CERTAIN COMMITTEE AMENDMENTS TO H.R. 10612

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FOURTH CONGRESS

SECOND SESSION

ON

CERTAIN COMMITTEE AMENDMENTS TO

H.R. 10612

JULY 20, 21, AND 22, 1976

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CERTAIN COMMITTEE AMENDMENTS TO H.R. 10612

THURSDAY, JULY 22, 1976

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met at 8:05 a.m., pursuant to recess, in room 2221, Dirksen Senate Office Building, Senator Russell B. Long (chairman of the committee) presiding.

Present: Senators Long, Talmadge, Ribicoff, Byrd, Jr., of Virginia, Nelson, Gravel, Bentsen, Curtis, Fannin, Hansen, and Dole.

Senator RIBICOFF (presiding). The committee will be in order.

Our first witness today is Mr. Filer.

Mr. Filer, you may proceed, sir.

[The prepared statement of Mr. John H. Filer follows:]

STATEMENT OF JOHN H. FILER

SUMMARY

1. Section 1508 of H.R. 10612 allows the filing of consolidated returns by both life insurance companies and mutual property-casualty insurance companies with their non-life affiliates, and thus eliminates existing discrimination against such companies by according them the same consolidation privilege that has long been enjoyed by industrial companies with non-life affiliates.
2. Through consolidation, section 1508 will permit immediate, rather than delayed, use of the tax benefits derived from losses that would otherwise shrink the insurance writing capital base of casualty affiliates. In that way, the provision will help to preserve the capacity of such companies to write insurance at precisely the time when the public interest most urgently requires the maintenance and increase in that capacity. It also will eliminate pressures which distort the investment policies of casualty affiliates to the detriment of capital markets.
3. The amendment has been fully and openly presented to both tax-writing committees of Congress. It was the subject of a hearing by this Committee in April of this year, when all interested parties had a full opportunity to present their views. It has also received favorable comment from the Joint Committee Staff, the Treasury Department and the Administration.
4. Section 1508 corrects a tax inequity, and helps alleviate a serious social and economic problem. In its presently modified form, it is a sound provision which should be retained in the bill.

STATEMENT

Mr. Chairman and members of the committee, my name is John H. Filer. I am Chairman of the Aetna Life & Casualty Co. of Hartford, Connecticut.

I am appearing today, as I had the privilege of appearing at your hearing on April 5, 1976, on behalf of an ad hoc group of twelve[1] stock and mutual life

[1] The twelve companies are: Aetna Life & Casualty, Hartford; CNA Financial Corp., Chicago; Connecticut General Life Insurance Company, Hartford; Equitable Life Assurance Society of the U.S., New York; Fidelity Mutual Life Insurance Company, Philadelphia; IDS Life Insurance Company, Minneapolis; Metropolitan Life Insurance Company, New York; Penn Mutual Life Insurance Company, Philadelphia; Prudential Insurance Company of America, Newark; Reserve Life Insurance Company, Dallas; State Mutual Life Assurance Company of America, Worcester; and Travelers Insurance Company, Hartford.

insurance companies to urge your support of what is now section 1508 of H.R. 10612. Section 1508 eliminates existing discrimination in the Internal Revenue Code, by allowing both life insurance companies and mutual property-casualty insurance companies to file consolidated returns with their non-life affiliates, a privilege that has long been accorded industrial companies with such affiliates.

As I explained in my prior testimony, the recent severe losses incurred by the property-casualty insurance industry have dramatically accelerated the erosion of its surplus position. Since surplus is the ultimate measure of capacity to insure risks, the result has been to place severe limits on both new risk assumption and the renewal of existing coverage by casualty insurance companies. Consolidation as contemplated by section 1508 would permit the tax savings attributable to the losses of a casualty affiliate to be recognized and assigned immediately to the affiliate, thereby easing its surplus crisis on a current, rather than a delayed, basis. By permitting immediate recognition of losses, consolidation would also eliminate present pressures to distort the investment policies of casualty affiliates in a way that would be detrimental to the capital market for corporate equities and state and municipal bonds. In short, consolidation will have its most significant effect when losses threaten further shrinkage of the capital base of the casualty industry, and that is precisely the time when the public most urgently needs insurance capacity to be maintained and increased.

In its present form, section 1508 contains several modifications of the original proposal with respect to which I previously testified. These include a 50 percent limit on losses of affiliates that may be offset against life insurance company taxable income in any one year, a delayed effective date of January 1, 1978, and an elective provision. These modifications reflect a careful balancing of various interests affected by the provision, without detracting from its overall objectives. Accordingly, I am pleased to indicate our continued strong support for section 1508 today.

In addition, through this statement I would like to furnish the Committee with a complete chronology of the genesis of section 1508, so as to dispel any doubts regarding the full and complete consideration it has received by the Congressional tax-writing committees.

On April 27, 1973, over three years ago, a statement on the subject from counsel for our ad hoc group was filed with the House Ways and Means Committee and printed in its Hearings on Tax Reform.

On July 25, 1973, the statement together with lengthy, additional detailed memoranda were submitted to the Staffs of the Joint Committee on Internal Revenue Taxation and the Treasury Department for their review and analysis.

House and Senate bills on this subject have been before the Congress since January, 1975.

On September 15, 1975, Tax Analysts and Advocates analyzed the proposal in its publication, Tax Notes.

In February 1976, the proponents of the amendment requested permission to testify orally at the Senate Finance Committee hearings on tax reform.

In April 1976, I appeared before the Committee in support of the provision, and two groups opposed to the provision filed written testimony with the Committee.

On May 25, 1976, the Treasury Department submitted a written report to Chairman Long, stating it was not opposed to the concept of consolidation embodied in the original proposal.

On May 27, 1976, the Finance Committee discussed and debated the proposal as it was presented by Senator Ribicoff in open session. Favorable comment was secured from the Joint Committee Staff. The Treasury Department also restated its views at that session. The Committee then approved the amendment, with the modifications I mentioned earlier, on a roll call vote.

On June 15, 1976, after the Committee reported the bill, the Administration stated that it had "no objection" to section 1508.

It is apparent, therefore, that the amendment has been fully and openly presented to the tax-writing committees of Congress. It was in fact the subject of a hearing by this Committee in April of this year, when all interested parties had a full opportunity to present their views before the Committee reached its decision to adopt the proposal in its present form and include it in the pending bill.

For these reasons, we believe it is clear that section 1508 has received full and careful consideration by the Committee. The provision corrects a tax inequity, and helps alleviate a serious social and economic problem. We urge its retention in the bill.

STATEMENT OF JOHN H. FILER, CHAIRMAN, AETNA LIFE & CASUALTY CO., HARTFORD, CONN.

Mr. FILER. Mr. Chairman, members of the committee, my name is John H. Filer. I am chairman of the Aetna Life & Casualty Co.

With me is Mr. Mortimer Caplin, our counsel.

I am appearing today, as I had the privilege to appear at your hearing on April 5th, on behalf of an ad hoc group of twelve stock and mutual life insurance companies, to urge your support of what is now section 1508 of H.R. 10612. Section 1058 eliminates existing discrimination in the Internal Revenue Code by allowing both life insurance companies and mutual property-casualty insurance companies to file consolidated returns with their nonlife affiliates, a privilege that has long been accorded industrial companies with such affiliates.

I have filed a written statement which I request be put in the record, and would like to make just a few brief comments in summary.

First, with respect to the chronology of the provision, of the extent to which this portion of the bill has been considered, it was over 3 years ago that a statement on this subject by counsel for our ad hoc group was first filed with the Ways and Means Committee and printed in its hearings on tax reform.

Three years ago, that statement, together with additional detailed memorandums, were submitted to the staffs of the Joint Committee on Internal Revenue Taxation and the Treasury Department for their review and analysis.

Bills on this subject have been before the Congress since January 1975.

In February of this year we requested permission to testify before this committee. Early in April I did appear before the committee in support of the provision, and two groups opposed to the provision filed written testimony with the committee.

And late in May the Treasury Department submitted a written report to the chairman of the committee, stating that it was not opposed to the concept of consolidation embodied in the original proposal.

Late in May, this committee, as you know, discussed the proposal as it was presented by Senator Ribicoff in open session. And favorable comment at that time was submitted from the Joint Committee staff. The Treasury Department also restated its views at that session. The committee then approved the amendment, with modifications, on a rollcall vote.

As to the substance of the bill, as I explained in my earlier testimony, it is the severe losses incurred by the property-casualty insurance industry in the last year to 18 months that quite dramatically accelerated the erosion of the surplus position of the entire industry. Since surplus is the ultimate measure of capacity to insure risks, the result has been to place severe limits on new risk assumption and the renewal of existing coverage by casualty insurance companies. Consolidation as contemplated by section 1508 would permit a portion of the tax savings attributable to the losses of a casualty affiliate to be recognized and assigned immediately to the affiliate, thereby easing its surplus crisis in part and on a current rather than a delayed basis.

In short, consolidation will have its most significant impact when losses threaten the further shrinkage of the capital base of the casualty

industry. That is the time that the public most urgently needs insurance capacity to be maintained and increased.

To summarize, for these reasons, it is clear that Section 1508 has received full and careful consideration by the committee. The provision, in our judgment, corrects a tax inequity and helps alleviate a serious social and economic problem.

Senator RIBICOFF. Mr. Filer, I regret that you had to come down from Hartford to testify this morning on a subject to which you testified quite extensively on April 5th before this very same committee.

For the benefit of those of my colleagues who have characterized this provision as one adopted at the last minute, without discussion, a special interest amendment, they could be no further from the truth.

I ask that Mr. Filer's April 5 testimony appear in the record at this point.

[The information referred to follows:]

STATEMENT OF JOHN H. FILER, CHAIRMAN, AETNA LIFE & CASUALTY CO., ACCOMPANIED BY JOHN J. CREEDON, SENIOR VICE PRESIDENT AND GENERAL COUNSEL OF THE METROPOLITAN LIFE INSURANCE CO.; AND MORTIMER CAPLIN OF THE FIRM, CAPLIN & DRYSDALE

Mr. FILER. Mr. Chairman, I am John Filer, and I am chairman of the Aetna Life & Casualty Co. of Hartford, Conn.

I am speaking today on behalf of the Aetna and 11 other life insurance companies, large and small, stock and mutual, which with their affiliates also write a variety of other kinds of insurance.

With me today is John Creedon, senior vice president and general counsel of the Metropolitan Life Insurance Co., and on my left, Mortimer Caplin of the firm Caplin & Drysdale, a Washington law firm.

I will summarize our position very briefly and ask that our written statement be made a part of the record.

Senator MONDALE. Very well.

Mr. FILER. We are supporting an amendment to the Code to repeal the present rule which prevents life insurance companies from joining in consolidated tax returns with their property-casualty insurance affiliates or other corporate affiliates.

We believe this amendment, which is reflected in S. 2985 and H.R. 12126, is necessary for two reasons, (a) because it is sound tax policy which will correct the discrimination that has existed for 18 years after the historical reasons for it have disappeared, and (b); because it is sound public policy, which will help to mitigate the serious social and economic problems which now plague the insurance industry as well as the public.

First with respect to the tax policy issues: Permitting corporations with common ownership to file consolidated returns is the general rule in our tax system. Thus, this legislation would not give any special treatment to life insurance companies. It would give them the same treatment which is available to virtually every other corporation in the country. Furthermore, consolidation recognizes business realities. As stated by this committee as long ago as 1918, and I quote: "The principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both for the taxpayer and to the Government."

Prior to 1958, life insurance companies were taxed solely on investment income, excluding capital gains, and this precluded consolidation of life companies with nonlife companies since the latter were generally taxed on a total income basis.

The 1959 Life Insurance Company Taxation Act adopted a total-income approach for life company taxation and, therefore, it is now feasible to consolidate life and nonlife companies, but it is not permitted under specific provisions of the present Internal Revenue Code.

The principal advantage of consolidation, of course, is that it allows current losses of one affiliate to be offset against profits of another. This offset is now permitted for a broad variety of corporations which, like life insurers, are subject to specialized tax provisions. Thus, other types of corporations can consolidate with their property-casualty affiliate and it makes no sense to preclude a life insurance company from doing so as well.

State statutes normally require separate corporations for life and property-casualty operations. So, although forced to incorporate separately, these companies actually function as a single business unit being under common ownership and control. They are separate corporately to protect the policyholders from risks of different types of business. But in many instances they report their financial results as a single consolidated unit, are served by many of the same agents, and use the same actuarial, accounting and claims support. Investment management and overall executive direction are also centralized. So it is clear that an integrated group such as this is a single business unit and should be permitted to be taxed under the normal consolidated return rules.

Turning from tax policy to public policy, it seems to us that the public has a clear stake in this measure.

The insurance industry today is facing a very real capacity shortage in the property-casualty area. Rising claim costs, largely the product of inflationary pressures and increased claims-consciousness, have created severe problems. For the past 2 years most property casualty companies have incurred substantial losses with resulting reductions of surplus. In fact, the prospect of insolvency exists for some companies. In any event, the industry as a whole is in a weakened capital position compared to just a few years ago.

More and more the public has come to believe that insurance is one of its basic rights and indeed insurance is often a necessity. Our ability to serve these insurance needs is the greatest single problem facing the casualty-property insurance business today. The capacity of a company to write insurance depends directly on its surplus. As claims costs have risen faster than premium income increases, surpluses have diminished and therefore so has capacity.

Because of this capacity crisis, insurers are not now fully able to serve the needs of the country for insurance coverage. They must control their premium volume, they must be more stringent in their underwriting, they must insist on higher deductibles and they must write shorter term policies, and this is in fact what they are doing.

Permitting consolidated returns by the companies will not in and of itself solve the capacity problem but it will help substantially. The tax savings resulting from any loss would accrue directly to the property-casualty companies with a favorable impact on their capacity.

It seems to us there are other public benefits as well. First of all in the area of innovation and competition, our changing economy is generating new demands for insurance coverage. Fairly recent examples are fiduciary liability coverage under the requirements of ERISA, municipal bond guarantee insurance, some forms of crop insurance and others. It is crucial that our private system respond to needs such as these. By assuring that the losses from the introduction of new insurance products will be promptly recognized like those of any other new business venture, consolidation will help make possible the capacity and creativity we need from the industry.

Finally, there is the area of investment stability; the property-casualty insurance business is a cyclical one alternating between profits and losses. The fact that consolidation is barred in the industry today leads to undesirable short-term swings in investment policy. One example is the switch from stocks to taxable bonds. Also State and municipal bonds become less attractive, which operates to the detriment of Government entities in need of financing. The amendment would make possible a more consistent investment policy and help maintain more stable capital markets, a goal desired by both private and governmental borrowers.

While the impact of the bar to consolidation on the casualty industry is the problem that we face today, the issue is a general and continuing one. In other conceivable circumstances, such as a significant unfavorable shift in mortality, due for example to a serious epidemic or disaster, it would well be the life insurance companies, not the casualty companies that are hampered by the ban on consolidation. We are not looking for short-term tax advantage but a long-term solution to problems.

In summary, it seems to us the bill corrects a tax inequity; simultaneously it helps to alleviate a serious social and economic problem. Such a combination is rare. We deeply hope for your favorable action this year.

Senator MONDALE. Thank you very much.

Senator Ribicoff?

Senator RIBICOFF. Mr. Chairman, first I would like to point out that not only is Mr. Filer an outstanding insurance executive, but without question one of the most public-spirited men in the State of Connecticut, and I am delighted to see you here with your colleagues, Mr. Filer.

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I am just curious, what other business corporations with common ownership in the United States are prevented from filing consolidated tax returns? I don't recall any——

Mr. CAPLIN. Senator, I am Mortimer Caplin, representing with our firm, Mr. Filer, and the ad hoc group of insurance companies.

Consolidation is the norm. Only a handful of corporations are not permitted to consolidate. They are essentially tax-exempt organizations. For example, tax-exempt orgnizations, per se, are not permitted to consolidate; a foreign corporation which is generally not subject to U.S. tax is not permitted to consolidate; nor are real estate investment trusts which are essentially nontaxable.

And DISC corporations, because again they are essentially nontaxable, cannot consolidate with the rest.

But aside from them, you have very disparate companies which are permitted to consolidate. For example, a cooperative could consolidate. A Western Hemisphere trading corporation, which is not categorized as a foreign corporation, could consolidate.

A bank could consolidate. Natural resources companies could consolidate; personal holding companies, too. So really what the insurance industry is asking is that it be given equal treatment and not be artificially carved out.

Senator RIBICOFF. For the record, Mr. Caplin. I would appreciate it if you would file for the record those corporations with common ownership which are prevented from filing consolidated returns outside the insurance industry, with a short explanation of why or the philosophy of why they are prevented from filing.

Mr. CAPLIN. We wil be very happy to do that.

[The information referred to follows:]

CORPORATIONS EXCLUDED FROM FILING CONSOLIDATED RETURNS

Corporations excluded from filing consolidated returns, other than insurance companies, are either (1) completely exempt from U.S. tax, (2) foreign or possession corporations which are taxed only on income effectively connected with the U.S. or U.S. source income; or (3) not subject to tax because they are in substance treated as "conduits" fo rtheir shareholders (that is, if certain distributions or other rules are met their income is not taxed at the corporate level). Specifically, the kinds of corporations, other than life insurance companies and mutual property liability insurance companies, presently barred by section 1504 (b) from joining in groups filing consolidated returns and the reason for their exclusion are as follows:

Excluded corporations	*Rationale for exclusion*
(1) Corporations exemption from taxation under § 501 (charities, unions, social clubs, etc.).	Tax exempt.
(2) Foreign corporations	Tax exempt, except for income eftively connected with the U.S.[1]
(3) So-called "possessions" corporations, as described in § 931.	Tax exempt, except for U.S. source income.
(4) China Trade Corporations[2]	Conduit.
(5) Regulated investment companies (i.e., mutual funds).	Do.
(6) Real estate investment trusts (i.e., "REITS").	Do.
(7) Domestic international sales corporations (i.e., "DISCs").	Do.

[1] A foreign corporation also acts as a conduit for its U.S. shareholders for subpart F income and foreign personnel holding company income.

[2] H.R. 10612 would repeal the tax benefits of such entities; if repealed, such corporations would become includable corporations.

Not a single one of the above 7 corporations is taxed on their total income, which is the case for insurance companies since their tax treatment was extensively revised in 1959 (for life companies) and 1962 (for mutual property-liability companies).

Senator RIBICOFF. Of course, one of the problems we have, Mr. Filer, is that there are many worthwhile requests for different tax treatment, and everybody is going to ask the question, "What is the revenue impact of this bill? I think in all fairness I should ask that question. Have you any idea what the revenue impact of this bill would be?

Mr. CAPLIN. Again, Senator, I would be glad to answer.

The Treasury and the Joint Committee staff are working together and looking at that, and we are cooperating with them. We have made an attempt to make our best possible estimate through circularizing a number of insurance companies. We believe that for 1976 this bill—if it were made effective as drafted, January 1, 1976—would result in an immediate loss. I underscore "immediate" because I am going to qualify that. In 1976, an immediate loss of $90 million. In 1977, it would be $41 million. In 1978, it would be $44 million.

Now, the reason why I underscore "immediate" is because everyone is agreed—including the Treasury and the Joint Committee estimator—that this is virtually all a matter of timing and that the overwhelming portion of these figures, the so-called revenue loss figures, will be used up as an offset against future income. In brief, over 90 percent of these losses will in effect be recaptured by the companies over a period of time.

Today, they do this by generating taxable income as they see that they have some revenue losses on the books; among other things, they might acquire profitable businesses or shift their investment portfolio, Mr. Filer could elaborate on how that is done, to generate income to be used as an offset against the revenue loss.

This may not be good economics, but it is good tax planning that they are forced into.

Secondly, so far as this revenue loss is concerned, Senator Mondale has been doing some very important work in his Budget Committee in connection with tax expenditures. Now, consolidation is not regarded as a tax expenditure. It is a norm. It is a part of taxable income as considered normative. In contrast, tax expenditures are deviations from the norm—preferences or special treatment. So again, it is difficult to regard the proposed legislation as creating any sort of real revenue loss.

Finally, as Mr. Filer pointed out, the industry is looking for a permanent solution to put it on a parity with all other corporations. We are not looking for any special benefits. We want to be able to function on a day-to-day basis without having to make artificial investment decisions or distorted ones. They are also prepared to have transition rules that would not result in heavy immediate revenue losses— provisions for phasing into the legislation, perhaps not 100-percent benefit under the first year, perhaps some fraction of that benefit, so that this industry could have a long-range permanent solution. We would be very happy to work on easing any initial impact on the budgetary process.

Senator RIBICOFF. I'll have some more questions when my turn comes again.

Senator HANSEN. I have none, so proceed.

Senator MONDALE. Why don't you proceed?

Senator RIBICOFF. I am trying to follow this. Now, maybe Mr. Filer or you could respond.

Mr. CAPLIN. Right.

Senator RIBICOFF. But taking the first 3 years and looking to a period we hope that the casualty companies won't always be a loss-producing part of the insurance industry. The time could come that a consolidation would bring in more money to the Treasury than less money. Isn't that true?

Mr. CREEDON. May I respond to that, Senator?

