against foreign-based entities. This is in direct contrast to the tax systems of our foreign-based competitors, which actually encourage those companies to be more competitive in winning foreign projects. What we need from Congress are improvements in our system that allow U.S. companies to compete more effectively, not further impediments that make it even more difficult and in some cases impossible to succeed in today's global oil and gas business environment. These improvements should include, among others, the repeal of the plethora of separate FTC baskets, the extension of the FTC carryover period, for foreign tax credits, and the repeal of section 907.

Testimony

of

America's Community Bankers

on the

Revenue Raising Provisions in the Administration's

Fiscal Year 1998 Budget Proposal

before the

Committee on Finance

of the

United States Senate

on

April 17, 1997

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Mr. Chairman and Members of the Committee:

America's Community Bankers appreciates this opportunity to submit testimony for the record of the hearing on the revenue raising provisions in the Administration's fiscal year 1998 budget proposal. America's Community Bankers is the national trade association for 2,000 savings and community financial institutions and related business firms. The industry has more than $1 trillion in assets, 250,000 employees and 15,000 offices. ACB members have diverse business strategies based on consumer financial services, housing finance and community development.

ACB wishes to focus on a provision included in the Administration's budget that will have a uniquely adverse impact on financial institutions. This is the provision that would modify the carryback and carryforward periods for net operating losses. ACB requests that, at a minimum, the limitation of the NOL carryback period to one year should not apply to banks and savings institutions because of the special regulatory accounting rules to which they are subject.

Introduction

The Administration proposes to reduce the NOL carryback period from three years to one, while extending the carryforward period from 15 years to 20 years. The diminution of the carryback period would not apply, however, to REITs, specified liability losses, excess interest losses, and corporate capital losses. While the loss of carryback years with respect to net operating losses will adversely impact a broad range of taxpayers, at least at some point, given the cyclical nature of most businesses, the impact is particularly severe on financial institutions because of the very conservative nature of the rules used to determine their capital adequacy.

There is a second, almost counter-intuitive impact of the Administration's proposal on the capital of financial institutions. It will cause many of them to suffer an immediate reduction in capital, despite the fact that they may have never had a net operating loss. In fact, this second impact of the Administration's proposal will compound the effect of a net operating loss on a bank's capital. The NOL cut back would cause these two impacts in conjunction with the conservative implementation by the banking regulators of the GAAP rules, set out in Financial Accounting Standards Board Statement (FASB) 109, that account for income taxes.

FASB 109

FASB 109 enhanced the ability of firms, in general, to represent as assets on their balance sheets currently the economic value of future tax benefits. These "deferred tax assets" can arise from two sources. The first is a "tax carryforward," arising from excess credits, as well as excess deductions created by an NOL in the current year, to the extent that either cannot be used in the carryback years. The second source is "temporary differences" that result from giving effect to an event earlier or later on the tax return than on the financial statements. Where the difference between the tax and GAAP rules causes a tax deduction to be taken later than the date it is reported as an expense on the financial statements, a "deductible temporary difference" has been created.

The deferred tax asset is the amount of tax reduction benefit created by a tax carryforward or a deductible temporary difference, calculated at the currently enacted tax rate applicable to the year when the deduction or credit is available. The deferred tax asset is offset by a "valuation allowance" to create a net asset value that reflects the probability that the business will be sufficiently profitable in the future to make use of the asset. One example of a deductible temporary difference is the annual addition to a loan loss reserve on the financial statements of a "large" bank, as defined by section 585(c)(2) of the Internal Revenue Code. Such an institution is no longer permitted to anticipate loan loss deductions by means of the reserve method on its tax return, but must await an actual charge-off. The amount of the reserve addition expense represents a future tax benefit to the extent it corresponds to the future charge-off.

Conversely, where a tax deduction is available earlier than the corresponding income statement expense, the amount by which taxable income will exceed financial statement income is a "taxable temporary difference". The most commonly cited example of a taxable temporary difference arises from the use of an accelerated depreciation method on the tax return and straight-line depreciation on the financial statements. The taxable temporary difference gives rise to a deferred tax liability, which is the amount of the resulting tax provision calculated at the rate applicable to the period in which the income is reported.

Capital Adequacy Regulations

The banking regulators have circumscribed the use of net deferred tax assets in computing regulatory capital. "Tier 1" capital, total assets, and risk-weighted assets of a financial institution must be reduced under the rules for determining capital adequacy to the extent that deferred assets, as determined under FASB 109, exceed the lesser of taxable income projected one year ahead or 10 percent of Tier 1 capital. (See e.g., section 325.5(g) of the FDIC Regulations.) Despite the requirement of FASB 109 that an offsetting valuation allowance must be set up initially and reevaluated as required, the reluctance of the regulators to permit the use of deferred tax assets attributable to NOL carryforwards to, in effect, create capital is understandable.

In the case of deferred tax assets attributable to deductible temporary differences, the refusal of the regulators to permit institutions that are historically and currently profitable to create an asset representing taxes prepaid beyond one year, despite the high probability of profitable future years, is more difficult to justify. . It is a source of growing frustration because the banking industry, over the past 10 years, has experienced a steady increase in deferred tax assets attributable to deductible temporary differences. This increase is due, at least in part, to a growing divergence between increasingly conservative regulatory accounting policies and tax law changes designed to raise revenue by accelerating income and deferring expense recognition (of which the NOL proposal is yet another example.)

By contrast, an industrial or commercial company that is strong and historically profitable might not have its capital immediately affected by the proposed substitution of carryforward years for carryback years. Such a company could plausibly argue to its auditors that it should be able to project as recoverable the full amount of its deductible temporary differences over 20 years and, thus, avoid any immediate impact from a loss of carryback years. It should be noted that this is an academic point. Under FASB 109, deferred tax assets are not discounted on a present value basis, and, thus, assuming no valuation accounts are required, the availability of a deferred tax asset in a future year, solely in the context of FASB 109, is worth as much as its current availability in a carryback years. There is, nevertheless, an impact on retained earnings over time resulting from the loss of the carryback years, however, in that cash will no longer be available from refundable taxes in the two carryback years to generate earnings from investments and operations.

The capital adequacy regulations, in a provision that carries over unchanged from FASB 109, permits taxes paid in the carryback years to be included in valuing the future benefits represented by deferred tax assets. While FASB 109 requires a deferred tax asset to be reduced by a valuation account to the amount that is likely to be realized based on projected taxable income in the permissible carryforward period and while the banking regulations require the portion of a deferred tax asset whose realization requires future income in excess of what can be projected for one year ahead to be deducted from capital, both FASB 109 and the regulations permit deferred tax assets to be recorded without limit to the extent of the taxes paid in the NOL carryback years.

The relationship of deductible temporary differences, which, by definition, are book/tax basis differences that, in the abstract, will reverse automatically within a definite or indefinite future period, to the waxing and waning of a statutory carryback period may not be immediately apparent. The relationship arises from the fact that the reversal of a deductible temporary difference has the effect of a deduction and where there is an excess of deductions, arising in conjuction with an NOL in a given year, a benefit will be created that can be used to recover refundable taxes in the carryback period. For banks, the severity of the one-year carryforward limitation in the regulatory computation of capital enhances the importance of the carryback period (as well as any offsetting taxable temporary differences), because, apart from the 10% overall limit, to the extent that the amount of the net deferred tax assets exceeds the refundable taxes from the carryback period and the one carryforward year, Tier 1 capital must be reduced.

The capital adequacy regulations put great weight on the refundable taxes of the institution rather than assuming that the institution will be ongoing. This is not quite liquidation accounting one year into the future, however, because for the purpose of determining the amount of net deductible temporary differences available in the carryforward year and carryback period, the regulations treat all of the institution's deductible and taxable temporary differences as reversing at the end of the current quarter, regardless of when they are actually scheduled to reverse.

Enactment of the loss carryback proposal could cause an immediate loss of capital by profitable and otherwise sound banks that are carrying significant deferred tax assets attributable to deductible temporary differences because of their inability to project more than one year's income to value net deferred tax assets for capital purposes. The loss of the two carryback years would also create the threat of a "one-two punch" to the regulatory capital of banks carrying net deductible differences in any year that the bank experiences a net operating loss. The loss of the two carryback years makes it much more likely that, not only will the tax benefit arising from the NOL, itself, be smaller than under current law, but that the NOL will eliminate at least some of the already diminished capital arising from net deductible temporary differences.

Examples

The interaction of FASB 109, the bank capital rules, and the Administration's proposal may be best understood by an example. Assume that on December 31, 1997, a bank that is a calendar year taxpayer has booked net deferred tax assets that arise from net deductible temporary differences of $30 under FASB 109. (They arise from, among other items, loan costs and other current book expenses required to be capitalized for tax purposes, additions to a loan loss reserve that the bank is not permitted to maintain for tax purposes, and securities identified as held for investment under section 475 of the tax code, but marked to market under FASB 115.) The $30 of net deferred tax assets (before any required reduction) is equivalent to 10% of Tier 1 capital. From 1994 to 1996, the institution was profitable and paid $5 of federal tax for each year. As the result of a one year projection that it does at the end of each quarter, the bank has reversed all of its deductible and taxable temporary differences and has determined that for the 1998 calendar year it will have $15 of taxable income. The bank determines that it will owe $5 of federal tax for 1997 and $5 for 1998.

Under these facts and the three-year carryback period of current law, the banking regulations would permit $25 of the net deferred tax assets to count as Tier 1 capital. The bank is permitted to count the $15 that can be realized from the taxes paid in the three carryback years, as well as the taxes owed for the current year and projected to be owed for 1998. If the Administration's proposal is enacted this year and two carryback years are eliminated, Tier 1 capital must be reduced by $10 to account for the loss of the carryback years. Thus, only $15 of the amount of the GAAP net deferred tax assets of $30 would count as Tier 1 capital.

Assume now that for 1997 the bank has a net operating loss of $15 and assume that, although the regulators believe that the bank is likely to become profitable again in the future, they are unwilling to permit it to project any taxable income for 1998. If the Administration's proposal is enacted for 1997, there would be no refundable taxes for the carryback period and the immediate carryforward year to support any amount of the existing net deferred tax asset. In other words, the entire $15 of capital attributable to the net deductible temporary differences, which would otherwise have been permitted under the previous example, will disappear.

Conclusion

Given the large and growing amounts of deferred tax assets currently being carried by many banks and savings institutions, it is likely that, if the Administration's NOL proposal is enacted, a number of these institutions may suffer a significant loss of capital. The capital of a financial institution determines, as a matter of leveraging, its ability to lend. Lending must be curtailed where an institution's capital decreases. Many of the affected institutions may be additionally required to adjust their lending activities to limit small business loans, for example, in favor of "bullet-proof" loans and some institutions may become subject to the prompt corrective action provisions of the law or come under the supervision of their regulators. Given the immediate reduction of bank and savings institution capital that will occur if the Administration's NOL carry back reduction is enacted, ACB asks the Committee to recognize the necessity of excepting financial institutions, just as the Administration did for REITs, assuming the Committee is even willing to enact this ill-advised proposal in any form. Recent history documents the effects on the taxpayers and the Treasury when financial institutions become under-capitalized and Congress should be wary of precipitating such situations again.

ACB is grateful to you, Chairman Roth, and to the other members of the Committee for the opportunity you have provided to us to make our views known on the Administration's tax proposals. If you have any questions or require additional information, please contact Jim O'Connor at 202-857-3125 or Brian Smith at 202-857-3118.

Statement Submitted to the Committee on Finance U.S. Senate

Regarding Revenue-Raising Proposals Included in President Clinton's Fiscal 1998 Budget Relating to the Dividends-Received Deduction

April 17, 1997

The undersigned businesses and trade associations appreciate the opportunity to respond to the Chairman's request for testimony to the Finance Committee on the revenue-raising provisions of President Clinton's fiscal 1998 budget plan. Specifically, we are testifying in opposition to the Administration's proposals to reduce, eliminate, or otherwise restrict the availability of the dividends-received deduction.

As the list of signers to this testimony demonstrates, a broad range of trade associations and companies believe that these proposals would exacerbate the multiple taxation of corporate income, penalize investment, and mark a retreat from efforts to develop a more rational tax system for the United States.

Rationale for the dividends-received deduction

The history of the dividends-received deduction (DRD) reflects its purpose and role to eliminate or at least alleviate the impact of potential multiple layers of corporate tax. Without the DRD, income would be taxed ***first*** when it is earned by a corporation, a ***second time*** when the income is paid as a dividend to a corporate shareholder, and finally, a ***third time*** when the income of the receiving corporation is paid as a dividend to an individual shareholder. The DRD serves to mitigate the middle level of taxation.

The DRD has been part of the federal law since 1909, when corporate income first became taxable. The deduction was enacted to provide for full deductibility of intercorporate dividends. This 100-percent deduction ensured that income earned by a corporation was not taxed more than once at the corporate level. Over time, the intended effect of the DRD has been eroded.

The DRD was reduced for the first time in 1935, to 90 percent, and then in 1936 to 85 percent. During this period, the corporate income tax included a surtax applicable to income above a certain level, called the "surtax exemption amount." At the time, there was concern that corporations would attempt to take advantage of multiple surtax exemptions by splitting income among several subsidiaries, each of which would be able to avoid the surtax up to the exemption amount. Subsidiary dividends then could be paid tax-free back to the parent as long as there was a 100-percent DRD. To preclude complete avoidance of the surtax through such "income splitting," the DRD was reduced to 85 percent. The result, for the first time, was a second level of corporate tax imposed on the same earnings (15 percent of intercorporate dividends) before they had left the corporate sector.

Underscoring the rationale that had prompted the earlier cut-back in the deduction, the full 100-percent deduction was restored in 1964 for dividends paid within affiliated groups that elected to use only one surtax exemption. In 1975, the use of a single surtax exemption for an affiliated group became mandatory, so the original rationale for reducing the DRD no longer existed. However, Congress did not act to restore the 100-percent deduction for all corporations. As part of the Tax Reform Act of 1986, Congress reduced the general DRD from 85 percent to 80 percent, a move apparently intended to leave unchanged the effective tax rate on dividends, taking into account the reduced corporate income tax rate under the 1986 Act.

In the Omnibus Budget Reconciliation Act of 1987, the deduction was reduced to 70 percent for dividends received from the stock of corporations in which the receiving corporation owns less than a 20-percent interest. Congress's stated rationale for reducing the deduction was that the prior 80-percent deduction was viewed as "too generous." The legislative history does not explain why precluding a second level of corporate tax (and a third level of tax when the earnings are paid to shareholders) should be viewed as "generous," rather than appropriate tax policy. Of course, the paramount objective of the 1987 Act was to reduce forecasted budget deficits.

THE ADMINISTRATION'S PROPOSALS

The Administration's FY 1998 budget includes three proposals relating to the DRD:

- The DRD available to corporations owning less than a 20-percent interest in the stock of a corporation would be reduced from 70 percent to 50 percent.

- The DRD would be eliminated for dividends on certain limited-term preferred stock. Many companies issue this type of instrument as an alternative to higher-cost means of financing their operations.

- The DRD would be eliminated if the recipient corporation does not satisfy modified holding period requirements. This proposal generally would affect companies that have in place programs aimed at managing investment risk.

MOVEMENT IN THE WRONG DIRECTION

The undersigned trade associations and companies believe that the Administration proposals run counter to sound tax policy principles:

- ***The proposals would exacerbate multiple taxation of corporate income.*** Most U.S. trading partners have adopted a single level of corporate taxation as a goal and provide some relief from double taxation of corporate income through "corporate integration" rules. Unlike the United States, other G7 countries (Canada, France, Germany, Italy, Japan, and United Kingdom) generally exclude from tax *altogether* dividends received by corporations. Adopting provisions that accentuate the problem of multiple taxation, rather than ameliorating this problem, would harm the international competitive position of U.S.-based corporations.

  The Treasury Department itself, in 1984, recommended that triple taxation of corporate income be eliminated, and double taxation be halved, as part of its blueprint for an ideal tax system. A subsequent Treasury Department report, released in January 1992, documented the substantial economic benefits of integration and the economic distortions caused by the current multi-tiered system of taxing corporate income. The report concluded that any of three proposed "integration" prototypes would increase investment in capital stock in the corporate sector by $125 billion to $500 billion and would decrease the debt-to-asset ratio in the corporate sector by 1 to 7 percentage points.

  These themes are echoed in recent proposals to restructure the U.S. tax system. While there are considerable differences over how a restructuring of the income tax system should be pursued, there appears to be growing consensus in support of reducing the multiple taxation of corporate income. The various restructuring proposals are grounded in the fundamental rationale that business investment, organization, and financial decisions should be driven by economic and not tax considerations, and that, from a policy perspective, corporate net income should be taxed just like other income – once and only once. Any further erosion of the DRD runs counter to the rationale behind these efforts.

- ***The proposals would penalize investment by corporations and individuals.*** Cutting back on the DRD would increase the cost of equity financing for U.S. corporations, thereby discouraging new capital investment. By contrast, the corporate integration regimes adopted by the other G7 countries do not add to a corporation's cost of financing new investments.

  Individuals also would be affected. Many individuals have invested in perpetual preferred equities, which provide a relatively predictable stream of earnings and stability of principal over time. Preferred equities represent a significant portion of many self-directed individual retirement portfolios. The Administration's proposals would have the effect of depressing the market for perpetual preferred stock, thereby decreasing the value of such shares. Individuals thus would see the value of current holdings and their retirement savings diminished.

- ***A reduction in the DRD would discriminate against particular business sectors and structures.*** The Administration's proposals may have a disproportionate impact on taxpayers in certain *industries*, such as the financial and public utility industries, that must meet certain capital requirements. Certain *types* of business structures also stand to be particularly affected. Personal holding companies, for example, are required to distribute their income on an annual basis (or pay a substantial penalty tax) and thus do not have an option to retain income to lessen the impact of multiple levels of taxation.

- ***Companies should not be penalized for minimizing risk of loss.*** As a result of the Administration's holding period proposal, the prudent operation of corporate liability and risk management programs could result in disallowance of the DRD. Faced with loss of the DRD, companies may choose to curtail these risk management programs.

- ***No tax abuse is targeted by the Administration's proposals.*** The Administration suggests that some taxpayers may be able to take advantage of the 70-percent deduction in a way that "undermines the separate corporate income tax." To the extent Treasury can demonstrate that the deduction may be subject to misuse, targeted anti-avoidance rules can be provided. The indiscriminate approach of sharply cutting back on the DRD goes beyond addressing inappropriate transactions and unnecessarily penalizes legitimate corporate investment activity – simply stated, it's bad tax policy.

- ***The Administration has no convincing defense for such a fundamental change to long-standing tax policy.*** The Administration argues that the current 70-percent deduction, for example, "is too generous." Since Congress already has addressed (in OBRA '87) the argument that an 80-percent deduction was "too generous," and responded by reducing the deduction to 70 percent, it is hard to see why only 10 years later the same deduction could again have become "too generous."

CONCLUSION

We urge the Committee not to consider the Administration's proposals to reduce the DRD. A more appropriate approach would be to reduce or eliminate the multiple taxation of corporation income, rather than further accentuate the inefficiencies and inequities of the current system.

America's Community Bankers
American Council on Capital Formation
American Insurance Association
American Council of Life Insurance
Edison Electric Institute
Financial Executives Institute
National Association of Manufacturers
PSA The Bond Market Trade Association
Securities Industry Association
U.S. Chamber of Commerce

Aetna Life and Casualty Company
American Bank of Connecticut
American Express Company
American States Financial Corporation
Baltimore Gas & Electric
Bear Stearns & Co., Inc.
B.C. Zieglar & Co.
Chapdelaine Corporate Securities
The Chase Manhattan Corporation
Cinergy Corp.
Citicorp
Colonial Pipeline Co.
Columbia Mutual Insurance Co.

Commonwealth Mortgage Assurance Co.
Cooper Industries Incorporated
Credit Suisse First Boston
Dominion Resources
Entergy Corporation
Erie Insurance Group
Family Farm Insurance Co.
Family Company Group
Flaherty & Crumrine Incorporated
Florida Power & Light Company
Goldman, Sachs & Co.
Household International
Houston Industries Incorporated
J.P. Morgan & Co. Incorporated
Kansas City Power & Light Company
Lehman Brothers Inc.
Lincoln National Corporation
Merchants Insurance Group
Mercury General Corporation
Merrill Lynch & Co., Inc.
MidAmerican Energy Company
Minnesota Power
Morgan Stanley & Co., Inc.
NYSEG (New York State Electric & Gas Corp.)
Northland Insurance Co.
Phoenix Duff & Phelps Investment Advisers
Pitney Bowes Inc.
Progressive Partners
Prudential Securities
Salomon Brothers
Spectrum Asset Management, Inc.
Smith Barney
Texaco, Inc.
The Travelers Group
Twenty-First Securities
Wisconsin Power & Light Company

HEARING BEFORE THE COMMITTEE ON FINANCE
U.S. SENATE

on

SELECTED REVENUE RAISING PROVISIONS IN THE ADMINISTRATION'S FY '98 BUDGET PROPOSAL

IMPACT OF REPLACING THE EXPORT SOURCE RULE WITH AN "ACTIVITY BASED" RULE

William C. Barrett
Applied Materials, Inc.

EXECUTIVE SUMMARY

High-tech is an integrated industry with numerous companies occupying a critical niche. Products cycles of 1-5 years are not uncommon and successful companies at each stage of the high-tech food chain must adapt and constantly improve their product lines. As these cycles repeat and new products and markets are created, residual markets from prior product cycles remain and as a result, the absolute market size and opportunity increases.

The high-tech industry is heavily export oriented. Recent statistics show that Silicon Valley's exports grew 30 percent in 1995 from $27 billion to $35 billion. For many Silicon Valley companies, exports exceed 50 percent of total sales. Much of this exported product is manufactured in the United States and because of the nature of the high-tech industry and its product cycles, a tremendous amount of research and development accompanies the manufacturing function. The linkage between research and manufacturing is very strong within the high-tech industry. Statistical studies have projected the impact of exports on job creation, including a Commerce Department study that equated 19,000 jobs for every $1 billion in exports.

The export source rule helps to mitigate the double tax impact when income is taxed both in the United States and in a foreign country and as a result, can have a direct impact to a high-tech company's global tax rate. The export source rule only applies when goods are manufactured in the United States and exported and within the context of high-tech, significant U.S. research and research related jobs accompany the manufacturing function. Repeal of the foreign source income rule would place upward pressure on the after tax cost of performing the manufacturing and related research activity in the United States.

Capital investment decision making is influenced by both tax and non-tax factors. However, as global infrastructure and education level improves, non-tax factors become increasingly less important in the capital investment decision-making and, therefore, U.S. tax laws that increase the after tax cost of doing business could have a profound impact on location of investment. This will in turn have a direct impact on exports and export related jobs not only for companies that respond quickly to after-tax returns, but also supplier companies that support the United States manufacturing and research activity. The high-tech industry is linked and investment decisions have a multiplier effect on where future geographic income will be earned.

Mr. Chairman and members of the Ways and Means Committee, my name is William Barrett and I am Director of Tax, Export and Customs for Applied Materials, Inc. Applied Materials is the world's largest producer of semiconductor manufacturing equipment with operations in over 20 countries. The company is the largest producer of wafer fabrication systems and services for the worldwide semiconductor industry and employs over 12,000 people, with over 9,500 in the United States. In addition to corporate manufacturing facilities in Austin, Texas and Santa Clara, California, Applied Materials maintains research and development centers in Europe and Japan, as well as technology centers in Israel, South Korea, and Taiwan.

Our 1996 revenues were $4.1 billion, a 35-percent increase over 1995 revenues. More than two-thirds of Applied Material's sales in 1996 were overseas: 16 percent in Europe, 15 percent in Asia-Pacific (Taiwan, Singapore, and Taiwan) and 14 percent in South Korea. The North American market accounted for 31 percent.

I recite these statistics to illustrate the importance of the global marketplace to Applied Materials. Our company competes with the world's best every day. One of the tools we use in this intense competition is the Export Source Rule, which we believe contributes to the success of not only Applied Materials, but to all U.S. exporting companies. Applied Materials believes that the Export Source Rule is sound public policy and should be retained.

The United States high-tech industry is innovative, highly profitable, drives academic institution curriculum and excellence, produces high paying jobs, produces a tremendous volume of exports, and serves as a model to the world. United States Government policies that discourage these U.S. based activities risk impeding very desirable attributes and drivers in the U.S. economy. Government policies that encourage these attributes will obviously promote these attributes.

Profile of a Typical High-Tech Silicon Valley Equipment Manufacturer

A Silicon Valley high-tech start up company begins with an innovative idea. This idea may or may not have large market potential in the early life cycle of the company. Those companies destined to become successful will either have a product that is ready for the current market[s] or the product idea will create a new market. High-tech products change every 1-5 years because industry innovation and global markets are constantly evolving. Successful companies at each stage of the high-tech food chain must adapt and constantly improve their product lines. High-tech companies that do not adapt or evolve their product lines do not survive.

High-tech is an integrated industry with numerous companies occupying a critical niche. For example, semiconductor equipment companies supply the semiconductor chip companies and the chip makers in turn provide the means for computers to perform complex software functions ranging from number crunching to multimedia. The explosion of the Internet and networking companies that link computers has been a more recent evolution in the high-tech industry. Computer software companies have been both pushing the semiconductor industry as well as adapting new software applications to existing computer capability. At each component stage, companies must keep pace with evolution and product cycles to survive. As these cycles repeat and new products and markets are created, residual markets from prior product cycles remain and as a result, the absolute market size and opportunity increases.

The profile of a high-tech multinational is no different from the above description but for the fact it either competes in or develops markets in multiple countries. To be successful in countries outside the United States, the multinational must understand different markets and adapt its corporate structure to accommodate those markets. A not uncommon profile as product lines evolve and/or the multinational adapts to foreign markets is that specific segments of manufacturing may be located offshore.[1] These segments may be older products lines or components of a product that are produced more efficiently offshore. In most cases, newer product lines, and the requisite research and development, remains in the United States and close to development centers.

Silicon Valley high-tech companies do not structure their global operations solely on the basis of local country tax rates. For example, as high-tech product lines mature, investment in alternate manufacturing sites is a natural process of growth and diversification of risk. However, this statement should not be interpreted to mean tax rates do not play a significant role. An increase in U.S. tax increases the cost of business in the U.S. and if a company is to maintain an after tax shareholder return, it must evaluate lower cost site locations. Populist rhetoric often characterizes U.S. industry as intent on the wholesale migration of manufacturing to offshore locations with the sole purpose of minimizing corporate income tax when in reality, companies are trying to remain competitive in a global market and tax rates represent a significant cost of business.

An analysis of a new manufacturing location will involve a comparison of factors such as the following:

- labor skills, consistent with the demands of product technical requirements
- labor productivity
- cost of labor
- cost of land and construction costs
- financial and physical infrastructure (e.g., highway and airport)
- proximity to customers and the market
- protection of intellectual property
- tax rates

[1] A successful company locates offshore to increase its global sales revenue and market share. Often, this râison d'être is lost in political rhetoric. If a company is less competitive in the global marketplace (i.e., does not increase its global market share) because of higher tax rates, that company will naturally evaluate where it places manufacturing and R&D capability. Similarly, import tariffs will influence global investment patterns. For example, the European Union in 1992 effectively placed a European manufacturing content requirement through imposition of duties on non-European manufactured semiconductors. United States and Asian semiconductor manufacturers now dominate the European semiconductor industry, which illustrates how investment decisions can be altered to reduce government imposed costs of doing business.

In reviewing this list, the superordinate goal of generating additional sales revenue and global market share may be overlooked. Any successful high-tech company is in the business of selling product and increasing financial return to its investors and when tax rates reduce potential return, they play an increased roll in the decision making process. A company that makes sensible investment decisions based on after tax returns that improves the ability to competitively price product stands a good chance to improve its market share.

Export Source Proposal

President Clinton's current budget proposal contains a provision that would eliminate the 50 percent foreign source income component of exported U.S. manufactured products. The proposal would instead source income from export sales under an "activity based" standard -- effectively eliminating the export source rule. "Activity based" sourcing is not defined in the proposal but might be patterned after a current income tax regulation example.[2] For U.S. exporters with excess foreign tax credits, the export source rule alleviates double taxation. In effect, the foreign source income rule operates as an export incentive for U.S. multinationals. The export source rule only applies in the context of companies that manufacture and perform R&D in the United States and export these U.S. manufactured products.

The Administration makes the following argument in support of repeal:

This export source rule provides a benefit to U.S. exporters that operate in high-tax foreign countries. Thus, U.S. multinational exporters have a competitive advantage over U.S. exporters that conduct all their business activities in the United States.

There are at least three flaws in this argument. First, a company without foreign operations may be a start-up that has not entered global markets. This new company cannot be compared to a large and well established multinational. As the new company grows into global markets, it too will benefit from the export source rule. Second, it is important to keep in mind that to claim a foreign tax credit using the export source rule, a foreign tax must be paid. Companies without foreign operations do not face the double taxation the export source rule is designed to alleviate. Thus rule does not create a competitive advantage; it levels the playing field. The foreign tax increases the cost of doing business offshore and therefore the multinational with foreign operations becomes less competitive without benefit of the export source rule. Finally, the argument in favor of eliminating the export source rule fails to take into account additional [non-tax] expenses that will be incurred by the multinational with foreign operations. Selling, marketing, administrative expenses associated with

[2] Treas. Reg. §1.863-3(b)(2) Ex. 1. The Tax Court in both *Phillips Petroleum Co.*, 97 TC 30 (1991) and *Intel Corp.*, 100 TC 616 (1993) found that the fact pattern in the regulation example did not apply to the facts of these cases. The facts in these cases are typical of most exporters and therefore, under current law "activity based" sourcing as described in Ex. 1 would rarely produce any foreign source income. The result, using an "activity based" model, would be zero percent foreign source income on exported U.S. manufactured product, which increases the global tax rate on this income.

a foreign location, and product adaptation to local market, all must be incurred to support the local market.. The conclusion is inescapable that establishing foreign operations will produce additional operating costs. A simple example illustrates the point using a conservative estimate of 15 percent additional costs on sales when there is an offshore site location and the foreign and U.S. tax rate are assumed to be 35 percent.

	U.S. Multinational With Foreign Operations	U.S. Exporter Without Foreign Operations
Sales	100	100
Cost of Sales	50	50
Margin	50	50
BLE Costs	30	15
Taxable Income	20	35
Global Tax After Foreign Tax Credit [3]	7	12.25
Net Income	13	22.75

Although operating costs will increase with foreign operations, the reality is that a U.S. manufacturing company cannot compete for global market share without establishing offshore operations. The resulting increased global market share increases high paying R&D and manufacturing jobs in the United States.

Tax Treaties are No Substitute

The Administration has stated that the United States income tax treaty network protects export sales income from tax in the foreign country where the goods are sold and thus protects companies from double taxation. They argue that the export source rule is no longer necessary as a result of this treaty protection.

We strongly disagree that the treaty network is a substitute for the export source rule, but even if it were, the network is far from complete. The United States treaty network is limited to 56 countries,

[3] The global tax rate is the combined U.S. and foreign tax less U.S. foreign tax credit. This example assumes that there is sufficient foreign source income to claim a full foreign tax. As foreign taxes paid increase, a full credit for foreign taxes paid may not be possible which increases the global tax rate on foreign earned income above 35 percent. Other impediments to credit for foreign taxes which can increase the global tax rate on income generated from U.S. exports include allocation of U.S. expenses to foreign source income and multiple foreign tax credit limitation "baskets."

leaving many more countries (approximately 170) without treaties with the United States. Moreover, many of the countries without treaties are developing countries, which are frequently high growth markets for American exporters. For example, the United States has no treaty with any Central or South American country.

With or without a tax treaty, under most foreign countries' tax laws, the mere act of selling goods into the country, absent other factors such as having a sales or distribution office, does not subject the United States exporter to income tax in the foreign country. Thus, export sales are not the primary cause of the excess foreign tax credit problem which many companies face in trying to compete overseas.

The real reason most multinational companies face double taxation is that U.S. tax provisions unfairly restrict their ability to credit foreign taxes paid on these overseas operations against their U.S. taxes. Requirements to allocate a portion of the costs of U.S. borrowing and research activities against foreign source income (even though such allocated costs are not deductible in any foreign country), cause many companies to have excess foreign tax credits, thereby subjecting them to double tax - i.e. taxation by both the United States and the foreign jurisdiction.

The export source rule alleviates double taxation by allowing companies who manufacture goods in the United States for export abroad to treat 50 percent of the income as "foreign source," thereby increasing their ability to utilize their foreign tax credits. Thus, the rule encourages these companies (facing double taxation as described above) to produce goods in the U.S. for export abroad.

As an effective World Trade Organization-consistent export incentive, the export source rule is needed now more than ever to support quality, high-paying jobs in U.S. export industries. Exports have provided the spark for much of the growth in the United States economy over the past decade. Again, the existence of tax treaties does nothing to change the importance of this rule to the United States economy.

The decision to allow 50 percent of the income from export sales to be treated as "foreign source" was in part a decision based upon administrative convenience to minimize disputes over exactly which portion of the income should be treated "foreign" and which should be "domestic." The rule still serves this purpose, and neither the tax treaty network nor the Administration's proposal to adopt an "activities-based" test for determining which portion of the income is "foreign" and which is "domestic" addresses this problem. Moreover, adopting an "activities-based" rule would create endless factual disputes similar to those under the section 482 transfer pricing regime.

Tax treaties are critically important in advancing the international competitiveness of U.S. companies' global operations and trade. In order to export effectively in the global marketplace, most companies must eventually have substantial operations abroad in order to market, service or distribute their goods. Tax treaties make it feasible in many cases for business to invest overseas and compete in foreign markets. Foreign investments by U.S.-based multinationals generate substantial exports from the United States. These foreign operations create a demand for U.S. manufactured components, service parts, technology, etc., while also providing returns on capital in the form of dividends, interest and royalties.

Tax treaties are not a substitute for the export source rule. They do not provide an incentive to produce goods in the United States. Nor do they address the most significant underlying cause of double taxation -- arbitrary allocation rules -- or provide administrative simplicity in allocating income from exports.

Capital Export Neutrality

In an ideal income tax system, income tax would not influence how a company structures transactions or where the company decides to build a manufacturing plant. Investment decisions would be influenced by other economic factors such as those listed above. To eliminate income tax from the investment location decision it would be necessary to structure the system such that the global tax rate on income earned anywhere in the world is no different than the domestic rate of tax. A system patterned after the "capital export neutrality" (CEN) concept would achieve this result.[4]

The CEN concept holds that an item of income, regardless of where it is earned, will not suffer a global rate of tax higher than the United States tax rate. Dividends received from both high and low tax countries suffer a double rate of tax first in the country in which the income was earned and second in the United States when received. The credit for foreign tax paid is designed to mitigate this double rate of tax. The export source rule operates to increase the credit for foreign taxes paid which in turn operates to more closely align the United States tax system with the concept of CEN. With sufficient foreign source income, the global rate of income tax on income earned in high tax countries approaches 35 percent.

A classical tax system that diverges from the CEN concept will increase the importance of income tax in plant location decision making. If the export source rule is repealed, the global rate of tax for multinationals that export from the United States will increase and for many high-tech companies this increase in tax rate, and corresponding reduction in return to shareholders, will alter plant investment decisions. Many companies will be forced to invest offshore rather than build new plants in the United States to remain competitive and maintain shareholder rate of return. Foreign investment

[4] CEN is also referred to as a classical tax system. In addition to the United States, Japan and the United Kingdom loosely base their tax systems on this concept. An alternative concept is "capital import neutrality" (CIN). Under CIN, the global rate of tax on foreign income does not exceed the foreign tax rate. In other words, under CIN income earned outside the home country is not taxed in the home country when received as a dividend or when the foreign operation is sold. "Territorial" based tax systems are patterned after the CIN concept. The Netherlands and France apply the "territorial" concept. Germany, Canada, and Australia apply the concept pursuant to income tax treaty with certain trading partners. For a detailed description of these principles, see *Factors Affecting The International Competitiveness Of the United States*, prepared by the Joint Committee on Taxation (JCS-6-91), Part III.

decisions will have a ripple effect within the high-tech industry because the industry is so closely interrelated. For example, a natural consequence of additional offshore investment by a semiconductor manufacturer will be that equipment suppliers will increase their offshore presence to meet the demands of their customers. This dynamic will be repeated in other segments of the industry creating a foreign investment multiplier effect.

Summary

The United States high-tech industry is innovative, highly profitable, drives academic institution curriculum and excellence, produces high paying jobs, produces a tremendous volume of exports, and serves as a model to the world.[5] United States Government policies that discourage these U.S. based activities risk impeding very desirable attributes and drivers in the United States economy. Government policies that encourage these attributes will obviously promote these attributes.

The elimination or scaleback of the export source rule will have a negative tax impact on U.S. multinationals that export U.S. manufactured product. For many companies this will result in a tax disincentive to manufacture in the United States vis -à-vis other countries with lower tax rates and is contrary to a "capital export neutrality" model which holds income tax should play a minor role in plant location decision making. Repeal of the export source rule would elevate the importance of tax rates in offshore plant location decision making, increase the importance of foreign income deferral tax planning, and is contrary to tax simplification within a "capital export neutral" model.[6]

[5] Studies have documented the impact exports have in job creation. Hufbauer and DeRosa project that in 1999, exports will increase $30.8 billion and $2.3 billion of additional wage income. In addition, the effect of the rule and the exports it generates will support 360,000 workers in export-related jobs, which also tend to be higher paying jobs (*Costs and Benefits of the Export Source Rule, 1998-2002*, Gary Hufbauer and Dean DeRosa, February 19, 1997, a report prepared for the Export Source Coalition). The Commerce Department has also reported that between 1986 and 1990, 2.2 million export related jobs were added in the United States. This increase equated to 19,000 jobs for every $1 billion in exports. A Treasury report issued in 1993 predicted that for 1990, there could be a reduction of up to $4 billion exports had the 50/50 foreign source income rule been repealed (U.S. Department of the Treasury (1993a). Report to the Congress on the Sales Source Rules. Washington, DC: National Technical Information Service). In addition, the studies indicate that jobs created by exports are higher paying. In Silicon Valley, it is estimated that over 125,000 jobs were added from 1992 through 1996. Also, in 1996 average real wages, after accounting for inflation, grew about 5.1 percent compared to a wage increase of less than 1 percent at the national level *(Joint Venture's Index of Silicon Valley, 1997*, prepared by Joint Venture: Silicon Valley Network). The *Joint Venture* study also reported that in 1995, Silicon Valley exports grew 30 percent to $35 billion.

[6] As income earned offshore increases as a result of additional foreign plant investment, history suggests complicated tax laws will be introduced in an attempt to tax this income before it is remitted back to the United States, contrary to efforts towards a more simplified income tax mode. PFIC and subpart F, as it relates to operating income earned from related party sales, are two remaining examples of this type of legislation.

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STATEMENT ON THE ADMINISTRATION'S FY 1998 BUDGET PROPOSAL TO MODIFY THE NET OPERATING LOSS CARRYBACK AND CARRYFORWARD

Submitted for the Record of the Hearing on
the Administration's Revenue Raisers
Before the Committee on Finance
on April 17, 1997

Vinson & Elkins is a law firm with offices in Washington, D.C. We submit the following comments on behalf of a group of commercial banks that includes Bank of America, Bank of Boston, Chase Manhattan Bank, Citibank, First National Bank of Chicago, Fleet Financial Corporation, Norwest Corporation, Mellon Bank, and Wells Fargo.

We urge the Committee to reject the proposal contained in the Administration's 1998 Budget to shorten the period for the carryback of net operating losses to one year. It represents bad tax policy as well as bad economic policy, and it has a particularly pernicious effect on the banking industry. We fear that this proposal may not receive the attention from the business community it deserves because of the relative economic prosperity of the last few years, which has lessened immediate concern about the NOL carryback. This concern would quickly return in the event of an economic downturn.

The net operating loss carryback is not a "loophole" or "corporate subsidy" in any sense of those terms. Its purpose is to prevent taxation before economic income is earned.

The federal income tax is necessarily based on an arbitrary annual accounting convention. Business income may, however, fluctuate over a somewhat longer period. The most obvious example is a business affected by the business cycle, the duration of which may be several years. The current upturn in the business cycle, which ironically has reduced concern about the Administration's proposal, is now in its fourth or fifth year. A downturn can last just as long or longer.

The impact of a serious economic downturn can be particularly hard on banks, as it was during the banking crisis of the late 1980's. And for banks, the Administration's proposed limitation on the carryback period presents a special problem. Capital provides banks protection against unanticipated losses. In difficult economic times, bank capital provides a cushion against extraordinary losses on loans and other business operations. A bank's ability to claim the tax benefit of a loss is an important means of conserving this capital in difficult economic times. If banks are denied the ability to carry back losses and obtain refunds for previously overpaid taxes --

as they would under the Administration's proposal -- they will be deprived of an important source of bank capital at the time when it is most needed. In effect, they will be forced in troubled times to lend needed bank capital to the federal government, in the form of prepaid taxes.

Furthermore, tax law changes made in 1986 deprived banks of the ability to deduct provisions made for bad debts using the reserve method. As a practical matter, this change also limited the ability of banks to spread losses associated with the write-off of bad debts taken in one year over a longer period of time. This 1986 change further exacerbates the hardship the Administration's proposal would work on banks.

For purposes of accounting for bank capital, bank regulatory agencies in general will recognize the potential tax benefit associated with a net operating loss -- or any other deferred tax asset -- only with respect to income that is available for carryback under tax law, and, at most, with respect to income in the year immediately following the loss, if any is reasonably anticipated. Any carryover of more than one year for tax purposes is therefore meaningless for purposes of determining regulatory capital. The carryback is therefore of crucial importance.

The carryback is so important to the banking industry, in fact, that during the banking crisis of the late 1980's, Congress permitted banks for a time to continue to carry back loan losses for ten years instead of the usual three. The effect of the President's proposal is to shorten the effective regulatory carryover/carryback period for banks from four years to two (one back and one forward). During difficult economic periods for banks, the result would be to further reduce bank capital, and consequently to reduce the ability of banks to make loans.

More generally, the purpose of the net operating loss carryback is to prevent income tax from being charged before the taxpayer has earned economic income. A simple example illustrates the point. If a company earns income of 10 in year 1, has no income or loss in year 2, and experiences a loss of 10 in year 3, it has earned no economic income. A net operating loss carryback operates to eliminate the tax imposed under the annual accounting convention in year 1. Without a carryback, the company would be required to pay tax on the year 1 income even though it has not yet earned any economic income.

Under current law, corporations are permitted to use net operating losses in a taxable year to offset income in the three preceding years. The Administration has proposed a reduction in the carryback period for net operating losses from three years to one year. In the example, application of the proposed rule would result in payment of income tax when the taxpayer has earned no economic income.

To operate correctly, the net operating loss carryback ought to have no limitation. Any limitation on the carryback -- including the three-year limitation of current law -- causes an arbitrary imposition of tax before economic income is earned. The Administration's proposal makes the present situation worse. It is an insufficient answer to extend the net operating loss carryforward. As in the case of the carryback, any limitation on the carryforward is arbitrary and unjustified. Moreover, the taxpayer must remain in business and earn income 15 or 20 years in the future to obtain a refund, then worth far less than a current refund.

The Administration says the purpose of its proposed shortening of the carryback period is to reduce the complexity and administration burden associated with carrybacks. This claim is hollow. Existing law permits taxpayers to elect to relinquish the carryback. Therefore, any burden incurred by the taxpayer is entirely voluntary. No "relief" such as that proposed by the Administration is needed.

In short, there is no tax policy reason to further limit the net operating loss carryback period. The Administration's proposal should be seen for what it is, a revenue-raising measure, and in this case one applied to taxpayers that are least able to bear it -- those taxpayers that are experiencing losses.

We submit that the Administration's proposal to reduce the net operating loss carryback to one year is ill-considered. The Committee ought to reject it.

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April 28, 1997

Editorial Section
United States Senate
Committee on Finance
Washington, D.C. 20510

Dear Sir/Madame:

In response to Chairman Roth's request, Bear, Stearns & Co. Inc. is submitting a statement concerning two revenue raising provisions in President Clinton's Fiscal Year 1998 Budget. One provision imposes constructive sale treatment on certain appreciated financial instruments and the other provision modifies the holding period rules for the dividends received deduction (the "DRD").

The following is a summary of our comments. These provisions would penalize legitimate hedging transactions and adversely affect the financial markets. The scope of the constructive sale legislation is so broad that it covers many bona fide hedging transactions and would inhibit a broad range of other non-tax motivated transactions. We believe that narrowly drafted legislation can target potential abuses without adversely affecting legitimate hedging transactions and the financial markets. We also believe that the proposed DRD changes would penalize legitimate hedging transactions by imposing triple level taxation on distributions of corporate earnings. Current law is entirely adequate to ensure that the DRD is available only for economic investments. We oppose the retroactive impact both of these provisions would have on existing transactions.

Please don't hesitate to call if you have any questions. Our designated representatives are:

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Very truly yours,

BEAR, STEARNS & CO. INC.

By:

Eli Wachtel
Senior Managing Director

Enclosure

STATEMENT OF BEAR, STEARNS & CO. INC. CONCERNING PROPOSED CONSTRUCTIVE SALE AND DRD HOLDING PERIOD PROVISIONS.

April 17, 1997

Summary

Two revenue raising provisions in the Administration's Fiscal Year 1998 Budget would **penalize legitimate hedging transactions and adversely affect the financial markets.** One provision imposes constructive sale treatment on certain appreciated financial instruments and another provision modifies the holding period rules for the dividends received deduction (the "DRD"). We join a diverse group of companies and industry representatives (including the Securities Industry Association and a coalition of the nation's leading options exchanges, and with respect to the DRD, the American Bankers Association and the DRD Working Group) that oppose these provisions.

The scope of the constructive sale legislation is so overbroad that it covers many bona fide hedging transactions and puts a "chill" on a broad range of other non-tax motivated hedging transactions. We believe that narrowly drafted legislation can target potential abuses (e.g., entering into a long-term, short-against-the box transaction to obtain a step-up in basis at death) without adversely affecting legitimate hedging transactions and the financial markets. We also believe that the proposed DRD changes move in the wrong direction--i.e., by imposing **increased triple taxation of corporate earnings** rather than a single level of taxation. Current law is entirely adequate to ensure that the DRD is available only for economic investments.

Constructive Sale Provision

The proposal would treat a taxpayer as having made a constructive sale of an appreciated stock, debt instrument or partnership interest when the taxpayer "substantially eliminate[s]" both risk of loss and opportunity for gain "for some period". There is no definition or guidance as to what triggers a constructive sale either in terms of: (1) what constitutes "substantial" elimination of risk of loss and opportunity for gain, or (2) what is the relevant "period" for such elimination. The provision appears to trigger a tax even if an investor hedges for only one day and thereafter retains all potential risk of loss and opportunity for profit.

The basic problem with the proposed legislation is that covers a broad range of legitimate hedging transactions and is not targeted to potentially abusive transactions. As a starting point, it must be stressed that management and reduction of risk for both businesses and investors should be encouraged and not penalized. Legislation which triggers tax on an appreciated financial position as a result of a non-tax motivated hedging transaction is simply bad tax policy.

Another major problem is the difficulty in applying the proposal's trigger of "substantially eliminate" both risk of loss and opportunity for gain. There are no meaningful objective criteria that an investor or his tax advisor can use to determine whether a transaction will result in a constructive sale. Accordingly, the proposed statutory framework is patently unworkable.

Because of the sweeping scope of the proposed legislation, taxpayers who enter into a broad range of hedging transactions with respect to appreciated financial positions will be unable to determine whether such hedges trigger tax. These taxpayers will be reluctant to enter into legitimate, non-tax motivated hedging transactions because of the fear of triggering a current tax.

The chilling effect of the proposed legislation will have a negative impact on the stock and option markets. Many investors hedge a particular stock or all or a portion of a portfolio because of an economic event with respect to a specific company or general market conditions. The proposed legislation will likely cause many of these investors to choose to maintain their risk exposure rather than risk payment of a tax. The decrease in investor participation in the financial markets (especially the stock and options markets) will result in wider spreads and greater volatility in option and stock pricing. Ultimately, this will lead to less liquidity in the markets.

We also oppose the retroactive effective date of the proposal. Under long-standing, well-settled tax law, short-against-the-box and other transactions covered by the proposal do not give rise to a taxable event. Taxpayers who have relied on this law should not be subject to a retroactive change of law, nor should they be required to incur the cost of unwinding existing positions in order to avoid a constructive sale.

The proposed legislation represents a dramatic change to current law. We urge Congress to carefully consider the impact this change would have on hedging practices and the financial markets. We believe that narrower legislation can address potential abuses that may exist under current law without impacting legitimate hedging transactions or adversely affecting the financial markets.

DRD Holding Period

The Administration would also modify the DRD holding period rules and would deny the DRD to a corporate shareholder that diminishes risk of loss within 45 days of the stock's ex-dividend date. The proposed change to the DRD holding period rules should not be enacted because it would have several major negative effects: (1) impose increased triple taxation of corporate earnings while many of the United States' major trading partners have moved to a system of single taxation of corporate earnings; (2) reduce participation in the options markets, resulting in increased volatility; and (3) increase the cost of capital for preferred stock issuers, especially in industries such as utilities in which preferred stock comprises a significant component of the capital structure. Finally, the proposed legislation is unnecessary because current law is adequate to ensure that the benefit of the DRD is available only for economic investments (as opposed to tax-motivated investments) in which the investor bears risk of loss for a meaningful period.

The United States has maintained its historical system of taxation whereby a corporation pays income tax on its corporate earnings and shareholders pay an additional tax upon distribution of earnings in the form of dividends. To minimize triple taxation of corporate earnings, U.S. corporations are allowed a 70-80% dividends received deduction for dividends received from other U.S. corporations.

The U.S. system of taxing corporate earnings should be compared to the tax systems of many of the United States' major trading partners such as Canada, England, France, Germany, Australia and New Zealand. These jurisdictions have an integrated system of taxation whereby corporate earnings are essentially subject to a single level of taxation. See January 1992 Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems Taxing Business Income Once.

By further limiting the availability of the DRD, the proposed legislation would increase the imposition of triple taxation on corporate earnings. Such triple taxation would result from a corporate tax being paid by the distributing corporation, a corporate tax paid by the recipient corporation, and a shareholder level tax. The proposed change to the DRD would result in a 74% tax on corporate level earnings before factoring in the additional cost of state and local taxes.

Example 1: A U.S. corporation ("Corporation A") earns $10000 and pays a U.S. federal income tax of $3500 on such earnings (35% tax rate). Corporation A distributes all of its earnings on a current basis and accordingly will distribute $65 to its 1% U.S. corporate shareholder ("Corporation B"). Corporation B has held the Corporation A stock for three years and plans to continue to hold the Corporation A stock for the indefinite future. However, Corporation B is concerned about the impact of a particular event on Corporation A and accordingly has purchased the right to put the Corporation A stock for 95% of its current fair market value in six months. Under the proposed change, Corporation B would not be eligible for the DRD and would pay a tax of $22.75 on such dividend (35% tax rate). Corporation B is owned by 10 individuals who are subject to tax at the highest U.S. marginal federal income tax rate of 39.6%. Such individual shareholders would collectively receive $42.25 in dividends and pay a collective tax of $16.73. Accordingly, such individual shareholders would collectively receive after-tax cash of $25.52; an effective tax rate of 74.5% on corporate earnings.[1]

The proposed legislation would also have a negative impact on the options markets. Market conditions often cause corporate investors to use various hedging techniques, especially through the use of options, to hedge a particular stock or all or a portion of a portfolio of stocks. These hedging transactions include cost-less collars (i.e., the purchase of an out-of-the-money put and the sale of an out-of-the-money call), the purchase of put options, and the sale of an "in-the-money" call that is more than one strike price in the money (i.e., non-qualified covered calls). The following examples are illustrative market-driven hedging transactions:

Example 2: Corporate investor purchases shares of Corporation X stock on July 13, 1996 for $50. On November 1, 1996, the stock price has dropped to $43/share and the investor believes that the stock price will rebound to $50 but does not want to take the risk of significant further decline. To limit its future loss while retaining the upside, the investor purchases a June 1998 $40 put for 3 7/8 and sells a June 1998 $50 call for 3 7/8 (i.e. the investor has the right to put the X stock at $40 and has sold the right to call the X stock at $50). Under current law, this cost-less collar would allow the investor to continue to receive the DRD. However, under the proposed change to the holding period rules, the investor would not be entitled to the DRD. The proposed legislation would discourage this investor from entering into legitimate market-driven hedging strategies by penalizing the investor through a disallowance of all or a portion of the DRD.

Example 3: A corporate investor purchases shares of Corporation Y stock for $42 on March 15, 1997. For the purposes of obtaining an enhanced return, the investor immediately sells a June 1997 $40 call on the Y stock for 4 1/8 (a qualified covered call) to make an expected gross profit of 2 1/8 because the investor believes there is a limited risk below $40. On June 19, 1997, two days prior to the expiration of the June contract, when the stock price of the Y stock is $46, the corporate investor continues to believe that the Y stock price has limited risk below $40. Therefore, the investor "rolls" its June call position into a December call position by buying back the June 1997 call at $6 and selling the December 1997 call for 8 1/4 for a net credit of 2 1/4. Under current law, all dividends received would be entitled to the DRD. Under the proposed change to the DRD holding period rules, the corporate investor would not be entitled to the DRD with respect to dividends received during the period it is hedged with the December call, subjecting dividends received by a corporate investor to three levels of taxation. Consequently, the proposed legislation would discourage corporate investors from engaging in enhanced return strategies.

Example 4: Similar to Example 3, a corporate investor buys Z stock at $53 with a 3.5% dividend yield in January 1995. For purposes of obtaining an enhanced return, the

[1] Most states follow the federal income tax rules in imposing a state corporate income tax on corporations. For individual shareholders that own stock in corporations that operate in states with a high marginal tax rate, the result of this change to the DRD rules are magnified. For instance, assuming that the corporation and the corporate shareholder under the facts of the example above operate in a high state taxing jurisdiction and pay an effective federal and state tax rate of 40%, the corporate shareholder would only receive a $60 dividend and would pay $24 of tax on such dividend. The corporate shareholder would then distribute the $36 to its individual shareholders who, after paying a tax of 39.6%, would be left with only $21.74. The corporate earnings would have been subject to an effective income tax rate of 78%.

investor sells a January 1997 $50 call on the Z stock (having an implied volatility of 22) for 8 1/2 because the investor believes there is limited price risk below $50. Prior to expiration, the Z stock is trading at $56. The investor continues to believe there is limited price risk below $50 and rolls its existing call position by buying back the January 1996 call at $6 and selling the January 1999 $50 call (which also has an implied volatility of 22) for 10 5/8, for a net credit of 4 5/8. Because of recent increased volatility in the stock market, the implied volatility of the January $50 call has increased from 22 to 30, although the Z stock is still trading in the $56 range. On a marked-to-market basis, with the price of the stock virtually unchanged, the January $50 1999 call has increased from 10 5/8 to 12 3/4. The taxpayer purchased the Z stock and wrote the calls with the expectation of receiving the DRD and an enhanced return from premium. The proposed change to the holding period rules would dramatically impact the expected return. More importantly, unwinding the position at this time would result in a projected loss of 2 1/8 per share. This example demonstrates that, if Congress were to enact the proposed change to the DRD holding period rules, it would be inequitable not to grandfather existing positions.

Corporate investors will be discouraged from entering into hedging transactions through the use of options such as those described above because of the possibility of losing the DRD. This decrease in corporate investor participation in the options markets would result in wider spreads and greater volatility in options pricing. Ultimately, this will lead to less liquidity in the options markets, including the stock market whose trading volume is greatly influenced by the trading volume of the option markets.

This change to the DRD holding period rules would also increase the cost of capital for many corporate issuers of stock, especially issuers of preferred stock. The proposed holding period changes will create uncertainty as to the availability of the DRD for many preferred stock investors. Preferred stock issuers likely will have to increase the dividend yield to compensate for this uncertainty. The increased cost of capital will have particular impact on certain industries, such as utilities, in which preferred stock comprises a significant component of the capital structure.

The current 46-day and 91-day holding period requirements and other related provisions ensure that the benefit of the DRD is available only for economic investments (as opposed to tax-motivated) in which the investor bears risk of loss for a meaningful period. First, no DRD is allowed with respect to any dividend on any share of stock which is held by the taxpayer for 45 days (90 days in the case of preferred stock) or less. In determining whether the taxpayer has held the stock for more than 45 days, the taxpayer's holding period is reduced for periods where the taxpayer's risk of loss is diminished. The regulations interpreting when the taxpayer has diminished its risk of loss are extremely broad and in essence treat the taxpayer as having diminished its risk of loss when the taxpayer enters into a broad range of hedging transactions (other than qualified covered calls). Thus, under current law, a corporate taxpayer must incur significant economic risk of loss during the 45 day holding period to be comfortable that it is entitled to the DRD.

Second, no DRD is allowed to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property. This rule is applicable to all dividend payments received by the corporate taxpayer and will prevent the taxpayer from obtaining a DRD even if the taxpayer has satisfied the holding period rules described above.

Third, no DRD is allowed to the extent that the taxpayer finances the purchase of its stock investment with indebtedness. This rule denies the DRD to a taxpayer that has satisfied with holding period rules and related payment rules described above.

The Administration proposes to make the provision effective for dividends paid or accrued 30 days after the date of enactment. The Administration's proposal has retroactive impact since corporate investors have entered into a variety of transactions whose economics were based upon the expectation of receiving the DRD. If Congress does choose to enact a modification to the DRD holding period rules, the provision, at a minimum, should have a prospective effect. The effective date of any legislation in this area should be for "positions entered into" after the date of enactment.

The proposed modification to the DRD holding period rules will place corporate investors in the position of having to choose between entering into a bona fide hedge to reduce risk or losing the DRD. Congress should not pass legislation which either discourages hedging or increases triple taxation of corporate earnings.

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Comments concerning the Export Source Rule
contained in the
Revenue Raising Provisions
in the Administration's
Fiscal Year 1998 Budget Proposals

Senate Finance Committee

Submitted by:
Caterpillar Inc.

April 30, 1997

It is vitally important to U.S. based manufacturers with significant export sales to retain the Export Source Rule in its present form. The replacement of the 50/50 rule with an activity-based rule will have serious detrimental effects on the level of export sales and ultimately on the level of jobs that are dependent on those sales.

In his remarks at the Treasury Conference on Formula Apportionment on December 12, 1996, Deputy Secretary of the Treasury Lawrence H. Summers cited the following five goals of the international tax system: neutrality of location, maintenance of competitiveness, administrability, protection of the revenue base, and compatibility with international norms. He further stated that "Any proposed change should be viewed in the context of these goals and must bear the burden of proof that it will improve, not merely match the performance of the current system." Caterpillar believes the current Export Source Rule is an effective tool for meeting those goals and that its replacement with an activity-based rule does not achieve the goals cited by Deputy Secretary Summers.

For decades the 50/50 Export Source Rule has played a significant role in allowing U.S. multinational companies like Caterpillar Inc., to remain globally competitive in spite of the fact that the U.S. tax rules make it increasingly difficult for these companies to avoid double taxation of their income. The U.S. tax system has continually expanded the base of worldwide income subject to current U.S. tax and, to make matters worse, this expansion has been accompanied by introduction of numerous rules restricting a U.S.-based multinational corporation's ability to credit foreign tax.

The resulting double taxation many U.S. companies incur is not compatible with internaticnal norms and places these companies at a competitive disadvantage in the global marketplace. An activity-based source rule will further restrict utilization of foreign tax credits by reducing foreign source income based on the fact that a company chose to locate plant operations -- and hence a major part of its activity -- in the U.S.. This "penalty" for U.S. activity is a definite deterrent in achieving the goal of location neutrality and could in fact encourage firms to locate operations outside the U.S..

It is generally accepted that current U.S. tax law, as it relates to international matters, is extremely complex. The provisions relating to the allocation and apportionment of income and expense required for the determination of foreign tax credit limitations are perfect examples of an onerous and expensive system. The compliance costs associated with data collection activities required to support this calculation are staggering.

An activity-based source rule will add yet another level of complexity to this calculation as companies are forced to gather and analyze data required to support allocation of income to foreign and U.S. sources on the basis of activity. The Export Source Rule has evolved into one of the few WTO-consistent export incentives remaining in U.S. tax code. For more than 70 years, this rule has worked as originally intended -- to avoid endless disputes and problems which would inevitably arise in administering an activity-based rule.

Finally, the Administration has cited increased tax revenues resulting from implementation of the activity-based source rule as a means of enhancing the current revenue base that may be diminished by tax cuts in other areas. Attempts to replenish the tax revenue base with the introduction of the activity-based source rule must be thoroughly examined. It is not appropriate to simply examine tax revenues associated with the current level of export sales since this sales base will inevitably be eroded as companies are encouraged to shift more of their manufacturing activities outside the U.S..

The 50/50 Export Source Rule encourages multinational companies like Caterpillar to produce goods in the U.S. and export. The relief that the rule provides with regard to the ability to generate foreign source income and thereby avoid double taxation allows companies that manufacture primarily from a U.S. base to remain globally competitive while providing high levels of employment in the U.S. The jobs that support export sales should not be jeopardized in the interest of raising tax revenues. Therefore, we would encourage the Committee to retain the Export Source Rule in its current form and reject proposals to replace it with an activity-based rule.

ATTACHMENT 1

The Export Source Rule Benefits Suppliers As Well As Manufacturers

A decision by a large U.S. company to manufacture in the U.S. for export benefits not only its workers but those of its suppliers. For example, Caterpillar, Inc., headquartered in Peoria, Illinois, is the world's largest manufacturer of construction and mining equipment, natural gas engines and industrial gas turbines, and is a leading global supplier of diesel engines. More than half of the company's U.S. production is exported, totaling some $5.50 billion in 1996. Those exports account for 16,500 Caterpillar jobs in the United States, and an additional 33,000 jobs among Caterpillar's 11,400 U.S. suppliers.

- Caterpillar is an American company with 75% of its manufacturing capacity in the United States. Caterpillar is also a multinational company with manufacturing operations in fourteen other countries.
- It is Caterpillar's mission to be globally competitive from primarily a U.S. manufacturing base.
- Exports are good for Caterpillar and good for the U.S. economy as well. When Caterpillar sells a 793C mining truck, manufactured in Decatur, Illinois, there is a positive ripple effect on its supplier chain. Approximately 250 individual firms operating in 31 states provide parts and components incorporated into the production of this vehicle. Those 251 firms are exporters as well.
- Most of our foreign competitors don't face equivalent tax burdens when exporting products -- - and that places exporters at a competitive disadvantage.
- From a competitive standpoint, it's unfortunate that proposed U.S. tax policy --- eliminating the export source rule --- may influence U.S. exporters' decisions on where to source product.
- In this regard, any proposed U.S. tax policy that may influence manufacturing decisions to source products closer to their markets -- rather than to manufacture in the U.S. and export -- appears shortsighted.

Therefore, we believe the export source rule should be retained. It is one of the few WTO-consistent tax rules that operates as an export incentive to U.S. manufacturers while helping to alleviate the double taxation of foreign income.

ATTACHMENT 2

Other Countries Provide More Favorable Tax Treatment for Companies Doing Business Abroad than the United States

The complex rules by which the U.S. taxes its companies doing business in foreign jurisdictions put them at a disadvantage when competing abroad. The export source rule is one of the few favorable tax rules which mitigate the harm done by other distortive U.S. tax rules that cause many U.S. multinationals to suffer significant double taxation on income earned from their international operations.

Double taxation occurs when U.S. multinationals pay taxes to both the U.S. and a foreign country on the same income, and the business cost is especially onerous when the foreign tax rate exceeds the U.S. statutory rate. The U.S. taxes worldwide income, but in order to avoid double taxation, allows a credit for foreign taxes paid. However, numerous restrictions and limitations in U.S. tax law often prevent U.S. multinationals from getting a dollar for dollar credit against their U.S. taxes for the foreign taxes paid, and thus the companies are subjected to double taxation.

By contrast, most other countries rarely subject their companies to double taxation on foreign business income. These countries often exempt such income from tax entirely or have less onerous rules for crediting foreign taxes paid. Avoidance of double taxation on foreign business income is essential if U.S. multinationals are to compete effectively in the global marketplace.

Territorial Systems of Taxation - Unlike the U.S., many countries, such as Germany, France and Austria, permit their corporations to operate in foreign jurisdictions without any risk of double taxation because they simply exclude foreign source income from domestic tax, either by statute or through their treaty network. Companies which call these countries home do not face any risk of double taxation on their overseas operations.

Worldwide Systems of Taxation - Even countries which tax resident companies on a worldwide basis similar to the U.S. offer their companies more protection from double taxation because they have less restrictive rules on the crediting of foreign taxes paid.

U.S. Restrictions on Crediting Foreign Taxes Paid - The U.S. tax laws contain numerous and unique restrictions on crediting foreign taxes paid by multinational companies on their overseas operations. The following are some of the key problem areas:

Foreign tax "baskets" - Separate foreign tax credit limitations apply for different types or "baskets" of income earned by the companies, such as shipping, financial services, passive, high withholding-tax interest, etc. Indeed, there is a separate limitation for income earned by each company which is owned at least 10% but not more than 50% by U.S. shareholders. No other country has such complex and restrictive limitations on the crediting of foreign taxes.

Allocation Rules - The U.S. tax laws require corporations to deduct numerous domestic expenses, such as interest and R&E expenses, from their foreign source income even though they do not actually get a deduction for these costs in the foreign country. The ability of a company to get credit for foreign taxes paid is dependent upon how much foreign source income it has. Therefore, reductions in a company's foreign source income (caused by allocating these domestic expenses to foreign source income) also reduce the amount of credit the company can get for foreign taxes paid. The magnitude of these allocations is unprecedented by international tax norms and one of the main causes of double taxation for U.S.-based multinationals.

Domestic Losses - If the U.S. operations of a multinational company lose money in any given year, this domestic loss reduces or eliminates the company's capacity to claim foreign tax credits in that year. Moreover, this loss in foreign tax credit capacity can not be made up in any other year. Thus, the company is prohibited from ever using foreign earnings in that year to claim foreign tax credits, and double taxation results.

Other Countries Give Tax Incentives For Exports and Overseas Operations - In addition to bearing the hidden tax costs buried in the details of the U.S. system described above, U.S. companies must also compete with foreign-based companies that are operating under tax laws that frequently offer incentives for exports and encourage their multinationals to invest overseas. Even countries which do not exempt foreign income from tax often enter into so-called "tax sparing" treaties which have the same effect. These agreements exempt foreign earnings from tax even when the earnings are "repatriated" – i.e., brought back to the home country. Many countries also offer incentives such as VAT exemptions for exports.

International Tax Reform - The export source rule is one of the few rules in the U.S. international tax regime which alleviates the double taxation caused by the provisions described above. If any changes to the rule are to be considered, they should be in the context of a comprehensive review of the overall manner in which the U.S. taxes the international operations of businesses and with a view to supporting and fostering the international competitiveness of U.S.-based companies.

STATEMENT OF
CHEMICAL MANUFACTURERS ASSOCIATION
BEFORE THE
SENATE COMMITTEE ON FINANCE
ON
REVENUE RAISING PROVISIONS IN THE
ADMINISTRATION'S FISCAL YEAR 1998 BUDGET PROPOSAL
APRIL 17, 1997

The Chemical Manufacturers Association ("CMA") appreciates this opportunity to present its views on the revenue raising provisions in the Administration's Fiscal Year 1998 Budget Proposal.

CMA is a non-profit trade association whose member companies represent more than 90 percent of America's productive capacity for basic industrial chemicals. Since 1991, the U.S. chemical industry has been the nation's leading exporter with gross exports in 1996 of $61.8 billion which produced a net trade surplus of $16.9 billion. The chemical industry now provides over one million high-wage, high-tech jobs for American workers. The chemical industry also ranks first in company-funded research and development spending among all U.S. manufacturing sectors with an estimated $18.3 billion in 1996.

Although CMA has concerns about the adverse impact of several of the Administration's revenue-raising proposals, we will limit our comments to the two proposals that would have immediate impact on the international competitiveness of products manufactured in the United States and on the security of the jobs of the American workers who produce them. These are the Administration's proposals to (1) replace the Export Source Rule and (2) revise the tax treatment of foreign oil and gas income.

In our statement submitted to the House Committee on Ways and Means in connection with its hearings on tax reform last year, CMA stressed the single, most important issue in tax reform is its impact on the international competitiveness of U.S. manufacturers and on the American jobs they provide. In recent years, the U.S. chemical industry has grown from producing basic commodity chemicals to producing commodity and specialty chemicals, and has greatly expanded its overseas operations and markets. Nonetheless, the chemical industry continues to provide over one million quality jobs for American workers. Today a substantial portion of those American jobs is directly dependent on the expanded market that growing U.S. chemical exports provide.

The present Export Source Rule is a strong, recognized incentive for the export of U.S.-manufactured products. For over 70 years the regulations under the Internal Revenue Code have allowed U.S. manufacturers to generate a combination of manufacturing and sales income with respect to exports of products manufactured in the United States. In general, these taxpayers are permitted to treat half of this combined income as U.S. manufacturing income and to treat the other half as foreign source income. The amount of foreign source income is crucial to the use of the foreign tax credit. Thus, U.S. manufacturers that pay rates of foreign tax in excess of U.S. rates can reduce or eliminate U.S. tax on their export sales or other foreign income.

Expanding foreign trade is central to increasing the market for U.S.-manufactured products and to providing greater job security for American workers. Reducing the incentive now provided by the Export Source Rule as proposed in the Administration's budget would clearly make U.S. chemical exports less competitive in world markets. Last year we urged you to reject the proposed changes to the Export Source Rule and we do so again this year.

The review and reform of U.S. taxation of foreign income is greatly needed. The United States remains one of few countries that now tax companies on their world-wide income. Even those other countries that tax world-wide income find means to allow their companies to compete without tax handicaps in world markets. Congress should not modify the present Export Source Rule until it is willing to undertake comprehensive reform of the taxation of foreign income.