I think you are exactly right. Just to take an illustration. If a company had a $1 million tax loss which it could offset against income on its life side, it would offset it and pay no income tax on the $1 million income on the life side. But if it had a $2 million profit the next year ,it would pay income-tax on the $2 million profit. Now, if you did not consolidate, it would have a $1 million tax loss this year which it would offset against the $2 million profit next and pay income tax only on $1 million next year. So I think what we are talking about here is simply a deferral rather than a permanent loss. This is the point Mr. Caplin made and I think it is a deferral with respect to 90 percent of the figures that he mentioned.

Senator RIBICOFF. I have been reading in the press, it is the national press, not just the Washington press, of GEICO, which must cover many, many people in this area, and the troubles that casualty companies are suffering.

I think there isn't a Senator who isn't getting letters from his constituents talking about the cancellation of his automobile liability policies.

And, of course, it is generally known that casualty companies are having problems. I won't say "are in trouble," but they have all got problems.

What are the causes of these problems?

Mr. FILER. Two causes, principally. It is terribly difficult in an inherently inflationary economy under the system of insurance that we have had to avoid a substantial time lag in the achievement of adequacy of rates through the regulatory processes of rate filings. You use historical data, and by the time you have the rate increase approved and put it into effect as policies renew, it takes 6 months, or 1 year for the premiums to increase and so there is an inherent lag. That is one problem.

We have had a change in claims consciousness in this country, the medical malpractice problems and automobile coverage problems are clear. The potential of product liability problems, unavailability of coverage, are clear. The public believes it has a "right to reimbursement" and the system is quite costly. And you have had a very substantial increase in claim costs.

The automobile insurance business had a particularly difficult time because when wage-price controls came off the small businessman was relieved first. The body repairman raised his prices. When the prices for automobile crash parts were increased, they were increased very substantially. Medical care costs came out from under controls and a very substantial escalation of inflation developed. This system is just not able to accommodate to it and, therefore, 1975 really was the worst year in the history of the insurance industry.

Senator RIBICOFF. Well, we have a very substantial public interest here, that if you have a consolidated return some of the more prosperous sides of the insurance business would be able to prop up the weak portions of the business, which are the casualty and automobile insurance segments of the industry.

Mr. FILER. I think it is in the public interest for the market, in the private sector, for people who need all lines of property-casualty coverage to get it. This is one way to help build and maintain the capacity of the property-casualty companies. In our company we don't lose tax-loss carryforwards, we use them up in a shift in investment policy. If we were able to consolidate, under statutory accounting, which is the accounting that determines how much surplus we have to support our business, we would immediately get an increase in surplus in our casualty-property companies through using the tax consolidation mechanism rather than waiting and using it through the loss carryover provisions through investment income.

So it would be a very clear direct increase in our surplus and permit us, frankly, to take more risk than would otherwise be the case.

Senator RIBICOFF. Let me ask you: In the past I understand that there was some concern expressed by some of the small casualty companies—that if this were done they would be in a bad competitive position. Does that pertain? Is there an answer to that?

Mr. FILER. Perhaps I might comment this way, Senator:

Since the bill was first drafted there have been a number of discussions and a number of changes and a great number of discussions within the industry. Some opposition that existed has disappeared. Some of the companies that didn't see any particular benefit and had some question as to the appropriateness of this bill have decided on a position of neutrality. They are no longer involved. I think it is fair to say there is much clearer understanding today of the need for this bill and how the provisions would operate. You can always make the theoretical argument that this could produce increasing competition and, therefore, be difficult for some companies. I happen to believe, however, that something that does open competition and does increase competition is in the public interest rather than the contrary. But I think to the extent that this makes each company in the situation where you have a life and nonlife affiliate better able to compete, I think that is in the public interest.

Senator RIBICOFF. My feeling is that there is not much problem here when it comes to the element of fairness to allow this industry to file a consolidated return the same way that every industry can file a consolidated return.

I was interested in your suggestion, Mr. Caplin, about the recognition of the revenue loss, which we are all going to struggle with in marking up the tax bill, one way or another, that there might be a way of phasing this in over a few years. I wonder if I could suggest—and I make this open suggestion—that the Treasury and the Joint Committee on Taxation and yourself might meet to see if you could work out a formula that would be acceptable to the Treasury, the Joint Committee on Taxation, and your industry?

I think this is a sound suggestion and since you have made it I would ask you that you try to work this out.

Mr. CAPLIN. I think there are some representatives here from the Joint Committee staff and we would be very happy to work with them and Treasury, too, on some transition rules.

Senator RIBICOFF. I think that the insurance industry in the casualty field has become so important when we consider, as I understand, the many casualty companies that are in such serious trouble, and I imagine one of the factors of having some life companies take over some casualty companies will depend on whether they can file a consolidated return or not?

Mr. CAPLIN. Yes, and there is this to be recognized: Today two life companies can file a consolidated return, and the Internal Revenue Service and Treasury are working on regulations to implement that.

But a life and a casualty company cannot file.

Senator RIBICOFF. Even though they have the same ownership?

Mr. CAPLIN. Yes. Furthermore, an industrial corporation that controls a casualty company—there are many of them—can file a consolidated return.

Senator RIBICOFF. I did not know that. In other words——

Mr. CAPLIN. For example, Sears, Roebuck, which owns All State, can file a consolidated return.

Senator RIBICOFF. Then I think it is very important for the record to have a list of industrial companies that own a casualty company that can file a consolidated return. This is the first I have known that they can file a consolidated return, but a life company cannot.

Mr. CAPLIN. We will be happy to do that.

Senator MONDALE. Very well, that will appear in the record.

Thank you very much.

[The material referred to and the prepared statement of Mr. Filer follows:]

STATEMENT OF JOHN H. FILER, CHAIRMAN, AETNA LIFE & CASUALTY

SUMMARY OF PRINCIPAL POINTS

1. Elimination of the bar to life insurance companies filing consolidated income tax returns with property-casualty and other non-life affiliates is both sound tax policy and sound public policy.

2. *Tax policy*

A. Life companies and their affiliates, though often forced to incorporate separately by state law, operate as full integrated economic units. The consolidation privilege should be available to reflect this business reality. The privilege is already available to virtually every other type of corporation, including many with tax rules as specialized and complex as those for life companies.

B. Since 1958, life insurance companies have been taxed on their total income, so they are fully compatible members of a consolidated group, and the historical basis for the exclusion no longer exists.

C. Consolidation of life and non-life companies is fully feasible under general consolidation principles, which treat each member as a distinct entity, whose separate taxable income is calculated in accordance with its own method of accounting, subject to adjustment of certain specified items on consolidation.

3. *Public policy*

A. The industry faces a severe capacity crisis in the property-casualty field, aggravated by the inability of a life-company's casualty affiliate to use losses currently for tax purposes.

B. Consolidation would ease this capacity problem because the tax saving to the group would be allocated to the property-casualty company experiencing the loss, reducing the impact of the loss on its surplus, and thereby increasing its insuring capacity.

C. Permitting consolidation would also promote innovation in the industry by assuring prompt recognition of losses on new types of insurance risks.

D. Investment stability would be promoted.

4. In summary, the measure corrects an unjustifiable tax inequity and simultaneously eases a serious economic and social problem. Such a combination is rare, and repeal of the ban on consolidation should be included in any tax measure reported by this Committee this year.

STATEMENT

My name is John H. Filer. I am Chairman of the Aetna Life & Casualty. I am speaking on behalf of an ad hoc group of twelve life insurance companies—large and small, stock and mutual—that are supporting an amendment to the Code to repeal the present rule which prevents such companies from joining in con-

solidated tax returns with their property-casualty insurance affiliates or other corporate affiliates.[1]

This amendment, reflected in S. 2985 and H.R. 12126, is necessary—

Because it is sound tax policy, correcting a discrimination that has existed for 18 years after the historical reasons for it have disappeared, and

Because it is sound public policy, mitigating a serious social and economic problem now plaguing both the insurance industry and the public.

I. SOUND TAX POLICY

Permitting corporations with common ownership to file consolidated tax returns is the general rule in our tax system. Thus, this legislation would not give any special treatment to life insurance companies. It would do no more than extend to them a privilege which is available to virtually every other corporation in the country.

Prior to 1958, the Federal income taxation of life insurance companies was based solely on investment income, and even then excluding certain forms of investment income, such as capital gains. As a result of the 1959 Life Insurance Company Taxation Act, which rewrote the law for the taxation of life companies, the Congress subjected all elements of a life company's income to tax under a formula designed to measure its total income on an annual basis. Thus, consolidation of life and nonlife companies is now entirely feasible under the normal consolidated return rules. Such rules treat each member as a separate and distinct entity which computes its own separate taxable income in accordance with its own method of accounting subject to adjustment of certain specified items upon consolidation.[2]

Under current law, consolidation is permitted for a broad variety of kinds of corporations. Like Life Insurance companies, many of them are subject to highly specialized tax provisions, for example, natural resource corporations, banks, Western Hemisphere Trade corporations, cooperatives, and stock property-casualty companies. This means that any corporation other than a life (or mutual property casualty) insurance corporation can acquire or establish a property-casualty business and can consolidate—the principal advantage being the ability to offset current profits against current losses. It simply makes no sense to encourage this sort of diversification, while setting up an artificial barrier to the more natural affiliation of life insurance and property-casualty insurance corporations.

Even apart from the issue of discrimination, permitting consolidation by life companies and their affiliates is good tax policy because it corresponds to economic and business reality. The policy underlying consolidated returns was stated by this Committee as long ago as 1918:[3] "The principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both for the taxpayer and to the government."

From a business viewpoint, it is certainly the case that a life insurance company and its affiliates are a single "business unit." They report their financial results to shareholders as a single consolidated unit. The life insurance and the casualty and other insurance elements of our companies are served by the same network of agents. They receive actuarial, accounting, and claims support from the same staffs, and investment management and overall executive direction are centralized. It is clear that an integrated group such as this should be taxed as a single business unit under the normal consolidated return rules.

Because of state regulatory requirements, life insurance operations and property-casualty operations normally must be conducted through separate corporations rather than as divisions of a single corporation. In short, though forced to incorporate separately, we function as a business unit, and we think the case for applying the normal consolidated tax rules is compelling.

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[1] A list of the life insurance companies most active to date in supporting the bill is attached. The bill would also repeal a similar ban on consolidated filing by mutual casualty insurance companies taxed under section 821. Stock casualty insurance companies taxed under section 831 have been permitted to file consolidated returns with other corporations [other than life or mutual casualty] since 1941.

[2] The many technical and policy reasons supporting the suggested Code amendment are discussed in detail in a series of memoranda previously submitted to the Joint Committee Staff and the Treasury Department by our attorneys, Caplin & Drysdale. With the Committee's permission our attorneys will submit for the record a single memorandum consolidating the various legal discussions.

[3] S. Rep. No. 617, 65th Cong., 3d sess. 9 (1918).

II. SOUND PUBLIC POLICY

There is an urgent public interest in this measure. As this Committee is aware, these are difficult times for our economy, times which raise real questions about the ability of our institutions to respond to the challenges we face from inflation, recession, technology and rising social needs. This challenge confronts us in the insurance industry as well, and this legislation will help us meet the challenge.

The capacity shortage

The insurance industry today faces a crisis in the property-casualty area. Rising claims costs, largely the product of inflationary pressures and the increased scale and frequency of claims, have created severe problems for the industry. Many property-casualty companies have incurred substantial losses, and the prospect of near insolvency exists for certain companies.

The shortage of capacity to satisfy the insurance needs of the public is perhaps the greatest single problem facing the property-casualty insurance business. The capacity of a company to write insurance depends on its ability to cover the risk shifted from the policyholder to the insurance company; this, in turn, depends ultimately on its surplus. As claims cost rise faster than premium income increases, underwriting losses develop, surplus is diminished, and so is capacity. The efforts to maintain or increase capacity can take numerous forms, such as larger deductibles, more reinsurance abroad with unfavorable balance of payments effects, cutting back on new customers, cancellation of old customers, shorter term policies and renewals, and even refusal to write important classes of insurance coverage, such as professional malpractice insurance, in short, the capacity crisis means that insurers are not fully able to serve the needs of the country for insurance coverage.

Obviously the bar to consolidation is not the source of the capacity problems, and permitting consolidated returns by the companies would not solve it entirely. But it is indisputable that the present bar to consolidate return filing by life insurance companies contributes to the industry's capacity difficulties.

There is an urgent public interest in this measure. As this Committee is aware, these are difficult times for our economy, times which raise real questions about the ability of our institutions to respond to the challenges we face from inflation, recession, technology and rising social needs. This challenge confronts us in the insurance industry as well, and this legislation will help us meet the challenge.

Our amendment would mitigate the problem because the tax saving resulting from the loss offset privilege permitted by consolidation would accrue directly to the property-casualty company experiencing the loss, since state regulatory authorities require that tax benefits be allocated to the particular corporation within a group whose loss was responsible for the saving. Thus, permitting consolidation with a profitable life insurance company would result in immediate reflection of the tax benefit in the loss casualty company's surplus, with a concommitant favorable effect on its capacity.

Other public benefits

The general public benefits of the change are not limited to capacity, but include relief of other current industry problems:

1. *Innovation and Competition.*—Our changing economy is generating new demands for insurance coverage. For example, articles have recently appeared in the Wall Street Journal concerning the potential of "all risk" crop insurance and product liability protection. It is crucial that our private economic system respond to these needs. By relieving the pressure on capacity and by enhancing competition (by assuring that the losses of a new subsidiary can be promptly recognized like any other new business venture) consolidation will help make possible the capacity and creativity we need from the industry.

2. *Investment Stability.*—The property-casualty insurance business is a cyclical one alternating between profit and loss periods. In order to assure utilization of the losses within existing carryover periods where consolidation is barred, sufficient taxable income must be generated during the applicable loss carryover periods. This leads to short term swings in investment policy. An example is a change from stocks to taxable bonds. Also state and municipal bonds become less attractive. The amendment would regularize investment policy and help maintain more stable capital markets.

III. OUR GOAL—LONG-TERM INSURANCE

We see the elimination of the current discrimination against insurance companies as an important long range improvement of our tax law. The impact of the bar to consolidation on the casualty element of the industry is the problem today, but the issue is a general and continuing one. Another round of inflation could intensify the problem for the casualty insurance business.

In other conceivable circumstances, e.g., a significant unfavorable shift in mortality rates, due for example to another influenza epidemic, it could well be the life insurance companies, not the casualties, that are hampered by the consolidation bar. This bill will provide some insurance against such results.

In any circumstances, it is clear that harmful and artificial effects will result from a tax rule which prevents current recognition of the losses of part of an integrated business unit.

* * * * * * *

In sum, the bill corrects a tax inequity and simultaneously mitigates a serious social and economic problem. Such a combination is rate, and we strongly urge that the proposed measure be included in any tax bill the Committee reports this year.

AD HOC GROUP SUPPORTING S. 2985

Aetna Life & Casualty, 151 Farmington Avenue, Hartford, Conn. 06115.
CNA Financial Corp., CNA Plaza, Chicago, Ill. 60685.
Connecticut General Life Insurance Co., Hartford, Conn. 06115.
The Equitable Life Assurance Society of the United States, 1285 Avenue of the Americas, New York, N.Y. 10019.
Fidelity Mutual Life Insurance Co., P.O. Box 7318, Philadelphia, Pa. 19101.
IDS Life Insurance Co., IDS Tower, Minneapolis, Minn. 55402.
Metropolitan Life Insurance Co., 1 Madison Avenue, New York, N.Y. 10010.
Penn Mutual Life Insurance Co., Independence Square, Philadelphia, Pa. 19105.
Prudential Insurance Co. of America, Prudential Plaza, Newark, N.J. 07101.
Reserve Life Insurance Co., 408 South Akard Street, Dallas, Tex. 75203.
State Mutual Life Assurance Co. of America, 440 Lincoln Street, Worcester, Mass. 01605.
The Travelers Insurance Co., 1 Tower Square, Hartford, Conn. 06115.

Senator RIBICOFF. Senator Proxmire and Ralph Nader's Tax Counsel called this a logical extension of the rule that permits noninsurance companies such as ITT to file consolidated returns, and thus offset casualty insurance losses against other business income.

To further point out just how logical this amendment is, I want to include in the record at this point a partial list of industrial corporations with property-liability affiliates which are presently eligible to file consolidated tax returns.

[The list referred to follows:]

PARTIAL LIST OF INDUSTRIAL CORPORATIONS WITH PROPERTY/LIABILITY AFFILIATES POTENTIALLY ABLE TO FILE CONSOLIDATED INCOME TAX RETURNS, MAY 14, 1971

1. AGWAY, INC.

Agway Insurance Company

2. AHMANSON, H. F., & COMPANY

Mohawk Insurance Company
Stuyvesant Insurance Company
National American Insurance Company
Trans-oceanic Insurance Company
National American Insurance Company of California

3. AMERICAN EXPRESS COMPANY

American Automobile Insurance Company
American Insurance Company
Associated Indemnity Corporation

Fireman's Fund Insurance Company
National Surety Corporation
Fireman's Fund Insurance Company of Texas
National Surety Corporation of California

4. AMERICAN FINANCIAL CORPORATION

American Empire Insurance Company
American National Fire Insurance Company
Agricultural Insurance Company
Constellation Reinsurance Company
Great American Insurance Company
American Continental Insurance Company
Republic Indemnity Company of America

5. ANDERSON CLAYTON AND COMPANY

Ranger Insurance Company
Pan American Fire & Casualty Company
Pan American Insurance Company
Pan American Thrift Insurance
Ranger-Allied Underwriters
Ranger County Mutual Insurance Company
Ranger Insurance Company
Ranger Lloyds

6. ARMCO STEEL CORPORATION

Belefonte Insurance Company
Compass Insurance
General Fire & Casualty Company

7. AVCO CORPORATION

Balboa Insurance Company
Meritplan Insurance Company
Newport Insurance

8. BALDWIN & LYONS, INCORPORATED

Protective Insurance Company

9. BAUSH AND LOMB, INCORPORATED

Sofiens Insurance Company

10. BENEFICIAL CORPORATION

American Centennial Insurance Company

11. BERKSHIRE-HATHAWAY, INCORPORATED

Cornhusker Casualty Company
Home & Automobile Insurance Company
Insurance Company of Iowa
Lakeland Fire & Casualty
National Fire & Marine Insurance Company
National Indemnity Company
Texas United Insurance Company

12. BUDGET INDUSTRIES

Transnational Casualty Insurance
Transnational Insurance

13. CIT FINANCIAL CORPORATION

North American Accident Insurance Company
North American Company for Property and Casualty Insurance

14. CITY INVESTING COMPANY

City Insurance Company
Home Insurance Company

Seaboard Surety Company
Home Indemnity Company

15. CONTINENTAL CORPORATION

Boston Old Colony Insurance Company
Buckeye Union Insurance Company
Commercial Insurance Company of Newark
Continental Insurance Company
Fidelity and Casualty Company of New York
Firemen's Insurance Company of Newark
Glens Falls Insurance Company
Kansas City Fire and Marine Insurance Company
London Guarantee and Accident Company of New York
National-Ben Franklin Insurance Company of Illinois
National Reinsurance Corporation
Niagara Fire Insurance Company
Pacific Insurance Company
Phoenix Assurance Company of New York
Seaboard Fire and Marine Insurance Company
First Insurance Company of Hawaii, Limited
Equitable Fire Insurance Company
Tokio Marine and Fire Insurance Company, Limited

16. CONTROL DATA CORPORATION

American Credit Indemnity Company
Calvert Fire Insurance Company
Cavalier Insurance Corporation

17. DEERE AND COMPANY

John Deere Insurance Company

18. EXXON CORPORATION

Petroleum Casualty Company

19. FORD MOTOR COMPANY

American Road Insurance Company

20. GENERAL ELECTRIC COMPANY

Manhattan Fire and Marine Insurance Company

21. GENERAL MOTORS CORPORATION

CIM Insurance Corporation
Motors Insurance Corporation

22. GULF AND WESTERN INDUSTRIES, INCORPORATED

Emmco Insurance Company
Excell Insurance Company
Providence Washington Insurance Company
Motor Vehicle Casualty Company
Providence Lloyds
Providence Washington Insurance Company
Providence Washington Insurance Company of Alaska
Western Alliance Insurance Company
York Insurance Company

23. HALLIBURTON COMPANY

Highlands Insurance Company
Highlands Underwriters Insurance Company

24. INTERNATIONAL BANK

Northeastern Insurance Company of Hartford
United Security Insurance Corporation

25. INTERNATIONAL HARVESTER COMPANY

Harco National Insurance Corporation

26. INTERNATIONAL TELEPHONE AND TELEGRAPH CORPORATION

Hartford Casualty Insurance Company
Hartford Accident and Indemnity Company
Hartford Fire Insurance Company
New England Reinsurance Corporation
New York Underwriters Insurance Company
Twin City Fire Insurance Company
First State Insurance Company
Pacific Insurance Company
Sentinel Insurance Company

27. KATY INDUSTRIES, INCORPORATED

Midland Insurance Company

28. CNA FINANCIAL

American Casualty Company of Reading
Continental Casualty Company
National Fire Insurance Company of Hartford
Valley Forge Insurance Company
Transportation Insurance Company
Transcontinental Insurance Company
CNA Casualty of California
CNA Casualty of Puerto Rico
Columbia Casualty Company
Mid-States Insurance Company

29. MOBIL OIL CORPORATION

Forum Insurance Company

30. NATIONAL DISTILLERS & CHEMICAL CORPORATION

Elkhorn Insurance Company

31. PENNEY, J. C. COMPANY, INCORPORATED

Educator & Executive Insurers, Incorporated

32. RELIANCE GROUP, INCORPORATED

Reliance Insurance Company
Commonwealth Land Title Insurance Company of New York

33. SEARS, ROEBUCK AND COMPANY

Allstate Fire Insurance Company
Allstate Insurance Company

34. STANDARD OIL COMPANY (INDIANA)

Imperial Casualty & Indemnity Company

35. TELEDYNE, INCORPORATED

Argonaut Insurance Company
Argonaut Midwest Insurance Company

Argonaut Northwest Insurance Company
Security National Insurance Company
Trinity Universal Insurance Company
Argonaut Southwest Insurance Company
Financial Indemnity Company
Georgia Insurance Company
Great Central Insurance Company
Trinity Universal Insurance Company of Kansas

36. TEXTRON, INCORPORATED

Metropolitan Fire Assurance Corporation
Connecticut Indemnity Company
Security Insurance Company of Hartford
Admiral Insurance
Fire & Casualty Company of Connecticut

37. TICOR

Pioneer National Title Insurance Company
Title Guarantee Company
Ticor Mortgage Insurance Company

38. TRANSAMERICA CORPORATION

Transamerica Insurance Company
Premier Insurance Company of New York
Automotive Insurance Company
Countrywide Insurance Company
Marathon Insurance Company
Mount Beacon Insurance Company
Olympia Insurance Company
Premier Insurance Company
Riverside Insurance Company
Transamerica Insurance Company
Wolverine Insurance Company

39. WACHOVIA CORPORATION

South State Insurance Company
Southeastern Fire Insurance Company

40. WYLY CORPORATION

Gulf Insurance Company

Senator RIBICOFF. I also submit for the record Treasury's bill report of May 25, 1976, and July 20, 1976.

[The reports referred to follow:]

DEPARTMENT OF THE TREASURY,
Washington, D.C., May 25, 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate,
Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your request for the views of this Department concerning S. 2985, entitled "A BILL To amend section 1504 of the Internal Revenue Code of 1954, as amended."

This bill would amend the Internal Revenue Code of 1954 to allow insurance companies taxable under section 802 (life insurance companies) or section 821 (most non-life mutual insurance companies) to be included in a consolidated return with other companies. Under present law, life insurance companies may file consolidated returns only with other life insurance companies, and section 821 companies are effectively precluded from filing any consolidated returns. The bill would be effective for taxable years beginning on or after January 1, 1976; however, the provision would be elective before January 1. 1979.

To allow the filing of such consolidated returns, the bill would change the special tax rates for section 821 companies that file such returns to the normal corporate rates. The bill would also amend section 843 of the Code to provide

that an insurance company which joins in the filing of a consolidated return may adopt the taxable year of the common parent corporation, even though such year is not a calendar year.

Under a special transitional rule set forth in the bill, loss and credit carryovers from, and carrybacks to, pre-1976 years of insurance companies taxable under section 802 or 821 could be applied only as an item of deduction or credit of such corporations. A similar rule would apply with respect to such carryovers and carrybacks of other companies. Further, this transitional rule would assure that previously existing affiliated groups would not be adversely affected by the inclusion of a section 802 or 821 company in an affiliated group.

With an effective date of January 1, 1976, S. 2985 will produce estimated annual revenue losses of $50 million for fiscal 1976 and the transitional quarter, $85 million for fiscal 1977, $55 million for fiscal 1978, $70 million for fiscal 1979, $80 million for fiscal 1980, and $70 million for fiscal 1981. Even if the effective date is deferred to January 1, 1977, the estimated annual revenue losses will be $35 million for fiscal 1977, $85 million for fiscal 1978, $95 million for fiscal 1979 and 1980, and $85 million for fiscal 1981.

In view of such revenue losses, the Treasury Department is opposed to S. 2985. However, the Treasury Department is not opposed in principle to allowing life and non-life mutual companies to file consolidated returns with other companies. We believe that the special provisions for taxing such insurance companies do not provide a sufficient basis for excluding them from the groups of taxpayers afforded this right. Many other types of specially treated corporations are not precluded from filing such returns, even though they present similar difficulties in determining the appropriate basis for computing the affiliated group's consolidated taxable income.

The Office of Management and Budget has advised the Treasury Department that there is no objection from the standpoint of the Administration's program to the presentation of this report.

Sincerely yours,

CHARLES M. WALKER,
Assistant Secretary.

SECTION 1508

CONSOLIDATED RETURNS FOR LIFE AND MUTUAL INSURANCE COMPANIES

July 20, 1976

Administration position

Given the 50 percent limitation, and the postponement of the effective date to 1978 which reduce the revenue impact of this amendment, the Administration does not object to this section of the bill.

Senator RIBICOFF. There have been full and complete reports of the Treasury. There has been full and complete discussion of this measure in open session. I reject completely any innuendoes or implications of any wrongdoing on the part of the Finance Committee.

I have a few questions, Mr. Filer.

When you testified before us in April, I asked you to comment on the concern expressed by some casualty companies that the adoption of this provision would place them in a bad competitive position. This point has been made again at these hearings, although I note with interest, not through the appearance of any of those who claim to be directly affected.

I wonder if you would care to comment at this point again.

Mr. FILER. Yes, I would, Senator.

I would be happy to do so. The critical point is the possible competitive effort would occur only at a time when there are substantial underwriting losses in the industry. The only time that this bill, for practical purposes, would impact the industry is when we are in an underwriting cycle of severe loss, shrinkage of capital and ability to expand our business, and it is just at that time that the public really

does require increasing capacity. At that point in time, which would be the only time of possible competitive damage to an insurance company, the public interest really does require that capacity be increased rather than be concerned about some possible competitive effect on a particular insurance company.

In any event, that competitive effect would be minimal.

Senator RIBICOFF. There also has been a suggestion since this provision does not take effect until 1978, it is not an urgent provision and therefore should be subject to further study.

May I point out, its effective date goes into 1978 because of my deep concern, the Internal Revenue Service, Treasury, members of this committee, to assure that there would be no revenue loss for next year.

Would you comment on that?

Mr. FILER. Yes, Senator, I would be glad to.

As my statement indicated, this matter has been before the tax-writing committees of Congress for over 3 years. We have been trying for that long to obtain its enactment. Had it been in effect, it would have been of value to the industry and to the public during this current severe underwriting downturn.

If the measure is to be useful and effective, it has to be in place before the next cyclical downturn in this industry. I do not know when it is coming. History shows that this is a cyclical business. I believe that the matter has been deferred until an effective date of January 1978 because of revenue considerations. There is no reason for further consideration of the bill because it has been thoroughly explored and considered.

Senator RIBICOFF. It has been suggested that the effect of the provision would be to subsidize startup losses of new casualty companies entering into the field.

What is your comment on that?

Mr. FILER. Senator, with respect to the startup losses for any companies that are now starting in the business, as the bill is not effective until January 1978, it would not, for example, have any impact on the startup losses of the casualty affiliates of the Metropolitan Life Insurance Co. or Prudential Life Insurance Co.

Second, as for startup losses incurred after 1978, it would simply place the company in the same position as any other startup casualty company affiliated with a nonlife company. We would have the tax effect, but so would competitors who would start a casualty company with an industrial affiliate.

Finally, as more new companies enter the field, as competition and capacity are strengthened, we believe that is clearly in the public interest.

Senator RIBICOFF. Senator Curtis?

Senator CURTIS. I just have one question.

Extending the right to file consolidated returns of insurance companies, they will have to meet the same minimum standards to qualify for the right to file a consolidated return as any other taxpayer; is that right?

Mr. FILER. That is correct.

Senator CURTIS. That is all.

Mr. CAPLIN. Two life companies can file consolidated returns today. It's just a life-casualty company group that is affected.

Senator CURTIS. I would like the record to show that.

Senator DOLE. Was this in the House bill?

Mr. CAPLIN. It was introduced. It was a separate bill in the House. It was not a part of the reform bill in the first sentence. It was then brought in by the reform bill on the Senate side, with full hearings, as Mr. Filer and Senator Ribicoff pointed out.

Senator DOLE. You did have hearings on the House side?

Mr. CAPLIN. There were no formal hearings. Excuse me, Senator. I did submit a statement on behalf of the group.

Senator DOLE. Did they take any action on the bill in the House?

Mr. CAPLIN. No.

Senator DOLE. Thank you.

Senator RIBICOFF. Thank you very much.

[The following information was subsequently supplied by Mr. Caplin:]

SUPPLEMENT TO MR. MORTIMER CAPLIN'S RESPONSE TO SENATOR DOLE'S QUESTION REGARDING HOUSE HEARINGS ON THE LIFE INSURANCE CONSOLIDATION PROPOSAL

As I testified, we submitted a lengthy statement on the subject of life insurance consolidation to the House Ways and Means Committee on April 27, 1973. Following the submission of our statement, discussions regarding the proposal, introduced in bill form in both the House and Senate in 1975, were begun with representatives of the Treasury Department and the Internal Revenue Service, as well as the Joint Committee Staff. At the time the House was considering the tax reform bill, the staffs were continuing to analyze the proposal and were not yet ready to state their views on the subject. In the absence of staff advice, the Ways and Means Committee was not in a position to take the matter up in time for inclusion in its version of the bill. The staff positions were ultimately formulated while the bill was pending before the Senate Finance Committee, and were presented to the Committee on May 27, 1976.

Senator RIBICOFF. The next witness is Mr. John W. Byrnes.

Mr. BYRNES. To coordinate the testimony and save time, could Mr. Halvorson and I make one presentation?

Senator RIBICOFF. Without objection, both statements will be put in the record.

Without objection.

[The prepared statement of Mr. John W. Byrnes follows:]

SUMMARY OF TESTIMONY IN SUPPORT OF SECTION 2101—MODIFICATION OF TRANSITION RULE FOR SALE OF PROPERTY BY PRIVATE FOUNDATIONS, ON BEHALF OF BADGER METER, INC., MILWAUKEE, WIS.

1. Section 2101 of H.R. 10612 does not involve a gain or loss in revenue. It relates only to certain regulatory matters affecting private foundations.

2. The Tax Reform Act of 1969 in effect prohibited certain transactions between a private foundation and its "disqualified persons" (generally, persons with an economic or managerial interest in the operation of the foundation). Among the transactions prohibited by the Act are the sale, exchange or leasing of property by the foundation to such persons (section 4941).

3. In recognition of the hardship that would result if certain existing leases of property by a private foundation to a "disqualified person" were immediately terminated, the Congress provided a transition rule permitting a continuation, under certain circumstances, of such leases until taxable years beginning after December 31, 1979. Prior to that date the leases must be terminated.

4. In some cases, such as the property currently leased by the Charles Wright Foundation to Badger Meter, Inc., a disqualified person, the property was designed to meet the particular needs of the leasee and the continued use of the property by Badger Meter, Inc., represents the highest and most economical use of the property. To sell or lease the property to a third person would only be possible at a financial sacrifice, while at the same time Badger Meter, Inc. will not be able to acquire similar property to meet its needs or will be able to do so only at very substantial additional cost.

5. As the law presently stands, after December 31, 1979, Badger Meter, Inc. can no longer continue to rent the property from the Charles Wright Foundation, nor can it purchase the property from the Foundation.

6. If due hardship to a foundation and its "disqualified person" is to be avoided under these circumstances, a transition rule is needed to permit a sale of the property to the disqualified person in those cases where the lease qualifies under the existing transition rule relating to leases and the foundation receives an amount which equals or exceeds the fair market value of the property.

7. It is believed that the failure to provide such a transition rule in the Tax Reform Act of 1969 was an oversight. As stated in the Committee Report, "It appears likely that if this particular point had been presented in 1969, the Act would have been modified to deal with the situation."

8. Section 2101 of H.R. 10612, Tax Reform Act of 1976, as reported by the Committee on Finance, provides such a transition rule for those cases where the sale occurs before January 1, 1978.

STATEMENT SUBMITTED ON BEHALF OF BADGER METER, INC., IN SUPPORT OF MODIFICATION OF TRANSITION RULE FOR SALE OF PROPERTY BY PRIVATE FOUNDATIONS

SECTION 2101 OF H.R. 10612, TAX REFORM ACT OF 1976

Background

Badger Meter, Inc. of Milwaukee, Wisconsin, is a substantial contributor to the Charles W. Wright Foundation, a private foundation, and comes within the definition of a "disqualified person" under the terms of the Tax Reform Act of 1969.

The manufacturing plant and administrative office of Badger Meter, Inc. is located in the Village of Brown Deer, Wisconsin. The administrative office was constructed to meet the needs of Badger Meter by the Charles Wright Foundation in 1957 on land acquired from Badger Meter. This land is contiguous to some 51 acres of Badger Meter property on which there are 187,000 square feet of buildings. A part of the administrative building is on land owned by Badger Meter.

In 1957, a 20-year lease was entered into whereby the Foundation leased the administrative building and surrounding land to Badger Meter. Subsequently, Badger Meter, at its own expense, made substantial improvements to the buildings and land.

Because of the close integration of the administrative building and other lease-hold improvements with the manufacturing plant and other facilities of Badger Meter, the continued use of the property by Badger Meter represents the highest and most economically feasible use of the proptrty from the standpoint of both Badger Meter and the Foundation. Subsequent to the enactment of the Tax Reform Act of 1969, the property was appraised as required by the Act. The appraisers concluded that the highest and best use of the property is its present use, that the location of the office layout is not suited to multi-tenant occupancy and that in all likelihood, another single tenant would not be found because of the geographic location, existing and planned freeways and public transportation. They also concluded that the sale of the property to a third party would be extremely disadvantageous to the Foundation for the same reason.

Tax Reform Act of 1969

The Tax Reform Act of 1969 made substantial changes in the law with respect to private foundations. Included in the changes was the imposition of taxes and penalties that in effect prohibit certain transactions between a private foundation and its "disqualified persons" (generally, persons with an economic or managerial interest in the operation of the foundation). Among the transactions covered by the prohibitions on such "self-dealing" is the sale or leasing of property.

Recognizing that the application of the new rules to existing arrangements would, in certain circumstances, cause unnecessary disruption, the Congress provided transition rules to cover certain arrangements which had come to the attention of the Congress.

To cover the case where there was an existing lease between the foundation and a disqualified person, the law permits a continuation of those leases in effect on October 9, 1969 until taxable years beginning after December 31, 1979,

as long as the lease remains at least as favorable to the private foundation as it would have been between unrelated parties. However, after December 31, 1979, the leasing arrangement must be terminated.

Another transition rule permits a private foundation to sell to disqualified persons any business holdings that the private foundation was required to dispose of because of the business holdings provision of the Act.

Overlooked in providing transition rules were situations where it would be advantageous for a foundation which has a lease with a disqualified person to sell the property to such person. Under the law as it presently stands, the foundation can neither continue to lease the property to the disqualified person after December 31, 1979, nor can the foundation sell the property to the disqualified person. The foundation must either find a new tenant or sell the property to a third person. In some situations, the leased property was designed or so modified to accommodate the disqualified person's business that it would be of little value to the foundation or anyone else, while the disqualified person will incur substantial additional cost if it has to acquire other property (which might not be available at any cost locally). Unless the transition rules are modified to make allowance for these cases, both the foundation and the disqualified person will suffer unnecessary losses.

Solution—Section 2101

Section 2101 of H.R. 10612, Tax Reform Act of 1976 as reported by the Committee on Finance, makes a perfecting amendment to the transition rules to permit, for a limited period, a private foundation to sell to a disqualified person property previously leased to such disqualified persons and which lease is within the present transition rule relating to leases to disqualified persons. It provides that such foundation shall receive for the disposition an amount which equals or exceeds the fair market value of the property.

The provisions of Section 2101 were unanimously reported to the House of Representatives by the Ways and Means Committee in the 92nd Congress (H.R. 9520, Report 92-965), but because of procedural problems, it was not considered by the House. In the 93rd Congress, the Ways and Means Committee approved the inclusion of the bill in the so-called Tax Reform Bill of 1974. The Committee, however, did not conclude its work on the bill and it was not reported to the House.

The Treasury Department filed reports on the bill in the 92nd and 93rd Congresses raising no objections to the bill.

Similar bills have been introduced in the 94th Congress. (H.R. 11118 and H.R. 12564 by Congressmen Schneebeli and Karth, respectively.)

Because the time during which a private foundation can continue to lease to a disqualified person is running out, it is imperative that Congress act at an early date to avoid severe and unintended penalties being imposed on certain foundations and their leasees who find themselves in situations similar to that of Badger Meter, Inc. and the Charles Wright Foundation. Section 2101, as reported by the Committee on Finance, provides such a transition rule.

STATEMENT OF JOHN W. BYRNES ON BEHALF OF BADGER METER, INC.

Mr. BYRNES. Mr. Chairman, members of the committee, I appear on behalf of the Badger Meter, Inc. of Milwaukee, Wis., in support of section 2101 of the bill that the committee has reported.

First I should say there is no revenue involved. The amendment addresses itself to the regulatory provisions of the code relating to foundation and the matter of self-dealing. In the Tax Reform Act of 1969, Congress in effect prohibited certain transactions between private foundations and what are called disqualified persons, generally persons with an economic or managerial interest in the operation of the foundation. Among the transactions prohibited by the act are the sale, exchange, or lease of property by the foundation to such a person.

In recognition of the hardship that would result if certain existing

arrangements were all of a sudden terminated, for instance, in the case of certain leases of property by a private foundation to a disqualified person, Congress provided a transition rule providing the continuation of such leases until the taxable year beginning after December 31, 1979.

As to property that was currently leased and under leases that were in existence prior to 1969, the rule permitted them to continue these leases. In the Badger Meter situation, the property here was specifically designed to meet the needs of this company by the Charles Wright Foundation, and it has been continued to be so leased by the foundation under the transition rule.

Now the question is how is that property to be sold? The appraisers have acknowledged that use by Badger Meter, Inc. is the highest economic use of the property. Who can the foundation sell it to? It was designed for this tenant.

The law that exists today prevents such a sale.

Mr. Halvorson will comment on the facts in his case.

[The prepared statement of Mr. Newman T. Halvorson, Jr., follows:]

STATEMENT OF THE MAY DEPARTMENT STORES CO.

SUMMARY OF PRINCIPAL POINTS

1. The May Department Stores Company ("the Company"), and The May Stores Foundation, Inc. ("the Foundation"), for the reasons set forth in the Company's written statement dated April 23, 1976, submitted to the Finance Committee, favor the enactment of Section 2101 of HR 10612 as reported by the Committee. That section would modify the transitional rules of the Tax Reform Act of 1969 for sales of property by private foundations.

2. Under arrangements entered into in 1965, and as permitted by the 1969 Act, the Company is leasing from the Foundation certain real property that houses facilities that are vital to the operation of the Company's Famous-Barr Co. department store in downtown St. Louis, Missouri. Other private foundations and disqualified persons around the country have similar arrangements.

3. The 1969 Act imposed broad restrictions on leasing and other "self-dealing" transactions between private foundations and disqualified persons. To avoid unnecessary disruptions and hardships with respect to pre-existing arrangements, various "transitional rules" were included in the Act.

4. Section 2101 of the present bill deals with a situation that falls between two existing transitional rules. One of those rules permits a "disqualified person" to lease property from a private foundation, until 1979, if the lease was entered into before the 1969 Act and if the rental paid under the lease is an arm's-length rental. The other transitional rule permits a private foundation to sell "excess business holdings" to a disqualified person if the sale price equals or exceeds the fair market value of the property being sold.

5. Section 2101 would permit property being leased under the first transitional rule to be sold to a disqualified person under the safeguards required for sales of excess business holdings under the second transitional rule.

6. Both the Finance Committee and the House Ways and Means Committee (which unanimously approved a similar provision in 1972) have observed that this provision will benefit charity by helping to preserve asset values for the private foundations in question and that it would likely have been included in the 1969 Act if the Congress had been aware of these fact situations at that time.

STATEMENT

Mr. Chairman and Members of the Committee, my name is Newman T. Halvorson, Jr. I am a lawyer with the firm of Covington & Burlington, Washington, D.C., and I am testifying this morning on behalf of The May Department Stores Company, headquartered in St. Louis, Missouri, in favor of the provisions set forth in Section 2101 of H.R. 10612 as reported by the Senate Finance Committee.

We appreciate this opportunity to present our views on the proposed modification of the transitional rules for sales of property by private foundations. We have previously submitted to this Committee a written statement dated April 23, 1976, concerning this same subject.

A. Description of the property

The May Department Stores Company (the "Company"), headquartered in St. Louis, Missouri, is a publicly owned corporation that operates 129 department and discount stores in major metropolitan markets coast to coast, 58 catalog showroom stores in the greater New York area and northern California, and 16 regional shopping centers. Major stores or groups of stores are located in St. Louis, Chicago, Akron, Cleveland, Youngstown, Denver, Baltimore, Washington, D.C. (The Hecht Co.), Los Angeles, San Diego, Pittsburgh, Portland (Oregon), Hartford, and Jacksonville.

The May Stores Foundation, Inc. (the "Foundation"), is a charitable corporation, established under New York law in 1945, and is a "private foundation" as defined in Section 509 of the Internal Revenue Code. It receives charitable contributions from the Company and makes grants primarily for various civic and educational activities. After the enactment of the Tax Reform Act of 1969, the Company was a "disqualified person," as defined in Section 4946 of the Internal Revenue Code, with respect to the Foundation.