The ability to compete internationally is a complex problem. In addition, overall U.S. tax policy frequently may discourage U.S.-based firms from making investments abroad that result in expanded U.S. exports and American jobs. In this respect, CMA has strongly opposed proposals to tax U.S. corporations currently on the income of their foreign subsidiaries, such as S-1597, "the American Jobs Act of 1996," introduced by Senator Dorgan (D-ND) in the last Congress. The Administration's proposal to tax foreign oil and gas income is little more than an attempt to end deferral. On principle, this proposal is very bad tax policy and we strongly urge the Committee on Finance to reject it.

The overseas operations of U.S. chemical companies have proven to be strong customers for U.S.-produced products. In 1990 U.S. chemical exports were $39.5 billion--then equal to the nation's total agricultural exports and significantly larger than U.S. aircraft exports of $30.1 billion in that same year. In 1990, we also enjoyed a healthy net U.S. trade surplus in chemicals of $16.8 billion. Six years later, U.S. chemical exports accounted for $61.8 billion with a net U.S. chemical trade surplus of $16. 9 billion in 1996. More importantly, the chemical industry today continues to provide over one million high-quality, high-paying jobs in the United States, while implementing major technological innovations and efficiencies.

Conclusion:

We again urge the Committee on Finance to consider the adverse impact on international competitiveness of the Administration's proposals to replace the Export Source Rule and to tax foreign oil and gas income and to reject those proposals accordingly.

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STATEMENT OF
THE CHICAGO BOARD OF TRADE AND
THE CHICAGO MERCANTILE EXCHANGE
SUBMITTED TO
COMMITTEE ON FINANCE
UNITED STATES SENATE
APRIL 17, 1997

The Chicago Board of Trade ("CBOT") and the Chicago Mercantile Exchange ("CME") are submitting this statement for the record of the hearing, April 17, 1997, on selected revenue raising provisions in the Administration's FY 1998 budget proposal. Our comments are directed to the proposal to impose a constructive sale on certain appreciated financial positions -- a proposal apparently designed in reaction to a "short-against-the-box" transaction in the stock market.

The CBOT and CME are the two largest markets in the world for transactions in futures contracts and options on futures contracts. The principal purpose of these contracts is to provide a means for the hedging of business and investment risks. The functioning of our markets can be impaired if tax rules threaten to penalize legitimate risk management activities.

The constructive sale proposal causes some concerns for our markets. Although the tax planning strategies seemingly targeted by the proposal cannot be implemented on U.S. futures exchanges, the outer boundaries of the proposal's scope are not clearly delineated in the Treasury Department's explanation. Moreover, the proposed statutory language submitted last year in connection with the constructive sale proposal in the President's 1997 Budget was so ambiguous that adoption in its proposed form would have cast unwarranted doubts on the tax treatment of some transactions on our markets.

We urge that, if it is believed desirable to address the tax results for the short-against-the-box transaction, the provision be drafted narrowly to ensure that U.S. exchange-traded futures and options on futures not be adversely affected.

Description of Proposal

Under the proposal, there is deemed to be a constructive sale of an appreciated position if the taxpayer (or a related person) enters into a position with respect to "the same or substantially identical property" that for some period "substantially eliminate[s] risk of loss and opportunity for gain" on the appreciated position. For this purpose, an appreciated position is apparently any position with respect to stock, a debt instrument, or a partnership interest if there would be gain upon the sale of the position. A constructive sale is not deemed to occur under the proposal if the appreciated position is subject to the existing constructive sale treatment under the mark-to-market rules of sections 475 or 1256.

A U.S. exchange-traded futures contract (or an option on a futures contract) would generally not itself be subject to constructive sale treatment under the proposal because it would generally be marked to market already under existing section 1256. However, the current Treasury explanation (when read in connection with the proposed statutory language for the 1997 Budget proposal) suggests that such contracts could result in constructive sales of other property. At least in theory, U.S. exchange-treated futures (or options on futures) could trigger a constructive sale of appreciated stock or an appreciated debt instrument under the proposal if the taxpayer holding such appreciated property entered into a futures contract (or an option on a futures contract) under circumstances where (i) the futures or options contract is with respect to property that is considered to be the same or substantially identical to the appreciated stock or debt obligation, and (ii) the futures or options position is considered to have the effect of substantially eli.ninating, for some period, both risk of loss and opportunity for gain on the appreciated stock or debt obligation.

Impact of Proposal on Futures and Options on Futures

The CBOT and CME, iike other U.S. futures exchanges, offer standardized futures contracts with respect to underlying property or indices. In the case of a conventional futures contract, one contracting party (the "long" party) agrees to buy and the other contracting party (the "short" party) agrees to sell a specified quantity of underlying property at a specific price on a specific delivery date in the future. Other futures contracts, particularly with respect to indices of property prices or other market information, call for final settlement in cash to reflect price fluctuations, as opposed to actual delivery of property. The exchanges also offer trading in options with respect to futures contracts. In the case of either futures or options on futures, most contracting parties close out their positions prior to the delivery or final settlement date by engaging in an offsetting transaction on the exchange (e.g., a party with a long futures position enters into a short position having the same underlying property, quantity and delivery month).

The most actively traded contracts on the CME and CBOT are futures that relate to financial instruments. For example, the CME has cash-settled futures (and options on futures) with respect to various broad-based stock indices (e.g., the S&P 500 stock index). Both the CBOT and CME have futures (and options on futures) with respect to debt obligations, some of which call for actual delivery of a debt obligation (e.g., the CBOT's contract for Treasury bonds) and some of which call for cash settlement (e.g., the CME's Eurodollar contract). Accordingly, taxpayers using these financial futures contracts in connection with underlying stock holdings or holdings of debt obligations might potentially be affected by the constructive sale proposal.

Any such cloud of doubt should be removed. Irrespective of whether it is considered desirable to alter the current law treatment of a short-against-the-box transaction, a constructive current sale should not be imposed on a taxpayer who uses financial futures transactions to hedge the risk associated with holdings of stock or debt obligations.

A contract to sell in the futures market and a current sale in the so-called "cash" market cannot be regarded as being interchangeable versions of the same substantive transaction.

- Unlike a sale in the current (or "cash") market, a futures transaction involves no current transfer of property and no current payment for a transfer of property. Any purchase, sale and payment of sale proceeds occurs in the future. In contrast, a short-against-the-box involves a current transfer of property (borrowed by the short seller) to a purchaser, who pays currently a purchase price for the transferred shares (with the sale proceeds generally being held by the stock lender to secure the short seller's obligation to "repay" the borrowed property).

- Because futures transactions involve sales (or cash settlements) in the future, the sales price in a futures transaction is rarely the same as the sales price in the cash market. The futures price may be higher or lower than the cash price, depending upon such factors as the period of time to delivery (or final cash settlement), costs associated with holding the underlying property, and the amount of current earnings realized by a holder of the underlying property. In any event, these price differences reflect a real economic difference between a futures transaction and a transaction in the cash market, including a short-against-the-box transaction.

- Because a futures contract involves no current sale or purchase, the holder of a short futures position who also holds stock or a debt obligation has the right to any dividends or interest on the underlying securities. In contrast, a short seller against-the-box effectively foregoes earnings on the securities he continues to own by obligating himself to make dividend or interest substitute payments to the securities lender.

- Persons who enter into short futures contracts (i.e., contracts to sell) in lieu of selling in the cash market generally do so to serve nontax risk management objectives related to the distinct economic characteristics of futures transactions, not to postpone a gain that would be realized in a sale on the cash market.

It would be especially inappropriate to impose constructive sale treatment in the case of hedges on U.S. futures exchanges because all transactions on those exchanges involve standardized contracts traded in public markets.

- Persons who enter into countervailing positions on a futures exchange and another public marketplace (including a pub'ic cash market) perform an important economic function of minimizing inter-market pricing distortions and enhancing the future price discovery function of the futures market. As noted above, there is generally a difference between a futures price and a cash market price. Arbitrageurs place appropriate trades in the respective markets to benefit when the price spreads are too wide or too narrow, and this profit-seeking activity also benefits the marketplace by tending to bring the respective price relationships back into proper alignment.

- Because U.S. exchange-traded contracts are standardized, a financial futures contract is rarely a perfect offsetting match for a position in the underlying property. The resulting "basis risk" means that hedges using U.S. exchange-traded financial futures (or options on futures) rarely, if ever, "substantially eliminate" risk of loss and opportunity for gain.

- Most futures contracts call for delivery (or final settlement) in the relatively near future and, in any event, rarely more than two years distant. This short-term feature, coupled with the mark-to-market and straddle rules, discussed below, makes U.S. exchange-traded futures (and options on futures) less susceptible than some off-exchange contracts to long-term deferral of tax on "locked-in" gain.

- Because of the liquidity of contracts traded on U.S. futures exchanges, futures positions can be readily disposed of. As a consequence, a hedge may be held for only a short period of time before being closed out through an offsetting exchange transaction. Unlike a typical short-against-the-box transaction where the taxpayer actually makes a sale (with borrowed shares) subject to an obligation subsequently to repay the borrowed shares, most holders of a short futures position never actually engage in a sale of the underlying property through the futures markets.

Most U.S. exchange-traded futures (and options on futures) are already marked to market under section 1256 and are also subject to the straddle rules of sections 1092 and 263(g).

- A taxpayer motivated solely by a desire to postpone recognition of gain on appreciated securities finds the futures markets an unaccommodating mechanism for doing so. Assume that a taxpayer with appreciated debt securities enters into short interest rate futures, and add the unlikely assumption that the appreciated securities and the short futures are so perfectly matched that risk of loss and opportunity for gain are "substantially eliminated." Under these circumstances, any subsequent market movement in the cash securities is offset by an opposite market movement in the short futures position, so that the preexisting gain might be regarded as being locked-in. But the locked-in gain is not effectively shielded from tax. If the appreciated securities subsequently lose value, the offsetting futures gain, and thus effectively a portion of the overall locked-in gain, will generally be taxed currently under the mark-to-market rules of section 1256. On the other hand, if the appreciated securities subsequently gain additional value, the resulting mark-to-market loss on the offsetting futures position cannot generally be recognized currently on account of the loss suspension rules for straddles under section 1092.

- Under section 263(g), interest and other costs of carrying a security must be capitalized, rather than deducted currently, if the security is hedged in a manner that substantially diminishes risk of loss.

- There is no need to create an additional constructive sale rule to prevent any taxpayer manipulations using futures contracts. A new constructive sale rule would only add complexity and create uncertainty for legitimate market-driven transactions.

Conclusion

We are concerned with the notion that a contract for future sale and delivery of property should be treated for tax purposes as a constructive current sale of the underlying property. Such a proposal is particularly disturbing if it has potential application to futures contracts traded on U.S. exchanges, which serve important non-tax risk management functions. A proposal inspired by purported tax manipulations through short-against-the-box transactions in the cash market for stock, should not cast any doubt on the continuation of current law treatment for futures transactions.

At a minimum, if the basic proposal is adopted, the legislation should make the following changes or clarifications:

- It should be made clear that stock index positions are not covered by the proposal. The regulations under section 246(c)(4)(C) and section 1092(d)(3)(B)(i)(II) provide detailed rules specifying the instances in which a taxpayer's stock portfolio sufficiently mimics a stock index so that a short position with respect to the index is regarded as being "substantially similar or related property" with respect to the stock portfolio. Under these Code provisions and regulations, the consequence of such a "substantially similar or related property" finding is application of straddle rules and, for corporate taxpayers, limitations on the dividends reduced deduction. The implication of these provisions is that a position with respect to a stock index is never considered to be a position with respect to property that is "substantially identical" to stocks in a portfolio. Cf. sections 246(c)(4)(A) and (C); sections 1092(d)(3)(B)(i)(I) and (II). If the short-against-the-box proposal is adopted, this implication should be confirmed to avoid undesirable disruption of stock portfolio hedging activities.

♦ If it is considered desirable to apply the proposal to debt obligations, notwithstanding the absence of evidence of tax deferral abuses with respect to such securities, the constructive sale treatment should not be applied with respect to debt obligations hedged through U.S. exchange-traded futures (or options on futures). Because of the standardization of exchange-traded contracts, it is very unlikely that such contracts should ever be regarded as "substantially eliminating" risk of loss and opportunity for gain with respect to debt obligations held by the taxpayer. Even if such a "substantial elimination" test could be met in a particular instance, the combination of the mark-to-market rules of section 1256 and the straddle rules of sections 1092 and 263(g) should be more than sufficient to prevent tax manipulations.

STATEMENT OF THE COALITION ON CREDIT CARD INTEREST IN CONNECTION WITH THE SENATE FINANCE COMMITTEE HEARINGS ON REVENUE RAISING PROVISIONS IN THE ADMINISTRATION'S FISCAL YEAR 1998 BUDGET PROPOSALS HELD ON APRIL 17, 1997

This statement is respectfully submitted on behalf of the Coalition on Credit Card Interest in connection with the Committee's hearings on revenue-raising provisions included in the President's fiscal year 1998 budget. The Coalition appreciates the Committee's interest in public comments on the Administration's revenue proposals and welcomes the opportunity to express its strong opposition to one of these proposals in particular -- the proposal to require a prepayment assumption in computing the accrual of grace period interest on credit card receivables outstanding at the end of a taxable year. The proposal is detrimental to credit card businesses located throughout the United States, including the credit card operations of commercial banking and thrift institutions, non-bank financial institutions and retailers.

BACKGROUND

Credit card issuers frequently provide an interest free "grace period" before customers are liable for any interest charges on purchases. In a typical arrangement, interest is not charged on a customer's credit card balance (other than the portion of the balance reflecting the principal amount of cash advances) during the grace period. The grace period typically begins on the date a customer's purchase is posted to his or her account and ends a specified number of days after close of the monthly billing cycle during which the purchase is posted.

For example, assume a customer purchases goods on November 15 using a credit card with a billing cycle ending the 12th of each month and a 25-day grace period. The purchase would likely be posted to the customer's account on November 15 or 16 and would be included on the customer's bill dated December 12. Under this arrangement, the customer would not incur a finance charge on the November 15 purchase if the December 12 balance, which includes the November 15 purchase, is paid on or before January 6. If, on the other hand, the customer fails to pay the balance by January 6, interest will generally be computed based on the average outstanding balance which was increased on the date the purchase was posted to the customer's account.

Under present law, a credit card issuer is not required to include grace period interest in taxable income until the grace period has expired. As the Committee knows, a provision in President Clinton's fiscal year 1998 budget would require a "reasonable payment assumption" for interest accruals on certain debt instruments.[1] These debt instruments would include pools of credit card receivables. The proposal would require credit card issuers to use an assumption about payment patterns to accrue interest income when the receivables are outstanding over the end of a taxable year. Simply stated, the proposal would require credit card issuers to accrue an estimate of the total amount of interest income expected to be earned at the end of the grace period. This estimate would be based on the credit card issuer's assumptions of the likelihood that its credit card customers will not pay their entire balance before the end of the applicable grace period.

The Administration is proposing that this provision be effective for taxable years beginning after the date of enactment.

PROBLEMS WITH THE ADMINISTRATION'S PROPOSAL

As discussed below, the Coalition believes that the Administration's proposal is an inappropriate departure from historic tax accrual standards. Additionally, the Coalition believes that this proposal is not an "unwarranted tax benefit" as the accrual method of accounting can hardly be viewed as "unwarranted" or contributing to "corporate welfare." On the contrary, adopting the proposal in question can only be viewed as a tax increase on credit

[1] See, Department of the Treasury, General Explanations of the Administration's Revenue Proposals, February 1997, at pages 52-53.

card issuers and an arbitrary departure from well-established tax policy. The Coalition strongly urges the Committee not to adopt the Administration's proposal in any form at any time.

1. The Proposal Is an Inappropriate Departure from Tax Accrual Standards

Accrual method taxpayers are generally governed by the "all events test" which dates back to the 1926 Supreme Court case of United States v. Anderson.[2] In deciding the appropriate time for an accrual method taxpayer to accrue a deduction for a munitions tax liability, the Court stated: "in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it."[3] The all events test subsequently became the consistent standard for accruing both income and expenses. The Treasury Regulations provide:

> Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.[4]

The importance of accruing income and expense items based on a consistent standard cannot be overstated. In order to prevent a distortion of taxable income, the use of estimates should not be required for accruing income if estimates are not permitted in accruing expenses. As you are aware, estimates are not permitted in accruing expenses. For example, taxpayers are not permitted to accrue an estimate of the liability for self-insured medical costs even though the amount of the liability to be incurred can be accurately predicted by the taxpayer.[5] In addition, all other types of reserves, including bad debt reserves, are not permitted as a deduction against taxable income.

As stated above, the right to receive credit card interest does not become fixed, and therefore is not includible in taxable income, until the end of the grace period. While the extent to which a credit card customer will pay the outstanding balance before the end of the grace period could be estimated, predictions of uncertain future events have long been rejected as a basis for tax accounting on both the income and the expense side. A return to the use of estimates solely on the income side represents a one-sided departure from long established accrual principals and will significantly distort taxable income solely for the sake of a one time revenue raiser.

2. The Administration Erroneously Equates Stated Interest on Credit Card Receivables with Original Issue Discount on REMIC Regular Interests and Qualified Mortgages.

The Treasury Department's General Explanations of the Administration's Revenue Proposals suggests that the rationale for this proposed change is to treat interest on credit card receivables in a manner similar to the current law treatment of real estate mortgage conduit (REMIC) regular interests and REMIC qualified mortgages. Treasury's explanation, however, fails to state that the prepayment catch-up method applied under current law to REMIC regular interests and REMIC qualified mortgages is used solely to amortize fixed amounts of original issue discount, market discount or bond premium. Thus, under current law, the prepayment catch up method merely effects the timing of the recognition of a fixed amount of income.

The prepayment catch-up method is not applied to the accrual of qualified stated interest. As a result, qualified stated interests on both REMIC regular interests and REMIC qualified mortgages is accrued under the all-events test of Internal Revenue Code section 451. Moreover, the prepayment catch up method is not applied under present law to accrue any amount of income that is not fixed.

Therefore, the fact that the prepayment catch up method applies under current law to REMIC regular interests and REMIC qualified mortgages does not provide any justification as a matter of tax policy for applying prepayment assumptions to the accrual of grace period interest on

[2] 269 US 422 (1926).
[3] 269 US at 441 (1926).
[4] Treas. Reg. §1.446-1(c)(1)(ii). See also Treas. Reg. §§1.451-1(a) and 1.461-1(a)(2)(i).
[5] United States v. General Dynamics Corp., 481 US 239 (1987).

credit card receivables. As stated above, grace period interest is not fixed until the end of the grace period. In addition, once it becomes fixed, it is qualified stated interest rather than an amount of discount or premium. Unlike with REMICs, applying prepayment assumptions to grace period interest effectively results in a tax on income that has not been, and may never be, earned.

RECOMMENDATIONS

For the reasons set forth above, the Coalition strongly urges the Committee not to approve the Administration's proposal to require the use of estimates for interest accruals on credit cards providing for a grace period, this year or in the future. The Coalition recognizes the need for modernization in the financial products area but believes this provision inappropriately attempts to treat contingent interest in the same manner as a fixed amount of original issue discount. Effectively, this proposal represents a tax increase on credit card issuers, not the elimination of an unwarranted tax benefit.

The Coalition appreciates the Committee's interest in its views on this significant issue.

Statement of
Caterpillar Inc.
on behalf of the Export Source Coalition

on Revenue Raising Provisions in the
Administration's FY 1998 Budget Proposal

Submitted to the
Senate Finance Committee
for the hearing record of
April 17, 1997

Caterpillar Inc. thanks Chairman Roth for this opportunity to discuss the critical importance of retaining the Export Source Rule in its present form and rejecting proposals to replace it with an activity-based rule.

Caterpillar, based in Peoria, Illinois is the world leader in the mining and construction equipment markets, and a major producer of gas turbine and diesel engines. We are also one of America's largest exporters. While seventy-five percent of our assets and people are in the United States, more than half our sales are to overseas customers. And we expect that percentage of sales to grow to 75 percent by 2010.

Last year, Caterpillar's export sales were a record $5.5 billion-- up about 7 percent over the previous year. We're very proud of this performance ... but we're especially proud of the fact that those exports directly supported some 16,500 Caterpillar jobs and around 33,000 supplier jobs here in the United States. Nationally, more than eleven million jobs -- or nearly ten percent of the total U.S. private sector employment -- are supported by exports.

With an increasing amount of our sales activity taking place outside the United States, Caterpillar has a keen appreciation for international tax policy -- especially when the issue is double taxation of our income. That's where the Export Source Rule becomes critical.

The United States taxes U.S. Corporations on their *worldwide* income -- that is income generated from sales and operations inside the U.S. as well as income generated from sales and operations outside the U.S. This "Worldwide" taxation approach creates a "double taxation" situation when foreign income also is taxed by the country in which it's earned. In an effort to mitigate double taxation of income earned abroad, The United States, like many other countries, allows a credit for income taxes paid to foreign countries with respect to foreign source income -- the "foreign tax credit." This provision has worked well since its inception in 1918.

In 1921, limitations were placed on foreign tax credits so that companies do not get a dollar-for-dollar credit for foreign taxes paid. Companies cannot claim credit for foreign taxes paid in excess of the U.S. rate ... that is higher than 35%. In addition, there are numerous other restrictions in U.S. tax law -- such as interest allocation rules and foreign tax credit "baskets" -- which limit the ability of companies to get credit for the foreign taxes which they have paid. As a result, multinational companies often find themselves with "excess" foreign tax credits. And in this case they face double taxation ... that is taxation by both the U.S. and the foreign country.

The credit a company can receive for foreign taxes paid depends not only on the tax rates in the foreign country, but also on the amount of income designated as "foreign source" under U.S. tax laws. The Export Source Rule treats approximately half of export income as "foreign source." In many cases, this enables a company to utilize more of its excess foreign tax credits, thus reducing double taxation.

This rule plays a significant role in Caterpillar's ability to be globally competitive from primarily a U.S. manufacturing base. It does so by increasing our foreign source income and thus increasing our ability to utilize foreign tax credits more effectively. By helping to alleviate double taxation, the Export Source Rule encourages companies like Caterpillar to produce goods in the U.S. and export, which is precisely the tax policy needed to support the goal of increasing exports.

One example of how this rule worked to increase exports and support jobs in the U.S. is based on the experience of one of the companies in the Export Source Coalition, a group of more than 50 companies and associations opposing changes to this rule. This company manufactures identical products in the U.S. and in Spain. Upon receiving an order from a customer in Germany, the company had to decide whether to produce the product in the U.S. and ship it to Germany, or to produce the product in Spain. The Export Source Rule was the deciding factor in determining that the product should be made in the U.S. rather than in Spain. By producing the goods in the U.S., the company increased its foreign source income ...and increased its ability to get credit for foreign taxes paid. This benefit outweighed the additional costs of shipping the product from the U.S. to Germany.

Companies with excess foreign tax credits face double taxation on their overseas operations. Our example demonstrates how the Export Source Rule can be the deciding factor in producing the goods in the U.S. rather than an overseas facility. Because more and more U.S. companies are finding they must have production facilities around the globe to compete effectively, the anecdote I shared is likely to become more and more common. The risk that these companies would shift production abroad if the rule is repealed is significant.

A study by Gary Hufbauer and Dean DeRosa estimates that for the year 1999 alone, the Export Source Rule will account for an additional $30.8 billion in exports, support 360,000 jobs, and add $1.7 billion to worker's payrolls in the form of export-related wage premiums. It concludes that the Export Source Rule furthers the goal of achieving a globally-oriented economy, with more exports and better paying jobs.

Just as labor, materials and transportation are among the costs factored into a production location decision, so is the overall tax burden. The Export Source Rule, by alleviating double taxation, helps reduce tax costs and, in the process, makes U.S. manufactured goods more competitive.

When Caterpillar exports a product from the United States, it's not just Caterpillar that benefits, but our employees, the employees of our 11,400 supplier firms, the U.S. economy and the U.S. Treasury as well. Here is a typical example: When Caterpillar sells a 793C mining truck, manufactured in Decatur Illinois there is a positive ripple effect on our supplier chain. More than 250 individual firms operating in 31 states supply parts and components incorporated into the production of this vehicle. At Caterpillar, we consider those 250 suppliers exporters as well.

Unlike the U.S., many countries, including Germany and France, permit their corporations to operate in foreign jurisdictions without any risk of double taxation because they simply exclude foreign source income from domestic tax. Companies which call these countries home do not face any risk of double taxation on their overseas operations. Even countries which tax resident companies on a worldwide basis similar to the U.S. offer their companies more protection from double taxation because they have less restrictive rules on the crediting of foreign taxes paid.

Any proposed policy that will make it more difficult for a U.S.-based company to rationalize producing goods here for export--as opposed to producing goods in their eventual markets--should be re-evaluated. The Export Source Rule has evolved into one of the few WTO-consistent export incentives remaining in our tax code. For more than 70 years, this rule has worked as originally intended -- to avoid endless disputes and problems which would inevitably arise in administering an activity-based rule. Given the acknowledged role of exports in sustaining growth in the U.S. economy and supporting higher paying U.S. jobs, and the effectiveness of this tax rule in encouraging exports, any attempt to reduce or eliminate the rule is counterproductive and unwise. The Administration has proposed changes to the source rule which are very short sighted and should be strenuously opposed.

Attached to this statement for the record are a list of the members of the Export Source Coalition and a series of short position papers which elaborate upon the benefits of this rule to exports and U.S. jobs and the reasons we strenuously oppose proposed changes to the rule.

ATTACHMENT 1

EXPORT SOURCE COALITION

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Washington, D.C. 20036
775-5026

MEMBERSHIP LIST

Abbott Laboratories
ALCOA
AlliedSignal Inc.
American Automobile Manufacturers Association
American Electronics Association
Applied Materials
Armstrong World Industries
Bison Gear and Engineering Corporation
Cargill, Incorporated
Caterpillar Inc.
Chemical Manufacturers Association
Dana Corporation
Digital Equipment Corporation
Dover Corporation
Dresser Industries
DuPont
Eastman Kodak Company
Electronic Industries Association
Emergency Committee for American Trade
Exxon Corporation
Ford Motor Company
FMC Corporation
General Electric
General Motors Corporation
Hewlett-Packard Company
Hughes Electronics Corporation
IMC Global Inc.
Information Technology Industry Council
Intel Corporation
IBM
International Paper
Johnson & Johnson
Kimberly-Clark Corporation
Leggett & Platt Incorporated
Lucent Technologies
Medtronic, Inc.
Merck & Co., Inc.
Microsoft
Mueller Industries, Inc.
National Association of Manufacturers
National Foreign Trade Council
Northrop Grumman
Olin Corporation
Pharmaceutical Research & Manufacturers of America (PhRMA)
Philip Morris Companies Inc.
Pioneer Hi-Bred International
Raychem Corporation
Rayonier
Raytheon Company
Rockwell International Corporation
Sara Lee Corporation
Sun Microsystems Incorporated
Tandem Computers Incorporated
Texas Instruments
Textron Inc.
Thiokol Corporation
TRW Inc.
United Technologies Corporation
U.S. Chamber of Commerce
U.S. Council for International Business
3M Corporation

ATTACHMENT 2

EXPORT SOURCE RULE

DESCRIPTION OF THE RULE

Since 1922, regulations under IRC section 863(b) and its predecessors have contained a rule which allows the income from goods that are manufactured in the U.S. and sold abroad (with title passing outside the U.S.) to be treated as 50% U.S. source income and 50% foreign source income. This export source rule (sometimes referred to as the "title passage" rule) has been beneficial to companies who manufacture in the U.S. and export abroad because it increases their foreign source income and thereby increases their ability to utilize foreign tax credits more effectively. Because the U.S. tax law restricts the ability of companies to get credit for the foreign taxes which they pay, many multinational companies face double taxation on their overseas operations, i.e. taxation by both the U.S. and the foreign jusrisdiction. The export source rule helps alleviate this double taxation burden and thereby encourages U.S.-based manufacturing by multinational exporters.

ADMINISTRATION PROPOSAL

The President's FY1998 Budget contains a proposal to eliminate the 50/50 rule and replace it with an "activities based" test which would require exporters to allocate income from exports to foreign or domestic sources based upon how much of the activity producing the income takes place in the U.S. and how much takes place abroad. The justification given for eliminating the rule is essentially that it provides U.S. multinational exporters that also operate in high tax foreign countries a competitive advantage over U.S. exporters that conduct all their business activities in the U.S. In this regard, the Administration prefers the foreign sales corporation rules (FSC) which exempt a lesser portion of export income for all exporters that qualify. The Administration also notes that the U.S. tax treaty network protects export sales from foreign taxation in countries with which we have treaties, thereby reducing the need for the export source rule. As discussed below, both these arguments are seriously flawed.

THE EXPORT SOURCE RULE SERVES AS AN EFFECTIVE EXPORT INCENTIVE

The export source rule, by alleviating double taxation, encourages companies to produce goods in the U.S. and export, which is precisely the tax policy needed to support the goal of increasing exports. The effectiveness of the rule as an export incentive was examined by the Treasury Department in 1993, as a result of a directive in the 1986 Tax Reform Act. The Treasury study found that if the rule had been replaced by an activity-based rule in 1992, goods manufactured in the U.S. for export would have declined by a substantial amount. The most recent study of the costs and benefits of the rule by Gary Hufbauer estimates that for the year 1999 alone, the export source rule will account for an additional $30.8 billion in exports, support 360,000 jobs, and add $1.7 billion to worker payrolls in the form of export-related wage premiums. The Hufbauer study concludes that the export source rule furthers the goal of achieving an outward-oriented economy, with more exports and better paying jobs.

INCREASING EXPORTS IS VITAL TO THE HEALTH OF THE U.S. ECONOMY

Exports are fundamental to our economic growth and our future standard of living. Although the U.S. is still the largest economy in the world, it is a slow-growing and mature market. As such, U.S. employers must export in order to expand the U.S. economy by taking full advantage of the opportunities in overseas markets. The U.S. is continuing to run a trade deficit (i.e. our imports exceed our exports) of over $100 billion per year. Increasing exports helps to reduce this deficit.

In 1996, exports of manufactured goods reached a record level of $653 billion. Over the past three years, exports have accounted for about one-third of total U.S. economic growth. Today, 96% of U.S. firms' potential customers are outside the U.S. borders, and in the 1990's 86% of the gains in worldwide economic activity occurred outside the U.S.

EXPORTS SUPPORT BETTER JOBS IN THE U.S.

According to the Commerce Department, exports are creating high paying, stable jobs in the U.S. In fact, jobs in export industries pay 13-18 percent more and provide 11 percent higher benefits than jobs in non-exporting industries. Exporting firms also have higher average labor productivity. In 1992, value-added per employee, one measure of productivity, was almost 16% higher in exporting firms than in comparable non-exporting firms.

Over the last three years more than one million new jobs were created as a direct result of increased exports. In 1995, 11 million jobs were supported by exports. This is equivalent to one out of every twelve jobs in the U.S. Between 1986 and 1994, U.S. jobs supported by exports rose 63%, four times faster than overall private job growth. Since the late 1980s, exporting firms have experienced almost 20% faster employment growth than those which never exported, and exporting firms were 9% less likely to go out of business in an average year.

EXPORT SOURCE RULE ALLEVIATES DOUBLE TAXATION

In theory, companies receive a credit for foreign taxes paid, but the credit is not simply a dollar for dollar calculation. Rather it is severely limited by numerous restrictions in the U.S. tax laws. As a result, multinational companies often find themselves with "excess" foreign tax credits and facing "double" taxation, i.e. taxation by both the U.S. and the foreign country. How much credit a company can receive for foreign taxes paid depends not only on the tax rates in the foreign country, but also on the amount of income designated as "foreign source" under U.S. tax law.

For example, for purposes of U.S. foreign tax credit rules, a portion of U.S. interest expense, as well as research and development costs, must be deducted from foreign source income (even though no deduction is actually allowed for these amounts in the foreign country). On the other hand, if the company incurs a loss from its domestic operations in a year, it is restricted from ever using foreign source earnings in that year to claim foreign tax credits.

These restrictions in the U.S. tax law, which reduce or eliminate a company's foreign source income, result in unutilized or "excess" foreign tax credits. The export source rule, by treating approximately half of the income from exports as "foreign source," increases the amount of income designated "foreign source" thereby enabling companies to utilize more of these excess foreign tax credits, thus reducing double taxation.

EXPORT SOURCE RULE HELPS TO "LEVEL THE PLAYING FIELD"

The export source rule does not provide a competitive advantage to multinational exporters vis-à-vis exporters with "domestic-only" operations. Exporters with only domestic operations never incur foreign taxes and thus, are not even subjected to the onerous penalty of double taxation. Also, domestic-only exporters are able to claim the full benefit of deductions for U.S. tax purposes for all their U.S. expenses, e.g., interest on borrowings and R&D costs because they do not have to allocate any of those expenses against foreign source income. Thus, the export source rule does not create a competitive advantage, rather it helps to "level the playing field" for U.S.-based multinational exporters.

EXPORT SOURCE RULE AFFECTS DECISION TO LOCATE PRODUCTION IN THE U.S.

Just as labor, materials, and transportation are among the costs factored into a production location decision, so is the overall tax burden. The export source rule, by alleviating double taxation, helps reduce this tax cost, thereby making it more cost efficient to manufacture in the U.S. For example, for one coalition member, the export source rule was the determining factor in deciding to fill a German customer order from a U.S. rather than a European facility making the identical product. By allowing half the income from the sale to be considered "foreign source," thereby helping the company utilize foreign tax credits, the export source rule outweighed other cost advantages such as transportation, and American workers filled the customer's order.

FSC REGIME AND TREATY NETWORK NOT SUBSTITUTES FOR EXPORT SOURCE RULE

If the export source rule is eliminated, the FSC regime will not be a sufficient remedy for companies facing double taxation because of excess foreign tax credits. Instead of using a FSC, many of these companies may decide to shift production to their foreign facilities in order to increase foreign source income. Since more and more U.S. companies are finding that they must have production facilities around the globe to compete effectively, this situation is likely to become more and more common. The risk that these companies (which by definition are facing double taxation because they already have facilities overseas) would shift production abroad if the rule is repealed is significant and not worth taking.

Our tax treaty network is certainly no substitute for the export source rule since it is not income from export sales but rather foreign earnings that are the main cause of the double taxation described above. To the extent the treaty system lowers foreign taxation, it can help to alleviate the double tax problem, but only with countries with which we have treaties, which tend to be the most highly industrialized nations of the world. We have few treaties with most of the developing nations which are the primary targets for our export growth in the future.

CONCLUSION

While this technical tax rule was not originally intended as an export incentive, it has evolved into one of the few WTO-consistent export incentives remaining in our tax code. It is also justified on the basis of administrative convenience. This 50/50 sourcing rule is working as originally intended to avoid endless disputes and problems which would inevitably arise in administering an activity-based rule.

Given the acknowledged role of exports in sustaining growth in the U.S. economy and supporting higher paying U.S. jobs, and the effectiveness of this tax rule in encouraging exports, any attempt to reduce or eliminate the rule is counterproductive and unwise. The Administration has proposed cutbacks and changes to the source rule which are very short sighted and should be strenuously opposed.

Sources:

Fourth Annual Report of the Trade Promotion Coordinating Committee (TPCC) on the National Export Strategy: "Toward the Next Century: A U.S. Strategic Response to Foreign Competitive Practices," October 1996. U.S. Department of Commerce. ISBN 0-16-048825-7;

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John Mutti and Harry Grubert, "The Significance of International Tax Rules for Sourcing Income: The Relationship Between Income Taxes and Trade Taxes," NBER Working Paper 5526, April 1996.

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ATTACHMENT 3

Existence of Tax Treaties Is No Reason To Repeal Export Source Rule

The Administration has stated that the U.S. income tax treaty network protects export sales income from tax in the foreign country where the goods are sold and thus protects companies from double taxation. They argue that the export source rule is no longer necessary as a result of this treaty protection.

We strongly disagree that the treaty network is a substitute for the export source rule, but even if it were, the network is far from complete. The U.S. treaty network is limited to 56 countries, leaving many more countries (approximately 170) without treaties with the U.S. Moreover, many of the countries without treaties are developing countries, which are frequently high growth markets for American exporters. For example, the U.S. has no treaty with any Central or South American country.

With or without a tax treaty, under most foreign countries' tax laws, the mere act of selling goods into the country, absent other factors such as having a sales or distribution office, does not subject the U.S. exporter to income tax in the foreign country. Thus, export sales are not the primary cause of the excess foreign tax credit problem which many companies face in trying to compete overseas.

The real reason most multinational companies face double taxation is that U.S. tax provisions unfairly restrict their ability to credit foreign taxes paid on these overseas operations against their U.S. taxes. Requirements to allocate a portion of the costs of U.S. borrowing and research activities against foreign source income (even though such allocated costs are not deductible in any foreign country), cause many companies to have excess foreign tax credits, thereby subjecting them to double tax - i.e. taxation by both the U.S. and the foreign jurisdiction.

The export source rule alleviates double taxation by allowing companies who manufacture goods in the U.S. for export abroad to treat 50% of the income as "foreign source," thereby increasing their ability to utilize their foreign tax credits. Thus, the rule encourages these companies (facing double taxation as described above) to produce goods in the U.S. for export abroad.

As an effective WTO-consistent export incentive, the export source rule is needed now more than ever to support quality, high-paying jobs in U.S. export industries. Exports have provided the spark for much of the growth in the U.S. economy over the past decade. Again, the existence of tax treaties does nothing to change the importance of this rule to the U.S. economy.

The decision to allow 50% of the income from export sales to be treated as "foreign source" was in part a decision based upon administrative convenience to minimize disputes over exactly which portion of the income should be treated "foreign" and which should be "domestic." The rule still serves this purpose, and neither the tax treaty network nor the Administration's proposal to adopt an "activities-based" test for determining which portion of the income is "foreign" and which is "domestic" addresses this problem. Moreover, adopting an "activities-based" rule would create endless factual disputes similar to those under the section 482 transfer pricing regime.

Tax treaties are critically important in advancing the international competitiveness of U.S. companies' global operations and trade. In order to export effectively in the global marketplace, most companies must eventually have substantial operations abroad in order to market, service or distribute their goods. Tax treaties make it feasible in many cases for business to invest overseas and compete in foreign markets. Foreign investments by U.S.-based multinationals generate substantial exports from the U.S. These foreign operations create a demand for U.S.-manufactured components, service parts, technology, etc., while also providing returns on capital in the form of dividends, interest and royalties.

Tax treaties are not a substitute for the export source rule. They do not provide an incentive to produce goods in the U.S. Nor do they address the most significant underlying cause of double taxation -- arbitrary allocation rules -- or provide administrative simplicity in allocating income from exports.

ATTACHMENT 4

The Foreign Sales Corporation (FSC) Rules Complement but Cannot Replace the Export Source Rule

The Export Source Rule allows the income from goods that are manufactured in the U.S. and exported (with title passing outside the U.S.) to be treated as 50% U.S. source income and 50% foreign source income for purposes of determining the foreign tax credit "limitation," i.e., the amount of foreign taxes that may be claimed as a credit against a company's U.S. tax liability.

Generally, this limitation on credits is equivalent to the U.S. tax rate (35%) multiplied by net foreign source income of a company. As a result, an increase in the amount of foreign source income causes an increase in the limitation on the amount of creditable foreign taxes. Thus, for companies with unutilized (excess) foreign tax credits, an increase in the amounts of income determined to be "foreign source" permits them to use more of these excess credits.

The Foreign Sales Corporation (FSC) rules, on the other hand, provide a smaller export incentive and operates independently from the foreign tax credit regime. A FSC is an entity which is separately incorporated, typically in a jurisdiction where it will not be taxed. U.S. exporters that route sales through their FSC's are entitled to a U.S. tax exemption on a portion of the export profits. The level of the exemption is based on the level of distribution activities performed by a FSC which operates as a "buy-sell" company. Alternatively, a FSC can operate as a commission agent, in which case the U.S. exporter can receive up to a 15% U.S. tax exemption on its export profits. Most FSC's operate as commission agents and thus generate a maximum U.S. tax savings of 5.25% (15% x 35% tax rate) U.S. tax benefit.

There is an interplay between the Export Source Rule and the FSC provisions. A company can pass title offshore on its export sales (and thus qualify for the Export Source Rule) and at the same time route those sales through a FSC. In such case, the company can elect whether or not to claim a FSC benefit.

If FSC benefits are elected (e.g., the 15% exemption), then only 25% of the export income may be characterized as foreign source income under the Export Source Rule (this is the so-called "FSC haircut"). A company with little or no unutilized foreign tax credits would typically elect the FSC benefit, and thereby generate less foreign source income and consequently a lesser amount of foreign tax credit limitation under the Export Source Rule.

If no FSC benefit is elected, under the export source rule 50% of the export income is characterized as "foreign source" thereby allowing the company to utilize more foreign tax credits. Exporters with unutilized (excess) foreign tax credits would normally elect no FSC benefit in order to characterize more income as foreign source.

Many multinational companies find themselves with excess foreign tax credits because of U.S. tax provisions that unfairly restrict their ability to credit foreign taxes against their U.S. taxes, e.g., requirements to allocate a portion of the costs of their U.S. borrowings and research activities against foreign source income (even though such allocated costs are not deductible in any foreign country.) FSC does nothing to address the double taxation caused by the foreign tax credit problems companies face on their overseas operations.

Both the Export Source Rule and FSC are considered consistent with WTO rules.

ATTACHMENT 5

The Export Source Rule Is Important to Small Businesses

Mueller Industries

Mueller Industries, Inc. headquartered in Memphis, Tennessee, employs 2500 people manufacturing at facilities in California, Maryland, Michigan, Mississippi, Ohio, Pennsylvania, and Tennessee. One plant in Canada was set up 70 years ago and produces approximately five percent of Mueller's output. Mueller exports from the United States to Canada, Mexico, Europe, Central & South America, Asia/Pacific Rim and the Middle East.

The market for copper tubing in the United States (used, for example, in plumbing and refrigeration) is mature. Thus, Mueller sees long term growth with exports, which now account for approximately 12% of sales and are growing by 10% per year.

As a result of its operations in Canada and the taxes paid on these operations for which Mueller cannot get full credit under U.S. tax laws, they are subject to double taxation, which raises their costs. When they offer product for sale, for example, in Mexico, one of the fastest growing markets for their products, these increased costs make it more difficult to compete. In Mexico they are competing against not only Mexican companies but also companies from South America, Europe and Asia. Mueller currently faces a 9% duty on sales of its product in Mexico, while competing Mexican companies sell duty free into the U.S. Loss of the Export Source Rule would further tilt this un-level playing field against Mueller. Each sale Mueller loses means fewer exports made by American workers.

Bison Gear and Engineering

Bison Gear and Engineering Corporation (The Bison Group) is an Illinois-based company with 200 employees manufacturing electric gear motors. Exports, currently six percent of sales, represent a growing share of its business.

The Bison Group is currently constructing a new manufacturing plant in Illinois, which will require an expanded workforce of 10 percent. In addition to supplying product for the U.S. market, it will provide components for its Netherlands facility, set up last year to better serve the European market. One of the primary reasons Bison chose The Netherlands was its central location with easy access to container shipments of components coming from its U.S. operations. Eventually, Bison plans to open other overseas assembly operations, to be supplied by its U.S. production facilities. Many of Bison's U.S. customers sell their products overseas, as well.

If the Bison Group cannot get full credit under U.S. tax laws for taxes paid on its overseas operations, its cost of doing business increases, making Bison less competitive. Thus, elimination of the Export Source Rule could impact Bison's future ability to grow its business and create additional U.S. jobs by increasing its tax cost, thereby limiting its ability to achieve an adequate return on investment.

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April 24, 1997

Editorial Section
United States Senate
Committee on Finance
Washington, D.C. 20510

Dear Sirs:

In re: **HEARING ON SELECTED REVENUE RAISING PROVISIONS IN THE ADMINISTRATION'S FISCAL YEAR 1998 BUDGET PROPOSAL**

We wish to comment on the Administration's proposals concerning the intercorporate dividends received deduction ("DRD").

Flaherty & Crumrine Incorporated ("**F&C**") is an investment adviser registered with the SEC that specializes in the management of preferred stock portfolios. Assets under F&C's management total approximately $1.2 billion, the great bulk of which is traditional preferred stocks that qualify for the DRD.

We are commenting on behalf of three publicly held investment companies for which F&C is the investment adviser, Preferred Income Fund, Preferred Income Opportunity Fund and Preferred Income Management Fund, that have over 30,000 shareholders potentially impacted by the proposals. Our firm also manages preferred stock portfolios for a small number of large corporate investors, but we do not purport to speak for them specifically.

OVERVIEW OF OUR POSITIONS ON THE DRD PROPOSALS AS THEY AFFECT THE TRADITIONAL PREFERRED STOCK MARKET

We shall address these proposals solely from the viewpoint of the preferred stock market simply because that is our area of expertise. We believe that many of the same considerations would apply to the common stock market as well, but we are not the right people to make those arguments.

In summary, these are our views:

- We believe the proposals **fail to recognize the market effects of increasing the cost of financing with traditional preferred stock,** which is already very high versus debt.

- The proposed reduction of the DRD from 70% to 50% **would accelerate the replacement of traditional preferreds** eligible for the DRD **with debt financing,** thereby harming an important segment of the capital markets and precluding increased tax revenues from preferred stocks. We will expand upon this later.

- The current **proposals to constrain so-called "tax deductible preferreds"** such as MIPS™, TOPrS™, Capital Securities, Trust Preferreds, etc. **would not alter the future course of events much** even if they were enacted. Tax deductible preferreds are basically debt. Only a few equity-like features such as the ability to defer interest for up to five years without triggering default and their treatment as equity for credit and financial statement purposes allow issuers to have both the tax benefits of debt and the other benefits of equity at the same time. Wall Street has learned how to sell corporate debt to Main Street, and that will not change even if Congress cleans up the more overreaching aspects of these tax deductible preferred securities.

- The proposals to eliminate the DRD on **"preferred stock with certain non-stock characteristics" are misguided with regard to the economics of the preferred stock market.** The test of a "stock" is equity risk, that is, the security's ranking in the financial order of priorities in which the issuer must meet its obligations. The proposals generally **attack features intended to deal with interest rate risk, which is fundamentally different than equity risk.** As Chairman Greenspan of the Federal Reserve recently pointed out in a Congressional hearing, interest rates are also a key driving force affecting common stocks. The only real issue we see here would be an extreme case involving an enforcement question of substance versus form.

- The proposal to **modify the holding period for the DRD is more debatable.** One could argue that certain positions, if they are sufficient to suspend the holding period initially, should not be ignored just because the holding period has been satisfied once. We are more inclined to question these proposals because of the lack of evidence that a lot of undesirable activity would be caught in this net. A long series of tax reform acts and regulations issued by the IRS has eliminated many of the "games" that were being played in the 1980's. The proposals would further **increase the complexity of the tax code without much to show for it.**

SIGNIFICANCE OF THE U.S. PREFERRED STOCK MARKET

The United States has the only well developed preferred stock market in the world. Traditionally, the DRD has allowed domestic issuers, particularly utilities and banks, to obtain lower cost equity capital in the preferred stock market by partially

shielding corporate investors from an additional layer of corporate taxation. Foreign issuers commonly access the U.S. market, often taking advantage of favorable tax treatment at home or under treaty with the United States.

The preferred stock market also provides a **"safety valve" for companies in need of equity capital.** This was best demonstrated by **the crisis in the U.S. banking industry in the early 1990's.** When the banks were unable to raise additional equity capital in the common stock market, their needs were **accommodated through the issuance of traditional preferred stocks eligible for DRD.**

Preferred stock dividends account for a **disproportionately large share of total dividend income received by corporate investors.** The yields of preferreds are much higher than those of common stocks, and the largest share of outstanding DRD eligible preferreds is owned by corporations. Thus, **structural changes in the preferred stock market** that would take place in response to a change in the DRD **would have a substantial impact on the amount of tax revenues gained or lost.**

REPLACEMENT OF TRADITIONAL DRD ELIGIBLE PREFERRED STOCKS BY NEW "TAX DEDUCTIBLE" PREFERRED SECURITIES

Since late 1993, there has been **dramatic growth in the issuance** of a new type of security variously called MIPS™, TOPrS™, Capital Securities, Trust Preferreds, etc., all of which are commonly referred to as **"tax deductible preferreds"**. These hybrid securities, which combine features of both debt and equity, are being used for new financing and to replace large amounts of traditional preferred stocks eligible for the DRD. The logic is best described by a spokesman for a large public utility currently making a repurchase offer for its outstanding traditional preferred stocks to be financed by a recently issued tax deductible preferred. He was quoted by Bloomberg last week as saying "This is strictly a refinancing, **substituting a tax-deductible preferred for a non-tax deductible preferred. There is an economic advantage."**

We estimate that the par value of **tax deductible preferreds** outstanding was **almost $61 billion as of 2/28/97, up from roughly $14 billion at the end of 1995.** New issues of such securities have been particularly heavy since last fall when the **Federal Reserve allowed domestic banks to treat them as Tier 1 equity capital.** In approving such equity credit, the Federal Reserve required that such securities have "...a minimum five-year consecutive deferral period on distributions to preferred shareholders", "...be subordinated to all subordinated debt and have the longest feasible maturity."

In contrast, the amount of **traditional preferred stocks eligible for the DRD is shrinking.** We estimate that the par value of such issues outstanding on 2/28/97 was **$59 billion, down from $66 billion** at the end of 1995. Looking a year or so ahead, **further shrinkage to around $50 billion is already well assured,** which would represent a contraction of almost 25% from the end of 1995. We calculate that companies participating in the recent rush of tax deductible preferreds to market have **approximately $6 billion** of high dividend rate traditional preferred stocks outstanding that will become redeemable for the first time between now and the end of 1997. We have also identified **another $3 billion** of recent issues of tax deductible preferreds that appear to be earmarked for refunding traditional preferred stocks that are first callable in 1998. There have been **no recent new issues of traditional preferreds eligible for the DRD.**

IMPACT OF A DRD CUT ON PREFERRED STOCK INVESTORS

Reducing the DRD to 50% would obviously make DRD eligible preferreds less attractive to corporate investors who are the marginal buyers of these securities. All other things being equal, the **after-tax yields to such investors would fall, causing declines in the market prices of DRD eligible preferreds.** It is difficult to justify this treatment of investors, both corporate and individual, who have relied on the tax laws as they have existed for many years.

The **interaction of DRD eligible preferreds with other market sectors** would also be an important factor if the DRD were cut. If only corporate investors were involved, reestablishing market equilibrium could require prices to decline and pre-tax yields to rise enough to bring preferred yields after corporate taxes back to the levels existing prior to the DRD cut. However, that sort of market adjustment would also cause the pre-tax yields on DRD eligible preferreds to rise relative to interest rates on bonds. Ultimately, that would make DRD eligible preferreds competitive with fully taxable bonds on a pre-tax yield basis, and **"total return investors"** such as pension funds would then become **potential buyers of DRD eligible preferred** stocks.

In a broad range for the DRD around 50%, we believe **DRD eligible preferreds would be "neither fish nor fowl."** Lower after-tax yields of DRD eligible preferreds would cause some corporate investors to lose interest. At the same time, the pre-tax yields of such preferreds would not be high enough to stimulate many total return investors to reorient their investment practices to include such preferreds. DRD eligible preferreds would be cushioned to a degree against further price decline, but the market's "audience" would shrink. This would be matched by shrinking supply, as discussed in the following section, which would **greatly reduce the depth of this important market sector.**

IMPACT OF A DRD CUT ON THE ISSUANCE OF PREFERRED STOCKS

Domestic corporations have **a strong bias toward financing with debt instead of equity**, particularly in good economic times. It is simply a matter of interest being deductible for income tax purposes while dividends are not. **A lower DRD would accentuate this bias** in favor of debt financing.

The proposed reduction of the DRD would **further increase the incremental cost of capital of issuing DRD eligible preferreds** versus financing with debt. The dividend rates on such preferreds would certainly rise relative to interest rates on bonds and other forms of debt, as discussed in the section immediately above. Since dividend payments are not deductible, higher dividend rates on newly issued preferreds would increase the issuer's after-tax cost of capital dollar for dollar with no corresponding increase in the cost of debt financing.

The experience of the last several years is abundant proof that corporate **financing decisions are extremely sensitive to the after-tax cost** of issuing DRD eligible preferreds versus debt. "Tax deductible preferreds", which stem from underlying debt, have replaced DRD eligible preferreds at a rapid pace, even with the DRD at 70%. Reducing the DRD to 50% in the face of the substantial potential redemptions of DRD eligible preferreds over the next several years would **open the floodgates for replacement of equity financing by debt**.

IMPLICATIONS FOR REVENUES TO THE TREASURY

The proposal to cut the DRD to 50% is **not just an incremental change** that would increase Treasury revenues without changing much else. A 50% DRD would set **in motion major structural changes** in the market for DRD eligible preferreds. Those changes must be taken into account in estimating the revenue impact.

We should point out that the **system is producing tax revenues that might not exist if there were no DRD**. When one corporation pays a dividend to another, an effective tax of 10.5% is imposed. If the same transaction took place in the form of interest on debt, the interest deduction to the payer would offset the interest income taxable to the payee, and no tax liability would be created on balance. In actuality, the process would be considerably more complex than this example, of course, but the point remains the same. It is quite **possible to reduce tax revenues** by raising the tax rate on a financial sector **if, as a result, the financial sector shrinks in size**.

Although revenue projections depend on many variables, none has a more profound impact than the extent of the replacement of traditional DRD eligible preferred stocks by debt financing. We have developed a computer model at F&C to test the sensitivity of Treasury revenues to changes in the critical underlying assumptions and would be more than willing to share our model with the Committee. **Based on the amount of such refinancing that has already occurred and is now in view,** we think it **is questionable whether,** with respect to DRD eligible preferreds, reducing the DRD would be **more likely to increase or decrease overall tax revenues.**

PROPOSED ELIMINATION OF THE DRD FOR "PREFERRED STOCK WITH CERTAIN NON-STOCK CHARACTERISTICS"

These proposals would essentially **eliminate new issues of adjustable rate preferred stocks, auction rate preferred stocks and sinking fund preferred stocks with maximum** lives **of less than twenty years** by making them prohibitively expensive forms of equity financing. Each of these types of preferred stock has a distinctive feature designed to deal with one aspect or another of interest rate risk. The implication that these features in some way reduce equity risk is not true. **Nothing in their structures provides any assurance about the issuer's financial standing** should it fall on hard times. Furthermore, if that happened, these preferreds would have **none of the typical remedies of debt instruments such as declaring default and instituting bankruptcy proceedings.**

The contention that these instruments are "...economically more like debt than stock" simply **ignores actual market history.** For example, when Bank of New England went bankrupt, its adjustable rate preferred became worthless. Similarly, when the big Texas bank holding company, M Corp., got into financial trouble, its auction rate preferred also became worthless. A further example is the market pressure currently impacting Niagara Mohawk Power's various traditional preferred stocks, including some adjustable and sinking fund issues, due merely to the company's delay in declaring the regular quarterly dividends on its preferred stocks. For decades, it has been common for sinking fund preferreds to have maximum lives of less than twenty years, which has still been plenty of time for many issuers' financial situations to deteriorate.

Adjustable rate preferred stock, auction rate preferred stock and sinking fund preferred stock are **all equity instruments that have been well established over time.** Eliminating their use would not produce new revenue. It would simply be **one more step toward replacing equity financing with debt.** This would also appear to be a dangerous step in the direction of "micromanaging" the capital markets through the tax laws.

THE "FAIRNESS ARGUMENT"

We have heard it argued that the DRD is "too generous" and is not fair because it allows a corporate investor holding a diversified portfolio of stocks to pay a tax that is significantly lower than an individual investor would pay on the same dividend income.

This argument ignores the reality that all taxes are ultimately borne by individual consumers and investors. Corporate investors are merely one step higher up the investment "food chain." **It is impossible to make the system fairer to individuals by taking more money out of the chain** before it gets to them. The system already falls between double and triple taxation of the same dollars before individuals get the benefit of them.

CONCLUSION

It is essential to **distinguish between corporate welfare and the structures that make the capital markets in United States so efficient** and the envy of the rest of the world. Reducing the DRD is a proposal that has come up many times before as a potential revenue raiser and has been turned down as counterproductive. We believe that any revenue produced by cutting the DRD would be meager in relation the administration's budget estimates and would come at a cost of damaging the DRD eligible preferred stock market. The recent shrinkage of that market would escalate, and its traditional base of corporate investors would be fragmented. This raises **issue of whether the market would have the capacity to rise to the occasion again if there were another crisis** on the scale of the domestic banking industry's problems in the early 1990's.

Very truly yours,

Donald F. Crumrine
Chairman of the Board

Statement of General Motors Corporation submitted for the record in the hearing of April 17, 1997 before the Committee on Finance of the U.S. Senate on Revenue Raising Provisions in the Administration's Fiscal Year 1998 Budget Proposal

General Motors is a member of the American Automobile Manufacturers Association (AAMA), which submitted a written statement for the record at the Senate Finance Committee hearing on April 17, 1997. General Motors fully endorses these AAMA positions which, in brief, express strong opposition to the Administration's proposals to:

- Repeal components of cost (COC) inventory accounting method;
- Modify the net operating loss (NOL) carryback and carryforward rules; and
- Replace the export source rule with an activity-based rule.

In addition, General Motors would like to register its concern and strong opposition to the Administration's proposed modifications to the so-called "Morris Trust" provisions of section 355 of the Internal Revenue Code, and especially to the Administration's proposed effective date for these modifications. If enacted and with the effective date as proposed by the Administration, these modifications would adversely impact a major pending transaction which General Motors has publicly announced, i.e., the spin-off of its defense electronics subsidiary Hughes Aircraft Company, followed by Hughes Aircraft's merger with the Raytheon Company.

The specific Administration provision of concern is the proposal to modify Code Section 355, which currently permits certain corporate spin-offs without taxation, to require a continuing minimum 50% level of both voting and equity shareholder interests for two years before and after a spin-off in order for tax-free treatment to apply. Of particular concern, the provision would be effective for distributions after the date of first committee action in Congress.

Background

On January 16, 1997, General Motors announced a series of transactions designed to address strategic challenges and to unlock shareholder value in its defense electronics, automotive electronics, and telecommunications and space business sectors. As a part of this, Hughes Aircraft, the defense electronics subsidiary of GM's Hughes Electronics Corporation, will be spun-off and immediately thereafter merged with Raytheon Company. This merger is considered by General Motors and Hughes management as essential for the Hughes defense business to be competitive in the defense industry, which is in the latter stages of a major consolidation that began several years ago and recently accelerated. The industry consolidation has been encouraged by the U.S. Department of Defense.

After the spin-off and merger with Raytheon, Hughes shareholders would have a continuing 80.1% voting interest and a continuing 30% equity interest. These transactions are covered by a legally binding contract, but their completion is contingent upon customary transaction conditions, including:

- Receipt of favorable tax rulings from the IRS;
- Receipt of anti-trust clearances; and
- Receipt of shareholder approvals.

Based on the above, the pending Hughes/Raytheon transactions would satisfy the continuing 50% voting requirement, but not the 50% equity requirement. Also the current effective date proposed by the Administration would not exclude these pending transactions from the new requirements since Congressional committee action will likely occur before the necessary approvals are secured and the transactions are completed. Thus, the Administration's proposal to change Code section 355 combined with the proposed effective date would almost certainly cause the pending Hughes/Raytheon transaction to become a taxable event to General Motors, and thereby effectively preclude General Motors and Raytheon from proceeding with the transaction.

Discussion

General Motors believes the Administration's proposed changes to Code section 355 should not be adopted in their present form. Under current law, a Morris Trust transaction is the only way for one corporation to combine tax-free with less than all of another corporation. This flexibility is particularly important when one would-be merger partner does not want to or cannot combine with the other would-be merger partner if such corporation continued to hold the business being spun-off. For example, the first merger partner may not be qualified to manage certain businesses, or may be prohibited because of regulatory or other reasons from owning such businesses.

Over thirty years of settled tax and business practice with respect to Morris Trust transactions has demonstrated that such transactions are in no sense abusive, but rather are an efficient means of rearranging and recombining corporate assets. The proposed legislation would make it significantly more costly for businesses to rearrange their component parts in an efficient manner. In increasingly competitive global markets and with the need to reduce government spending through less costly operations of defense contractors, the efficiency of domestic businesses should be encouraged, not discouraged.

The tax imposed by the proposed legislation would be unwarranted as a policy matter. The shareholders would continue to own a share of what they previously owned without any increase in tax basis; thus, no one would escape any shareholder-level tax. Moreover, all assets that were previously held in corporate solution continue to be held in corporate solution without any increase in tax basis. No owners of these businesses have received income that has escaped tax, and no corporation has escaped any corporate-level tax. As a result, the Administration's proposal to deny tax-free treatment to a Morris Trust spin-off would cause the assets underlying the spun-off corporation effectively to be subject to three levels of tax, i.e., tax would be imposed on (i) the distributing corporation, (ii) the spun-off corporation when such corporation sells its assets, and (iii) the spun-off corporation's shareholders when such shareholders sell their shares of the spun-off corporation. Taxation without a corresponding basis adjustment violates the basic tenet of tax symmetry, and the resulting imposition of three levels of tax on the same economic income is not a sound policy goal.

As to the effective date, the Administration's same proposal in last year's Budget to modify Section 355 would have excluded transactions that were publicly announced, under a binding contract, or pending the receipt of tax clearances at the proposed effective date. Similarly, fair tax policy this year should exclude transactions pending as of the effective date, e.g., date of first committee action, from any change to section 355. This is necessary so as not to disrupt current market activities and normal business transactions, such as the pending Hughes/Raytheon merger that is part of the ongoing consolidation of the defense industry. S. 612 and H.R. 1365 introduced on April 17, 1997, (and clarified on April 18, 1997) by Senate Finance Committee Chairman Roth, Senator Moynihan and Ways and Means Committee Chairman Archer to amend Section 355, provide transitional exemptions for distributions made pursuant to, or described in, certain binding written agreements, ruling requests filed with the IRS, SEC filings and public announcements. This is the appropriate concept for establishing an effective date for any changes to Section 355.

In summary, General Motors believes the Administration's proposed changes to Code section 355, as currently offered, should not be adopted. However, if Section 355 is modified, General Motors strongly urges that the changes be made prospective in application so as not to affect pending transactions which have relied on long-standing, settled tax law and business practice.

Statement for the Record
on Hearings Before
the Committee on Finance
United States Senate
on the President's Fiscal Year 1998 Budget
April 17, 1997

Submitted by
the International Swaps and Derivatives Association, Inc.
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The International Swaps and Derivatives Association, Inc. ("ISDA") is an international trade association whose membership includes 316 of the largest commercial, merchant and investment banks, corporations and other institutions that are engaged in privately negotiated derivatives transactions. ISDA is, therefore, vitally concerned about the effects of a proposal included in the President's budget that would "Require Recognition of Gain on Certain Appreciated Positions in Personal Property" (the "Proposal"). The Proposal would effectively impose a new tax regime on certain hedging transactions and thus would seriously affect use of derivatives transactions in hedging by businesses and investors.

The Proposal would require a taxpayer to recognize gain (but not permit recognition of loss) upon a "constructive sale" of any appreciated position in stock, a debt instrument or a partnership interest. A constructive sale would occur when the taxpayer or a related person either (a) "substantially eliminates" risk of loss and opportunity for gain by entering into one or more positions with respect to the same or "substantially identical" property, or (b) enters into a transaction that is marketed or sold as being economically equivalent to eliminating the risk of loss and opportunity for gain, regardless of whether the transaction involves the same or substantially identical property. The Proposal is retroactive, because it applies to constructive sales entered into after January 12, 1996 and before the date of enactment, if the transaction resulting in the constructive sale remains open 30 days after the date of enactment.

ISDA strongly opposes the Proposal, for the following reasons, which are explained in more detail in this statement:

- Although the Proposal was motivated by certain well-publicized transactions that are perceived by some as abusive, including "short-against-the-box" sales of stock, the Proposal is much broader than necessary to deal with those transactions. The Proposal potentially applies to a variety of legitimate hedging techniques used by investors and businesses to manage risk. Current law rules applicable to taxpayers that enter into straddles and similar transactions--including Sections 1092, 263(g) and

1258 of the Internal Revenue Code--adequately address transactions that use offsetting positions to manipulate the timing and character of income.

- The Proposal, at least as it applies to derivatives transactions, is based on a flawed analogy between hedging transactions and sales. An actual current sale of stock owned by a taxpayer involves a current transfer of stock, including the risks and rewards of stock ownership, by the taxpayer-seller to a new stock owner in exchange for cash. In contrast, a taxpayer in a typical hedging transaction does not transfer stock to a new owner, reduces risk only temporarily, receives no immediate cash payment and incurs counterparty credit risk. As a result, the position of a taxpayer that has entered into a hedging transaction treated as a "constructive sale" under the Proposal is quite different from the position of a taxpayer that has actually sold a financial instrument.

- The Proposal represents a major departure from the fundamental tax principle that capital gains must be realized before they are taxed. The realization requirement is essential to the administration and perceived fairness of the federal income tax system. Any exception to the realization requirement--particularly one that is as broad and unclear in scope as the Proposal--should be adopted only after careful and thorough consideration.

- The Proposal will discourage economically useful risk management transactions, and thus may reduce both economic efficiency and market liquidity, while increasing market volatility.

- The Proposal is so vague and uncertain in its scope that it will be difficult or impossible to administer in certain cases. If the Proposal is enacted and is not limited to short-against-the-box transactions, we strongly urge that it not apply to other transactions until after the Treasury Department has issued regulations resolving a number of technical issues.

- Even apart from the merits of the Proposal, retroactive application would be unfair, and the threat of retroactive application will disrupt normal market activities and business transactions. We respectfully suggest that the Chairman of the Finance Committee announce that, if the Proposal is approved by the Committee, it will be prospective only.

I. PROPOSAL IS MUCH BROADER THAN NECESSARY TO DEAL WITH TRANSACTIONS PERCEIVED AS ABUSIVE

The Proposal is directed at so-called short-against-the-box sales in which a taxpayer that owns appreciated stock borrows identical stock and then sells the borrowed shares, rather than the appreciated shares already owned, thus recognizing no gain or loss. In such a transaction, the taxpayer completely eliminates any risk of loss or potential for profit from changes in price, and does so for an indefinite term. If the taxpayer is an individual, and dies owning the stock that was sold short, the unrealized appreciation in that stock is never taxed because the basis of the stock is increased to its fair market value at death. The Proposal was motivated, in particular, by well-publicized transactions in which individuals have engaged in short-against-the-box sales, intending to benefit from this "step-up" in tax basis of the hedged shares at their death. The Proposal would treat the sale of the borrowed shares in a short-against-the-box transaction as a constructive sale of the appreciated shares already owned.

Although it is targeted primarily at short-against-the-box sales by individuals, the Proposal adopts rules that apply much more broadly. The Proposal applies to transactions in which--in contrast to a short-against-the-box sale--the taxpayer has not actually sold any property, but instead has merely used various contractual arrangements to hedge the risk of holding property for a limited time period. Such contracts include equity swaps, which provide for payments based on changes in the value of (and, sometimes, dividends from) the property. Thus, the Proposal would treat a taxpayer that enters into an offsetting position to hedge the risk of holding a security as having sold that security.

The Proposal also applies to positions in financial instruments other than stock, including positions in debt and partnership interests. We are particularly concerned about the Proposal's potential application to debt instruments. Targeting debt instruments is especially misguided because, so far as we know, there is no evidence that transactions involving debt instruments are tax motivated in the way that some short-against-the-box transactions in stock are perceived to be. Moreover, the potential scope of the Proposal as applied to debt instruments is particularly unclear and broad. Based on the statutory language released in March 1996 with President Clinton's proposed Fiscal Year 1997 budget, it appears that if a taxpayer owning an appreciated bond enters into an interest rate swap having roughly the same term as the remaining term of the bond, the taxpayer would be treated as having constructively sold the bond.

We believe that current law is adequate to prevent use of offsetting positions to manipulate the timing and character of income. Congress has already enacted a number of provisions that serve to prevent such manipulation, including Sections 1092, 263(g) and 1258. Section 1092 defers a deduction for losses in certain straddles to the extent that a taxpayer has an unrealized gain in an offsetting position. Section 263(g) requires capitalization of costs to carry straddle positions. Section 1258 prevents use of forward sales to convert what might be viewed as equivalent economically to interest income into capital gain.

II. PROPOSAL IGNORES FUNDAMENTAL ECONOMIC DIFFERENCES BETWEEN HEDGING TRANSACTIONS AND ACTUAL SALES

The Proposal's application to equity swaps, forwards, options and other derivative contracts appears to be based on the premise that entering into these contracts is economically equivalent to an actual sale. This premise is incorrect and ignores a number of fundamental differences between a hedging transaction and an actual sale.

First, in a sale, the taxpayer exchanges its position for cash or other property, which it may then use as it pleases. In a hedging transaction, such as a swap or forward contract, the taxpayer does not receive cash. A hedger may have reduced its price or market risk, but the hedging transaction has not increased the hedger's liquidity. We recognize that a taxpayer may be able to realize cash by borrowing against the hedged item. However, a taxpayer can borrow against any appreciated marketable security. The ability to borrow does not distinguish a taxpayer that enters into an equity swap from a taxpayer holding an appreciated security that does not enter into a swap.

Second, in an equity swap or other derivative contract, the taxpayer retains "counterparty risk", meaning that it may not be paid if the counterparty to the contract defaults. Thus, the taxpayer is not fully insulated from market risk on its underlying hedged position. There is no similar risk faced by a taxpayer that sells its position (except in the case of a taxpayer that enters into an installment sales contract).