In 1965, four years prior to the enactment of the Tax Reform Act of 1969, the Company conveyed to the Foundation, as a charitable contribution, the Company's entire fee and leasehold interests in certain improved real property north of and across Locust Street from the Company's Famous-Barr Co. department store facility in downtown St. Louis. The Company claimed a charitable deduction for the value of the property interests so conveyed.

Immediately after receiving the property from the Company, the Foundation leased it back to the Company for an approximate 24-year term ending in 1989. Under the Company's leases with the Foundation, the property is used, as it had been previously, to provide vital support services to the department store facility, such as a receiving, sorting and shipping center for goods involved in the Company's St. Louis retail department store operations. The support property also houses the power plant and other utilities for the department store facility and is connected with the department store facility through a system of underground tunnels and conveyors.

B. Effect of the 1969 Act and the proposed new transitional rule

The provisions of the Tax Reform Act of 1969 permit the Company's leases with the Foundation to continue only until December 31, 1979. See Section 101 (1)(2)(C) of the Act (Public Law 91-172). By that date the leases between the Company and the Foundation will have to be terminated to avoid violation of the self-dealing rules that were added to the Code by the Tax Reform Act as Section 4941 of the Code.

Although the Tax Reform Act requires that the leases be terminated by 1979, it does not permit the Company to purchase, at any price, the property previously conveyed to the Foundation and presently subject to the leases. Thus the likely effect of present law will be ultimately to deprive the Company of any use of this vital support property after 1979. In view of the "umbilical cord" relationship between the property and the Company's adjacent department store, this could cause a serious disruption for the Company's retail operations in St. Louis. Nor would this have any offsetting benefit for charity, because the price that any third party could be expected to pay for this property, uniquely valuable only to the Company in connection with the operation of its downtown St. Louis department store facility, would be no greater than the price the Company would be willing to pay.

There are apparently a number of other foundations and disqualified persons around the country faced with a similar problem. This was recognized by the House Ways and Means Committee early in 1972 when it unanimously approved, without objection by the Treasury Department, an amendment (H.R. 9520) to the transitional rules in the Tax Reform Act. Similar bills have been introduced in subsequent Congresses. E.g., H.R. 1118 and H.R. 12546, introduced in the 94th Congress by Congressmen Schneebeli and Karth, respectively. The amendment contemplated by these bills, and by Section 2101 of the present bill, would permit a private foundation to sell to a disqualified person, for not less than fair market value, any property being leased by that person under a lease

described in Section 101(1)(2)(C) of the Tax Reform Act. Although there was no known opposition to H.R. 9520 in 1972, the bill was never brought to a floor vote in the House.

The reasons for the legislation are cogently set forth in the House Report which accompanied H.R. 9520 and in the Senate Report accompanying the present bill. See H.R. Rep. 92–965, 92d Cong., 2d Sess. (1972) (copy attached) and S. Rep. No. 94–938, 94th Cong., 2d Sess. 591–93 (1976). As both reports indicate, if these situations had been called to the attention of Congress in 1969, Congress probably would have minimized the resulting hardships with a divestiture rule similar to the divestiture rule available for the disposition of excess business holdings under Section 4943 of the Code.

C. Conclusion

For these reasons, Section 2101 of H.R. 10612 represents an important refinement of existing law and it should be retained in the final version of this legislation.

[H.R. 92–965, 92d Cong., 2d sess.]

MODIFICATION OF TRANSITIONAL RULE FOR SALES OF PROPERTY BY PRIVATE FOUNDATIONS

The Committee on Ways and Means, to whom was referred the bill (H.R. 9520) to amend section 101(1)(2) of the Tax Reform Act of 1969, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are as follows:

Page 2, line 4, after "leasing" insert "substantially all of".

Page 2, line 6, strike out "persons" and insert "person".

Page 2, strike out lines 16, 17, and 18, and insert:

"(b) The amendments made by subsection (a) shall apply to dispositions after the date of the enactment of this Act in taxable years ending after such date."

I. Summary

H.R. 9520 makes a perfecting amendment to transitional rules provided in the Tax Reform Act of 1969 with regard to sales of property by private foundations to disqualified persons could continue an existing lease through 1979 without violating the self-dealing rules, if the private foundation had the benefit of any bargain that might exist in the lease. Also, the 1969 Act permitted a private foundation to sell to disqualified persons any business holdings that the private foundations was required to dispose of because of the excess business holding provisions of that Act.

This bill deals with a situation that falls between these two transitional rules. It permits a private foundation to sell to a disqualified person (at a price at least as high as the fair market price) property substantially all of which is subject to a lease protected under the present law's transitional rule with regard to pre-1969 Act leases.

The committee has reported this bill unanimously and the Treasury Department does not object to its enactment.

II. Reasons for the Bill

The Tax Reform Act of 1969 amended the Internal Revenue Code of 1954 to impose taxes upon certain transactions between a private foundation and its "disqualified persons" (generally, persons with an economic or managerial interest in the operation of that foundation). Among the transactions covered by these taxes on "self-dealing" are the sale, exchange, or leasing of property (sec. 4941). In order to avoid unnecessary disruption of existing arrangements, however, the Act provided transitional rules permitting the continuation of any existing lease (in effect on October 9, 1969) between a foundation and a disqualified person until 1979, so long as the lease remains at least as favorable to the private foundation as it would have been under an arm's-length transaction between unrelated parties. However, for taxable years beginning after the end of 1979, the leasing arrangements must be terminated (sec. 101(1)(2)(C) of the Act).

Cases have been brought to your committee's attention in which a private foundation is leasing to a disqualified person property of a nature which is peculiarly suited to the use of that person. In these cases, the value of the property to the

disqualified person is greater than that to any other person. Since under present law such a leasing arrangement must be terminated not later than the end of the last taxable year beginning in 1979, and the property cannot be sold to the disqualified person by the private foundation, the foundation probably would be put in the position of being forced to dispose of its property to unrelated persons for less than the value of that property to disqualified persons.

Another transitional rule provided in the 1969 Act permits a private foundation to sell excess business holdings to a disqualified person, so long as the sales price equals of exceeds the fair market value of the property being sold. However, this rule applies only to business holdings, and not to passive investments, including passive leases (sec. 101(1)(2)(B) of the Act).

This particular combination of circumstances regarding the sale of leased property was not brought to the attention of Congress when it was considering the Tax Reform Act of 1969. In effect, the sale-of-leased-property situation happens to fall between the above-noted existing transitional rules. It appears likely that if this particular point had been presented in 1969, the Act would have been modified to deal with the situation. Accordingly, your committee's bill minimizes this hardship by the addition of a new transitional rule.

III. Explanation of Provision

The bill amends the transitional rules applicable to the private foundation provisions of the Tax Reform Act of 1969 by adding a new transitional rule to deal with the sale of property by a private foundation to a disqualified person. Under this rule, a private foundation may sell, exchange, or otherwise dispose of property (other than by lease) to a disqualified person if, at the time of the disposition, the foundation is leasing substantially all of that property under a lease subject to the 1979 lease transitional rule described above, and the foundation receives in return an amount which equals or exceeds the fair market value of the property. In computing the fair market value of the property, no diminution of that value is to result from the fact that the property is subject to any lease to disqualified persons.

In order to qualify for the provisions of the bill, the sale, exchange, or other disposition must occur before January 1, 1975.

The bill applies to dispositions occurring after the date of enactment in taxable years ending after that date.

IV. Costs of Carrying Out the Bill and Vote of the Committee in Reporting the Bill

In compliance with clause 7 of rule XIII of the Rules of the House of Representatives, the following statement is made relative to the effect of the revenues of this bill. Your committee estimates that this bill will have no effect, or at most less than $100,000, on the revenues. The Treasury Department agrees with this statement.

In compliance with clause 27(b) of rule XI of the Rules of the House of Representatives, the following statement is made relative to the vote by the committee on the motion to report the bill. The bill was ordered reported unanimously, by voice vote.

V. Changes in Existing Law Made by the Bill, as Reported

In compliance with clause 3 of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

TAX REFORM ACT OF 1969

*   *   *   *   *   *   *

TITLE I—TAX EXEMPT ORGANIZATIONS

Subtitle A—Private Foundations

*   *   *   *   *   *   *

Sec. 101. Private Foundations.

*   *   *   *   *   *   *

(1) SAVINGS PROVISIONS.—

(1) REFERENCES TO INTERNAL REVENUE CODE PROVISIONS.—Except as otherwise expressly provided, references in the following paragraphs of this subsection are to sections of the Internal Revenue Code of 1954 as amended by this section.

(2) SECTION 4941.—Section 4941 shall not apply to—

(A) any transaction between a private foundation and a corporation which is a disqualified person (as defined in section 4946), pursuant to the terms of securities of such corporation in existence at the time acquired by the foundation, if such securities were acquired by the foundation before May 27, 1969;

(B) the sale, exchange, or other disposition of property which is owned by a private foundation on May 26, 1969 (or which is acquired by a private foundation under the terms of a trust which was irrevocable on May 26, 1969, or under the terms of a will executed on or before such date, which are in effect on such date and at all times thereafter), to a disqualified person, if such foundation is required to dispose of such property in order not to be liable for tax under section 4943 (relating to taxes on excess business holdings) applied, in the case of a disposition before January 1, 1975, without taking section 4943(c)(4) into account and it receives in return an amount which equals or exceeds the fair market value of such property at the time of such disposition or at the time a contract for such disposition was previously executed in a transaction which would not constitute a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior law);

(C) the leasing of property or the lending of money or other extension of credit between a disqualified person and a private foundation pursuant to a binding contract in effect on October 9, 1969 (or pursuant to renewals of such a contract), until taxable years beginning after December 31, 1979, if such leasing or lending (or other extension of credit) remains at least as favorable as an arm's-length transaction with an unrelated party and if the execution of such contract was not at the time of such execution a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior law);

(D) the use of goods, services, or facilities which are shared by a private foundation and a disqualified person until taxable years beginning after December 31, 1979, if such use is pursuant to an arrangement in effect before October 9, 1969, and such arrangement was not a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior law) at the time it was made and would not be a prohibited transaction if such section continued to apply; [and]

(E) the use of property in which a private foundation and a disqualified person have a joint or common interest, if the interests of both in such property were acquired before October 9, 1969[.]*; and*

(F) the sale, exchange, or other disposition (other than by lease) of property which is owned by a private foundation to a disqualified person if: (i) such foundation is leasing substantially all of such property under a lease to which subparagraph (C) applies; (ii) the disposition to such disqualified person occurs before January 1, 1975; and (iii) such foundation receives in return for the disposition to such disqualified person an amount which equals or exceeds the fair market value of such property at the time of the disposition or at the time a contract for the disposition was previously executed in a transaction which would not constitute a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior law).

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STATEMENT OF NEWMAN T. HALVORSON, JR., SPECIAL COUNSEL FOR THE MAY DEPARTMENT STORES CO.

Mr. HALVORSON. My client is the May Department Stores Co. In their case the foundation owns the property right across the street in downtown St. Louis. The property owned by the foundation houses the support facilities, the powerplant, and other facilities and is connected

with the department store through an elaborate system of underground systems and conveyors.

This arrangement, this leasing arrangement was entered into in 1965, 4 years before the Tax Reform Act.

Mr. BYRNES. In the case of Badger Meter, these are the administrative offices, research facilities contiguous to the manufacturing facility, and overlapping onto some of the property that is owned by Badger Meter itself.

Senator CURTIS. What is the remedy that applies to this property under the proposed legislation?

Mr. BYRNES. What the amendment would permit is an arm's length sale as long as it is at fair value or in excess, a sale to a disqualified person where it was under a lease that was continued in accordance with the transition rule for leases. They are occupying the property now, perfectly legal under the transition rule provided in 1969. But come December 31, 1979, they cannot continue to lease, nor can they buy it. Section 2101 provides such a transition rule.

I should say that the House passed this provision in 1972. It got tied up with procedural problems with other bills, some of the same problems that exist today in terms of private bills, individual bills dealing with specific problems of not great general application. We are advised there are at least four or five foundations and principal benefactors in the same situation as Badger Meter, Inc. and the May Department Stores Co.

It has been approved by the Treasury since 1972. This approach was recommended by the staff of the Joint Committee on Internal Taxation.

Mr. HALVORSON. We might point out, there is a provision in the Employee Retirement Security Act of 1974, closely analogous to this. Under that provision, a plan is allowed to lease property to the employer under circumstances very similar to what we are proposing here.

This is something that was in the committee report. This was overlooked in 1969. Had it been brought to the attention of Congress, the feeling was it probably would be included as an additional transitional rule.

Mr. BYRNES. That is all, Mr. Chairman.

Senator RIBICOFF. I have no questions.

Are there any other questions?

Thank you, gentlemen.

The next witness is Mr. Townsend Hoopes and Mr. Edwin Cohen.

[The prepared statement of Mr. Townsend Hoopes follows:]

STATEMENT OF THE ASSOCIATION OF AMERICAN PUBLISHERS AND THE AD HOC COMMITTEE FOR EQUITABLE TAX TREATMENT OF THE PUBLISHING INDUSTRY

SUMMARY OF PRINCIPAL POINTS

1. The publishing industry of the United States strongly supports Section 1305 of H.R. 10612.

2. Section 1305 prevents retroactive application of Revenue Ruling 73-395 which purports to require publishers to capitalize prepublication expenditures directly attributable to development of textbooks and teaching aids.

3. A comprehensive survey establishes that such capitalization would be contrary to a long-standing and substantially uniform practice of deduction previously accepted by the Internal Revenue Service.

4. Deduction of these amounts is directly comparable to the deduction of research and development expenses allowed to other industries.

5. The impact of Revenue Ruling 73-395 would fall most heavily on educational publications, which should not be subjected to additional burdens.

6. Section 1305 does no more than preserve the status quo unless and until the Treasury Department adopts new rules through the Regulation process, which affords interested parties an opportunity to be heard.

7. No revenue loss is involved since prior law is preserved.

8. For the foregoing reasons, Section 1305 which was approved by the Committee on Ways and Means and passed by the House of Representatives, should be adopted by this Committee and the Senate.

STATEMENT

I. Introduction

The Association of American Publishers, a not-for-profit trade association, represents publishers of 80 to 85 percent of the general books, textbooks and educational materials produced in the United States. The Ad Hoc Committee for Equitable Tax Treatment of the Publishing Industry represents Harcourt, Brace, Jovanovich, Inc.; Macmillan, Inc.; W. W. Norton, Inc.; and G. P. Putnam's Sons as well as all members of the Association of American Publishers. The Ad Hoc Committee thus represents publishers of approximately 90 percent of the books published in the United States.

The Association of American Publishers and the Ad Hoc Committee file this statement in support of Section 1305 of H.R. 10612, which in substantially its present form was contained in the bill as passed by the House of Representatives and was approved by the Finance Committee during its open mark-up session on May 27, 1976.

Section 1305 will prevent the unfair retroactive application of Revenue Ruling 73-395 by permitting publishers to continue their customary treatment of prepublication expenditures without regard to that ruling until Treasury decides that these consistent practices should be changed. Any change would be through prospective regulations issued with notice of proposed rule-making, thus providing the public an opportunity to comment formally.

The prepublication expenditures affected by Section 1305 are those paid or incurred in connection with the taxpayer's trade or business of publishing or writing for the writing, editing, compiling, illustrating, designing or other development or improvement of a book, teaching aid or similar product. These prepublcation expenditures are the equivalent for the publishing industry of the research and development expenses of other industries which Section 174 of the Code allows to be deducted currently.

Section 1305 is identical to the provision in the House bill, except for clarifying technical changes and its extension to cover professional authors.

II. Need for legislation

The need for the proposed legislation arises from the Internal Revenue Service's pronouncement in Revenue Ruling 73-395 on September 24, 1973, that publishers could not currently deduct expenditures incurred in writing, editing, design and art work, which were directly attributable to the development of textbooks and teaching aids. The ruling held that such costs must be capitalized, and amortized over the useful life of the copyright of the book for which such expenditures were made, unless the taxpayer were able to provide a shorter useful life for the book.

Although the ruling affected the entire publishing industry, it was issued without prior notice and opportunity for industry comment. The publishers' accounting practices for these costs have, in many cases, been consistently followed for more than 50 years, have been approved by competent, reputable accounting firms, and have, until recently, been approved by IRS audit personnel either tacitly by not raising the issues or explicitly by dropping the issue after it was raised.

The extent to which the ruling would alter the dominant industry methods of accounting was clearly revealed by a recent Ad Hoc Committee survey of the tax treatment of prepublication expenditures. The segments of the industry covered by the Ad Hoc Committee survey included some forty publishers of elementary and secondary school textbooks, college textbooks, technical, scientific, medical and business books and subscription reference books (primarily encyclopedias). Publishers of these types of books represent over 50 percent of the total publish-

ing industry sales, and are those which have been most directly affected by the IRS ruling. The companies which responded to the Ad Hoc Committee survey account for some 83 percent of the dollar sales of the publishers in the surveyed segments of the publishing industry. A detailed analysis of this survey was given several months ago to the Joint Committee Staff, to the Finance Committee Staff and to the Treasury and the Internal Revenue Service.

The Ad Hoc Committee survey showed that there has been a substantially uniform practice among publishers of currently expensing all "editorial" and "production" expenditures (primarily art, design, purchasing and administrative functions), with the possible exception of expenditures for editorial and production work performed under contract by outsiders. Approximately one-sixth of the responding publishers indicated they employ some method of deferral for outside editorial and production costs. With respect to "plant" costs (primarily outside artwork, composition, negatives and plates), about one-third of the responding companies have currently expensed those amounts, and about two-thirds of them have written the amounts into inventory or amortized them over a number of years. The substantial uniformity of publishers expensing prepublication expenditures, particularly editorial and production costs, as revealed by the survey, underscores the inequity of the sudden reversal of IRS audit practice by its issuance of Revenue Ruling 73-395.

The results of this survey demonstrate that the compulsory retroactive change attempted to be imposed by Revenue Ruling 73-395 affects a large segment of the industry. Over one-third of the responding companies reported that the IRS has challenged the company's income tax accounting for one or more categories of prepublication expenditures. Since many companies still have back years open for audit, the number of companies directly affected could be far greater if Section 1305 is not enacted. Thus, this is clearly an industry-wide problem.

The costs which the ruling asserts to be not currently deductible are the publishing industry's equivalent of the research and development expenditures that are paid or incurred by other business taxpayers in the creation of new products.[1] They include salaries and fees paid to employees and consultants who design, edit, illustrate, compile and revise the books and teaching aids published by the industry. Like any other industry which must develop and market its own products, the publishing industry's development expenditures are a normal and recurring cost of doing business. Many of these expenditures in any event should be deductible under Section 162 as ordinary and necessary business expenses. In enacting Section 174 as part of the 1954 Code, Congress intended to eliminate controversy as to whether a particular expenditure for research, product development and the like is or is not covered by Section 162. Nonetheless, the ruling arbitrarily singles out and excludes the publishing industry from expensing these amounts, and thereby increasing the cost and discouraging the development of publishing textbooks, reference works and teaching aids, thereby penalizing school systems, students and every American who reads.

Because it represents such an abrupt change in tax accounting practices, the ruling has created considerable confusion in the publishing industry, posing questions as to potential retroactive tax liability for amounts spent on books already published and creating uncertainty as to the proper handling of the costs of publications to be undertaken in the future. Since the promulgation of the rulings, IRS auditing agents have proposed disallowing deductions previously consistently taken by a number of publishers in their development of new books. However, it appears that no two audits have resulted in selection of the same expenses for capitalization or an equivalent amortization treatment of items capitalized. Indeed, in each case to date in which the ruling has been invoked on audit, it has been applied in markedly different ways. The impact of the ruling on a publisher now seems to depend greatly upon the location of the IRS office responsible for the audit.

Despite the longstanding practice of current deduction of prepublication costs shared by most of the publishing industry, the IRS insisted that the ruling reversing that practice be applied retroactively. On February 11 of this year, despite earlier votes by the House and by the Senate Finance Committee approving leg-

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[1] *Compare* Revenue Procedure 69-21, 1969-2 Cum. Bull. 303 in which the IRS ruled that the costs of developing computer software in many respects so closely resemble research and experimental expenditures within the purview of Section 174 as to warrant accounting treatment similar to that accorded under Section 174.

islation to end the retroactivity, the IRS National Office instructed a field office to proceed with enforcement of retroactive tax assessments under the ruling. A subsequent IRS press release of March 11, 1976, which announced the suspension of audit and appellate activity under the ruling pending the completion of a project to re-examine the matter, does not obviate the need for prompt enactment of this legislation, since the IRS has given the industry no assurance that it will alter its insistence on the retroactive application of the tax rules announced in the ruling.

III. Legislative solution

Section 1305 merely provides a "do-not-disturb" rule to preserve the status quo for the period before a long-run solution is put into effect. Under this legislation, for the period before regulations for the future go into effect, a taxpayer is allowed to treat his prepublication expenditures in the manner in which he consistently treated them before the issuance of Revenue Ruling 73-395.

The publishing industry will continue its co-operation with the Joint Treasury-IRS Task Force that is studying the problem and attempting to develop a permanent administrative solution to be applied prospectively. However, if the Task Force is unable to devise an adequate administrative solution, the industry will be forced to seek a permanent resolution of the problem by means of additional legislation.