Third, in an actual sale there is a real transfer to a new owner of all the incidents of ownership of stock, including the right to vote the stock, the right to all dividends and the right to transfer the stock to a third party. In contrast, an owner of stock that enters into an equity swap, a forward contract, or a combination of options retains the right to vote the stock and generally retains the right to transfer the stock to third parties. The counterparty to the contract does nct receive these rights. In addition, an owner of stock that enters into a forward contract, a combination of options or an equity swap (other than a "total return" swap) retains the right to dividends.

Fourth, many derivatives used to hedge, including equity swaps, cash settled options and forward contracts, are temporary arrangements. A sale is a permanent disposition of a position. At the end of the equity swap, the taxpayer is in the same posture with respect to the hedged position as it was before the transaction. A short-term hedging transaction does not resemble an outright sale of appreciated property as an economic matter, even if the hedging transaction eliminates all the burdens and benefits of ownership for a limited time period. In an outright sale, in contrast, a taxpayer disposes of all the burdens and benefits of ownership forever.

III. PROPOSAL IS A BROAD AND UNPRECEDENTED DEPARTURE FROM THE REALIZATION REQUIREMENT, WHICH IS CRUCIAL TO THE ADMINISTRATION AND FAIRNESS OF THE TAX LAW

A fundamental principle of the income tax system is that gain from appreciation of an asset is generally subject to tax only when it is realized by sale or exchange. The realization requirement is essential to the administration and fairness of the income tax system. The realization requirement ensures that taxpayers (and the Internal Revenue Service) know when tax is due. In general, gain is realized when, but only when, a taxpayer receives cash or property in exchange for appreciated property. The realization requirement generally also ensures that taxpayers have the ability to pay tax, because tax is imposed only when a taxpayer has received cash or property that can be used to pay the tax.

Although Congress has enacted several exceptions to the realization requirement, those exceptions have been both narrow and precise. The exceptions include Sections 1256 and 475. Each of these exceptions applies to very limited classes of taxpayers and positions, and each was based on a rationale that does not generally apply to positions subject to the Proposal.

Section 1256 generally requires mark-to-market accounting for regulated futures contracts and certain other narrowly defined categories of positions, including foreign currency contracts, nonequity options and dealer equity options. The legislative history of Section 1256 states that mark-to-market accounting was justified for regulated futures contracts because, under the rules of U.S. commodities exchanges, holders of such contracts can withdraw cash on a daily basis as their positions appreciate, and thus are in constructive receipt of appreciation. In contrast to appreciation in regulated futures contracts, appreciation in positions subject to the Proposal cannot be realized in cash, other than by borrowing. The mere ability to borrow against an appreciated position has never before been seen to justify taxation of that appreciation, and the ability to borrow does not distinguish positions subject to the Proposal from any position in marketable securities.

Section 475 generally requires taxpayers classified as dealers in securities to use mark-to-market accounting for their positions in securities. The legislative history of Section 475 explained that this requirement was justified for dealers because inventories of securities "are currently valued at market in determining their income for financial statement purposes and in adjusting their inventory using the LCM method for Federal income tax purposes". This rationale does not generally apply to taxpayers and positions that would be subject to the Proposal.

Each of Sections 1256 and 475 was enacted only after exhaustive review by Congress, the staffs of the tax writing committees and experts in the Treasury and the Internal Revenue Service. Each of these two sections applies to losses as well as to gains. In contrast, the Proposal would, if enacted, impose a partial mark-to-market regime for gains--but not losses--in certain hedging transactions without the benefit of such review and debate.

IV. PROPOSAL WILL DETER ECONOMICALLY USEFUL RISK MANAGEMENT

The Proposal will discourage investors and businesses from prudent risk management by imposing tax when they enter into certain kinds of hedging transactions. Risk management through temporary hedging is useful economically for a number of reasons. First, it increases the efficiency of markets by disseminating pricing information more widely and more rapidly than would be the case in the absence of hedging. Second, it reduces the volatility of markets. Third, it increases the liquidity of markets. The economic benefits produced by hedges of equity positions are analogous to the economic benefits that result when businesses hedge price, interest rate and currency risk through commercial hedging transactions. In both cases, hedging, like insurance, allows risks to be reallocated to those market participants that can bear them most efficiently.

The economic value of hedging has been recognized by both Congress and the Treasury Department. Commercial hedging transactions are excepted from the mark-to-market rules under Section 1256 and the straddle rules of Sections 1092 and 263(g). There are also special rules for hedges under Section 475, and the economic benefits of hedging are acknowledged in the legislative history of that section. In addition, hedging regulations promulgated within the past few years, under Sections 1221 and 446, were intended to provide tax rules that do not discourage commercial hedges. In light of the recognized concern regarding possible tax impediments to hedging transactions, the potential application of the Proposal to legitimate hedges seems especially inappropriate.

We recognize that the Proposal would not impose tax on all hedging transactions. The Proposal would apply only where the taxpayer "substantially eliminates" risk of loss and opportunity for gain. Thus, a taxpayer that eliminates risk of loss by purchasing a put option, but retains opportunity for gain, would not be affected by the Proposal. Such hedging is frequently not practical, however. Taxpayers often cannot afford to purchase temporary loss protection (e.g., by buying a put) unless they also temporarily sell at least some of the opportunity for gain by selling a call.

V. SCOPE OF PROPOSAL IS VERY UNCLEAR, MAKING ADMINISTRATION AND COMPLIANCE DIFFICULT

Based on the description of the proposal released by the President on February 6, the scope of the Proposal is uncertain. Extension of the Proposal beyond core cases (tax-motivated short-against-the-box transactions) creates significant ambiguity for transactions that may not be within the intended reach of the Proposal. The Proposal raises many complex interpretive questions and will create real uncertainties, which will result in market distortions and inefficiencies.

The financial markets have already witnessed the real economic costs that can result from a state of uncertainty in the tax treatment of common hedging transactions. Such uncertainty resulted from the Supreme Court's decision in Arkansas Best v. Commissioner, 485 U.S. 212 (1988), and was remedied only by the Treasury Department's issuance of regulations in 1993 clarifying the treatment of business hedges (Treasury Regulation Section 1.1221-2). In the interim, this uncertainty discouraged economically useful hedging transactions, resulting in inefficiencies that were recognized in the Conference Committee's report on the Revenue Reconciliation Act of 1993.

We are concerned that these uncertainties may be inherent in the Proposal, at least in its current broad form, and will not easily be resolved as statutory language is drafted. Our concerns are borne out by the statutory language released in March 1996 with President Clinton's proposed Fiscal Year 1997 budget, which included a proposal very similar to the Proposal.

The Proposal does not achieve its goal of clearly identifying a specific class of transactions that are economically equivalent to actual sales. Uncertainties arise in a number of different respects.

First, the Proposal, in its current broad form, requires a determination of whether a particular transaction "substantially eliminates the taxpayer's risk of loss and opportunity for gain" with respect to a position. Neither the Proposal, nor the statutory language released in March 1996, gives any guidance as to the degree to which a taxpayer must shift risk of loss and opportunity for gain before they are "substantially eliminated". Has a taxpayer substantially eliminated opportunity for gain if it retains the first 5% of price appreciation? the first 10%? the first 25%? Is there a constructive sale if the taxpayer retains a significant portion of the upside (or downside) potential, but not the first portion (e.g., the taxpayer retains the benefit of appreciation of between 15% and 30%)?[1]

Second, it is not clear whether the Proposal applies if a taxpayer retains the right to dividends and enters into option contracts, a forward contract or an equity swap that provides for payments based only on price changes. Arguably, application of the Proposal in these cases should depend on whether dividends are a substantial part of the expected return from the stock. In the case of a nondividend paying stock, retention of the right to dividends may be insignificant.

In contrast, if the owner of a dividend-paying stock retains the right to dividends, it cannot be said to have substantially eliminated risk of loss and opportunity for gain. For example, a forward contract to sell a dividend-paying stock does not substantially eliminate opportunity for gain unless the forward price provides for adjustment to reflect actual dividend payments. Similarly, put and call options with strike prices that are not adjusted to take into account actual dividends do not eliminate risk of loss and opportunity for gain if the underlying stock pays dividends.

A taxpayer that enters into a forward contract to sell a dividend-paying stock is in a significantly different economic position compared to a taxpayer that actually sells the same stock. The price at which an actual sale takes place is the price in the cash (or "spot") market. In contrast, the pricing of forwards (as well as options and certain swaps) reflects pricing in the forward market. There are significant differences in pricing in these two markets. The forward price of a financial instrument is based both on the cash price and on the expected net cost to carry the instrument during the period ending on the settlement date. The net cost to carry an instrument is equal to the excess of the cost of financing a position in the instrument over the return from the position (including dividends). Because of the cost-to-carry factor, and the resulting pricing differences between the cash and forward markets, a taxpayer that hedges with certain derivatives has not substantially eliminated risk of loss and opportunity for gain.

Third, there is uncertainty as to how the Proposal would apply to swaps involving the return from a market sector or a broader market index. For example, an investor might exchange the return

[1] If a provision similar to the Proposal is enacted, we urge that Congress include in the legislative history examples to clarify that a taxpayer in the following situations has not constructively sold stock because it has retained meaningful benefits and burdens of ownership. First, a taxpayer who owns stock worth $100 buys a put with a strike price of $95 and sells a call with a strike price of $105. Second, the same taxpayer buys a put at $100 and sells a call with a strike price of $110. Third, the same taxpayer buys a put with a strike price of $105 and sells a call with a strike price of $115.

from a single equity for the return from a market sector or broad market index that includes the single equity, in order to diversify risk. Alternatively, an investor might enter into a swap under which it pays the return from a portfolio of stocks that includes a stock in which the investor holds an appreciated long position. In these transactions, would the Proposal be applied by decomposing the index or portfolio, so that the swap is treated as separate swaps on each of the equities that make up the index or portfolio? We note that the Treasury Department has issued regulations under Section 246, which provide complex rules to address analogous issues.

Fourth, it is not clear from the Proposal or the March 1996 statutory language how long the term o:'the hedging transaction must be before the Proposal applies. Under the statutory language released in 1996, a constructive sale would occur if a taxpayer substantially eliminates risk of loss and opportunity for gain "fcr a period". This is vague language. Does it mean that constructive sale treatment applies if a taxpayer has substantially eliminated risk of loss and opportunity for gain for a very short time period? for a day? for a week?

We believe that the Proposal should be clarified so that no constructive sale is deemed to have occurred unless the taxpayer has substantially eliminated risk of loss and opportunity for gain for a specified time period that is substantial. Such a limitation is consistent with the purposes of the Proposal. Taxpayers that wish to achieve the equivalent of an actual sale are more likely to use very long term contracts, because such contracts most closely approximate the elimination of price risk that results from an actual sale.

Fifth, it is not clear how much weight, if any, is to be given to counterparty credit risk in determining whether the "substantially eliminates" test is met.

Sixth, it is not clear what, if any, significance is to be given to the taxpayer's lack of subjective intent to use a transaction to eliminate risk with respect to an appreciated long position. In the case of a derivative that is marketed to a taxpayer as eliminating risk of loss with respect to a particular long position, the taxpayer's subjective intent is clear. In many other cases, particularly in cases involving groups of related business entities, there may be no subjective intent to eliminate risk of loss. Frequently, affiliated groups of corporations include a number of different business units that operate largely independently. One unit may enter into a derivative contract either as a speculation or a hedge of its own position, without knowing that the derivative has the effect of hedging the risk from a position held by another business unit in the same affiliated group.

These issues are particularly likely to arise in the case of debt instruments. Consider for example, an affiliated group of corporations, one of which owns appreciated investment grade debt securities. Another member of the group enters into an interest rate swap in order to hedge a future borrowing. The Proposal, in contrast to Sections 1256 and 1092, provides no exception for such business hedging transactions, and it appears (based on the March 1996 statutory language) that the Proposal could treat the swap as a constructive sale of the debt securities.

The foregoing questions are not hypothetical. If the Proposal is enacted in its current broad form, all the issues discussed above will arise immediately from transactions that already are widely used in the market. It can be expected that taxpayers and their advisors will, quite reasonably, take a wide variety of positions as to how these issues should be resolved, and thus as to whether the Proposal applies to very common transactions. We submit that such uncertainty will seriously undermine confidence in the fairness and predictability of the law.

Some supporters of the Proposal might seek to dismiss our concerns on the ground that uncertainty will create a useful in terrorem effect. Those supporters may believe that uncertainty about the scope of the Proposal will deter taxpayers from entering into any transaction that, under the broadest possible reading of the Proposal, would be a constructive sale. If the Proposal were in fact to have such effects, the Proposal would discourage economically useful transactions that the Proposal was not intended to cover. However, we do not believe that all taxpayers will necessarily construe the Proposal so broadly; in the absence of clear answers, taxpayers likely will take a variety of positions. More conservative taxpayers and their advisors are likely to construe the Proposal broadly, while more aggressive taxpayers and advisors will take the position that the scope of the Proposal is very narrow. Vague and poorly defined provisions, such as the Proposal, thus tend to put conservative taxpayers and their advisors at a competitive disadvantage.

We note that the issues summarized above are analogous to difficult technical issues that arise under Section 246(c)(4), which denies a corporation the deduction for dividends received with respect to stock if that corporation hedges its risk of loss from holding that stock in certain ways. Sections 246(c)(4)(A) and (B) may effectively deny the dividends received deduction if the taxpayer has an option to sell, is under a contractual obligation to sell, has made a short sale of, or grants an option to buy, substantially identical stock and securities. Section 246(c)(4)(C) may effectively deny the dividends received deduction if a taxpayer has diminished its risk of loss by holding one or more other positions with respect to substantially similar or related property. Whether Sections 246(c)(4)(A) and (B) apply to a particular case generally is clear, and thus these rules took effect prior to issuance of regulations. In contrast, the scope of Section 246(c)(4)(C) is vague and poorly defined. Accordingly, Congress wisely provided that Section 246(c)(4)(C) was to take effect only under regulations. We strongly urge that, if the Proposai is to apply to transactions other than short-against-the-box transactions, any such broader application not take effect until regulations are issued addressing the technical issues summarized above.

VI. RETROACTIVE APPLICATION IS UNFAIR AND DISRUPTIVE

Although the Proposal generally would be effective for constructive sales entered into after the date of enactment, the Proposal also would apply to constructive sales entered into after January 12, 1996 and before the date of enactment if the transaction resulting in the constructive sale remains open 30 days after enactment. In such a case, the constructive sale is deemed to occur on the date that is 30 days after enactment.

ISDA strongly opposes the Proposal's retroactive application.

Retroactive application of the Proposal would be contrary to a joint statement issued March 29, 1996 by the chairs of the Senate Finance Committee and the House Ways and Means Committee. The Proposal's retroactive effective date is the same as that of the similar proposal included in President Clinton's proposed Fiscal Year 1997 budget, which was released on March 19, 1996. Shortly after that budget was released, Ways and Means Committee Chair Bill Archer and Finance Committee Chair William Roth stated that new revenue provisions would be effective no earlier than the date Congress approves them. They said that the effective dates would be delayed "so that business and investment decisions can move forward while Congress considers the merits of the administration's tax proposals".

Accordingly, businesses and investors have entered into transactions that might constitute constructive sales under the Proposal, believing that those transactions would continue to be subject to existing law. Although a taxpayer theoretically can close a transaction within 30 days after the date of enactment, and avoid the Proposal, sometimes it is not possible to do so. Although a taxpayer can close a short-against-the-box transaction by delivering shares, a taxpayer that has entered into a derivative contract generally cannot do so without the consent of the counterparty. Generally change to, or termination of, a swap, option or forward contract of the kind entered into by ISDA's members requires the consent of the other party to the contract. Even if it were practical for a taxpayer to terminate a contract within 30 days after enactment of the Proposal, it would be unfair to require a taxpayer to do so to avoid taxation. A taxpayer entering into a derivative contract agrees to pricing and other terms based on the assumption that the contract will remain in effect for its full term, and arranges its risk management strategies accordingly.

Release of the Proposal on February 6 with a retroactive effective date may already be disrupting normal business transactions. We are concerned that many taxpayers contemplating entering into derivative contracts to manage risk are unwilling to do so because they cannot predict the tax consequences of those transactions.

Committee on Finance

United States Senate

Hearing on Revenue Raising Provisions in the
Administration's Fiscal Year 1998 Budget Proposal
April 17, 1997

Statement for the Record
By the Interstate Natural Gas Association of America

Submitted
April 17, 1997

I. The Interstate Natural Gas Association o* America and The Foreign Pipeline Projects of Its Members.

The Interstate Natural Gas Association of America ("INGAA") is a non-profit national trade association that represents virtually all of the major interstate natural gas transmission companies operating in the United States. These companies handle over 90 percent of all natural gas transported and sold in interstate commerce. INGAA's United States members are regulated by the Federal Energy Regulatory Commission pursuant to the Natural Gas Act, 15 U.S.C. §§-717-717w, and the Natural Gas Policy Act of 1978, 15 U.S.C. §§-3301-3432.

In recent years a number of INGAA's members have become engaged in the design, construction, engineering, ownership and operation of major pipeline and power plant projects outside the United States. Investments are made in these foreign projects generally by foreign subsidiaries of the U.S. companies. These projects, which are highly capital-intensive, often involve construction of a natural gas pipeline and related facilities to transport gas from its point of extraction within one or more foreign countries to an electric generating facility for use as fuel in the generation of power or for local distribution. The project may include the generating plant, and in some cases may also include an interest in the gas wells which provide the gas supply. The gas being transported in the pipeline may or may not be owned by the pipeline owner. Most of these projects are being undertaken in Latin America, Asia, India and in less developed countries in other parts of the world.

Most of these large energy projects are awarded through a bidding process. The bidding is highly competitive, and the economics of such projects are tax sensitive. In many cases there is substantial income tax payable to the local country where the project is based. U.S. bidders are currently at a disadvantage vis-a-vis their foreign competitors, including particularly those based in Canada, Australia, or Europe, because of the manner in which U.S. tax law currently applies to such projects, as is explained below.

The Administration's proposal to revise the tax treatment of foreign oil and gas income (the "Proposal") would, if enacted, have a substantial adverse effect on the ability of INGAA members to compete for these projects, and would drastically affect the economics of projects already undertaken, resulting in losses and adverse financial statement effects to INGAA members. As this testimony will demonstrate, the Proposal has no tax policy justification, but is simply a targeted tax increase that would seriously affect INGAA members with foreign pipeline operations. INGAA recommends that Congress reject the Proposal. Moreover, INGAA recommends that the taxation of foreign oil and gas income be reformed by Congress to eliminate certain clear inequities of current law as applicable to foreign pipeline projects.

II. The Administration's Proposal.

On February 6, 1997 the Administration put forth the Proposal, which would result in a substantial change in the taxation of foreign oil and gas income. Briefly, the Proposal would treat all foreign income earned by a controlled foreign corporation ("CFC") relating to oil and gas activities, including income from the transportation of gas through a pipeline, as being subject to current U.S. taxation pursuant to Subpart F, even though not repatriated to the U.S. shareholders of the CFC. Moreover, the foreign income taxes paid with respect to that income would be subject to a separate foreign tax credit limitation instead of being included as part of the "general basket" of active income.

In the General Explanation of the Proposal the Treasury Department does not articulate any reason for taxing all foreign oil and gas income currently under Subpart F, or for creating a separate basket for foreign oil and gas income under the foreign tax credit limitation. Treasury's "Reasons for Change" addresses only the issue of whether or not a foreign tax should be creditable. The absence of a stated Treasury tax policy rationale for the Proposal should raise a question as to whether any such rationale exists.

In its Description and Analysis of Certain Revenue-Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposal, issued March 12, 1997, the Staff of the Joint Committee on Taxation identified "simplification" as a possible rationale for both the Subpart F and the foreign tax credit features of the Proposal.[1] However, the Joint Committee Staff identified a powerful counter-argument to the Subpart F proposal:

> [O]thers argue that the proposed expansion of the subpart F rules is inconsistent with the tax policy underlying such provisions. The subpart F rules historically have been aimed at requiring current inclusion of income of a CFC that is either passive or easily movable. The categories of foreign oil and gas income that would be added to subpart F income under the proposal (i.e., foreign oil and gas extraction income and certain same-country

[1] Description and Analysis of Certain Revenue-Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposal, prepared by the Staff of the Joint Committee on Taxation for a Public Hearing Before the House Committee on Ways and Means on March 12, 1997, 105th Cong. 1st Sess. at 66 (1997).

foreign oil related income) do not constitute income that is either passive or manipulable as to location.[7]

INGAA concurs with this analysis. There is no policy justification for treating active income earned by a CFC from transporting locally extracted natural gas through a pipeline, whose location cannot be manipulated, as Subpart F income. Nor is there any tax policy reason to separate foreign oil and gas transportation income from other active income for purposes of the foreign tax credit limitation.

In this testimony INGAA will describe current law, illustrate the inequity of current law to INGAA members, and then further illustrate how the Proposal would greatly exacerbate this inequity.

III. U.S. Taxation of Foreign Pipelines Under Current Law.

A. Subpart F.

1. Description of Current Law.

Under the Subpart F rules, U.S. 10 percent shareholders of a CFC are subject to U.S. tax currently on their proportionate shares of "Subpart F income" earned by the CFC, whether or not it is distributed to the U.S. shareholders. Included among the categories of Subpart F income is "foreign base company oil related income." See section 954(g). Foreign base company oil related income is income derived outside the United States from the processing of minerals extracted from oil or gas wells into their primary products; the transportation (including by pipeline), distribution or sale of such mineral or primary products; the disposition of assets used in a trade or business involving the foregoing; or the performance of any related services.

There are two significant exceptions to this classification of income.

a. The extraction exception: Income, including income from operating a pipeline, derived from a source within a foreign country in connection with oil or gas which was extracted by any person from a well located in such foreign country is not foreign base company oil related income.

b. The consumption exception: Income, including income from operating a pipeline, derived from a source within a foreign

[7] Id. (Emphasis added).

country in connection with oil or gas (or a primary product thereof) which is sold by the CFC or a related person for use or consumption within the foreign country is not foreign base company oil related income.

There is a general exception to this Subpart F provision for CPCs which do not produce 1,000 barrels per day of foreign crude oil and natural gas; this exception is often not available because for this purpose all related persons are aggregated, and many significant investors in natural gas pipelines and power projects around the world own foreign production which exceeds 1,000 barrels per day.

c. Unavailability of high tax exception: All types of foreign base company income except foreign oil related income may be excluded from current taxation under Subpart F if the income is subject to an effective rate of local income tax greater than 90 percent of the U.S. corporate rate. Section 954(b)(4). No reason is given in the legislative history as to why this high tax exception is not applicable to foreign oil related income. Because Congress chose not to allow this exception, highly taxed income from the operation of foreign pipelines by a CFC may be subject to current U.S. tax under Subpart F, with a likelihood that credit will not be available for the foreign income tax paid and international double taxation will occur.

2. Tax Policy Rationale of Current Law.

The Subpart F taxation of foreign oil related income was enacted in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), P.L. 97-248, September 3, 1982. The Senate Finance Committee legislative history explaining the tax policy rationale for the Subpart F treatment of foreign oil and gas income is as follows:

> because of the fungible nature of oil and because of the complex structures involved, oil income is particularly suited to tax haven type operations.

S. Rep. No. 494, 97th Cong., 2d Sess. 150 (1982).

The only other reference made in the legislative history of TEFRA to any reason for including foreign oil related income in Subpart F is the general statement of the Finance Committee that "the petroleum companies have paid little or no U.S. tax on their foreign subsidiaries' operations despite their extremely high revenue." Id. Accordingly, Subpart F taxation was imposed on all foreign oil related income without analysis of whether such income fit the criteria of Subpart F, i.e., was passive in nature or moveable. Income from the ownership and operation of foreign gas pipelines is neither passive or moveable. Moreover, it is unlikely that such income could have been a target of TEFRA since there was little foreign pipeline investment by U.S. companies at that time.

B. Foreign Tax Credit.

U.S. persons are subject to U.S. income tax on their worldwide income. To eliminate international double taxation, i.e., the taxation of the same income by more than one tax authority, the United States allows a credit against the U.S. tax on foreign source income for foreign income taxes paid. The amount of credits that a taxpayer may claim for foreign taxes paid is subject to a limitation intended to prevent taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. The foreign tax credit limitation is calculated separately for specific categories of income. Generally speaking, the foreign income activities conducted by INGAA members, such as operating pipelines to transport natural gas in foreign countries, produce "active basket" (sometimes referred to as "general basket") foreign source income. Income from the extraction of oil and gas is also generally "active basket" income, although foreign oil and gas extraction income taxes are creditable only to the extent that they do not exceed 35 percent of the extraction income.

The "separate basket" approach of current law was instituted in the Tax Reform Act of 1986. In 1986 Congress expressed a concern that the overall foreign tax credit limitation permitted a "cross crediting" or averaging of taxes so that high foreign taxes on one stream of income could be offset against U.S. tax otherwise due on only lightly taxed foreign income. Nevertheless, in 1986 Congress endorsed the overall limitation as being "consistent with the integrated nature of U.S. multi-national operations abroad," and therefore concluded that averaging credits for taxes paid on active income earned anywhere in the world should generally be allowed to continue. General Explanation of the Tax Reform Act of 1986, 99th Cong., 2d Sess. 862 (1986) ("1986 Blue Book"). Congress limited the cross crediting of foreign taxes when it would "distort the purpose of the foreign tax credit limitation." Id. For example, one identified concern was the use of portfolio investments in stock in publicly-traded companies, which could quickly and easily be made in foreign countries rather than in the United States. In order to limit the opportunities for cros ı-crediting, Congress added additional baskets for income that frequently either bore little foreign tax or abnormally high foreign tax, or was readily manipulable as to source. The baskets enacted in 1986 included passive income, financial services income, shipping income, high withholding tax interest, and dividends from non-controlled section 902 corporations. H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. 564-66 (1986).

IV. Current Law is Unfair to INGAA Members Which Participate in Pipeline Projects Abroad.

A. Subpart F.

As described above, CFCs owned by INGAA members participate in large foreign projects which typically involve the construction and operation of gas pipelines and related facilities, sometimes include the participation in power plants, and occasionally also include investment in gas wells. These are all active business activities which have occurred only in recent years. As illustrated by the legislative history of TEFRA, Congress expressed no policy reason why this type of income should be currently taxed to U.S. shareholders of a CFC under Subpart F. This foreign income of CFCs owned by INGAA members is no more "particularly suited to tax haven operations" (as the Senate Finance Committee Report states) than is any foreign manufacturing or processing activities conducted by a CFC, such as the manufacture of consumer or industrial goods. Surely it is not possible to "manipulate" income earned by a CFC from operating a gas pipeline permanently installed in a particular foreign country.

Most U.S. bidders have generally only won projects where either the "extraction" or "consumption" exceptions applied. If a pipeline project does not qualify for one of these exceptions to Subpart F it is unlikely that a U.S. bidder could successfully win a bid for that project against foreign competitors. Such a U.S. bidder is at a competitive disadvantage even for projects with local income taxes higher than the U.S. corporate rate because the Subpart F exception for high-tax income does not apply.

Moreover, the exceptions to Subpart F for foreign oil related income apply irrationally. Consider the example where gas is extracted and processed by persons unrelated to the CFC in country A. The CFC constructs a pipeline from country A through country B and into country C where the gas is delivered to a power plant. Assume that the CFC rēceives $100 for transportation of the gas in each of countries A, B, and C, and that each country imposes tax on the CFC of $35. The U.S. taxation of the $300 of income is as follows:

> Country A -- the $100 is not subpart F income because the extraction exception applies -- the income is derived from country A where the gas was extracted.
>
> Country B -- the $100 is Subpart F income, currently taxed in United States because the income is not earned either in a country where the gas was extracted (Country A) or consumed (Country C).

Country C -- the $100 is Subpart F income if the CFC does not own the gas but instead charges a tariff for transportation -- however, if the CFC takes title to the gas and sells it in country C, the consumption exception applies and the $100 is not Subpart F income.

As a matter of tax policy, different tax treatment of each separate $100 of income cannot be justified. It is submitted that none of this $300 of income should be Subpart F income because it is not passive or moveable. At the very least, the consumption exception should apply to the income earned in Country C irrespective of whether the CFC owns the gas, since the gas is consumed in Country C. (Such application would make the consumption exception operate in the same manner as the extraction exception, where ownership of the gas by the CFC is irrelevant). In addition, under current law the high-tax exception does not apply to exempt the income earned in Countries B and C from Subpart F -- this is also incorrect as a tax policy matter.

Note that if the CFC also participates in ownership of the power plant, income from that activity is not Subpart F income.

B. Foreign Tax Credit.

Under current law, all income from the transportation of natural gas through a foreign pipeline is active basket income. This is clearly the correct result. INGAA members, however, are frequently in an excess foreign tax credit position because of the substantial interest expense on debt incurred to finance domestic capital expenditures which is apportioned to foreign source income, reducing the numerator of the foreign tax credit limitation which in turn reduces the amount of the foreign tax credit. Thus, as a practical matter it is difficult for a U.S. pipeline company to obtain foreign tax credits with respect to the income earned from its foreign operations. In the example described above, although the $200 of income from Countries B and C would be subject to U.S. tax under Subpart F, it is unlikely that the $70 of foreign income taxes paid to Countries B and C would be available as a foreign tax credit. Thus international double taxation would result.

V. The Proposal Would Greatly Exacerbate The Unfairness Of Subpart F For Pipelines, Would Be A Substantial Tax Increase With Respect To Existing Projects, Would Materially Harm U.S. Businesses and Their Employees, And Would Not Achieve Simplification.

Under the Proposal all income of a CFC from the extraction, processing and transportation of gas in any foreign country would be subject to U.S. tax irrespective of whether any of the income is distributed to U.S. shareholders (and irrespective of whether it is subject to a high local income tax). In the example discussed above, $300 would be subjected to U.S. tax, and the $105 of foreign taxes paid with respect to the $300 (to countries A, B and C) would be subject to a separate foreign tax credit limitation. Income derived from the power plant would not be subject to current tax under Subpart F under the Proposal because it is not foreign oil and gas income. When the income from operating the power plant is distributed, however, it would be included in the general basket for purposes of the foreign tax credit limitation, not the new foreign oil and gas income basket which includes the pipeline income. Thus, the income from an integrated project would be divided into two baskets, a foreign oil and gas income basket for income from activities up to the delivery of the gas to the power plant, and a general basket for income from the operation of the power plant. It would be difficult and complex to separate out how much of a project's income is foreign oil and gas income, which would be currently taxed under Subpart F and subject to a separate foreign tax credit basket, and other income, which would not be Subpart F income and would be general basket income when it is eventually subject to U.S. tax. Certainly the Proposal cannot be justified as simplification; the result for INGAA members would be the antithesis of simplicity.

As articulated above, there is no tax policy basis for the current Subpart F taxation of income from the operation of foreign pipelines. The one sentence policy rationale in the legislative history of TEFRA certainly does not apply to foreign income from gas pipelines, as no "fungible" gas is involved, nor is a "complex structure" being used. Moreover, the Treasury Department did not even attempt to set forth a policy rationale for the Proposal in its General Explanation. The Joint Committee's Analysis could only identify "simplification" as a possible policy rationale for the Proposal. This rationale clearly does not apply to pipelines. Moreover, separation of foreign oil and gas income into a separate foreign tax credit limitation basket would be contrary to the basic general Congressional determination in 1986 that all active income from anywhere in the world should be included in one foreign tax credit limitation basket.[3]

[3] Shipping and financial services income, which are both active income, were subjected to separate basket treatment in 1986, either because the income "frequently" bore little foreign tax or abnormally high foreign tax or was manipulable as to source. 1986 Blue Book at 863-64. The income from operating foreign gas pipelines is not more frequently subject to either abnormally high or low foreign tax than manufacturing income, nor is it manipulable as to source.

The Proposal would materially harm U.S. businesses, affecting U.S. jobs and U.S. competitiveness in the global economy. The effect of the Proposal would be to preclude most U.S. investors from successfully bidding for the capital-intensive foreign pipeline projects. The current U.S. taxation of a project's income before its distribution, with little chance of obtaining a credit for foreign taxes paid on income from the project, would substantially impair the economics for a U.S. bidder. Thus, the Proposal would probably disqualify most U.S. companies from participating in foreign pipeline projects. This would have the effect of destroying a thriving business currently available to INGAA members. This business creates a demand for U.S. jobs, particularly engineering and support services, which is highly desirable in an industry where not many new pipeline projects are being undertaken in the United States. Moreover, auxiliary industries in the United States, such as the exportation of pipe and related materials and services, are benefitted by the participation by U.S. companies in these foreign projects. Elimination of most U.S. pipeline companies from participating in foreign pipeline projects seems to INGAA to be wholly counterproductive and misguided tax policy which would cost U.S. jobs.

In addition, the Proposal would apply to projects already completed and in operation. U.S. investors would therefore realize returns greatly different from their economic projections, with large losses likely and materially adverse financial statement impacts. Indeed, because of the likely significant losses, U.S. investors would most probably be required to sell to their foreign competitors those projects which the Proposal would make uneconomic. In short, enactment of the Proposal would create profound economic harm for INGAA members with foreign pipeline activities.

VI. Recommendations

A. Reject the Proposal.

The Proposal must be rejected because it is not firmly grounded in tax policy and would result in a catastrophic tax increase for INGAA members which own foreign gas pipelines.

B. Reform the Subpart F Taxation of Foreign Oil Related Income As It Applies to Gas Pipelines.

Current law includes all foreign oil related income as Subpart F income. It is INGAA's position that ownership and operation of gas pipelines and other immovable assets in foreign countries as described herein should never result in Subpart F income, whether or not the activities occur in a country where the gas was extracted or consumed, and whether or not the CFC takes title to the gas being transported, because these activities do not produce income which is passive or manipulable. At a minimum, as noted above the consumption exception should be amended to apply in the same manner as the extraction exception, i.e., its application should not be dependent upon whether the CFC takes title to the gas it is transporting. Moreover, the high-tax exception to foreign base company income should be amended so that it applies to foreign base company oil related income as it does to all other foreign base company income.

INGAA appreciates the opportunity to provide this testimony and would be pleased to furnish any information requested by the Committee.

STATEMENT
OF THE
INVESTMENT COMPANY INSTITUTE

ON REVENUE RAISING PROVISIONS IN
THE ADMINISTRATION'S FISCAL YEAR 1998 BUDGET PROPOSAL

SUBMITTED TO THE
COMMITTEE ON FINANCE
U.S. SENATE

APRIL 17, 1997

The Investment Company Institute (the "Institute")[1] submits for the Committee's consideration the following comments regarding proposals to (1) require sellers of securities to calculate gains and losses using an average cost basis, (2) increase the penalties under section 6721 for failure to file correct information returns, and (3) modify section 1374 of the Internal Revenue Code[2] to require current gain recognition on the conversion of a large C corporation to an S corporation.

I. Average Cost Basis For Securities

Background

Taxpayers who sell stocks or other securities generally calculate gain or loss on disposition by either specifically identifying the securities sold (the "specific identification" method) or treating the shares held longest as sold first (the "first-in-first-out" or "FIFO" method). Dispositions of shares in a regulated investment company ("RIC") also may be accounted for using either the single-category or double-category average cost basis method. Under the single-category average cost method, the basis of shares sold is calculated by adding together the amounts paid for all of the shareholder's investments in the RIC (total cost basis), subtracting the amount of basis attributable to prior redemptions and dividing the remainder by the total number of shares owned by the shareholder immediately prior to the redemption.[3]

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,226 open-end investment companies ("mutual funds"), 443 closed-end investment companies and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about $3.627 trillion, accounting for approximately 95% of total industry assets, and have over 59 million individual shareholders.

[2] All references to "sections" are to sections of the Internal Revenue Code.

[3] Treas. Reg. section 1.1012-1(e).

Proposal

The President's Fiscal Year 1998 budget includes a proposal which would require taxpayers to calculate gains and losses on dispositions of substantially identical securities, including shares of a RIC, using the single-category average cost basis method. The proposal would apply to securities sold more than 30 days after enactment of the proposal.

Recommendation

The Institute strongly opposes the average cost basis proposal. The proposal would increase taxes on securities investors, reduce incentives to save, discourage capital investment and complicate tax calculations.

By eliminating the present law option to specifically identify the securities sold, the proposal would increase taxes on securities investors. Millions of middle-income investors saving for retirement and other long-term objectives (such as college tuition for their children) would be disadvantaged by this proposal. By increasing taxes on investors, the proposal would reduce incentives to save and discourage capital investment. Moreover, the proposal would discourage reinvestment in successful companies, but would have no effect on those who purchase a particular type of security only once.

Requiring use of the average cost basis method also would complicate, rather than simplify, tax calculations. For example, if a RIC investor purchased shares and reinvested quarterly dividends for ten years, the investor's cost basis for a single share would not be the price paid for that share, but would instead be an average of 41 different purchases occurring over a ten year period. Holding RIC shares for longer time periods and/or purchasing shares more frequently, such as through a monthly periodic purchase plan or participation in a monthly dividend reinvestment plan, would increase significantly the complexity of these calculations.[4]

Complexity also would arise from the attribution rules that would be needed to prevent avoidance of the average cost basis requirement through the use of related persons and controlled entities. For example, attribution rules would be required to prevent avoidance by (1) having securities held by the taxpayer's children or other relatives, (2) holding securities in joint accounts, and (3) establishing separate partnerships, trusts and other entities to hold securities.

The proposal's effective date, applying to all securities sales more than 30 days after date of enactment, would retroactively affect in an adverse manner every investor who purchased securities when the specific identification method of determining cost basis was permissible. By applying to securities already held as well as shares purchased in the future, millions of RIC shareholders would be required to perform these detailed and cumbersome calculations. While many RICs now provide average cost basis information to their shareholders, they typically do so only for accounts opened after (or shortly before) the

[4] For example, an investor holding 41 different blocks of shares would compute an average cost basis by adding together the purchase prices for each of the 41 blocks of shares and dividing by the number of shares owned. Each additional purchase would require an additional calculation, which would increase the likelihood of arithmetic error.

implementation of a system for providing average cost basis information. The provision of average cost basis information to new accounts reflects the fact that RICs, as a practical matter, cannot accurately determine the average cost basis with respect to old accounts (1) from which shares were redeemed prior to the establishment of the system to calculate average cost basis[5] or (2) for which less than all of the cost data is stored in machine-readable format.[6] In addition, in many cases a RIC would not be able to provide average cost basis calculations to investors who acquire shares by gift or inheritance, or to investors who otherwise did not purchase the securities from the RIC seeking to provide the average cost basis calculations. Thus, it is erroneous to assume that the necessary average cost basis calculations will be provided to all RIC investors. Those many investors who do not receive average cost information will be burdened with new, time consuming mathematical computations.

II. Increased Penalties for Failure to File Correct Information Returns

Background

Current law imposes penalties on payers, including RICs, that fail to file with the Internal Revenue Service ("IRS") correct information returns showing, among other things, payments of dividends and gross proceeds to shareholders. Specifically, section 6721 imposes on each payer a penalty of $50 for each return with respect to which a failure occurs, with a maximum penalty of $250,000.[7] The $50 penalty is reduced to $15 per return for any failure that is corrected within 30 days of the required filing date and to $30 per return for any failure corrected by August 1 of the calendar year in which the required filing date occurs.

Proposal

The President's Fiscal Year 1998 budget contains a proposal which would increase the $50-per-return penalty for failure to file correct information returns to the greater of $50 per return or five percent of the aggregate amount required to be reported correctly but not so reported. The increased penalty would not apply if the total amount reported for the calendar year was at least 97 percent of the amount required to be reported.

[5] In this case, because the RIC does not know which shares the taxpayer claimed on his or her tax return to have redeemed, the RIC does not know the cost basis of the remaining shares. For example, if a shareholder purchased 100 shares at each of three prices ($10, $11 and $12) and later redeemed 100 shares before the average cost program were implemented, the average cost of the remaining 200 shares would be: (1) $10.50, if the $12 shares had been redeemed, (2) $11, if the $11 shares had been redeemed or (3) $11.50, if the $10 shares had been redeemed.

[6] Any data that does not exist on a firm's current computer system (such as because it is stored only on paper or on paper and old computer tapes incompatible with the current system) would have to be inputted manually into the new system before cost basis calculations could be performed. Both the time commitment and the likelihood of error would be significant if manual input were required.

[7] Failures attributable to intentional disregard of the filing requirement are generally subject to a $100 per failure penalty that is not eligible for the $250,000 maximum.

Recommendation

The Institute opposes the proposal to increase the penalty for failure to file correct information returns. Information reporting compliance is a matter of serious concern to RICs. Significant effort is devoted to providing the IRS and RIC shareholders with timely, accurate information returns and statements. As a result, a high level of information reporting compliance is maintained within the industry.

The Internal Revenue Code's information reporting penalty structure was comprehensively revised by Congress in 1989 to encourage voluntary compliance. Information reporting penalties are not designed to raise revenues.[8] The current penalty structure provides adequate, indeed very powerful, incentives for RICs to promptly correct any errors made.

III. Conversions of Large C Corporations to S Corporations

Background

Section 1374 generally provides that when a C corporation converts to an S corporation, the S corporation will be subject to corporate level taxation on the net built-in gain on any asset that is held at the time of the conversion and sold within 10 years. In Notice 88-19, 1988-1 C.B. 486, the IRS announced that regulations implementing repeal of the so-called General Utilities doctrine would be promulgated under section 337(d) to provide that section 1374 principles, including section 1374's "10-year rule" for the recognition of built-in gains, would be applied to C corporations that convert to RIC or real estate investment trust ("REIT") status.

Notice 88-19 was supplemented by Notice 88-96, 1988-2 C.B. 420, which states that the regulations to be promulgated under section 337(d) will provide a safe harbor from the recognition of built-in gain in situations in which a RIC fails to qualify under Subchapter M for one taxable year and subsequently requalifies as a RIC. Specifically, Notice 88-96 provides a safe harbor for a corporation that (1) immediately prior to qualifying as a RIC was taxed as a C corporation for not more than one taxable year, and (2) immediately prior to being taxed as a C corporation was taxed as a RIC for at least one taxable year. The safe harbor does not apply to assets acquired by a corporation during the C corporation year in a transaction that results in its basis in the assets being determined by reference to a corporate transferor's basis.

Proposal

The President's Fiscal Year 1998 budget proposes to repeal section 1374 for large corporations. For this purpose, a corporation is a large corporation if its stock is valued at more than five million dollars at the time of the conversion to an S corporation. Thus, a conversion of a large C corporation to an S corporation would result in gain recognition both to the converting corporation and its shareholders. The proposal further provides that Notice 88-19 would be revised to provide that the conversion of a large C corporation to a RIC or REIT would result in the immediate recognition of the corporation's net built-in gain. Thus, the

[8] In the Conference Report to the 1989 changes, Congress recommended to IRS that they "develop a policy statement emphasizing that civil tax penalties exist for the purpose of encouraging voluntary compliance." H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 661 (1989).

Notice, if revised as proposed, would no longer permit a large corporation that converts to a RIC or REIT to elect to apply rules similar to the 10-year built-in gain recognition rules of section 1374.

Recommendation

Because the safe harbor set forth in Notice 88-96 is not based upon the 10-year built-in gain rules of section 1374, the repeal of section 1374 for a large C corporation should have no effect on Notice 88-96. The safe harbor is based on the recognition that the imposition of a significant tax burden on a RIC that requalifies under Subchapter M after failing to qualify for a single year would be inappropriate. Moreover, the imposition of tax in such a case would fall directly on the RIC's shareholders, who are typically middle-class investors.

The Institute understands from discussions with the Treasury Department that the proposed revision to section 1374 and the related change to Notice 88-19 are not intended to impact the safe harbor provided by Notice 88-96.

Should the Congress adopt this proposal, the Institute recommends that the legislative history include a statement, such as the following, making it clear that the proposed revision to section 1374 and the related change to Notice 88-19 would not impact the safe harbor set forth in Notice 88-96 for RICs that fail to qualify for one taxable year:

> This provision is not intended to affect Notice 88-96, 1988-2 C.B. 420, which provides that regulations to be promulgated under. section 337(d) will provide a safe harbor from the built-in gain recognition rules announced in Notice 88-19, 1988-1 C.B. 486, for situations in which a RIC temporarily fails to qualify under Subchapter M. Thus, it is intended that the regulations to be promulgated under section 337(d) will contain the safe harbor described in Notice 88-96.

Statement of
MERRILL LYNCH & CO., INC.

Before the
COMMITTEE ON FINANCE

Submitted for the Record of the Hearing on
Revenue Raising Provisions in the Administration's FY 1998 Budget Proposal
on

APRIL 17, 1997

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Merrill Lynch is pleased to provide this written statement for the record of the April 17, 1997 hearing of the Committee on Finance on "Revenue Raising Provisions in the Administration's Fiscal Year 1998 Budget Proposal."[1]

I. INTRODUCTION

Merrill Lynch believes that a strong, healthy economy will provide for increases in the standard of living that will benefit all Americans as we enter the challenges of the 21st Century. Investments in our nations future through capital formation will increase productivity enabling the economy to grow at a healthy rate. Merrill Lynch is, therefore, extremely supportive of fiscal policies that raise the United States savings and investment rates. For this reason, Merrill Lynch has been a strong and vocal advocate of policies aimed to balance the federal budget. Merrill Lynch applauds the continuing efforts of this Congress to do so.

While Merrill Lynch applauds the ongoing efforts to balance the federal budget, it is unfortunate that many of the tax changes proposed by the Administration in its FY 1998 Budget would raise the costs of capital and discourage capital investment – policies contradictory to the objective of a balanced budget. The Administration's FY 1998 Budget contains a number of revenue-raising proposals that would raise the cost of financing new investments in plant, equipment, research, and other job-creating assets. This will have an adverse effect on the economy.

Merrill Lynch agrees with the comments related by Chairman Bill Archer of the House Ways & Means Committee to President Clinton when many of these same proposals were being considered for inclusion in the Administration's FY 1997 Budget. On a broad basis, Chairman Archer stated that he is "deeply troubled and believe(s) that the impact of your plan is fundamentally anti-business, anti-growth and . . . further concerned that the manner in which you have arrived at these proposals appears to be based on how much revenue you can raise from tax increases rather than how to improve the current tax code based on sound policy changes." See, Letter from Chairman Bill Archer to President Clinton (dated December 11, 1995). Chairman Archer also stated that:

> "you have proposed numerous new tax increases on business which reflect anti-business bias that I fear will diminish capital formation, economic growth, and job creation. For example, I don't understand why you would want to exacerbate the current problem of multiple taxation of corporate income by reducing the intercorporate dividends received deduction and denying legitimate business interest deductions. . . . it will not only be America's businesses that pay the tab; hard-working, middle income Americans whose nest-eggs are invested in the stock market will pay for these tax hikes."

The U.S. enjoys the world's broadest and most dynamic capital markets. These markets allow businesses to access the capital needed for growth, while providing investment vehicles individuals can rely on to secure their own futures. Our preeminent capital markets have long created a competitive advantage for the United States, helping our nation play its leading role in the global economy.

Merrill Lynch is seriously concerned about the damage the Administration's proposals could cause to the capital-raising activities of American business and the investments these companies are making for future growth. Merrill Lynch believes these proposals are anti-investment and anti-capital formation. If enacted, they would increase the cost of capital for American companies, thereby harming investment activities and job growth.

[1] Merrill Lynch also endorses the comments submitted to the Committee on these provisions by the Securities Industry Association and PSA The Bond Market Association.

Unfortunately, the Administration's proposals would serve to limit the financing alternatives available to businesses, harming both industry and the individuals who invest in these products. Merrill Lynch believes this move by the Administration to curtail the creation of new financial options runs directly counter to the long-run interests of our economy and our country.

While Merrill Lynch is opposed to all such proposals in the Administration's FY 1998 Budget,[2] our comments in this written statement will be limited to the proposals that:

- **Defer original issue discount deduction on convertible debt.** This proposal would place additional restrictions on the use of hybrid preferred instruments and convertible original issue discount ("OID") bonds and would defer the deduction for OID and interest on convertible debt until payment in cash (conversion into the stock of the issuer or a related party would not be treated as a "payment" of accrued OID);

- **Deny interest deductions on certain debt instruments.** Under this proposal, no deduction would be allowed for interest or OID on a corporate debt instrument that either (i) has a maturity of more than 40 years; (ii) has a maturity of more than 15 years and is not shown as indebtedness on the balance sheet of the issuer (including certain "trust preferred" instruments); or (iii) is payable in stock of the issuer or a related party, including an instrument that is mandatorily convertible or convertible at the issuer's option into stock.

- **Limit the dividends-received deduction ("DRD").** This proposal would reduce the DRD from 70% to 50% for corporations with limited corporate holdings; modify the holding period for the DRD deduction; and deny the DRD for preferred stock with certain non-stock characteristics.

Hereinafter these proposals will be referred to as the "Administration's proposals."

To be clear, these proposals are not "loopholes" or "corporate welfare." They are fundamental changes in the tax law that will increase taxes on savings and investment. They do little more than penalize middle-class Americans who try to save through their retirement plans and mutual funds. Rather than being a hit to Wall Street, as some claim, these proposals are a tax on Main Street – a tax on those who use capital to create jobs all across America and on millions of middle-class individual savers and investors.

It is unfortunate that the Treasury has chosen to characterize these proposals as "unwarranted corporate tax subsidies" and "tax loopholes." The fact is, the existing tax debt/equity rules in issue here have been carefully reviewed – some for decades – by Treasury and Internal Revenue Service ("IRS") officials, and have been deemed to be sound tax policy by the courts. Far from being "unwarranted" or "tax loopholes," the transactions in issue are based on well established rules and are undertaken by a wide range of the most innovative, respected, and tax compliant manufacturing and service companies in the U.S. economy, who collectively employ millions of American workers.

Merrill Lynch urges Congress to get past misleading "labels" and weigh the proposals against long standing tax policy. Under such analysis, these proposals will be exposed for what they really are – nothing more than tax increases on Americans.

Merrill Lynch believes that these proposals are ill-advised, for four primary reasons:

- **They Will Increase The Cost of Capital, Undermining Savings, Investments, and Economic Growth**. While Treasury officials have stated their tax proposals will primarily affect the financial sector, this is simply not so. In reality, the burden will

[2] Other anti-business, anti-growth proposals include the *Morris Trust* proposal, the "short-against-the-box" proposal, and the average cost basis proposal. There is no inference of support for proposals not mentioned in this written statement.

fall on issuers of, and investors in, these securities – that is, American businesses and individuals. Without any persuasive policy justification, the Administration's proposals would force companies to abandon efficient and cost-effective means of financing now available and turn to higher-cost alternatives, and thus, limit productive investment. Efficient markets and productive investment are cornerstones to economic growth.

- **They Violate Established Tax Policy Rules**. These proposals are nothing more than *ad hoc* tax increases that violate established rules of tax policy. In some cases, the proposals discard tax symmetry and deny interest deductions on issuers of debt instruments, while forcing holders of such instruments to include the same interest in income. In other cases, the proposals look to regulatory or financial statement rules to characterize an instrument for tax purposes – but only when it raises revenues. In addition, the Administration substitutes its unsubstantiated opinion of how an instrument is "viewed," even though such opinion is contradictory to all available facts and circumstances. Disregarding well-established tax rules for the treatment of debt and equity only when there is a need to raise revenue is a dangerous and slippery slope that can lead to harmful tax policy consequences.

- **They Will Disrupt Capital Markets**. Arbitrary and capricious tax law changes have a chilling effect on business investment and capital formation. Indeed, the Administration's proposals have already caused significant disruption in capital-raising activities, as companies reevaluate their options.

- **They Will Fail to Generate Promised Revenue**. The Administration's proposals are unlikely to raise the promised revenue, and could even lose revenue. Treasury's revenue estimates appear to assume that the elimination of the tax advantage of certain forms of debt would cause companies to issue equity instead. To the contrary, most companies would likely move to other forms of debt issuance – ones that carry higher coupons and therefore involve higher interest deductions for the issuer.

At a time when the private sector and the federal government should join to pursue ways to strength the U.S. economy, the Administration has proposed tax law changes that would weaken the economy by disrupting capital-raising activities across the country. Merrill Lynch strongly urges the Administration and Congress to set aside these proposals. Looking forward, Merrill Lynch would be delighted to participate in full and open discussions on the Administration's proposals, so that their ramifications can be explored in depth.

The following are detailed responses and reaction to three of the Administration's proposals that would directly affect capital-raising and investment activities in the U.S.

II. PROPOSAL TO DEFER OID DEDUCTION ON CONVERTIBLE DEBT

The Administration's FY 1998 Budget contains proposals that would defer the deduction for original issue discount ("OID") until payment and deny an interest deduction if the instrument is converted to the stock of the issuer or a related party. These proposed changes to fundamental tax policy rules relating to debt and equity come under two separate (but related) proposals.

One proposal, among other things, defers OID on convertible debt. The only stated "Reasons for Change" relating specifically to this proposal is contained in the Treasury Department's "General Explanations of the Administration's Revenue Proposals" (February 1997):

> "In many cases, the issuance of convertible debt with OID is viewed by market participants as a de facto purchase of equity."

A related Administration proposal to deny interest deductions on certain debt instruments is discussed in more detail in Section III, below. The "Reasons of Change" cited with iespect to this proposal are as follows:

> "The line between debt and equity is uncertain, and it has proved difficult to formulate general rules to classify an instrument as debt or equity for all purposes or to bifurcate an instrument into its debt and equity components. While the IRS has taken the position that some purportedly debt instruments with substantial equity features should be treated as equity, other instruments have not been specifically addressed. Taxpayers have exploited this lack of guidance by, among other things, issuing instruments that have substantial equity features (including many non-tax benefits of equity), but as to which they claim interest deductions. In many cases, these instruments have been issued in exchange for outstanding preferred stock."

The Treasury Department goes on to say that the proposal would "not affect typical convertible debt" – apparently suggesting that typical convertible debt is viewed somehow as more like debt than other convertible instruments (e.g., instruments with OID).

Merrill Lynch strongly opposes the Administration's proposal to defer or eliminate deductions for OID on Original Issue Discount Convertible Debentures ("OIDCDs") for a number of reasons more fully described below. To summarize:

- The Treasury's conclusion that the marketplace treats OIDCD as de facto equity is demonstrably false and inconsistent with clearly observable facts;
- In an attempt to draw a distinction between OIDCDs and traditional convertible debt, Treasury misstates current law with regard to the deduction of accrued but unpaid interest on traditional convertible debentures;
- The proposal ignores established authority that treats OIDCDs as debt, including guidance from the IRS in the form of a private letter ruling;
- The proposed elimination of deductions for OID paid in stock is at odds with the tax law's general treatment of expenses paid in stock;
- The proposal would destroy the symmetry between issuers and holders of debt with OID. This symmetry has been the pillar of tax policy regarding OID. The Administration offers no rationale for repealing this principle;
- The proposal disregards regulations adopted after nearly a decade of careful study by the Treasury and the Internal Revenue Service. Consequently, the Administration's proposal would hastily reverse the results of years of careful study; and
- While billed as a revenue raiser, it is clear that adoption of the Administration's proposal would in fact reduce tax revenue.

A. Treasury's Conclusion That The Market Treats OIDCD As De Facto Equity Is Demonstrably False And Inconsistent With Clearly Observable Facts.

The proposal is based on demonstrably false assumptions about market behavior, which assumptions are also inconsistent with clearly observable facts. There is no uncertainty in the marketplace regarding the status of OIDCDs as debt. These securities are booked on the issuers' balance sheets as debt, are viewed as debt by the credit rating agencies, and are treated as debt for many other legal purposes, including priority in bankruptcies. In addition, zero coupon convertible debentures are typically sold to risk averse investors who seek the downside protection afforded by the debentures. Thus, both issuers and investors treat convertible bonds with OID as debt, not equity. Accordingly, it is clear that the market's "view" supports the treatment of OIDCD as true debt for tax purposes.

Treasury makes clear that its proposal would not affect "typical" convertible debt on the grounds that the "typical" convertible debentures are not certain to convert. Because OIDCDs have been available in the market place in substantial volume for over ten years, it is possible to compare the conversion experience of so-called "typical" convertible debentures with the conversion experience of OIDCDs, nearly all of which have been zero coupon convertible debt. The data shows that "typical" convertible debentures are much more likely to convert to equity, that is, to be paid off in stock, than zero coupon convertible debentures.

An analysis of all 90 zero coupon convertible debt securities sold in the public debt markets since 1985 shows that 48 of those issues have already been retired.[3] Of those 48, only 13 were finally paid in stock. The other 35 were paid in cash. The remaining 42 of the 90 issues were still outstanding as of December 31, 1996. If those 42 securities were called today, only 12 of them would convert to stock and the other 30 would be paid in cash. In other words, the conversion features of only 12 of the 42 issues remaining outstanding were "in the money." Overall, only 28% of the 90 public offerings of zero coupon convertible debt securities have been (or would be if called today) paid in stock. Thus, in only 28% of the OIDCD issuances has the conversion feature ultimately controlled.

On the other hand, an analysis of 605 domestic issues of "typical" convertible debt retired since 1985 shows just the opposite result. Seventy-five percent (75%) of these offerings converted to the issuer's common stock. In light of the historical data, Treasury's statement that "the proposal would not affect typical convertible debt" because of the uncertainty of the conversion is completely at odds with the proposed treatment of OIDCDs.

The Treasury's proposal is clearly without demonstrable logic. It makes no sense to say that an instrument that has a 28% probability of converting into common stock is "viewed by market participants as a de facto purchase of equity," and therefore, the deduction for OID on that instrument should be deferred (or denied), while an instrument that has a 75% probability of conversion should be treated for tax purposes as debt.[4] In Treasury's defense, officials admit to not having this data when the original proposal was developed. We would be happy to provide this data, and any other relevant information, to the Administration and Congress.

B. Proposal Misstates Current Law

The Treasury's statement of "Current Law" contained in the "General Explanation of the Administration's Revenue Proposals" (February 1997) misstates the law regarding interest that is accrued but unpaid at the time of the conversion. The Treasury suggests that the law regarding "typical" convertible debt is different from the law for convertible debt with OID. This is clearly not the case. Both the Treasury's own regulations and case law require that stated interest on a convertible bond be treated the same as OID without regard to whether the bondholder converts.

When the Treasury finalized the general OID regulations in January, 1994 (T.D. 8517), the Treasury also finalized Treasury Regulations section 1.446-2 dealing with the method of accounting for the interest. The regulations state:

> "Qualified stated interest (as defined in section 1.1273-1(c)) accrues ratably over the accrual period (or periods) to which it is attributable and accrues at the stated rate for the period (or periods). See, Treas. Reg. Section 1.446-2(b).

[3] Analysis as of December 31, 1996.

[4] Given this data, even if one accepted the Treasury's assertion that probability of conversion in some way governed appropriate tax treatment, the proposal obviously addresses the wrong convertible security.

All interest on a debt obligation that is not OID is "qualified stated interest." Treasury regulations define "qualified stated interest" under Treas. Reg. Section 1.1273-1(c) as follows:

> (i) In general, qualified stated interest is stated interest that is unconditionally payable in cash or in property . . . or that will be constructively received under section 451, at least annually at a single fixed rate . . .
>
> (ii) Unconditionally payable . . . For purposes of determining whether interest is unconditionally payable, the possibility of a nonpayment due to default, insolvency or similar circumstances, or due to the exercise of a conversion option described in section 1272-1(e) is ignored. This applies to debt instruments issued on or after August 13, 1996 (emphasis added).

Thus, according to the Treasury's own regulations, fixed interest on a convertible bond is deductible as it accrues without regard to the exercise of a conversion option. The Treasury's suggestion to the contrary in the description of the Administration's proposal contradicts the Treasury's own recently published regulations.

In addition, case law from the pre-daily accrual era established that whether interest or OID that is accrued but unpaid at the time an instrument converts is an allowable deduction depends on the wording of the indenture. In Bethlehem Steel Corporation v. United States, 434 F.2nd 1357 (Ct. Cl. 1971), the Court of Claims interpreted the indenture setting forth the terms of convertible bonds and ruled that the borrower did not owe interest if the bond converted between interest payment dates. The Court merely interpreted the indenture language and concluded that no deduction for accrued but unpaid interest was allowed because no interest was owing pursuant to the indenture. The Court stated that if the indenture had provided that interest was accrued and owing, and that part of the stock issued on conversion paid that accrued interest, a deduction would have been allowed. The indentures controlling all of the public issues of zero coupon convertible debt were written to comply with the Bethlehem Steel court's opinion and thus, the indentures for all of these offerings provide that if the debentures convert, part of the stock issued on conversion is issued in consideration for accrued but unpaid OID.

Thus, there is no tax law principle that requires a difference between "typical" convertible bonds and zero coupon convertible deductions. The only difference is a matter of indenture provisions and that difference has been overridden by the Treasury's own regulations.

C. Proposal Ignores Established Authority That Treats OIDCDs As Debt, Including Guidance From The IRS In The Form Of A Private Letter Ruling.

Under current law, well-established authority treats OIDCDs as debt for tax purposes, including guidance from the IRS in the form of a private letter ruling. The IRS has formally reviewed all the issues concerning OIDCDs and issued a private letter ruling confirming that the issuer of such securities may deduct OID as it accrues. See, PLR 9211047 (December 18, 1991). Obviously rather than having not "exploited [a] lack of guidance"[5] from the IRS, issuers of OIDCDs have relied on official IRS guidance in the form of a private letter ruling. That the IRS issued a ruling on this topic confirms that OIDCDs do not exploit any ambiguity between debt and equity. If any such ambiguity existed the IRS would not have issued its ruling.

[5] See, Treasury's "Reasons for Change" described above on page 5.

D. Proposal Is Inconsistent With The Fundamental Principle That Payment In Stock Is Equivalent To Payment In Cash.

We would now like to focus not on the timing of the deduction but on the portion of the Administration's proposal that would deny the issuer a deduction for accrued OID if ultimately paid in stock. The proposal is inconsistent with the general policy of the tax law that treats a payment in stock the same as a payment in cash. A corporation that issues stock to purchase an asset gets a basis in that asset equal to the fair market value of the stock issued. There is no difference between stock and cash. A corporation that issues stock to pay rent, interest or any other deductible item may take a deduction for the item paid just as if it had paid in cash.

More precisely on point, the 1982 Tax Act added section 108(e)(10)[6] to repeal case law that allowed a corporate issuer to escape cancellation of indebtedness income if the issuer retired corporate debt with stock worth less than the principal amount of the corporate debt being retired. The policy of that change was to make a payment with stock equivalent to a payment with cash. Section 108(e)(10) clearly defines the tax result of retiring debt for stock. As long as the market value on the stock issued exceeds the amortized value of the debt retired, there is no cancellation of indebtedness income. The Administration's proposal to treat payment of accrued OID on convertible debt differently if the payment is made with stock rather than cash is inconsistent with the fundamental rule that payment with stock is the same as payment with cash. The Administration's proposal would create an inconsistency without any reasoned basis.

E. Treasury's Proposal Removes The Long Established Principle Of Tax Symmetry Between Issuers And Holders Of Debt With OID.

As discussed above, the current law is clear that an issuer of a convertible debenture with OID is allowed to deduct that OID as it accrues. The Service's private letter ruling, cited above, confirms this result. It is important to note that the OID rules were originally enacted to ensure proper timing and symmetry between income recognition and tax deductions for tax purposes. Proposals that disrupt this symmetry violate this fundamental goal of tax law.

The Administration's proposal reverses the policy of symmetry between issuers and holders of OID obligations. Since 1969, when the tax law first addressed the treatment of OID, the fundamental policy of the tax law has been that holders should report OID income at the same time that the issuer takes a deduction. The Administration's proposal removes this symmetry for convertible debt with OID. Not only would the holders report taxable income before the issuer takes a deduction, but if the debt is converted, the holders would have already reported OID income and the issuer would never have an offsetting deduction. The Administration does not offer any justification for this unfairness.

F. Treasury's Proposal Is An Arbitrary Attempt To Reverse Tax Policies That Were Adopted After Nearly A Decade Of Careful Study.

The manner in which this legislative proposal was offered is a significant reason to doubt the wisdom of enacting a rule to defer or deny deductions for OID on convertible debentures. When the Treasury issued proposed regulations interpreting 1982 and 1984 changes in the Internal Revenue Code regarding OID, the Treasury asked for comments from the public regarding whether special treatment was necessary for convertible debentures. See, 51 Federal Register 12022 (April 18, 1986).

This issue was studied by the Internal Revenue Service and the Treasury through the Reagan, Bush and Clinton Administrations. Comments from the public were studied and hearings were held by the current administration on February 16, 1993. When the current Treasury Department adopted final OID regulations in January of 1994, the final

[6] All section references are to the Internal Revenue Code of 1986, as amended.

regulations did not exclude convertible debentures from the general OID rules. After nearly nine years of study under three Administrations and after opportunity for public comment, the Treasury decided that it was not appropriate to provide special treatment for OID relating to convertible debentures. Merrill Lynch suggests that it is not wise policy to reverse, in the heat of budget negotiations and without opportunity for hearings or study, a tax policy that Treasury had adopted after nearly a decade of study.

G. Proposal Regarding OID Convertible Debentures Would Reduce Tax Revenue.

While billed as a "revenue raiser," adoption of the Administration's proposal with respect to OIDCDs would in fact reduce tax revenue for the following reasons:

- Issuers of OIDCDs view them as a debt security with an increasing strike price option imbedded to achieve a lower interest rate. This *a priori* view is supported by the historical analysis of OIDCDs indicating that over 70% have been, or if called would be, paid off in cash.

- If OIDCDs were no longer economically viable, issuers would issue straight debt.

- Straight debt rates are typically 200 to 300 basis points higher than comparable rates. Therefore, issuers' interest deductions would be significantly greater.

- According to the Federal Reserve Board data, at June 30, 1995 over 60% of straight corporate debt is held by tax deferred accounts versus less that 30% of OIDCDs held by such accounts.

Consequently, the empirical data suggests that if OIDCDs are not viable, issuers will issue straight debt with higher interest rates being deducted by issuers and paid to a significantly less taxed holder base. The Administration's proposal would therefore reduce tax revenue while at the same time interfering with the efficient operation of the capital markets.

Giving full consideration to the above data, Merrill Lynch believe rejection of the proposal with respect to OIDCDs is warranted and the reasons for doing so compelling.

III. .PROPOSAL TO DENY INTEREST DEDUCTIONS ON CERTAIN DEBT INSTRUMENTS

The Administration has proposed denying interest deductions on certain debt instruments that have a maturity of longer than 40 years, or a maturity of longer than 15 years where the instruments are not characterized as debt in an issuer's financial statements (including "trust preferred" instruments, TOPrS, etc.). The Administration's reasons for this proposal are cited in Section II, above.

A. Debt with Maturity Over 40 Years

The Administration has proposed to deny interest deductibility on any debt obligation with a weighted average maturity of over 40 years. Merrill Lynch believes this is bad tax policy. With regard to any financial instrument, it is wrong to base the deductibility of interest on an arbitrary maturity limit. Indeed, the Administration's proposal represents a significant departure from existing IRS rules and practices regarding the classification of debt and equity. Currently, in distinguishing between the two, a facts and circumstances test should apply. In applying this test, the IRS considers the following factors:

- A reasonable maturity date;

- Whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future;
- Whether holders of the instruments possess the right to enforce the payment of principal and interest in the event of a default;
- Whether the rights of the holders of the instruments are subordinate to rights of general creditors;
- Whether the instruments give the holders the right to participate in the management of the issuer;
- Whether the issuer is thinly capitalized;
- Whether there is identity between holders of the instruments and stockholders of the issuer;
- The label placed upon the instruments by the parties; and
- Whether the instruments are intended to be treated as debt or equity for non-tax purposes.

On all but the first of these attributes, it is immediately obvious that debt obligations with maturities over 40 years enjoy exactly the same features as other debt instruments. On the remaining attribute – a reasonable maturity date – it has been well established that a debt obligation with a maturity over 40 years will be deemed to possess a "reasonable maturity date" if the issuer's business is expected to continue for the period the obligation remains outstanding. In addition, recent public offerings of debt obligations with maturities greater than 40 years were priced to provide investors with a debt return, not an equity return. The fact is that investors view these instruments as possessing the characteristics of debt – including the attributes of a reasonable maturity date. Is there any reason whatsoever why a 41 year instrument with the same terms and conditions as a 39 year instrument should be afforded different treatment for tax purposes? What if the 39 year debt was issued by a credit risky start-up company and the 41 year debt was issued by a financially secure publicly traded company? Does focusing solely on the length of maturity make any sense?

Finally, if this proposal were adopted, Merrill Lynch believes most issuers would simply shift to long-term debt with a maturity under 40 years – not to equity. This seems to be contrary to the assumptions underlying Treasury's "scoring" of this proposal. Given that issuers would respond to this proposal by continuing to issue debt – and therefore deduct coupon payments – Merrill Lynch believe it is unlikely that there will be an increase in revenue to the U.S. Treasury resulting from this proposal.

B. Deny Deductibility on Other Debt Obligations

The Administration has also proposed to deny interest deductibility on obligations with a maturity greater than 15 years, which are not shown as indebtedness on the issuer's balance sheet. This proposal appears to be aimed at eliminating the interest deductibility of innovative new financial instruments, such as Monthly Income Preferred Securities (MIPS) and Trust-Originated Preferred Securities (TOPrS).

Merrill Lynch believes that a careful analysis of these instruments reveals that they possess *all* of the critical attributes of debt listed above. Indeed, the Administration's proposal does not rely on any of these attributes to curtail the interest deductibility of these instruments.

Application of a facts and circumstances test that applies the factors relied on by the IRS, as described above, establishes that these instruments possess all the critical attributes of debt. First, they have a definite term to maturity. In cautioning against unreasonably long maturities in Notice 94-47,[7] the IRS indicated that the reasonableness of an instrument's term (including that of a relending obligation or similar arrangement) is determined under a facts and circumstances test, including the issuer's ability to satisfy

[7] Significantly, Notice 94-47 was published in response to the issuance of instruments now referred to as MIPS.

the instrument. In this regard, MIPS, TOPrS and other similar instruments are issued by well-established companies that are likely to remain in business throughout the term of the obligation. Second, investors have full creditor rights upon default, and default can force an issuer into bankruptcy or liquidation. If interest is deferred, investors must impute interest income as is the case with other debt instruments, but not with equity. Third, these instruments are priced to give investors a debt return, not an equity return. Lastly, although subordinated, these instruments are secured and senior to equity.

Rather then using the same facts and circumstances test that they have applied in the past, the Administration has focused on the fact that MIPS, TOPrS, and similar products are not typically shown as debt on a company's balance sheet. The reality is, financial accounting treatment of these instruments has never before been the overriding factor regarding their tax treatment. Nor should it be.

TOPrS are a case in point. A company utilizing these instruments issues debt obligations to a trust which, in turn, issues trust securities (i.e., TOPrS) to investors. The transaction is structured in this way to improve the attractiveness of the securities to the public. Because these debt obligations are issued through a trust, TOPrS are not shown on the issuers' balance sheet as debt, although the status of the obligations as indebtedness is clearly disclosed in a footnote to the company's balance sheet. These obligations are, however, shown as a non-debt liability.

The balance-sheet characterization of TOPrS – or MIPS – as a non-debt *liability* does not alter the conclusion that the underlying debt securities possess all the critical attributes of debt for tax purposes. This is clearly illustrated by the facts that:

- Investors in these instruments are the legal owners of an undivided interest in the underlying debt obligations, and they enjoy all the legal rights and economic benefits as if they had purchased the debt obligations directly from the issuer rather than certificates from the trust.

- Issuers of these securities – despite their ability to extend an interest payment period for up to five years – have an absolute obligation to pay interest and principal at maturity.

Moreover, treatment for regulatory or financial accounting purposes should not be the sole source for determining treatment of an instrument for tax purposes. In fact, by so doing, tax policy would become subject to the whims of other agencies who establish rules for fundamentally different reasons. Relying on accounting rules as the basis for how a particular instrument is taxed would effectively grant tax policy authority to the Financial Accounting Standards Board ("FASB") and the Securities Exchange Commission ("SEC").

The concerns of credit agencies, FASB and the SEC are very different from the concerns that should drive the federal tax system. Rating agencies, FASB and the SEC are focused on determining the likelihood of the issuer defaulting; while the IRS normally concerns itself with distinguishing debt from equity based on whether the instrument has a return which represents a participation in the profits and risks of the business enterprise. Given the different objectives of the tax system, and other agencies, the labels attached by the latter should have no bearing on tax classification.

In fact, many times rating agencies disagree as to the proper label for an instrument. Importantly, the National Association of Insurance Commissioners ("NAIC") has recently classified TOPrS, MIPS and other similar instruments as qualifying as bonds for statutory accounting by insurance companies. The NAIC expressed the view that there was "no discernible difference" between capital securities (including MIPS) and other types of debt.

The Administration's budget itself is internally inconsistent and contradictory with respect to following non-tax regulatory and financial treatment. In this instance, the Administration's budget forces taxpayers to follow the treatment of regulators. Whereas, in other parts of the Administration's budget, taxpayers are specifically prohibited from following regulatory and financial accounting treatment for tax purposes (see, budget proposals relating to inventory method changes).

With regard to the Administration's proposals, it is also crucial to recognize that no other major industrialized country has adopted such restrictive and arbitrary limitations on interest deductibility. Our global competitors instead look to the rights of a holder of an instrument under corporate law to determine its categorization for tax purposes. If enacted, the proposal would restrict financial flexibility of U.S. corporations. Ironically, under this proposal, foreign issuers would be allowed to access the U.S. capital markets with instruments (such as long-dated or perpetual debt) far more desirable to both issuers and investors – exploiting the vacuum created in part by this proposal.

Examples of the competitive disadvantage American companies face due to tax law restrictions on interest deductibility is increasing. Recently, Merrill Lynch completed a uniquely structured convertible offering for a foreign bank that involved tax deductible, perpetual debt securities that can be converted to noncumulative preferred stock by the foreign bank. This transaction was attractive to the foreign issuer but not widely available to U.S. issuers because of the current and proposed restrictions on interest deductibility. Enactment of additional tax restrictions will only further disadvantage U.S. companies seeking to raise capital in the global marketplace.

Contrary to Treasury's revenue projections, Merrill Lynch also believes this proposal will fail to raise revenue. Issuers that are impacted by the proposed legislation will either choose to issue MIPS- or TOPrS-like securities with a maturity of 15 years or less, or they will maintain the 15+ year maturity of the instruments and issue them directly to investors, rather than through a partnership or trust. Either way, the Administration's proposal will ultimately fail to reduce the amount of interest issuers deduct, and it will therefore, be unlikely to raise tax revenue.

Merrill Lynch firmly believes that MIPS, TOPrS, and other similar instruments are debt obligations, not equity, and they should be taxed as such regardless of their treatment for regulatory and financial accounting purposes.

IV. PROPOSAL TO REDUCE THE DRD, MODIFY THE DRD HOLDING PERIOD, AND ELIMINATE THE DRD ON CERTAIN LIMITED PREFERRED STOCK.

The Administration has proposed to: (1) reduce the DRD from 70% to 50% for corporations owning less than a 20% interest in the stock of another corporation; (2) modify the holding period for the DRD; and (3) eliminate the DRD for dividends on certain limited-term preferred stock.

It has long been recognized that the "double taxation" of dividends under the U.S. tax system tends to limit savings, investment, and growth in our economy. The DRD was designed to mitigate this multiple taxation, by excluding some dividends from taxation at the corporate level.

Unfortunately, the Administration's proposal to reduce the DRD, modify the DRD holding period, and eliminate the DRD on certain stock would significantly undermine this policy. In the process, it would further increase the cost of equity capital and negatively affect capital formation. Indeed, the Administration's proposal would boost the effective tax rate on inter-corporate dividends by 67%. Ultimately, the burden of the resultant triple taxation will be borne by the individual investor at a maximum effective overall tax rate of 67.6%.

From an economic standpoint, Merrill Lynch believes that in addition to exacerbating multiple taxation of corporate income, the Administration's proposal are troubling for a number of reasons and would have a number of distinct negative impacts:

- Dampen Economic Growth. If the DRD reduction were enacted, issuers would react to the potentially higher cost of capital by: lowering capital expenditures, reducing working capital, moving capital raising and employment offshore, and otherwise slowing investments in future growth. In particular, American banks, which are dependent on the preferred stock market to raise regulatory core capital, would see a significant increase in their cost of capital and, hence, may slow their business-loan generation efforts.

- Limit Competitiveness of U.S. Business. The reduction in the DRD would also further disadvantage U.S. corporations in raising equity vis-à-vis our foreign competitors, especially in the UK, France, and Germany. In these countries, governments have adopted a single level of corporate taxation as a goal, and inter-corporate dividends are largely or completely tax free. As long as American firms compete in the global economy under the weight of a double- or triple-taxation regime, they will remain at a distinct competitive disadvantage.

- Discriminate Against Particular Business Sectors and Structures. The Administration's proposal may have a disproportionate impact on taxpayers in certain industries, such as the financial and public utility industries, that must meet certain capital requirements. Certain types of business structures also stand to be particularly affected. Personal holding companies, for example, are required to distribute their income on an annual basis (or pay a substantial penalty tax) and thus do not .ave the option to retain income to lessen the impact of multiple levels of taxation.

- Companies Should Not Be Penalized for Minimizing Risk of Loss. As a result of the Administration's proposal, the prudent operation of corporate liability and risk management programs could result in disallowance of the DRD. Faced with loss of the DRD, companies may well choose to curtail these risk management programs.

- No Tax Abuse. In describing the DRD proposal, the Administration suggests that some taxpayers may be able to take advantage of the 70% deduction in a way that "undermines the separate corporate income tax." To the extent Treasury can demonstrate that the deduction may be subject to misuse, targeted anti-avoidance rules can be provided. The indiscriminate approach of arbitrarily cutting back on the DRD goes beyond addressing inappropriate transactions and unnecessarily penalizes legitimate corporate investment activity.

- The Justification for the DRD Proposal is Unconvincing. The Administration argues that the current 70% DRD "is too generous." Since Congress already has addressed (in the "Omnibus Reconciliation Act of 1987") the argument that an 80% deduction was "too generous," and responded by reducing the deduction to 70%, it is hard to see why only 10 years later the same deduction could again be considered "too generous."

The Administration's proposal to modify the DRD holding period is a change that Merrill Lynch believes would impair trading-market liquidity. Currently, investors have to be "at risk" (i.e., unhedged) for 46 days on their equity portfolio securities to qualify for the DRD. Given the volatility of the equity markets, the risk inherent in a 46-day holding period is already significant. The proposal to have a "rolling" holding period requirement with respect to every dividend payment date is unwarranted and will cause disruption for dealers attempting to provide liquidity in the equity markets.

While the overall revenue impact of the DRD proposal may be positive, Merrill Lynch believes the revenue gains, particularly with respect to the elimination of the DRD on certain limited-term preferred stock, will not be nearly as large as projected, due to anticipated changes in the behavior of preferred-stock issuers and investors.

- Issuers of Preferred Stock. Reducing the DRD will increase the cost of preferred-stock financing and cause U.S. corporations to issue debt instead of preferred stock because of interest deductibility. This overall increase in deductible interest would result in a net revenue loss to Treasury.

- Secondary Market for Preferred Stock. Currently, the market for outstanding preferred stock is divided into two segments:

  (1) A $15 billion to $20 billion variable-rate preferred stock market where dividends are set via Dutch auctions. The dividend rate on these securities will necessarily increase to adjust for the lower DRD, and may cause some of these issuers to call these preferred securities at par and replace them with debt. This will result in a revenue loss to Treasury.

  (2) A $45 billion to $55 billion fixed-rate preferred stock market where the issuing corporations cannot immediately call the securities. Retail investors, who comprise 80% of this market cannot utilize the DRD and therefore pay full taxes on dividends. Hence, there will be no meaningful revenue gains to Treasury from this market segment.

This proposal may also create losses for individual investors. Institutions, which own approximately 20% of all fixed-rate preferred stock, may sell their holdings given the increased taxation. Individual investors will bear the brunt of any price decline, because they currently account for about 80% of the fixed-rate preferred market. These capital losses, when taken, will offset any capital gains and result in a revenue loss to Treasury.

At a time when U.S. tax policy should be moving toward fewer instances of "double taxation," Merrill Lynch believes it would be a mistake to reduce the DRD, modify the DRD holding period, or eliminate the DRD on certain limited-term preferred stock. Any such action will make "*triple* taxation" even more pronounced in, and burdensome on, our economy.

V. CONCLUSION

Based on the discussion set forth above, Congress should reject the Administration's proposals out of hand. These proposals which include the denial or deferral of legitimate interest deductions and the reduction, modification, and elimination of the DRD are nothing more than tax increases which raise the cost of financing new investments, plant, equipment, research, and other job-creating assets. These tax increases hurt the ability of American companies to compete against foreign counterparts and are born by the millions of middle-class Americans who try to work and save through their retirement plans and mutual fund investments. These impediments to investment and savings would hurt America's economic growth and continued leadership in the global economy.

Moreover, from a tax policy perspective, the Administration's proposals are ill-advised, arbitrary and capricious tax law changes that have a chilling effect on business investment and capital formation. Indeed, the Administration's proposals are nothing more than *ad hoc* tax increases that violate established rules of tax policy. In some cases, the proposals discard tax symmetry and deny interest deductions on issuers of certain debt instruments, while forcing holders of such instruments to include the same interest in income. In other cases, the proposals look to regulatory or financial statement rules to characterize an instrument for tax purposes – but only when it raises revenues. In addition, the Administration substitutes its unsubstantiated opinion of how an instrument is "viewed," even though such opinion is contradictory to all available facts and circumstances. Disregarding well-established tax rules for the treatment of debt and equity only when there is a need to raise revenue is a dangerous and slippery slope that can lead to harmful tax policy consequences.

The Administration's proposals also are unlikely to raise the promised revenue, and could even lose revenue. Treasury's revenue estimates appear to assume that the elimination of the tax advantage of certain forms of debt would cause companies to issue equity instead. To the contrary, most companies would likely move to other forms of debt issuance – ones that carry higher coupons and therefore involve higher interest deductions for the issuer.

Far from being "unwarranted" or "tax loopholes," the transactions in issue are based on well established rules and are undertaken by a wide range of the most innovative, respected, and tax compliant manufacturing and service companies in the U.S. economy, who collectively employ millions of American workers.

Merrill Lynch urges Congress to get past misleading "labels" and weigh the proposals against long standing tax policy. Under such analysis, these proposals will be exposed for what they really are – nothing more than tax increases on Americans.

For all the reasons stated above, the Administration's proposals should be rejected in toto.

Monsanto

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Statement of
MONSANTO, CO.

Before the
COMMITTEE ON FINANCE

Submitted for the Record of the Hearing on
Revenue Raising Provisions in the Administration's FY 1998 Budget Proposal
on
April 17, 1997

Monsanto, Co. is pleased to provide this written statement for the record of the April 17, 1997 hearing of the Committee on Finance on "Revenue Raising Provisions in the Administration's Fiscal Year 1998 Budget Proposal."

I. BACKGROUND

Monsanto, Co. ("Monsanto") is a Delaware corporation engaged in a number of businesses that are principally involved in manufacturing and sales of four product lines – crop and lawn protection, performance chemicals, fibers, and food ingredients. This is coupled with Monsanto's leadership position in the biotechnology arena. In addition, Monsanto is involved in the pharmaceutical industry through its wholly owned subsidiary, G.D. Searle, a manufacturer and seller of a variety of ethical drugs. Monsanto is a major exporter of "U.S. made" products. With about 40% of its sales occurring outside the United States, Monsanto is an important participant in the Global economy. Some of Monsanto's leading products are Roundup (an agricultural herbicide), NutraSweet (a sweetener), and Ambien (a pharmaceutical product).

In 1996, Monsanto decided to "spin-off" its chemical business (fibers and performance chemicals) and to focus on its "Life Science" business (agricultural, food ingredients and pharmaceuticals). The spin-off was approved by Monsanto's Board of Directors and publicly announced on December 6, 1996. Monsanto submitted a ruling request to the Internal Revenue Service ("IRS") on December 20, 1996. Pending approval by the IRS, Monsanto expects to complete the "spin-off" sometime in the late summer of 1997. Substantial resources in the form of time and money have been and will continue to be expended to complete all necessary steps to accomplish the "spin-off."

II. CURRENT LAW - IRC SECTION 355[1] "SPIN-OFFS"

Under section 355 of current law, a corporation which distributes stock in a controlled corporation to its shareholders is not required to recognize gain on the distribution (or "spin-off"), provided certain requirements are met. To be tax-free, the distributing company must distribute stock representing at least an 80% interest in the controlled subsidiary; both the distributing company and the controlled subsidiary must be engaged in an active five-year old business following the stock distribution; and there must be a valid business purpose for the "spin-off."

[1] Unless otherwise noted, section references are to the Internal Revenue Code of 1986, as amended.

The reason no gain is recognized is that all of the assets remain in "corporate solution." The distribution or "spin-off" of the controlled corporation is simply a reorganization of the companies, and not a sale of stock.

A company is considered to have entered into a *Morris Trust*[2] transaction, if following a "spin-off," the company engages in a pre-arranged merger or reorganization of either the distributing company or the "spun-off" controlled subsidiary. A *Morris Trust* transaction simply combines two tax-free transactions (e.g., a tax-free "spin-off" followed by a tax-free merger or reorganization). For over 30 years, the courts and the IRS have upheld tax-free treatment for "spin-offs" which were followed by pre-arranged mergers or reorganizations of the distributing company, consistent with the theory that capital gains tax should not be imposed on assets that have not left "corporate solution."[3]

III. SUMMARY OF ADMINISTRATION'S *MORRIS TRUST* PROPOSAL

One of the revenue raising provisions in the Administration's FY 1998 Budget proposal is a provision which would adopt additional restrictions on nonrecognition of gain on certain distributions of controlled corporation stock (the "*Morris Trust* proposal").

The Administration's FY 1998 proposal is effective for distributions after the date of "first committee action." Importantly, this year's proposal does not provide "transition relief" for taxpayers who are complying with current law and who will not be able to complete their transaction by the date of "first committee action." A similar *Morris Trust* proposal was contained in the FY 1997 Budget plan proposed by the Administration last year. However, last year's proposal did contain reasonable transition relief for transactions which were either: (1) made pursuant to a binding written contract, (2) described in an IRS ruling request, or (3) described in a public announcement or SEC filing.

The Administration's *Morris Trust* proposal would overturn 30 years of tax law and deny tax-free treatment on legitimate "spin-offs," unless the shareholders of the distributing corporation hold stock representing at least 50 % of the vote and value of both the distributing corporation and the "spun-off" corporation for a 4 year period beginning 2 years prior to the "spin-off" (e.g., 2 years before and 2 years after the "spin-off"). Accordingly, any change in stock ownership of 50% or more, even if as a result of a subsequent tax-free transaction (e.g., a merger or acquisition), could trigger a new tax.

An exception is provided if the change in stock ownership is not related to the "spin-off," meaning not pursuant to a "common plan or arrangement" that includes the "spin-off." The Administration proposal goes on to state that a subsequent friendly acquisition transaction "will generally be considered related to the distribution ("spin-off") if it is pursuant to an agreement negotiated (in whole or in part) prior to the distribution ("spin-off")."

The practical effect is that if there is a 50% or greater change in stock ownership (resulting from a tax-free merger or reorganization of either the distributing or controlled corporation) within a 4 year period surrounding the "spin-off," the transaction will be subject to unwarranted IRS scrutiny as to whether a "common plan or arrangement" existed at the time the stock of the "spun-off" corporation was distributed to shareholders.

[2] The term *Morris Trust* comes from a tax case, Commissioner v. Morris Trust, 367 F.2d 794 (4th Cir. 1966) which found a spin-off to be tax-free even though there was a pre-arranged merger and reorganization of the distributing company following the spin-off.

[3] See, Rev. Rul. 68-603, 1968-2 C.B. 148 (upholding the *Morris Trust* case); Rev. Rul. 76-527, 1976-2 C.B. 103 (upholding a "reverse *Morris Trust*" transaction where the spun-off subsidiary was a party to a subsequent reorganization); and Rev. Proc. 96-30 (which recognizes the valid business purpose of a *Morris Trust* transaction). Note that Rev. Proc. 96-30 was issued after the Administration first introduced a *Morris Trust* Budget proposal.

Moreover, if the subsequent tax-free transaction is a friendly acquisition, the subjective test to be administered by the IRS is whether or not the acquisition was "pursuant to an agreement negotiated (in whole or in part)" prior to the "spin-off." The Administration's proposal does not clarify the scope of what is meant by "negotiated (in whole or in part)." Existing case law and administrative guidance also give no direction for interpreting this critical phrase.

The stated reason for this fundamental change in tax policy is contained in Treasury's "General Explanations of the Administration's Revenue Proposals" (February 1997) which states:

> "Corporate nonrecognition under section 355 should not apply to distributions that are effectively dispositions of business."

Acting Assistant Secretary Donald C. Lubick clarified to some extent the intended goal of the proposal as "prevent[ing] tax-free disguised sales of businesses."[4]

IV. ECONOMIC AND TAX POLICY CONCERNS WITH PROPOSAL

The Administration's *Morris Trust* proposal would reverse long-standing tax policy regarding treatment of tax-free reorganizations and impose another layer of capital gains tax on legitimate corporate restructuring transactions. Fundamentally, the proposal is anti-business and anti-growth.

1. Inconsistent With Efforts To Lower Tax On Capital Gains And Tax Reform

At a time when Congress is considering a reduction in the capital gains tax, it would be inconsistent and counterproductive to adopt a proposal which adds yet another layer of tax to the current system. Further, imposing a "double or triple" level of tax on corporate earnings would be the antithesis of tax integration and fundamental tax reform.

One of the fundamental goals of tax reform is to integrate the corporate and individual tax systems so that income is not taxed twice (i.e., once when the corporation earns the money and again when those earnings are distributed to individual shareholders). Any proposal that increases the "double" taxation of corporate income cannot be considered sound tax policy.

2. The Proposal Is Misguided and Undermines U.S. Competitiveness

With a constantly changing regulatory and corporate environment, pressures exist for many corporations to become more efficient and profitable by restructuring, combining or separating businesses and assets. Many industries, including the chemical, pharmaceutical, high-tech and communications industries have faced the challenge of rearranging businesses and assets in corporate solution. The Administration's *Morris Trust* proposal would impinge on these efforts by forcing companies to either maintain inefficient business structures or risk incurring another layer of tax.

Business inefficiencies and multiple layers of tax raise the cost of capital for corporations and impede investment in plant, equipment and jobs. Overall it damages America's economic and job growth. In addition, multiple levels of taxation hurt our global competitiveness and undermine efforts to reduce burdens on U.S. companies competing in international markets.

[4] Statement of Donald C. Lubick, Acting Assistant Secretary (Tax Policy), Department of the Treasury, Hearing on the Education and Training Tax Provisions of the Administration's Fiscal Year 1998 Budget Proposal, House Ways & Means Committee (March 5, 1997).

3. The Proposal Is Overly Broad

Many corporations spend great amounts of time and effort considering a variety of ways to improve their business structures. Some of these actions are seen through to completion while others involve many "starts" and "stops." Some of the activities are "pre-arranged," while others take time to fully develop. From a tax policy perspective, whether a series of independent tax-free transactions take place back-to-back should not change the results of what are each legitimate tax-free restructuring arrangements.

If the intent of the Administration is to attack abusive "disguised sales" of businesses, the proposal is overly broad. The proposal goes well beyond addressing any specific anecdotal abuses which may occur as a result of so-called "debt stuffing," in which companies have used the traditional *Morris Trust* format to restructure, but have allocated a disproportionate share of debt to one of the entities in the process. The Administration's proposal is not targeted to such situations, but rather applies to all *Morris Trust* transactions that occur pursuant to a "common plan or arrangement" or that may be "negotiated (in whole or in part)" before the "spin-off." If there is a perceived abuse with "debt stuffing" transactions, the legislation should target that abuse and not apply to all *Morris Trust* situations.

Further, by disallowing back-to-back tax-free transactions (e.g., a tax-free "spin-off" followed by a tax-free reorganization) using a subjective test to determine whether a "common plan or arrangement" existed at the time of the "spin-off" will result in uncertainty and confusion. Under such a test, any taxpayer which engages in a "spin-off" will face continuous, unwarranted scrutiny by the IRS if within 2 years the taxpayer (or the "spun-off" corporation) enters into another legitimate tax-free transaction. This intrusive scrutiny will exist even if there was never a thought about a subsequent restructuring at the time of the "spin-off." The taxpayer in any case will still have to spend time and money proving that there was never a "common plan or arrangement" to enter into the subsequent transaction at the time of the "spin-off." This needlessly imposes additional costs and burdens on U.S. taxpayers.

More disturbing is the issue of whether of not a subsequent tax-free friendly acquisition resulted from an "arrangement negotiated (in whole or in part)" prior to the "spin-off." With no guidance in the proposal or under current law as to what is meant by "negotiated (in whole or in part)," taxpayers are left in the dark and subject to unwarranted IRS scrutiny of legitimate tax-free transactions. If the proposal moves forward these subjective tests must be further clarified and narrowed.

4. Potential Revenue Is Not Worth The Costs

Finally, if these transactions are subjected to a new layer of tax many of the reorganizations will simply not take place. Not only will Treasury not recognize the estimated revenue, but any revenue collected will be at the cost of burdening the efficient reorganizing of many industries.

In sum, the proposal as drafted is anti-business, anti-growth, misguided, overly broad, and will result in a tax increase on legitimate corporate transactions.

V. PROPOSAL DOES NOT PROVIDE TRANSITION RELIEF

The most disturbing aspect of the Administration's *Morris Trust* proposal is its failure to provide any "transition relief" for taxpayers who are fully complying with current law. The failure to provide such relief either would result in a retroactive tax increase on affected corporations or would force such corporations to forego transactions which would be very disruptive to the marketplace.

Many taxpayers are incurring substantial transactional costs and are dutifully relying on current law as they enter into restructuring arrangements. To retroactively tax such taxpayers who have fully complied and detrimentally relied on current law would be fundamentally unfair and inconsistent with the goals of the tax legislative process.

Monsanto agrees with sentiments by some Members of Congress expressing concern that several of the new proposals from the Administration still have "retroactive effective dates or retroactive impact." We firmly believe that any fundamental change in tax policy should not be made on a retroactive basis.

Finally, the proposed effective date of "first committee action" with no "transition relief" is extremely arbitrary and capricious. Taxpayers who entered into binding written contracts long before the date the proposal was first announced can be affected, while other taxpayers who have yet to enter into a transaction may not be affected.

Should the Congress move forward with a *Morris Trust* type proposal, Monsanto strongly urges that it provide transition relief which will fairly treat taxpayers who have detrimentally relied on and are complying with current law. The transition relief should be at least as broad as that which was provided in the Administration's FY 1997 Budget plan and cover taxpayers who have either: (1) entered into a binding written contract, (2) submitted a ruling request to the IRS, or (3) made a public announcement or SEC filing.

VI. CONCLUSION

Monsanto opposes the *Morris Trust* proposal contained in the Administration's FY 1998 Budget plan. The proposal is anti-business, anti-growth, misguided, overly broad, and will result in a tax increase on legitimate corporate transactions. It also contains unworkable subjective tests (e.g., the determination of what is meant by "negotiated (in whole or in part)") which would cause uncertainty and confusion.

Moreover, the failure of the Administration to provide "transition relief" either would result in a retroactive tax increase on affected corporations or would force such corporations to forego transactions which would be very disruptive to the marketplace.

Should the Congress move forward with a *Morris Trust*-type proposal, Monsanto strongly urges that it provide transition relief which will fairly treat taxpayers who have detrimentally relied on and are complying with current law. The transition relief should be at least as broad as that which was provided in the Administration's FY 1997 Budget plan and cover taxpayers who have either: (1) entered into a binding written contract, (2) submitted a ruling request to the IRS, or (3) made a public announcement or SEC filing.

Comments
of
The National Association of Independent Insurers
on
Revenue Provisions of the President's 1997 Budget Proposal
to the
Senate Committee on Finance

May 2, 1997

The National Association of Independent Insurers (NAII) is a trade association representing 555 property and casualty insurance companies. The NAII was founded 50 years ago on the principles of open competition and pricing flexibility in the insurance industry. Our members range in size from the very largest national writers to the smallest one state writers. Among our members are mutual and stock companies and reciprocal exchanges. Their marketing strategies range from providing the widest range of insurance products to those specializing in a relatively few product lines. NAII members account for one third of all property-casualty insurance premiums written in the United States.

On behalf of our members companies we respectfully submit the following comments on the revenue provisions of the President's 1998 budget.

Dividends Received Deduction

Current law provides corporations with a deduction equal to 70 percent of the dividends they receive from corporations in which they own less than 20 percent of the stock by vote and value.[1] The dividends received deduction is designed to mitigate the double and triple taxation on corporate earnings. The President proposes to reduce the dividends received deduction available to 50 percent. NAII strongly opposes such a reduction.

The property-casualty insurance industry invests its assets primarily in bonds and securities. A far higher proportion of the assets of property and casualty insurers are held in these investments than are held by nonfinancial corporations. In 1995, 12.9 percent of the property-casualty industry's $765.2 billion assets were held in marketable securities; $10.6 billion in preferred stocks and $87.9 billion in common stock.[2] Reducing the dividends received deduction would result in a 66.7 percent tax increase on these investments, severely impacting insurers and policyholders.

A reduction in the dividends received deduction raises the effective tax rate on dividends, raising the cost of capital and further disadvantaging U.S. equity investment. Market experts estimate that reducing the deduction from 70 to 50 percent would result in price declines of one and one

[1] Internal Revenue Code §243

[2] Best's Aggregates and Averages - Property-Casualty, A.M. Best Company, 1996, p. 2

half to seven percent for preferred stocks.[3] For industries, such as property-casualty insurance, this increased tax expense will significantly depreciate the market value of their portfolios resulting in a corresponding decrease in surplus, thus impairing the capacity of the U.S. insurance industry to support existing and new business.

It can be argued that even the current taxation of dividends is a contentious tax area because it represents a punitive system that taxes the same income multiple times. In addition to its punitive nature, the current system also places U.S. investment at a distinct disadvantage. Many of our trading partners have a 100 percent dividends received deduction, thus providing international competitors with an advantage in raising capital in the U.S. market. The President's proposal would also exacerbate these problems.

Extension of Interest Deduction Disallowance

Current law disallows a deduction for interest on debt incurred or continued to purchase or carry tax-exempt bonds.[4] In general, a deduction is disallowed only when indebtedness is directly related to tax-exempt obligations. Taxpayers may establish the purpose of the interest either by direct or circumstantial evidence. Direct evidence exists when the proceeds of indebtedness are directly traceable to the purchase of tax-exempt obligations or when the tax-exempt instruments are used as collateral. In the absence of direct evidence, a deduction is disallowed only when the totality of the facts and circumstances establishes a sufficiently direct relationship between the tax-exempt instruments and the indebtedness. Financial institutions, however, are subject to allocation of their interest expense. Interest deductions for financial institutions are disallowed in the same proportion as the average basis of their tax-exempt obligations bear to the average basis of all their assets. [5]

President Clinton proposes to extend the financial institutions rule to all corporations, other than insurance companies. Under current law, the deduction for losses incurred by property and casualty companies is reduced by 15 percent of the company's tax-exempt interest and the deductible portion of dividends received. If the committee accepts the President's proposal, it is imperative that the exemption for insurers be retained. Property and casualty insurers are already penalized in this regard by proration, which requires the inclusion of at least a portion of tax-exempt interest in their regular tax base and in their alternative minimum tax base under the adjusted current earnings rule. Requiring property and casualty insurers to use the proportional method rule would eliminate practically any remaining incentive for these companies to invest in tax-exempt bonds. The property and casualty insurance industry currently invests considerable sums in state and local tax-exempt bonds, however, application of the proportional method rule would severely diminish these investments, robbing state and local governments of a valuable source of funding.

[3] Flaherty and Crumrine, Inc., Dec. 1995

[4] Internal Revenue Code §265

[5] Internal Revenue Code § 265(b)(2)

Penalty for Failure to File Correct Information Returns

Businesses are required by law to file an informational report with the Internal Revenue Service for each service provider to whom it makes payments which in aggregate total $600 or more per year.[6] These reports must include the name, address and taxpayer identification number of the service provider, as well as the amount of the payments.

Under current law, taxpayers who fail to timely file correct information returns, such as a Form 1099, are subject to a penalty of up to $50 per return, up to $250,000 during any calendar year. Maximum penalties for companies with average taxable incomes of less than $5 million for the previous three years are reduced to $100,000.[7] President Clinton proposes to increase the maximum penalty for failure to file information returns to the greater of $50 per return or five percent of the amount required to be reported. The yearly maximum penalties would remain the same. In cases where businesses correctly report in aggregate 97 percent of the aggregate amount required to be reported, the penalty would remain $50 per return. NAII opposes this provision.

Increased reporting penalties would be particularly burdensome and costly for property-casualty insurers. Property-casualty companies make tens of millions of payments each year on behalf of policyholders to third-party service providers, such as auto repair shops, towing services, construction companies, doctors, and hospitals. Typically, the insurer has no role in selecting the service provider or control over the information provided by the third-party. Insurance personnel generally do not contract with the service provider. In fact, some states prohibit insurers from requiring claimants to utilize a specific service provider. The first notice the insurer has of the arrangement is often the receipt of an invoice from the service provider. Such arrangements make it extremely difficult for insurers to obtain timely and accurate taxpayer information. Nevertheless, the President's proposal would punish an insurer for an inaccurate report that occurs through no fault of its own.

The provision would also be particularly onerous for property-casualty insurers who face extensive state requirements to assure timely payment of claims. The Unfair Claim Practice Laws of most states require that insurers attempt in good faith to make prompt payment of insurance claims. Individual states often impose specific payment deadlines, such as California which requires that payments for auto repairs be made within 10 days from the receipt of the invoice.[8] Several states, including Florida, Kentucky and Louisiana, impose penalties or interest on insurers if payments are not made within specified time periods following a proof of loss.[9] Insurance companies face the almost insurmountable task of acquiring information from third-parties with which they often have no contractual arrangement in a very compressed period of time. The President's proposal would unfairly penalize property-casualty insurers for errors which they did not intend and cannot avoid.

[6] Internal Revenue Code § 6041 and 6041A

[7] Internal Revenue Code § 6723

[8] California Insurance Code § 560

[9] Florida Insurance Code § 627.4265
Kentucky Insurance Coda § 304.12-235
Louisiana Insurance Code § 22:658

Net Operating Loss Carryback

Taxpayers are permitted under current law to carryback a net operating loss (NOL) for three years and carryforward for 15 years.[10] The President proposes to reduce the carryback period for NOLs arising in tax years beginning after the date of enactment to one year and extend the carryforward period to 20 years. NAII strongly opposes this proposal.

The NOL carryback enables taxpayers to spread the effects of losses and to properly reflect the effects of activities on taxable income. The ability to spread the effects of loss is particularly important for the property-casualty industry. Property-casualty insurers often experience losses which are directly related to activities in prior taxable years. Claims, particularly liability, relating to coverage written and premiums collected in a taxable year are often not paid until several years later. The NOL carryback provision allows property-casualty companies to more accurately reflect income and spread the effect of such losses to profitable years.

In recent years, the property-casualty industry has suffered enormous catastrophic losses. In terms of inflation-adjusted losses, seven of the eight most severe U.S. catastrophes have occurred since 1989. In fact, the industry experienced over $67 billion in catastrophic losses from 1989-1995—more than 50 percent greater than the losses of the entire 1980s.[11] The catastrophic losses of the past seven years represent approximately 30 percent of the industry's collective surplus, and the industry is examining many alternatives to try to deal with this issue. The likelihood of more devastating losses in the future is very real—increasing the potential for significant loss periods. There is a 25 percent chance that the property-casualty industry could experience losses exceeding $10 billion in any given year and a 20 percent chance that single year catastrophic losses could top $50 billion during any ten-year period.[12]

A reduction in the NOL carryback period would hamper the ability of the industry to respond to such disasters by eliminating a significant mechanism for capital restoration. The recovery of taxes previously paid and the ability to spread tax liability to profitable years allow the industry to weather catastrophic losses by providing a needed infusion of capital and spreading of risk. The President's proposal would threaten the capacity of insurers to support existing and new businesses, reduce availability, and drive up the cost of insurance products.

Reporting of Payments to Attorneys

Current law requires that amounts in excess of $600 per calendar year paid to non-corporate attorneys be reported on Form 1099-Misc.[13] However, payments made jointly to an attorney and claimant by an insurer are exempted from the reporting requirement unless the insurer knows the amount of the payment that will be retained by the attorney.[14] President Clinton's budget proposes

[10] Internal Revenue Code § 172(b)(1)(A) & (B)

[11] Lighting Candles in the Wind, Conning & Co., Hartford, 1994, p. 29

[12] Catastrophe Risk: A National Analysis of Earthquake, Fire Following Earthquake, and Hurricane Losses to the Insurance Industry, Risk Management Solutions, Inc. and ISO, 1995, p.8

[13] Internal Revenue Code §.6041(a)

[14] Internal Revenue Regulations § 1.6041-1(d)

that the gross amount of payments made to attorneys by a trade or business in the course of that trade or business be reported on Form 1099-B. Under the proposal, payments would be subject to reporting regardless of whether or not the attorney is the exclusive payee.

Pursuant to settlements, insurance companies make numerous payments to claimants through attorneys, a portion of which represents attorney fees. The Joint Committee on Taxation description of the proposal clearly contemplates the situation in which an insurer makes simultaneous payments to an attorney — one representing the attorney's fee and one representing the settlement with the client.[15] In this instance, under the President's proposal, the payment representing attorney's fees would be reported while the remaining amounts would be excluded under Sections 6041 or 6045. However, industry practice is to issue a joint check to the plaintiff and counsel. In almost no instances do insurers issue separate checks. In fact, once an attorney letter is posted to a claim file a lien obligation is created and the insurer is obligated to issue payment to the attorney of record and claimant. As such, under the proposal, insurance companies would be required to issue 1099-Bs reflecting the gross amount of the settlement to claimants represented by counsel. Insurers would also be required to secure taxpayer identification numbers (TINs) for each attorney included in a payment. In cases where they are not able to obtain a proper TIN, insurers could be required to subject payments to backup withholding.

Although, the proposal clearly contemplates reporting of gross proceeds, it is unclear what amount would be subject to backup withholding. Attorney compensation is the result of a contractual agreement negotiated between the claimant and his or her representative. Insurance companies are not privy to such information and have no way to ascertain what portion of the settlement payment will be retained by the attorney. In such instances, the insurance company would be placed in the untenable position of trying to determine on what amount to calculate backup withholding or of withholding on the entire amount when clearly not all of the settlement will be retained by counsel.

The President's attorney reporting proposal would create costly new compliance burdens for the insurance industry and potentially place insurers in violation of state unfair claim practices laws, while yielding little additional useful information to the Internal Revenue Service. The property and casualty insurance industry processes tens of millions of claims per year, a large portion of which involve attorney representation. For example, the Insurance Research Council found in a 1994 study that for bodily-injury claims Alabama had the least number of claims represented by an attorney at 27 percent, while in Maryland over 74 percent of the claims involved an attorney.[16] Even in the best case scenario of a state like Alabama where a typical insurance company may process over 150,000 claims per year, an individual insurance company would be required to issue 40,500 new 1099-Bs per year. And that number only represents one property and casualty insurance in one state. For the industry this provision will require the issuance of millions of new 1099-Bs. As with any business, issuing 1099s is a costly endeavor for the insurance industry. The expenses associated with obtaining taxpayer identification information, data and processing time, and mailing can cost a property and casualty company a minimum of $5 to $10 per 1099.

[15] Joint Committee on Taxation Staff Description and Analysis of Revenue Raising Provisions in President Clinton's FY 1998 Budget Proposal, JCS-10-97, April 16, 1997

[16] Insurance Research Council - "Auto Injuries: Claiming Behavior and Its Impact on Insurance Costs;" 1994, p. 56

Compliance costs alone could easily top $10 million per year for the property-casualty insurance industry — more than the entire seven year revenue projection for the provision — and result in increased insurance premiums for consumers.

Despite the enormous compliance cost associated with the provision, these expenses may well be the least of the problems created for the insurance industry by this provision. The property and casualty insurance industry is regulated at the state level and companies are subject to the unfair claims practice laws of each individual state. As previously noted, most state laws require companies to make full and complete payment within a specific time period following settlement or judgment of a claim.[17] Companies may be required to remit payment in as little as five, but generally not more than 30, days. If Congress adopts the President's attorney reporting requirement, insurers would be forced to attempt to obtain taxpayer identification information within the applicable time period for remitting payment. If an insurer is unable to validate the TIN within the requisite time, the company is faced with the prospect of issuing payment subject to backup withholding or being in violation of state law mandating prompt payment — neither of which is an attractive or even viable option.

State insurance laws further provide that insurers who do not make full and complete payment within the specified time are subject to monetary penalties, interest on the overdue amount, and reasonable attorney fees associated with the collection of such expenses. [18]In cases where the insurer may be forced to delay payment while attempting to obtain taxpayer identification information, the insurer could be liable under state law for interest on the amount of the settlement. If the insurer chose to make prompt payment and withhold, the company could be liable for interest on the underpayment amount. In either instance, the claimant would have the right to take the insurer to court to force payment, subjecting the company to penalties, court costs and additional attorney fees.

NAII strongly opposes adoption of this provision which would require the submission of millions of new 1099s, impose enormous compliance costs, and place property and casualty companies in potential violation of state unfair claim practice laws. As Congress seeks to reduce the paperwork burdens imposed by government regulations, it seems ironic that it would consider adopting such a costly and burdensóme provision which is projected to add only a minimal amount to the federal treasury over the next seven years and it unlikely to provide the IRS with useful additional information.

Determination of Basis of Substantially Identical Securities on an Average Cost Basis

Under current law, taxpayers who dispose of a portion of their holdings of stocks or bonds are permitted to identify the securities disposed of for purposes of recognizing gain or loss on the sale and determining whether the gain or loss is treated as a long-term gain or loss. If the stock or bond disposed of cannot be adequately identified, the taxpayer is generally deemed to have

[17] For example: Florida Insurance Code § 627.4265; Kentucky Insurance Code § 304.12-23; Louisiana Insurance Code § 22:658

[18] For example: Louisiana Insurance Code § 22 658(B)(1)

disposed of the securities in the order of acquisition. The President proposes to require that in the case of substantially identical securities the basis of the securities would be determined on a average basis. For purposes of computing holding period, taxpayers would be deemed to have disposed of the securities first acquired. The proposal would apply to stocks; partnerships or beneficial interests in widely held or publicly traded partnerships; notes, bonds, debentures, or other evidence of indebtedness; and certain interest rate, currency or equity notational principal contracts. NAII opposes the use of average cost basis.

Property-casualty insurers would be severely impacted by this proposed change. As previously noted, the property-casualty insurance industry invests its assets primarily in bonds and securities. The property-casualty insurance industry in 1995 held $98.5 billion in common and preferred stocks and over $111.5 billion in corporate bonds — 27 percent of the industry's total assets.[19] As such, the industry maintains large portfolios and engages in countless sales transactions per year. The use of average cost basis would require insurers to account for basis in all shares of substantially identical securities each and every time they choose to sell a number of those shares. Insurers would be required to create and maintain two sets of records for each and every investment: one for average cost and one for acquisition date. NAII opposes this provision which would impose significant compliance and recordkeeping costs and burdens for taxpayers to address what is essentially the timing aspect of reporting gain or loss from the sales of stocks and securities.

Superfund Excise Tax and Corporate Environmental Income Tax

The Superfund program was created by Congress is 1980 to ensure cleanup of America's most hazardous waste sites. Prior to January 1, 1996, the Superfund Trust Fund was supported by imposition of a 9.7 cent per barrel excise tax on domestic and imported crude and refined products, an excise tax ranging from 22 cents to $4.87 per ton on certain hazardous chemicals, and an excise tax on imported substances which use any of the taxed substances in their manufacture or production.[20] In addition, corporations were subject to a .12 percent tax on the amount of modified alternative taxable income exceeding $1 million.[21] The President proposes to reinstate the excise taxes effective for the period after enactment of the legislation and before October 1, 2007 and to reinstate the corporate environmental income tax for taxable years beginning after December 31, 1996 and before January 1, 2008.

In the last 16 years billions of tax dollars have been collected and spent on Superfund cleanup, yet very little progress has been made in ridding the nation of toxic waste. Currently, nearly half of every Superfund dollar goes toward bureaucratic overhead and for legal expenses to settle disputes between the Environmental Protection Agency and Potentially Responsible Parties (PRPs) at a given site, between PRPs and their insurance companies, and between PRPs and others brought into Superfund litigation through third-party lawsuits.

[19] Best's Aggregates and Averages - Property-Casualty, A M. Best Company, 1996, p. 2 and 104

[20] Internal Revenue Code §§ 4611, 4661, 4671

[21] Internal Revenue Code § 59A

As NAII supports meaningful reform of the Superfund law, we believe extension of the Superfund excise tax and the corporate environmental income tax should be a part of that reform and should not be used to offset the cost of a deficit reduction package.

NAII appreciates the opportunity present our views on the revenue raising provisions in the President's fiscal year 1998 budget. As the committee reviews the revenue raising provisions, we recommend that the foregoing proposals be rejected.

Respectfully submitted

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STATEMENT ON REVENUE RAISING PROVISIONS IN THE ADMINISTRATION'S FY 1998 BUDGET PROPOSAL

BY THE NATIONAL ASSOCIATION OF MANUFACTURERS

SUBMITTED TO THE COMMITTEE ON FINANCE,
U.S. SENATE

APRIL 17, 1997

I. INTRODUCTION

The National Association of Manufacturers (NAM) wishes to express its appreciation to the Committee's Chairman, Mr. Roth, for holding a hearing on the revenue raising provisions in the Administration's FY 1998 budget proposal. The NAM is the nation's oldest and largest broad-based industrial trade association. Its 14,000 member companies and subsidiaries, including approximately 10,000 small manufacturers, are in every state and produce about 85 percent of U.S. manufactured goods. Through its member companies and affiliated associations, the NAM represents every industrial sector and the interests of more than 18 million employees.

The NAM is firmly committed to a balanced federal budget. However, we do not believe that the Administration's FY 1998 budget proposal appropriately accomplishes that goal. According to Administration estimates, the Administration's FY 1998 budget proposal contains approximately $78 billion in tax increases, largely to fund new spending programs. Under the guise of targeting inappropriate tax benefits, the Administration proposes that more than half of this revenue be generated from the corporate community, largely the manufacturing sector. Although the Joint Committee on Taxation (JCT) scores these increases at $73 billion, this is still a significant tax increase. Furthermore, the types of tax increases proposed are anti-growth and run counter to sound tax policy. They would discourage savings and investment and significantly raise the cost of capital. Although this is not an exhaustive list, the NAM opposes the following revenue raising proposals.

II. PROVISIONS RELATING TO SHAREHOLDER-CORPORATION MULTIPLE TAXATION

A. Dividends-Received Deduction

The dividends-received deduction (DRD) was designed to alleviate the impact of multiple layers of corporate taxation. Without the DRD, income would be taxed three times: 1) when it is earned by a corporation; 2) when the income is paid as a dividend to a corporate shareholder, and

3) when the income of the receiving corporation is paid as a dividend to an individual shareholder. The DRD was enacted to provide for full deductibility of intercorporate dividends.

The Administration proposes to lower the corporate DRD from 70 percent to 50 percent. The NAM believes that the Administration's DRD proposal runs counter to sound tax policy principles. The proposal would exacerbate the multiple levels of taxation placed on corporate taxpayers. The proposal would also increase the amount of income subject to triple taxation. Most U.S. trading partners have adopted a single level of corporate taxation as a goal and provide some relief from double or triple taxation through corporate integration. Unlike the United States, other G7 countries generally exclude from tax altogether dividends received by corporations. Adopting provisions that accentuate the problem of multiple taxation, rather than ameliorating this problem, would harm the international competitive position of U.S.-based corporations.

The proposal would also penalize investment by corporations and individuals. Cutting back on the DRD would increase the cost of equity financing for U.S. corporations, thereby discouraging new capital investment.

The Administration is not targeting abusive tax situations with the DRD proposal. The Administration has suggested that some taxpayers may be able to take advantage of the 70 percent deduction in a way that "undermines the separate corporate income tax." To the extent Treasury can demonstrate that the deduction may be subject to misuse, targeted anti-avoidance rules can be provided. The indiscriminate approach of sharply cutting back on the DRD goes beyond addressing inappropriate transactions and unnecessarily penalizes legitimate corporate investment activity. Simply stated—it is very bad tax policy.

The NAM urges the Finance Committee to reject the Administration's proposal to reduce the DRD. A more appropriate approach would be to reduce or eliminate the multiple taxation of corporate income, rather than further accentuate the inefficiencies and inequities of the current corporate tax system.

B. Average Cost-Basis for Securities

Under current Treasury regulations, if a taxpayer sells a portion of his holdings in stocks or bonds, the taxpayer is allowed to identify the securities disposed of for purposes of determining gain or loss on the disposition. If the stock or bonds sold cannot be identified, the taxpayer is generally deemed to have disposed of the securities first acquired. Mutual fund investors are also allowed to determine the adjusted bases of their shares based on the average cost of all such shares.

The issue of accounting for capital gains is becoming more important because an increasing share of the American public now owns stock. Many corporations are using stock options as part of incentive compensation and pay-for-performance plans. Some large corporations have substantial employee stock ownership programs. Quite apart from this, many Americans have independently invested much of their savings in the stock market. It is now estimated that as much as half the adult population owns stock.

The Administration's proposal to require cost-basis averaging would raise taxes on individual investors and result in larger capital gains tax liabilities than under current law. The United States already has some of the highest capital gains rates in the world, and this proposal would further heighten such taxes and, consequently, penalize investment. Additionally, the proposal would greatly complicate calculation of gains and losses by requiring taxpayers to determine the cost basis for any share of stock by averaging the costs of all "substantially identical securities." Such a requirement would be particularly problematic for investors who incrementally invest in securities through reinvestment plans or through employee stock option plans. The NAM is strongly opposed to the adoption of such a requirement.

III. CORPORATE PROVISIONS

A. Net Operating Loss Carry-Back and Carry-Forward Rules

The current three-year carry-back period for net operating losses (NOLs) has been in place for nearly 40 years. As Congress has emphasized when previously extending the carry-back period, the ability to carry losses back rather than forward serves as an effective counterweight to economic reverses by allowing businesses to recover previously paid taxes when they need it most in order to carry on business operations.

The Administration's proposal would reduce the carry-back period for NOLs from three years to one year, and extend the carry-forward period from fifteen to twenty years. The proposal effectively operates as a tax increase on business activity and kicks in at the worst possible time: when a company is down due to poor economic conditions.

The Administration's proposal would also extend the total period in which NOLs could be used. The extension is of virtually no practical significance because a business insufficiently profitable to use an NOL over a fifteen year carry-forward period is unlikely to turn around in an additional five years.

By contrast, the reduction in the carry-back period has a real and substantial effect. Business cycles often extend for three years or more, leaving cyclical businesses in loss positions for a number of years in succession. Under the Administration's proposal, such businesses will be left having paid tax on income that has been offset by losses at a time when their financial resources are least able to handle an incremental tax burden.

The NAM believes there is no credible tax policy justification for shortening the NOL carry-back period. On the contrary, the considerable revenue generated by this proposal would, by definition, be a tax on non-existent profits. The practical effect would be to force businesses to pay tax when they can least afford it. Such a policy would have a negative effect on employment during economic downturns, thereby hurting workers when they can least afford it. Furthermore, with a reduced loss carry-back period, companies will be forced to borrow money for continuing operations and put their credit ratings at risk. This proposal would increase their cost of capital and further exacerbate the situation.

The three-year NOL carry-back period has served its purpose well for nearly 40 years. The NAM strongly urges that it be retained.

B. Superfund Taxes

Superfund has historically been funded by three taxes—the corporate environmental tax, the petroleum excise tax, and the chemical feed stock tax—all of which expired as of December 31, 1995. The Administration's budget proposal would reinstate both the petroleum excise tax and the chemical feed stock tax at their previous levels from the date of enactment through September 30, 2007. The corporate environmental tax would be reinstated at its previous level for taxable years beginning after December 31, 1996 and before January 1, 2008.

Under the proposal, these taxes would be used to generate general revenues to balance the budget. The use of such tax revenues for deficit reduction purposes should be rejected. The decision whether to re-impose these taxes dedicated to financing Superfund should instead be made as part of a comprehensive examination of reforming the entire Superfund program. While the NAM understands that the Superfund taxes are not technically within the scope of this hearing, we believe the Administration's proposals in this area represent particularly bad tax policy.

IV. FOREIGN PROVISIONS

A. Treatment of Foreign Oil and Gas Income and Dual-Capacity Taxpayers

The NAM supports the general principle of restoring a full, effective foreign tax credit to the Internal Revenue Code. The complexities of current law, particularly the multiplicity of separate "baskets," should be eliminated, while deferral of U.S. tax on income earned by foreign subsidiaries should not be further eroded. However, the Administration's budget proposal moves in the opposite direction with regard to foreign oil and gas income. It would limit use of the foreign tax credit and repeal deferral of U.S. tax on foreign oil and gas income.

This selective attack on a single industry's utilization of the foreign tax credit and deferral is not justified. U.S.-based oil companies are already at a competitive disadvantage under current law since most of their foreign-based competition pay little or no home country tax on foreign oil and gas income. The proposal increases the risk of foreign oil and gas income being subject to double taxation, which will severely hinder U.S. oil companies in the global oil and gas exploration, production, refining, and marketing arena.

Under the Administration's proposal, so-called "deferral" would be eliminated. That would result in the current taxation of foreign subsidiary oil and gas income before it is ever repatriated. All foreign oil and gas income would be treated as "Subpart F" income as defined under I.R.C. section 904(d). Furthermore under the proposal, in those situations where taxpayers are subject to a foreign tax and also receive an economic benefit from the foreign country (so-called "dual-capacity taxpayers"), such taxpayers would be able to claim a credit for foreign taxes under I.R.C. section 902 only if the foreign country has a "generally applicable income tax" that has "substantial application" to all types of taxpayers, and then only up to the level of taxation that would be imposed under that generally applicable income tax.

The Administration's proposal would further tilt the playing field against the U.S. petroleum industry's foreign exploration and production efforts, and would increase (or make prohibitive) the U.S. tax burden on foreign petroleum industry operations. It will not only stymie new investment in foreign exploration and production projects, but also change the economics of some past investments. The availability of the foreign tax credit, along with so-called "deferral" of taxation of foreign subsidiary earnings until repatriation, make up the foundation of U.S. taxation of foreign source income by alleviating the problem of double taxation. This targeted Administration proposal, which conflicts with sound tax policy, also is in direct conflict with the U.S. trade policy of global integration, embraced by both Democratic and Republican Administrations.

B. Sales Source Rules (Export Source Rule)

The NAM strongly opposes the Administration's proposal to replace the current export source rule with an activity-based sourcing rule. Since 1922, tax regulations have contained the export source rule, which allows the income from goods that are manufactured in the U.S. and sold abroad to be treated as 50 percent U.S. source income and 50 percent foreign source income. As a result, the export source rule increases the ability of U.S. exporters to utilize foreign tax credits and thus avoid double taxation of foreign earnings.

The Administration contends that the export source rule is not needed to alleviate double taxation because of our tax treaty network. We strongly disagree. The U.S. has tax treaties with fewer than a third of all jurisdictions. More significantly, double taxation is generally caused by the many restrictions in U.S. tax laws on crediting foreign taxes paid on the international operations that U.S. companies must have to compete in the global marketplace. Among these restrictions are the allocation rules for interest and R&D expenses, the many foreign tax credit "baskets," and the treatment of domestic losses.

By reducing double taxation, the export source rule encourages U.S.-based manufacturing and exports. A recent Hufbauer/DeRosa study estimates that for the year 1999 alone, the export source rule will account for an additional $30.8 billion in exports, support 360,000 jobs, and add $1.7 billion to worker payrolls in the form of export-related wage premiums. (This study is an analysis of the economic impact of the export source rule, a document submitted as part of Gary Hufbauer's testimony on March 12, 1997.) The Administration's proposal would essentially eliminate this WTO-consistent (World Trade Organization) export incentive. Such action would be harmful to U.S. economic growth and high-paying, export-related jobs. This proposal would also take away the administrative simplicity of the export source rule and require enormously complex factual determinations which would add administrative burdens and create controversies. The NAM strongly urges Congress to retain the current export source rule.

V. ACCOUNTING PROVISIONS

A. Lower of Cost or Market Inventory Accounting Method

A taxpayer that sells goods in the active conduct of its trade or business generally must maintain inventory records in order to determine the cost of goods it sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period. Because of the difficulty of applying the specific identification method of accounting, taxpayers often use methods such as "first-in, first-out" (FIFO) and "last-in, first-out" (LIFO). Taxpayers not using a LIFO method are allowed to determine the carrying values of their inventories by applying the lower of cost or market (LCM) method and by writing down the cost of goods that are unsalable at normal prices or unusable in the normal way because of damage, imperfection or other causes (the "subnormal goods" method).

The Administration's proposal would repeal the LCM method. The NAM is opposed to repeal of LCM because, particularly in a time of rapid technological advance, the value of items accounted for in inventory is often diminished due to external factors. LCM allows this loss of value to be accounted for in the period in which it occurs. To retain the historic cost basis in such instances would be both unfair and fail to achieve a proper matching of costs and revenue, resulting in a failure to clearly reflect income. The NAM strongly urges the retention of the LCM method.

B. Components of Cost Inventory Accounting Method

Finally, the NAM opposes the Administration's proposal to repeal the Components of Cost (COC) method used to determine inventory accounting values, typically under "last-in, first-out" (LIFO) accounting. The COC method has been in use for over 50 years by many companies, both large and small, chiefly manufacturing firms. Its use predominates in industries where specialized and customized products are manufactured and where products change to a high degree from one year to the next. For those companies, the method has been indispensable. In fact, the American Institute of Certified Public Accountants (AICPA) states that it is the only practical method for a manufacturer with substantial work in process to use.

Absent COC, many manufacturers would be forced to determine their LIFO inventory using current alternatives such as the inventory price index computation or total product cost. However, both of these methods are enormously complex and unworkable. Accordingly, the repeal of COC as proposed by the Administration would effectively force many manufacturers off LIFO.

Equally troubling to the NAM is the fact that the manufacturers impacted by this repeal will have to incur exorbitant costs to install and operate a totally new, redundant, cost accounting method for financial reporting and internal management purposes since COC has been deemed by the AICPA as the preferable method under GAAP and endorsed by the Securities and Exchange Commission (SEC). For many of our members, the installation cost alone of a new accounting system would be tens of millions of dollars.

VI. EFFECTIVE DATES

Certain proposed corporate revenue raising provisions contained in the Administration's FY 1998 budget proposal would be effective on the date of first committee action, but with no provision to exclude transactions-in-process [e.g., proposals to treat certain preferred stock as "boot," to reform the tax treatment of certain corporate stock transfers (section 304), and to require gain recognition on certain distributions of controlled stock (section 355)]. This obviously creates uncertainty in the business community, and, as former President Lyndon Johnson stated, "the most damaging thing you can do to any businessman in America is to keep him in doubt, and to keep him guessing, on what our tax policy is."

The NAM concurs with the statements made last year by the chairmen of the congressional tax- writing committees, in connection with the FY 1997 budget proposals, that the effective dates of any new revenue raising tax proposals should not disrupt market activities and normal business transactions. In this regard, the completion of many contractually binding business transactions, predating the first committee action, can be subject to delays or contingencies, such as shareholder approval or government antitrust or tax clearances. Nevertheless, these bona fide transactions would fail the Administration's effective date rule if final closing were to occur after such date even though the transactions were contractually bound prior to the effective date. This disrupts on-going commercial activities and ultimately amounts to a retroactive tax increase on pending but not completed transactions.

The NAM believes it would be highly inappropriate to adversely impact pending business transactions in this way. Accordingly, the NAM urges that if Congress adopts any revenue raisers, whatever effective date it chooses (e.g., enactment date, first committee action, etc.), it should include an exception for pending transactions that are publicly announced, subject to binding contracts or contingent upon necessary third party approvals.

VII. CONCLUSION

While the NAM fully supports balancing the federal budget and, in fact, believes such action is necessary to the economic health of the country, we believe that the revenue raisers discussed above would provide disincentives to savings and investment and raise the cost of capital for manufacturers. The NAM not only doesn't support these and other tax increases in the Administration's budget, but we believe that pro-growth policies, such as alternative minimum tax (AMT) reform, capital gains tax decreases, estate tax repeal, permanent extension and improvement of the research and experimentation tax credit, and S corporation rate relief, combined with spending reductions, would stimulate economic growth, leading to both a healthier overall economy and a balanced budget.

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Comments of the

National Association of Real Estate Investment Trusts®

to the

Committee on Finance
U.S. Senate

regarding certain

Revenue Provisions in the President's

Fiscal Year 1998 Budget

**Submitted by Milton Cooper, NAREIT Chair and
Chairman and Chief Executive Officer, Kimco Realty Corporation**

April 17, 1997

As requested in Press Release No. 105-71 (April 9, 1997), the National Association of Real Estate Investment Trusts® ("NAREIT") respectfully submits these comments in connection with the Ways and Means Committee's review of certain revenue provisions presented to the Ways and Means Committee as part of the President's Fiscal Year 1998 Budget. NAREIT's comments will address the Administration's proposal to amend section 1374 of the Internal Revenue Code to treat an "S" election by a large C corporation as a taxable liquidation of that C corporation. We appreciate the opportunity to present these comments.

NAREIT represents over 240 real estate investment trusts (known as "REITs"), about 200 of which trade on the New York Stock Exchange, the American Stock Exchange, or the National Market System of the NASDAQ. In addition, NAREIT represents over 1,600 analysts, investment bankers, lawyers, accountants, and others that provide services related to the REIT industry.

Congress established REITs in 1960 to allow small investors to obtain the diversification and professional management of capital-intensive real estate that beforehand were only available to large, sophisticated investors.[1] The market capitalization of publicly traded REITs has blossomed from under $9 billion at the beginning of 1991 to about $100 billion today, as hundreds of thousands of small investors assisted in the recapitalization of portions of America's premier commercial real estate properties.

This growth in the use of the public equity market as a source of funds for real estate has played a critical role in solidifying the foundation of many quality real estate operating companies, as well as improving the assets of banks, insurance companies and pension plans. It also has resulted in an opportunity for achieving Congress' goal of providing small investors with the opportunity to become owners of those properties along with the best real estate managers in the country.

I. APPLICATION OF SECTION 1374 TO REITs

As the Committee knows, prior to its repeal as part of the Tax Reform Act of 1986, the holding in an old court case named General Utilities permitted a C corporation to elect S corporation or REIT status (or transfer assets to an S corporation or REIT in a carryover basis transaction) without incurring a corporate-level tax. With the repeal of the General Utilities doctrine, such transactions arguably would have been subject to tax but for Congress' enactment of section 1374. Under section 1374, a C corporation making an S corporation election can elect to have the S corporation pay any tax that otherwise would have been due on the "built-in gain" of the C corporation's assets, but only if those assets were sold or otherwise disposed of during a 10-year "recognition period." The application of the tax upon the disposition of the assets, as opposed to the election of S status, worked to distinguish legitimate conversions to S status from those made for purposes of tax avoidance.

In Notice 88-19,1988-1 C.B. 486 (the "Notice"), the Internal Revenue Service (the "IRS") announced that it intended to issue regulations under section 337(d)(1) that in part would address the avoidance of the repeal of General Utilities through the use of REITs and RICs. In addition, the IRS noted that those regulations would permit the

[1] Congress ensured that REITs operate in that manner by instituting various ownership tests comparable to those applied in the identification of a personal-holding company. See I.R.C. sections 856(a)(5) and (a)(6).

REIT to be subject to rules similar to the principles of section 1374. Thus, under regulations that have to yet been issued, C corporations would have the ability to elect REIT status and incur a corporate-level tax only if the REIT sells assets during the "recognition period."

In a release issued February 22, 1996, the Department of the Treasury (the "Treasury Department") announced that it intends to revise Notice 88-19 to conform to the Administration's proposed amendment to limit section 1374 to corporations worth less than $5 million, with an effective date similar to the statutory proposal. This proposal would result in a double layer of tax: once to the shareholders of the C corporation in a deemed liquidation and again to the C corporation itself upon such deemed liquidation. The Administration's 1998 proposal reiterates this amendment.

Because of the Treasury Department's intent to extend the proposed amendment of section 1374 to REITs, the remainder of these comments addresses the proposed amendment as if it applied to both S corporations and REITs.

II. ARGUMENTS IN SUPPORT OF THE CURRENT APPLICATION OF SECTION 1374 TO REITS

As stated above, the Administration's proposed amendment would limit use of the 10-year election to REITs valued at less than $5 million. NAREIT believes that this proposed amendment would contravene Congress' original intent regarding the formation of REITs, would be both inappropriate and unnecessary in light of the statutory requirements governing REITs, would impede the recapitalization of commercial real estate, likely would result in lower tax revenues, and ignores the basic distinction between REITs and partnerships.

A fundamental reason for a continuation of the current rules regarding a C corporation's decision to elect REIT status is that the primary rationale for the creation of REITs was to permit small investors to make investments in real estate without incurring an entity level tax, and thereby placing those persons in a comparable position to larger investors. H.R. Rep. No. 2020, 86th Cong., 2d. Sess. (1960).

By placing a toll charge on a C corporation's REIT election, the proposed amendment would directly contravene this congressional intent, as C corporations with low tax bases in assets (and therefore a potential for a large built-in gains tax) would be practically precluded from making a REIT election. As previously noted, the purpose of the 10-year election was to continue to allow C corporations to make S corporation and REIT elections when those elections were supported by non-tax business reasons (e.g., access to the public capital markets), while protecting the Treasury from the use of such entities for tax avoidance.

Additionally, REITs, unlike S corporations, have several characteristics that support a continuation of the current section 1374 principles. First, there are statutory requirements that make REITs long-term holders of real estate. The REIT "thirty-percent gross income test"[2] and prohibited transactions tax[3] are direct compliments to the 10-year election mechanism.

Second, while S corporations may have no more than 35 shareholders, a REIT faces no statutory limit on the number of shareholders it may have, are required to have at least 100 shareholders, and in fact some REITs have hundreds of thousands of beneficial shareholders. NAREIT believes that the large number of shareholders in a REIT and management's responsibility to each of those shareholders preclude the use of a REIT as a vehicle to be used primarily in the circumvention of the repeal of General Utilities. Any attempt to benefit a small number of investors in a C corporation through the conversion of that corporation to a REIT is impeded by the REIT widely-held ownership requirements.

In addition, REIT management has a legal and fiduciary responsibility to determine the timing and reasons for the disposition or distribution of the entity's assets with the intention of benefiting all shareholders. Thus, there is no tax avoidance if a REIT sells assets in the first 10 years, but rather only a deferral.

The consequence of this proposal would be to preclude C corporations in the business of managing and operating income-producing real estate from accessing the substantial capital markets infrastructure comprised of investment banking specialists, analysts, and investors that has been established for REITs. In addition, other C corporations that are not primarily in the business of operating commercial real estate would be precluded from recognizing the value of those assets by placing them in a professionally managed REIT. And in

[2] I.R.C. § 856(c)(4).
[3] I.R.C. § 857(b)(6).

both such scenarios, the hundreds of thousands of shareholders owning REIT stock would be denied the opportunity to become owners of quality commercial real estate assets.

Furthermore, the $5 million dollar threshold that would limit the use of the current principles of section 1374 is unreasonable for REITs. While many S corporations are small or engaged in businesses that require minimal capitalization, REITs as owners of commercial real estate have significant capital requirements. As previously mentioned, it was Congress' recognition of the significant capital required to acquire and operate commercial real estate that led to the creation of the REIT as a vehicle for small investors to become owner's of such properties. The capital intensive nature of REIT's makes the $5 million threshold essential meaningless for REITs.

It should be noted that this proposed amendment is unlikely to raise any substantial revenue with respect to REITs, and may in fact result in a loss of revenues. Because of the high cost that would be associated with making a REIT election if this amendment were to be enacted, it is unlikely that any C corporations would make the election and incur the associated double level of tax without the benefit of any cash to pay the taxes. In addition, by remaining C corporations, those entities would not be subject to the REIT requirement that they make a taxable distribution of 95% of their income each tax year. While the REIT is a single-level of tax vehicle, it does result in a level of tax on nearly all of the REIT's income each year.

Last but far from least, the Administration justifies its de facto repeal of section 1374 by stating that "[t]he tax treatment of the conversion of a C corporation to an S corporation generally should be consistent with the treatment of its conversion to a partnership." Regardless of whether this stated reason for change is justifiable for S corporations, in any event it should not apply to REITs because of the differences between REITs and partnerships.

Unlike partnerships, REIT cannot (and have never been able) to pass through losses to its investors. Further, REITs can and do pay corporate level income and excise taxes. Simply put, REITs are C corporations. Thus, REITs indirectly are less susceptible to the tax avoidance concerns raised by the 1986 repeal of the General Utilities doctrine.

III. SUMMARY

The 10-year recognition period of section 1374 currently requires a REIT to pay a corporate-level tax on assets acquired from a C corporation with a built-in gain, if those assets are disposed of within a 10-year period. Combined with the statutory requirements that a REIT be a long-term holder of assets and be widely-held, current law assures that the REIT is not a vehicle for tax avoidance. The proposal would frustrate Congress' intent to allow the REIT to permit small investors to benefit from the capital-intensive real estate industry in a tax efficient manner.

Accordingly, NAREIT believes that tax policy considerations are better served if the Administration's section 1374 proposal is not enacted as it applies to REITs. If you would like to discuss this in greater detail, feel free to contact Tony M. Edwards, NAREIT's Vice President and General Counsel, at (202) 785-8717.

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STATEMENT OF THE NATIONAL FOREIGN TRADE COUNCIL, INC. SUBMITTED TO THE COMMITTEE ON FINANCE, UNITED STATES SENATE BY FRED F. MURRAY, VICE PRESIDENT FOR TAX POLICY APRIL 17, 1997

ON THE IMPACT ON INTERNATIONAL COMPETITIVENESS OF CERTAIN OF THE FOREIGN PROVISIONS IN THE ADMINISTRATION'S FISCAL YEAR 1998 BUDGET PROPOSAL

Mr. Chairman, and Members of the Committee:

The National Foreign Trade Council, Inc. (the "NFTC" or the "Council") is appreciative of the opportunity to present its views on the impact on international competitiveness of certain of the revenue raising foreign provisions in the administration's fiscal year 1998 budget proposal.

The NFTC is an association of businesses with some 550 members, originally founded in 1914 with the support of President Woodrow Wilson and 341 business leaders from across the U.S. Its membership now consists primarily of U.S. firms engaged in all aspects of international business, trade, and investment. Most of the largest U.S. manufacturing companies and most of the 50 largest U.S. banks are Council members. Council members account for at least 70% of all U.S. non-agricultural exports and 70% of U.S. private foreign investment. The NFTC's emphasis is to encourage policies that will expand U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax inequities in the treatment of U.S. companies operating abroad.