IV. Revenue effect

No revenue loss will result from enactment of the stop-gap legislation. Rather, the legislation will prevent the IRS from retroactively producing tax revenues by administrative action from a source never intended by Congress. The House Ways and Means Committee report to the House on the legislation as passed by the House in December, 1975, stated that no revenue loss will result, and the Finance Committee Report on H.R. 10612 (p. 405) confirms that little or no revenue loss is involved.

V. Status of the legislation

The Association of American Publishers and the Ad Hoc Committee requested the opportunity to testify on this subject before the House Ways and Means Committee in July, 1975, in its hearings on tax legislation that became H.R. 10612, but were not called to testify. In lieu of oral testimony, a statement in support of H.R. 8736 (identical to S. 2340) was filed, and appears in the printed transcript of the Ways and Means hearings on the subject of tax reform (commencing on page 839). The Committee on Ways and Means did not adopt a permanent solution to the problem, but in its open mark-up sessions in October 1975 did approve the stop-gap do-not-disturb provision which was passed by the House on December 4, 1975, as Section 1306 of H.R. 10612.

The Association and the Ad Hoc Committee made written request to testify before the Finance Committee in connection with its public hearings on H.R. 10612, but were not called to testify. Accordingly, they filed with the Finance Committee a written statement dated April 23, 1976, in support of this provision. The statement was referred to in the Staff pamphlet dated April 30, 1976, summarizing statements that had been submitted (p. 32).

The provision was considered by the Finance Committee in an open mark-up session on May 27, 1976, and was approved with technical clarifying changes and an extension to cover professional authors.

Thus Section 1305 has been under public consideration and discussion approximately a year, statements in support of it have been filed in hearings before both Committees and it has received the approval of both Committees in open mark-up sessions.

VI. Conclusion

For the reasons stated above it is respectfully submitted on behalf of the publishing industry that Section 1305 as previously approved by the Committee on Finance, at least as it applies to publishers, should be enacted.

STATEMENT OF TOWNSEND HOOPES, PRESIDENT, ASSOCIATION OF AMERICAN PUBLISHERS, INC., AND MEMBER, AD HOC COMMITTEE FOR EQUITABLE TAX TREATMENT OF THE PUBLISHING INDUSTRY, ACCOMPANIED BY DARRELL PETERSON, CHAIRMAN OF THE BOARD, SCOTT FORESMAN CO., AND CHAIRMAN, AD HOC COMMITTEE FOR EQUITABLE TREATMENT OF THE PUBLISHING INDUSTRY, AND EDWIN S. COHEN, SPECIAL COUNSEL FOR THE ASSOCIATION OF AMERICAN PUBLISHERS, INC., AND THE AD HOC COMMITTEE FOR EQUITABLE TAX TREATMENT OF THE PUBLISHING INDUSTRY

Mr. HOOPES. My name is Townsend Hoopes. I am the president of the Association of American Publishers. Accompanying me, on my right, Darrell Peterson, chairman of the board of Scott Foresman and also chairman of the ad hoc committee for Equitable Tax Treatment of the Publishing Industry; and on my left, Edwin S. Cohen, special counsel for both organizations.

The association and the ad hoc committee represent publishers of 80 to 85 percent of the general books, textbooks and educational materials published in this country.

We urge the committee to reaffirm its earlier approval of section 1305 of H.R. 10612, which was approved by the Committee on Ways and Means, and passed by the House of Representatives.

We filed with this committee on April 23, 1976, a written statement in support of this section and filed a similar statement in connection with this hearing.

Section 1305 will prevent the unfair retroactive application of Revenue Ruling 73-395 that announced, without prior oportunity for the industry to be heard, that publishers must capitalize rather than currently deduct expenditures in writing, editing, design and art work directly attributed to the development of textbooks and teaching aids.

The sole effect of this section is to preserve the status quo by permitting publishers and authors to continue their customary treatment of expenditures until new regulations are issued.

Congress should enact section 1305 for the following reasons: Without any prior notice or opportunity for industry comment, the IRS ruling abruptly reversed, on a retroactive basis, industrywide tax accounting practices that have been approved through decades of IRS audit practice. An ad hoc committee survey of the tax treatment accorded prepublication expenditures by educational textbook publishers, which is that segment of the industry most affected by the ruling, demonstrates that currently deducting most prepublishing expenditures has been a substantially uniform practice throughout the industry.

The ad hoc committee survey also demonstrated that the ruling poses an industrywide rather than a one-company problem. Over one-third of the companies responding to the survey indicated that IRS challenged the accounting in one category.

Many additional companies with back years still open for audit would be challenged if retroactive application of the ruling is permitted. The impact falls most heavily on educational publications who should not be subjected to additional burdens.

We emphasize, Mr. Chairman, that the legislative reversal of the retroactive feature of the ruling involves no revenue loss. It will merely prevent the IRS from producing additional unanticipated tax revenue by overturning prior practice.

Publishers are not seeking a special subsidy or tax incentive. The legislative remedy they seek here is preservation of the status quo as it has long existed, and that is equal treatment with the research and development expenses of other industries until such time that it is determined that a change should be made.

Any change should be approached by the issuance of prospective regulations, advance notice of hearings, and an opportunity for the industry to present its views to the Treasury, if necessary, to the Congress.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, sir.

The next witness will be Mr. Irwin Karp, counsel of the Authors League of America.

[The prepared statement of Mr. Irwin Karp follows:]

STATEMENT OF THE AUTHORS LEAGUE OF AMERICA

(By Irvin Karp, Counsel)

Mr. Chairman and Members of the Meeting: My name is Irwin Karp. I am Counsel for The Authors League of America, the national society of professional writers. I respectfully request that this statement by The Authors League be included in the record of the Committee's hearings on H.R. 10612.

This statement concerns the tax treatment of research, travel and similar expenses incurred by professional authors in gathering information, preparing and writing books and other literary works. As the Courts have ruled, these are ordinary and necessary expenses of the professional author's trade and business of writing which he is entitled to deduct in the year they are incurred. However, a 1973 Ruling by the Internal Revenue Service disputes that right. Section 1306 (H.R. 10612) would suspend application of the Ruling to professional authors, and to publishers.

The Authors League respectfully urges that Section 1306 be approved by the Committee on Finance and adopted by the Senate. We should stress that the Section does not grant professional authors new rights. On the contrary, it preserves rights which the Courts have held they possess.

BACKGROUND

In 1971, a District Court opinion reaffirmed the right of professional authors to currently deduct research and similar expenses incurred by them in preparing and writing books and other literary works. *Stern* v. *United States*, 1971-1 USTC 86.419 (Par. 9375). Professional authors had long followed this practice. Courts upheld it.

The IRS did not appeal the *Stern* decision. Instead, it issued Rev. Rul. 73-395, contending that these "prepublication expenses" could not be currently deducted by publishers, and had to be depreciated over a period of years. The Ruling concludes with a refusal by the IRS to follow the *Stern* decision and has been applied to authors.

Sec. 1306 of the House Tax Reform Bill, also submitted as an amendment by Senator Bentsen, suspended application of the Ruling with respect to publishers. Professional authors were not protected by the Section, although the Ruling is aimed at a decision that correctly upheld their right to deduct these expenses in the year incurred.

Your Committee amended Section 1306 to also apply it to authors engaged in the trade or business of writing. The Authors League had, on April 20, 1976, submitted a statement to the Committee urging that amendment. It should be noted that Section 1306, as thus amended, would apply only to professional authors, i.e. those engaged in "the trade or business of writing"; this criterion is often applied by the IRS and the courts in distinguishing professional authors from amateurs under various sections of the Internal Revenue Code.

A recent "News Release" by the IRS announces it will "suspend audit and appellate activity with respect to cases in which the deductibility of these pre-publication expenses is an issue" pending completion of a "project" which may lead to new regulations or additional rulings. However, the release is limited to publishers. And it leaves professional authors completely in the dark as to the position the IRS would take if they continued to currently deduct research, travel and similar expenses, as the Courts have ruled they are entitled to do.

REASONS FOR ADOPTING SECTION 1306

(i) In the case of novels, histories, biographies and other books of general interest, it is the self-employed author, not the publisher, who pays the travel, research and other expenses incurred in gathering information and material for a book. As the Court indicated, in *Stern* v. *U.S.*, these expenditures are not non-deductible expenditures for the improvement of a capital asset (which must be depreciated). On the contrary, ruled the Court,

> (these) expenses were ordinary and necessary expenses of carrying on plaintiff's business of a writer and hence are deductible under 26 U.S.C. 162(a). See *Doggett* v. *Burnet* (65 F 2d 191); *Brooks* v. *C.I.R.* (274 F.2d 96.)

Travelling to conduct interviews, consulting research sources and similar preparatory work are as much part of the process of writing a book as are putting the words down on paper. The expenses of doing this work are ordinary business expenses.

(ii) It is totally inconsistent to rule that these ordinary business expenses must be capitalized and depreciated. Sec. 1221(3) of the Internal Revenue Code prohibits authors from treating their literary, dramatic and musical works as "capital assets." In this and other sections, authors are held to be persons who earn "ordinary income" by their personal efforts. As this Committee stated in regard to Sec. 401(c)(2)(C), "income from an author's writing . . . is (so) clearly a result of his individual efforts."

(iii) An author must pay his research and travel expenses as they are incurred. And he does not have the financial resources to spread their deduction over a period of years through depreciation. If he cannot deduct them in full in the year they are incurred, he suffers a much harder financial blow than a publishing corporation. Moreover, these prepublication expenses usually are incurred during the same period that the author receives compensation from the publisher (in the form of an "advance") from which he pays these expenses. This compensation is fully taxable to the author at the time of its receipt.

We thank the Committee for the opportunity to submit this statement.

STATEMENT OF IRWIN KARP, COUNSEL, THE AUTHORS LEAGUE OF AMERICA

Mr. KARP. Mr. Chairman, I am here on behalf of the Authors League, which is a national society of professional writers, who urge the Committee on Finance to reaffirm and approve section 1305.

Mr. Hoopes has described the purpose of the section. I should point out briefly that this committee amended that section to apply to authors as well as writers. The reason for that is that the ruling which has led to this problem for both publishers and professional authors

was actually triggered by a decision of the district court in California which affirmed in 1971 the longstanding practice and right of authors engaged in the business of writing to deduct expenses engaged in research in preparation of books on a current basis.

In that case, the court actually addressed the very problem which gave rise to the ruling, stating that one of the issues that remained to be considered was whether the expenses claimed should be treated as deductible business expenses or an uncapital expenditure for improvement of capital assets.

The court, on the basis of longstanding precedent, held that in the case of professional authors the expenses involved were indeed ordinary and necessary current business expenses and not capitalizable expenses.

Following the decision, the Internal Revenue Service decided not to appeal; instead issued this ruling. Although the ruling is couched in terms applicable to publishers, it concludes with a very flat statement that the Internal Revenue Service would not follow the Stern case that dealt primarily and solely with the right of professional authors to deduct these expenses.

As we point out both in the statement we filed with the committee in April and our present statement, there is absolutely no basis in the law for the ruling as it applies to authors.

I might note very briefly that the Internal Revenue Code is replete with sections that prohibit authors from ever treating a literary work they create as a capital asset—section 1221, section 1231 and others. In other words, throughout the Code the author is treated as an individual who earns his income by his efforts and labor. When we come to the expenses incurred in carrying out that type of work and earning that income, we are told by the Service we are now creating a capital asset and must capitalize and amortize the expenses.

We think that position is wrong and the courts happen to agree with us, but with the ruling issued, our only recourse was to ask the Senate and the House to give us this relief.

We urge the committee to include section 1305.

The CHAIRMAN. Thank you very much, sir.

Next we will hear from Mr. Kenneth Wahlberg, persident of Investors Syndicate of America.

I see that Mr. Wahlberg is not here. Then we will hear from Dr. N. J. Rogers on behalf of Texas State Optical Co.

[The prepared statement of Dr. N. J. Rogers follows:]

SUMMARY OF PRINCIPAL POINTS OF TESTIMONY OF DR. N. JAY ROGERS, PARTNER, TEXAS STATE OPTICAL CO. (TSO)

1. TSO is a partnership for the practice of optometry and sale of eyeglasses and frames with approximately 128 outlets, some of which have been sold, and some owned in partnership with managing optometrists.

2. TSO advertises its services and provides low cost eye-care.

3. General advertising and small size of outlets dictates certain controls being imposed which have resulted in adverse tax impact.

4. 1969 franchise transfer tax law directed at fast food outlets dictates ordinary income treatment for income from transfers of franchise, trademarks, and trade names, rather than capital gains.

5. Contrary to almost invariable practice, the law failed to consider binding contracts entered into prior to the date of enactment based on previous law.

6. The Committee on Finance passed an equitable grandfather clause amendment which we support applying to transfers of professional practices.

7. Another part of the amendment adopted closes off capital gains treatment of a franchise transfer to a partnership and then the sale of a partnership interest, thereby otherwise circumventing 1969 franchise tax provision.

TESTIMONY OF DR. N. JAY ROGERS

Thank you, Mr. Chairman, for allowing me the opportunity to express my views on section 1311 of H.R. 10612, relating to the transfer of certain franchises. My name is Dr. N. Jay Rogers and I am a partner in the firm of Texas State Optical (TSO), a partnership which operates in Texas and Louisiana. TSO is owned by myself and my brother. We started our optometry practice in 1936, and have, over the years, opened approximately 128 outlets, usually also connected with the sale of eyeglasses and eye frames. From about 1944 to the present we sold approximately 60 of these outlets. We operate 39 others in partnership with the optometrists who operate the offices, and own the other 29 outright.

Over the years, we have been able to provide to our customers inexpensive but quality eye care, eyeglasses, and prescriptions. In fact, because of the way we operate, we have been able to furnish these glasses and prescriptions at a price which is significantly below what would be charged in most other areas of the country. One of the methods we use in providing this is to have an extensive program of advertising. This program obviously benefits all of the outlets in the advertising area, with the result that we must require all outlets to participate in the advertising. We were innovators in the advertising of eyeglasses and eye frames, something which the Federal Trade Commission has recently adopted as one of its recommended policies. However, because of our advertising operation, and the small size of our outlets which dictate certain controls being imposed for good business purposes, we have been adversely affected by a tax provision which was adopted by the Congress in 1969 and which became effective the following year.

Prior to 1970, if someone transferred a franchise, trademark, or trade name to another person, the character of any gain recognized on the transaction would be subject to the normal tax rules. Under these rules, some situations would give rise to ordinary income treatment and others would result in capital gains treatment. In 1969, Congress adopted a provision aimed at the fast food industry which became effective in 1970 which mandated ordinary income treatment for all of these transfers. In doing so, however, it failed to take into account that taxpayers might have already entered into binding contracts and would be caught in this amendment. As you know, Congress generally "grandfathers" binding contract situations when they adopt rules which change the tax law. Because this was not done for this change, the economics of our transactions covered by these contracts were significantly and adversely affected. They obviously had been negotiated under the prior law, which we believe in our situation would have given rise to capital gains treatment. Instead, because of the law change, we now find ourselves having binding contracts with prices which presume capital gains treatment but which now may result in ordinary income treatment. Most of these contracts were not entered into in 1970 or subsequent years but in 1968 or earlier years.

When our accountants called this situation to our attention, we gave considerable thought to whether or not to petition the Congress, as is our constitutional right, to consider our situation, and decided to ask for the adoption of an equitable grandfather clause which would take into consideration that certain binding contracts had been entered into before 1970. We rejected an approach which we felt equitable, after consultation with the congressional staffs, that would have excluded all professional practices from these rules which were originally adopted because of abuses in the fast food franchise area. Obviously, when this provision was first adopted nobody thought that professional practices and businesses connected thereto would be swept under this provision. In order to correct this inequity which we pointed out, the Committee on Finance adopted a provision which grandfathered those contracts entered into before 1970, which were entered into with employees or partners of the transferor, and which involved the transfer of a franchise, trademark, or trade name which was connected with a business in which a professional practice is involved. It is my opinion that this is a very sound approach. These tests cover those situations which Congress found deserved attention but at the same time are restrictive enough so that they do not cover situations which, if brought to the attention of Congress, would be considered inequitable.

The Committee also adopted as part of this section a reform provision which has the effect of denying taxpayers a method of avoiding the ordinary income treatment provided under the franchise rules. It is possible under present law for taxpayers to transfer a franchise, trademark, or trade name to a partnership and then sell the partnership interest and receive capital gains therefrom, rather than deriving ordinary income if this sale had been made directly to the purchaser. TSO has opinion of counsel that certain of our transactions would also be covered by this provision. We recognize that Congress may want to close this avenue of avoiding the franchise rules, and accept the Committee's decision on this point. We would, however, like to point out that the effect of this entire provision is to drive the price of these outlets up for very small entrepreneurs who are trying to establish a business. Furthermore, we might also point out that these rules were originally developed for problems which had arisen in the fast food franchise area and nobody at the time thought they covered the sale of a professional practice.

Because of situations like this, it is our opinion that the Committee on Finance is doing a commendable job in reviewing broad based legislation subsequent to its enactment in order to determine if the legislation should be changed to cover situations that were not covered under the original draft or to exclude equitable situations which should not have been covered but which were because of the breadth of the statute.

On my behalf and for my brother, I wish to state we seek no unfair tax advantage, but we respectfully ask what is wrong with our requesting that an obvious legislative oversight be corrected by the addition of a binding contracts clause, a provision common to almost every tax law change.

STATEMENT OF N. J. ROGERS, PARTNER, TEXAS STATE OPTICAL CO.

Mr. ROGERS. My name is Dr. N. J. Rogers. I am a partner in the Texas State Optical Co., a partnership that operates in Texas, New Mexico, and Louisiana.

Over the years we have opened 128 optometry offices that dispense eye glasses and contact lenses. Since 1944 we have sold approximately 60 of these outlets. We operate 39 others in partnership with the optometrists who operate the offices, and we own the other 29 outright.

We have been able to provide to our customers and patients high quality eye care, eyeglasses and prescriptions at prices significantly below what would be charged in most other areas of the country. We were innovators in optical advertising, something which the FTC recently adopted as a recommended policy.

However, because of our advertising and certain policy controls imposed for good business purposes, we have been adversely affected by a tax provision adopted in 1969.

This provision, aimed at the fast food industry, mandated ordinary income treatment for such franchise transfers. In doing so, however, Congress failed to consider that taxpayers might have already entered into binding contracts that might be caught under this amendment.

As you know, Congress generally grandfathers binding contract situations. The economics of our transactions covered by these contracts were significantly and adversely affected. They obviously were negotiated under prior law, which in our situation would have given capital gains treatment.

Instead, we now find ourselves having binding sales contracts with prices which presume capital gains treatment but which now may result in ordinary income treatment. These contracts were entered into prior to 1970 when the change became effective.

Obviously when this provision was first adopted, nobody thought that professional practices would be covered. In order to correct this inequity that we pointed out, the Committee on Finance adopted a

provision that grandfathered those contracts entered into before 1970, that were entered into with employees or partners of the transferor, that involved the transfer of the trade name that was connected with a professional practice.

This is a very sound approach to a situation Congress found deserved attention, but was restrictive enough not to cover inequitable situations.

I was surprised that Treasury said that adoption of section 1311 would reinstate the uncertainty of prior law for our company. Apparently Treasury, and the so-called public interest groups which endorse Treasury's views, are unaware that in the Turnoff case in 1968, the Tax Court interpreted a contract involving Texas State Optical, and the contracts issued today, and found that the payments made by the purchaser were not deductible. As a corollary, it was clear that we had sold capital assets.

Treasury's comment also assumed that the contracts we entered into prior to 1970 were not binding. These contracts were binding on us. The only way we could avoid them would be under such extraordinary circumstances such as if the purchaser became an alcoholic or a drug addict, which never happened, by the way.

It is true that some purchasers are former employees, and were not bound under these contracts to the same degree as my brother and I, but this was done for their protection. Even the so-called public interest spokesmen agreed. And an exception that grandfathers later sales made under contracts binding in 1969 may be warranted and may be even retroactive enactment of one 6 years later is defensible.

We agree with this conclusion and believe enactment of this particular amendment is not only defensible but necessary to correct an inequity. As indicated, the comments of critics of this amendment not requiring a binding contract are inapplicable to our situation. As for the amendment being defective because it also covers the transfer of a business relating to a professional practice, my answer to that is that this is a part of the practice of optometry.

As for section 1311—should I stop here?

The CHAIRMAN. I suggest you submit the rest of your statement.

Senator DOLE. Mr. Chairman?

The CHAIRMAN. Yes.

Senator DOLE. Have you discussed your differences with Treasury?

Mr. ROGERS. We are in the process of doing that at the present time on some of these contracts.

Senator DOLE. Treasury should present any view they have before we finish.

The CHAIRMAN. Yes.

Thank you very much.

Next we will call Mr. Robert Juliano, legislative representative on behalf of the Hotel and Restaurant Association.

[The prepared statement of Mr. Robert Juliano follows:]

STATEMENT OF THE AMERICAN HOTEL AND MOTEL ASSOCIATION AND THE NATIONAL RESTAURANT ASSOCIATION

SUMMARY

1. The amendment in Committee Bill Section 1312: Clarification of an Employer's Duty to Keep Records and to Report Tips, does *not* bestow any tax bene-

fit on any employer or employee; nor does it free employers from reporting tip income received by their employees.