The founding of the Council was in recognition of the growing importance of foreign trade to the health of the national economy. Since that time, expanding U.S. foreign trade and incorporating the United States into an increasingly integrated world economy has become an even more vital concern of our nation's leaders. The value of U.S. international trade (imports plus exports) as a percentage of GDP has more than doubled in recent decades: from 7 percent in the 1960's to 17 percent in the 1990's. The share of U.S. corporate earnings attributable to foreign operations among many of our largest corporations now exceeds 50 percent of their total earnings. Direct investment by U.S. companies in foreign jurisdictions continues to exceed foreign direct investment in the United States (in spite of the net debtor status of the U.S.) by some $180 billion in 1994. In 1995, U.S. exports of goods and services totaled $805 billion -- 11.1 percent of GDP.[1] In 1993, 58 percent of the $465 billion of merchandise exports from the U.S. were associated with U.S. multinational corporations: $110 billion of the exports went to foreign affiliates of the U.S. companies, and another $139 billion of the exports were shipped directly to unrelated foreign buyers.[2] Even these numbers in and of themselves do not convey the full importance of exports to our economy and to American-based jobs, because they do not address the additional fact that many of our smaller and medium-sized businesses do not consider themselves to be exporters although much of their product is supplied as inventory or components to other U.S.-based companies who do export.

Foreign trade is fundamental to our economic growth and our future standard of living.[3] Although the U.S. economy is still the largest economy in the world, its growth rate represents a mature market for many of our companies. As such, U.S. employers must export in order to expand the U.S. economy by taking full advantage of the opportunities in overseas markets. Today, some 96% of U.S. firms' potential customers are outside the United States, and in the 1990's 86% of the gains in worldwide economic activity occurred outside the United States. Over the past three years, exports have accounted for about one-third of total U.S. economic growth; and, projected exports of manufactured goods reached a record level in 1996 of

[1] U.S. Department of Commerce, "Survey of Current Business," April 1996.

[2] U.S. Department of Commerce, "U.S. Multinational Companies: Operations in 1993," June 1995, at 39.

[3] "Continued robust exports by U.S. firms in a wide variety of manufactures and especially advanced technological products — such as sophisticated computing and electronic products and cutting-edge pharmaceuticals — are critical for maintaining satisfactory rates of GDP growth and the international competitiveness of the U.S. economy. Indeed, it is widely acknowledged that strong export performance ranks among the primary forces behind the economic well-being that U.S. workers and their families enjoy today, and expect to continue to enjoy in the years ahead." Gary Hufbauer (Reginald Jones Senior Fellow, Institute for International Economics) and Dean DeRosa (Principal Economist, ADR International, Ltd.), "Costs and Benefits of the Export Source Rule, 1998-2002," A Report Prepared for the Export Source Coalition, February 19, 1997.

$653 billion.[4]

The Council's Concerns

The NFTC is concerned that this and previous Administrations, as well as previous Congresses, have often turned to the international provisions of the Internal Revenue Code to find revenues to fund domestic priorities, in spite of the pernicious effects of such changes on the competitiveness of United States businesses in world markets. The Council is further concerned that such initiatives may have resulted in satisfaction of other short-term goals to the serious detriment of longer-term growth of the U.S. economy and U.S. jobs through foreign trade policies long consistent in both Republican and Democratic Administrations, including the present one.

United States policy in regard to trade matters has been broadly expansionist for many years, but its tax policy has not followed suit. The provisions of Subchapter N of the Internal Revenue Code of 1986 (Title 26 of the United States Code is hereafter referred to as the "Code") impose rules on the operations of American business operating in the international context that are much different in important respects than those imposed by many other nations upon their companies. Some of these differences, described in more detail in the sections that follow, may make American business interests less competitive in foreign markets when compared to those from our most significant trading partners:[5]

o The United States taxes worldwide income of its citizens and corporations who do business and derive income outside the territorial limits of the United States. Although other important trading countries also tax the worldwide income of their nationals and companies doing business outside their territories, such systems generally are less complex and subject to less significant limitations under their tax statutes or treaties than their U.S. counterparts.

o The United States has more complex rules for the limitation of "deferral" than any other major industrialized country. Although the United States taxes the worldwide income of its companies, it permits deferral of the tax on unrepatriated foreign earnings of controlled foreign corporations, except where one of six complex, overlapping series of "anti-deferral" provisions of the Code apply. In addition, the anti-deferral provisions of most countries do not tax active business foreign income of their companies, while those of the U.S. inappropriately impose current U.S. tax on some active business foreign income as well as on passive foreign income.

o The current U.S. Alternative Minimum Tax (AMT) system imposes numerous rules on U.S. taxpayers that seriously impede the competitiveness of U.S. based companies. For example, the U.S. AMT provides a cost recovery system that is inferior to that enjoyed by companies investing in our major competitor countries; additionally, the current AMT 90-percent limitation on foreign tax credit utilization imposes an unfair double tax on profits earned by U.S. multinational companies -- in some cases resulting in a U.S. tax on income that has been taxed in a foreign jurisdiction at a higher rate than the U.S. tax.

o The U.S. foreign tax credit system is very complex, particularly in the computation of limitations under the provisions of section 904 of the Code. While the theoretic purity of the computations may be debatable, the significant administrative costs of applying and enforcing the rules by taxpayers and the government is not. Systems imposed by other countries are in all cases less complex.

o The United States has more complex rules for the determination of U.S. and foreign source net income than any other major industrialized country. In particular, this is true with respect to the detailed rules for the allocation and apportionment of deductions and expenses. In many cases, these rules are in conflict with those of other countries, and where this conflict occurs, there is significant risk of double taxation.

As noted above, the United States system for the taxation of the foreign business of its citizens and companies is more complex than that of any of our trading partners, and perhaps more complex than that of any other country.

That result is not without some merit. The United States has long believed in the rule of law and the self-assessment of taxes, and some of the complexity of its income tax results from efforts to more clearly define the law in order for its citizens and companies to apply it. Other countries may rely to a greater degree on government assessment and negotiation between taxpayer and government -- traits which may

[4] See, Fourth Annual Report of the Trade Promotion Coordinating Committee (TPCC) on the National Export Strategy: "Toward the Next Century: A U.S. Strategic Rosponse to Foreign Competitive Practices," October 1996, U.S. Department of commerce, ISBN 0-16-048825-7; J. David Richardson and Karin Rindal, "Why Exports Matter: More!," Institute for International Economics and the Manufacturing Institute, Washington, D.C., February 1996.

[5] See, Financial Executives Research Foundation, *Taxation of U.S. Corporations Doing Business Abroad: U.S. Rules and Competitiveness Issues*, 1996, Ch. 9.

lead to more government intervention in the affairs of its citizens, less even and fair application of the law among all affected citizens and companies, and less certainty and predictability of results in a given transaction. In some other cases, the complexity of the U.S. system is simply ahead of development along similar lines in other countries -- many other countries have adopted an income tax similar to that of the United States, and a number of these systems have eventually adopted one or more of the significant features of the U.S. system of taxing transnational transactions: taxation of foreign income, anti-deferral regimes, foreign tax credits, and so on. However, while difficult to predict the ultimate evolution, none of these other country systems seems prone to the same level of complexity that affects the United States system. This reluctance may be attributable in part to recognition that the U.S. system has required very significant compliance costs of both taxpayer and the Internal Revenue Service, particularly in the international area where the costs of compliance burdens are disproportionately higher relative to U.S. taxation of domestic income and to the taxation of international income by other countries.[6]

Many foreign companies do not appear to face the same level of costs in their operations. The European Community Ruding Committee survey of 965 European firms found no evidence that compliance costs were higher for foreign source income than for domestic source income.[7] Lower compliance costs and simpler systems that often produce a more favorable result in a given situation are competitive advantages afforded these foreign firms relative to their American counterparts.

Short of fundamental reform -- a reform in which the United States federal income tax system is eliminated in favor of some other sort of system -- there are many aspects of the current system that could be reformed and greatly improved. These reforms could significantly lower the cost of capital, the cost of administration, and therefore the cost of doing business for American firms. For example, the NFTC strongly supported the International Tax Simplification for American Competitiveness Act of 1996, S. 2086 (104th Cong., 2nd Sess.), introduced by Mr. Pressler (R-SD) and Mr. Baucus (D-MT) of this Committee. The NFTC continues to support similar efforts in the 105th Congress.

In the light of this background, the NFTC would today like to specifically address three of the President's Fiscal Year 1998 proposals: (1) Modification of the Export Source Rule (also known as the "Inventory Sales Source Rule," and sometimes as the "Title Passage Rule"); (2) Modification of so-called "deferral" as it currently applies to foreign oil and gas income; and, (3) Modification of the rules for foreign tax credit carrybacks and carryovers.

Modification of the Export Source Rule

Description of the Rule[8]

The "Export Source Rule," as it is commonly called, is but one of a number of sales source rules found in sections 861, 862, and 863 of the Internal Revenue Code of 1986 (the"Code"), and the Treasury regulations thereunder. In fact, the Export Source Rule is not in the statute, but is instead found in Treasury Regulations § 1.863 - 3(b), and has been there or in its predecessor provisions for more than 70 years.

As noted above, the United States taxes U.S. citizens and residents and U.S. corporations on their worldwide income. That is, a U.S.-based enterprise is taxed by the United States not only on the income from its operations and sales in the United States, but also on the income from its operations and sales in other countries. This worldwide taxation creates "double taxation" when that same foreign income is taxed in the other country where it is derived. Each of the affected countries has its own internal tax rules to determine the "source" of the income involved, the application of which rules may determine whether the income in question may be taxed under its laws and to what extent.

To mitigate double taxation of income earned abroad, the United States, like many other countries, has since 1918 allowed a credit for income taxes paid to foreign countries with respect to foreign source income — the "foreign tax credit." That is, in cases where it applies, the United States cedes its jurisdiction in favor of the foreign country where the income is sourced, (i.e., the source country taxes the income and the U.S. does not).

Since 1921, foreign tax credits have been subject to a limitation in some form. Generally, the limitation is intended to allow a credit to be claimed only to the extent that the credit does not exceed the amount of U.S. income tax that would be due on the foreign-source income absent the credit. In other words, the United States does not allow a credit for the entire amount of foreign tax imposed — only that amount that would have been the U.S. tax if it had chosen to impose its tax on the income. For example, a U.S.

[6] See Marsha Blumenthal and Joel B. Slemrod, "The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications," in *National Tax Policy in an International Economy: Summary of Conference Papers*, (International Tax Policy Forum: Washington, D.C., 1994).

[7] *Id.*

[8] Parts of the following discussion of the rule were abstracted from material prepared for the Export Source Coalition.

company paying a tax at a 40% rate in a foreign country would only receive a foreign tax credit up to the maximum 35% U.S. rate. The general limitation can be expressed in an algebraic equation:

$$\begin{array}{c}\text{U.S. tax (pre-credit)}\\ \text{on worldwide income}\end{array} \quad \times \quad \frac{\text{foreign source taxable income}}{\text{worldwide taxable income}}$$

Under the formula, as foreign source taxable income increases (e.g., by operation of the Export Source Rule), the limitation on foreign tax credits available to offset U.S. tax increases (and therefore the foreign tax credit that can be utilized in most cases increases, up to the full amount of foreign taxes paid or accrued).

To the extent that the foreign income tax is less than the limitation, the United States collects a residual tax on the foreign source income. If the foreign income tax exceeds the limitation, the taxpayer pays tax, in the current year, on foreign source income at the effective foreign tax rate (rather than the lower U.S. tax rate). This results in foreign tax credits in excess of the general limitation in the current year (an "excess foreign tax credit position"). These excess credits may, under current law, be "carried back" for up to two years and "carried forward" for up to five years, subject to the general limitation in each of those years.[9]

Higher foreign tax rates are only one reason many companies are in an excess foreign tax credit position. A multitude of other U.S. tax rules place restrictions on crediting foreign taxes.

As noted above, the amount of the credit is dependent on the amount of income designated as "foreign source" under U.S. tax law. For example, under restrictions in U.S. law, a portion of U.S. interest, as well as research and development costs, must be allocated to and reduce foreign source taxable income (even though no deduction may actually be allowed for these amounts in the foreign country). On the other hand, if a company incurs a loss in its domestic operations, it is never able to use foreign source earnings from that year to claim foreign tax credits.

The system is further complicated by other rules, such as the "basket" limitation rules of section 904 of the Code. Under these provisions, foreign source income is divided into separate baskets for various situations and types of income to each of which the limitation is applied. These rules may result in hundreds of separate limitations being applied to the credits. (Thus, a U.S. company might nevertheless end up with excess foreign tax credits, even though without such rules the company would have been able to fully utilize its foreign tax credits.)

These U.S. rules are orders of magnitude more complex than the similar limitation systems of any of our foreign trading partners. Lost credits and the cost of compliance only add to the disparity in tax burden between U.S.-based and foreign-based multinationals, mitigated in part by the Export Source Rule.

The Code contains two source rules for the sale of inventory property that are of particular importance to U.S. exporters. One rule is for inventory property that the exporter produces and sells; and, the other is for inventory property that the exporter purchases and sells[10].

The source of income derived from the sale of property produced[11] in the U.S. and sold outside the U.S. (or vice versa) is determined under section 863 of the Code. Treasury Regulations promulgated in 1996, following regulations that date back to 1922, and which implement section 863 and its predecessor statutes, provide three rules for making the determination of the amount of income that is foreign source. The first and most commonly used of these is known as the "50-50 Method" (also known as the "Export Source Rule")[12].

Under the so-called "50-50 Method," 50 percent of the income to be allocated between U.S. source and foreign source is allocated based on the location of the taxpayer's property used in the production of the

[9] In other words, the return for the second preceding tax year is recomputed with the newly available credit carryback, and to the extent that the foreign tax credits previously available in that year plus the foreign tax credits carried back to that year do not exceed the general limitation, the taxes carried back may be utilized in that year to reduce the U.S. tax paid in that year. If excess credits remain, the same procedures are followed for the first preceding tax year, and then the first succeeding tax year, the second succeeding tax year, and so on, until they are used up, or until the five year limitation causes them to "expire."

[10] The source of gross income derived from inventory property that is purchased by an exporter in the U.S. and sold outside the U.S. is determined under the "title-passage" rule of section 862(a)(6), which treats such income as derived entirely from the country in which the sale occurs. That is, such property sales generally produce foreign source income.

[11] Section 864 of the Code provides that "produced property" includes property that is "created, fabricated, manufactured, extracted, processed, cured, or aged."

[12] The second method is the "Independent Factory Price Method" or "IFP Method;" and, the third permits a method based on use of the taxpayer's own method of allocation made in its books and records with the IRS District Director's consent.

inventory, and the source of the other 50 percent is based on the title-passage rule. Assuming title to the inventory passes outside the United States, this generally allows U.S. manufacturers to treat at least half of their export income from manufacture and sale of their products as derived from foreign sources, even though the manufacturer's production activity is located in the U.S.

EXAMPLE[13]:

American Widget Company exports widgets to European markets and is in an excess foreign tax credit position. It costs American $90 to produce, sell, and transport a unit from one of its 14 U.S. plants, but only $88 to produce and sell a unit in the Czech Republic where it has located a plant to make widgets for the East European market. The U.S. made units sell for $100 each in West European markets.

Assume American produces a widget in the U.S. with U.S. jobs and manufacturing plant, and passes title to the widget in Romania, paying no tax in Romania on the sale. American has $10 of pre-tax income, $5.00 of which is considered foreign source income. Assuming a 35% U.S. tax rate, it may utilize $1.75 additional foreign tax credits, and therefore has $8.25 of after-tax income from the sale [($10.00 X 65%) + $1.75].

As an alternative, American could produce a widget in the Czech Republic for sale in Romania. American would have $12.00 of net income. Assume again that American would pay no Romanian tax and that the Czech tax rate is 35%. American would have $7.80 of after-tax income.

With the Export Source Rule, American has an incentive to maintain production in the U.S. ($8.25 > $7.80). Without the Rule, American would have an incentive to increase its Czech production. ($7.80 > $6.50):

	U.S. Production		Czech Production
	With Export Source Rule	Without Export Source Rule	
Sales Price	$100.00	$100.00	$100.00
Cost of Goods Sold	($90.00)	($90.00)	($88.00)
Pre-tax Income	$10.00	$10.00	$12.00
U.S. tax	$3.50	$3.50	$4.20
Czech tax	-	-	$4.20
Foreign Tax Credit	($1.75)	-	($4.20)
Net tax	$1.75	$3.50	$4.20
After-tax Income	$8.25	$6.50	$7.80

As another way to view the situation, if American requires an 8.25% Return On Sales to support its capital structure, without the Export Source Rule, American would have to raise its unit price at least $2.69 to obtain the same $8.25 return. If the market would not support this new price, it would have to shift production to a location where a lower cost structure can be found, or lose its market to lower cost competitors.

[13] For purposes of this example, a number of other U.S. tax rules, such as "deferral" and the "subpart F" rules, other credit limitations, and the like are ignored — they do not change the basic result, but serve to complicate the illustration.

For example, the following two structures result with and without the Export Source Rule:

	With Export Source Rule	Without Export Source Rule
Sales Price	$100.00	$102.69
Cost of Sales	90.00	90.00
Profit	$10.00	$12.69
Net tax	$3.50	$4.44
Less: Foreign Tax Credit	($1.75)	–
Net tax	$1.75	$4.44
After-tax profit	$8.25	$8.25

The Administration's Proposal

The President's Fiscal Year 1998 Budget contains a proposal to eliminate the "50/50 Rule" and replace it with an "activities based" test which would require exporters to allocate income from exports to foreign or domestic sources based upon how much of the activity producing the income takes place in the U.S. and how much takes place abroad.

In addition to introducing considerable administrative complexity and cost into the system[14], this modification essentially eliminates the benefits of the rule. The justification given for eliminating the rule is essentially that it provides U.S. multinational exporters that also operate in high tax foreign countries a competitive advantage over U.S. exporters that conduct all their business activities in the U.S. In this regard, the Administration prefers the foreign sales corporation rules (FSC) which exempt a lesser portion of export income for all exporters that qualify. The Administration also notes that the U.S. tax treaty network protects export sales from foreign taxation in countries with which we have treaties. The NFTC believes that these arguments are flawed.

The Export Source Rule does not provide a competitive advantage to multinational exporters vis-à-vis exporters who conduct all their operations in the United States. First, exporters with domestic only operations do not incur foreign taxes and therefore do not suffer double taxation. Also, domestic-only exporters are able to claim the full benefit of deductions for U.S. expenses for U.S. tax purposes (e.g., interest on borrowings and Research & Development costs) because they are also not subject to the rules applied to multinational operations that require allocation of a portion of these expenses against foreign source income. Absent the Export Source Rule, the current Code would have even more of a bias against foreign operations. Second, this is important because the Administration argument also ignores the fact that export operations ultimately lead to foreign operations for U.S. companies. Exporting companies conduct foreign operations to enter and serve foreign markets; marketing, technical and administrative services, and even specialized manufacturing activities are necessary to gain markets and to keep them — to compete with foreign-based companies. Further, and importantly, the Export Source Rule, by alleviating the cost of double taxation, encourages U.S. companies to locate production in the United States. Tax costs are like other costs (e.g., labor, material, and transportation) affecting the production and marketing of these products and services; a recent study suggests that these decisions are now much more tax-sensitive in fact than was previously the case.[15]

Although the FSC regime of the Code[16] is itself valuable to promoting U.S. exports, these provisions do not in themselves afford relief to U.S. exporters with foreign operations that face double taxation because of

[14]"Moreover, the 50/50 source rule of present law can be viewed as having the advantage of administrative simplicity; the proposal to apportion income between the taxpayer's production activities and its sales activities based on actual economic activity has the potential to raise complex factual issues similar to those raised under the section 482 transfer pricing rules that apply in the case of transactions between related parties." Joint Committee on Taxation, "Description and Analysis of Certain Revenue-Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposal," JCX-10-97, March 11, 1997.

[15]"A second key is the sensitivity of plant location to the tax environment. Not right away perhaps, but over a period of years a country that penalizes export production with high taxes will forfeit first investment and then export sales." Hufbauer, DeRosa, Id., at 15.

[16]The Foreign Sales Corporation ("FSC") provisions of sections 921 through 927 of the Code are one of the most important U.S. tax incentives for exports from the United States. These provisions were adopted to offset disadvantages to U.S. exporters in relation to more favorable tax schemes allowed their foreign competitors in the tax systems of our trading partners. These provisions encourage the development and manufacture of products in the United States and their export to foreign markets.

limited use of foreign tax credits. Further, because the FSC benefits are less than those attributable to the loss of foreign tax credits in a situation where the Export Source Rule may be applicable, they may be insufficient to keep an exporter from moving its production overseas to generate foreign source income.[17]

Our tax treaty network, valuable as it is, is no substitute for the Export Source Rule. First, the countries with which the U.S. currently has double taxation agreements number approximately forty-eight.[18] These nations tend to be our most developed trading partners, and relatively few developing nations are included. Much of the world is not yet covered by these treaties. Further, the treaties provide relief from double taxation in such cases only where the export income is solely allocable to the U.S. — i.e., where the U.S.-based exporter does not have a permanent establishment in the foreign jurisdiction to which income is allocable. These circumstances only occur where a U.S. company exports to a foreign treaty partner, and has no operations in that host country that have anything to do with its export sales.

To the contrary, the Export Source Rule supports significant additional U.S. exports and worker earnings. For example, in 1999, for an adjusted net tax revenue cost of $1.1 billion, the U.S. will ship an additional $30.8 billion of exports and add $1.7 billion to worker payrolls in the form of the export earnings premium. The additional exports will support 360 thousand workers in export-related jobs who in a full employment economy would otherwise be working in lower paid sectors of the U.S. economy.[19]

Modification of "Deferral" and Limitation of Foreign Tax Credits from Foreign Oil and Gas Income

The Concept and Policy of Deferral

As noted above, the United States exerts jurisdiction to tax all income, whether derived in the United States or elsewhere, of U.S. citizens, residents, and corporations. By contrast, the United States taxes non-resident aliens and foreign corporations only on income with a sufficient nexus to the United States. U.S. citizens and residents and U.S. corporations (collectively "U.S. persons") are taxed currently by the United States on their worldwide income, subject to the foreign tax credit discussed in the last section of this statement. Income earned by a foreign corporation, the stock of which is owned in whole or in part by U.S. persons, generally is not taxed by the United States until the foreign corporation repatriates those earnings by payment to its U.S. stockholders. Therefore, two different sets of U.S. tax rules apply to U.S. taxpayers that control business operations in foreign countries; which rules apply depends on whether the business operations are conducted directly, for example, through a foreign branch, or indirectly through a separately incorporated foreign company.

U.S. persons that conduct foreign operations directly (i.e., not through a foreign corporation) include income (or loss) from those operations on the U.S. tax return for the year the income is earned or the loss is incurred. The U.S. taxes that income currently, subject to any reductions by credits such as the foreign tax credit.

U.S. persons that conduct foreign operations through a foreign corporation generally pay no U.S. tax on the income from those operations until the foreign corporation repatriates its earnings to the U.S. (i.e., the taxation is "deferred" — hence the concept of "deferral). The income is taxed in the year it comes home, again subject to reductions by available foreign tax credits.

In general, two kinds of transactions are repatriations that end deferral and trigger tax. First, in the case of any foreign corporation, an actual dividend payment ends deferral — that is, any U.S. recipient must include the dividend in income. Second, in the case of a "controlled foreign corporation" or "CFC," an investment in "U.S. property" such as a loan back to the parent company or the purchase of certain U.S. property is also treated as a repatriation that ends deferral in an amount measured by the investment. However, realizing

[17] U.S. firms with excess foreign tax credits that use the Export Source Rule pay a "blended" tax rate of 17.5 percent on their export earnings — zero percent on half and 35 percent on half. U.S. firms can conduct their export sales through a FSC and exclude a maximum of 15 percent of their net export earnings from U.S. taxation. In this case, the "blended" rate is 29.75 percent — zero percent on 15 percent of export earnings and 35 percent on 85 percent of export earnings.

[18] The United States has in force some forty-eight Conventions for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income ("income tax treaties") with various jurisdictions, not including other agreements affecting income taxes and tax administration (*e.g.*, Exchange of Tax Information Agreements or Treaties of Friendship and Navigation that may include provisions that deal with tax matters). It has taken more than sixty years to negotiate, sign, and approve the treaties that form the current network. A number of new agreements are being negotiated by the Treasury Department. Nevertheless, the U.S. treaty network has never been as extensive as the treaty networks of our principal competitors. The U.S. treaty network covers only about 22 percent of the developing world, compared to coverage of 40 to 46 percent by the networks of Japan and leading European nations. This discrepancy has persisted for many years, even though the United States relies on the developing world to buy a far larger share of its exports than does Europe.

[19] Hufbauer, DeRosa, Id., at 1.

the potential for use of deferral for unintended reasons, the Code has since 1937 provided a number of regimes to avoid abuses of the general deferral. Today, the Code contains no less than six complex sets of such rules: the CFC rules (sections 951-964); the foreign personal holding company rules (sections 551-558); passive foreign investment company ("PFIC") rules (sections 1291-1297); the personal holding company rules (sections 541-547); the accumulated earnings tax (sections 531-537); the foreign investment company rules (sections 1246 and 1247); and, the rules that apply to sales or reorganizations of the shares of a foreign corporation (sections 367(b), 1246, and 1248).

Despite the gradual erosion of deferral through enactment and modification over the decades of the significant limitations noted in the last paragraph, deferral remains a significant component of the competitiveness of U.S. businesses operating abroad. The NFTC has long believed that the anticipatory taxation of earning of foreign subsidiaries would have the following consequences:

1. An increase in American industry's overall tax burden from foreign operations and loss of revenue over the long term for the U.S. Treasury;
2. Reduction in the ability of U.S. multinational companies to compete abroad;
3. Erosion of the foreign resources of American companies and a decrease in the profitability of these companies;
4. An adverse impact on U.S. exports and employment and on the nation's balance of payments;
5. Reduction of investments abroad by U.S. firms without generating additional investment in the United States; and,
6. Risk of countervailing taxes by foreign governments.

Deferral permits U.S. taxpayers operating through foreign corporations to compete internationally by reinvesting their foreign earnings without subjecting such earnings to current U.S. income taxation. This is significant, as the O.E.C.D. has found that the cost of capital for both domestic (8.0 percent) and foreign investment (8.8 percent) by U.S. companies is significantly higher than the averages for the other G-7 countries (7.2 percent domestic anbd 8.0 percent foreign). In fact, the O.E.C.D. determined that the U.S. is tied with Japan as the least competitive G-7 countries in which a multinational company may be headquartered, taking into account taxation at the individual and corporate levels.[20]

Unlike the anti-deferral regimes of other developed countries, that generally eliminate deferral only for passive income[21], the U.S. anti-deferral regimes have been inappropriately modified to eliminate deferral on some types of active trade or business income: including financial services income [22], oil-related refining income, international shipping and aircraft income, and certain other types of non-passive income.

The anti-deferral regimes reflect a series of responses to the need to raise revenue and/or to correct perceived shortcomings in the general rule of deferral existing at the time of enactment. However, the resulting hodgepodge of overlapping rules create disparate limitations on deferral that require current taxation of certain types of income by reference to different factors or criteria, and in other cases impose interest charges or other additions to the taxation of such income otherwise allowed deferral. The various regimes have different rules of priority, different attribution rules, and contain other issues making their application difficult and costly. The regimes are to a substantial degree redundant, and impose on both the taxpayer and the government overlapping and expensive compliance requirements, unlike the anti-deferral regimes of the other developed countries.[23]

[20] O.E.C.D., *Taxing Profits in a Global Economy: Domestic and International Issues* (1991), pp. 147-149, 154, 460. See also, Financial Executives Research Foundation, Id., at 65.

[21] These systems are generally much simpler as well. See analysis of the systems of France, Germany, and Japan, Financial Executives Research Foundation, Id., at 92-93.

[22] For example, the income of the active business of financial service companies such as banks, finance companies, and the like was removed from deferral in 1986. The rationale of the change was to target operations of tax haven banks that had no real operations in the haven; but, the changes were sweeping, and our nation's commercial banks and finance companies were subjected overnight to significantly higher costs of capital for operations in all jurisdictions vis-à-vis their foreign competitors. The change had negative repercussions on these businesses. For example, one of our members advises that it was the owner of the fourth largest commercial bank in Switzerland (the largest non-Swiss owned bank), and that it was forced to dispose of its holding due to the increase in costs attributable to this change in U.S. tax law. The disposition was to foreign competition. Similarly, we are advised that the loss of deferral and resulting increase in cost of operations and cost of capital serve as an entry barrier to U.S. institutions attempting to acquire foreign banking interests in foreign markets.

[23] Perhaps the most aggregious example is the overlap between the CFC and the PFIC rules. The CFC rules have been in the Code since the early 1960's (and need significant change in themselves), and the PFIC rules were enacted as part of the Tax Reform Act of 1986 to address perceived abuses in the taxation of widely held offshore foreign investment funds. The resulting statute, however, catches many active CFC's in its reach.

The Administration's Proposals

The President's Fiscal Year 1998 Budget contains a proposal to repeal deferral for all "foreign oil and gas income." Such income would be treated as subpart F income (and taxed currently), and additionally would be trapped in a new separate FOGI basket under the separate basket foreign tax credit limitations of section 904. In situations where taxpayers are subject to a foreign tax and also receive an economic benefit from the foreign country (e.g., a royalty on production), taxpayers would be able to claim a foreign tax credit for such taxes under section 902 only if the country has a "generally applicable income tax" that has "substantial application" to all types of taxpayers and then only up to the level of taxation that would be imposed under the generally applicable income tax. Treaty provisions to the contrary (for foreign tax credit calculations) would be respected. The NFTC opposes these proposals. In addition to creating significant new limitations on the foreign tax credits attributable to foreign oil and gas income, the proposals represent another piecemeal repeal of deferral.

Subpart F treatment in theory is generally limited to passive income that is easily manipulated as to source of income, and that may be shifted to low or no tax jurisdictions. The Administration's proposal does not provide any justification for this approach to taxing foreign oil extraction operations. Such income is derived where and when the natural resource is extracted, without tax manipulation, in an active business. Further, potential abuses of deferral and the foreign tax credit have been addressed previously in sections 901(f), 907(a) and (b) and (c), and 954(g) of the Code, and in the "dual capacity" income tax regulations under section 901 of the Code.[24] The Administration has not demonstrated that these provisions of law and regulation are not adequate and should be amended.

The proposals go well beyond amendment of these provisions to total elimination of deferral for the natural resources industry and significant limitation of the foreign tax credits available to this specific industry. This piecemeal repeal of deferral will significantly increase the cost of capital in that industry and make U.S. companies less competitive vis-à-vis their foreign competitors.

Modification of the Rules for Foreign Tax Credit Carrybacks and Carryovers

As noted above, if a foreign income tax exceeds the limitation, the taxpayer pays tax, in the current year, on foreign source income at the effective foreign tax rate (rather than the lower U.S. tax rate). This results in

[24] Congress legislated changes in the treatment of oil and gas income, and related foreign tax credits, in the 1970's and 1980's. These changes reflected concerns about the relatively high tax rates in some foreign jurisdictions in which there was significant oil recovery, and also a concern over whether payments by the petroleum companies were in fact disguised royalties.

Under section 907(a), the amount of taxes on foreign oil and gas extraction income ("FOGEI") may not exceed 35% (i.e., the highest U.S. marginal rate) on such income. Excess credits may be carried over like excess foreign tax credits in the general limitation basket. (FOGEI is income derived from the extraction of oil and gas, or from the sale of exchange of assets used in extraction activities.) In addition, under section 907(b), the Treasury has regulatory authority to determine that a foreign tax on foreign oil related income ("FORI") is not creditable to the extent that the foreign law imposing the tax is structured, or in fact operates, so that the tax that is generally imposed is materially greater than the amount of tax on income that is neither FORI nor FOGEI. (FORI is foreign source income from: (1) processing oil and gas into primary products; (2) transporting oil and gas or their primary products, (3) distributing or selling these products, or (4) disposing of assets used in the foregoing activities.) To date, the Treasury has not exercised this authority; however, see the discussion below of the safe harbor rule of Treas. Reg. § 1.901-2A(e)(1).

Under section 954(g), foreign base company oil related income (an element of subpart F income not eligible for deferral) generally includes FORI other than income derived from a source within a foreign country in connection with either (1) oil or gas which was extracted from a well located in that foreign country (FOGEI); oil, gas, or a primary product of oil or gas which is sold by the foreign corporation or a related person for use or consumption within that foreign country, or is loaded in that country on a vessel or aircraft as fuel for that vessel or aircraft.

In addition, in 1983, the I.R.S. promulgated the "dual capacity" regulations (Treas. Reg. § 1.901-2A). Since mineral rights in many countries vest in the sovereign, payments to the sovereign may take the form of royalties or other payments for the mineral or as taxes to the sovereign on the income represented by the production. To help resolve the possible controversy of whether such payment are royalties or creditable income taxes, the regulations provide that a taxpayer must establish under the facts and circumstances method the amount of the intended tax payment that otherwise qualifies as an income tax payment but is not paid in return for a specific economic benefit. The remainder is a deductible rather than creditable payment (in the case of oil and gas products, a royalty). A "safe harbor" method is available under Treas. Reg. § 1.901-2A(e)(1), under which a formula is used to determine the tax portion of the payment to the foreign sovereign (e.g., the amount that the taxpayer would pay under the foreign country's general income tax law). Where there is no generally applicable income tax, the safe harbor rule of the regulation allows the use of the U.S. tax rate in a "splitting" computation (the U.S. tax rate is considered the country's generally applicable income tax rate).

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foreign tax credits in excess of the general limitation in the current year (an "excess foreign tax credit position"). These excess credits may, under current law, be "carried back" for up to two years and "carried forward"for up to five years, subject to the general limitation in each of those years.[25]

The Administration's Proposal

The President's Fiscal Year 1998 Budget contains a proposal to reduce the carryback period for excess foreign tax credits from two years to one year. The proposal also would extend the excess foreign tax credit carryforward period from five years to seven years.

As noted by the Joint Committee on Taxation,[26] one of the purposes of the carryover of foreign tax credits is to address timing differences between U.S. tax rules and foreign tax rules. Income may be subject to tax in one year under U.S. rules and in another tax year under applicable foreign rules. The carryback and carryover of foreign tax credits helps to ensure that foreign taxes will be available to offset U.S. taxes on the income in the year in which the income is recognized for U.S. purposes. Shortening the carryback period and increasing the carryforward period also could have the effect of reducing the present value of foreign tax credits and therefore increasing the effective tax rate on foreign source income.

In Conclusion

Again, the Council applauds the Chairman and the Members of the Committee for giving careful consideration to the proposals raised by the Administration. The NFTC is appreciative of the opportunity to work with the Committee and the Congress in going forward into this process of consideration of various alternatives, and the Council would hope to make a contribution to this important business of the Committee.

[25] See footnote 9.

[26] JCX-10-97, Id., at 62.

STATEMENT OF THE NATIONAL MINING ASSOCIATION
TO THE COMMITTEE ON FINANCE
U.S. SENATE
ON THE ADMINISTRATION'S
FISCAL 1998 TAX PROPOSALS
APRIL 17, 1997

The National Mining Association (NMA) appreciates the opportunity to submit this statement for the Committee's record on the President's Fiscal 1998 tax proposals. The NMA is an industry association representing most of the Nation's producers of coal, metals, industrial and agricultural minerals. Our membership also includes equipment manufacturing firms and other providers of products and services to the mining industry. The NMA has not received a Federal grant, contract or subcontract in Fiscal years 1997, 1996 or 1995.

Mining employs some 300,000 workers directly and supports three million jobs in allied industries. Processed material of mineral origin such as coal, copper, gold, zinc and silver total $391 billion, or about 5 percent of the United States gross domestic product. The headquarters of operations of NMA member companies are located in nearly every state of the Union and some form of mining represented by the NMA occurs in all 50 states.

The U.S. Department of Labor reports that the mining industry provides some of the highest paying non-supervisory jobs in the United States. The average mining wage in 1995 was $45,270 (not including benefits) -- far above the nation-wide average wage of $27,845. We believe that tax policy should foster the creation of more of these high-paying jobs. Unfortunately, the Administration's proposals to repeal the percentage depletion allowance for certain minerals and the sunset of the placed-in-service date for Section 29 Nonconventional Fuel Credit do just the opposite.

DEPLETION

Of primary concern to our industry is the proposal in the Administration's budget to repeal the percentage depletion allowance for minerals mined on lands where mining rights were originally acquired under the Mining Law. We are adamantly opposed to this proposal.

Repeal of the allowance is a major tax increase on companies that have mines located primarily in the western United States. As it is not uncommon for ownership of mineral deposits to change hands, the proposal would especially penalize mining companies who purchased their properties from original claimants or other intermediary mining concerns.

From our perspective, the President's depletion proposal has more to do with mining on public lands in the western states than it does with tax policy. The NMA and its member companies continue to support responsible amendments to the Mining Law, including a reasonable royalty provision. This reform effort has been stymied at every turn by anti-mining groups. Those opposing responsible amendment to the Mining Law seek changes that would make mining on public lands nearly impossible. The Administration's proposal to increase the tax burden on certain hardrock mines would appear to be a coordinated effort to accomplish that goal.

Increasing the tax burden on the mining industry is effectively an increase in production costs. Because minerals are commodities traded in the international marketplace at prices determined by the world-wide supply and demand factors, mining companies cannot recover higher costs by raising prices. Most mines affected by this proposal will see their tax burden increase by as much as 8 percent to 10 percent.

This tax increase is likely to have the following short- and long-term disruptive effects on the industry:

- Reduce the operating lives of many mines by increasing the ore cut-off grade. Minerals that would otherwise have been economic to extract will remain in the ground and not be recovered, resulting in poor stewardship of our natural resources. Existing jobs, federal, state and local tax revenues will be lost.
- Higher taxes will reduce the ability of companies to make the necessary investment in existing operations to improve production efficiencies and respond to constantly changing environmental, reclamation, health and safety standards.
- Investment in new projects will decline. This change to long-standing tax policy will adversely affect the economics of new projects and lower expected after-tax rates of return. Many new projects will become uneconomic, resulting in lost opportunities for new jobs and tax revenues.

The long-term consequences of this tax increase are serious. Without continuous investment in new domestic projects to replace old mines, mineral production in the United States will decline. The increasing short-fall between the nation's demand for mineral products and domestic supply will be satisfied by imports of minerals mined by foreign workers. Our exports will be jobs and many areas of the country will experience declining economies and erosion of state and local tax bases.

The mining industry is characterized by relative rarity of commercially viable mineral deposits, high economic risks, geologic unknowns, extreme costs and long lead times for development of new mines. The depletion allowance recognizes the unique nature of mineral extraction by providing a rational and realistic method of measuring the decreasing value of a deposit as minerals are extracted. As the replacement cost of a new mine is always higher in real terms than the mine it replaces, the allowance helps generate the capital needed to bring new mines into production.

A significant amount of capital is needed to develop and operate a mine, be it on federal or non-federal land. It is not uncommon to spend in excess of $400 million to bring a domestic world-scale mine into production. The cost of processing facilities is high: A state-of-the-art smelter can have capital costs approaching $1 billion. To argue that minerals are "free for the taking" and mining companies are recipients of so-called corporate welfare is fallacious at best.

The mining industry (and other capital-intensive industries) already pay high effective tax rates through the application of the corporate alternative minimum tax (AMT). The General Accounting Office in a 1995 study reported that the average effective tax rate for mining companies under the AMT is 32 percent. The AMT gives the United States the worst capital cost recovery system in the industrialized world. Rather than increasing the tax burden on mining, as proposed by the Administration, it should be reduced by reform of the corporate AMT.

SECTION 29: Credit for Producing Fuel From A Nonconventional Source

Section 29 (c) was enacted to provide incentives for alternative or non-conventional fuels produced from coal or biomass. It provides that synthetic fuel produced form coal and biomass produced from a facility placed in service before July 1, 1998, pursuant to a binding contract entered into before January 1, 1997, are eligible for a tax credit, if produced before January 1, 2008. The credit encourages clean technologies that provide significant environmental benefits.

The Administration's budget contains a proposal to shorten the placed in service date by one year to July 1, 1997. This proposal is unfair will have a devastating impact on producers who have entered into contacts based on the specifications in the 1996 Small Business Tax Bill. The very existence of the proposal has had a chilling effect on the ability of companies to raise the capital needed to successfully complete the contracts they entered into based on current law. We urge the Committee to reject this arbitrary reduction in the placed-in-service date.

The fact is that because of the long lead time, up to two years or more, needed for plant planning, permitting and construction, many clean coal projects may not meet the July 1, 1998, deadline. Therefore, rather than shortening the placed-in-service date, we advocate that Congress build on the compromise reached in 1996 and extend the placed-in-service date to July 1, 1999. Extension of the placed-in-service date will help ensure that companies with binding contracts in place under current law have a reasonable amount of time to complete projects that otherwise would qualify for the credit.

CONCLUSION

We urge the Committee and the Congress to reject these job-killing and self-defeating tax increases targeted at the mining industry. Instead, Congress should pass tax legislation designed to foster investment and economic growth in mining and other capital intensive industries and should include reform of the corporate AMT and extension of the Section 29 placed-in-service date.

Statement by
John J. Doherty
Commissioner of the New York City Department of Sanitation
on the
The President's FY98 Budget Request to the Committee on Finance
of the United States Senate
April 17, 1997

The New York City Department of Sanitation ("the Department") respectfully urges the Senate Committee on Finance to protect an extension of the Alternative Fuel Tax Credit in the Internal Revenue Service Code, Section 29 as passed in 104th Congress, Second Session, House of Representatives Report 104-737 to accompany H.R. 3448.

Protection of the Alternative Fuel Tax Credit in its present form would allow New York City's reclamation of methane gas from the nation's largest landfill, Fresh Kills, located on Staten Island. The landfill receives approximately 13,000 tons per day of residential municipal solid waste.

Background:

Refuse contained in landfills decomposes producing methane gas and odors that can be recovered through United States Environmental Protection Agency ("EPA") approved landfill gas technologies. EPA's Methane Outreach Program encourages municipal landfill operators like New York City to implement landfill gas recovery projects. These projects reduce greenhouse gas emissions and provide a clean source of fuel. The tax credit extension, in its present form, continues a valuable private sector incentive for recovering methane gas emissions.

The City has initiated a methane gas recovery project at Fresh Kills. Based on an estimated cost of approximately twenty five million dollars in infrastructure to set up the technology, the credit is the only tangible financial incentive left for companies to build, maintain and operate a recovery facility.

The Department has diligently pursued both contractual and infrastructure commitments -to secure the tax credit for New York City with a placed in service date of July 1, 1998. Any acceleration of that date would prevent the Department and New York City from qualifying for the tax credit. In December 1996, the Department entered into a contractual agreement with a private firm in an effort to comply with the requirements of Section 29, in reliance on meeting the July 1, 1998 deadline. If that date were changed to June 30, 1997, the Department's ability to qualify for the tax credits would fail for several reasons including: it would be impossible to complete construction within three months; without assistance from the private sector costs to install a gas control system are prohibitive; and the Department's proposal submission dates, based on existing deadlines as referenced above in the House Conference Report on Section 29, would be inadequate.

As currently structured, the tax credit would provide a one million dollar per year payment to New York City's landfill gas recovery program for the next twenty years. Failure to obtain this credit would result in a deficit and disqualify the program as a concession. As a consequence New York City would be responsible for the full cost of a program.

In closing, the New York City Department of Sanitation respectfully urges the Finance Committee to protect an extension of the Alternative Fuel Tax Credit.

WRITTEN TESTIMONY SUBMITTED TO THE
FINANCE COMMITTEE
U.S. SENATE

REGARDING A PROPOSAL IN PRESIDENT CLINTON'S
FISCAL YEAR 1998 BUDGET
TO INCREASE PENALTIES FOR FAILURE TO FILE
CORRECT INFORMATION RETURNS

April 17, 1997

The undersigned associations, which represent a broad range of financial institutions, including both large and small institutions, reiterate their strong opposition to the Administration's proposal to increase penalties for failing to file correct information returns. As included in the President's fiscal year 1998 budget, the proposal generally would increase the penalty for failure to file correct information returns on or before August 1 following the prescribed filing date from $50 for each return to the greater of $50 or 5 percent of the amount required to be reported1. We believe the proposal is overly broad in that it applies to all types of information returns, including Forms 1099-INT, -DIV, -OID, -B, -C, and -MISC, as well as Form W-2.

The proposed penalties are unwarranted and place an undue burden on already compliant taxpayers. The financial services community devotes an extraordinary amount of resources to comply with current information reporting and withholding rules and is not compensated by the U.S. government for these resources. The proposed penalties are particularly inappropriate in that (i) there is no evidence of significant current non-compliance and (ii) the proposed penalties would be imposed upon financial institutions while such institutions were acting as integral parts of the U.S. government's system of withholding taxes and obtaining taxpayer information.

Current Penalties are Sufficient

We believe the current penalty regime already provides ample incentives for filers to comply with information reporting requirements. In addition to penalties for inadvertent errors or omissions2, severe sanctions are imposed for intentional reporting failures. In general, the current penalty structure is as follows:

The combined standard penalty for failing to file correct information returns and payee statements is $100 per failure, with a penalty cap of $350,000 per year.
Significantly higher penaltiesùgenerally 20 percent of the amount required to be reported (for information returns and payee statements), with no penalty capsùmay be assessed in cases of intentional disregard.3

Payors also may face liabilities for failure to apply 31 percent backup withholding when, for example, a payee has not provided its taxpayer identification number (TIN).

There is no evidence that the financial services community has failed to comply with the current information reporting rules and, as noted above, there are ample incentives for compliance already in place. It seems, therefore, that most of the revenue raised by the proposal would result from higher penalty assessments for inadvertent errors, rather than from increased compliance with information reporting requirements. Thus, as a matter of tax compliance, there appears to be no justifiable policy reason to substantially increase these penalties.

Penalties Should Not Be Imposed to Raise Revenue

Any reliance on a penalty provision to raise revenue would represent a significant change in Congress' current policy on penalties. A 1989 IRS Task Force on Civil Penalties concluded that penalties "should exist for the purpose of encouraging voluntary compliance and not for other purposes, such as raising of revenue."4 Congress endorsed the IRS Task Force's conclusions by specifically enumerating them in the Conference Report to the Omnibus Budget Reconciliation Act of 1989.5 There is no justification for Congress to abandon its present policy on penalties, which is based on fairness, particularly in light of the high compliance rate among information return filers.

Safe Harbor Not Sufficient

Under the proposal, utilization of a 97 percent substantial compliance "safe harbor6" is not sufficient to ensure that the higher proposed penalties apply only to relatively few filers. Although some information reporting rules are straightforward (e.g., interest paid on deposits), the requirements for certain new financial products, as well as new information reporting requirements,7 are often unclear, and inadvertent reporting errors for complex transactions may occur. Any reporting "errors" resulting from such ambiguities could easily lead to a filer not satisfying the 97 percent safe harbor.

Application of Penalty Cap to Each Payor Entity Inequitable

We view the proposal as unduly harsh and unnecessary. The current-law $250,000 penalty cap for information returns is intended to protect the filing community from excessive penalties. However, while the $250,000 cap would continue to apply under the proposal, a filer would reach the penalty cap much faster than under current law. For institutions that file information returns for many different payor entities, the protection offered by the proposed penalty cap is substantially limited, as the $250,000 cap applies separately to each payor.

In situations involving affiliated companies, multiple nominees and families of mutual funds, the protection afforded by the penalty cap is largely illusory because it applies separately to each legal entity. At the very least, any further consideration of the proposal should apply the penalty cap provisions on an aggregate basis. The following examples illustrate why aggregation in the application of the penalty cap provisions is critical.

BXAMPLB I -- Paying Agents

A bank may act as paying agent for numerous issuers of stocks and bonds. In this capacity, a bank may file information returns as the issuers' agent but the issuers, and not the bank, generally are identified as the payors. Banks may use a limited number of information reporting systems (frequently just one overall system) to generate information returns on behalf of various issuers. If an error in programming the information reporting system causes erroneous amounts to be reported, potentially all of the information returns subsequently generated by that system could be affected. Thus, a single error could, under the proposal, subject each issuer for whom the bank filed information returns, to information reporting penalties because the penalties would be assessed on a taxpayer-by-taxpayer basis. In this instance, the penalty would be imposed on each issuer. However, the bank as paying agent may be required to indemnify the issuers for resulting penalties.

Recommendation: For the purposes of applying the penalty cap, the paying agent (not the issuer) should be treated as the payor.

BXAMPLB II -- Retirement Plans

ABC Corporation, which services retirement plans, approaches the February 28th deadline for filing with the Internal Revenue Service the appropriate information returns (i.e., Forms 1099-R). ABC Corporation services 500 retirement plans and each plan must file over 1,000 Forms 1099-R. A systems operator, unaware of the penalties for filing late Forms 1099, attempts to contact the internal Corporate Tax Department to inform them that an extension of time to file is necessary to complete the preparation and filing of the magnetic media for the retirement plans. The systems operator is unable to reach the Corporate Tax Department by the February 28th filing deadline and files the information returns the following week. This failure, under the proposal, could lead to substantial late filing penalties for each retirement plan that ABC Corporation services (in this example, up to $75,000 for each plan)8.

Recommendation: Retirement plan servicers (not each retirement plan) should be treated as the payor for purposes of applying the penalty cap.

BXAMPLB III -- Related Companies

A bank or broker dealer generally is a member of an affiliated group of companies which offer different products and services. Each company that is a member of the group is treated as a separate payor for information reporting and penalty purposes. Information returns for all or most of the members of the group may be generated from a single information reporting system. One error (e.g., a systems programming error) could cause information returns generated from the system to contain errors on all subsequent information returns generated by the system.

Under the proposal, the penalty cap would apply to each affiliated company for which the system(s) produces information returns.

Recommendation: Each affiliated group9 should be treated as a single payor for purposes of applying the penalty cap.

While these examples highlight the need to apply the type of penalty proposed by the Treasury on an aggregated basis, they also illustrate the indiscriminate and unnecessary nature of the proposal.

CONCLUSION

The undersigned associations represent the preparers of a significant portion of the information returns that would be impacted by the proposal to increase penalties for failure to file correct information returns. In light of the current reporting burdens imposed on our industries and the significant level of industry compliance, we believe it is highly inappropriate to raise penalties. Thank you for your consideration of our views.

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ENDNOTES

[1] A similar proposal was included in President Clinton's fiscal year 1997 budget.
[2] It is important to note that many of these errors occur as a result of incorrect information provided by the return recipients such as incorrect taxpayer identification numbers (TINs).
[3] The standard penalty for failing to file correct information returns is $50 per failure, subject to a $250,000 cap. Where a failure is due to intentional disregard, the penalty is the greater of $100 or 10 percent of the amount required to be reported, with no cap on the amount of the penalty.
[4] Statement of former IRS Commissioner Gibbs before the House Subcommittee on Oversight (February 21, 1989, page 5).
[5] OBRA 1989 Conference Report at page 661.
[6] The increased penalties would not apply if the aggregate amount that is timely and correctly reported for a calendar year is at least 97 percent of the aggregate amount required to be reported for the calendar year. If the safe harbor applies, the present-law penalty of $50 for each return would continue to apply.
[7] For example, Form 1099-C, discharge of indebtedness reporting.
[8] If the corrected returns were filed after August 1, the penalties would be capped at $250,000 per plan.
[9] A definition of "affiliated group" which may be used for this purpose may be found in Section 267(f) or, alternatively, Section 1563(a).

May 6, 1996

The Honorable Bill Archer
Chairman
Ways & Means Committee
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1236 Longworth House Office Bldg.
Washington, D.C. 20515-4307

The Honorable William V. Roth, Jr.
Chairman
Senate Finance Committee
U.S. Senate
104 Hart Senate Office Bldg.
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The Honorable Sam M. Gibbons
U.S. House of Representatives
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The Honorable Daniel P. Moynihan
U.S. Senate
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Gentlemen:

I am writing to express The New York Stock Exchange's (NYSE) strong views on two proposals included in Title IX of the Administration's Fiscal Year 1997 Budget Proposals, released March 19, 1996.

Average Cost Basis Proposal

The NYSE is strongly opposed to the proposal that would require the use of an average cost basis for purposes of determining gain or loss on the sale or other disposition of securities. The average cost basis proposal would reduce the after-tax return on an investment in securities, discouraging new investment, inhibiting job growth and impeding economic expansion. Moreover, the transition to using average cost basis would result in downward pressure on securities markets as investors accelerate sales of securities prior to the effective date of the proposal.

Under current law, investors may specifically identify securities to be sold. Investors who do not specifically identify securities to be sold must use the first-in-first-out method of accounting to determine the adjusted basis. Under the average cost basis proposal, investors would be required to determine gain or loss on the sale or other disposition of securities using an average cost basis of all substantially identical securities held at the time of disposition. If investors sell less than all of the substantially identical securities, the investors would be treated as having disposed of the securities first acquired for purposes of determining the holding period of the securities sold and of the remaining securities.

The average cost basis proposal effectively increases the capital gains tax by accelerating gain recognition in the case of a sale of less than all of an investor's substantially identical securities having different adjusted bases. This is contrary to the Administration's stated goals of increasing savings[1] and promoting economic growth[2]. Continued economic expansion and the resulting creation of jobs depends in part on the availability of low-cost capital. By reducing the after-tax return on investments in securities, the average cost basis proposal would tend to discourage savings and increase the cost of capital, thus limiting new investment in plants, equipment and technology. In addition, to the extent investors continue to hold existing securities to avoid the increased tax exposure created by this proposal, the average cost basis proposal restricts the efficient flow of capital to its highest and best use, which also will inhibit economic growth. Moreover, we note that middle-income investors will be hardest hit by this proposal because it is these investors who will not be able to avoid selling securities in order to pay for certain expenses, such as college tuition.

Because the average cost basis proposal increases the tax burden on capital gains, it is likely that investors will accelerate sales of securities after enactment of the proposal and before its effective date. In its current form, the average cost basis proposal would apply to sales of securities beginning 30 days after the date of its enactment. We believe that this effective date provision could create substantial downward pressure on securities markets.

In light of the foregoing, we strongly encourage you not to include provisions such as those embodied in the average cost basis proposal in any budget or tax legislation. In the event you decide to include the average cost basis proposal or similar measures -- and the NYSE strongly urges that you do not -- to reduce the downward pressure on securities markets, we ask that the average cost basis proposal apply only to securities acquired on or after the date of enactment.

Constructive Sale Proposal

The NYSE is concerned about the proposal that would require a taxpayer to recognize gain (but not loss) upon entering into a constructive sale of an appreciated position in either stock, a debt instrument or a partnership interest. This provision is overly broad and would not only address abusive transactions but also would discourage legitimate risk management transactions.

We applaud the Administration's desire to combat abusive transactions such as those which are structured to permit a taxpayer to avoid permanently the realization of capital gains on an appreciated stock or debt instrument position in order to permit a stepped-up basis on the taxpayer's death. However, many legitimate risk management transactions also would be covered by the Administration's constructive sale proposal. We believe that it is counterproductive to attack a relatively few abusive transactions with a proposal so broad that it would prevent a large number of taxpayers from entering into prudent, short-term (for example, transactions of nine months or less) risk management transactions.

In light of the foregoing, we urge that any provision relating to constructive sales in any budget or tax legislation be narrowly drawn so as to capture only abusive transactions while not encompassing legitimate, short-term hedging transactions.

Sincerely yours,

Sheila C. Bair

[1] See, e.g., Letter from Robert E. Rubin to Rep. Michael N. Castle, 96 TNT 57-66, March 13, 1996, available in LEXIS, Fedtax Library, TNT File (stating that the President's Fiscal Year 1997 Budget, submitted February 5, 1996, balances the budget with sufficient savings for modest tax cuts that, among other things, will spur long-term savings).

[2] President Clinton's Fiscal Year 1997 Supplemental Budget Message (Budget Supplement Chapter 12: Promoting Tax Fairness) (legislative proposal), 96 TNT 56-42, March 19, 1996, available in LEXIS, Fedtax Library, TNT Files (stating the budget proposes tax reforms that "encourage activities that foster economic growth"); Administration's News Conference Presenting the Administration's Fiscal Year 1997 Budget Proposal, 1996 FDCH Political Transcripts, March 19, 1996, available in LEXIS, Nexis Library, CURNWS File (President Clinton stating "our nation must change course and once again provide growth and opportunity for the American people" and emphasizing the Administration's commitment to job creation, low inflation and productivity).

PSA THE BOND MARKET TRADE ASSOCIATION

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Statement of
PSA The Bond Market Trade Association

before the
U.S. Senate
Committee on Finance

April 17, 1997

PSA The Bond Market Trade Association is pleased to present its views on certain revenue-raising tax proposals in the Clinton administration's fiscal year 1998 budget. PSA represents securities firms and banks that underwrite, trade and sell debt securities, both domestically and internationally. Our membership includes most major dealers in the corporate and municipal bond markets, the two areas of focus in this statement.

PSA's members help provide capital financing for corporations and state and local governments throughout the nation. PSA takes a very active interest in issues that affect the cost of capital for issuers of debt instruments. PSA firmly believes that investment in capital assets, both public and private, in addition to creating jobs, is one of the most important factors that determines productivity. Improved productivity, in turn, is the means by which the standard of living for all Americans improves. We are, therefore, extremely supportive of fiscal policies that raise the levels of savings and investment. For this reason, PSA has long been a vocal advocate of a balanced federal budget. Eliminating the deficit is the most direct way to raise savings rates. Taking the federal government out of the competition for a limited pool of funds available for investment will lower the cost of capital for other borrowers and will result in higher levels of private-sector and state and local capital spending. Indeed, one of the most important reasons for balancing the federal budget is the positive effect on savings and investment.

PSA is dismayed, therefore, that the administration's plan to balance the budget is based in part on proposed tax increases which would raise the cost of capital for corporations and state and local governments and discourage capital investment. We strongly disagree with the administration's characterization of instruments affected by its proposals as "unwarranted corporate tax subsidies" and "tax loopholes."[1] Moreover, the revenue-raising proposals are targeted at capital investment, an activity which we feel the tax code should encourage. We agree with Chairman Roth that the tax code ought to foster economic growth. We therefore appreciate the opportunity to express our firm opposition to proposed tax increases in the president's budget which would increase the cost of capital for corporations and state and local governments, discourage capital investment and job creation, and weaken the overall economy.

A number of proposals in the administration's FY 1998 budget released on February 6, 1997 would have negative effects on the capital markets and savings and investment. Our statement focuses on the following four:

- Deny interest deduction on certain debt instruments;
- Reduce dividends-received deduction to 50 percent and eliminate dividends-received deduction for certain preferred stock;
- Defer original issue discount deduction on convertible debt; and
- Extend pro rata disallowance of tax-exempt interest expense to all corporations.

The staff of the Joint Committee on Taxation has estimated that together, these proposals represent a tax increase on capital investment of nearly $3 billion over the period 1997-2002, and approximately $7.4 billion over the period 1997-2007.[2]

When they were originally released in December 1995, the above provisions were proposed with an immediate effective date.[3] The result was considerable uncertainty and confusion among capital markets

[1] Budget of the Unites States Government, Fiscal Year 1998, "Analytical Perspectives," page 48.

[2] Staff of the Joint Committee on Taxation, Estimated Budget Effects of Revenue Provisions Contained in President's FY 1998 Budget Proposal (JCX-8-97), February 27, 1997, page 4.

participants. Transactions that were on the verge of execution were suspended. The trading and issuance of certain financial instruments was virtually halted. As Chairman Roth recognized last year, the proposals had a "chilling effect" on the market.[4] It took the March 29, 1996 joint statement by Chairman Roth and Ways and Means Committee Chairman Bill Archer on the effective dates of the pending proposals to put to rest the market's concerns over when the administration's tax proposals would be applied if they were enacted.[5] PSA is grateful to Chairman Roth and to Chairman Archer for this clarification. We are also pleased that in its current budget proposal, the administration generally proposed effective dates of "first committee action" or final enactment with regard to the above proposals. However, we remain steadfastly opposed to the substance of the proposals. In addition, even the more sensible effective dates proposed by the administration this year raise significant questions regarding the effect that the proposals would have on the value of certain outstanding financial instruments, especially preferred stock, if the tax treatment of their future payments were changed adversely.

In our written statement to the House Ways and Means Committee last year,[6] we outlined some of the opposition to the administration's tax proposals that had arisen since their release in December 1995. Since that statement, opposition has intensified. Indeed, we are aware of no public expression of support for the proposals by any member of Congress in the 16 months since their original release. PSA has compiled a collection of statements by numerous members of Congress and market participants opposing the above proposals which outlines the scope and breadth of opposition. We have made this compilation available to Finance Committee members and staff.

The characterization of debt and equity

Three of the administration's proposals outlined above relate to the taxation of financing instruments issued by corporations. The proposals entail major policy changes related to the distinction between debt and equity financing.

Corporations have available to them two ways to finance capital investment: equity and debt. In general, because they are business expenses, payments or accruals on debt are characterized as interest and are deductible for corporate taxpayers. Payments on equity instruments are characterized as dividends and generally are not deductible. The non-deductibility of dividends on equity capital, discussed further below, results in the multiple taxation of corporate earnings, which in turn makes the after-tax cost of equity capital much higher than it would otherwise be. Because of the multiple taxation of corporate earnings, tax considerations play a role in a corporation's choice of financing mechanism. However, the decision to raise capital in the first place is not tax-motivated. Corporations issue securities and raise capital, debt or equity, because the expected returns on the assets financed from the proceeds of the securities is attractive. The deductibility of payments or accruals on debt securities, therefore, cannot be reasonably characterized as a tax loophole or benefit.

The administration's proposals related to corporate financing instruments reflect a fundamentally new approach to the characterization for tax purposes of corporate debt and equity, an approach which is a radical departure from accepted tax policy and which would entail negative consequences for corporate investment in capital assets. Indeed, the administration's proposals represent a significant departure from existing Internal Revenue Service (IRS) rules and practices regarding the classification of debt and equity. Currently, in distinguishing between the two, the IRS considers the following eight factors[7]:

- whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future;
- whether holders of the instruments possess the right to enforce the payment of principal and interest;
- whether the rights of the holders of the instruments are subordinate to rights of general creditors;
- whether the instruments give the holders the right to participate in the management of the issuer;
- whether the issuer is thinly capitalized;
- whether there is identity between holders of the instruments and stockholders of the issuer;
- the label placed upon the instruments by the parties; and

[3] The proposal to "eliminate dividends-received deduction for certain preferred stock" was first released in August 1996 with a proposed "date-of-enactment" effective date.
[4] United States Senate, Committee on Finance, Press Release #104-175, March 29, 1996.
[5] Senator William V. Roth and Representative Bill Archer, Press Release, "Archer, Roth Statement on Treasury Revenue Provision Effective Dates," March 29, 1996.
[6] PSA The Bond Market Trade Association (formerly the Public Securities Association), "Statement of the Public Securities Association to the Committee on Ways and Means, U.S. House of Representatives, on Tax Proposals in the President's 1997 Budget," May 15, 1996.
[7] Internal Revenue Service, Notice 94-47.

- whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

According to the IRS, "no particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. The weight given to any factor depends upon all the facts and circumstances and the overall effect of an instrument's debt and equity features must be taken into account." As discussed below, however, the administration's proposals would impose new, arbitrary criteria which would supersede a "facts-and-circumstances" evaluation of particular financing instruments.

Although we do not necessarily disagree with a "facts-and-circumstances" approach to distinguishing between debt and equity, the existing guidelines leave unanswered questions regarding the tax status of particular financial instruments and products. Even more important, the guidelines fail to recognize some fundamental differences in the nature of the income derived from debt and equity instruments and place undue emphasis on accounting factors in distinguishing between the two. PSA believes that there are several general, guiding principles that should apply in defining debt and equity for tax purposes. Before addressing the administration's proposals specifically, a discussion of these principles would be useful.

Single taxation of corporate earnings

The problem of double and triple taxation of corporate profits under prevailing tax law is a fundamental concern for PSA. Because corporate equity is not afforded the same tax treatment as debt, corporations' earnings are often taxed multiple times. If a corporation holds stock in another corporation, it is taxed on the dividends paid on that stock to the extent that the dividends do not qualify for the dividends-received deduction (DRD). It is also, of course, taxed on its earnings from all other sources. If the corporation pays dividends to a tax-paying investor, that investor pays taxes on the dividends. To the extent that accumulated, unpaid earnings are represented in the appreciated price of a stock, those earnings are taxed as capital gains when shares are sold by a taxable investor. If the stock is part of an estate, the holdings are taxed when the estate is distributed. The effect of these multiple levels of taxation is to raise financing costs for corporations, reduce incentives for capital formation, and create serious concerns about global competitiveness.

Ultimately, the solution to the problem of multiple taxation of corporate earnings — short of moving to an entirely new system of taxation, such as a consumption tax — is to integrate fully the corporate and individual tax systems. Many of the proposals for corporate tax integration which have been circulated in recent years suggest either abolishing the corporate income tax altogether and taxing all corporate earnings at the level of investors, or exempting investment earnings from taxation at the individual level and fully subjecting all corporate earnings, whether paid as interest or dividends, to the corporate income tax.[1] PSA would fully support further study and consideration of the issue of corporate tax integration with the goal of amending the federal tax code to ensure that corporate earnings are not taxed more than once. In the end, these issues would be more appropriately considered in the context of a fundamental review of the entire tax system. Short of fully integrating the individual and corporate tax systems, however, we firmly believe that in cases where a reasonable question exists as to the characterization of an instrument as debt or equity, tax law should err on the side of treatment as debt so as to minimize the problem of multiple taxation.

The nature of equity investment

Equity and debt investments are fundamentally different in an important sense. An investor typically buys an equity instrument as a way to participate directly in the long-term growth of the issuing corporation. Such is the case with common stock. Debt investments do not afford this benefit to holders. In buying a debt instrument, an investor is purchasing an income stream or interest accrual, not a participation in the success or failure of a company. It is true that a debt investor can benefit from a corporation's strong performance — if a corporation's financial condition improved enough so that its credit rating were upgraded, for example — or can be hurt by a corporation's poor performance — if a corporation were downgraded or the company went bankrupt. However, the potential risks and rewards of a corporate debt investment related to the performance of a company usually represent only a very small aspect of an investor's total return on his or her investment.

Ultimately, the characterization of an instrument as equity or debt should rest on whether by buying the instrument in question, an investor is purchasing a direct participation in the long-term growth of the

[1] See, for example, U.S. Department of the Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, January 6, 1992.

issuing corporation, or a stream of cash flows based on an agreed upon rate. A reasonable test to distinguish debt and equity might include the following questions:

- Does the holder receive or accrue periodic income at an agreed-upon rate?
- Does the instrument offer the holder the opportunity to participate in the growth or decline of the company during the period in which payments are made or accrued?
- Can the obligations of the issuer be enforced? Can a default force the issuer into bankruptcy or, ultimately, liquidation?

For most financial instruments, the distinction between debt and equity is obvious. Common stock clearly is equity. Senior and subordinated corporate bonds clearly are debt. Capital securities[9] also represent interests in fixed streams of payments, and therefore would be debt.

Accounting treatment and tax policy

How a financing instrument is treated under accounting rules should play no role in determining its tax treatment. Distinguishing between debt and equity for accounting purposes serves a goal fundamentally different from that for tax purposes. The characterization of financial instruments under accounting rules is based on an issuer's payment obligations and an investor's rights in bankruptcy. The rules also provide common definitions and conventions so that the accounting statements of one company are easily comparable to those of another. The distinction under the tax code exists so that similar types of income are afforded similar tax treatment. There is no reason to expect that the treatment of a given financial instrument under the tax code should necessarily mirror its treatment under generally accepted accounting principles (GAAP) or under the information disclosure requirements of securities statutes and regulations.

Indeed, relying on accounting rules as the basis for how a particular instrument is taxed would effectively grant tax policy authority to the Financial Accounting Standards Board and the Securities and Exchange Commission (SEC). With all due respect to these two highly regarded organizations, PSA firmly believes that tax policy authority should rest with Congress and, to the extent such authority is granted in law, the Treasury Department. The designation of certain hybrid financial instruments as non-debt liabilities in SEC filings, for example, relates to accounting concerns with respect to their status in bankruptcy, not to the nature of the income or other benefits received by the holder or to the obligations of the issuer.

Deny interest deduction on certain debt securities

The administration's budget plan contains a proposal to deny corporate interest expense deductions for debt with a maturity longer than 40 years and instruments with maturities longer than 15 years not characterized as debt in an issuer's SEC filings. This proposal appears to be aimed at eliminating the interest deductibility of innovative new financial instruments, such as capital securities. These instruments are issued by a wide variety of companies, including banks, utilities, insurance companies, media and telecommunications companies, energy companies and manufacturers. They are bought by both institutional and retail investors. In 1996, U.S. corporations raised over $32 billion of investment capital through the sale of these instruments. Since 1993, corporations have issued over $62 billion of capital securities.

Capital securities are popular among corporations because by providing a long-term, fixed-rate source of capital that is junior to all other debt but senior to all equity, they fill an important void in a corporation's capital structure. Traditional preferred stock, for a variety of reasons, is an expensive and relatively unattractive source of capital for most corporations. Capital securities can fill an important gap in many corporations' balance sheets. Most forms of capital securities offer corporate issuers the added feature of the deferability of interest payments. In most cases an issuer can, if necessary, defer payments on capital securities for up to five consecutive years. The deferral entails several requirements. A corporation must first stop paying dividends on all common and preferred stock. During the deferral period, interest continues to accrue and is treated under current tax rules as original-issue discount. At the end of five years, if the issuer is still unable to make payments to capital securities investors, its obligations are fully enforceable. Nevertheless, the ability to defer payments in a time of stress is attractive and gives corporations a great deal of financial flexibility. Conceivably, for example, it could prevent a corporation from taking more drastic cost-cutting actions during a downturn, such as lay-offs or plant closings.

[9] "Capital securities" is a collective term referring to any of several types of financing instruments which have virtually all the characteristics of junior subordinated debt. Certain capital securities are also known as trust-preferred securities, debt-equity hybrid instruments, capital securities and preferred debt. They also go by a number of proprietary names such as Capital Trust Pass-through Securities (TruPS), Trust-Originated Preferred Securities (TOPrS) and Monthly Income Preferred Securities (MIPS).

The administration has proposed essentially to prohibit companies from issuing capital securities longer than 15 years apparently on grounds that "they have substantial equity features (including many non-tax benefits of equity)."[10] The administration has characterized this proposal as a way to curb transactions which have "exploited" regulatory ambiguity. However, there is no evidence that corporations have in any way attempted to skirt existing distinctions between debt and equity or have otherwise engaged in abusive activity. Indeed, it is only because of a favorable IRS ruling several years ago that capital securities can now be issued. PSA disagrees with the administration that the current tax treatment of these instruments needs to be changed. Even if the current tax status of these instruments were under debate, capital securities can in no way be reasonably characterized as abusive. Issuers are able to deduct interest payments on capital securities because these instruments are virtually identical to other forms of corporate debt with regard to payment characteristics and the legal and financial obligations assumed by issuers.

A careful analysis of the affected instruments reveals that they possess the critical attributes of debt. Indeed, Treasury's proposal does not rely on any of these attributes to curtail the interest deductibility of these instruments. Rather, Treasury has focused on the fact that capital securities are not typically shown as debt on a company's balance sheet. The reality is, balance-sheet treatment of these instruments has never before been relevant to their tax treatment and whether they are identified as debt obligations for tax purposes.

Capital securities issued through a trust are a case in point. A company utilizing these instruments issues debt obligations to a trust which, in turn, issues trust securities to investors. The transaction is structured in this way because securities issued through a trust are viewed more favorably by a nationally recognized credit rating agency. Because these debt obligations are issued through a trust, they are not shown on an issuer's consolidated balance sheet as debt, although the footnotes to the corporation's balance sheet disclose that the sole asset of the trust is the junior, subordinated debt of the company. It should also be noted that capital securities are not characterized as equity on an issuer's balance sheet.

The balance-sheet characterization of capital securities as non-debt liabilities does not alter the conclusion that the underlying debt securities possess all the critical attributes of debt. This is clearly illustrated by the facts that:

- Investors in these instruments are the legal owners of an undivided interest in the underlying debt obligations, and they enjoy all the creditor rights and economic benefits as if they had purchased the debt obligations directly from the issuer. In addition, holders of these instruments do not enjoy any participation in an issuing corporation's growth, as do holders of common stock.
- Companies that issue these securities — despite their ability to extend an interest payment period for up to five years — have an absolute obligation to pay interest and principal at maturity. In the case of a default, investors can enforce the obligations of an issuer through the bankruptcy court.
- Holders of capital securities are higher in seniority — the "pecking order" of payments in the case of bankruptcy — than any equity investors.

Contrary to Treasury's revenue projections, this proposal would likely fail to raise revenue. Issuers that are affected by the proposed legislation would either choose to issue hybrid preferred securities with a maturity of 15 years or less, or they would maintain the 15-plus-year maturity of the instruments and issue them directly to investors, rather than through a partnership or trust, albeit at a potentially higher overall cost of capital. In only very few cases — limited to commercial banks due to unique regulatory capital rules — would an issuer substitute its hybrid financing with equity. In cases where a higher financing cost makes an investment project unfeasible, an issuer would simply not undertake the transaction at all. In any case, Treasury's proposal will ultimately fail to reduce substantially the amount of interest issuers deduct, and it will therefore be unlikely to raise significant tax revenue.

Electric utilities represent a good example of the efficiency and flexibility that capital securities provide corporations. Traditionally, utilities have depended on fixed-rate sources of financing for a significant portion of their overall capitalization, and in recent years utility companies have been significant issuers of capital securities. In 1996 alone, for example, at least 26 utility companies issued $3.4 of capital securities. None of these transactions could have taken place if the administration's proposal had been law last year. The financial flexibility that capital securities provide utilities is particularly important given the radical deregulation at both the federal and state levels that is transforming the industry. Deregulation will almost certainly require that utility companies undertake significant new capital investment. Prohibiting utilities from taking advantage of this efficient financing source would exacerbate the competitive pressures already affecting the industry.

[10] Department of the Treasury, *General Explanation of the Administration's Revenue Proposals*, February 1997, page 36.

The administration's proposal would also affect corporate debt instruments with maturities longer than 40 years. Here, the administration's distinction between debt and equity is completely arbitrary. Under the proposal, two otherwise identical debt securities, one with a maturity of 40 years and the other with a maturity of 41 years, would be treated in entirely different ways.

In the past two years, corporations have taken to issuing debt with very long maturities, sometimes as long as 100 years. The reasons involve the unique market conditions which have prevailed in recent months that have made the transactions attractive to both issuers and investors. Because they can borrow for 100 years at interest rates only slightly higher than, say, 30-year financing, corporations are able to take advantage of stable and long-term financing sources. Domestic corporations are not the only borrowers who have discovered this means of financing. Foreign corporations and governments have also issued 100-year bonds in the U.S. market over the past two years. Since 1990, corporations have raised approximately $8 billion in capital through the sale of 50- to 100-year debt securities. Relative to the corporate bond market overall — corporations issued nearly $449 billion in debt securities in 1996 alone — instruments with very long maturities represent only a very small portion of total corporate debt financing. However, the instruments provide an attractive, alternative financing source for certain companies.

The administration has offered no explanation as to its choice of 40 years as the criterion for debt. It has also not explained why maturity alone should characterize an instrument as debt or equity when it otherwise has all the characteristics of debt. Any distinction based solely on one factor — the maturity of an instrument — ignores long-standing definitions and conventions regarding what constitutes debt financing. The administration's proposal would prevent corporations from accessing an efficient source of financing. Foreign corporations, which generally are not burdened by such arbitrary tax policy distinctions as those represented in the president's budget, would still have access to this source of long-term capital and hence would enjoy an advantage over domestic companies. In addition, the administration's proposals would deny debt treatment for certain instruments without fully re-characterizing them as equity so that they would qualify for the dividends-received deduction. These instruments would, in effect, be subject to the worst tax aspects of both debt and equity.

The definition of equity should rest on more than the criteria proposed by the administration. It should encompass only securities whose returns are directly related to the long-term growth of the issuing corporation, such as common stock. Neither long-dated corporate bonds nor capital securities afford this benefit to holders. In both cases, the holder is buying an income stream, not an equity participation.

Reduce dividends-received deduction to 50 percent and eliminate dividends-received deduction for certain preferred stock;

Under current law, corporate taxpayers that earn dividends on investments in other corporations are permitted a tax deduction equal to at least 70 percent of those earnings. The deduction is designed to mitigate the negative economic effects associated with multiple taxation of corporate earnings. The administration has proposed reducing the minimum dividends-received deduction (DRD) to 50 percent, which would increase the taxation of corporate earnings and discourage capital investment. A companion proposal to eliminate the DRD altogether for preferred stock with certain characteristics would also entail harmful effects.

A generous DRD is important because it reduces the effects of multiple taxation of corporate earnings. As discussed earlier, when dividends are paid to a taxable person or entity, those funds are taxed twice, once at the corporate level and once at the level of the taxpayer to whom the dividends are paid. These multiple levels of taxation raise financing costs for corporations, create global competitiveness problems, and generally reduce incentives for capital formation. The DRD was specifically designed to reduce the burden of one layer of taxation by making dividends largely non-taxable to the corporate owner.

The administration has argued only that the current 70-percent DRD is "too generous."[11] It has provided little additional justification for a proposal which would magnify the problem of multiple taxation of corporate earnings and raise the cost of capital investment for U.S. corporations. It has also argued that certain preferred stock, such as variable-rate and auction-set preferred, "is economically more like debt than stock."[12] However, the administration has not proposed that such instruments be formally characterized as debt eligible for interest payment and accrual deductions. As with the previous proposal to deny an interest deduction for certain debt instruments, the administration has sought to characterize certain preferred stock in such a way as to maximize tax revenue; it would be ineligible for both the DRD and the interest expense deduction.

[11] *Ibid.*, page 40.

[12] *Ibid.*, page 42.

Scaling back the DRD would exacerbate the effects of multiple taxation. The change would be tantamount to a tax increase on corporate earnings since the minimum deduction available to certain investors would fall. This tax increase would flow directly to issuers of stock, especially preferred stock, who would face higher borrowing costs as investors demanded higher pre-tax yields. In response, corporations would tend to cut capital expenditures, reduce working capital, move capital raising and employment overseas, and otherwise slow growth-oriented investment. Amplifying the competitive disadvantages of multiple taxation of American corporate earnings would be the fact that many of our largest economic competitors have already adopted tax systems under which inter-corporate dividends are largely or completely untaxed. Eliminating the DRD altogether for preferred stock with certain characteristics would cut U.S. corporations off from an efficient source of financing. The administration's DRD proposal would thus have a wide range of unintended consequences that would harm the national economy.

The administration's proposal to reduce the DRD to 50 percent would be effective for "dividends paid or accrued more than 30 days after the date of enactment."[13] While the proposed effective date can not strictly be characterized as retroactive, it would apply to a large volume of outstanding instruments and would have some very negative consequences for investors and issuers. The proposal would be applied to instruments which were issued and purchased under an assumption of a 70-percent DRD. Reducing the DRD to 50 percent would substantially erode the after-tax value to investors of future payments on these instruments. If a holder sold its investment in the secondary market, its price would reflect the lower, less attractive DRD. In these cases, investors would effectively bear the additional tax liability. A large volume of recently issued preferred stock was originally sold with "gross-up" provisions which essentially require issuers to compensate investors for the additional tax liability associated with adverse changes to the DRD. In these cases, issuers would directly bear the burden of the tax increase. In both cases, taxpayers who made decisions based on prevailing tax policy would be harmed by an adverse change. When the DRD was lowered in previous years, the legislation contained "grandfather" provisions to protect issuers and investors who would have been harmed by the change. While we remain steadfastly opposed to the proposal to reduce the DRD to 50 percent, we feel strongly that at the very least it should apply only to stock issued after the date of enactment.

Defer original issue discount on convertible debt

The administration has proposed to change the tax treatment of original issue discount (OID) on convertible debt securities. OID occurs when the stated coupon of a debt instrument is below the yield demanded by investors. The most common case is a zero-coupon bond, where all the interest income earned by investors is in the form of accrued OID. Under current law, corporations that issue debt with OID may deduct the interest accrual while bonds are outstanding. In addition, taxable OID investors must recognize the accrual of OID as interest income. Under the administration's proposal, for OID instruments which are convertible to stock, issuers would be required to defer their deduction for accrued OID until payment was made to investors in cash. For convertible OID debt where the conversion option is exercised and the debt is paid in stock, issuers would lose the accrued OID deduction altogether. Investors would still be required to recognize the accrual of OID on convertible debt as interest income, regardless of whether issuers took deductions.

The administration's proposal is objectionable on several grounds. First, convertible zero-coupon debt has efficiently provided corporations with billions of dollars in capital financing. The change the administration proposes would significantly raise the cost of issuing convertible zero-coupon bonds, and in doing so would discourage corporate capital investment. Second, the administration's presumptions for the proposal are flawed. The administration has argued that "the issuance of convertible debt with OID is viewed by market participants as a de facto purchase of equity."[14] However, performance does not bear out this claim. In fact, of the convertible zero-coupon debt retired since 1985, approximately 70 percent has been retired in cash, and only 30 percent has been converted to stock. Indeed, the market treats convertible zero-coupon bonds more as debt than as equity.

Third, and perhaps most important, the administration's proposal violates the basic tenet of tax symmetry, the notion that the recognition of income by one party should be associated with a deduction by a counterparty. This fundamental principle exists to help ensure that income is taxed only once. Under the proposal, investors would be taxed fully on the accrual of OID on convertible zero-coupon debt, but issuers' deductions would be deferred or denied. The proposal would compound problems associated with the multiple taxation of investment income, thereby raising the cost of corporate capital.

[13] *Ibid.*, page 40.
[14] *Ibid.*, page 38.

Because the proposal would exacerbate problems of multiple taxation of corporate income and because it would raise the cost of corporate capital investment, PSA urges the rejection of the administration's proposal.

Extend* pro rata *disallowance of tax-exempt interest expense to all corporations

Another proposed tax increase in the administration's budget, while it would nominally apply to corporations, would in reality be borne by state and local governments in the form of higher financing costs. Rather than closing a "tax loophole" for corporations, the proposal would make it more expensive for state and local governments to finance vital public services.

Under current law, investors, including corporations, are not permitted to deduct the interest expense associated with borrowing to finance purchases of tax-exempt securities. Financial institutions that earn non-qualified tax-exempt interest are automatically disallowed a portion of their interest expense deduction in proportion to the ratio of municipal bond holdings to total assets. Non-bank corporations that earn tax-exempt interest, in order to avoid a loss of interest-expense deduction, must demonstrate that they did not borrow to finance their purchases. Under an IRS procedure in place since 1972, as long as a corporation's tax-exempt bond portfolio does not exceed two percent of its total assets, the IRS does not attempt to determine whether the corporation borrowed to finance its municipal bond holdings.[15] This is the so-called "two-percent *de minimis* rule." The administration's proposal would effectively repeal this safe harbor and automatically deny corporations that earn tax-exempt interest a *pro rata* portion of their interest expense deduction. The proposal effectively exempts insurance companies from its proposed new treatment.

The administration's proposal would raise the costs of borrowing for state and local governments, and would make it more expensive to finance new investment. The Treasury Department argues that the proposal would not significantly affect municipal borrowing rates. In a letter sent last year, Treasury Secretary Rubin argues that "eliminating the 2 percent *de minimis* rule will not materially affect the costs of borrowing for State and local governments because non-financial corporations hold only about 5 percent of outstanding tax-exempt bonds."[16] While it is true that non-financial corporations account for a small percentage of total municipal securities outstanding, the administration's argument fails to recognize the absolutely vital role they play in two important market segments: short-term municipal notes and certain variable-rate securities state and local government housing and student loan bonds, and municipal leasing transactions. The effects of the administration's proposal would be most felt by state and local governments in these three areas.

Short-term municipal note market

State and local governments issue short-term securities to finance a variety of programs and services. The most common use of short-term financing is to fund mismatches between revenues and expenditures. States and localities may incur expenditures before they receive tax and other revenues. Through short-term borrowing, state and local governments can finance temporary cash-flow shortfalls. States and localities also issue longer term bonds that are designed to behave like short-term instruments in order to appeal to certain investors and to take advantage of prevailing market conditions. These longer term "variable rate demand notes" (VRDNs) are issued to finance a variety of public investment projects.

Non-financial corporations are major purchasers of short-term municipal notes and VRDNs. Corporations buy short-term municipals as a cash management vehicle. In doing so, corporations finance their municipal investments from surplus cash and working capital accounts, not from the proceeds of borrowing. Corporate investment in the municipal market is almost never tied to corporate borrowing in any way. By participating actively in the short-term market, corporations help to keep municipal borrowing rates incredibly stable. Currently, short-term municipal borrowing rates are approximately 65.5 percent of comparable taxable rates. This ratio has remained virtually constant in recent years, due largely to participation in this market by corporations. The ratio of longer term municipal borrowing rates to taxable rates is much more volatile, ranging in recent years from 75 to 90 percent, since corporations do not actively participate in the market for longer dated municipal bonds. The administration's proposal would effectively discourage virtually all corporate investment in the municipal market. In doing so, the proposal would significantly raise the cost of short-term borrowing for state and local governments and would make short-term municipal rates more volatile relative to taxable rates. We agree with Chairman Archer that the administration's proposal "would plainly have a negative impact on State and local governments that rely

[15] Internal Revenue Service, Revenue Procedure 72-18.

[16] Letter from the Honorable Robert Rubin, Secretary of the Treasury, to the Honorable Mitch McConnell, U.S. Senator, April 23, 1996.

upon tax-exempt debt."[17] We also appreciate Chairman Archer's commitment to "resist attempts to include this provision in any balanced budget agreement."[18] Numerous others in Congress have expressed similar sentiments, including over one-third of the Senate in the 104th Congress,[19] and we are encouraged by these expressions of opposition to this short-sighted proposal.

The administration has argued that the law as presently written permits non-financial corporate taxpayers "to reduce their tax liabilities inappropriately through double Federal tax benefits of interest expense deductions and tax-exempt interest income."[20] Implicit in the administration's argument is the assumption that corporations have deliberately engaged in arbitrage practices by borrowing in the short-term market and investing in tax-exempt obligations. However, there is no evidence to suggest that corporations are engaging in abusive, arbitrage-motivated transactions. Holdings of municipal bonds have averaged only 0.47 percent of the financial assets and 0.15 percent of the total assets of non-financial corporations since 1987,[21] a level that has remained fairly consistent. Moreover, given that the top corporate income tax rate is 35 percent and the short-term tax-exempt/taxable yield ratio hovers around 65.5 percent, the level of after-tax return available to corporations in the municipal market simply does not justify arbitrage transactions.

The Treasury has also argued that "the treatment of financial institutions and dealers should be applicable to all corporations, without regard to the type of business activity the corporation conducts."[22] In reality, the proposal would result in grossly unfair treatment for a large number of corporations which, under current law, may legitimately invest in the tax-exempt bond market by clearly showing they did not borrow to do so. It would do this through a provision that would extend the *pro rata* disallowance of interest expense on a combined basis to "affiliated companies" that file consolidated returns and by eliminating the present-law analysis of the intent of the corporation.

Non-financial corporations currently purchase a substantial portion of newly issued short-term state and local securities. They are, in effect, buyers of last resort that prevent excessive interest rate volatility. In their absence, short-term, tax-exempt rates would likely rise in times when other short-term investors are net sellers. Non-financial corporations would not be major buyers of short-term municipals in the future under the proposal, with the result being higher, more volatile state and local borrowing rates.

Housing and student loan bonds

The housing and student loan sectors of the municipal market would also be negatively affected by the administration's proposal. State and local governments issue bonds to finance home mortgage loans for low- and moderate-income families as well as loans for low-income, multi-family rental projects. Both these programs provide limited, targeted, below-market financing for housing. Over the past several decades, state and local housing bonds have provided tens of billions of dollars in rental housing for low-income families and have made home ownership available to families who may not have been able to finance a home through any other source. Student loan bonds are issued to finance below-market loans to college students who may not otherwise be able to obtain tuition financing.

Together, Fannie Mae, Freddie Mac, Sallie Mae and other government-sponsored corporations and agencies hold about $8.6 billion of outstanding municipals. These entities invest primarily in state and local housing bonds (Fannie Mae and Freddie Mac) and student loan bonds (Sallie Mae). Indeed, it is a condition of Fannie Mae's and Freddie Mac's statutory charters that they help support the market for low- and middle-income housing, and investing in state and local housing bonds is one of the ways in which these agencies carry out that obligation. Under the administration's proposal, these organizations would simply stop buying municipals. As a result, the cost of mortgage financing provided through state and local governments would increase substantially.

Municipal leasing transactions

The proposal would also have profound effects on municipal leasing. States and localities routinely lease assets and equipment, such as school buses, police cars, and computers. If the administration's

[17] Letter from the Honorable Bill Archer, Member of Congress, to the Honorable Phil English, Member of Congress, January 19, 1996.
[18] *Ibid.*
[19] See, for example, letter from the Honorable Max Baucus, U.S. Senator, the Honorable Orrin Hatch, U.S. Senator and 33 other members of the Senate to the Honorable Robert E. Rubin, secretary of the Treasury, March 6, 1996, letter from the Honorable Nancy Johnson, Member of Congress, and 12 other members of Congress to the Honorable Bill Archer, Member of Congress, December 15, 1995 and letter from the Honorable Kenneth E. Bentsen, Member of Congress, to the Honorable Robert Rubin, Secretary of the Treasury, January 10, 1996.
[20] Department of the Treasury, page 44.
[21] Source: Federal Reserve Board.
[22] Department of the Treasury, *idem*.

proposal were adopted, equipment lessors estimate that their cost of financing for state and local governments would increase dramatically. After originating municipal lease transactions, most lessors generally sell their financing contracts to private funding sources to generate the capital they need to continue to operate their business. Those who invest in tax-exempt leasing include corporations, commercial banks and investment banks. Individuals and mutual funds, through certificates of participation, also purchase tax-exempt leases. Although the administration's proposal would not apply "to certain non-salable tax-exempt bonds acquired by a corporation in the ordinary course of business in payment for goods and services sold to a state or local government," this intended relief is illusory. The vast majority of equipment manufacturers who sell to state and local governments prefer not to hold municipal leases because they do not want to tie up their capital. These companies generally sell their financing contracts to third party investors. The administration's proposal would discourage vendor financing of capital equipment leased to states and localities. As a direct result, the cost of new capital investment by state and local governments would rise substantially.

Summary

Again, we appreciate the opportunity to comment on the tax proposals contained in the administration's FY 1998 budget proposal. Although we strongly oppose many of the administration's proposals on the grounds that they would discourage capital formation and public and private investment, we welcome the Finance Committee's attention to these important issues, and we look forward to working with members and staff of the committee as your work on the budget progresses.

PSA is truly encouraged that a balanced federal budget may finally be at hand. We support eliminating the deficit because we believe a balanced budget would foster capital investment and thereby create jobs and provide for a stronger economy. A balanced budget will foster greater levels of savings and investment, which in turn will result in higher productivity and better living standards. We are deeply troubled, however, that the administration has proposed increased taxes on capital investment as part of its balanced budget plan. PSA believes that policy-makers at all levels should be looking for ways to encourage greater savings and investment, not discourage it by making it more expensive for corporations and state and local governments to raise capital. We strongly urge the committee in its deliberations on the administration's budget to oppose all proposals that would increase the cost of capital investment.

WRITTEN STATEMENT OF THE SECURITIES INDUSTRY ASSOCIATION SUBMITTED FOR THE RECORD OF A HEARING BEFORE THE SENATE COMMITTEE ON FINANCE CONCERNING CERTAIN REVENUE PROVISIONS IN PRESIDENT CLINTON'S FISCAL YEAR 1998 BUDGET UNITED STATES SENATE APRIL 17, 1997

The Securities Industry Association[1] is pleased to share its views on some of the revenue provisions in the President's fiscal 1998 budget. SIA commends the Committee for holding this hearing. We believe that future economic growth requires both a balanced budget and an increased U.S. savings rate. SIA particularly appreciates the considerable efforts of Chairman Roth over the years to encourage all Americans to save and invest.

The President and Congress are making considerable efforts to balance the budget. We are encouraged by provisions in the Administration's budget that recognize the importance of savings and investment – in particular, proposals to improve Individual Retirement Accounts and make targeted cuts in capital gains tax rates. We believe, however, that these provisions should be expanded to allow all Americans to make tax-deductible contributions to their IRAs, and to provide for broad-based capital gains tax cuts that treat all assets equally.

Several revenue-raising provisions in the budget, however, contradict a policy of savings and investment and would have a negative impact on our capital markets. In particular, 14 revenue proposals would impose approximately $5.9 billion[2] in new taxes on certain securities products and transactions that companies use to raise capital to finance growth, expansion, and new jobs and to reduce uncertainty and risk in the marketplace. These are not new proposals. Indeed, Treasury first published many of them last year as part of the Administration's 1997 budget. Congress – recognizing that more taxes on the capital markets would slow economic growth – struck these proposals from the final budget.

Congress should reject Treasury's capital markets tax proposals again this year. They are an ill-considered reaction to a few well-publicized transactions, and are not sound tax policy. These proposals will make it more difficult for companies to raise capital, deter individuals from protecting their investments against risk, increase taxes on businesses and investors, and add to the regulatory and reporting burdens of securities firms. The capital markets tax increases will stifle savings and investment when Congress should be encouraging economic growth.

PROPOSALS THAT HARM INVESTORS

Individuals are investing in the capital markets as never before. Stable interest rates, steady price appreciation for stocks and bonds, and low returns on traditional long-term savings products are a few of the reasons more than one adult in three owns corporate stock. Less than a decade ago, it was one in five adults. Despite this record level of investment, however, the savings rate in the U.S. is still far too low when compared with the rest of the industrialized world. Two of Treasury's proposals – average cost basis and short against the box – are aimed directly at individual investors. Rather than encourage individuals to save and invest, Treasury's proposals send the wrong message by raising taxes on investors.

[1] The Securities Industry Association brings together the shared interests of more than 760 securities firms throughout North America to accomplish common goals. SIA members – including investment banks, broker-dealers, specialists, and mutual fund companies – are active in all markets and in all phases of corporate and public finance. In the U.S., SIA members collectively account for approximately 90 percent, or $100 billion, of securities firms' revenues and employ about 350,000 individuals. They manage the accounts of more than 50-million investors directly and tens of millions of investors indirectly through corporate, thrift, and pension plans. (More information about SIA is available on its home page: http://www.sia.com.)

[2] This figure is from the Joint Committee on Taxation's revenue estimate. The Treasury Department estimates that these provisions would raise $7.3 billion over the same six-year period.

Average Cost Basis for Securities

Treasury proposes to modify the rules under which investors compute capital gains on sales of securities. Under current law, when investors sell securities, they are allowed to identify the shares that they sell to calculate their basis – the price they originally paid for the securities. The Treasury proposal, on the other hand, would require sellers of stocks, bonds, or other securities to compute capital gains or losses using an "average cost basis" – the average amount paid for shares of Corporation X stock, whenever purchased – rather than the amount actually paid for the shares sold.

SIA opposes Treasury's average cost basis proposal. The current law rules for determining cost basis – where sellers of securities have an option to compute gain and loss using either the specific identification or first-in-first-out (FIFO) – are simple and fair. The specific identification method allows investors who purchase securities at different times and different prices to identify, if they wish, which shares they are selling.

Raises Taxes on Individual Investors. The proposal would result in larger capital gains tax liabilities – compared to those arising from the specific identification method – regardless of whether an investor sells less than all of his or her shares of a particular company. The U.S. already has among the highest capital gains tax rates in the world. The proposal increases this already-too-high rate and penalizes, rather than encourages, investment. Consequently, the proposal would encourage investors to hold – rather than sell – securities, thereby exacerbating the lock-in effect caused by capital gains taxation and reducing the flow of capital to higher-return investments.

Overly Complex. In addition, the proposal would greatly complicate the calculation of gains and losses by requiring that a taxpayer determining the cost basis of any share of Corporation X stock take into account every share of Corporation X stock in his or her portfolio. These calculations would be particularly burdensome for investors who repeatedly purchase additional shares of a particular company, such as through a dividend reinvestment program. For example, a shareholder reinvesting dividends in a company with quarterly dividends would have 41 separate blocks of shares at the end of 10 years. Any company that were to attempt to calculate average cost basis for its investors would incur significant systems modifications that would increase costs and reduce investor returns.

Investment Disincentive. The proposal would discourage additional purchases of shares in successful companies. In a rising market, average cost basis in a particular security will be less than the basis of recently acquired shares, increasing the capital gains that will be due on sales. As a result, investors would have a disincentive to purchase additional shares in the same corporation – as opposed to equally priced shares of another corporation – because basis in the additional stock would be lower than the purchase amount. This would penalize individuals who invest in the same company over time.

Short Against the Box

SIA strongly opposes Treasury's proposal to treat certain appreciated financial positions as constructive sales. Current law allows taxpayers to enter into hedging transactions to reduce or eliminate risk of loss on financial assets without incurring taxable gains. As a general rule, gain or loss is realized on financial assets only when they are sold or otherwise disposed of (the "realization" requirement). Treasury, however, would require taxpayers to recognize gain (but not loss) upon entering into a "constructive sale" of any appreciated position in stock, debt instrument, or partnership interest. For purposes of the provision, a constructive sale occurs when an investor "substantially eliminates" risk of loss and opportunity for gain on an investment by entering into one or more positions -- i.e., short sale, equity swap – with respect to the same or substantially identical property. Any effort to integrate this proposal with the realization requirement would raise insurmountable line-drawing problems, create substantial uncertainty, and chill legitimate hedging transactions. We note that the proposal with regard to income in respect of a decedent would prevent taxpayers from using hedging transactions to avoid gain recognition. The remainder of the proposal is intended to prevent taxpayers from deferring gain recognition to a later date. This proposal, as drafted, far exceeds what is necessary to address the abuses it is intended to prevent.

Technical Deficiencies. There are also a number of serious technical problems with the proposal, and SIA is not persuaded that these problems can be fixed. For example, taxpayers would be treated as having sold appreciated financial positions even though they did not borrow, or otherwise monetize, their positions. Given that taxpayers generally sell appreciated property to obtain the proceeds of the sale, this treatment is irrational – the "selling" taxpayers would not even have the money to pay the resulting tax. Likewise, under the proposal, temporary hedging of an appreciated position would result in a constructive sale, even though the hedge was closed before the end of the taxable year and could not result in a deferral of gain for tax purposes. The proposal would affect a broad range of hedging transactions which serve important economic purposes, which do not resemble sales, and which have nothing to do with avoiding tax.

Overly Broad Response. **This proposal was issued shortly after the press called attention to several transactions by high-net-worth individuals. As drafted, however,** constructive sales treatment turns on whether the taxpayer had "substantially eliminated risk of loss and opportunity for gain." The transactions which might, or might not, result in constructive sales (depending on how Treasury interprets the language) is far broader than the proposal's original intent. It would include collar transactions, issuances of exchangeable debt securities, issuances of letter stock, issuances of employee stock options and other incentive compensation, forward sales agreements, and hedging transactions of all sorts. Moreover, the consequences of a constructive sale under any particular set of circumstances and its interaction with numerous other tax rules and regimes, would be fraught with uncertainty and complexity. **Congress should not take the bold step of deeming certain hedges to be sales for tax purposes without first considering all the collateral effects such a proposal would have on other provisions of the Internal Revenue Code.**

Retroactive Tax Increase. **The proposal would apply to all constructive sales entered into after the date of enactment, as well as transactions entered into before that date but after January 12, 1996, if they are not closed within 30 days of the date of enactment.** SIA objects to the January 12 effective date. The basic rule that a short sale against the box is not a taxable event dates back to specific guidance issued by the IRS over 65 years ago. Taxpayers who have relied on this long-standing guidance should not be penalized retroactively by making their earlier transactions taxable. Nor should they be forced to incur the economic and tax costs of closing their short positions. If Congress enacts legislation similar to Treasury's proposal, we urge that constructive sales treatment be generally applied only to transactions that are entered into after Treasury issues detailed and fully considered guidelines. If a date-of-enactment effective date is applied to certain specific transactions that are viewed as abusive, then those transactions should be described in the legislation, and Treasury should be granted regulatory authority to deal with new transactions on a prospective basis. Congress took a similar approach in dealing with hedging transactions which minimize a taxpayer's risk of loss under section 246(c)(4).

Proposals That Harm Issuers

The U.S. capital markets are the most liquid, efficient markets in the world. Every year since 1991, the securities industry raised over $1 trillion in capital for U.S. companies – capital that is used to finance research and development, expansion, and new jobs. Our clients rely on us to raise low-cost capital to meet their particular financing needs. Several Treasury proposals, however, are aimed directly at the ability of U.S. companies to raise capital. Congress should not enact policies that discourage innovation in the capital markets, but rather, should encourage growth through sound economic policies.

Deny Interest Deductions for Certain Debt Securities

Treasury would restrict the ability of corporations to raise capital by severely limiting the availability of certain widely used debt securities, including long-term bonds, trust-preferred securities, and convertible debt securities. These proposals would disallow interest deductions for debt instruments that Treasury believes have substantial equity characteristics. The structured debt instruments affected by the proposal, however, are clearly debt under principles of federal income taxation. They include:

- Long-term bonds, which permit issuers to lock in low interest rates for up to 100 years. The proposal would not allow companies to deduct interest on bonds that do not mature for at least 40 years;

- **Greater-than-15-year notes held through a trust.** By issuing debt through a trust, rather than selling it directly to the public, companies are able to maintain good credit ratings and satisfy regulatory requirements that limit the amount of a company's debt. The proposal would classify trust-preferred securities as equity if they have a maximum term of at least 15 years and are not reported as debt on the issuing corporation's balance sheet; and

- **Convertible debt payable in equity of the issuer or a related party,** which permit corporations to issue stock in the future. The proposal would classify such investments as equity, and would deny the interest deduction that a company would normally receive for such a debt security.

Incoherent Tax Policy. SIA opposes enactment of tax proposals that restrict the ability of U.S. corporations to raise capital and urges Congress to reject them. Treasury's proposals are reactive – they strike at innovative products developed by the securities industry to serve our clients' needs. Treasury's "reverse engineering" to address perceived abuses on a case-by-case basis further muddies the line between debt and equity. Treasury has ample authority to formulate general debt/equity rules, but has not done so since 1986. Instead, they draw an arbitrary line between debt and equity with these proposals without considering the broader tax policy implications of such a move. Such a complex matter should not be undertaken on an ad hoc basis, but should be given careful, comprehensive consideration.

Structured Debt is Not Equity. Furthermore, Treasury's assertion that these innovative financial instruments are really equity masquerading as debt is unfounded. Long-term debt obligations have all the same attributes as other debt instruments. These bonds are typically issued by well-established, stable companies that are likely to remain in business throughout the obligation's term. Issuing companies price their long-term obligations to give investors a stable return over time, and investors do not assume the risks, or reap the rewards, of equity investments. In addition, the balance sheet characterization of innovative debt securities does not change the fact that the securities possess all the characteristics of debt. Investors who purchase notes issued through a trust have a direct ownership interest in the underlying debt and have the same legal rights as if they had purchased the debt directly from the company. As with any debt security, issuers of trust-preferred securities have an absolute obligation to pay the interest and principal at maturity.

Defer Deductions for Original Issue Discount Until Payment

Many companies issue debt securities that allow either the issuing company or the investor, at some time in the future, to convert the debt into shares of stock of the issuer or a related party. If these instruments are issued at a discount – less than face value – companies are able to deduct the original issue discount (OID) as it accrues over the term of the debt, regardless of whether it is paid at maturity in stock or cash. The Treasury proposes to defer deductions for interest accruing on convertible debt instruments with OID until this interest is paid. At the same time, however, they do not propose to alter the tax treatment of OID for holders of these instruments. So while companies will not be able to deduct OID until they pay it out, investors will still be required to pay taxes on OID, even though they have not received this income

Contrary to Congressional Intent, Regulatory Policy. SIA opposes this proposal and urges Congress to reject it. Congress enacted the OID rules to eliminate the distortions caused by the mismatching of income and deductions by lenders and borrowers. The IRS reviewed the deductibility of OID in 1991 and determined in a private letter ruling that zero-coupon convertible securities are indeed debt, and that OID is deductible as it accrues. In fact, statistics bear out the IRS's determination. Only 30 percent of all zero-coupon convertible debt retired since 1985 were paid in common stock, while the remaining 70 percent were retired with cash. In contrast, of all non-OID convertible debt retired since 1985, 79 percent were converted into common stock, while only 21 percent were retired with cash. Furthermore, the Treasury Department, after nine years of study, did not single out convertible debt OID for special treatment when they issued the final OID regulations in 1994. Treasury's proposal would abruptly reverse this policy without public hearings or full consideration of the consequences.

Reduce the Dividends Received Deduction to 50 Percent or to Zero for Limited-Term Preferred Stock

Treasury proposed to exacerbate the multiple taxation of corporate dividends by lowering the dividends received deduction (DRD) to 50 percent – and in some cases to zero. Corporate income is already taxed at least twice – first to the corporation when it is earned; and second, to the shareholder when dividends are paid out. Corporations that own less than 20 percent of the common and preferred stock of other corporations are allowed to deduct 70 percent of the dividends they receive from this stock from their taxable income. The DRD rises to 80 percent if the corporation owns more than 20 percent, and to 100 percent if the corporation owns more than 80 percent of the other corporation. By allowing corporate shareholders to deduct at least 70 percent of dividends received, the law mitigates – but does not alleviate – a third layer of tax on this income. Indeed, the partial DRD imposes an additional tax burden on corporations in excess of $1 billion annually.

International Competitiveness. Treasury, however, would reduce the DRD to 50 percent, except for shares of limited-term preferred stock, for which the DRD would be eliminated entirely. This proposal applies to all dividends received after the effective date – not just to dividends received on stock purchased after that time – and does not grandfather existing holdings. SIA opposes this proposal because it unfairly targets income that is already subject to multiple layers of taxation. Allowing companies to deduct only 50 percent of their inter-corporate dividends would move closer to imposing a full triple tax on profitable companies. As it stands, the U.S. is the only major industrialized country that subjects corporate profits to multiple layers of tax. Our trading partners either allow a 100 percent deduction for dividends received or have integrated their corporate and income tax systems to alleviate this problem altogether. SIA believes Congress should increase the DRD, if anything, as a matter of international competitiveness.

Increases the Cost of Capital. Corporations invest heavily in the common and preferred stock of other companies, providing a significant source of capital to finance growth, research, and new jobs. As the DRD is reduced and the return corporations can earn on their investments in other companies falls, corporate investors will require a higher rate of return from issuing companies – raising the cost of capital. A higher cost of capital will make corporations more likely to rely on debt, rather than equity, to finance expansion. Interest on debt may be deducted by the issuing company, and is not subject to multiple levels of tax.

Significant Impact on Preferred Stock Market. These proposals will change the rules for the entire preferred stock market. Reducing the DRD would immediately decrease the value of preferred stock and yield-oriented common stocks that have a regular schedule of dividend payments. SIA is particularly troubled by Treasury's willingness to impose a retroactive effective date on this proposal. By not grandfathering existing positions, the proposals penalize corporations for investments made in reliance on existing rules. At the very least, Congress should specify that this provision applies to positions established after the date of enactment.

Furthermore, by eliminating the DRD for limited-term preferred stock – such as money market preferred and adjustable rate preferred stocks – Treasury removes a powerful incentive for companies to issue this class of shares. Companies issue limited-term preferred stock to raise low-cost, short-term capital as an alternative to commercial paper. Indeed, this is a substantial market – at present there are $11 billion in money market preferred stocks outstanding, and another $4 billion in adjustable rate preferred shares outstanding. Cutting the DRD altogether makes it more likely that companies will issue debt, rather than other types of equity, to raise short-term cash.

Modify the DRD Holding Period

Treasury would modify the DRD holding period requirement for corporations that hold stock in other corporations. SIA opposes this proposal and urges Congress to reject it. It would interfere with prudent hedging practices, reduce the efficiency of the financial markets, and expose investors to increased risks.

As explained above, corporations generally are entitled to a dividends received deduction (DRD) for dividends received on stock they hold. They are entitled to the DRD only if they own the dividend-paying stock for at least 46 days (91 days for certain types of preferred stock). The holding period is not satisfied if, at any time during that period, the shareholder corporation is protected from risk of loss (i.e., has hedged the position). Once the holding period is satisfied, it need not be met again with respect to subsequent dividends paid by the same stock.

The Treasury proposal, on the other hand, provides that a corporate shareholder is not entitled to the DRD if the holding period is not met during the time immediately before and after each dividend is received. The proposal would be effective for all dividends received more than 30 days after the date of enactment, regardless of when the shares were purchased.

Treasury once again is imposing a retroactive tax hike on shareholders because the proposal does not grandfather existing positions.

Discourages Risk Reduction. Modifying the DRD holding period would discourage companies from hedging against market and interest rate risk. Market conditions prompt investors to use various hedging techniques to reduce risk in their portfolios, and interest rate hedging is an important component of corporate risk management. Prudent hedging strategies to reduce these risks could put corporations afoul of the modified holding period requirements and disqualify certain dividends from the DRD. In addition, the proposal changes the rules in the middle of the game for corporations that hedged positions in stock in reliance on existing rules. Retroactively penalizing risk reduction strategies is not sound public policy. At the very least, Congress should clarify that the proposal applies to positions established after the date of enactment.

Increases Compliance Costs. SIA believes, however, that Congress should refrain from modifying the DRD holding period at all. Changes in the holding period will force companies with large portfolios to monitor how hedging activities may impact the aggregate DRD. Every corporation will have to maintain detailed records to substantiate their DRD. The projected revenue increase from modifying the holding period is so slight that it does not warrant the significant increase in compliance costs for companies.

Morris Trust

Treasury proposes to restrict the ability of corporations to reorganize in the most efficient manner by taxing Morris Trust transactions – in which a company effects a tax-free spin-off of a division or line of business as part of a merger. SIA opposes the Morris Trust proposal. It contradicts fundamental income tax principles and would discourage tax-efficient corporate reorganizations that are motivated by legitimate non-tax business purposes.

Section 355 of the Internal Revenue Code generally allows a parent corporation to "spin-off" a subsidiary – through a distribution of stock to shareholders – on a tax-free basis, provided that the spin-off meets certain requirements. If these requirements are not met, a corporation generally must recognize gain on the distribution of the subsidiary, and shareholders must treat the distribution as a dividend. A Morris Trust transaction generally involves a corporation that spins off a subsidiary and then merges with another corporation. These transactions occur most often to address antitrust concerns arising from a merger. In these transactions, the corporation's shareholders hold stock after the spin-off in both the spun-off subsidiary and in the newly-merged corporation. Courts and the IRS determined that a Morris Trust transaction constitutes a tax-free spin-off and merger under sections 355 and 368.

Treasury, however, would impose additional restrictions under section 355 on acquisitions and dispositions of the stock of both the distributing corporation and the spun-off subsidiary. Specifically, the distributing corporation would be required to recognize gain on the distribution unless its shareholders "control" the stock of both the parent and the subsidiary during the four-year period beginning two years before the distribution. Shareholders would "control" this stock if they own at least 50 percent of the voting shares and 50 percent of all other classes of the parent corporation's stock. As a result, a corporation generally would not be able to spin off a subsidiary without recognizing gain if it intends to merge with a larger corporation. In those cases, shareholders would own less than 50 percent of the vote and value of the stock in the merged company.

Contradicts Sound Tax Policy. This proposal is contrary to fundamental income tax principles. The rationale behind tax-free spin-offs and reorganizations is that gains or losses should be recognized only when an investment leaves corporate solution – that is, when shareholders cash out their investments. All corporate earnings and assets in the parent corporation and the spun-off subsidiary continue to be held by a corporation at their original tax basis and, as such, remain subject to corporate-level taxes. Shareholders end up with the same assets as when they started, but in different form.

Ignores Legitimate Business Purposes. In addition, this proposal does not consider that corporate reorganizations ar: driven by business needs and market opportunities. The tax law has long provided for tax-free transactions to encourage efficient management and deployment of business assets. Business reasons for spin-offs include:

Maximizing management efficiencies, particularly where the acquiring corporation lacks the industry expertise to manage the unwanted business.

Addressing antitrust concerns or regulatory restrictions regarding the acquiring corporation's ownership of the subsidiary. In this case, Treasury's proposal directly conflicts other areas of federal law and will force corporations to incur great expense to comply with laws and regulations.

Protecting the corporation's customer base, when the customers of the acquiring corporation's may compete with the subsidiary.

Current section 355 rules allow tax-free treatment only if the transaction has a valid business purpose. Other rules specify that the transactions cannot be a "device" for the distribution of earnings and profits. Moreover, the corporation and the subsidiary must stay in business after the reorganization. Taken together, these rules ensure that spin-off transactions are not undertaken primarily for tax reasons and make the Treasury's proposal an unnecessary restriction on corporate reorganizations.

Finally, the Treasury proposal will apply to a number of transactions which are subject to written agreements or for which ruling requests have been filed with the IRS or public announcements or SEC filings have been made, but which may not be completed by the time the Committee acts. Imposing such a fundamental change in the corporate tax rules retroactively to these transactions would be unfair.

Proposals to Increase Regulatory and Reporting Burdens of Securities Firms

Treasury also includes two proposals that increase the regulatory and reporting burdens of securities firms by requiring registration of confidential corporate tax shelters and imposing increased penalties for failure to file information returns. SIA opposes all unjustified increases in the regulatory and compliance burdens of securities firms. Securities regulations serve very important customer protection and market integrity purposes and are crucial to maintaining the public's trust and confidence in the markets and the industry. Regulatory requirements such as tax shelter registration and information return penalties, however will not provide any additional safeguards or information to justify the added costs and burdens of compliance.

Registration of Confidential Tax Shelters

Current law requires offerors of large-scale syndicated partnerships to register tax shelters with the IRS, and penalizes taxpayers for taking a position in a tax shelter without either informing the IRS or having substantial authority for the position. Treasury's proposal, however, would require individual companies to register with the IRS all confidential tax shelters in which the organizers receive more than $100,000 in fees.

SIA opposes the tax shelter registration proposal. The registration, disclosure, and penalty requirements of current law are adequate to address abusive transactions. The proposal, however, will increase the reporting burdens of corporations and tax advisors engaged in transactions for legitimate business purposes. By imposing a disclosure requirement when a tax-planning strategy is discussed (rather than when a position is taken on a return) the proposal is excessively broad. In addition, it would require registration of transactions that are clearly permissible under IRS rules and regulations. This will significantly increase the burdens of business advisors and tax planners, without any corresponding benefit to the IRS.

In addition, the proposal would interfere with confidential business relationships. Business transactions are negotiated in confidentiality because premature disclosure might disrupt the market. Because tax consequences are always an important consideration in business transactions, this proposal would significantly alter the relationships of parties by requiring disclosure of information about a transaction while it is still under development.

Information Return Penalties

Securities firms, banks, mutual fund companies, and corporations are required to file certain "information" returns with the IRS to report items such as employee wages, dividends, and interest. Current law includes substantial penalties for non-compliance, which include a $50 penalty per failure to file information returns, with an annual cap of $250,000 per payor; and higher penalties and no cap for intentional failures to file. Treasury's proposal would increase the penalty for failure to file an information return by August 1 to the greater of $50 or 5 percent of the amount required to be reported, capped at $250,000 annually. Firms in substantial compliance (97 percent) would continue to be fined at $50 per return.

Because compliance rates are high within the securities industry, the proposal will raise revenue from higher penalties, in direct contradiction to Congressional intent that "civil tax penalties exist for the purpose of encouraging voluntary compliance." Following Congress' direction, it is IRS policy that civil penalties are not considered a source of revenue. Absent a high rate of non-compliance, the increased penalties are unjustified and unfair. There is no evidence that firms do not comply with the reporting requirements. The IRS has vigorously enforced these provisions, using its authority to fine companies that do not comply, whether inadvertently or intentionally. The extremely high level of voluntary compliance is proof that current penalties are adequate.

In addition, the proposal singles out entities who file returns under multiple names for harsher treatment. Rather than apply the penalty cap to the entire institution, the proposal would create a separate penalty cap for every name under which an institution files information returns. This would produce particularly onerous results for banks, broker dealers, mutual fund companies, and transfer agents, all of which file returns under many different names. This proposal significantly increases the potential liability of these institutions, without any showing of noncompliance with filing requirements.

Finally, the industry devotes substantial resources to timely and accurate compliance with information reporting requirements. Given their excellent record of compliance, this provision would unjustly increase the burdens of securities firms without providing any corresponding benefit to the IRS.

EFFECTIVE DATES

SIA believes that none of the 14 capital markets tax proposals should be included in the budget, and we urge you to strike them from the outset. If these proposals are included in the budget, however, we request in fairness that the effective dates be postponed until at least the "date of enactment." Any earlier date would hit taxpayers conducting routine business financing transactions with unforeseen taxes.

Retroactive or immediate effective dates would send shock waves through the capital markets; the mere announcement of these proposals in December 1995 caused enough uncertainty that many companies suspended legitimate financing transactions structured in reliance on the existing tax laws. We urge Congress to consider, at the very least, a "date of enactment" effective date that grandfathers all existing positions and transactions to give market participants a reasonable time to consider the implications of the proposals without interrupting the normal course of their businesses.

CONCLUSION

Thank you for allowing SIA to share the securities industry's opposition to the Administration's capital markets tax increases. We share your commitment for a balanced budget, but believe it must not come at the expense of savings, investment, and capital formation. SIA looks forward to working with you to find solutions to the issues identified in our testimony.

Comments on Selected Revenue Raising Provisions of the Administration's Fiscal Year 1998 Budget Proposal

April 30, 1997

Submitted by
The Tax Policy Group
within the Council on Tax & Fiscal Policy
An Initiative of Joint Venture: Silicon Valley Network

Reasons for Our Comments

These comments are submitted for inclusion in the printed record of the April 17, 1997 hearing on selected revenue-raising provisions in the Administration's fiscal year 1998 budget proposal. Our comments focus only on two of the proposals:

1) average cost basis for securities, and
2) replacement of the export sales source rule with an activity-based rule.

The Proposals Threaten Silicon Valley Success Factors

The success of the Silicon Valley economy stems from several factors. Unfortunately, three of these success factors are threatened by the proposals listed above. The success factors at risk are: 1) the widespread use of stock options to compensate employees and to encourage them to become owners of the high-tech companies they work for, 2) the existence of tax rules favorable to investments in growth stocks, and 3) the continual building of a strong export base. Enactment of the proposals would be counter-productive to the creation of high-paying jobs and economic growth. The current version of the rules that the Administration is attempting to change have worked well for Silicon Valley and other high-tech regions in the U.S. and should not be changed.

The Proposals Are Revenue Losers, Not Revenue Raisers

These proposals have tremendous potential to harm workers and the continuing growth of high-quality jobs in Silicon Valley and other high-tech regions, and thus, could lose revenue over the long term. The proposal to require use of average cost basis for securities would adversely affect many Silicon Valley employees who have compensation packages that include stock options and stock purchase plans to enable them to join in the financial rewards of their employer's success and to become owners of the companies they work for. Enactment of the average cost basis proposal would create undue complexity which would discourage employees from becoming shareholders in the companies they work for. The average cost basis proposal would change the law to favor investments in dividend-paying securities, rather than growth stocks (such as high tech company stocks). The export sales proposal would also have a negative impact to Silicon Valley because it would create an incentive for a U.S. company's expansion plans to call for manufacturing offshore rather than manufacturing in the U.S. and then exporting the items produced. A significant part of the economic success of Silicon Valley has stemmed from its continuous growth in exports. Exports create high-quality jobs which benefit the local, state and national economies. Loss of these jobs and the job growth potential which stem from exports would have a negative impact on U.S. companies, and consequently, the revenues of governments at all levels, and the U.S. economy as a whole.

Our specific concerns with each of these two proposals are explained in more detail in this submission.

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Background on the Tax Policy Group and Joint Venture

The Tax Policy Group consists of individuals from business, federal, state and local governments, and academia. The Group meets monthly to discuss federal, state and local tax issues of importance to Silicon Valley. The Group has analyzed and sent comments on various legislative proposals to its Congressional and state legislative delegation and others. The Tax Policy Group also holds periodic seminars to provide objective information on tax topics of interest to Silicon Valley businesses. Current areas that the Group is involved with include: simplification and clarification of the federal worker classification rules, tax incentives for getting technology into grades K - 12, permanent extension of the federal research tax credit, international tax reform and simplification, selected revenue raising proposals suggested by the Administration, and major federal tax reform. The Tax Policy Group is a committee within the Council on Tax & Fiscal Policy, an initiative of Joint Venture: Silicon Valley Network.

Joint Venture: Silicon Valley Network is a dynamic model of regional rejuvenation with a vision to build a community collaborating to compete globally. Joint Venture brings people together from business, government, education, and the community to act on regional issues affecting economic vitality and quality of life. It is co-chaired by Hewlett-Packard CEO Lew Platt and San Jose Mayor Susan Hammer. One of its initiatives is the Council on Tax & Fiscal Policy.

Drafting

The views expressed in these comments represent the collective views of the Tax Policy Group within the Council on Tax & Fiscal Policy of Joint Venture: Silicon Valley Network, and not necessarily the views of any individual members of the Study Group, the Council or of Joint Venture. The primary draftspersons of these comments were Dan Kostenbauder, General Tax Counsel, Hewlett-Packard Company (average stock basis), and William C. Barrett, Director: Tax, Export & Customs, Applied Materials, Inc. (export sourcing). The comments were reviewed by members of the Tax Policy Group and the Council on Tax & Fiscal Policy.

Average Cost Basis for Securities

Executive Summary

There are a great number of reasons why the proposed requirement for taxpayers always to use the average cost basis method would be an inappropriate change in the tax law that would have the effect of significantly increasing the tax on capital gains. The reasons for not adopting the average cost basis method of computing capital gains include reductions in the benefits of employee stock ownership, negative impacts on capital markets, a hidden increase in capital gains taxes, and tremendous increases in the complexity of complying with and administering the tax laws.

Employee Stock Ownership Would Be Discouraged

Many employees participate in employer-provided benefit programs that encourage the acquisition of stock over time. Requiring use of average cost basis would encourage sale of shares when acquired, thereby discouraging long-term ownership of company shares by employees.

Many companies, particularly those in high-technology industries, also award stock options to broad groups of employees, not just to senior management. Employees who exercise stock options would be negatively impacted. Not only would individuals exercising options generate ordinary income equal to the "bargain element" on the date of exercise, but when some of those shares are sold immediately to pay for the taxes on the bargain element (a very common and necessary practice), there could be substantial additional capital gains taxes. In addition, employees exercising incentive stock options would have additional recordkeeping complexities because of the need to also track average stock basis for alternative minimum tax (AMT) purposes. These adverse impacts that would result from the required use of average cost basis would greatly diminish the value of these programs as an incentive to employee stock ownership.

Capital Markets Would Be Impaired and Savings and Investment Discouraged

The average cost basis proposal represents a significant tax increase for securities owners. As such, it would discourage participation in the securities markets, and thus, savings generally, by making financial assets relatively less attractive. At a time of bi-partisan discussion of capital gains reduction to encourage savings and investment, it would be counterproductive to adopt this capital gains tax increase.

Capital markets would be distorted because the average cost basis provision would make dividend stocks relatively more attractive than growth stocks. This is because more of the future value of growth stocks would be reflected in the share price relative to dividend-paying stocks. This again is a particular concern of companies in the fast-growing technology sectors of the U.S. economy.

Other distortions of capital markets would occur because of the lock-in and lock-out effects that would be expected to result from use of the average cost basis method. By increasing capital gain tax liabilities, the average cost basis method would encourage investors to hold shares rather than selling them and paying high capital gains taxes. The effect is to lock-in capital and reduce the flow of capital to higher-return investments. The lock-out effect would occur if shareholders decide not to purchase additional shares of a company in which they have already invested and instead, invest in a different company, solely to avoid the need to use the average cost basis method when they sell the shares of the company in which they initially invested.

The proposal would also make dividend reinvestment plans (DRIPs) less appealing to investors. The main feature of such plans is the acquisition of new stock through the reinvestment of dividends. Because new stock is typically purchased on a quarterly basis by long-term investors, computing gain or loss on any shares sold using the average cost basis would be very complex, and often would result in higher taxes, thereby diminishing the attractiveness of DRIPs.

The direct impact of the proposal on corporations would be limited in general, because few corporations make regular, significant investments in the same company's stock over time. However, venture capitalists, who play a critical role in encouraging new high-growth, job-creating businesses, are an exception to the generalization in the preceding sentence and might be discouraged from making certain investments if the proposal were enacted. An indirect, but significant impact to companies which would likely occur under the proposal is an increased difficulty in raising capital because the after-tax returns of investing in securities would be lower if the proposal were enacted (as explained earlier).

In addition, the proposal would result in companies with a stock purchase plan and/or stock option program to be providing their employees with a less valuable benefit (relative to current law), because employees would realize lower after-tax returns.

Capital Gains Taxes Would Be Increased

The average cost basis method for computing capital gains and losses on the sale of stock is permitted under current tax regulations for certain mutual fund shares. However, it is often preferable for taxpayers to specifically identify high cost basis shares for sale, resulting in lower capital gains. Because this rule has been in the tax regulations for decades, changing and expanding it under the guise of simplification really amounts to a tax increase on capital gains.

In addition, if taxpayers could no longer specifically identify shares to donate, charitable contributions of appreciated stock to charities, such as universities and the United Way, would no longer be as attractive. Under present law, individuals may deduct the full market value of appreciated securities donated to charities.

Increases in Complexity

The complexity for individual taxpayers trying to compute capital gains tax would be greatly increased under the proposal. If a taxpayer were to purchase shares of a company's stock on more than one occasion and never liquidate his or her position, calculating capital gain (loss) would require documentation establishing, i) for every purchase, the price, date and number of shares; and ii) for every disposition, the date and number of shares. This would be true even if a person late in life sold shares in a company that he or she acquired early in life. It would be particularly true for investors in DRIPs.

Another example of the extreme complexity created by the average cost basis proposal is the case of a taxpayer making gifts (such as a graduation present to a grandchild). Presumably the taxpayer would need to provide the gift recipient with all records needed to document the average cost basis of the shares gifted because gifted shares normally have a carryover basis. This would be unduly cumbersome and also could interfere with a donor's desire to keep his or her transactions private.

An additional complexity exists for employees exercising incentive stock options and employers granting such options. The parties would find it more difficult to track whether a disqualifying disposition occurred where the employee has purchased employer stock on more than one occasion. Also, there would be added complexity in determining the tax consequences for both employer and employee that result from a disqualifying disposition.

In addition, there is no assurance that the philosophy of the proposal would be embraced at the state level. Therefore, non-conformity between the federal and state income tax systems would result, and among state systems as well. This disparity could have the effect of forcing an individual to account for his or her basis in stock on a cost average basis for federal purposes while using another method for state tax purposes.

The provision's inherent complexity, plus the effect of probable non-conformity between the state and federal income tax systems, and among the states themselves, probably would have the effect of increasing non-compliance.

Summary

The proposal to require capital gains and losses for securities to be computed using the average cost basis method should not be enacted. As explained above, this proposal would adversely affect employee/shareholders, negatively impact capital markets, act as a "hidden" increase in capital gains taxes, make it more difficult for high-technology companies to raise capital, and add undue complexity to the income tax laws.

Replacement of Sales Source Rule with an Activity-Based Rule

Executive Summary

High-technology industries comprise integrated industries with numerous companies occupying critical niches. Product cycles of 1-5 years are not uncommon and successful companies at each stage of the high-tech food chain must adapt and constantly improve their product lines. As these cycles repeat and new products and markets are created, residual markets from prior product cycles remain and as a result, the absolute market size and opportunity increases.

High-tech industries are heavily export oriented. Recent statistics show that Silicon Valley's exports grew 30 percent in 1995 from $27 billion to $35 billion. For many Silicon Valley companies, exports exceed 50 percent of total sales. Much of this exported product is manufactured in the United States and because of the nature of high-tech industries and their product cycles, a tremendous amount of research and development accompanies the manufacturing function. The linkage between research and manufacturing is very strong within high-tech industries.

The export source rule helps to mitigate the double taxation faced by many U.S. exporters when income is taxed both in the United States and in a foreign country, and as a result, can have a direct effect on a high-tech company's global tax burden. The export source rule only applies when goods are manufactured in the United States and exported. In high tech industries, significant U.S. research and research related jobs accompany the U.S. manufacturing function. Repeal of the export source rule would place upward pressure on the after tax cost of performing the manufacturing and related research activity in the United States.

Capital investment decision-making is influenced by both tax and non-tax factors. However, as global infrastructure and education levels improve, non-tax factors become increasingly less important in the capital investment decision-making and, therefore, U.S. tax laws that increase the after-tax cost of doing business could have a profound impact on location of investment. This will in turn have a direct impact on exports and export-related jobs not only for companies that respond quickly to after-tax returns, but also supplier companies that support the U.S. manufacturing and research activities. The various sectors within high-tech industries tend to be very closely linked and interdependent so that investment decisions by one sector will have a multiplier effect on where future geographic income will be earned.

U.S. high-tech industries are innovative, highly profitable, drive academic institution curriculum and excellence, produce high-paying jobs, produce a tremendous volume of exports, and serve as a model to the world. Repeal of the export source rule would serve to discourage these U.S.-based activities.

Marketing and Sales, Not Tax, Drives Multinational Corporate Structures

A Silicon Valley high-tech start up company begins with an innovative idea. This idea may or may not have large market potential in the early life cycle of the company. Those companies destined to become successful will either have a product that is ready for the current market[s] or the product idea will create a new market. High-tech products change every 1-5 years because industry innovation and global markets are constantly evolving. Successful companies at each stage of the high-tech food chain must adapt and constantly improve their product lines. High-tech companies that do not adapt or evolve their product lines do not survive.

High-technology represents integrated industries with numerous companies occupying critical niches. For example, semiconductor equipment companies supply the semiconductor chip companies and the chip makers in turn provide the means for computers to perform complex software functions ranging from number crunching to multimedia. The explosion of the Internet and networking companies that link computers has been a more recent evolution in high-tech industries. Computer software companies have been both pushing the semiconductor industry as well as adapting new software applications to existing computer capability. At each component stage, companies must keep pace with evolution and product cycles to survive. As these cycles repeat and new products and markets are created, residual markets from prior product cycles remain and as a result, the absolute market size and opportunity increases.

The profile of a high-tech multinational company is no different from the above description, but for the fact that it either competes in or develops markets in multiple countries. To be successful in countries outside the U.S., the multinational must understand different markets and adapt its corporate structure to accommodate those markets. A not uncommon profile as product lines evolve and/or the multinational adapts to foreign markets, is that specific segments of manufacturing may be located offshore.[1] These segments may be older products lines or components of a product that are produced more efficiently offshore. In most cases, newer product lines, and the requisite research and development, remain in the U.S. and close to development centers.

Silicon Valley high-tech companies do not structure their global operations solely on the basis of local country tax rates. For example, as high-tech product lines mature, investment in alternate manufacturing sites is a natural process of growth and diversification of risk. However, this statement should not be interpreted to mean tax rates do not play a significant role. An increase in U.S. tax increases the cost of business in the U.S. and if a company is to maintain an after-tax shareholder return, it must evaluate lower cost site locations. Popular rhetoric often characterizes U.S. industries as intent on the wholesale migration of manufacturing to offshore locations with the sole purpose of minimizing corporate income tax when in reality, companies are trying to remain competitive in a global market and taxes represent only one, albeit a significant, cost of doing business.

An analysis of a new manufacturing location will involve a comparison of factors, such as the following:

- labor skills, consistent with the demands of product technical requirements
- labor productivity
- cost of labor
- cost of land and construction costs
- financial and physical infrastructure (e.g., highway and airport)
- proximity to customers and the market
- protection of intellectual property
- tax rates

In reviewing this list, the superordinate goal of generating additional sales revenue and global market share may be overlooked. Any successful high-tech company is in the business of selling product and increasing financial return to its investors and when tax rates reduce potential return, they play an increased role in the decision-making process. A company that makes sensible investment decisions based on after-tax returns that improve the ability to competitively price product stands a good chance to improve its market share.

There are Fundamental Flaws In The Administration's Export Source Proposal

President Clinton's FY 1998 budget proposal contains a provision that would eliminate the export source rule, which allows 50 percent of the income from the sale of goods manufactured in the U.S. and exported to be considered "foreign source income". The proposal would instead source income from export sales under an "activity based" standard -- effectively eliminating the export source rule. "Activity based" sourcing is not defined in the proposal, but might be patterned after a current income tax regulation example.[2] For U.S. exporters with excess foreign tax credits, the

[1] A successful company locates offshore to increase its global sales revenue and market share. Often, this râison d'être is lost in political rhetoric. If a company is less competitive in the global marketplace (i.e., does not increase its global market share) because of higher tax rates, that company will naturally evaluate where it places manufacturing and R&D capability. Similarly, import tariffs will influence global investment patterns. For example, the European Union in 1992 effectively placed a European manufacturing content requirement through imposition of duties on non-European manufactured semiconductors. United States and Asian semiconductor manufacturers now dominate the European semiconductor industry which illustrates how investment decisions can be altered to reduce government imposed costs of doing business.

[2] Treas. Reg. §1.863-3(b)(2) Ex. 1. The Tax Court in both *Phillips Petroleum Co.*, 97 T.C. 30 (1991) and *Intel Corp.*, 100 T.C. 616 (1993), found that the fact pattern in the regulations example did not apply to the facts of these cases. The facts in these cases are typical of most exporters and therefore, under current law "activity based"

export source rule alleviates double taxation, and thereby operates as an export incentive for U.S. multinationals. The foreign source income rule only applies if companies manufacture goods in the U.S. and export them. In the case of high-tech companies this usually means the company is also performing substantial R&D in the U.S.

The Administration makes the following argument in support of repeal:

> The existing 50/50 rule provides a benefit to U.S. exporters that also operate in high-tax foreign countries. Thus, U.S. multinational exporters have a competitive advantage over U.S. exporters that conduct all their business activities in the United States.[3]

There are at least three flaws in this argument. First, companies without foreign operations do not face the double taxation the export source rule is designed to alleviate. Thus, the rule does not create a competitive advantage; instead, it levels the playing field. Double taxation increases the cost of doing business offshore and therefore, the multinational with foreign operations becomes less competitive without benefit of the foreign source income rule. Second, a company without foreign operations may be a start-up that has not entered global markets. This new company cannot be compared to a large and well-established multinational. As the new company grows into global markets, it too will benefit from the export source rule. Finally, the argument in favor of eliminating the foreign source income rule fails to take into account additional [non-tax] expenses that will be incurred by the multinational with foreign operations. Selling, marketing, administrative expenses associated with a foreign location, and product adaptation to local market, all must be incurred to support the local market. The conclusion is inescapable that establishing foreign operations will produce additional operating costs. Although operating costs will increase with foreign operations, the reality is that a U.S. manufacturing company cannot compete for global market share without establishing offshore operations. The resulting increased global market share increases high -paying R&D and manufacturing jobs in the U.S.

Tax Treaties are No Substitute For The Export Source Rule

The Administration has stated that the United States income tax treaty network protects export sales income from tax in the foreign country where the goods are sold and thus, protects companies from double taxation. Treasury argues that the export source rule is no longer necessary as a result of this treaty protection.

The tax treaty network is not a substitute for the export source rule, but even if it were, the treaty network is far from complete. The U.S. treaty network is limited to 56 countries, leaving many more countries (approximately 170) without treaties with the U.S. Moreover, many of the countries without treaties are developing countries, which are frequently high-growth markets for American exporters. For example, the U.S. has no treaty with any Central or South American country.

With or without a tax treaty, under most foreign countries' tax laws, the mere act of selling goods into the country, absent other factors such as having a sales or distribution office, does not subject the United States exporter to income tax in the foreign country. Thus, export sales are not the primary cause of the excess foreign tax credit problem which many companies face in trying to compete overseas.

The real reason most multinational companies face double taxation is that U.S. tax provisions unfairly restrict their ability to credit foreign taxes paid on these overseas operations against their U.S. taxes. Requirements to allocate a portion of the costs of U.S. borrowing and research

sourcing as described in Example 1 would rarely produce any foreign source income. The result, using an "activity based" model, would be zero percent foreign source income on exported U.S. manufactured product, which increases the global tax burden on this income.

[3] Description of Administration's tax proposals; http:/www.ustreas.gov/treasury/whatsnew/whatsnew/html.

activities against foreign source income (even though such allocated costs are not deductible in any foreign country), cause many companies to have excess foreign tax credits, thereby subjecting them to double tax, i.e., taxation by both the U.S. and the foreign jurisdiction.

As previously explained, the export source rule alleviates double taxation by allowing companies who manufacture goods in the United States for export abroad to treat 50 percent of the income as "foreign source", thereby increasing their ability to utilize their foreign tax credits. Thus, the rule encourages these companies (facing double taxation as described above) to produce goods in the U.S. for export abroad.

As an effective World Trade Organization-consistent export incentive, the export source rule is needed now more than ever to support quality, high-paying jobs in U.S. export industries.[4] Exports have provided the spark for much of the growth in the U.S. economy over the past decade. Again, the existence of tax treaties does nothing to change the importance of this rule to the U.S. economy.

The decision to allow 50 percent of the income from export sales to be treated as "foreign source" was in part a decision based upon administrative convenience to minimize disputes over exactly which portion of the income should be treated "foreign" and which should be "domestic". The rule still serves this purpose, and neither the tax treaty network nor the Administration's proposal to adopt an "activities-based" test for determining which portion of the income is "foreign" and which is "domestic" addresses this problem. Moreover, adopting an "activities-based" rule would create endless factual disputes similar to those under the section 482 transfer pricing regime.

Tax treaties are critically important in advancing the international competitiveness of U.S. companies' global operations and trade. In order to export effectively in the global marketplace, most companies must eventually have substantial operations abroad in order to market, service or distribute their goods. Tax treaties make it feasible in many cases for business to invest overseas and compete in foreign markets. Foreign investments by U.S.-based multinationals generate substantial exports from the United States. These foreign operations create a demand for U.S. manufactured components, service parts, technology, etc., while also providing returns on capital in the form of dividends, interest and royalties.

Tax treaties are not a substitute for the export source rule. They do not provide an incentive to produce goods in the United States. Nor do they address the most significant underlying cause of double taxation - arbitrary allocation rules - or provide administrative simplicity in allocating income from exports.

Capital Export Neutrality Model As A Guide For Tax Simplification

In an ideal income tax system, income tax would not influence how a company structures transactions or where the company decides to build a manufacturing plant. Investment decisions would be influenced by other economic factors such as those listed above. To eliminate income tax from the investment location decision it would be necessary to structure the system such that the global tax rate on income earned anywhere in the world is no different than the domestic rate of tax. A system patterned after the "capital export neutrality" (CEN) concept would achieve this result.[5]

[4] Studies have shown that average exporting plants have higher blue-collar and white-collar wages, and that average workers at exporting plants have higher benefits. J. David Richardson and Karin Rindal, Why Exports Matter: More!, The Institute for International Economics and The Manufacturing Institute, February 1996, page 11.

[5] CEN is also referred to as a classical tax system. In addition to the United States, Japan and the United Kingdom loosely base their tax systems on this concept. An alternative concept is "capital import neutrality" (CIN). Under CIN, the global rate of tax on foreign income does not exceed the foreign tax rate. In other words, under CIN income earned outside the home country is not taxed in the home country when received as a dividend or when the foreign operation is sold. "Territorial" based tax systems are patterned after the CIN concept. The Netherlands and

The CEN concept holds that an item of income, regardless of where it is earned, will not suffer a global rate of tax higher than the U.S. tax rate. Dividends received from both high and low tax countries suffer a double rate of tax first in the country in which the income was earned and second in the United States when received. The credit for foreign tax paid is designed to mitigate this double taxation. The export source rule operates to increase the credit for foreign taxes paid which in turn operates to more closely align the United States tax system with the concept of CEN. With sufficient foreign source income, the global rate of income tax on income earned in high tax countries approaches 35 percent.