2. In enacting the 1965 amendments to the Internal Revenue Code, Congress decided that the only practical way to determine actual tip income for tax purposes was to require the employee who receives the tips to report the amount received to his employer. Section 6053 was added to the Code in 1965 for this purpose.

3. Congress also recognized the common practice of tip splitting and tip pooling and determined that only tips received by an employee in his own behalf would constitute wages or income to that employee. Any portion of a tip which an employee splits or gives to a tip pool is income to the ultimate recipient. As a result of this determination, section 6051 of the Code was amended in 1965 to provide that an employer's report of tip income on Form W-2 "shall include only" that tip income reported by the employee of his employer.

4. The legislative history of the 1965 amendments shows that Congress was fully aware of the practices and customs of tipped employees, and was deeply concerned that employers reporting and record-keeping requirements be minimal.

5. For nearly a decade employers and employees have followed these procedures as prescribed in the law and as clearly intended by Congress.

6. The need to reaffirm and clarify Congress' intention to limit the employer's tip income, record-keeping, and reporting burdens to only that tip income reported by the employee arises from the IRS ruling that would require employers to keep a record of all charge tips passed over to each employee and to reflect the total amount on the Form W-2, whether or not this amount had been reported by the employee.

7. Compliance with this ruling would be inconsistent with the law and Congressional intent; would impose a new and extensive record-keeping and reporting burden on employers; would unjustifiably impugn the honesty of many thousands of tipped employees; and would create a source of conflict between employer and employee.

Mr. Chairman and members of the Committee: The National Restaurant Association and the American Hotel and Motel Association are the principal trade associations in the foodservice and hotel-motel industries. We both have the firm support of our large nationwide membership in urging the enactment of Committee Bill Section 1312: Clarification of an Employer's Duty to Keep Records and to Report Tips (sec. 1312 of the bill and secs. 6001 and 6051 of the Code.)

At the outset it should be noted that this amendment does not bestow any tax benefit on any employer or employee; nor does it free employers from reporting tip income received by their employees. The amendment simply states the intent of Congress as reflected by the legislative history surrounding the 1965 amendments to the Internal Revenue Code.

The need for this clarifying amendment arose in this way. From the inception of the tax laws in 1917 until 1965, employers were not involved in reporting on or withholding taxes related to tip income. Employees were merely required to report their tips and to pay taxes thereon on a calendar year basis. In 1965, however, Congress changed all this by making employers responsible for including tip income on employees' earnings reports (Form W-2) and for withholding income and social security taxes thereon. The legislative history demonstrates that Congress did not do this lightly. It spent several years studying and planning the administrative provisions governing the taxation and reporting of tip income. These provisions reflect the Congressional concern to minimize to the maximum degree possible the burdens placed on employers in reporting and withholding taxes on tip income.

In establishing the employer's responsibility to report and withhold taxes on tip income, Congress confronted and resolved troublesome issues, two of which are especially important here. The first of these arose because of the pervasive practice of tip pooling and tip splitting among tipped employees in the restaurant and hotel-motel industries. Congress recognized these practices and determined that the tax burden should fall upon the ultimate recipient of the tip.

> Only tips received by an employee on his own behalf and not on behalf of another employee constitute wages. Thus, where employees practice tip splitting, the ultimate recipient of the tip (or portion thereof) is the employee who is receiving the tips as wages. [H.R. Rep. No. 213, 89th Cong., 1st sess. 219 (1965).]

Recognizing the nature of the tipping transaction, a second principal issue was how does the employer determine the amount of tip income on which to report and withhold taxes? Congress concluded that:

> The only equitable way of counting tips ... [would be] on the basis of actual amounts of tips received and that the only practical way to get this informa-

tion [would be] to require employees to report their tips to the employer. [H.R. Rep. No. 213, 89th Cong., 2d sess. 96 (1965).]

Following this logic, Congress added a new section 6053 to the Code which requires employees to report tips received on their own behalf by the 10th day after the month in which they are received. Section 313 of Public Law 89-97 effected corresponding changes to the income tax withholding provisions (sections 3401 et sequi), the social security tax withholding provisions (sections 3101 et sequi), and the general reporting provisions (section 6051) of the Internal Revenue Code to make reporting and withholding of social security and income taxes on tip income "applicable only to such tips as are included in a written statement furnished to the employer pursuant to section 6053(a)." Finally, Congress amended section 6051 of the Internal Revenue Code to similarly limit the amount of tips to be shown on the annual statements which employers prepared for employees to reflect income and withholding during the year (Form W-2). As amended in 1965, section 6051 provides:

> In the case of tips received by an employee in the course of his employment, the amounts required to be shown . . . *shall include only such tips as are included in statements furnished to the employer pursuant to section 6053(a)*. [Emphasis added.]

We see no reason to burden the Committee with an extended expedition through the Code and Treasury Department Regulations to establish that under the Code and the regulations the Form W-2 constitutes the only report of wages, compensation, remuneration, and income paid to employees which is required to be made by an employer. This is not disputed. As you are all aware, copies of the Form W-2 are supplied for IRS and to the employee for his records.

For nearly a decade after the enactment of the 1965 amendments to the Internal Revenue Code, employers followed the prescription of section 6051 and withheld taxes on and reported only that tip income reported by their employees. Then, in 1975, without any change in the law, IRS issued a ruling (Rev. Rul. 75-400) which required the employer to keep a record of all charge tips which he pays over to an individual employee and to report the sum total of those charge tips on that employee's Form W-2. This sum total of charge tips was to be reported to IRS whether or not the tips had been reported by the employee and without regard to the identity of ultimate recipients of the tip through tip splitting and pooling arrangements. We contested this ruling wih IRS, without success. Our contention was and is that the ruling is inconsistent with the intent of Congress when it enacted the amendment to section 6051 of the Internal Revenue Code in 1965 which requires that the amount to be reported as tips "shall include only such tips are are included in statements furnished to the employer pursuant to section 6053(a)." We were and are now also deeply concerned that, due to the practice of tip splitting and tip pooling, assigning the entire charge tip to an individual employee will require the employer to knowingly make a false inaccurate report. That such reports will result in conflicts between the employer and his employees and in an unjustifiable reflection upon the honesty of our industries' employees are also disturbing probabilities. While the Committee was considering an amendment to clarify this matter, IRS issued a new revenue ruling (Rev. Rul. 76-231) which, while more detailed than its predecessor, continues the same burdensome requirement.

As we understand it, the Internal Revenue Service finds its authority to circumvent section 6051 of the Code in section 6041. Section 6041 provides that,

> All persons engaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensations, remuneration, emoluments, or other fixed determinable gains, profits, and income * * * of $600 or more in any taxable year, * * * shall render a true and accurate return to the Secretary or his delegate * * * setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

We believe that section 6051 of the Code and the legislative history of the 1965 amendments make it eminently clear that Congress intended to limit an employer's obligation to report tip income to, "only such tips as are included in statements furnished to the employer pursuant to section 6053 (a)." and that section 6041 does not apply. We base this conclusion on the following facts:

a. The entire legislative history of the 1965 amendments as it relates to taxing and reporting tip income reflects a thorough understanding by Congress of the practices and customs of tipped employees and a deep concern for the accounting problems these amendments would present to employers. This concern was reflected in the House Committee Report in these words,

> The employee would be required to report to his employer in writing the amount of tips received and the employer would report employees' tips along with the employees' regular wages * * * A provision is included under which the Secretary of the Treasury or his delegate is authorized to issue regulations under which the employer will be permitted to gear these new reporting procedures into his usual payroll. *It is the understanding of your Committee that regulations will be issued along these lines to the end that the procedures required of the employer with respect to this reporting requirement will be minimal.* [House Report No. 1548, 88th Cong., 2d sess. 11 (1964) (Emphasis added.)]

b. One cannot argue that Congress did not anticipate or have knowledge of charge tips as opposed to tips received directly from the customer, for the House Committee Report specifically refers to charge tips in these words,

> The employee would be required to report to his employer in writing the amount of tips received and the employer would report the employee's tips along with the employee's regular wages. *The employee's report to his employer would include tips paid to him through the employer as well as those received directly from customers of the employer.* [House of Representatives Report No. 312, 89th Cong., 1st sess. (March 29, 1965) (Emphasis supplied.)]

c. As mentioned above, Congress clearly established that "only tips received by an employee on his own behalf and not on behalf of another employee constitute wages." Yet, IRS relies upon section 6041 to require employers to keep independent records of charge tips paid directly to each employee and to reflect this amount on the Form W-2, even though in most cases a portion of that amount will not fall within the terms of the salaries, wages, compensation, and remuneration to which 6041 applies. We should also note that the transfer by the employer to the employee of the amount designated by the customer on the charge slip does not constitute a "payment" by the employer within the meaning of section 6041 any more than a meal charged on a credit card account constitutes a sale of the meal to the company issuing the credit card. The employer is nothing more than a conduit through which the payment passes from the customer to the employee, just as a bank is a conduit when it cashes a check.

d. Section 6041 upon which the IRS relies makes no mention of tip income. Since section 6041 preceded section 6053 and the 1965 amendment to section 6051 limiting the employer's reporting obligation to that tip income reported by the employee under section 6053, the more recent and specific requirements of sections 6051 and 6053 clearly supersede the earlier general requirements of section 6041. Further it is abundantly clear from the legislative history that Congress was concerned that the employer's record keeping and reporting obligations not become burdensome and that it was fully aware of the problems posed by tip splitting and pooling. Congress did not intend that the employer be saddled with a reporting and record keeping burden of the nature which IRS now seeks to impose. It was the intent of Congress that sections 6051 and 6053 control the matter of reporting tip income.

The amendment in Committee Bill Section 1312 will serve to reinforce and clarify the plain intent of Congress when it passed the 1965 amendments and preclude the imposition of a requirement which is unduly burdensome and expensive for employers; creates a source of conflict between employer and employee; and unjustifiably calls into question the honesty of many thousands of tipped employees.

We respectfully urge the Committee to reaffirm its adoption of Committee Bill Section 1312.

STATEMENT OF ROBERT E. JULIANO, LEGISLATIVE REPRESENTATIVE, HOTEL & RESTAURANT EMPLOYEES & BARTENDERS INTERNATIONAL UNION, AFL-CIO

Mr. Chairman, in behalf of our general president, Edward T. Hanley, and the 500,000 members we are proud to represent, we are gratified at the opportunity to appear before your Committee to discuss a matter of vital importance to our international union.

First of all, we would like to extend our thanks to the Committee for their thorough deliberation of the tip income issue which culminated in a clarifying amendment being overwhelming adopted on May 27, 1976. The merits of this issue today are as strong as they were when this Committee adopted the aforementioned amendment. I am pleased to appear today in behalf of a Union which represents a half-million members, approximately 25 percent of whom are classified as tipped employees. We also realize our appearance in this matter will

assist thousands and thousands of tipped employees who are not part of the organized labor movement. Our members, as well as the working people of America, are in fact our "Special Interest."

Mr. Chairman, tipped employees have been covered under the Fair Labor Standards Act since 1966. The system created by the Congress heretofore has been fair. It required the employee to keep track of his own tips, report them to the employer in writing, and be taxed and subjected to withholding on them as so reported.

Last year, the Internal Revenue Service promulgated Revenue Ruling 75-400, which was subsequently superseded in May, 1976, by Revenue Ruling 76-231. Unless there has been a change in our constitutional process that I am unaware of, we are laboring under the impression that Congress is the legislative branch of the government and is supposed to create laws, and the Internal Revenue Service is part of the Executive Branch of government which is supposed to implement the laws. There has not been a change regarding the area of tipped income since the Fair Labor Standards Act of 1966 covered tipped employees for the first time. The Legislative intent and the legislation itself is clear. Revenue Ruling 75-400 and subsequently 76-231 apparently make no effort to take into account existing law. The clarifying amendment which your Committee overwhelmingly adopted on May 27, wisely reiterates the law as written by the Congress of the United States.

Due to the Revenue Ruling, Mr. Chairman, there was another unfortunate development which occurred. In many cities our members are on a checkoff system, which means that by signing a form they authorize the employer to deduct union dues from their payroll check, and these monies are forwarded to the union. A matter such as this is spelled out in a duly negotiated collective bargaining agreement between labor and management. We received word from our local union in Minneapolis, that due to the Revenue Ruling our members received payroll checks which were so low, and some which were even blank, that the employer could not deduct union dues and was telling the union that they would have to go to the member directly and get the union dues themselves. So a further consequence of these Revenue Rulings has been in some instances to abrogate a collective bargaining agreement which has been duly and legally negotiated between labor and management. Again, here we have an intrusion into the sacrosanct area of collective bargaining agreements by an agency of the Executive Branch with no regard for existing law or any negative consequences that might be engendered.

When H.R. 6675 was passed in 1965 specifically covering the taxation and reporting of tip income, the whole subject was treated and the legislative history from that time, makes it clear that the reporting burden should properly be on the employee. The legislative history included the following statement:

"* * * the only equitable way of computing tips toward benefits is on the basis of actual amounts of tips received and that the only practical way to get this information is to require employees to report their tips to the employer."

With this in mind Mr. Chairman, we sincerely believe that there is no basis for the recent ruling of the Internal Revenue Service regarding the handling of tipped income. It is our strong feeling that the Committee wisely adopted, after very thorough debate, the clarifying amendment on May 27, 1976. We appear here today in behalf of all of our gratuity employees and all others affected by this matter and urge strongly that the Committee adhere to the amendment which they adopted by an overwhelming vote and is now a part of H.R. 10612.

STATEMENTS OF ROBERT JULIANO, LEGISLATIVE REPRESENTATIVE, ON BEHALF OF THE HOTEL & RESTAURANT EMPLOYEES & BARTENDERS INTERNATIONAL UNION, AFL-CIO; AND RICHARD BENEFIELD, GENERAL MANAGER OF THE MAGEE HOTEL, BLOOMSBURG, PA., ON BEHALF OF THE AMERICAN HOTEL & MOTEL ASSOCIATION AND THE NATIONAL RESTAURANT ASSOCIATION, ACCOMPANIED BY ALBERT McDERMOTT, AMERICAN HOTEL & MOTEL ASSOCIATION, AND ROBERT NEVILLE, NATIONAL RESTAURANT ASSOCIATION

Mr. JULIANO. I would like to ask your permission that my testimony be part of the record, and I have a few comments.

Our members as well as all of the other working people of America are in fact special interest. Congress is legislative branch and the IRS is part of the executive branch. There has been no change regarding declaration of tip income since 1966. So the IRS apparently takes the position that they can write new legislation and are oblivious to the current law and legislative intent which is very clear.

Not only would our gratuity people have to be bookkeepers with the new revenue ruling, but the paperwork involved would place a burden on all businesses, both large and small.

Due to Revenue Ruling 75–400 that was superseded May 1976 by Revenue Ruling 76–231, major problems have arisen. One of the more prominent is most of our collective bargaining rules have a checkoff system. Our members have received minimal paychecks, and in some cases, blank payroll checks. Management has then told the union to go ahead and collect the dues themselves. So now the IRS with its supposedly helpful and innocuous ruling has abrogated duly negotiated collective bargaining agreements arrived at under the auspices of the Taft-Hartley Act.

Mr. Alexander of the IRS Commission testified two days ago:

> I think, too, that it can be seriously questioned whether the patchwork legislation that results from reversing specific ruling of the Service results in the kind of broad legislative overview that Congress perhaps should be giving questions of this sort.

Apparently Commissioner Alexander questions the wisdom and authority of your committee, Mr. Chairman, since you saw fit to deliberate this matter thoroughly and passed a clarifying amendment on May 27, 1976 that reiterates the intent of Congress. If Mr. Alexander is overly concerned about the role of the legislative branch and its lack of ability, might we suggest that he resign from office and run for either the Senate or the House, wherever he is domiciled.

Commissioner Alexander further stated: "Failure to report income from tips is a chronic and persistent compliance problem." The Commissioner assumes, again, "conservatively, the noncompliance in the tipped area is 35 percent."

I greatly resent the fact, even though the language is euphemistic, that he is calling my members crooks.

When Mr. Alexander testified before this distinguished committee a few months ago, his presentation indicated that Revenue Ruling 75–400 would mean an accrual of approximately $5 million to the Treasury. In his presentation 2 days ago, he came up with some new form of higher mathematics that indicated that the failure to allow a full implementation of Revenue Ruling 76–231 would be a loss of $100 million.

Perhaps Commissioner Alexander wants to attribute this gross exaggeration of figures to the inflation rate or some other ethereal form of mathematics because we wonder how a figure could change so dramatically in 2 months.

I was amused to see that the Commissioner quoted a preliminary decision of a court case involving the ruling. The judge said of the new IRS ruling that it is "drafted with such well-crafted obscurity as to conceal its intended meaning from ordinary citizens with the possible exception of those whose life work is the interpretation of Internal Revenue regulations.

Mr. Chairman, we feel that the facts are simple and clear. The subject of declaration of tipped income has been the same since 1966. The committee adopted the clarifying amendment on May 27. We appear here on behalf of all our gratuity employees and all other workers affected by this matter and urge strongly that the committee adhere to the amendment that they adopted by an overwhelming vote and is now part of H.R. 10612.

The CHAIRMAN. Thank you very much.

Do you have additional statements? I assure you I will personally read all your statements. I intend to continue to support your position.

Thank you very much. I suggest you submit the other statement. I assure you we will make full use of them.

Mr. JULIANO. Thank you very much.

The CHAIRMAN. Next we will call Senator James Allen, one of our most effective lawmakers. He has so far almost 100 percent batting average on his amendments in the Senate on tax measures.

[The prepared statement of Senator Allen follows:]

SUMMARY OF STATEMENT SUBMITTED BY SENATOR JAMES B. ALLEN OF ALABAMA

I urge the adoption of Section 1308 of the Senate version of the Tax Reform Act which amends Section 543(a) of the Internal Revenue Code.

1. Under Section 543(a)(6) of the Internal Revenue Code rents received by a corporation from a 25 percent or more shareholder for the use of corporate property is treated as personal holding company income unless its other personal holding company income is 10 percent or less of its gross income.

2. The Internal Revenue Service has taken the position that payments received for the lease of intangible property to a shareholder are royalties under Section 543(a)(1) rather than rents under Section 543(a)(6).

3. There should be no distinction between tangible and intangible properties leased to a shareholder where they are part of an integral group of business assets used by the shareholder in an active trade or business.

4. This provision retroactively corrects the statute to allow similar treatment for tangible and intangible assets leased to a shareholder for use in his business. It does not however, allow shareholder rents to be used to shelter other passive income and preserves the intent of the personal holding company provisions.

5. Retroactive relief is even more justified for this provision than when the Congress granted similar retroactive relief in 1950 and 1955.

STATEMENT SUBMITTED BY SENATOR JAMES B. ALLEN OF ALABAMA

Mr. Chairman, I wish to thank the Committee for giving me an opportunity of appearing before it in support of Section 1308 of the Committee bill. This provision is the same as S. 3288 which Senator Sparkman and I introduced last April as an amendment of Section 543(a) of the Internal Revenue Code.

The purpose of this provision is to correct what I believe is an unintended result occasioned by the personal holding company provisions dealing with rental payments by shareholders to their corporations. Specifically, the problem involves the treatment of payments received for leasing intangible property as royalties under Section 543(a)(1) rather than shareholder rents under Section 543(a)(6).

The problem was first presented to me through a company in my home state of Alabama whose stock is owned by two trusts. The Company owns and leases to several partnerships assets used by each partnership in the business of making and selling a soft drink product within a specified area. The two trusts own a majority of the partnership interests of each partnership, and three individuals own the minority partnership interests. The assets used by these partnerships consist of land and buildings, machinery and equipment, automobiles, delivery equipment and coolers, *and the exclusive right to make and sell the product within such specified area.* The reason for this manner of operating the business of that in 1934 ownership of all of the assets, tangible and intangible, used in the

business was transferred to the Company in order to conserve and preserve title to these assets in a continuing entity, thereby insulating these assets from the death of, or other changes in, the partners of the partnerships.

The Internal Revenue Service has taken the position that the Company was a personal holding company on the grounds that a substantial portion of the payments to the Company from the partnerships should be treated *as royalties* under section 543(a)(1) of the Code rather than as compensation for the use of corporate property under section 543(a)(6). The Internal Revenue Service takes the position that the payment for the exclusive right to make and sell the product is a royalty.

Section 543(a)(6) of the Code provides that amounts received as compensation for the use of, or right to use, property of the corporation, where 25 percent or more of its stock is owned by an individual entitled to use the property, constitutes personal holding company income, unless its other personal holding company income (excluding rents under section 543(a)(2)) is 10 percent or less of its ordinary gross income. That is, payments for the use of corporate property by its shareholders will not constitute personal holding company income unless these payments are used to shelter passive income in excess of 10 percent of the corporation's ordinary gross income. Since the portion of the payments from the partnerships which are treated by the Service as income (i.e., the royalties) under section 543(a)(1) was greater than 10 percent of the ordinary gross income, all of the payments from the partnerships constituted personal holding company income under sections 543(a)(1) and 543(a)(6).

The Company had no other personal holding company income other than a minor amount of interest income in several years amounting to far less than 10 percent of its ordinary gross income for any such year.