A classical tax system that diverges from the CEN concept will increase the importance of income tax in plant location decision-making. If the foreign source income rule is repealed, the double taxation of U.S. multinationals that export from the United States will increase and for many high-tech companies this increase in taxes, and corresponding reduction in return to shareholders, will alter plant investment decisions. Many companies will be forced to invest offshore rather than build new plants in the U.S. to remain competitive and maintain shareholder rate of return. Foreign investment decisions will have a ripple effect within high-tech industries because they are so closely interrelated. For example, a natural consequence of additional offshore investment by a semiconductor manufacturer will be that equipment suppliers will increase their offshore presence to meet the demands of their customers. This dynamic will be repeated in other industry segments creating a foreign investment multiplier effect.

An Argument to Expand The Foreign Source Income Rule

U.S. transfer pricing rules, and associated penalty provisions for non compliance, are designed to ensure proper allocation of revenue and expense between geographic regions. One theoretical argument against allocating U.S. expenses to foreign source income is that expenses are properly allocated to U.S. or foreign activities under transfer pricing rules and as a result, there is no theoretical justification for allocating U.S. expenses to foreign source income. The export source rule helps to offset the negative impact of expense allocations to foreign source income. As previously discussed, if an "activities based" rule is enacted, the result could be either effective repeal or a subjective standard that will become a matter of contention between taxpayers and the Service which will then lead to protracted arguments in the IRS appeals process and the courts. The result could be similar to current transfer pricing controversies. Therefore, a strong argument for keeping the existing rule is that the export source rule is administratively convenient and minimizes subjective arguments that have the potential to become contentious when dealing with the IRS.

In the March 12, 1997 Ways & Means Committee hearings on the Administration's revenue raising proposals, compelling economic arguments were presented by Gary Hufbauer that lead to the conclusion that repealing the rule would result in a loss of U.S. capital investment and jobs. Silicon Valley anecdotal evidence supports this empirical analysis. Therefore, the debate has resulted in an argument that the export source rule promotes and sustains a certain level of U.S. investment in manufacturing activity and it is equally intuitive that if the Administration is honest about balancing the budget by a specified future time period, then *the export source rule should be expanded because of the positive impact it has on the U.S. economy.* With Gary Hufbauer's analysis and a recent Joint Committee on Taxation report[6] that reinforces his concerns, an opportunity exists going into the final budget process to turn this debate into something positive. If 50 percent foreign source is good, a higher percent should be better. Suggesting that Congress might consider increasing the foreign source income percent on U.S. is a compelling argument based on the evidence.[7]

The Proposal Would Tend To Encourage Manufacturing Outside of the U.S.

The elimination or scale back of the foreign source income rule will have a negative tax impact on U.S. multinationals that export U.S. manufactured product. For many companies this will result in a tax disincentive to manufacture in the U.S. vis-à-vis other countries with lower tax rates and is contrary to a "capital export neutrality" model which holds that income tax should play a minor role in plant location decision-making. Repeal of the foreign source income rule would elevate the importance of taxes in offshore plant location decision-making and is contrary to tax simplification within a "capital export neutral" model.[8]

Summary

United States high-tech industries are innovative, highly profitable, drive academic institution curriculum and excellence, produce high-paying jobs, produce a tremendous volume of exports, and serve as a model to the world.[9] U.S. government policies that discourage these U.S.-based activities risk impeding very desirable attributes and drivers in the U.S. economy. Government policies that encourage these attributes will obviously promote these attributes. Therefore, the Administration's export sourcing proposal should not be enacted.

France apply the "territorial" concept. Germany, Canada, and Australia apply the concept pursuant to income tax treaty with certain trading partners. For a detailed description of these principles, see *Factors Affecting The International Competitiveness Of the United States*, prepared by the Joint Committee on Taxation (JCS-6-91), Part 2. III.

[6] Joint Committee on Taxation *Description and Analysis of Certain Revenue-Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposal* (JCX-10-97).

[7] This would have to be tested against GATT standards. Because a U.S. multinational would only be increasing its foreign tax credit for foreign taxes actually paid, our trading partners should have no problem with enhanced foreign source income.

[8] As income earned offshore increases as a result of additional foreign plant investment, history suggests complicated tax laws will be introduced in an attempt to tax this income before it is remitted back to the U.S., contrary to efforts towards a more simplified income tax mode. PFIC and subpart F, as it relates to operating income earned from related party sales, are examples of this type of legislation.

[9] Studies have documented the impact exports have in job creation. Hufbauer and DeRosa project that in 1999, exports will increase $30.8 billion and $2.3 billion of additional wage income. In addition, the effect of the rule and the exports it generates will support 360,000 workers in export-related jobs, which also tend to be higher paying jobs (*Costs and Benefits of the Export Source Rule, 1998-2002*, Gary Hufbauer and Dean DeRosa, February 19, 1997). In Silicon Valley, it is estimated that over 125,000 jobs were added from 1992 through 1996. Also, in 1996 average real wages, after accounting for inflation, grew about 5.1 percent compared to a wage increase of less than 1 percent at the national level (*Joint Venture's Index of Silicon Valley, 1997*, prepared by Joint Venture: Silicon Valley Network). The *Joint Venture* study also reported that in 1995, Silicon Valley exports grew 30 percent to $35 billion.

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STATEMENT BY

SUN COAL AND COKE CO.
INLAND STEEL COMPANY &
NORTHERN INDIANA PUBLIC SERVICE

on the

FULL COMMITTEE HEARING ON SELECTED REVENUE RAISING PROVISIONS IN THE ADMINISTRATION'S FISCAL YEAR 1998 BUDGET

submitted to the

SENATE FINANCE COMMITTEE
UNITED STATES SENATE

April 29, 1997

Mr. Chairman and Members of the Committee, we are pleased to submit testimony concerning a specific revenue initiative involving the Section 29 alternative fuels tax credit and its importance to the American environment.

SUMMARY

President Clinton's recent budget proposal includes an ill conceived and unjust 12-month roll-back of the placed-in-service date for biomass and coal facilities under I.R.C. Section 29, which was approved by Congress just last year. Having enacted a binding contract rule in conjunction with the extended placed-in-service date last year, Congress, if it were to adopt the Administration's proposal, would unfairly penalize stakeholders in facilities currently under construction pursuant to a pre-1997 binding contract. Such action would also be at odds with the joint statement last year of the two Chairmen of the tax writing committees declaring that none of the revenue proposals included in the Clinton Administration's fiscal 1997 budget plan would be effective later than the date of appropriate congressional action so as not to disrupt normal market activities and business transactions.

The Committee should not initiate a proposal to roll back the Section 29 placed-in-service date because:

- Companies have made binding economic decisions based on current law and a change in the "rules of the game" is neither fair nor equitable.
- A change in current law would place a financial burden on companies that made investments in reliance on the actions of the 104th Congress.
- The Section 29 credit promotes production of environmentally sound, non-conventional fuels.
- Congress has recognized the value of Section 29 in the past and extended it as a matter of desirable and appropriate policy.

PROJECT SPECIFICS

The glaring inequity of retroactive effective dates is best illustrated by a complex, real-world business transaction. Multiple parties have made substantial capital commitments and entered into long-term supply contracts based upon the extension of Section 29 last year. This transaction, referred to as the Indiana Harbor project, involves capital investments totaling approximately $350 million by three companies which are each independently owned and operated. This project will secure a long-term, economically and environmentally advantageous coke supply for the Inland Steel Company No. 7 blast furnace. Coke, which is a fuel for the iron-making process, will be produced by a proprietary coke-making process which is environmentally benign and produces heat that can be converted to electricity. The project will create approximately 135 new jobs with an estimated annual payroll (including benefits) in excess of $5 million annually in an economically depressed area. It is estimated that the project will generate an additional 600 full-time equivalent jobs during construction.

The three companies investing capital in the Indiana Harbor project are Sun Coal Company, NIPSCO Industries and Beemsterboer Slag & Ballast Corp. Inland Steel Company is the purchaser of the predominant portion of the coke produced by the Project.

- Sun Coal Company, headquartered in Tennessee, is in the business of coal production from mines in Virginia and Kentucky and coke manufacturing at a facility in Vansant, Virginia. It is a subsidiary of Sun Company, Inc., an independent refiner and marketer of petroleum products, headquartered in Philadelphia.

- NIPSCO Industries, with headquarters in Hammond, Indiana, is an energy-based holding company whose regulated subsidiaries provide natural gas and electric services throughout northern Indiana. The company's non-regulated businesses are primarily energy focused.

- Beemsterboer Slag & Ballast Corp.,a privately held company headquartered in South Holland, Illinois, is in the coal and slag handling and processing business.

- Inland Steel Company is the fifth-largest integrated steel producer in the U.S. with a 1,900 acre steel-making complex located in East Chicago, Indiana. It annually produces more than 5.5 million tons of steel, which it sells to automobile, appliance, and office furniture makers, and is headquartered in Chicago, Illinois.

On October 27, 1996, Sun Coal Company, through its affiliates, entered into a binding written contract with Raytheon for the construction of a 1.22+ million ton per year coke making facility to be built on a 95-acre site in East Chicago, Indiana. It is anticipated that construction of the coke ovens will be completed by June 30, 1998, thereby qualifying its production for the Section 29 tax credit. Coke qualifies for the Section 29 credit as a synthetic product of coal. Capital committed by Sun Coal under this contract equals approximately $185 million. This aspect of the Indiana Harbor project consists of 268 state-of-the-art Jewell design Thompson coke ovens and supporting facilities using Sun Coal's proprietary "non-recovery" coke technology.

Sun Coal has refined the technology for this environmentally benign method of making coke. Pursuant to the 1990 amendments to the Clean Air Act, the EPA has promulgated regulations which establish MACT (maximum achievable control technology) standards for new coke oven batteries based on the use of the Sun Coal non-recovery process. This aspect of the project will, upon completion, employ approximately 108 persons in an area with high unemployment and a high poverty rate that was designated as an Economic Enterprise Zone with the approval and support of local and state government.

Concurrent with the execution of the binding construction contract, Sun Coal entered into a 15-year take-or-pay contract to supply Inland Steel with 1.22 million tons of coke annually. Thus, Sun made multiple strategic business commitments in 1996: first, a commitment of capital of $185 million; second, a contractual commitment to supply coke to a customer for 15 years; third, a contractual commitment to provide waste heat to a co-generation facility as described below; and finally, a requirement for a $28 million coal-handling facility to be constructed and operated by a third party based on a long-term coal-handling commitment from Sun Coal.

A second component of this sizable joint-venture project includes construction of a co-generation facility to capture the waste heat from the coking facility. A unit of NIPSCO Industries will design, build, finance and operate an 87-megawatt co-generation plant that will remove sulfur from the coke plant's flue gas and use the heat from the coke plant to produce steam and electricity. Capital employed is estimated to be $137 million. Concurrent with the execution of the construction contract for the coke facility, Sun Coal entered into a contractual commitment to provide NIPSCO's facility with waste heat for 15 years.

The third part of the Indiana Harbor Project capital investment will be made by a unit of Beemsterboer. Beemsterboer is constructing a coal blending and handling facility at a $28 million projected cost. This front-end plant will store, crush and blend various coals to supply the proper quality of coal for charging the coke ovens. The coal will be owned by Sun Coal, but the facility will be independently owned and operated by Beemsterboer. This facility will cover 49 acres of the common site. The NIPSCO and Beemsterboer portions of the project are expected to employ an additional 25 to 30 persons.

Inland Steel Company has contractually agreed to purchase 1.22 million tons of coke produced by the Inland Harbor project to supply the largest of its three iron-making blast furnaces. Inland closed the last of its coke ovens in 1993, necessitated by the inability of the facilities to meet environmental regulations and their deteriorating condition and performance. A major consideration in Inland's entering into this 15-year purchase arrangement was the anticipation that production from the project would qualify for the Section 29 tax credit. If so, this project will make Inland more competitive in an intensely competitive international marketplace by dramatically reducing its costs for coke, a key raw material in the production of iron. If, however, there is a retroactive change in law, the cost of coke to Inland will increase pursuant to the terms of the take-or-pay contract, negatively impacting the economics of its supply of a major raw material component of its business through 2007. It would adversely affect the project's core concept, that of securing a long-term economically and environmentally advantageous coke supply for the Inland Steel Company which employs 10,000 employees at its East Chicago facility, thereby removing the opportunity for Inland to compete more effectively with foreign steel-makers who have historically hurt the U.S. steel industry by systematic dumping in the U.S.

REASONS FOR RETAINING CURRENT LAW:

Binding Economic Decisions Have Been Made Based on Current Law

President Clinton's fiscal 1998 budget submission to the Congress is punitive and inequitable in its roll-back of the placed-in-service date for fuel production from nonconventional sources. Moving the current-law placed-in-service-date back twelve months, from July 1, 1998 to July 1, 1997, would be unjust since companies had written binding contracts for projects in effect before 1997.

In reliance on Section 29 tax credit provisions, Sun, Inland, and NIPSCO in this instance -- but a number of other companies in other cases -- entered into a venture project to build and produce efficient coke. The contracts to build the coke plant and supply Inland with domestically produced fuel were signed (and construction began) before President Clinton's 1998 budget proposal was announced. To change that treatment mid-stream with total disregard to the taxpayer's reliance on the law would not only be inequitable, but also irresponsible.

Change Will Be a Financial Burden for Companies Which Relied on the Actions of the 104th Congress

It has long been recognized that Federal tax treatment of capital expenditure is a critical part of investment planning decisions and project pricing. Not surprisingly, tax provisions motivate behavior, and the Sun Project utilized the Section 29 credit as allowed under the law. Taxpayers should not be unfairly penalized for relying on the law. Retroactively :olling back the economic benefits associated with the credit would be financially compromising to the parties involved who acted in good-faith reliance on current law.

As noted, well over a quarter of a billion dollars of capital investment has been committed to this project, which is already under way and scheduled to be completed by the July 1, 1998 statutory deadline. In addition to Sun's capital investment, Inland has entered into a binding 15-year long-term supply contract with Sun for coke from the new plant. The tax credit was important in providing coke at a substantially lower price than from other coke facilities.

Rolling back the date under which projects must be constructed and completed is unfair. Why? Because meeting a retroactive deadline is not possible. Multi-million dollar construction projects cannot be accelerated to (12 months) early completion to meet an arbitrary deadline. Certainly, such retroactive action could have a chilling effect in the future should the Administration and/or the Congress seek again to encourage new technologies to protect the environment and U.S. competitiveness.

The Section 29 Credit Is Environmentally Sound

The Section 29 credit applies to the production and sale of certain nonconventional fuels produced by a facility placed in service by July 1, 1998. The fuels made possible by this credit have been proven to be highly effective, technologically innovative, internationally efficient, and clean burning.

1. Sun's specific benign coke technology is state-of-the-art and technologically innovative. The technology employed by the new Sun plant is far and away more environmentally sound than that used in existing batteries. The favorable environmental implications of Sun's benign coke technology are striking. When this new plant opens, the Sun facilities will be the only coke plants in the U.S. to meet the EPA's newly proposed air-quality standards. The non-recovery process incinerates all the volatile gases produced during coking. The only remaining contaminant, sulfur dioxide, is removed from the flue gas in the co-generation process. Chemical by-products from coking by these ovens are not recovered but are incinerated harmlessly during the coking process by Jewell's unique coke technology, which virtually eliminates pollutants.

2. The import of foreign coke would harm the environment. If the tax benefits of Section 29 are eliminated, industrial users will be forced to consider purchasing foreign produced coke. Domestic capacity for coke production has declined since enactment of the Clean Air Act amendments in 1990. The negative environmental and competitive implications of increased foreign production -- from China, for example, which has no equivalent air standards -- and increased domestic use of this coke are significant.

3. Change in Section 29 law is inconsistent with the 1990 Clean Air Act and the EPA's proposed regulations on air quality. It is inconsistent to eliminate Section 29 credits for the Sun coke process, which the 1990 Clean Air Act specifically identified as setting the industry standard for coke-emission controls. Moreover, if the EPA's new rules for air quality are adopted, the Sun Project would be the only coke plant in the country that does not produce carcinogenic emissions. Congress should not remove a tax provision which motivates the very behavior that produces sound environmental policy sought by the Administration.

4. The project is being constructed on a potential "brownfield" site. Under current environmental law, prior industrial use of the Inland East Chicago site effectively prohibits sale of the land. The Sun project utilizes environmentally sound technology and puts the land to productive use. The project has been described as the largest brownfield project in the State of Indiana.

Congress Has Valued the Section 29 Credit in the Past

The credit was originally enacted in 1980, during the aftermath of the oil embargo, as an inducement for Americans to look for fuel in unusual places. The country had just gone through oil shortages, gas lines, spiraling inflation, and record-high interest rates driven by increasing energy prices. The Section 29 credit was part of a strategy intended to use what fuel we have more efficiently and give business incentives to tap resources for fuel that could not be economically produced without the credit.

The credit was initially intended to expire in 1989. It has been extended three times. In 1992, Congress cut back the list of fuels that qualify to two: gas from biomas and synthetic fuel from coal. But in retaining a credit for viable coal and gas technologies Congress reaffirmed a rational strategy to develop coal based fuels and land fill gas to protect the environment and reduce dependence on foreign oil.

CONCLUSION

The overall economics of this multi-party, multi-faceted project utilized the Section 29 credit as allowed and contemplated under the law. To retroactively "roll back" the economic benefits associated with the credit would not only be unjust, but financially compromising to all the parties involved who acted in good-faith reliance on the actions of the 104th Congress. Certainly such an abrupt policy reversal would have a chilling effect on the investment marketplace in the future.

The reason the roll-back of the placed-in-service date is harsh and oppressive is that the rest of the world does not roll-back. The taxpayer has entered into a binding written contract to construct the facility in reliance on Congressional action last year. This construction contract does not roll-back. It is by definition binding. Foundations have been poured and persons employed. They cannot be rolled back. Long-term supply arrangements have been signed. These cannot be rolled back. Negative competitive impacts in the global marketplace cannot be rolled back.

Congress has often used the existence of a binding contract as a standard for a determination of whether application of a tax change would be fair. How ironic it would be if Congress repealed a provision, in effect punishing taxpayers who are parties to a binding-contract rule which Congress only months ago enacted. Such an action could aptly be described as bait-and-switch taxation.

To deny the use of the credit to those who have binding contracts for facilities designed to produce fuels in compliance with current law is blatantly wrong and would penalize American taxpayers who relied in good-faith on the laws passed by the U.S. Congress. The Administration's proposal is misguided and will seriously impact ongoing transactions and jeopardize American jobs and businesses.

STATEMENT OF THE TAX COUNCIL

TO THE SENATE FINANCE COMMITTEE REGARDING

REVENUE RAISING PROVISIONS IN THE ADMINISTRATION'S

FY 1998 BUDGET PROPOSALS

April 17, 1997

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INTRODUCTION

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

The Tax Council is pleased to present its views on the Administration's Budget proposals and their impact on the international competitiveness of U.S. businesses and workers. The Tax Council is an association of senior level tax professionals representing many of the largest corporations in the United States, including companies involved in manufacturing, mining, energy, electronics, transportation, public utilities, consumer products and services, retailing, accounting, banking, and insurance. We are a nonprofit, business supported organization that has been active since 1967. We are one of the few professional organizations that focus exclusively on federal tax policy issues for businesses, including sound federal tax policies that encourage both capital formation and capital preservation in order to increase the real productivity of the nation.

The Tax Council applauds the Senate Finance Committee for scheduling these hearings on the Administration's budget proposals involving taxes. We do not disagree with all of these proposals, for example, we support expended individual retirement accounts and extension of the tax credit for research. These provisions will go a long way toward increasing our declining savings rate and improving the competitive advantage of U.S. companies. However, in devising many of its other tax proposals, the Administration replaced sound tax policy with a short sighted call for more revenue.

Many of the revenue raisers found in the Administration's latest Budget proposals lack a sound policy foundation. Although they may be successful in raising revenue, they do nothing to achieve the objective of retaining U.S. jobs and making the U.S. economy stronger. For example, provisions are found in the Budget to reduce the carryback rules for foreign tax credits and net operating losses, extend Superfund taxes without attempting to improve the cleanup programs, arbitrarily change the sourcing of income rules on export sales by U.S. based manufacturers, eliminate so-called "deferral" for multinationals engaged in vital petroleum exploration and production overseas, and restrict the ability of so-called "dual capacity taxpayers" to take credit for certain taxes paid to foreign countries.

In its efforts to balance the budget, the Administration was unwise to target publicly held U.S. multinationals doing business overseas, and the Tax Council urges that such proposals not be adopted by Congress. The predominant reason that businesses establish foreign operations is to serve local overseas markets so they are able to compete more efficiently. Investments abroad provide a platform for the growth of exports and indirectly create jobs in the U.S., along with providing help in the U.S. balance of payments. The creditability of foreign income taxes has existed in the Internal Revenue Code for over 70 years as a way to help alleviate the double taxation of foreign income. Replacing such credits with less valuable deductions will greatly increase the costs of doing business overseas, resulting in a competitive disadvantage to U.S. multinationals versus foreign based companies.

In order that U.S. companies can better compete with foreign-based multinationals, Congress should work with the Administration to instead do all it can to make the U.S. tax code more friendly. Rather than making proposals that reward some industries and penalize others, the budget should be written with the goal of reintegrating sound tax policy into decisions about the revenue needs of the government. Provisions that merely increase business taxes by eliminating legitimate business deductions should be avoided. Ordinary and necessary business expenses are integral to our current income based system, and needless elimination of them will only distort that system. Higher business taxes impact all Americans, directly or indirectly. For example, they result in higher prices for goods and services, stagnant or lower wages paid to employees in those businesses, and smaller returns to shareholders. Those shareholders may be the company's employees, or the pension plans of other middle class workers.

Corporate tax incentives, like export sourcing incentives, have allowed companies to remain strong economic engines for our country, and have enabled them to fill even larger roles in the health and well being of their employees. For these reasons, sound and justifiable tax policy should be paramount when deciding on taxation of business--not mere revenue needs.

POSITIVE TAX PROPOSALS

As stated above, two of the Administration's tax proposals will have a positive impact on the economy. They are:

EXPANDED IRAs

One proposal would expand IRAs by increasing the income limits on deductible IRA contributions and indexing the contribution limit for inflation. Special IRAs would be available for higher income taxpayers. This would help turn around the serious saving crisis that the United States currently faces. Not only are we saving considerably less than at any time since World War II, we are also saving considerably less than all of our major international competitors. It is firmly established that the restrictions imposed on IRAs in 1986 have played an important role in the decline of U.S. saving. The personal saving rate has averaged 4.5 percent since 1936, compared to 7.2 percent when the IRA was available to all taxpayers.

Over the last few years, there has been an abundance of academic research produced on the effectiveness of IRAs. A long list of top academic economists have found that IRAs do increase saving. The list includes Martin Feldstein (Harvard), David Wise (Harvard), James Poterba (MIT), Steven Venti (Dartmouth), Jonathan Skinner (UVA), Glenn Hubbard (Columbia), Richard Thaler (Cornell)), and former Harvard economist Lawrence Summers, now the Deputy Treasury Secretary. The IRA is a proven savings vehicle that is popular with Americans and good for the economy. IRAs promote self-reliance by encouraging Americans to prepare for retirement while at the same time providing the economy with the investment capital it needs to grow.

EXTENSION OF RESEARCH TAX CREDIT

Another proposal would extend the research tax credit and also is to be applauded. The credit, which applies to amounts of qualified research in excess of a company's base amount, has served to promote research that otherwise may never have occurred. The buildup of "knowledge capital" is absolutely essential to enhance the competitive position of the U.S. in international markets--especially in what some refer to as the Information Age.

Encouraging private sector research work through a tax credit has the decided advantage of keeping the government out of the business of picking specific winners or losers in providing direct research incentives. The Tax Council recommends that Congress work together with the Administration to extend the research tax credit on a permanent basis.

PROVISIONS THAT SHOULD NOT BE ADOPTED

The Tax Council offers the following comments on certain specific tax increase proposals set forth in the Administration's budget:

FOREIGN OIL AND GAS INCOME

The Tax Council's policy position on foreign source income is clear--"A full, effective foreign tax credit should be restored and the complexities of current law, particularly the multiplicity of separate "baskets," should be eliminated. Deferral of U.S. tax on income earned by foreign subsidiaries should not be further eroded."

The President's budget proposal dealing with foreign oil and gas income moves in the opposite direction by limiting use of the foreign tax credit and repealing deferral of U.S. tax on foreign oil and gas income. This selective attack on a single industry's utilization of the foreign tax credit and deferral is not justified. U.S. based oil companies are already at a competitive disadvantage under current law since most of their foreign based competition pay little or no home country tax on foreign oil and gas income. The proposal increases the risk of foreign oil and gas income being subject to double taxation which will severely hinder U.S. oil companies in the global oil and gas exploration, production, refining and marketing arena.

CHANGE IN CARRYOVER / CARRYBACK PERIODS

Two of the Administration's proposals would decrease the time period for carrying back foreign tax credits ("FTCs") from 2 years to 1 year, and decrease the net operating loss ("NOL") carryback period from 3 years to 1 year. At the same time, the FTC carryforward period would be extended from 5 to 7 years while the NOL carryforward period would be increased from 15 to 20 years. Although these changes were arguably made to simplify tax administration, they are clearly mere revenue raisers that will actually cause highly inequitable results.

When companies invest overseas, they often receive very favorable local tax treatment from foreign governments, at least in the early years of operation. For example, companies are often granted rapid depreciation write-offs, and low or even zero tax rates, for a period of years until the new venture is up and running. This results in a very low effective tax rate in those foreign countries for those early years of operation. For U.S. tax purposes, however, those foreign operations must utilize much slower capital recovery methods and rates, and are still subject to residual U.S. tax at 35 percent. Thus, even though those foreign operations may show very little profit from a local standpoint, they may owe high incremental taxes to the U.S. government on repatriations or deemed distributions to the U.S. parent. However, once such operations are ongoing for some length of time, this tax disparity often turns around, with local tax obligations exceeding residual U.S. taxes. At that point, the foreign operations generate excess FTCs but without an adequate carryback period, those excess FTCs will just linger and expire. Extending the carryforward period will not alleviate the problem since the operation will likely continue to generate excess FTCs in comparison with the U.S. residual tax situation, resulting in additional FTCs for eventual expiration.

The U.S. tax system is based on the premise that FTCs help alleviate double taxation of foreign source income. By granting taxpayers a credit against their U.S. liability for taxes paid to local foreign governments, the U.S. government allows its taxpayers to compete more fairly and effectively in the international arena. However, by imposing limits on carrying back excess FTCs to earlier years, the value of these FTCs diminish considerably (if not entirely in many situations). Thus, the threat of double taxation of foreign earnings becomes much more likely.

A similar argument can be made for NOLs. Although the federal income tax is based on an arbitrary annual accounting concept, business income may fluctuate over a somewhat longer period. The most obvious example is a business affected by business cycles, the duration of which may be several years. The NOL carryback helps prevent the income tax from being charged before the taxpayer has earned any net income, e.g., if a company earns income of 10 in year one, 0 in year two, and a loss of 10 in year three. While the current NOL rules would eliminate any tax imposed in year one, the Administration's proposal would eliminate the offset in this example and cause tax to be owed when the taxpayer has not, in fact, earned any income. To be conceptually correct, the NOL carryback should have no limitation. Therefore, if Congress truly intends to allow taxpayers to offset positive earning years with loss years, fewer (not more) limits should be placed on the utilization of those NOLs.

REPEAL OF SECTION 863(b)

When products manufactured in the U.S. are sold abroad, §863(b) enables the U.S. manufacturer to treat half of the income derived from those sales as foreign source income, as long as title passes outside the U.S. Since title on export sales to unrelated parties often passes at the point of origin, this provision is more often applied to export sales to foreign affiliates. Unless a U.S. manufacturer has foreign affiliates or subsidiaries, it will not generally benefit from accumulating additional foreign source income.

The Administration proposes to repeal Sec. 863(b) because it believes that it gives multinational corporations a competitive advantage over U.S. exporters that conduct all of their business activities in the U.S. It also believes that replacing §863(b) with an allocation based on actual economic activity will raise $7.5 billion over five years. This proposal has two critical defects.

First, to compete effectively in overseas markets, most U.S. manufacturers find that they must have operations in those foreign markets to sell and service their products. Many find it necessary to manufacture products specially designed for a foreign market in the country of sale, importing vital components of that product from the U.S. wherever feasible. Thus, the supposed competitive advantage over a U.S. exporter with no foreign assets or employees is a myth. There are many situations in which a U.S. manufacturer with no foreign activities simply cannot compete effectively in foreign markets.

Second, except in the very short term, this proposal would reduce the Treasury's revenues rather than increase them. This is because the multinational corporations, against which this proposal is directed, may have a choice. Instead of exporting their products from the U.S., they may manufacture them abroad. If even a small percentage of U.S. exporters are in a position to avail themselves of this option, the proposal will fail to achieve the desired result and taxes on manufacturing profits and manufacturing wages will pour into foreign treasuries, instead of to the U.S. In fact, the Administration seems to encourage this result by calling for an allocation based on "actual economic activity." More economic activity in foreign jurisdictions means more foreign jobs, investment, and profits.

At present, the U.S. has few tax incentives for exporters, especially compared to foreign countries with VAT regimes. Given our continuing trade deficit, it would be unwise to remove one of the few remaining tax incentives for multinational corporations to continue making export sales from the United States. Ironically, this proposal could result in multinationals using foreign manufacturing operations instead of U.S. based operations to produce export products. We encourage Congress not to adopt it.

AVERAGE STOCK BASIS

The Administration also proposes to eliminate the long-standing "identification rule" under which a taxpayer who buys shares of the same stock at different times and later sells less than all of the shares may identify which shares are being sold (usually the shares with the highest basis). Instead, the taxpayer would be treated as having sold shares with an "average basis.

The Tax Council is opposed to this proposal for three reasons. First, we believe it runs directly counter to the broader federal income tax treatment of sales of stock and securities, and therefore leads to anomalous results. If a taxpayer purchases shares of stock A on day one and stock B on day two, the taxpayer is perfectly entitled to choose to sell the shares of stock B, which have a higher basis, rather than the shares of stock A, which have a lower basis. There is no good tax policy rational for changing the rule merely because stock A and stock B are substantially identical. Although this proposal may have something to do with the Administration's concern about short-against-the-box transactions, the Administration has already addressed this concern with a more direct proposal.

Second, the Tax Council believes the provision would lead to greater complexity in the record-keeping and reporting of purchases and sales of stock. Taxpayers (and their agents) would have to maintain and consult with historical records for all of the taxpayer's transactions relating to a given stock each time a taxpayer undertook to sell a few shares. Each sale would change the basis of the remaining shares (presumably under detailed regulations which would explain precisely how the average basis rule works), so that the basis calculations for subsequent sales would depend in part on the mechanics of previous sales. We do not think this approach would be well-suited to routine equity transactions given their sheer volume and the number of individuals they affect.

Third, if 100 shares of stock A were held long term, while another 100 shares of stock A were held short term, and 50 shares were sold, we are not sure what the rule would be regarding the holding period of the sold shares, i.e., whether all 50 would be treated as long term, all 50 as short term, or averaged. Tax fairness and policy is best served by a direct matching of the actual basis of the item being sold with the proceeds of the sale, so that neither phantom gain nor loss is deemed to be realized on the transaction, and there is no question of the appropriate holding period for the sale.

LOWERING THE DIVIDEND RECEIVED DEDUCTION

The Administration proposed to both lower the corporate dividends received deduction (DRD) from 70% to 50% for dividends received by corporations that own less than 20 percent of other corporations, and to have taxpayers establish a separate and distinct 46 day holding period in a stock in order for each dividend to qualify for the DRD. We believe that both of these proposals will be making changes to the law that are not in the best interests of public policy. Currently, the U.S. is the only major western industrialized nation that subjects corporate income to multiple levels of taxation. Over the years, the DRD has been decreased from 100% for dividends received by corporations that own over 80 percent of other corporations, to the current 70% for less than 20 percent owned corporations. As a result, corporate earnings have become subject to multiple levels of taxation, thus driving up the cost of doing business in the U.S. To further decrease the DRD would be another move in the wrong direction.

Since the DRD is intended to avoid multiple levels of taxation, the imposition of any holding period in the stock cannot be justified. Again, over time, the requisite holding period requirement has risen from 16 to 46 days. The reason for the adoption of this rule was to stop taxpayers from purchasing the stock just prior to a dividend record date and selling the stock shortly thereafter, resulting in both a tax-preferenced dividend and a capital loss. However, imposing a separate holding period requirement for each dividend does not enhance the rule and, in fact, just adds further needless complexity.

SUPERFUND TAXES

The three taxes that fund Superfund (corporate environmental tax, petroleum excise tax, and chemical feed stock tax) all expired on December 31, 1995. The President's budget would reinstate the two excise taxes at their previous levels for the period after the date of enactment through September 30, 2007. The corporate environmental tax would be reinstated at its previous level for taxable years beginning after December 31, 1996 and before January 1, 2008.

These taxes, which were previously dedicated to Superfund, would instead be used to generate revenue to balance the budget. This use of taxes historically dedicated to funding specific programs for deficit reduction purposes should be rejected. The decision whether to re-impose these taxes dedicated to financing Superfund should instead be made as part of a comprehensive examination of reforming the entire Superfund program.

MODIFICATION OF THE SUBSTANTIAL UNDERSTATEMENT PENALTY

The Administration proposed to make any tax deficiency greater than $10 million "substantial" for purposes of the penalty, rather than applying the existing test that such tax deficiency must exceed 10% of the taxpayer's liability for the year. While to the individual taxpayer or even a privately-held company, $10 million may be a substantial amount of money--to a publicly-held multinational company, in fact, it may not be "substantial." Furthermore, a 90% accurate return, given the agreed-upon complexities and ambiguities contained in our existing Internal Revenue Code, should be deemed substantial compliance, with only additional taxes and interest due and owing. There is no policy justification to apply a penalty to publicly-held multinational companies which are required to deal with much greater complexities than are all other taxpayers.

The difficulty in this area is illustrated by the fact that the Secretary of the Treasury has yet to comply with Section 6662(d)(2)(D) of the IRC, which requires the Secretary to publish a list of positions being taken for which the Secretary believes there is not substantial authority and which would affect a significant number of taxpayers. The list is to be revised not less frequently than annually. Taxpayers still await the Secretary's FIRST list.

DENIAL OF CERTAIN INTEREST DEDUCTIONS

The Administration proposes to deny legitimate interest deductions on certain debt instruments. Those affected include (1) debt with a maturity longer than 40 years (e.g., long term bonds); (2) instruments with maturities longer than 15 years not characterized as debt in an issuer's financial statements; and (3) investment units payable in equity of the issuer or a related party. The Tax Council strongly opposes this proposal because it would seriously restrict the ability of U.S. corporations to raise capital. Thus, it would impair investment and job growth. This proposal draws arbitrary lines in distinguishing debt from equity for tax purposes, because distinctions based solely on length to maturity necessarily fail to recognize the true characteristics of debt versus equity. Moreover, treating instruments as equity for tax purposes based solely on regulatory and/or financial accounting treatment is inconsistent with well established notions of fundamental tax policy.

DEFERRAL OF OID ON CONVERTIBLE DEBT

The Administration also proposes to defer deductions for interest accrued on convertible debt instruments with original issue discount ("OID") until interest is paid in cash. However, these hybrid instruments and convertible OID bond instruments have allowed many U.S. companies to raise tens of billions of dollars of investment capital. Again, the Tax Council opposes this proposal because it is contrary to the sound tax policy that matches accrual of interest income by holders of OID instruments with the ability of issuers to deduct accrued interest.

Moreover, the instruments in question are truly debt rather than equity. Recent statistics show that over 70 percent of all zero-coupon convertible debt instruments were retired with cash, while only 30 percent of these instruments were convertible to common stock. Recharacterizing these instruments as equity for tax purposes is fundamentally incorrect and will put American companies at a distinct disadvantage to their foreign competitors, who are not bound by such restrictions.

REQUIRING GAIN ON DISTRIBUTIONS OF CORPORATION STOCK

Another proposal would impose a capital gains tax on certain reorganizations of corporate assets. Tax would be imposed if a company engages in a "spin-off" of a division or line of business as part of a merger or reorganization. Under current law, these transactions (known as "Morris Trust" transactions) are tax free since all assets remain in corporate solution. Thus, this proposal reverses long-standing tax policy regarding treatment of tax-free reorganizations and imposes another layer of capital gains tax on legitimate corporate restructuring transactions. It would severely restrict the ability of corporations to restructure businesses into more economically efficient forms. Products and markets are constantly changing, and business combinations that make economic sense one day may no longer make sense the next. It is, therefore, important that corporations be given the flexibility to reorganize and recombine businesses within corporate solution on a tax-free basis.

This anti-growth and anti-business proposal also fails to provide transition relief, which would result in either a retroactive tax increase on affected corporations, or force such corporations to forego transactions. Thus this proposal would be very disruptive to the marketplace and should not be adopted.

APPLYING ASSUMPTIONS TO CREDIT CARD RECEIVABLES

The Administration proposed to apply a prepayment assumption to credit card receivables. Such a change would impose a tax on grace period interest even where no financial benefit has been received or accrued. This proposal ignores the accrual rules and goes beyond even the doctrine of constructive receipt. For accrual method taxpayers, the recognition of income depends on when the taxpayer's right to receive the income becomes fixed and determinable. In the case of "grace period interest," however, unless and until payment of a credit card balance is delayed beyond the grace period, even the doctrine of constructive receipt would not apply (because no income is available).

The Administration's stated goal of "equalizing" the treatment of REMIC interests and credit card receivables is misplaced. The REMIC prepayment rule applies solely for purposes of determining the inclusion of OID, amounts that the payee is entitled to receive. The proposal ignores the fact that the federal income tax is calculated on an annual basis so that income is determined and reported at fixed intervals of a year and the accrual method requires taxpayers to determine income under the "all events" test at year-end. There is no precedent for departing from the annual accounting period where income has not been constructively received.

PRO RATA DISALLOWANCE

The Tax Council strongly opposes the Administration's proposal to extend the *pro rata* disallowance of tax-exempt interest expense to all corporations. By reducing corporate demand for tax-exempts, this proposal only serves to increase the financing costs of state and local governments. The application of the *pro rata* rule on an affiliated company basis penalizes companies that hold tax-exempt bonds to satisfy state consumer protection statutes, such as state money transmitter laws, but happen to be affiliated with other businesses that have interest expense totally unrelated to the holding of the tax-exempt bonds. These corporate investors, holding principally long-term bonds, are critical to the stable financing of America's cities and states. Treasury currently has the authority to prevent any abuse in this area by showing that borrowed funds were used to carry tax-exempt securities; this more targeted approach provides appropriate protection without disrupting the public securities market.

Secondly, corporations often invest some operating funds in tax-exempt bonds for cash management reasons. No evidence exists that these corporations are engaged in improper interest-rate arbitrage. Not only are there no tax-motivated abuses in this area which merit increasing the borrowing costs of states and local governments, these investors help support an active and liquid short-term municipal bond market vital to states and localities. Again, the result of the Administration's proposal would be to reduce demand for tax-exempt bonds and drive up costs for states and local governments. This is something that Congress should not do when it is looking to these very same state and local governments to do more.

INCREASED PENALTIES FOR FAILURE TO FILE RETURNS

The Administration also proposed to increase penalties for failure to file information returns, including all standard 1099 forms. IRS statistics bear out the fact that compliance levels for such returns are already extremely high. Any failures to file on a timely basis generally are due to the late reporting of year-end information or to other unavoidable problems. Under these circumstances, an increase in the penalty for failure to timely file returns would be unfair and would fail to recognize the substantial compliance efforts already made by American business.

EFFECTIVE DATES

Before concluding, we would like to make one last-comment regarding the effective dates of tax proposals. The Tax Council believes that it is bad tax policy to make significant tax changes in a retroactive manner that impose additional burdens on businesses. Businesses should be able to rely on the tax rules in place when making economic decisions, and expect that those rules will not change while their investments are still ongoing. It seems plainly unfair to encourage businesses to make economic decisions based on a certain set of rules, but then change those rules midstream after the taxpayer has made significant investments in reliance thereon.

CONCLUSION

The Tax Council strongly urges Congress not to adopt the provisions identified above when formulating its own proposals, since they are based on unsound tax policy. Congress, in considering the Administration's budget, should elevate sound and justifiable tax policy over mere revenue needs. Revenue can be generated consistent with sound tax policy, and that is the approach that should be followed as the budget process moves forward.

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Statement on Federal Unemployment Tax Act (FUTA) Items

Included among Revenue Raising Provisions in

The Administration's Fiscal Year 1998 Budget Proposal

Submitted to the

Senate Finance Committee

on behalf of

UBA, Inc.

by

Eric J. Oxfeld
President, UBA, Inc.

April 30, 1997

On behalf of employers and a sound unemployment compensation system, UBA respectfully urges the Senate Finance Committee to reject two Federal Unemployment Tax Act (FUTA) proposals included in the Administration's FY 1998 budget. UBA is a national business organization specializing exclusively in public policy advocacy relating to unemployment and workers' compensation. We also head the Coalition for U.C. Tax Reform, a coalition of business and employer associations that we organized in 1995 to promote elimination of the 0.2% surtax on employers under the FUTA.

The administration's first budget proposal would extend the 0.2% FUTA surtax, which is now scheduled to expired at the end of 1998, through the end of the year 2007. In connection with this extension, the proposal includes provisions to increase the ceiling on the amount of FUTA funds that may be held in various accounts in the Unemployment Trust Fund (UTF). The second proposal would require employers to pay FUTA and state unemployment taxes monthly rather than quarterly, beginning in the year 2002. These proposals, which are motivated by budgetary rather than unemployment policy reasons, will be costly to employers, states, and the federal government. Moreover, by adding to the cost of employment, they will also have a detrimental impact on job creation and impede integration of welfare recipients into the work force.

An extension of the 0.2% FUTA surcharge would again violate a commitment to employers that this "temporary" tax increase would be allowed to expire. Congress imposed the surcharge in 1976 to retire a deficit created by Congress under a federally funded supplemental benefits program, which lengthened the duration of unemployment benefits beyond the normal 39 weeks of regular and extended unemployment benefits. The cost of emergency benefits payable after 39 weeks should never have been an employer obligation, which Congress recognized by financing later supplemental benefit programs out of general revenues rather than FUTA. The FUTA deficit for which the surcharge was imposed was paid in full in 1987. Although employers kept their side of the bargain, previous Congresses violated the commitment and extended the surcharge. Continuation of the surcharge has directly caused an unhealthy build-up in the loan account (FUA) within the UTF. A further continuation of the surcharge is not just unfair to employers. It is also totally unnecessary for sound financing of the unemployment compensation program. Because FUTA revenue may be used only for limited purposes, and the UTF has more than adequate FUTA balances into the foreseeable future, there is absolutely no reason for another extension of this tax.

The proposal to raise the limit on the amount that may be held in FUA is an integral element of the proposal to extend the unnecessary 0.2% FUTA surtax on employers. The rationale for increasing the FUA cap is, in essence, to create a mechanism to hold the additional revenues collected by extending the surtax. If the surtax is allowed to expire, there is no need to raise the ceiling. UBA is strongly opposed to any increase in the FUA ceiling, with or without an extension of the surtax, because there is no need for any additional revenue in this account. The administration's economic forecast does not suggest that states are likely to be in a position to borrow any significant amounts. More important, the present rules for borrowing and repayment of loans, which require borrowers to pay market interest rates, provide powerful incentives for states to finance their benefit accounts without reliance on borrowing and to repay promptly when they do. These rules have successfully addressed the abuses that were prevalent during the last major economic downturn. The continued size and scope of the FUA account will also be an element in the restructuring of administrative financing. While it is possible that the FUA ceiling may eventually be reached even without extension of the 0.2% surtax, the amounts of any overage would be relatively small, and they should be permitted to roll over into the state benefit trust accounts or other Trust Fund accounts, as provided under current law.

The proposal to change to monthly collection of both federal and state unemployment taxes would triple the number of required submissions. This acceleration of payments is nothing more than an accounting "gimmick." While it would be "scored" for budget purposes as a one-time federal budget revenue increase, it actually captures no net additional revenue it just requires that the same amount of money be collected in an earlier fiscal year. We believe this is an exceedingly flimsy reason to triple the tax filing paperwork for employers and states.

UBA has long been outspoken in our advocacy of responsible financing and efficient administration of the unemployment compensation program, which is vital to workers and employers. In fact, we have developed a proposal on restructuring administrative financing of state unemployment compensation agencies, the principal purpose for the FUTA tax, which would improve services to jobless workers while reducing costs for employers. We hope Congress will soon consider legislation based on this proposal and other necessary reforms, such as enactment of H.R. 125 to clarify that state law rather than federal governs the determination of the base period for unemployment compensation eligibility. However, extending the 0.2% FUTA surcharge, raising the ceiling on the FUTA-funded accounts, and accelerating the payment of FUTA and state unemployment taxes would move in precisely the wrong direction.

As you make final decisions about the federal budget for FY 1998, we urge you to reject these unwise proposals, whose enactment risks real harm to the unemployment compensation system and needlessly raises costs for the federal government, states, and employers.

Statement of the UI Tax Working Group

to the
Committee on Finance
United States Senate

Revenue Raising Provisions
in the Administration's FY 1998 Budget
April 17, 1997
Submitted for the Hearing Record by:

American Payroll Association
American Society for Payroll Management
American Trucking Associations
Interstate Conference of Employment Security Agencies, Inc.
National Association of Manufacturers
National Federation of Independent Business
Service Bureau Consortium
Society for Human Resource Management
UBA, Inc.

The UI Tax Working Group is an informal coalition of employers, service providers and state governments whose focus is the Unemployment Tax Act ("FUTA") provisions in the Administration's FY 1998 budget proposal and their relationship to UI reform. Our working group has involved a broad array of organizations: the American Payroll Association, the American Society for Payroll Management, the American Trucking Associations, the Interstate Conference of Employment Security Agencies, Inc., the National Association of Manufacturers, the National Federation of Independent Business, the Service Bureau Consortium, the Society for Human Resource Management, and UBA, Inc.

These organizations oppose the Administration's FUTA proposals and believe that any restructuring of the FUTA/State Unemployment Insurance ("SUI") tax rules should only be considered in the context of broad-based UI programmatic reforms. Furthermore, we believe any reform of the UI system should include a streamlining of the FUTA/SUI collection system, thereby creating greater efficiencies and reduced costs for the federal and state governments and for employers.

We are deeply concerned that the FUTA proposals contained in the Administration's FY 1998 budget would create substantial new burdens for both taxpayers and state government administrators. In addition, if enacted, the budget scoring of these proposals would make meaningful UI reform more difficult to achieve.

The Administration's FY 1998 UI Proposals

The Administration's FY 1998 budget contains two FUTA tax proposals: the first proposal would extend the current .2 percent FUTA surtax scheduled to expire at the end of 1998 through the year 2007; the second would accelerate, from quarterly to monthly, the collection of most federal and state UI taxes beginning in the year 2002.

Surtax Extension. The FUTA surtax was enacted in 1976 to eliminate a deficit in the Unemployment Trust Fund. Although that debt was retired in 1987, the surtax has not been allowed to expire. The proposal to again extend the tax was designed to respond more to out-year budget considerations than to demonstrated UI funding needs. It must be evaluated with full appreciation of the significant current balances in the federal UI trust funds and the continuing state frustration with federal practices regarding reimbursement of administrative expenses. We doubt that you will find any justification for a further extension of this "temporary" tax. Private sector employers are unanimous in opposing it.

UI Tax Deposit Speed-Up. Accelerating the collection of existing federal and state UI taxes is a device that generates a one-time artificial revenue increase for budget-scoring purposes and real, every year increases in both compliance costs for employers and collection costs for FUTA and SUI tax administrators. The Administration's proposal is fundamentally inconsistent with every reform proposal that seeks to streamline the operation of the UI system and with its own initiatives to reduce paperwork and regulatory burdens.

The proposal would increase federal revenues in FY 2002, as taxes scheduled to be collected in FY 2003 are accelerated into the previous year.[1] No new revenues would be collected by the federal or state governments by virtue of this proposal -- the federal government would simply record, in FY02, revenues that would otherwise be received a year later.

This proposal is even more objectionable than other tax speed-up gimmicks considered in budget reconciliation proposals in the past. For example, proposals that might move an excise tax deposit date forward by one month into an earlier fiscal year make little policy sense, but also do not create major additional administrative burdens. This particular proposal would result directly in significant and continuing costs to taxpayers and to the federal and state governments. By tripling the number of required UI tax collection filings from 8 to 24 per affected employer each year, the proposal would exacerbate current inefficiencies and substantially raise costs to employers and both federal and state UI tax administrators. Tripling the required number of deposits can only dramatically escalate the cost to employers of the duplication inherent in the current separate FUTA/SUI quarterly collection practices -- now estimated to cost employers up to $500 million a year.

Furthermore, the one-time, budget score-keeping gain will be far more than offset by the real, every year administrative costs of additional FUTA tax collection to the IRS and SUI tax collection to the states. Monthly submission requirements can only increase the $100 million the IRS now receives annually from the UI Trust funds to process and verify the quarterly FUTA deposits.

In addition, since the federal government is required to reimburse states for their UI administrative costs, reimbursement of states for the added costs of monthly SUI collection is

[1] Ironically, the amount of revenue recorded through this one-time accounting speed-up results from yet another budgeting device. State UI tax revenues are included as assets of the federal government for budget-scoring purposes, notwithstanding the fact that the federal government does not mandate the rate of this tax, collect it, or even have the right to use the proceeds. All state monies in these Trust Fund Accounts are automatically transferred back to the states to pay UI benefit obligations as they occur. In the interim, they cannot be used by the federal government for any other purpose.

another hidden federal outlay cost in this ill-conceived proposal.[3] To the extent the federal government does not reimburse the states for these higher SUI collection costs, the states will experience yet another form of unfunded mandate.

The Administration implicitly recognizes that the added federal and state deposit requirements would be burdensome, at least for small business, since the proposal includes an exemption for certain employers with limited FUTA liability. Many smaller businesses that add or replace employees or hire seasonal workers would not qualify for the exemption since new FUTA liability accrues with each new hire, including replacement employees. Further, this new exemption would add still another distinction to the many already in the tax code as to what constitutes a "small" business. This deposit acceleration rule makes no sense for businesses large or small, and an exception for small business does nothing to improve this fundamentally flawed concept.

The Need for Reform

Rather than move forward with complicated budget gimmicks as proposed in the Administration's budget, Congress should seek to streamline and consolidate the tax collection process.

Recommendations to reform the UI system and the collection of unemployment taxes address a wide range of issues related to the goals, financing and administration of the system. With respect to tax collection issues, there is broad agreement that the current duplicate collection system results in unnecessary expense for federal and state government administrators. For employers, this system is both expensive and complex. They must deal with two levels of tax administration for payments, record keeping and audit. Furthermore, they must confront varying FUTA/SUI tax rate structures and wage bases, as well as definitions of covered employment that differ between the federal system and the states -- and among the states. For multi-state employers the system has becomu extremely complex.

State governments collected approximately 80 percent of the $28.6 billion in the total federal/state UI taxes collected in FY96. Transfer of the FUTA tax collection to the states would place responsibility for the collection of the entire tax on the administering authority having the most compelling interest in maintaining an efficient and comprehensive collection system. Consolidation would also eliminate the need for duplicate tax submissions by every employer, the redundant verification of tax deposits, and multiple audits now necessitated by two separate collection systems.

The notion of consolidating tax collection with state administrators is neither new nor radical. The 1980 UI Commission chaired by the late Wilbur Cohen proposed the concept. The 1995 Advisory Council chaired by Janet Norwood endorsed it.

Conclusion

[3] The Administration's budget does not appear to factor in such increased federal and state collection costs as an outlay offset to the increased FUTA revenues projected.

UI reform should focus on simplifying the system, reducing the burden of our employers and reducing the costs of administration to federal and state governments. Transferring FUTA tax collection to the states would dramatically simplify the system and save hundreds of millions of private and public sector dollars annually. Adopting the revenue raising provisions in the Administration's FY 1998 budget proposal would take the system in exactly the opposite direction, creating even greater burdens than the current system.

The attached charts provide a graphic representation of the present situation. They contain a simple but important message:

- Chart A: Where we are (the current system);
- Chart B: Where we need not go (the Administration's proposal);
- Chart C: Where simplification can take us.

We urge the Committee to reject the speed-up in collection of FUTA and SUI taxes as well as the extension of the .2 percent surtax proposed in the Administration's budget. Any consideration of tax collection issues should take place only in the context of system-wide reform. We believe that such consideration will demonstrate that FUTA/SUI tax collection should be simplified, not further complicated as the Administration has proposed.

STATEMENT
# of the
UNITED STATES COUNCIL
FOR INTERNATIONAL BUSINESS

TO THE
SENATE FINANCE COMMITTEE

COMMENTS ON THE
ADMINISTRATION'S BUDGET PROPOSALS

MAY 1, 1997

UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS
1212 Avenue of the Americas, New York, New York 10036. (212) 354-4480

INTRODUCTION

The United States Council for International Business (USCIB) is pleased to present its views on the Administration's Budget proposals and their impact on the international competitiveness of U.S. businesses and workers. The USCIB advances the global interests of American business both at home and abroad. It is the American affiliate of the International Chamber of Commerce), the Business and Industry Advisory Committee (BIAC) to the OECD, and the International Organisation of Employers. As such, it officially represents U.S. business positions in the main intergovernmental bodies, and vis-a-vis foreign business and their governments.

The USCIB For International Business applauds the Senate Finance Committee Committee for scheduling these hearings on the Administration's budget proposals. We do not disagree with all of these proposals, as, for example, we support expanded individual retirement accounts and extension of the tax credit for research. These provisions will go a long way toward increasing our declining savings rate and enhancing the competitive advantage of U.S. companies. However, in devising many of its other tax proposals, the Administration replaced sound tax policy with a short sighted call for more revenue.

Many of the revenue raisers found in the Administration's latest Budget proposals lack a sound policy foundation. Although they may be successful in raising revenue, they do nothing to achieve the objective of retaining U.S. jobs and making the U.S. economy stronger. For example, provisions are found in the Budget to reduce the carryback rules for foreign tax credits and net operating losses, arbitrarily change the sourcing of income rules on export sales by U.S. based manufacturers, eliminate so-called "deferral" for multinationals engaged in vital petroleum exploration and production overseas, and restrict the ability of so-called "dual capacity taxpayers" to take credit for certain taxes paid to foreign countries.

In its efforts to balance the budget, the Administration has unwisely targeted publicly held U.S. multinationals doing business overseas, and The USCIB strongly urges that such proposals not be adopted by Congress. The predominant reason that businesses establish foreign operations is to serve local overseas markets so as to compete more efficiently and effectively. Investments abroad provide a platform for the growth of exports and indirectly create jobs in the U.S., along with providing help in the U.S. balance of payments. The creditability of foreign income taxes has existed in the Internal

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Revenue Code for over 70 years as a way to help alleviate the double taxation of foreign income. Replacing such credits with less valuable deductions will greatly increase the costs of doing business overseas, resulting in a competitive disadvantage to U.S. multinationals versus foreign based companies.

For U.S. companies to better compete with foreign-based multinationals, Congress should work with the Administration to do all it can to make the U.S. tax code more user-friendly. Rather than engaging in gimmicks that reward some industries and penalize others, the budget should be written with the goal of reintegrating sound tax policy into decisions about the revenue needs of the government. Provisions that merely increase business taxes by eliminating legitimate business deductions should be avoided. Ordinary and necessary business expenses are integral to our current income based system, and needless elimination of them will only distort that system. Higher business taxes impact all Americans, directly or indirectly. For example, they result in higher prices for goods and services, stagnant or lower wages for employees in those businesses, and smaller returns to shareholders. Those shareholders may be the company's employees, or the pension plans of other workers.

Corporate tax incentives, like export sourcing incentives, have allowed companies to remain strong economic engines for our country, and have enabled them to fulfill even larger roles in the health and well being of their employees, and for society generally . For these reasons, sound and justifiable tax policy should be paramount when deciding on taxation of business--not mere revenue needs.

POSITIVE TAX PROPOSALS

As stated above, two of the Administration's tax proposals will have a positive impact on the economy, expanded IRAs, and extension of the research tax credit.

EXPANDED IRAs

One proposal would expand IRAs by increasing the income limits on deductible IRA contributions and indexing the contribution limit for inflation. Special IRAs would be available for higher income taxpayers. This would help turn around the serious saving crisis that the United States has faced for many years now. Not only are we saving considerably less than at any time since World War II, we are also saving considerably less than all of our major international competitors. It has been firmly established that the restrictions imposed on IRAs in 1976 played an important role in the decline of the U.S. saving rate. The personal saving rate has averaged 4.5 percent since 1976, compared to 7.2 percent when the IRA was available to all taxpayers.

Over the last few years, there has been an abundance of academic research on the effectiveness of IRAs. A long list of top academic economists have found that IRAs do increase saving. The list includes Martin Feldstein (Harvard), David Wise (Harvard), James Poterba (MIT), Steven Venti (Dartmouth), Jonathan Skinner (UVA), Glenn Hubbard (Columbia), Richard Thaler (Cornell)), and former Harvard economist Lawrence Summers, now the Deputy Treasury Secretary. The IRA is a proven savings vehicle that is popular with Americans as well as good for the economy. IRAs promote self-reliance by encouraging Americans to prepare for retirement while at the same time providing the economy with the investment growth capital it needs.

EXTENSION OF RESEARCH TAX CREDIT

Another proposal which we support would extend the research tax credit. The credit, which applies to amounts of qualified research in excess of a company's base amount, has served to promote research that otherwise may never have occurred. The buildup of "knowledge capital" is absolutely essential to enhance the competitive position of the U.S. in international markets-- especially in what some refer to as the "Information Age". Encouraging private sector research work through a tax credit has the decided advantage of keeping the government out of the business of picking specific winners or losers in providing direct research incentives. The USCIB recommends that Congress work together with the Administration to extend the research tax credit on a permanent basis.

PROVISIONS THAT SHOULD NOT BE ADOPTED

We set forth below our comments on certain specific tax increase proposals in the Administration's budget.

FOREIGN OIL AND GAS INCOME

The USCIB's policy position on foreign source income is clear. We strongly believe that a full, effective foreign tax credit should be restored and the complexities of current law, particularly the multiplicity of separate 'baskets,' should be eliminated. Deferral of U.S. tax on income earned by foreign subsidiaries should not be further eroded.

The President's budget proposal dealing with foreign oil and gas income moves in the opposite direction by limiting use of the foreign tax credit and repealing deferral of U.S. tax on foreign oil and gas income. This selective attack on a single industry's utilization of the foreign tax credit and deferral is not justified. U.S. based oil companies are already at a competitive disadvantage under current law since most of their foreign based competition pay little or no home country tax on foreign oil and gas income. The proposal increases the risk of foreign oil and gas income becoming subjected to double taxation which will severely handicap U.S. oil companies in the global oil and gas exploration, production, refining and marketing arena.

CHANGE IN CARRYOVER / CARRYBACK PERIODS

Two of the Administration's proposals would decrease the time period for carrying back foreign tax credits ("FTCs") from 2 years to 1 year, and decrease the net operating loss ("NOL") carryback period from 3 years to 1 year. At the same time, the FTC carryforward period would be extended from 5 to 7 years while the NOL carryforward period would be increased from 15 to 20 years. Although these changes were arguably made to simplify tax administration, they are clearly revenue raisers that will actually cause highly inequitable results.

When companies invest overseas, they often receive very favorable local tax treatment from foreign governments, at least in the early years of operation. For example, companies are often granted rapid depreciation write-offs, and low or even zero tax rates, for a period of years until the new venture is up and running. This results in a very low effective tax rate in those foreign countries for those early years of operation. For U.S. tax purposes, however, those foreign operations must utilize much slower capital recovery methods and rates, and are still subject to residual U.S. tax at 35 percent. Thus, even though those foreign operations may show very little profit from a local standpoint, they may owe high incremental taxes to the U.S. government on repatriations or deemed distributions to the U.S. parent. However, once such operations are ongoing for some length of time, this tax disparity often turns around, with local tax obligations exceeding residual U.S. taxes. At that point, the foreign operations generate excess FTCs but without an adequate carryback period, those excess FTCs will just linger and expire. Extending the carryforward period will not alleviate the problem since the operation will likely continue to generate excess

FTCs in comparison with the U.S. residual tax situation, resulting in additional FTCs for eventual expiration.

The U.S. tax system is based on the premise that FTCs alleviate double taxation of foreign source income. By granting taxpayers a credit against their U.S. liability for taxes paid to local foreign governments, the U.S. government allows its MNCs to compete more effectively in the international arena. However, by imposing limits on carrying back excess FTCs to earlier years, the value of these FTCs diminish considerably (if not entirely, in many situations). Thus, the threat of double taxation of foreign earnings becomes more likely. A similar argument can be made for NOLs. If Congress truly intends to allow taxpayers to offset positive earning years with loss years, fewer limits should be placed on the ability to utilize those NOLs.

REPEAL OF SECTION 863(b)

When products manufactured in the U.S. are sold abroad, §863(b) enables the U.S. manufacturer to treat a substantial portion (usually one-half) of the income derived from those sales as foreign source income, as long as title passes outside the U.S. Since title on export sales to unrelated parties often passes at the point of origin, this provision is more often applicable on export sales to foreign affiliates. Additionally, unless a U.S. manufacturer has foreign affiliates or subsidiaries, it will not generally benefit from generating additional foreign source income.

The Administration proposes to repeal Sec. 863(b) because it believes that it gives MNCs a competitive advantage over U.S. exporters that conduct all of their business activities in the U.S. It also believes that replacing §863(b) with an allocation based on actual economic activity will raise $7.5 billion over five years.

The proposal has one glaring defect. To compete effectively in overseas markets, most U.S. manufacturers find that they must carry on activities in those foreign markets to sell and service their products. Many find it necessary to manufacture products specially designed for a foreign market in the country of sale, although, importantly, importing vital components of that product from the U.S. Thus, the purported competitive advantage over a U.S. exporter with no foreign assets or employees is unrealistic. There are many situations in which a U.S. manufacturer with no foreign activities simply cannot compete effectively in foreign markets.

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At present, the U.S. law has very limited tax incentives for exporters. Given our continuing trade deficit, it would be unwise to remove one of the few remaining tax incentives for MNCs to continue making export sales from the United States. Ironically, this proposal could result in multinationals attempting to use foreign manufacturing operations instead of U.S. based operations to produce export products. We encourage Congress not to adopt it.

LOWERING THE DIVIDEND RECEIVED DEDUCTION

The Administration proposes to both lower the corporate dividends received deduction (DRD) from 70% to 50% for dividends received by corporations that own less than 20 percent of a dividend paying corporation, and to have taxpayers establish a separate and distinct 46 day holding period in a stock before its dividends qualify for the DRD. We believe that both of these proposals will be making changes to the law that are ill advised. Currently, the U.S. is the only major western industrialized nation that subjects corporate income to multiple levels of taxation. Over the years, the DRD has been decreased from 100% for dividends received from over 80 percent owned corporations, to the current 70% for less than 20 percent owned corporations. As a result, corporate earnings have become subject to multiple levels of taxation, driving up the cost of doing business in the U.S. To further decrease the DRD would continue a trend which heads in the wrong direction.

Since the DRD is intended to avoid multiple levels of corporate taxation, the imposition of any holding period in the stock cannot be justified. Again, over time, the requisite holding period requirement has risen from 16 to 46 days. The reason for the adoption of this rule was to stop taxpayers from purchasing the stock just prior to a dividend record date and selling the stock shortly thereafter, resulting in both a tax-preferenced dividend and a capital loss. However, imposing a separate holding period requirement for each dividend does not enhance the rule and, in fact, just adds needless complexity.

MODIFICATION OF THE SUBSTANTIAL UNDERSTATEMENT PENALTY

The Administration proposes to make any tax deficiency greater than $10 million "substantial" for purpose of the penalty, rather than applying the existing test that such tax deficiency must exceed 10% of the taxpayer's liability for the year. While to the individual taxpayer or even a privately-held company, $10 million may be a substantial amount of money--to a publicly-held MNC such amount is usually not "substantial." Furthermore, a 90% accurate return, given the agreed-upon complexities and ambiguities contained in our existing Internal Revenue Code, should be deemed substantial compliance, with only additional taxes and interest due and owing. There is no policy justification to apply a penalty to publicly-held multinational companies which are required to deal with much greater complexities than are most other taxpayers.

The difficulty in this area is illustrated by the fact that the Secretary of the Treasury has yet to comply with Section 6662(d)(2)(D) of the IRC, which requires the Secretary to publish a list of positions being taken for which the Secretary believes there is not substantial authority and which would affect a significant number of taxpayers. The list is to be revised not less frequently than annually. Taxpayers still await the Secretary's FIRST list.

INCREASED PENALTIES FOR FAILURE TO FILE RETURNS

The Administration also proposes to increase penalties for failure to file information returns, including all standard 1099 forms. IRS statistics bear out the fact that compliance levels for such returns are extremely high. Any failures to file on a timely basis generally are due to the late reporting of year-end information or to other unavoidable problems. Under these circumstances, an increase in the penalty for failure to timely filed returns would be unfair and would fail to recognize the high level of existing compliance by the U.S. business community.

EFFECTIVE DATES

The USCIB believes that it is unsound tax policy to effect significant tax changes retroactively . Business should be able to rely on the tax rules in place when making economic decisions, and to expect that those rules will not change substantially while their investments are still ongoing. It is ill advised and inequitable to encourage businesses to make economic decisions based on a certain set of rules, and change those rules after the taxpayer has made significant investments in reliance thereon. Thus, whenever possible, we call on Congress to assure that significant tax changes do not have retroactive application.

CONCLUSION

The USCIB strongly urges Congress, when formulating its own proposals, not to adopt the provisions identified above, which, as noted, are based on unsound tax policy. Congress, in considering the Administration's budget, should elevate sound and justifiable tax policy over mere revenue needs. Revenue can be generated consistent with sound tax policy, and that is the approach that should be followed as the budget process moves forward.

Statement of the
Ad Hoc Coalition of Utilities For Capital Formation (the "Coalition")
on
The Administration's FY1998 Budget Proposal
To Deny Interest Deductions On Certain Debt Instruments

Submitted for the Record of the Hearing before the
Committee On Finance
on
April 17, 1997

The Administration's Fiscal Year 1998 Budget includes a proposal to deny interest deductions on certain debt instruments that are widely used by the electric utility industry and others.[1] The Coalition strongly opposes this proposal on the grounds that it would increase the cost of capital to the industry, slowing investment and inhibiting international competition. Moreover, the proposal would restrict the financing options available to the electric utility industry at a time when this industry requires flexibility to adjust to an increasingly deregulated and competitive global marketplace. The Administration's proposal represents an arbitrary departure from established tax principles, and inappropriately relies on non-tax accounting considerations to justify its result. For these reasons, the proposal should be rejected to preserve the ability of electric utilities and others to raise flexible low-cost capital.

Summary Of The Administration's Proposal

The Administration's proposal would reclassify debt as equity if the debt has a term of more than 15 years, and is not shown as indebtedness on the separate balance sheet of the issuer. The proposal would only apply to corporations that file annual financial statements with the Securities and Exchange Commission ("SEC"), and the relevant balance sheet is the balance sheet filed with the SEC. The proposed effective date is for instruments issued on or after the date of first committee action.

I. The Administration's Proposal Would Affect Debt Instruments Widely Used By Electric Utilities.

Electric utilities have issued debt instruments widely known as "Capital Securities," in the form of "Monthly Income Preferred Shares" ("MIPS"), "Quarterly Income Preferred Shares" ("QUIPS"), and "Trust Originated Preferred Securities" ("TOPrS"), to strengthen balance sheets and provide flexibility in meeting capital requirements. While it is clear that Capital Securities meet all the requirements to be classified as debt under current law, the Administration's proposal would treat MIPS,

[1] *See* "General Explanation of the Administration's Revenue Proposals," ("Green Book") Department of the Treasury (February 1997) at page 36.

QUIPs, and TOPrS as equity, with the result that issuers would be denied deductions for interest payments on these instruments. The effect of denying deductions for corporate earnings paid out to investors is to subject the payments to multiple levels of taxation (once in the hands of the corporation and again when paid to the investor). In turn, multiple taxation raises financing costs to the issuer.

A. Background: In View of Increasingly Competitive Markets, Electric Utilities Require Maximum Flexibility In Financing Options.

1. *Electric utilities are in the midst of a revolutionary process to transform a government-regulated system to a competitive marketplace.* In 1992, Federal legislation (the Comprehensive National Energy Policy Act) opened the electric utility industry to increased competition at the wholesale level by requiring electric utilities to share their transmission lines with other utilities. The 1992 Federal law left authority over retail competition to the states. At last count, 47 of the 50 states were considering some form of deregulation of their electric utility industries. Even in advance of state action, however, retail competition has been spurred by companies acting as brokers of interstate electricity sales ("power marketers"). In 1992, there were only eight power marketers; today there are about 250.[2] Further, many argue that additional Federal legislation may be required to allow states to implement policies they enact (*e.g.*, repeal of the Public Utility Holding Company Act that governs utilities operating in more than one state). It is clear that the electric utility industry is facing a fundamental change in the regulatory system.

2. *The electric utility industry must be afforded maximum flexibility to prepare for handling the transition costs associated with deregulation.* In preparing for the potential benefits of deregulation - increased customer choice and lower prices for electricity - electric utilities will face costs associated with building new infrastructure, developing new services, and reorganizing to meet competition. Further, there is an ongoing and public debate about the electric utility industry's ability to recover the stranded costs of investments that were made to meet regulatory obligations, with the expectation that regulation would provide an opportunity for full cost recovery. These stranded costs represent a potential loss in asset value of investments that may become uneconomic as the result of deregulation.