Thus, the Company has not been used to shelter passive investment income since practically all of its income comes from the payment for use of business properties—i.e., those in connection with the manufacture and sale of the product. Nevertheless, it has been unwittingly trapped into personal holding company status because, although all of the income which it receives from the partnerships is for the use of assets comprising a single business, some of this income is treated unfairly as income under section 543(a)(1) rather than as compensation for the use of corporate property under section 543(a)(6).

The statute should be amended to provide that all of such payments should be treated as compensation for the use of corporate property under section 543(a)(6), so that such payments will constitute personal holding company income only if these payments are used to shelter substantial amounts of other passive investment income. The legislative history of section 543(a)(6) clearly demonstrates that rents from stockholders for the use of property in legitimate business enterprises are not intended to be classified as personal holding company income unless these rents are used to shelter other passive investment income.

In the past Congress has provided retroactive relief under a similar set of circumstances. Prior to the Revenue Act of 1950, personal holding company income included amounts received for the use of corporate property by 25 percent shareholders. By 1950 the attention of the Finance Committee had been called to examples "where, through a set of fortuitous circumstances, corporations have become closely held and also have rented most of their assets for use in the operation of businesses to the individuals holding the stock of the companies. Thus, unwittingly the corporations have become personal holding companies and subject to the penalty tax." S. Rept. No. 2375, 81st Cong. 2nd Sess. (1950), 65. To take care of this problem, section 223 of the Revenue Act of 1950 provided for the elimination of rents for the use of a corporation's property by its shareholders from the category of personal holding company income, where the property is used "in the operation of a bona fide commercial, industrial, or mining enterprise." This provision applied retroactively to taxable years ending after 1945 and before 1950. In 1955, the application of this relief provision was extended again retroactively to years before 1954, in recognition of the fact that the Internal Revenue Code of 1954 provided relief from this problem for years beginning with 1954. See H. Rept. 1353, 84th Cong., 1st sess. (1955), 1955-2 C.B. 844.

The 1954 Code relieved this problem by exempting shareholder rents from personal holding company income unless the corporation has other personal holding company income in excess of 10 percent of its ordinary gross income. Thus, the basic purpose of section 543(a)(6) is to prevent payments from shareholders to corporations from sheltering outside passive investment income. See

S. Rept. No. 1622, 83d Cong., 2nd sess. (1954), 74, where in connection with section 543(a)(6) the Finance Committee stated that "in the absence of appreciable amounts of other investment income, rental income received from shareholders does not constitute a tax avoidance problem."

The continued concern of Congress since 1950 for exempting from personal holding company income payments for the use of corporate property by shareholders in their active business clearly should cover situations, like the instant case, where the assets of the corporation used in the shareholders' business consist of intangible, as well as tangible, property. Such a corporation is no more the "incorporated pocketbook" at which the personal holding company provisions are aimed than a corporation whose assets happen not to include intangible rights necessary for the business, and such corporation should not be trapped into personal holding company status in the absence of the prescribed amount of outside investment income.

It is important to note that this amendment will apply only where the intangible assets are part of an integral group of business assets consisting of tangible and intangible assets, and will not apply where the corporation merely licenses an intangible asset. Also, the amendment leaves undisturbed and preserves the existing prohibition against using payments from shareholders for the use of business assets to shelter substantial amounts of outside investment income. The amendment also insures that rents and royalties which are described under section 543(a)(6) and are excluded from personal holding company income under that section will be excluded from sections 543(a)(1) and 543(a)(2).

Since the purpose of this amendment is to relieve the unintended hardship of section 543(a)(6) on a taxpayer who unwittingly became trapped into personal holding company status this amendment should be made retroactive in a manner similar to what we did in 1950 and 1955. Actually there is more justification for retroactive relief here than in the previous cases since here we are correcting a situation not intended by the statute while before we merely granted relief from a clear statutory provision.

The Treasury voiced no objection to this amendment in its Administrative Position dealing with this bill dated June 15, 1976. However, apparently because of the recent publicity surrounding this and other amendments, the Treasury now attempts to criticize the amendment by claiming that the favorable treatment for rents should not apply to passive income such as royalties. But this claim is specious, since it is clear that the amendment covers only the limited situation of payments for intangible property which is leased along with tangible property for use in a single active business, in which case the payment for the intangible property should be treated the same as the payment for the tangible property. This situation does not allow circumvention of the personal holding company provisions, as would exist in the case of the mere receipt of royalties by a corporation existinig to hold title to inatngible assets. The Treasury has confused this latter situation with the one covered by the amendment, since the lease of an integrated business consisting of tangible and intangible property does not constitute a technique for avoiding the personal holding company provisions.

This same confusion underlies the Treasury's claim that it is inappropriate to permit individuals to accumulate royalty income in their corporation. Where an integrated business consisting of intangible and tangible property is leased, the payment for the intangible property cannot be characterized as passive income, as in the case of mere royalty payments received by a corporation for the use of intangible property alone. The payments for the integrated business should, as in the case of rents under present law, be free from personal holding company taint.

While it is true that the amendment does not provide relief for payments from nonshareholders for intangible assets leased along with tangible assets in an integrated business, such relief is fully warranted and should be provided in future legislation.

STATEMENT OF HON. JAMES B. ALLEN, A U.S. SENATOR FROM THE STATE OF ALABAMA

Senator ALLEN. Thank you, Mr. Chairman and members of the committee.

I appreciate this opportunity to appear before the Committee on Finance in support of section 1308 of the committee bill dealing with personal holding company income. This provision is the same provision as found in S. 3288, introduced earlier in the session by Senator Sparkman and me, and the same provision was introduced by us in a separate bill in 1972. The committee did not act on it at that time. It is not a provision that is just now coming to the attention of the committee because the original bill reached the committee back in 1972. And I ask the committee to consider this bill during its deliberations on the present tax bill.

Our bill was made a part of the committee bill by adopting S. 3288. Essentially, this provision relieves an unintended hardship under section 543(a)(6) of the Internal Revenue Code on taxpayers who have unwittingly become subject to the personal holding company tax. As the chairman and members of the committee know, the personal holding tax is a 7 percent tax that is imposed——

Senator HANSEN. Seventy?

Senator ALLEN. Seven percent tax over and above other taxes. It is penal and punitive and confiscatory, so corporations, of course, seek to avoid coming under the provisions of the holding company tax law.

Under the present tax law, a corporation can lease its property to a 25 percent shareholder without the rental income being considered to be personal holding company income so long as no more than 10 percent of its other income is personal holding company income. The theory behind this provision is that rents received from a 25 percent shareholder for the use of corporate property in a legitimate business enterprise should not be personal holding company income unless those rents are used to shelter other passive investment income. In other words, rent of a corporation of its property or assets to a 25 percent shareholder in the corporation is not to be considered personal holding company income unless the corporation has personal holding company income in excess of 10 percent of its gross income.

The Internal Revenue Service, however, has taken the technical position that where the rented property consists of both tangible and intangible assets, any payments which relate to the intangible property are audited under section 543(a)(1) rather than rentals under section 543(a)(6). Consequently, where the rents attributable to the intangible property are more than 10 percent of the corporation's gross income it falls into the personal holding company classification even though the company has not been used to shelter passive investment income.

In other words, if more than 10 percent is personal holding company income, then all of these rents become personal holding company income.

This problem was first brought to my attention and to Senator Sparkman's attention by one of our constituents in Alabama who is involved with a company that owns assets used in the bottling of a soft drink beverage and also has the exclusive right to sell the beverage within a specified area. For good business reasons the company decided to rent all of its physical assets along with the exclusive right to bottle the beverage to partnerships consisting of the corporations' shareholders. The partnerships then conducted the business of bottling and selling the beverage.

Under section 543(a)(6), this arrangement appeared to be perfectly proper so as not to create personal holding company income, even

though the lessees of the property owned more than 25 percent of the stock of the corporation. As I previously pointed out, this section of the code precludes personal holding company income status for rentals received from a 25-percent shareholder so long as there is no more than 10 percent passive income in the corporation. Since the corporation of which I speak had little or no income other than the rentals received for the assets leased to its shareholders, there appeared to be no problem, especially since section 543(a)(6) makes no distinction between tangible and intangible property.

The CHAIRMAN. Senator, we have a 5-minute rule here. I have to call it on all of us, including our Senators on the committee.

I read your statement and you made a very fine case. I want to assure you I expect to support your position.

Senator ALLEN. I thank the chairman.

The CHAIRMAN. I hope that your 100-percent batting average on these amendments will hold up.

Senator ALLEN. Thank you, Mr. Chairman. If I had a 100-percent batting average, it is because I followed the recommendations of the chairman, I might say.

Senator TALMADGE. Mr. Chairman, Senator Allen, is it not a fact that Congress has granted similar relief in similar hardship cases on several occasions?

Senator ALLEN. Yes, sir, that is true. They did it in 1950 and they did it again in 1955. The question is, if the chairman will indulge me, in 1971 even though the law had been on the books since 1954, the Internal Revenue Service ruled that intangible property, that is a franchise, could not be included along with other property that was being leased.

They then popped the taxpayers with as many back years of this punitive tax that the law allowed. It creates a tremendous hardship. Treasury found that this will have a negligible effect on the revenue of the Government.

As far as I know, there is only one small town bottler that is involved, a relatively small one.

The CHAIRMAN. Senator, I take it that you agree with my view. If someone is being done an injustice, even if it is a single citizen, the Government should consider his plea.

Senator ALLEN. That is exactly right. I do submit my written statement. I thank the chairman.

The CHAIRMAN. Next we will hear from Mr. Daniel Davis, vice president of First National Bank of Dallas.

[The prepared statement of Mr. Daniel M. Davis follows:]

AMERICAN BANKERS ASSOCIATION MEMORANDUM ON MISCELLANEOUS PROVISIONS

1. Tax-Exempt Annuity Contracts (Sec. 1505 of the Committee bill):

Section 1505 of the Committee bill would add closed-end mutual funds to open-end mutual funds as permissible investments under section 403(b) of the Code whereby certain tax-exempt employers may purchase tax-sheltered annuities for their employees. The ABA believes that just as the distinction between open-end and closed-end funds was found irrelevant for purposes of 403(b) investment, likewise the exclusion of deposit accounts (savings accounts, certificates of deposit and time-open accounts) is inappropriate.

The tax-exempt employer making contributions for 403(b) purposes should have the choice of investment in deposits of banks, savings and loans, and credit unions which often offer a more stable and reliable source of retirement benefits than might be true of mutual funds. Long term deposit accounts may earn interest at annual rates of 7.5% and above.

Federal depository institutions offer the additional assurance of federally-backed insurance up to $40,000 as do state insured banks.

2. Swap Funds (June 11 Committee Action):

The Finance Committee of June 11 regarding the treatment of so-called "swap funds" appears intended to parallel the House approved bill on this subject, H.R. 11920. Assuming that the Finance Committee would in fact track the House language, the Association wishes to point up one result, apparently unintended, which would be totally inappropriate.

The House bill makes clear that the beneficiaries of a trust should not be allowed to obtain tax-free diversification of portfolio stocks through an exchange for an interest in a common trust fund. The language of the bill would seem to make the merger of common trusts funds, typically occuring subsequent to bank mergers, subject to taxation. Such common trust fund mergers are totally beyond the control of trust beneficiaries and their purpose is in no way to achieve tax-free diversification. Rather their purpose is to achieve efficiency of operation and a reduction in costs. The investment interest of the trust remains basically unchanged. The bill should make clear that such mergers are not taxable events.

3. Extension of Study Reduction and Cash or Deferred Profit-Sharing Plans (Sec. 1507 of the Committee bill):

A large number of employees, in banking and other industries, could be adversely affected if the current freeze of section 2006 of the Employee Retirement Income Security Act expires without an orderly resolution of tax treatment of salary reduction and cash-deferred profit-sharing plans.

The Association strongly supports the proposed extension of time to complete the study contemplated by ERISA section 2006 since it is virtually impossible to do so prior to the present January 1, 1977 deadline.

4. Extension of Time to Confrom Charitable Remainder Trusts for Estate Tax Purposes (Section 2104 of the Committee bill):

Section 2104 of the Committee bill would amend Code Section 2055(e)(3) to extend for two years the time by which the governing instrument of a charitable remainder trust may be amended so as to allow the remainder interest to qualify for the estate tax charitable contribution deduction. The complexities of the 1969 Tax Reform Act relative to charitable remainder trusts dictate such time extension to insure fairness to the taxpayers.

The American Bankers Association urges approval of this extension.

AMERICAN BANKERS ASSOCIATION,
Washington, D.C., December 15, 1975.

Re proposed regulation § 1.613A.

COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C.
(Attention: CC:LR:T).

DEAR MR. COMMISSIONER: The following comments are submitted on behalf of the American Bankers Association regarding the above-captioned regulation published in the Federal Register of October 17. 1975 at pages 48691 through 48696. The deadline for comments on the proposed regulation has been extended from November 17, 1975 to December 17, 1975.

Section 613A continues the availability of percentage depletion under section 613 to small producers (including a trust) subject to certain limitations. One of these limitations is that a "transfer" (other than a "transfer at death") of the producing oil and gas interest has not been made after December 31, 1974. Proposed regulation § 1.613A-7(n) states:

> *Transfer.* The term 'transfer' means any change in legal or equitable ownership by sale, exchange, gift, lease, sublease, assignment, contract, a change in the membership of a partnership or the beneficiaries of a trust, or other disposition (including any contribution to or any distribution by a corporation, partnership, or trust). However, the term does not include a transfer of property at death (including a distribution by an estate) nor an exchange to which section 351 applies (until the tentative quantity determined under the table contained in section 613A(c)(3)(ii) ceases to be allocated under section 613A(c)(8) between the transferor and transferee). A transfer is deemed to occur on the day on which a binding contract to transfer such property is executed, or, if no such contract is executed, on the day on which the document which causes title to the property to pass is executed.

We believe that for the reasons set forth below this definition, as applied to trusts and their beneficiaries, is both uncertain in operation and too expansive in scope.

REVOCABLE TRUSTS

The first sentence of proposed § 1.613A-7(n) refers to "any change in legal * * * ownership by" certain stated events, including a "gift" or "other disposition." In the past there have been a significant number of cases where member banks have acted as trustees of fully revocable trusts consisting in whole or in part of oil and gas interests. A revocable trust is not an independent income tax entity and is ignored for income tax purposes. All income received by the trust is considered as income received directly by the grantor. An important non-tax reason exists for the creation of such a trust—probate costs at the grantor's death (including the expense of ancillary administration for oil and gas interests) that would be incurred if the interest formed a part of his probate (testamentary) estate are avoided. If the interest were a part of the grantor's probate estate, the transfer at death exception would be applied.

The placing of oil and gas interests in a revocable trust after December 31, 1974 is not a "transfer" after that date for purposes of section 613A because, as a result of the second sentence of proposed § 1.613-7(o), there is no "transferee". However, under the proposed regulations, a distribution from the trust at the grantor's death is not specifically covered by the transfer at death exception. We recommended that the second sentence of the proposed regulation be amended to provide:

> However, the term does not include a transfer of property at death (including a distribution by an estate *or by a trust which was fully revocable at death*) nor an exchange to which section 351 applies (until the tentative quantity determined under the table contained in section 613(c)(3)(ii) ceases to be allocated under section 613A(c)(8) between the transferor and transferee). (underscored words added)

CHANGE IN BENEFICIARIES

The first sentence of proposed § 1.613A-7(n) also refers to "any change in * * * equitable ownership by * * * a change in the beneficiaries of a trust". These words may be interpreted to result in a "transfer" when any event (other than perhaps death) causes a change in the trust beneficiaries. For example, consider a trust which directs that income be paid to A for 10 years and thereafter to B for his life with the principal to be distributed to B's issue who survive him, *per stirpes*. Does a "transfer" take place at the expiration of the 10 year period when A ceases to be a beneficiary? Does a "transfer" take place upon the birth of a child of B during the trust term? These questions should be answered in the negative. Our difficulties with the proposed language could be overcome by eliminating the words "or the beneficiaries of a trust" in the first sentence of proposed § 1.613A-7(n). We believe consideration should also be given to eliminating the words "legal or equitable" in this sentence which tend to create uncertainty in application.

TRANSFER AT DEATH

The December 31, 1974 transfer rule does not apply to a "transfer at death". The proposed definition of "transfer" does not give a clear explanation as to the scope of this exception. To illustrate, in the example discussed in the preceding paragraph the trust terminates at the death of B and the trust property is distributed to B's then living issue, *per stirpes*. Is the transfer at death exception applicable? The regulations should answer this question, which is important because the death of a beneficiary is the most frequent even causing a trust to terminate.

ACQUISITION BY ESTATE

In some cases an estate will acquire after the decedent's death oil and gas properties which turn out to be producing and then distribute the properties to the beneficaries, which may include one or more trusts. This case differs from the
the beneficiaries, which may include one or more trusts. This case differs from the
death exception clearly applies to the latter case, but arguably does not apply to porperty acquired after death. Nevertheless, since the beneficial interests in the estate take effect at death there should be no "transfer" of any such interest when distributions are made. One way or another, the regulations should provide

that property acquired by an estate after a decedent's death is not deemed to be transferred for purposes of section 613A when distributed by the estate.

PREEXISTING TRUSTS

The intent of the December 31, 1974 transfer rule is to prevent the intentional creation of multiple "small producers" by post-1974 transfers. See Statement of Senator Cranston on page S4260 of the Congressional Record of March 18, 1975. This cannot occur with respect to oil and gas property held in an irrevocable trust on December 31, 1974 where the distribution from the trust to a beneficiary occurs as a result of a mandatory provision rather than the exercise of a discretionary power. The application of the December 31, 1974 transfer rule to a mandatory distribution would be unfair and amount to retroactive legislation. We suggest the addition of the following new sentence to the proposed regulations § 1.613A-7(n):

> A distribution from a trust which was irrevocable on December 31, 1974 of property held in the trust on such date shall be deemed a "transfer" only if made pursuant to the exercise of a discretionary power.

In the normal property law context the "transfer" takes place when the trust is created.

Respectfully submitted.

ROBERT L. BEVAN,
Associate Federal Legislative Counsel.
RICHARD B. COVEY,
Special Counsel, American Bankers Association.

STATEMENT OF DANIEL M. DAVIS ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. Chairman and Members of the Committee: My name is Daniel M. Davis. I am a Vice President of The First National Bank in Dallas. I am accompanied by Robert L. Bevan, an Associate Federal Legislative Counsel of the American Bankers Association. The American Bankers Association is an association composed of about 14,000 banks or some 96% of the banks in the country. Approximately 4,000 of the banks exercise fiduciary powers serving their customers as trustees and executors. Thus, the Association is keenly interested in any changes in the tax laws affecting trusts and estates.

The list of subjects to be considered at these hearings includes Section 1317 of H.R. 10612 which is now before the Senate. This Section contains needed amendments to section 613A of the 1954 Code which was enacted as part of the Tax Reduction Act of 1975. The ABA is particularly concerned with the amendments proposed in subsection (b) of Section 1317, which relates to trusts. We strongly support these amendments, which do nothing more than cure inequities in our tax law, but also recommend for reasons I will mention that additional action be taken by your Committee to cure other inequities.

Section 613A eliminates the percentage depletion deduction for oil and gas produced on or after January 1, 1975 subject to certain exceptions which include a so-called "small independent producer" exemption. In order to prevent fractionalization of interests and the multiple use of the exemption, section 613A (c)(9) provides that the exemption is not available "in the case of a transfer . . . after December 31, 1974 of an interest (including an interest in a partnership or trust) in any proven oil or gas property" except "a transfer of property at death" or a transfer in a section 351 exchange. This provision is uncertain in scope and if applied literally produces inequitable results in the case of "transfers" of oil and gas interests by trusts and estates.

Section 613A(d) is even worse. It provides that the depletion deduction for small independent producers cannot exceed 65% of the taxpayer's "taxable income" for the year involved computed without regard to depletion and certain other items. The use of "taxable income" is inappropriate for a trust because in arriving at this amount distributions to beneficiaries under sections 651 and 661 are deducted. The law of many states requires a trust to add an amount equal to the depletion deduction to principal. In such cases the trust would, before the enactment of section 613A(d), have had no "taxable income" because the deduction would have offset the retained income. Under section 613A(d), the trust will now have to pay a tax as a result of a disallowance of 35% of the depletion deduction. To disallow a part of the deduction and to produce a

tax at the trust level without adding back the section 651 and 661 deductions is grossly unfair.

During December 1975 the ABA filed comments with the Commissioner of Internal Revenue on the proposed regulations to section 613A dealing with some of its defects. A copy of these comments is filed with this statement. No mention was made of section 613A(d) because of our belief that its inadequacy as to trusts could only be solved by amending the statute.

The amendments recommended by Section 1317 to section 613A(c)(9) and section 613A(d) would alleviate some of the inequities referred to above by providing that in applying section 613A(d) to a trust the 65% limitation would be computed *before* taking into account any deduction for distributions under sections 651 or 661, and by amending section 613A(c)(9) to provide that a change of beneficiaries of a trust by reason of the "death, birth, or adoption of any beneficiary if the transferor was a beneficiary or is a lineal descendant of the grantor or any other beneficiary". The change in section 613A(c)(9) is too narrow and does not solve other problems that exist in applying the "transfer" rule to trust and estate dispositions and which are referred to in our comments on the proposed regulations to section 613A.