B. Electric Utilities Have Utilized Capital Securities to Help Issuers Maintain Investment Grade Credit Ratings.

Typically, Capital Securities are issued to outside investors by a special purpose entity. In the case of TOPrS, for example, a company utilizing these instruments issues debt obligations to a trust that, in turn, issues trust securities (*i.e.*, TOPrS) to investors. The transaction is structured in this way to improve the attractiveness of the securities to the public. The borrowing between the trust and the company is subordinated to the company's other debt, has a stated maturity, and bears a market rate of interest that is

[2] "*Power Brokers*," NATIONAL JOURNAL, 11/30/96, page 2594, at page 2595.

equal to the return on the securities issued to the trust's outside investors. Although the company usually has the option to defer interest payments for up to five years without going into default, the company is unconditionally obligated to pay interest to the trust, out of which the trust pays a return to the outside investors.

Capital Securities are characterized as "minority interest" (rather than debt) for non-tax accounting purposes, although the status of the obligations as indebtedness is clearly disclosed in a footnote to the company's balance sheet as debt. Also, for purposes of determining its overall credit rating, the borrower receives more favorable treatment from rating agencies then it would for the issuance of senior debt. Very generally, the favorable treatment by rating agencies is due to the relatively long term (usually 30 or 40 years), subordination, and the borrower's ability to defer interest payments for a period of time. For Federal income tax purposes, however, it is clear that Capital Securities qualify as debt, the interest on which is deductible.

II. The Administration's Proposal To Treat MIPS, QUIPS, And TOPrS as Equity Represents A Radical Departure From Accepted Tax Policy.

A. The Internal Revenue Service ("IRS") has Reviewed and Approved the Treatment of Capital Securities as Debt.

Under case law, as properly summarized by the IRS in Notice 94-47, the characterization of an instrument as debt or equity depends on all surrounding facts and circumstances; no particular factor is viewed as conclusive.[3] Notice 94-47, which adopts the approach of the case law as a matter of policy, sets forth the following factors to be considered in classifying a security as debt or equity:

- whether there is an unconditional promise to pay a sum certain at a fixed date that is in the reasonably foreseeable future;
- whether the holders possess the right to enforce payment of principal and interest;
- whether the holders have the right to participate in management;
- whether the issuer is thinly capitalized;
- whether there is identity between holders of the instrument and stockholders of the issuer;
- whether a label has been placed on the instrument by the parties; and
- whether the instruments are intended to be treated as debt or equity for non-tax purposes.

[3] Notice 94-47, 1994-1 C.B. 357.

Application of Treasury's test establishes that Capital Securities possess all the critical attributes of debt. First, they all have definite terms of maturity. In cautioning against unreasonably long maturities in Notice 94-47, the IRS indicated that the reasonableness of an instrument's term (including that of a relending obligation or similar arrangement) is determined under a facts-and-circumstances test, including the issuer's ability to satisfy the instrument. In this regard, Capital Securities are typically issued by well-established companies that are likely to remain in business throughout the term of the obligation. Second, investors have full creditor rights upon default, and default can force an issuer into bankruptcy or liquidation. Third, holders have no rights to participate in management. Fourth, issuers are not thinly capitalized. Fifth, if interest is deferred, investors must impute interest income as is the case with other debt instruments, but not equity. Sixth, the markets price the instruments as debt instruments - giving investors a debt return, not an equity return. Lastly, the instruments are senior to all preferred equity.

Significantly, Notice 94-47 was published in response to the issuance in significant volume of the instruments now referred to as MIPS. Thus, the IRS specifically reviewed instruments "that are designed to be treated as debt for federal income tax purposes but as equity for regulatory, rating agency, or financial accounting purposes." Notice 94-47 simply gives notice that the status of instruments such as MIPS will be scrutinized on audit. We believe that Notice 94-47 sets forth an appropriate standard of review. Notably, Notice 94-47 did *not* identify the accounting treatment of Capital Securities as a concern; rather, the IRS singled out only two "equity features" of "particular interest:" an unreasonably long maturity and an ability to repay principal with the issuer's stock. Even in the case of an instrument with those two features, however, the notice did not resort to a formalistic classification.

B. How Credit Rating Agencies or Accountants View a Security Should Have no Bearing on its Classification for Federal Income Tax Purposes.

The concerns of credit rating agencies and the SEC are very different from those of the IRS. Rating agencies and the SEC are focused on determining the likelihood of the issuer defaulting, while the IRS normally concerns itself with distinguishing debt from an equity security whose return represents a participation in the profits and risks of the business enterprise. Given the different objectives of the IRS and rating agencies and the SEC, the label attached by the latter should have no bearing on the tax classification. Indeed, to illustrate the vagaries inherent in basing tax consequences on non-tax labels, consider the fact that at least one national rating agency has announced that it will rate Capital Securities as bonds, and not quasi-equity.[4] Moreover, as noted above, in a bankruptcy proceeding, Capital Securities are senior to equity.

Regarding the proposal's reliance on accounting practices to determine the tax treatment of Capital Securities, it is interesting to note that the Administration took the exact opposite approach in certain other provisions included in its FY1998 Budget.

[4] "Fitch to Rate New Securities as Bonds," *Wall Street Journal* (December 6, 1996)).

Specifically, the Administration has proposed to repeal the "lower of cost or market" method of valuing inventory,[5] notwithstanding the fact that this method has been long-accepted as a generally accepted accounting principle and has been allowed by Treasury regulations since 1918.[6] The staff of the Joint Committee on Taxation's analysis of this proposal correctly points out the often separate principles underlying tax and financial accounting treatment.[7] Similarly, the Administration would repeal the components-of-cost inventory accounting method,[8] despite the fact that this method "is accepted (and in some cases, favored) under...GAAP....applicable to the preparation of financial statements."[9]

Not only is the Administration's overall budget proposal internally inconsistent with respect to the deference to be accorded to financial accounting treatment, in the case of the proposal to deny interest deductions there is no reasoned tax policy basis for referencing the financial accounting treatment of affected instruments.

IV. The Administration's Proposal Would Inhibit the International Competitiveness of American Corporations.

By limiting the financing options of U.S. corporations, the Administration's proposal would limit their ability to invest in new plant and equipment. A reduction in investments would have an adverse impact on economic growth and the international competitiveness of U.S. businesses. In this regard, it should be noted that no other major industrialized country has adopted such restrictive and arbitrary limits on the deductibility of interest. Ironically, if the Administration's proposal is enacted, foreign issuers would remain free to access the U.S. capital markets using Capital Securities. Thus, U.S. corporations would be generally disadvantaged *vis-a-vis* their foreign competitors. In the case of electric utilities, which are just beginning to compete in the global market, any proposal that raises the cost of capital will make it more difficult for the industry to weather difficult financial times and more likely for the industry to be forced into radical cost cutting measures.

CONCLUSION

The Administration's proposal to deny interest deductions on Capital Securities represents an unjustifiable tax increase on businesses and investors, based on a convenient but ill-advised reliance on non-tax accounting principles with no basis in tax policy. Moreover, particularly in the case of electric utilities, the enactment of this proposal would exacerbate competitive pressures already affecting U.S. businesses that require flexibility to compete in the global marketplace.

[5] See page 77 of the Green Book.

[6] *See* "Descriptions and Analysis of Certain Revenue-Raising Provisions Contained In the President's Fiscal Year 1998 Budget Proposals," prepared by the staff of the Joint Committee On Taxation (march 11, 1997) (JCX-10-97) at page 72.

[7] *Id.*

[8] See page 78 of the Green Book.

[9] JCX-10-97 at page 75.

Statement Of Washington Counsel, P.C., Attorneys-at-Law
on the
Administration's FY1998 Budget Proposal To Require Gain Recognition On Certain Distributions Of Controlled Corporation Stock (the "*Morris Trust* Proposal")

Submitted for the Record of the Hearing before the

Senate Committee on Finance

on April 17, 1997

Washington Counsel, P.C. is a law firm based in the District of Columbia that represents a variety of clients on tax legislative and policy issues.

The *Morris Trust* Proposal is seriously flawed and, if enacted as proposed, would threaten major disruptions in legitimate corporate restructurings. The proposal would effect a fundamental change in tax policy, based on anecdotal reports of a limited number of transactions that are perceived by some as being abusive. In addition, the *Morris Trust* Proposal is not necessarily consistent with the efforts underway in this Congress – *viz.*, to reduce tax on capital gains, provide increased flexibility for the telecommunication, entertainment, utility, and other industries to respond to the changing regulatory environment, and lay the foundation for fundamental tax reform.

This statement also addresses the need to provide transition relief for taxpayers who are complying with current law – failure to provide transition relief, should the proposal move forward, would result in a retroactive tax increase on affected corporations.

Summary of the Administration's *Morris Trust* Proposal

The *Morris Trust* Proposal would require taxable gain recognition for certain Section 355[1] transactions that take the form of "spin-offs" – *i.e., pro rata* distributions of subsidiary stock where shareholder-distributees surrender no stock in the distributing corporation. Based on the Administration's stated rationale that "corporate nonrecognition under Section 355 should not apply to distributions that are effectively dispositions of a business," the proposal would deny tax-free treatment to the distributing corporation in a spin-off, unless its shareholders hold stock representing 50 percent of the vote and value in both the distributing and the controlled subsidiary for a four-year period beginning two years prior to the spin-off. Thus, tax-free treatment could be denied where a spin-off is followed by the tax-free merger of the distributing corporation into another corporation, even where the only consideration received by the shareholders is stock representing a continuing proprietary interest in the distributing corporation. In this example, the arb:trary 50-percent test under the proposal would allow tax-free treatment

[1] Unless otherwise noted, references to a "Section" are to the Internal Revenue Code of 1986, as amended.

only in the event of a subsequent merger party that is exactly equal in value to – or of lesser value than – the distributing corporation.

I. Current Law Serves Its Intended Purpose Of Allowing Shareholders To Rearrange Their Investments Without Triggering A Tax On The Appreciation In Value Of A Business's Underlying Assets.

Like other tax-free reorganization provisions, Section 355 is premised on the theory that a corporate restructuring is not an appropriate time to impose a tax, to the extent that a taxpayer's investment remains in corporate solution, and a distribution of stock represents merely a new form of participation in a continuing enterprise.[2] Consistent with the theory of tax-free reorganizations, Section 355 permits a corporation to distribute the stock in a controlled subsidiary to shareholders without triggering tax at the shareholder or corporate level.

Section 355 transactions are better policed than other corporate reorganizations. Under the statutory requirements applicable to a tax-free Section 355 spin-off, the distributing corporation must distribute stock representing an 80-percent controlling interest, and both the distributing corporation and the controlled subsidiary must be engaged in an active five-year old business following the distribution. Moreover, Treasury regulations condition the application of Section 355 on the distributing corporation's ability to establish the existence of a valid business purpose for a spin-off.[3] For over thirty years, both the courts and the Internal Revenue Service ("IRS") have examined these transactions and permitted corporations to utilize tax-free spin-offs of an unwanted business to facilitate the *tax-free* acquisition of either the distributing corporation or the spun-off subsidiary [4] – referred to as a "*Morris Trust*" transaction after the case (cited in note 4 below).

A *Morris Trust* transaction simply combines two tax-free reorganizations. Consistent with the theory of the reorganization provisions, shareholders who receive stock of a spun-off subsidiary and then participate in a second reorganization, retain continuing proprietary interests via stock received in both transactions. As observed by the court in the *Morris Trust* case, these transactions involve "no empty formalism, no utilization of empty corporate structures, no attempt to recast a taxable transaction in nontaxable form, and *no withdrawal of liquid assets* (emphasis added)."

[2] See generally, Bittker And Eustice, *Federal Income Taxation of Corporations and Shareholders*, 12.01[3] regarding "General Theory for Tax-free Treatment."

[3] Treasury reg. sec. 1.355-2(b).

[4] *See Commissioner v. Morris Trust, 367 F.* 2d *794 (*4th *Cir.* 1966) (subsequent reorganization involving the distributing corporation); Rev. Rul. 68-603, 1968-2 C.B. 148 (where the Internal Revenue Service accepted the holding of the *Morris Trust* case); Rev. Rul 76-527, 1976-2 C.B. 103 ("blessing" a "reverse Morris Trust" where the spun-off subsidiary was party to a subsequent reorganization); and Rev. Proc. 96-30 (issued on May 6, 1997, after the Administration first unveiled the proposal in question, and explicitly recognizing the valid business purpose of a *Morris Trust* transaction).

II. The Administration's *Morris Trust* Proposal is Fundamentally Flawed.

The Administration's Morris Trust Proposal is flawed, in that it is overly broad, inconsistent with the movement toward fundamental tax reform and current efforts to reduce the cost of capital and lower the capital gains tax rate, and would impose a "new" capital gains tax on legitimate transactions. Moreover, in certain cases, the proposal would tax the *wrong* capital gain.

A. The *Morris Trust* Proposal is Overly Broad.

The *Morris Trust* Proposal would impinge on the ability of corporations to effect restructurings at a time when many businesses feel compelled to concentrate industries, separate, or combine to remain competitive in changing market and regulatory environments. As an unintended consequence of enacting the proposal, companies would be forced to maintain inefficient business structures or incur additional tax. As explained more fully below, any perceived problems can be addressed without penalizing all *Morris Trust* transactions.

The *Morris Trust* Proposal goes far beyond the intended goal of preventing tax-free disguised sales of businesses.[5] Reportedly, the *Morris Trust* proposal was prompted by several widely publicized transactions in which a spin-off was combined with an acquisitive, tax-free reorganization, and it appeared that newly incurred debt was used as a device to pay a cash purchase price for the company acquired in the reorganization. The concern raised by these transactions was highlighted by the use of a spin-off in the disposition of Viacom Inc.'s cable business to TCI, with respect to which the IRS issued a favorable Section 355 ruling in 1996. There, as reported by *Newsweek* and the April 3, 1996 edition of *Tax Notes Today*, a Viacom subsidiary holding a cable business incurred $1.7 billion of new debt, spun off its non-cable business plus the cash proceeds of the borrowing to its corporate parent, and was then effectively "acquired" by virtue of the issuance of stock to TCI in exchange for cash. In short, it appears that liability for the new debt was assumed by TCI, while the cash generated by the borrowing went to the spun-off business that was retained by historic shareholders. The Viacom transaction was followed by similar deals where the assumption of debt "overwhelmed" the value of the stock that exchanged hands – *e.g.*, El Paso's acquisition of a Tennoco subsidiary in exchange for stock valued at about $914 million plus the assumption of $3.6 billion in liabilities. The perceived abuse in these cases is that the combined spin-off/reorganization constitutes a "disguised sale." Clearly, the *Morris Trust* Proposal goes far beyond this type of transaction.

To the extent that the identified abuse motivating the *Morris Trust* proposal involves the issuance of new debt that will be repaid by the acquirer, the solution offered is not responsive to the real issue. The proposal goes far beyond what is needed to

[5] *See* Statement of Donald C. Lubick, Acting Assistant Secretary (Tax Policy), Department of the Treasury, Before the House Ways and Means Committee (March 5, 1997).

prevent the use of Section 355 to effect disguised sales, because the proposal would apply even where a debt-free company is acquired. It must also be recognized that the assumption of liabilities in the course of a spin-off is a commonplace transaction, and care should be taken to distinguish cases where a corporation has normal business borrowings that remain with the business that generated the need for the debt. **Should the Committee adopt a provision that targets cases where a spun-off subsidiary has debt in excess of tax basis, as has been proposed by others, we would urge the inclusion of a safe harbor for debt that was incurred more than two years before the spin-off. A two-year period applicable to debt would be consistent with the window proposed by the Administration under the general rule to trigger gain recognition.**

B. The *Morris Trust* Proposal is Antithetical to Fundamental Tax Reform, to the Extent it Would Exacerbate Problems Associated With the Double Taxation of Corporate Income.

One of the fundamental goals of Structural Tax Reform is to integrate the corporate and individual tax systems – to prevent the imposition of "double tax" on income earned by corporations. The effect of the *Morris Trust* proposal would be to create a new potential for two levels of tax on a corporation's distribution of controlled subsidiary stock – one tax based on the distributing corporation's gain and another based on gain at the shareholder level.

Double taxation is particularly egregious when applied to appreciation in value of a corporation's original capital. Current law appropriately avoids double taxation in the case of an in-kind distribution of stock in a controlled subsidiary, where the distribution is made to historic shareholders and the controlled subsidiary is engaged in an ongoing business. Neither should taxation be required if shareholders maintain a continuing equity interest in a combined enterprise that includes the capital originally invested in an on-going business. The proposal, however, would trigger gain recognition by the distributing corporation in a spin-off, where the distributee/shareholders maintain an indirect ownership interest through stock received in a subsequent reorganization of the spun-off subsidiary.

The existing "double tax" regime already places U.S. corporations at a competitive disadvantage in worldwide capital markets. Multiple levels of taxation raise the financing costs for corporations, and generally reduce incentives for capital formation. Moreover, "double taxation" creates global competitiveness problems, because many of our major trading partners (e.g., Germany, the United Kingdom, and Japan) have some mechanism for integrating the corporate- and shareholder-level taxes. Thus, the *Morris Trust* Proposal would undermine efforts to prevent our tax system from unduly burdening U.S. companies competing in international markets.

C. The *Morris Trust* Proposal is Clearly Inconsistent With Current Efforts To Lower the Capital Gains Tax Rate.

The *Mörris Trust* Proposal would impose a "new" capital gains tax on the appreciation in value of underlying corporate assets, representing gain that may be largely inflationary. This proposal is particularly questionable at a time when many in Congress are looking for ways to eliminate the taxation of inflationary gains (*e.g.*, by indexing the basis of capital assets).

Moreover, at a time when Congress is considering a reduction in the capital gains tax, it would be inconsistent and counterproductive to adopt a proposal that creates a "new" capital gains tax. A "new" capital gains tax would be created because the proposal would trigger recognition of gain that is untaxed under current law. The capital gains tax resulting from application of the proposal would thus further interfere with the market's allocation of capital.

D. The Morris Trust Proposal Would Apply *Incorrectly* to Tax the Appreciation in Value of Assets Retained by Historic Shareholders.

Upon a subsequent merger of the *distributing corporation* in a spin-off, the *Morris Trust* Proposal would apply to treat stock in the *controlled subsidiary* as "disqualified" consideration. Under Section 355(c), the distributing corporation's recognized gain would be measured by the difference between the value of the stock in the spun-off subsidiary and the basis in that stock. Thus, rather than taxing the appreciation in value of the business viewed as disposed of, the proposal would result in a tax on the business that is retained by historic shareholders. These issues clearly require more thought and analysis before the Ways and Means Committee acts to tax ordinary spin-off and merger activity.

IV. The Most Troubling Aspect of the *Morris Trust* Proposal Is Its Retroactive Application To Taxpayers Who are Complying With Current Law.

In any event, Should a *Morris Trust* Proposal go forward, the Ways and Means Committee should provide for prospective application. As proposed, the *Morris Trust* Proposal would apply to a transaction that is completed before the date of enactment but after the date of "first committee action." Notably, the proposed effective date is arbitrary and capricious, in that taxpayers who entered into binding commitments before the proposal was announced could be caught, while other taxpayers who have yet to make commitments would be unaffected if they complete transactions before the date of first committee action. In this regard, the Chairmen of both the Senate Finance Committee and the House Ways and Means Committee have expressed concerns that tax changes not be retroactive, and that proposed corporate tax changes be prospective to avoid disrupting normal market activities during the period of deliberation.[6]

Failure to provide a prospective effective date, should this proposal move forward, would result in a retroactive tax increase on affected corporations. The only guidance now available to taxpayers caught in the midst of transactions that cannot be completed before the "date of first committee action" are the transition rules proposed by the Administration when the *Morris Trust* Proposal was first offered in the President's FY1997 Budget. Recognizing the need for appropriate transition relief, the Administration proposed grandfather rules for distributions meeting any one of the following three tests:

(1) made pursuant to a written agreement in effect on the effective date;

(2) described in a ruling request filed with the IRS on or before that date; or

(3) described in a public announcement or filing with the Securities and Exchange Commission on or before that date.

We urge the Committee to include, at a minimum, similar transition rules with a "date of enactment" effective date. In view of the fact that *Morris Trust* transactions have been accepted and approved by the courts and the IRS for over 30 years, it would be inappropriate to impose a restrictive effective date with no transition relief – treatment that is normally reserved for anti-abuse legislation. Taxpayers who have incurred substantial transactional costs in reliance on current law should not be penalized by a retroactive enactment.

The affected transactions often take months to consummate even after the signing of binding commitments and required filings with government agencies. Similar to the Administration's transition rule proposal in the FY1997 Budget, the parties to a contract should be allowed to condition a written agreement on the buyer's performance of due diligence, or on approval by the target corporation's Board of Directors or shareholders. This result would be consistent with precedents for treating a contract as binding even if subject to a condition, as long as the condition is not within the control of either party.[7]

[6] On March 29, 1996, after the Administration first announced the *Morris Trust* Proposal and other corporate tax changes, Ways and Means Committee Chairman Bill Archer and Senate Finance Committee Chairman William Roth issued a joint statement to this effect.

[7] *See* page 352 of the *General Explanation of the Tax Reform Act of 1986* – in the context of the *General Utilities* repeal: "An acquisition of stock or assets will be considered made pursuant to a binding contract even though the contract is subject to normal commercial due diligence or similar provisions and the final terms of the acquisition may vary pursuant to such provisions."

Notably, the transition rules proposed in the FY1997 Budget would not constitute "limited tax benefits" subject to the Line Item Veto Act (Public Law 104-130).[8] The statute excepts "binding contract" rules, and thus the proposal for "written agreements in effect" should not implicate the Line Item Veto Act.[9] In the case of other transitional-relief provisions, the number of beneficiaries that triggers veto authority is 10 or fewer. Regarding the grounds for excluding the other two proposed rules (*viz.*, an IRS ruling request and public announcement) from application of the Line Item Veto Act, based on our information and belief, there are many more than 10 transactions to which each of the proposed transition rules would apply.

[8] . We note that the Line Item Veto Act has been declared unconstitutional by a federal court, but include this discussion in case that decision is reversed.

[9] Section 1026(9)(C) of the Line Item Veto Act provides an exception for transitional relief provided with respect to all binding contracts or other legally enforceable obligations in existence on a date contemporaneous with congressional action specifying the date.

WRITTEN TESTIMONY OF
WASHINGTON COUNSEL, P.C.

ON THE NEED TO CLARIFY THAT SHORT-AGAINST-THE-BOX LEGISLATION WILL NOT CREATE UNRELATED BUSINESS TAXABLE INCOME TO TAX EXEMPT ENTITIES

BEFORE THE COMMITTEE ON FINANCE

UNITED STATES SENATE

Submitted April 24, 1997

Committee on Finance Hearings on Revenue Raising Provisions
in the Administration's Fiscal Year 1998 Budget Proposal
April 17, 1997

This testimony is submitted for the purpose of seeking clarification of short-against-the-box legislative proposals submitted by the Clinton Administration and by Congresswoman Barbara Kennelly. Clarification is needed to ensure that the adoption of such legislation not inadvertently result in unrelated business taxable income to tax-exempt entities.

Background. On February 6, 1997, the Clinton Administration released descriptions of proposed changes to federal income tax law in connection with its Fiscal Year 1998 budget proposal. Among those provisions is a proposal to require a taxpayer to recognize gain upon entering into a constructive sale of any appreciated position in either stock, a debt instrument, or a partnership interest. This is the so-called "short-against-the-box" proposal. On February 16, 1997, Congresswoman Barbara Kennelly introduced substantially similar legislation, H.R. 846.

This testimony is not offered for the purpose of commenting on the appropriateness of the Administration and Kennelly proposals. Instead, this testimony is offered for the more narrow purpose of requesting that in the event the Committee decides to adopt short-against-the-box legislation, it clarify the reach of such legislation with respect to the potential unrelated business taxable income of certain tax-exempt entities.

Current Law. Under section 511 of the Internal Revenue Code, tax is imposed on the unrelated business taxable income ("UBTI") of certain tax-exempt entities. As defined in section 513, UBTI consists generally of gross income from an "unrelated trade or business" minus allowable deductions. Unrelated trade or business income includes income from trade or business activities the conduct of which is not substantially related to the performance by such organization of its charitable, educational, or other purpose on which its exemption is based. Section 512(b) sets forth several types of income that are generally not treated as giving rise to UBTI including dividends, interest, gains on dispositions of property other than inventory, real property rent, and royalties. However, as provided for in section 512(b)(4) and defined in section 514, income from property that is otherwise not taxable is treated as taxable UBTI to the extent that the property is debt-financed. Therefore, to the extent that a tax-exempt entity incurs debt with respect to the ownership of property, any income from that property would be considered UBTI to the tax-exempt entity notwithstanding the general rule that such income is not taxable.

This could present an issue in the case of short sales of property if the shares borrowed are considered to create an obligation that would be considered an indebtedness. This issue was clarified in Revenue Ruling 95-8, 1995-1 C.B. 107, where the Internal Revenue Service (the "Service") ruled that income of a tax-exempt organization from a short sale of publicly-traded stock is not income attributable to debt-financed property under Section 514. Citing *Deputy v. du Pont,* 308 U.S. 488, 497-98 (1940), the Service reasoned that, although a short sale creates an obligation on the part of the seller, it does not create indebtedness within the meaning of Section 514.

Thus, although this issue is clear in current law, without further clarification questions could arise under the short-against-the-box legislation now under consideration. We are concerned that under the current legislative proposals before Congress, a tax-exempt entity could be deemed to have entered into a borrowing with respect to short sales of property. As a result, transactions that are currently not considered to be UBTI, and therefore are not subject to tax, would become taxable.

Clarification Sought. The policy objective behind the short-against-the-box proposals is to require realization of gain where a taxpayer has disposed of the economic risks and rewards of owning appreciated property. Should such legislation be adopted by the Committee, we request clarification that it will be confined to this objective. Specifically, we would like confirmation, similar to that provided in Revenue Ruling 95-8, that a "constructive sale" of stock[1] for purposes of gain realization will not result in a deemed borrowing on the part of the tax-exempt entity for purposes of Section 514 and the tax on UBTI.

This clarification would permit tax-exempt entities to continue to make investments in the most efficient, profit-maximizing way possible. Tax-exempt entities, such as educational institutions, pension funds, and charities, manage their investment portfolios to limit their risk while maximizing return. In some cases this requires that they engage in the type of short sales that could be affected by the short-against-the-box legislative proposals now before Congress. Because these are tax-exempt entities, and the income from short sales is not UBTI, these investments are obviously not undertaken for tax avoidance purposes. There is no tax payable under current law on the short sales of property by tax-exempt entities and there is no rationale for changing that treatment under the pending proposals.

Because investments in assets which produce UBTI have a much lower rate of return while creating increased administrative burden, tax-exempt entities avoid such investments. To the extent the treatment of short sales is in doubt, the tax-exempt community is likely to avoid these investments altogether. Such uncertainty artificially and unnecessarily reduces the investment opportunities otherwise available to these organizations and inhibits their ability to generate funding for their tax-exempt purposes.

Summary. In the event that the Committee decides to adopt short-against-the-box legislation which would require a taxpayer to recognize gain upon entering into constructive sales of appreciated property, it should clarify that such constructive sales will not result in a deemed borrowing for purposes of section 514 and the tax on UBTI. This clarification would permit tax-exempt entities to continue to manage their investments by the most efficient means without interfering with the intentions of Congress in enacting short-against-the-box legislation. This clarification has broad support within the tax-exempt community. We hope the Committee will carefully consider this request as tax legislation moves through the Congress this year.

[1] The ruling did not address sales of debt or partnership interests, which are covered by the short-against-the-box legislation.

Statement Of Washington Counsel, P.C., Attorneys-at-Law
Submitted on Behalf of An *Ad Hoc* Group of U.S.-owned Foreign Finance and Credit Companies
Relating to the Administration's FY1998 Budget Proposal
To Expand Subpart F Provisions Regarding Income From Notional Principal Contracts and Stock Lending Transactions
Submitted for the Record of the Hearing before the
Committee on Finance
on
April 17, 1997

The President's FY1998 Budget proposes to expand the anti-deferral rules of Subpart F,[1] to create a new category of Subpart F income from notional principal contracts. The President's proposal to amend Subpart F presents the opportunity to address a serious inequity created by the application of Subpart F to the U.S. financial services industry. The balance of this statement sets forth the analysis underlying the proposal by an *ad hoc* group of U.S. Finance and Credit Companies[2] to amend Subpart F to restore deferral for active financial services income.

While deferral of current U.S. taxation is the general rule for foreign-source business income earned by controlled foreign corporations, the Tax Reform Act of 1986 ended deferral for financial services income derived from the active conduct of a securities, insurance, banking, financing, or similar business. The growing interdependence and integration of world financial markets, coupled with the international expansion of U.S.-based financial services entities, warrants a reexamination of whether the foreign activities of the financial services industry should be eligible for deferral on terms comparable to that of manufacturing and other non-financial businesses. Much of the recent debate has focused on the activities of banking, insurance, and securities firms. This statement is submitted on behalf of an *ad hoc* group of leading finance and credit companies whose activities fall outside of these specific categories but within the catch-all concept of a "financing or similar business."

The *ad hoc* group of finance and credit companies includes entities providing a full range of financing, leasing, and credit services to consumers and other unrelated businesses, including the financing of third-party purchases of products manufactured by affiliates (collectively referred to as "Finance and Credit Companies"). The treatment of Finance and Credit Companies under the current U.S. international tax regime raises the very same tax policy concern that has been identified by other sectors of the financial services industry – *viz.*, U.S. tax rules that hinder international competitiveness by, inappropriately, subjecting *active* financial services businesses to anti-deferral rules that were originally enacted to reach *passive* investment funds.

This statement sets forth the analysis underlying the proposal by the *ad hoc* group of Finance and Credit Companies to amend Subpart F to restore deferral for active financial services income. Specifically, the statement highlights the particular concerns of Finance and Credit Companies, describes the ordinary business transactions conducted by these entities, provides information regarding the unique role these companies play in expanding U.S. international trade, and explains how the current U.S. tax rules hinder the ability of Finance and Credit Companies to compete effectively with their foreign counterparts.

I. Finance and Credit Companies Conduct Active Financial Services Businesses.

[1] "Subpart F" consists of Sections 951 through 964 of the Internal Revenue Code of 1986, as amended; except as noted, all references to "Sections" herein are to the Internal Revenue Code.
[2] The ad hoc group on behalf of which this statement is submitted consists of: AT&T Capital, Ford Motor Credit, and GE Capital.

Finance and Credit Companies are financial intermediaries that borrow to engage in all the activities in which banks customarily engage when issuing and servicing a loan or entering into other financial transactions. Indeed, many countries (*e.g.*, Germany, Austria, and France) actually require that such a company be chartered as a regulated bank. For example, one member of the *ad hoc* group has a European Finance and Credit Company that is regulated by the Bank of England and, under the European Union ("EU") Second Banking Coordination Directive, operates in branch form in Austria, France, and a number of other EU jurisdictions. The principal difference between a typical bank and a Finance and Credit Company is that banks normally borrow through retail or other forms of regulated deposits, while Finance and Credit Companies borrow from the public market through commercial paper or other publicly issued debt instruments. In some cases, Finance and Credit Companies operating as regulated banks are required to take deposits, although they may not rely on such deposits as a primary source of funding. In every important respect, Finance and Credit Companies compete directly with banks to provide loan and lease financing to retail and wholesale consumers.

A. A Finance and Credit Company's Activities Include A Full Range Of Financial Services.

The active financial services income derived by a Finance and Credit Company includes income from financing purchases from third parties; entering into leases; making personal, mortgage, industrial or other loans; factoring; providing credit card services; and hedging interest rate and currency risks with respect to active financial services income. These activities include a full range of financial services across a broad customer base and can be summarized as follows:

- **Specialized Financing**
Loans and leases for major capital assets, including aircraft, industrial facilities and equipment and energy-related facilities; commercial and residential real estate loans and investments; loans to and investments in management buyouts and corporate recapitalizations.

- **Consumer Services**
Private label and bank credit card loans; time sales and revolving credit and inventory financing for retail merchants; auto leasing and lending and inventory financing; and mortgage servicing.

- **Equipment Management**
Leases, loans and asset management services for portfolios of commercial and transportation equipment, including aircraft, trailers, auto fleets, modular space units, railroad rolling stock, data processing equipment, telecommunications equipment, ocean-going containers, and satellites.

- **Mid-Market Financing**
Loans and financing and operating leases for middle-market customers, including manufacturers, vendors, distributors, and end-users, for a variety of equipment, such as computers, data processing equipment, medical and diagnostic equipment, and equipment used in construction, manufacturing, office applications, and telecommunications activities.

Each of the financial services described above is widely and routinely offered by foreign-owned finance companies in direct competition with Finance and Credit Companies.

Finance and Credit Companies finance wholesale and retail sales of products by manufacturers to unrelated customers. In some cases, the Finance and Credit Company is an affiliate of the product manufacturer, and in other cases, the Finance and Credit Company is unrelated to the manufacturer. By way of example, Finance and Credit Companies affiliated with a U.S. auto maker provide wholesale financing and capital loans to franchised dealers and other dealers associated with such franchisees, purchase retail installment sales contracts and retail leases from these dealers, and make loans to vehicle leasing companies (the majority of which are affiliated with such dealers). A Finance and Credit Company affiliated with the same U.S. auto maker is actively engaged in non-affiliate product financing.

As another example, a Finance and Credit Company is a leading provider of financial services to automotive customers worldwide; offering retail financing to consumers, inventory financing to dealers, and private label programs to manufacturers. In 1995, the U S. Parent of this Finance and Credit Company acquired the finance arm (a private label credit business) of the largest retailer in Australia. The same U.S. parent acquired the French finance company that supports Peugeot Citroen throughout Europe and owns one of Hong Kong's leading installment sales finance companies.

Further, as a third example, a Finance and Credit Company provides financing and servicing support to unrelated multinational equipment manufacturers as these companies expand their sales efforts around the globe. In order to provide local financing capabilities in the international markets in which these manufacturers sell their products, this U.S.-based company has established an extensive network of Finance and Credit Companies through which local financing support is provided.

As an alternative to traditional lending, leasing has developed into a common means of financing acquisitions of fixed assets, and is growing at double digit rates in international markets. Consistent with this trend, a Finance and Credit Company acquired a leading provider of vendor leasing services in the United Kingdom, and one of the Finance and Credit Company's affiliates provides a full range of aircraft financing products and related services to more than 150 airlines around the globe, including operating leases, spare parts, and maintenance support.

B. Finance and Credit Companies Are Located In The Major Markets In Which They Conduct Business And Compete Head-on Against "Name Brand" Local Competitors.

Finance and Credit Companies provide services to foreign customers or U.S. customers conducting business in foreign markets. The customer base for Finance and Credit Companies is widely dispersed; indeed, a large Finance and Credit Company may have a single customer that itself operates in numerous jurisdictions. As explained more fully below, rather than operating out of regional, financial centers (such as London or Hong Kong), Finance and Credit Companies must operate in a large number of countries to compete effectively for international business and provide local financing support for foreign offices of U.S. multinational vendors. Finance and Credit Company affiliated with a U.S auto maker, for example, provide services to customers in Australia, India, Korea, Germany, the U.K., France, Italy, Belgium, China, Japan, Indonesia, Mexico, and Brazil, among other countries. Another member of the *ad hoc* group conducts business through Finance and Credit Companies in virtually all the major European countries, in addition to maintaining headquarters in Hong Kong, Europe, India, Japan, and Mexico. Yet another member of the *ad hoc* group currently has offices that provide local leasing and financing products in 22 countries.

Finance and Credit Companies are legally established, capitalized, operated, and managed locally, as either branches or separate entities, for the business, regulatory, and legal reasons outlined below:

1. *Marketing and supervising loans and leases generally require a local presence.* The provision of financial services to foreign consumers requires a Finance and Credit Company to have a substantial local presence – to establish and maintain a "brand name," develop a marketing network, and provide pre-market and after-market services to customers. A Finance and Credit Company must be close to its customers to keep abreast of local business conditions and competitive practices. Finance and Credit Companies analyze the creditworthiness of potential customers, administer and collect loans, process payments, and borrow money to fund loans. Inevitably, some customers have trouble meeting obligations. Such cases demand a local presence to work with customers to ensure payment and, where necessary, to terminate the contract and repossess the asset securing the obligation. These active functions require local employees to insure the proper execution of the Finance and Credit Company's core business activities – indeed, a single member of the ad hoc group has approximately 15,000 employees in Europe. From a

business perspective, it would be almost impossible to perform these functions outside a country of operation and still generate a reasonable return on the investment. "Paper companies" acting through computer networks would not serve these local business requirements.

In certain cases, a business operation and the employees whose efforts support that operation may be in separate, same-country affiliates for local business or regulatory reasons. For example, in some Latin American jurisdictions where profit sharing is mandatory, servicing operations and financing operations may be conducted through separate entities. Even in these situations, the active businesses of the Finance and Credit Companies are conducted by local employees.

2. *Like other financial services entities, a Finance and Credit Company requires access to the debt markets to finance its lending activities, and borrowing in local markets often affords a lower cost of funds.* Small Finance and Credit Companies, in particular, may borrow a substantial percentage of their funding requirements from local banks. Funding in a local currency reduces the risk of economic loss due to exchange rate fluctuations, and often mitigates the imposition of foreign withholding taxes on interest paid across borders.

Alternatively, a Finance and Credit Company may access a capital market in a third foreign country, because of limited available capital in the local market – Australian dollar borrowings are often done outside Australia for this reason. The latter mode of borrowing might also be used in a country whose government is running a large deficit, thus "soaking up" available local investment.

A Finance and Credit Company may also rely for funding on its U.S. parent company, which issues debt and on-lends to affiliates (with hedging to address foreign exchange risks). By way of example, one member of the *ad hoc* group uses the world's capital markets to finance its operations, balancing costs and availability in conducting its funding. Short-term funds are raised in six different markets, for example: A Canadian affiliate issues commercial paper sold through all major dealers; its European commercial paper program is one of that market's largest; and an Indian affiliate participates in the Indian rupee inter-corporate deposit market, in which short-term funds are raised directly from major Indian corporate investors. This company uses interest rate and currency derivatives (primarily swaps) to reduce interest rate and currency risk – all such transactions are related to specific business transactions.

3. *In many cases, consumer protection laws require a local presence.* Finance and Credit Companies must have access to credit records that are maintained locally. Many countries, however, prohibit the transmission of consumer lending information across national borders. Additionally, under "door-step selling directives," other countries preclude direct marketing of loans unless the lender has a legal presence.

4. *Banking or currency regulations may also dictate a local presence.* Finance and Credit Companies must have the ability to process local payments and – where necessary – take appropriate action to collect a loan or repossess collateral. Foreign regulation or laws regarding secured transactions often require U.S. companies to conduct business through local companies with an active presence. For example, as noted above, French law generally compels entities extending credit to conduct their operations through a regulated "banque" approved by the French central bank. Other jurisdictions, such as Spain and Portugal, require retail lending to be performed by a regulated entity, but it need not be a full-fledged bank.

In addition, various central banks preclude movements of their local currencies across borders. In such cases, a Finance and Credit Company's local presence (in the form of either a branch or a separate entity) is necessary to the execution of its core activities of lending, collecting, and funding.

As noted above, EU directives allow a regulated bank headquartered in one EU jurisdiction to have branch offices in another EU jurisdiction, with the "home" country exercising the majority of the bank regulation. Thus, for example, one Finance and Credit Company in Europe operates in branch form, engaging in cross-jurisdictional business in the economically integrated countries that comprise the EU. The purpose of this branch structure is to consolidate European assets into one corporation to achieve increased borrowing power within the EU, as well as limit the number of governmental agencies with primary regulatory authority over the business.

II. Finance and Credit Companies Play A Critical Role In Supporting International Trade Opportunities.

As U.S. manufacturers and distributors expand their sales activities and operations around the world, it is critical that U.S. tax policy be coordinated with U.S. trade objectives, to allow U.S. companies in developed markets to operate on a level playing field with their foreign competitors. In emerging markets where competition in the financing business may be less fierce, U.S. tax policy should not hamper efforts to provide financing support for product sales. Significantly, U.S.-based multinationals currently account for only 22% of the world's output, roughly the same percentage as at the start of the 1980's.[3] In this regard, one of the important tools available to U.S. manufacturers and distributors in seeking to expand foreign sales is the support of Finance and Credit Companies providing international leasing and financing services.

U.S. manufacturers, in particular, include the availability of financing services offered by Finance and Credit Companies as an integral component of the manufacturer's sales promotion in foreign markets. For related manufacturing or other businesses to compete effectively, Finance and Credit Companies establish local country financial operations to support the business. As an example, the Finance and Credit Company affiliate of a U.S. auto maker establishes its operations where the parent company's sales operations are located, in order to provide marketing support.

In supporting the international sales growth of U.S. manufacturers and distributors in developed markets, Finance and Credit Companies are themselves forced into competition with foreign-owned companies offering the same or similar leasing and financing services. In addition to U.S. trade policy (as explained below in Section III of this statement) the U.S. tax regime plays an important role in the ability of Finance and Credit Companies to participate fully in the opportunities available in these markets. To the extent Finance and Credit Companies are competitively disadvantaged by U.S. tax policy, U.S. manufacturers and distributors either are prevented from competing with their counterparts or must seek leasing and financing support from foreign-owned companies operating outside the United States.

In emerging markets, U.S. tax policy should not unduly burden a Finance and Credit Company attempting to support affiliate sales. For example, where a local financing industry is incapable of supporting sales –such as in India, Indonesia, or Russia – Finance and Credit Company affiliates of U.S. auto makers sometimes accompany or precede the manufacturing or sales affiliate, to provide retail and wholesale financing of vehicle sales. Often, Finance and Credit Companies affiliated with the auto industry are the lenders of last resort (at non-usurious rates) to dealers selling an affiliate's cars.

III. The Imposition Of A Current U.S. Tax On A Finance and Credit Company's Undistributed Active Financial Services Income Has An Anti-Competitive Effect

As an exception to the general rule of deferral, the Congress enacted the *anti*-deferral rules of Subpart F of the Code in 1962,[4] to limit deferral to cases where the taxpayer is engaged in *bona fide* business activities. As originally enacted and as justified in subsequent amendments, Subpart F is aimed at

[3] See the summary of a National Bureau of Economic Research working paper published in *Business Week* (October 14, 1996) page 30 (citing economists, Robert E. Lipsey, Magnus Blomstrom, and Eric D. Ramstetter).

[4] Excepted as noted, all references to the "Code" are to the Internal Revenue Code of 1986, as amended, and all references to "Sections" are to sections therein.

"mobile" or "tax haven inc ome – *i.e.*, income that can easily be shifted to low-tax jurisdictions where the taxpayer has no significant business presence. Passive income is targeted because it is mobile and *in certain cases* can just as easily be earned in the United States. In this regard, the post-1962 legislative history of Subpart F affirms the long-standing tax policy goal of striking a reasonable balance between the need to guard against the potential for abuse and the ability of U.S. businesses to compete abroad. As explained more fully below, however, the current version of Subpart F upsets the balance that was reached in 1962 by discriminating against income earned by Finance and Credit Companies in the active conduct of a financial services business.

A. The Active Financial Services Income Derived By Finance and Credit Companies Is Inappropriately Treated In The Same Manner As Passive, Investment Income.

There is no tax policy reason for treating active financial services income earned by a Finance and Credit Company differently from income earned by manufacturers. Although a Finance and Credit Company earns "interest" and "rent" through the conduct of an active financial services business, its income is treated as passive and subjected to the anti-deferral rules of Subpart F:

- *All interest* income, including that arising from finance leases, conditional sales, and straight loans, is treated as Subpart F income, subject to two limited exceptions.[5]

- *Rental income* earned on true, operating, leases is similarly taxable under Subpart F, subject to the limited "active rent" exception of Section 954(c)(2)(A). Under regulations interpreting the "active rent" exception to Subpart F, the availability of deferral often turns on whether a Finance and Credit Company happens to come within a safe harbor that requires active leasing expenses (exclusive of rent, depreciation and similar deductions that would be allowed to a domestic corporation by a Section other than Section 162) to be at least equal to 25% of leasing profits. Generally speaking, an efficient Finance and Credit Company leasing operation will fail to meet the limited safe harbor. The 25% safe harbor may be available in the start-up phase of a leasing business but as efficiencies are realized the 25% safe harbor becomes more difficult to attain. In addition, the 70% full inclusion rule of Section 954(b)(3)(B) often trumps the "active rent" exception.

1. The "High Tax" exception to Subpart F fails to serve the intended function of providing relief to business transactions that were not undertaken for the purpose of deferring U.S. tax. Finance and Credit Companies receive little relief under the Subpart F exception for passive income that has been subject to an effective foreign tax rate greater than 90 percent of the maximum U.S. corporate tax rate. Although a large part of the earnings of international leasing and financing companies are earned in high-tax jurisdictions, much of this income may not be subject to a high foreign tax rate on a current basis, due to tax accounting and other differences between the U.S. and foreign tax systems.

By way of example, many countries (such as Germany) provide tax incentives for capital investment, such as accelerated depreciation. In such a country, a leasing transaction entered into by a Finance and Credit Company may receive U.S. tax accounting treatment (slower depreciation and therefore higher earnings and profits than "home country" taxable income) that differs substantially from the treatment in the foreign taxing jurisdiction. As a result of timing differences between the amount of income reported for U.S. and foreign purposes, the "high tax" exception often will not provide relief from current taxation of a Finance and Credit Company's profits. Consequently, the Finance and Credit Company is placed at a competitive pricing disadvantage, because it is effectively denied the benefit of local accelerated depreciation made available to foreign competitors.

[5] The exceptions are for export financing interest from banking activities and interest paid by a related corporation, organized in the same foreign country as the recipient.

2. *In addition to the application of Subpart F, Finance and Credit Companies are subject to the regime for passive foreign investment companies ("PFICs").* The PFIC rules were enacted for the stated purpose of curtailing the use of foreign mutual funds to obtain deferral, but they can apply to any Finance and Credit Company whose active business assets (such as accounts receivable generated by consumer loans) necessarily generate the kind of income that is currently treated as passive. The PFIC rules are even more onerous than those of Subpart F because they impose a current U.S. tax on *all* of a PFIC's income, regardless of whether the income is passive in nature. Thus, for example, even if a Finance and Credit Company qualifies an item of income under the "active rent" exception to Subpart F, the PFIC rules can still eliminate deferral.

The PFIC rules unfairly discriminate against Finance and Credit Companies because they do not clearly provide a net operating loss (" NOL") regime similar to the "active deficit" rules found in Subpart F. If a Finance and Credit Company has a deficit in its earnings for the year, it generally will be unable to carry the loss forward to future years, even though its U.S. -owned banking competitors are entitled to use the Subpart F deficit regime to offset Subpart F earnings in future years. The rationale for the absence of an NOL rule under the PFIC regime – *viz.*, the intended impact on "incorporated pocketbooks" in tax havens and foreign mutual funds – does not apply to the very active operations maintained by Finance and Credit Companies.

The PFIC rules were amended in 1993 to add the securities industry to a list of exceptions that already included banks and insurance companies. Thus, while the Congress has explicitly recognized the active nature of banking, insurance, and broker-dealer securities firms, Finance and Credit Companies remain outside of the PFIC exceptions for no apparent tax policy reason. In addition to the restoration of deferral for Finance and Credit Companies (discussed in detail in Section IV of this statement, below), current law should be amended to end the disparate treatment of banks and non-banking entities conducting substantially similar businesses, by providing an exception from the PFIC rules for Finance and Credit Companies.

3. *Concerns regarding the "mobility" of passive income should be addressed without impairing the international competitiveness of legitimate business operations.* The legitimate business transactions executed by Finance and Credit Companies are plainly distinguishable from the type of tax-motivated incorporations that prompted the Congress to expand Subpart F and enact the PFIC rules in the Tax Reform Act of 1986. As explained by the staff of the Joint Committee on Taxation, the Congress acted on the belief that "the lending of money is an activity that can often be located in any convenient jurisdiction, simply by incorporating an entity in that jurisdiction and booking loans through that entity, even if the source of the funds, the use of the funds, and substantial activities connected with the loans are located elsewhere."[6]

The active financial services income derived by Finance and Credit Companies is not susceptible to the kind of manipulation described as the basis for the 1986 amendments. Rather, as described above, Finance and Credit Companies are established, capitalized, operated, and managed locally for business, regulatory, and legal reasons. The cross-jurisdictional business that does occur (*e.g.*, one Finance and Credit Company owned by an auto maker has branch activity within the economically integrated regions of the EU) is not dictated by U.S. tax costs. Finance and Credit Companies establish active operations in foreign countries in order to service their clients. These operations involve substantial investments and numbers of employees, and are not "movable" to take advantage of tax havens.

4. *A Finance and Credit Company's active financial services business qualifies as an active trade or business for every other purpose of the Code.* Statutory requirements for the "active conduct of a trade or business" are found both in Section 355 (providing tax-free treatment for certain reorganizations involving the division of one or more active trades or businesses) and Section 367 (providing tax-free treatment for incorporations and reorganizations involving foreign corporations). In general, outside of

[6] *General Explanation of the Tax Reform Act* of 1986 (May 4, 1987) at page 966.

Subpart F, a corporation is treated as engaged in an active trade or business if its officers and employees carry out substantial managerial and operational activities. As described above (in section I.B.1 of this statement), Finance and Credit Companies perform active and substantial management and operations functions that constitute "active" businesses under both Section 355 and Section 367.

5. ***Current law already provides a starting point for defining the active financial services income derived by Finance and Credit Companies.*** In 1993 testimony before a House Ways and Means Subcommittee regarding the PFIC exclusions for certain financial services entities that earn interest income by virtue of the nature of their business activities, the (then) Assistant Treasury Secretary for Tax Policy cited "major administrative problems" as the basis for distinguishing between the entities excepted from the PFIC rules and other sectors of the financial services industry. Both the Congress and the Internal Revenue Service have defined financial services entities to include Finance and Credit Companies, for purposes of the separate foreign tax credit ("FTC") limitation on financial services income. The Conference Report on the Tax Reform Act of 1986 provided a general definition of a financial services entity as one that is predominately engaged in the active conduct of a banking, insurance, financing or similar business.[7] In turn, the Internal Revenue Service ("IRS") prescribed a bright-line test, defining a financial services entity as one that derives 80% or more of its gross income from active financing income.[8] This test may require some adjustment for Finance and Credit Company purposes. One situation where an adjustment would be appropriate is where a Finance and Credit Company does not qualify as a financial services entity because it conducts a substantial business in operating leases.[9] In that case, the operating lease business that precludes financial services entity status is clearly not passive.[10] This active financing business should not fall outside the scope of any legislative solution directed toward Finance and Credit Companies. The same definition formulated to exempt a Finance and Credit Company's active financing income from Subpart F should also apply to provide an exception from the PFIC rules.

B. Deferral is Necessary To Allow Finance and Credit Companies To Compete Effectively In Foreign Financial Centers.

Deferral would advance competitiveness by insuring that Finance and Credit Companies engaged in business in a foreign country are taxed in a manner consistent with their foreign counterparts. Countries in which the parent companies of major financial institutions are organized generally refrain from taxing the active financing income earned by foreign subsidiaries. Thus, the lack of deferral places Finance and Credit Companies at a significant competitive disadvantage in any third country having a lower effective tax rate (or a narrower current tax base) than the United States (because the Finance and Credit Company will pay a residual U.S. tax in addition to the foreign income tax).

The lack of deferral hinders the ability of a Finance and Credit Company to bid competitively against its foreign counterparts. As explained more fully above, timing differences between the calculation of U.S. income and income taxable by a foreign country often result in Finance and Credit Companies being subject to residual U.S. tax on Subpart F income that represents a tremendous cash flow disadvantage. These disadvantages weaken a Finance and Credit Company's competitiveness, because – in view of the relatively low profit margins in the international financing markets – these tax costs must be passed on to customers in the form of higher financing rates. Obviously, foreign customers can avoid higher financing costs by obtaining financing from a foreign-controlled finance company that is not burdened by current home-country taxation, or – in the case of Finance and Credit Companies financing third-party purchases of an affiliate's product – purchasing the product from a foreign manufacturer offering a lower all-in cost.

[7] at II-571.

[8] Treas. Reg. Section 1.904-4(e)(3)(i).

[9] See Treas. Reg. Section 1.904-4(e)(2)(i)(V).

[10] Treas. Reg. section 1.904-4(b)(2)(i).

IV. The Ad Hoc Group Of Finance and Credit Companies Urges The Reinstatement Of An "Active Financing" Exception To Subpart F.

The *ad hoc* group of Finance and Credit Companies seeks legislation to address the anomalous treatment of the financial services industry under Subpart F, and the inexplicable omission of Finance and Credit Companies from the list of financial services entities that are currently exempted from the PFIC rules. This proposal can be appropriately implemented as a stand-alone amendment to the U.S. international tax regime (e.g., in the tax title of a Budget Reconciliation bill that includes other amendments to Subpart F) or as part of a more comprehensive reform package (such as H.R. 1690 and S. 2086, the International Tax Simplifications bills that were introduced in the House and Senate, respectively, during the last Congress).

Concerns about the use of controlled foreign corporations to route income through tax haven countries can be addressed by a limitation such as the provision that was included in S. 2086; that bill would provide an exception from Subpart F for active financing income, but only in the case of a corporation "predominantly engaged in the active conduct" of a financing business. For purposes of this rule, the definition of "predominantly engaged" would require the corporation to derive more than 70 percent of its gross income from transactions with unrelated persons, and more than 20 percent from unrelated persons located within the corporation's home country. Of course, other approaches are possible, consistent with the goal of developing reasonable rules that distinguish between a Finance and Credit Company that has an active business presence in its home country and a case where profits are merely isolated in a low-tax jurisdiction. In any case, particularly in view of the business reasons for using branch operations within the EU, it would be appropriate to allow for the use of branches that generate active financing income by providing an exception for qualified branches of Finance and Credit Companies.

The statutory limitation proposed in S. 2086 would allow for the case where a portion of a Finance and Credit Company's active financial services income is derived (through a branch or a separate entity) from transactions with unrelated persons within the same economic region, such as the European Union – such a limited exception would be consistent with provisions of Subpart F that reflect concerns about income shifting to low-tax countries. The "same country exception" to Subpart F applies to dividends and interest received by a controlled foreign corporation from a related person organized and engaged in a trade or business in the same foreign country – this is a circumstance where the U.S. tax would have been deferred on the active income out of which the dividends and interest are paid in any event. Similarly, income from services performed in a controlled foreign corporation's home country is excepted from Subpart F.[9] In addition, the current taxation of foreign base company sales income is subject to exceptions where a controlled foreign corporation manufacturers or constructs the property sold, or the goods are intended for use or disposition in the home country. In the case of a financial intermediation business such as that conducted by a Finance and Credit Company, a similar exception should apply where the Finance and Credit Company originates a financial transaction in its own right.

The *ad hoc* group of Finance and Credit Companies urges the Senate Committee On Finance to remedy the current categorization of a Finance and Credit Company's income as passive for Subpart F purposes, and to address the current unfairness in the PFIC rule that discriminates between "licensed" financial institutions (such as banks) and Finance and Credit Companies. The members of the *ad hoc* group would be happy to work with the Committee On Finance to accomplish this important legislative goal.

[9] See Section 954(e)(1)(B).

Statement Of Washington Counsel, P.C., Attorneys-at-Law
on the
Administration's FY1998 Budget Proposal
To Require Gain Recognition On Certain Distributions Of Controlled Corporation Stock (the "*Morris Trust* Proposal")
Submitted for the Record of the Hearing before the
Senate Committee on Finance
on April 17, 1997

Washington Counsel, P.C. is a law firm based in the District of Columbia that represents a variety of clients on tax legislative and policy issues.

The *Morris Trust* Proposal is seriously flawed and, if enacted as proposed, would threaten major disruptions in legitimate corporate restructurings. The proposal would effect a fundamental change in tax policy, based on anecdotal reports of a limited number of transactions that are perceived by some as being abusive. In addition, the *Morris Trust* Proposal is not necessarily consistent with the efforts underway in this Congress – *viz.*, to reduce tax on capital gains, provide increased flexibility for the telecommunication, entertainment, utility, and other industries to respond to the changing regulatory environment, and lay the foundation for fundamental tax reform.

This statement also addresses the need to provide transition relief for taxpayers who are complying with current law – failure to provide transition relief, should the proposal move forward, would result in a retroactive tax increase on affected corporations.

Summary of the Administration's *Morris Trust* Proposal

The *Morris Trust* Proposal would require taxable gain recognition for certain Section 355[1] transactions that take the form of "spin-offs" – *i.e.*, *pro rata* distributions of subsidiary stock where shareholder-distributees surrender no stock in the distributing corporation. Based on the Administration's stated rationale that "corporate nonrecognition under Section 355 should not apply to distributions that are effectively dispositions of a business," the proposal would deny tax-free treatment to the distributing corporation in a spin-off, unless its shareholders hold stock representing 50 percent of the vote and value in both the distributing and the controlled subsidiary for a four-year period beginning two years prior to the spin-off. Thus, tax-free treatment could be denied where a spin-off is followed by the tax-free merger of the distributing corporation into another corporation, even where the only consideration received by the shareholders is stock representing a continuing proprietary interest in the distributing corporation. In this example, the arbitrary 50-percent test under the proposal would allow tax-free treatment

[1] Unless otherwise noted, references to a "Section" are to the Internal Revenue Code of 1986, as amended.

only in the event of a subsequent merger party that is exactly equal in value to – or of lesser value than – the distributing corporation.

I. Current Law Serves Its Intended Purpose Of Allowing Shareholders To Rearrange Their Investments Without Triggering A Tax On The Appreciation In Value Of A Business's Underlying Assets.

Like other tax-free reorganization provisions, Section 355 is premised on the theory that a corporate restructuring is not an appropriate time to impose a tax, to the extent that a taxpayer's investment remains in corporate solution, and a distribution of stock represents merely a new form of participation in a continuing enterprise.[2] Consistent with the theory of tax-free reorganizations, Section 355 permits a corporation to distribute the stock in a controlled subsidiary to shareholders without triggering tax at the shareholder or corporate level.

Section 355 transactions are better policed than other corporate reorganizations. Under the statutory requirements applicable to a tax-free Section 355 spin-off, the distributing corporation must distribute stock representing an 80-percent controlling interest, and both the distributing corporation and the controlled subsidiary must be engaged in an active five-year old business following the distribution. Moreover, Treasury regulations condition the application of Section 355 on the distributing corporation's ability to establish the existence of a valid business purpose for a spin-off.[3] For over thirty years, both the courts and the Internal Revenue Service ("IRS") have examined these transactions and permitted corporations to utilize tax-free spin-offs of an unwanted business to facilitate the *tax-free* acquisition of either the distributing corporation or the spun-off subsidiary [4] – referred to as a "*Morris Trust*" transaction after the case (cited in note 4 below).

A *Morris Trust* transaction simply combines two tax-free reorganizations. Consistent with the theory of the reorganization provisions, shareholders who receive stock of a spun-off subsidiary and then participate in a second reorganization, retain continuing proprietary interests via stock received in both transactions. As observed by the court in the *Morris Trust* case, these transactions involve "no empty formalism, no utilization of empty corporate structures, no attempt to recast a taxable transaction in nontaxable form, and *no withdrawal of liquid assets* (emphasis added)."

[2] See generally, Bittker And Eustice, *Federal Income Taxation of Corporations and Shareholders*, 12.01[3] regarding "General Theory for Tax-free Treatment."

[3] Treasury reg. sec. 1.355-2(b).

[4] *See Commissioner v. Morris Trust, 367 F.* 2d *794 (*4th *Cir.* 1966) (subsequent reorganization involving the distributing corporation); Rev. Rul. 68-603, 1968-2 C.B. 148 (where the Internal Revenue Service accepted the holding of the *Morris Trust* case); Rev. Rul 76-527, 1976-2 C.B. 103 ("blessing" a "reverse Morris Trust" where the spun-off subsidiary was party to a subsequent reorganization); and Rev. Proc. 96-30 (issued on May 6, 1997, after the Administration first unveiled the proposal in question, and explicitly recognizing the valid business purpose of a *Morris Trust* transaction).

II. The Administration'ɛ *Morris Trust* Proposal is Fundamentally Flawed.

The Administration's Morris Trust Proposal is flawed, in that it is overly broad, inconsistent with the movement toward fundamental tax reform and current efforts to reduce the cost of capital and lower the capital gains tax rate, and would impose a "new" capital gains tax on legitimate transactions. Moreover, in certain cases, the proposal would tax the *wrong* capital gain.

A. The *Morris Trust* Proposal Is Overly Broad.

The *Morris Trust* Proposal would impinge on the ability of corporations to effect restructurings at a time when many businesses feel compelled to concentrate industries, separate, or combine to remain competitive in changing market and regulatory environments. As an unintended consequence of enacting the proposal, companies would be forced to maintain inefficient business structures or incur additional tax. As explained more fully below, any perceived problems can be addressed without penalizing all *Morris Trust* transactions.

The *Morris Trust* Proposal goes far beyond the intended goa! of preventing tax-free disguised sales of businesses.[5] Reportedly, the *Morris Trust* proposal was prompted by several widely publicized transactions in which a spin-off we combined with an acquisitive, tax-free reorganization, and it appeared that newly incurred debt was used as a device to pay a cash purchase price for the company acquired in the reorganization. The concern raised by these transactions was highlighted by the use of a spin-off in the disposition of Viacom Inc.'s cable business to TCI, with respect to which the IRS issued a favorable Section 355 ruling in 1996. There, as reported by *Newsweek* and the April 3, 1996 edition of *Tax Notes Today*, a Viacom subsidiary holding a cable business incurred $1.7 billion of new debt, spun off its non-cable business plus the cash proceeds of the borrowing to its corporate parent, and was then effectively "acquired" by virtue of the issuance of stock to TCI in exchange for cash. In short, it appears that liability for the new debt was assumed by TCI, while the cash generated by the borrowing went to the spun-off business that was retained by historic shareholders. The Viacom transaction was followed by similar deals where the assumption of debt "overwhelmed" the value of the stock that exchanged hands – *e.g.*, El Paso's acquisition of a Tennoco subsidiary in exchange for stock valued at about $914 million plus the assumption of $3.6 billion in liabilities. The perceived abuse in these cases is that the combined spin-off/reorganization constitutes a "disguised sale." Clearly, the *Morris Trust* Proposal goes far beyond this type of transaction.

To the extent that the identified abuse motivating the *Morris Trust* proposal involves the issuance of new debt that will be repaid by the acquirer, the solution offered is not responsive to the real issue. The proposal goes far beyond what is needed to

[5] *See* Statement of Donald C. Lubick, Acting Assistant Secretary (Tax Policy), Department of the Treasury, Before the House Ways and Means Committee (March 5, 1997).

prevent the use of Section 355 to effect disguised sales, because the proposal would apply even where a debt-free company is acquired. It must also be recognized that the assumption of liabilities in the course of a spin-off is a commonplace transaction, and care should be taken to distinguish cases where a corporation has normal business borrowings that remain with the business that generated the need for the debt. **Should the Committee adopt a provision that targets cases where a spun-off subsidiary has debt in excess of tax basis, as has been proposed by others, we would urge the inclusion of a safe harbor for debt that was incurred more than two years before the spin-off. A two-year period applicable to debt would be consistent with the window proposed by the Administration under the general rule to trigger gain recognition.**

B. The *Morris Trust* Proposal is Antithetical to Fundamental Tax Reform, to the Extent it Would Exacerbate Problems Associated With the Double Taxation of Corporate Income.

One of the fundamental goals of Structural Tax Reform is to integrate the corporate and individual tax systems – to prevent the imposition of "double tax" on income earned by corporations. The effect of the *Morris Trust* proposal would be to create a new potential for two levels of tax on a corporation's distribution of controlled subsidiary stock – one tax based on the distributing corporation's gain and another based on gain at the shareholder level.

Double taxation is particularly egregious when applied to appreciation in value of a corporation's original capital. Current law appropriately avoids double taxation in the case of an in-kind distribution of stock in a controlled subsidiary, where the distribution is made to historic shareholders and the controlled subsidiary is engaged in an ongoing business. Neither should taxation be required if shareholders maintain a continuing equity interest in a combined enterprise that includes the capital originally invested in an on-going business. The proposal, however, would trigger gain recognition by the distributing corporation in a spin-off, where the distributee/shareholders maintain an indirect ownership interest through stock received in a subsequent reorganization of the spun-off subsidiary.

The existing "double tax" regime already places U.S. corporations at a competitive disadvantage in worldwide capital markets. Multiple levels of taxation raise the financing costs for corporations, and generally reduce incentives for capital formation. Moreover, "double taxation" creates global competitiveness problems, because many of our major trading partners (e.g., Germany, the United Kingdom, and Japan) have some mechanism for integrating the corporate- and shareholder-level taxes. Thus, the *Morris Trust* Proposal would undermine efforts to prevent our tax system from unduly burdening U.S. companies competing in international markets.

C. The *Morris Trust* Proposal is Clearly Inconsistent With Current Efforts To Lower the Capital Gains Tax Rate.

The *Morris Trust* Proposal would impose a "new" capital gains tax on the appreciation in value of underlying corporate assets, representing gain that may be largely inflationary. This proposal is particularly questionable at a time when many in Congress are looking for ways to eliminate the taxation of inflationary gains (*e.g.*, by indexing the basis of capital assets).

Moreover, at a time when Congress is considering a reduction in the capital gains tax, it would be inconsistent and counterproductive to adopt a proposal that creates a "new" capital gains tax. A "new" capital gains tax would be created because the proposal would trigger recognition of gain that is untaxed under current law. The capital gains tax resulting from application of the proposal would thus further interfere with the market's allocation of capital.

D. The Morris Trust Proposal Would Apply *Incorrectly* to Tax the Appreciation in Value of Assets Retained by Historic Shareholders.

Upon a subsequent merger of the *distributing corporation* in a spin-off, the *Morris Trust* Proposal would apply to treat stock in the *controlled subsidiary* as "disqualified" consideration. Under Section 355(c), the distributing corporation's recognized gain would be measured by the difference between the value of the stock in the spun-off subsidiary and the basis in that stock. Thus, rather than taxing the appreciation in value of the business viewed as disposed of, the proposal would result in a tax on the business that is retained by historic shareholders. These issues clearly require more thought and analysis before the Ways and Means Committee acts to tax ordinary spin-off and merger activity.

IV. The Most Troubling Aspect of the *Morris Trust* Proposal Is Its Retroactive Application To Taxpayers Who are Complying With Current Law.

In any event, Should a *Morris Trust* Proposal go forward, the Ways and Means Committee should provide for prospective application. As proposed, the *Morris Trust* Proposal would apply to a transaction that is completed before the date of enactment but after the date of "first committee action." Notably, the proposed effective date is arbitrary and capricious, in that taxpayers who entered into binding commitments before the proposal was announced could be caught, while other taxpayers who have yet to make commitments would be unaffected if they complete transactions before the date of first committee action. In this regard, the Chairmen of both the Senate Finance Committee and the House Ways and Means Committee have expressed concerns that tax changes not be retroactive, and that proposed corporate tax changes be prospective to avoid disrupting normal market activities during the period of deliberation.[6]

Failure to provide a prospective effective date, should this proposal move forward, would result in a retroactive tax increase on affected corporations. The only guidance now available to taxpayers caught in the midst of transactions that cannot be completed before the "date of first committee action" are the transition rules proposed by the Administration when the *Morris Trust* Proposal was first offered in the President's FY1997 Budget. Recognizing the need for appropriate transition relief, the Administration proposed grandfather rules for distributions meeting any one of the following three tests:

(1) made pursuant to a written agreement in effect on the effective date;

(2) described in a ruling request filed with the IRS on or before that date; or

(3) described in a public announcement or filing with the Securities and Exchange Commission on or before that date.

We urge the Committee to include, at a minimum, similar transition rules with a "date of enactment" effective date. In view of the fact that *Morris Trust* transactions have been accepted and approved by the courts and the IRS for over 30 years, it would be inappropriate to impose a restrictive effective date with no transition relief – treatment that is normally reserved for anti-abuse legislation. Taxpayers who have incurred substantial transactional costs in reliance on current law should not be penalized by a retroactive enactment.

The affected transactions often take months to consummate even after the signing of binding commitments and required filings with government agencies. Similar to the Administration's transition rule proposal in the FY1997 Budget, the parties to a contract should be allowed to condition a written agreement on the buyer's performance of due diligence, or on approval by the target corporation's Board of Directors or shareholders. This result would be consistent with precedents for treating a contract as binding even if subject to a condition, as long as the condition is not within the control of either party.[7]

[6] On March 29, 1996, after the Administration first announced the *Morris Trust* Proposal and other corporate tax changes, Ways and Means Committee Chairman Bill Archer and Senate Finance Committee Chairman William Roth issued a joint statement to this effect.
[7] *See* page 352 of the *General Explanation of the Tax Reform Act of 1986* – in the context of the *General Utilities* repeal: "An acquisition of stock or assets will be considered made pursuant to a binding contract even though the contract is subject to normal commercial due diligence or similar provisions and the final terms of the acquisition may vary pursuant to such provisions."

Notably, the transition rules proposed in the FY1997 Budget would not constitute "limited tax benefits" subject to the Line Item Veto Act (Public Law 104-130).[8] The statute excepts "binding contract" rules, and thus the proposal for "written agreements in effect" should not implicate the Line Item Veto Act.[9] In the case of other transitional-relief provisions, the number of beneficiaries that triggers veto authority is 10 or fewer. Regarding the grounds for excluding the other two proposed rules (*viz.*, an IRS ruling request and public announcement) from application of the Line Item Veto Act, based on our information and belief, there are many more than 10 transactions to which each of the proposed transition rules would apply.

[8] . We note that the Line Item Veto Act has been declared unconstitutional by a federal co ırt, but include this discussion in case that decision is reversed.

[9] Section 1026(9)(C) of the Line Item Veto Act provides an exception for transitional relief provided with respect to all binding contracts or other legally enforceable obligations in existence on a date contemporaneous with congressional action specifying the date.