We urge your Committee to approve additional changes in this section which will solve *all* of the problems referred to in our comments filed with the Commissioner. We note that the report of the Finance Committee on H.R. 10612 states that the transfer rule was not intended to apply to "some cases of transfers which occur by operation of law". This intent should certainly exempt transfers from pre-existing trusts from the scope of 613A(c)(9).

Mr. Chairman, we also submit with this statement a memorandum on the following provisions of H.R. 10612, as reported:

1. Tax-Exempt Annuity Contracts (Section 1505).
2. Swap Funds (June 11 Committee action).
3. Extension of Study of Salary Reduction and Cash or Deferred Profit-Sharing Plans (Section 1507).
4. Extension of Time to Conform Charitable Remainder Trusts for Estate Tax Purposes (Section 2104).

STATEMENT OF DANIEL H. DAVIS, VICE PRESIDENT, THE FIRST NATIONAL BANK, DALLAS, TEX., ACCOMPANIED BY ROBERT L. BEVAN, ASSOCIATED FEDERAL LEGISLATIVE COUNSEL, AMERICAN BANKERS ASSOCIATION

Mr. DAVIS. Mr. Chairman and members of the committee, my name is Daniel Davis. I am a vice president of the First National Bank in Dallas. I am accompanied by Mr. Robert L. Bevan, an associate Federal legislative counsel of the American Bankers Association. The American Bankers Association is an association composed of about 14,000 banks or some 96 percent of the banks in the country. Approximately 4,000 of the banks exercise fiduciary powers serving their customers as trustees and executors. Thus, the Association is keenly interested in any changes in the tax laws affecting trusts and estates.

The list of subjects to be considered at these hearings includes section 1317 of H.R. 10612 which is now before the Senate. This section contains needed amendments to section 613(a) of the 1954 code which was enacted as part of the Tax Reduction Act of 1975. The ABA is particularly concerned with the amendments proposed in subsection (b) of section 1317, which relates to trusts. We strongly support these amendments, which do nothing more than cure inequities in our tax law, but also recommend for reasons I will mention that additional action be taken by your committee to cure other inequities.

Section 613(a) eliminates the percentage depletion deduction for oil and gas produced on or after January 1, 1975, subject to certain

exceptions which include a so-called small independent producer exemption. In order to prevent fractionalization of interests and the multiple use of exemption, section 613A(c)(9) provides that the exemption is not available "in the case of a transfer after December 31, 1974, of an interest—including an interest in a partnership or trust—in any proven oil or gas property" except "a transfer of property at death" or a transfer in a section [illegible] exchange. This provision is uncertain in scope and if applied literally produces inequitable results in the case of transfers of oil and gas interests by trusts and estates.

Section 613A(d) is even worse. It provides that the depletion deduction for small independent producers cannot exceed 65 percent of the taxpayer's taxable income for the year involved computed without regard to depletion and certain other items. The use of taxable income is inappropriate for a trust because in arriving at this amount distributions to beneficiaries under section 651 and 661 are deducted.

The CHAIRMAN. Thank you very much for a very fine statement. I assure you that I will read the rest of it. I understand what you are talking about.

Senator DOLE. Mr. Chairman.

The CHAIRMAN. Senator Dole.

Senator DOLE. The chairman may recall there was a certain amount of publicity over these rather minor technical amendments. I am happy to have the testimony. There was never any question about the amendment except in the publication. They were not offered for any single purpose. I am pleased to know there are many beneficiaries. I am not sure who they may be.

It wasn't an intended result. If somebody is born in a class or by adoption, they should not be denied the depletion allowance. It should be called a transfer. It is a very technical thing. IRS and Treasury approved it, and by advice of the staff and others, it was offered.

I think you covered it pretty well in your testimony. We appreciate it.

The CHAIRMAN. Incidentally, the people who drafted that are here in this room. They inform me that that about which you are complaining was an inadvertent error in drafting a floor amendment that had to be a broad amendment developed for Senator Cranston on the floor.

Senator Cranston understands that. I am sure you are aware of the fact there has been a lot of publicity that the amendment was my idea. I frankly did not know the problem existed. You are talking about a proposed Treasury regulation insofar as the beneficiaries of the trust are concerned, is that not right?

Mr. DAVIS. Yes, sir.

The CHAIRMAN. Thank you very much, gentlemen.

Next we will call Mr. Carl Sebits, Kansas Independent Gas and Oil Association.

[The prepared statement of Mr. Carl Sebits follows:]

STATEMENT OF CARL W. SEBITS, INDEPENDENT OIL AND GAS OPERATOR

Summary of principal points

1. Pertains to "Retailer Exclusion" provision.
2. Pertains to Exception to Transfer Rule for Beneficiaries of Trusts.

My name is Carl W. Sebits and my office is in Wichita, Kansas. I am a managing partner of Pickrell Drilling Company and I appear today in that capacity and as Chairman of the Tax Committee of the Independent Petroleum Associa-

tion of America. I am also a member of the Executive Committee of that association.

RETAILER EXCLUSION

Pickrell Drilling Company is an exploration and oil and gas producting company with nearly all of its operations in the state of Kansas. Our company operates two rotary drilling rigs continuously, in a search for oil and gas, and also operates approximately 3000 barrels daily oil production. The company operates about 20 million cubic feet of gas per day.

For many years a small group of investors has participated with us in our exploration program as a part of their diversified business investment programs. They and we are quite naturally concerned about tax measures which would make exploration investment less attractive and this statement bears more specifically upon the "retailer exclusion" provision in the new tax proposals which would deny percentage depletion to a taxpayer who is classified as a "retailer" of oil or gas or products derived from oil or gas.

One of our investor-participants in our exploration program is a large grease manufacturer, and although nearly all of his sales are at the wholesale level, some small part of his sales would classify as retail sales of grease and related lubricant products.

Still another of our investor-participants is an owner-operator of retail stores handling western wear clothing and related items. Many of the items which he stocks and retails are manufactured from petroleum chemical derivatives, such as polyester suits and dress materials, and other retail items which have as their base material some kind of petroleum derived source. In fact it would be quite difficult for most retailers of general merchandise to avoid handling and selling products which did not in some way have their origin in petroleum derivatives, since petroleum chemicals have become so predominantly used in almost the entire gamut of consumer products manufacturing.

Still another of our investor-participants owns and either operates or leases out to lessees on a participation basis several retail gasoline filling stations, as a part of his diversified business investment program. Whereas this man's operations could not in any way be compared to a major integrated oil company, the narrowness of definition of the "retailer excluded" provision would undoubtedly prevent this investor from the deduction of percentage depletion.

Each of the previously described investors has informed our company that in the event that a too-narrow interpretation of a "retailer" lessens the feasibility of investing in oil and gas exploration, since we all recognize it as a high-risk venture, then it is quite possible that they will withdraw from our program and in turn we will be forced to decrease the scope of our exploration effort. In time this could result in a complete shut-down of this program.

A provision exempting a taxpayer whose annual gross receipts from the retail sale of oil or gas or products derived therefrom would not exceed $5 million for the taxable year would surely be most helpful. It would eliminate a too-narrow definition of the "retailer excluded" provision and assure the above described investors that they could continue to spend their dollars in a search for more oil and gas production within the United States. We and our investor-participants are indeed hopeful that such an amendment will be given favorable consideration.

EXCEPTION TO TRANSFER RULE FOR BENEFICIARIES OF TRUSTS

The Committee on Finance of the United States Senate has added an additional exception to the transfer rule contained in paragraph (9) of Section 613A (c) of the Internal Revenue Code. This additional exception expands the exception provided by present law for transfers of oil and gas property at death. The new provision extends the exception to changes of beneficiaries of a trust if the change occurs by reason of the death, birth, or adoption of any beneficiary provided the transferee was a beneficiary of the trust prior to the event or is a lineal descendant of the grantor or any other beneficiary.

Such transfers by reason of death, birth or adoption obviously are not the type of transfers which the statute sought to prevent to avoid a proliferation of proven oil and gas reserves which when produced are eligible for percentage depletion. This exception is considered necessary to clarify the normal transfer of beneficial interests in trusts (as opposed to the sale of oil and gas property) to intended beneficiaries and to insure that the right to percentage depletion of property in the trust will continue to be enjoyed by the beneficiaries thereof.

STATEMENT OF CARL SEBITS, KANSAS INDEPENDENT GAS & OIL ASSOCIATION, ACCOMPANIED BY DONALD P. SCHNACKE

Mr. SEBITS. Mr. Chairman and gentlemen, my name is Carl W. Sebits. My office is in Wichita, Kans. I am a managing partner of Pickrell Drilling Co., and I appear today in that capacity and as chairman of the Tax Committee of the Independent Petroleum Association of America. And I am also a member of the executive committee of that association.

I am a vice president and member of the executive committee of the Kansas Independent Oil & Gas Association. On my left is Mr. Don Schnacke, who is executive vice president.

I am here to give testimony pertaining to two points, two amendments that are being considered by the Senate Finance Committee, one being the retailer exclusion provision; the other pertaining to the exception to transfer rule for beneficiaries of trusts and the 65-percent depletion limitation.

In our exploration effort we have investment participants who by reason of some peculiarity in their investment program could be deprived of statutory depletion because of some small retail operation in their business. We have an investment participant who owns and operates or leases out on a participation basis three filling stations, service stations, who might, by this provision, be deprived of statutory depletion. We have an associate who owns a business building with a parking garage as a part of that building, and with a gasoline pump purely for the convenience of his tenants and parking customers.

We certainly have felt as long as there was a provision that did retain depletion for small producers, that it was inconsistent to deprive that kind of person of his depletion allowance, and certainly we then feel that this amendment that the Finance Committee is considering, that would exclude those people unless they had $5 million or more of oil and gas sales or products derived therefrom, certainly we hope that the committee will give that favorable consideration.

The other matter is a matter of actually the transfer rule and an expansion of that rule so that the exception provided by the present law for transfers of oil and gas property, at best, would also then consider death, birth, or adoption of any beneficiary. We feel that this is an expansion that came up when the application of that part of the law became evident.

We are certainly in favor of that consideration of the amendment.

As to the 65-percent limitation on depletion as it applies to a trust, again we feel that this was an excellent amendment that was needed. Just the mechanics of filing an income tax return on a trust could serve to deprive the trust and its beneficiaries of depletion that we surely feel could not have been the intention of our tax laws.

In my mind, the creation and administration of a trust is a very worthwhile and honorable effort. Very often it is a matter of financial climbing for a family, even the surviving widow or children who could be minor children, and it would seem to me that the very last person, the beneficiary or taxpayer that should be deprived of depletion is a trust beneficiary.

Again we know that this provision is anything but legislation directed at any one person or group of persons. There are thousands of trusts in our society. We see it as a very worthwhile effort, and we do

appreciate the fact that the Senate Finance Committee considers such an amendment. We hope that they consider it favorably.

The CHAIRMAN. Thank you very much.

Senator DOLE. I just want to make the point again that Mr. Sebits has. The ridiculously unintended effect was, if you had an interest in a gas station, you lost the depletion allowance. It was never intended, it was a very technical amendment. With the help of staff, which I appreciate very much, I think we have solved it. The Treasury Department frankly, I think, was looking for some solution. Also, your comments with reference to the trusts I think are accurate, and dealing with the technical amendment. The result was never intended. It is corrected by the technical amendment.

As the Chairman has said many times, as long as the amendment is proper, the Senator from Kansas will try to get it adopted, even if it is defeated, as long as I help my constituents.

The CHAIRMAN. Thank you very much.

Next we will hear from Mr. John E. Chapoton, Jr., on behalf of Domestic Wildcatters Association & Small Producers for Energy Independence.

[The prepared statement of Mr. John E. Chapoton, Jr. follows:]

JOHN E. CHAPOTON—SUMMARY OF STATEMENT

The Tax Reduction Act of 1975 repealed the percentage depletion deduction for oil and gas. One exception retained the deduction for a limited quantity of domestic production under a "small producer exemption." The small producer exemption provisions, contained in new section 613A of the Internal Revenue Code, were adopted by Senate floor amendment and thus did not receive the careful attention usually afforded Internal Revenue Code provisions through the committee process. As a result many technical defects and inequities have been found in this new section. This Committee's adoption of section 1317 of H.R. 10612 corrects the most glaring errors of section 613A.

The attached statement makes the following points:

1. *Bulk sales of oil and gas.*—The exclusion of bulk sales to industrial and commercial users from the term retail sales implements the intent of Congress in adopting section 613A(c), gives effect to the common usage of the term retail sales, and will prevent inefficient realignment of direct producer-industrial consumer sales.

2. *Retail sales in excess of $5,000,000.*—The limitation of prohibited retail activities to those exceeding $5,000,000 in gross receipts is consistent with the Congressional purpose of adopting the small producer exemption and will resolve ambiguous factual situations which would otherwise invite needless controversy and litigation.

3. *Transfers of interests in trusts.*—Exempting certain transfers of beneficial interests in trusts from the possible loss of the small producer exemption is clearly necessary and desirable. It is submitted, however, that a more general exemption from the transfer rule of section 613A(e)(9) is necessary to remove the arbitrary and inequitable results which flow from the strait-jacket approach of the present provision (a suggested statutory draft is attached as Exhibit B).

4. *65 percent limitation in the case of trusts.*—Applying the 65% of taxable income limitation to trusts before the deduction for distributions to beneficiaries is necessary to make the statutory scheme for taxation of trusts and their beneficiaries work correctly. This amendment should be broadened to cover estates as well.

5. *Partnership basis rules.*—It is necessary to correct technical deficiencies relating to the computation of depletion and basis with respect to oil and gas properties in the case of a partnership and its partners.

STATEMENT OF JOHN E. CHAPOTON, HOUSTON, TEX., ON BEHALF OF THE DOMESTIC WILDCATTERS ASSOCIATION

My name is John E. Chapoton. I am an attorney in Houston, Texas. I am appearing on behalf of the Domestic Wildcatters Association, an association com-

posed of more than 30 independent explorers and producers of oil and natural gas in Texas and Louisiana.

I am here today to testify with respect to certain provisions in section 1317 of H.R. 10612, the Tex Reform Bill of 1976, as reported to the Senate by this Committee on June 10, 1976. Section 1317 of H.R. 10612 makes certain changes, mostly technical, in section 613A of the Internal Revenue Code ("Code"), which was enacted by the Congress as a part of the Tax Reduction Act of 1975 enacted in March 1975.

BACKGROUND

By the enactment of section 613A of the Code the Tax Reduction Act of 1975 repealed the percentage depletion deduction for oil and gas effective January 1, 1975. It did not, however, affect the percentage depletion deduction allowed all other minerals under the Code. Two exceptions were provided in section 613A. One permits the continuance of the percentage depletion deduction at the old 22 percent rate and under the pre-1975 rules for (i) natural gas sold under a fixed contract in effect on February 1, 1975, and (ii) natural gas produced and sold before July 1, 1976, while subject to federal price regulation. This natural gas exemption is not the subject of my testimony today.

The second exemption, referred to generally as the "small producer exemption," retains the percentage depletion deduction on a limited amount of domestic oil and gas production at a diminishing depletion rate. The maximum amount of production eligible for percentage depletion under the small producer exemption is 2,000 barrels average daily producion of crude oil or its Btu equivalent in cubic feet of gas (established at a 1:6000 ratio in the legislation), for 1975 and phases down to 1,000 barrels of oil per day or 6 million cubic feet of gas per day for 1980 and thereafter. The percentage depletion rate for production which is eligible under the small producer exemption is retained at 22 percent through 1980 and then is phased down to a permanent rate of 15 percent for 1984 and later years. Production resulting from secondary and tertiary processes is treated differently under the legislation only by retaining the 22-percent through 1983 (however, the total amount of production eligible for depletion under the small producer exemption is not increased). In 1984 and later years secondary and tertiary production is subject to the same 15-percent rate as primary production.

The percentage depletion deduction allowed a taxpayer under the small producer exemption is subject to a ceiling equal to 65 percent of the taxpayer's taxable income for the year, computed without regard to the depletion deduction taken under the small producer exemption and without regard to any net operating loss or capital loss carrybacks to the taxable year.

In addition, no depletion deduction is allowed a taxpayer, even though he may otherwise qualify, with respect to production from his interest in an oil or gas property if his interest in the property was transferred after 1974 and the property was "proven" at the time of the transfer.

Finally, a taxpayer is not allowed any depletion deduction under the small producer exemption during any period for which such taxpayer or a related person is classified as a retailer of oil or gas, or any product derived there from or engages in the refining of crude oil (if the refinery runs of the taxpayer and such related person exceed 50,000 barrels on any day during the taxable year).

AMBIGUITIES IN THE 1975 LEGISLATION

The computation of percentage depletion under the small producer exemption introduced many new rules and concepts into the computation of percentage depletion for oil and gas. In many instances the new rules are simply not set forth in sufficient detail in new section 613A of the Code. In other instances, new and in precise terms, such as "retail outlet," the meaning of a "related person" in this context, and the definition of a "proven property," are utilized in the legislation. Many of these problems could have been solved by the prompt promulgation of reasonable interpertative regulations by the Treasury Department. However, this administrative clarification has not been forthcoming. The Treasury Department published very abbreviated proposed regulations on October 17, 1975, and although a hearing was held on the proposed regulations in January 1976, no final regulations have been issued to date.

What is worse, the abbreviated proposed rules evidenced an inclination on the part of the administrator to follow the cold statutory language to totally illogical results, clearly inconsistent in many instances with the purposes of the small producer exemption as indicated by its legislative history. This was par-

ticularly evident in the provisions of the proposed regulations defining a retailer. The proposed regulations would have found a "retail outlet" to exist, for example, by reason of direct bulk sales of natural gas from the wellhead to an industrial consumer. As another example an independent producer could be denied a percentage depletion deduction in toto by reason of relatively small retail sales of oil products resulting from a business activity totally unrelated to the taxpayer's oil or gas production business. Although the Treasury Department indicated informally some inclination to temper the most absurd results flowing from its proposed rules, it has failed to do so in the nine months which have elapsed since the publication of the proposed regulations.

Section 1317 of H.R. 10612 handles many of these problems in a logical manner, giving effect to the obvious intent of Congress in adopting the small producer exemption.

SECTION 1317(A)—RETAILER EXCLUSION

Exclusion of bulk sales from the definition of retail sales.—As discussed earlier, the small producer exemption is denied if the taxpayer, directly or through a related person, operates a retail outlet which sells oil or natural gas or any product derived therefrom. In the Treasury Department's regulations proposed under section 613A, bulk sales of oil or natural gas, or products derived therefrom, would be considered retail sales if made to an enduser of the item. For example, a direct sale of natural gas by a producer from the wellhead to an electric utility for use as fuel for its furnaces would constitute a retail sale. The proposed regulations went on to provide that if such retail sales constituted more than 5 percent of the gross receipts from the "place" where such sales are made, then such place constitutes a retail outlet operated by the producer, resulting in the loss of percentage depletion on all of that producer's oil and gas production, wherever located and to whomever sold. The proposed regulations added a perplexing rule that bulk sales to industrial or commercial users would be disregarded in making this 5 percent computation if such sales accounted for less than 25 percent of the taxpayer's gross receipts derived from all sales of oil or natural gas, or products derived therefrom, during the taxable year. The purpose or logic of this 25 percent rule, which could cause the existence of the "retail outlet" to be dependent on the taxpayer's total production from other fields, was never adequately explained.

The proposed regulation definition of retail outlet was clearly inconsistent with the common usage of that term and would most assuredly impede the Congressional intent of making the small producer exemption available to normal independent producers who operate no service stations for the retail distribution of their production. Moreover, because of the devastating impact of classification as a retailer (causing the loss of the entire percentage depletion deduction on all of the producer's domestic oil and gas income), such a nonsensical rule would result in wholesale realignment of sales arrangements to avoid direct sales to industrial and commercial users. The result would be the economically unnecessary insertion of a middleman with somewhat higher costs to the industrial consumer and eventually higher costs to the customers who use its product. Moreover, the proposed Treasury rule would frustrate the policy of the Federal Power Commission, adopted in its Order No. 553 dated August 28, 1975, to encourage direct interstate sales of natural gas to industrial consumers.

This Committee's amendment would correct this situation by providing that bulk sales of oil and natural gas and products derived therefrom to commercial or industrial users shall not be considered in determining whether a producer is a retailer. This is a proper clarification of the 1975 legislation.

It is my understanding from public statements by Treasury Department officials that the Treasury Department had already decided its inclusion of such bulk sales within the definition of retail sales was erroneous. Nonetheless, a clarification of the law is clearly desirable in view of the Treasury's proposed rules and the absence of final corrective regulations. It is obviously desirable to prevent further inefficient and inflationary realignment of sales arrangements between independent procedures and commercial and industrial users.

Limitation of prohibited retail activities to those having combined gross receipts exceeding $5,000,000.—The retailer exclusion from the small producer exemption contained in section 613A would literally apply to a producer if he sells "oil or natural gas, or any product derived from oil or natural gas" directly through a retail outlet operated by the taxpayer, or indirectly through a retail outlet operated by a related person. It is clear from the legislative history that the intent of the retailer exclusion was to deny a percentage depletion deduction

under the small producer exemption to oil and gas producers who are large integrated producers carrying on both production and marketing (and/or refining) activities. (Attached as Exhibit A are excerpts from the Senate floor debate of the small producer exemption indicating this Congressional intent.) It is difficult to interpret the statutory language in such a way as to limit its application to major integrated businesses, but it is obvious that some rule of reason must be utilized in applying its provisions in order to prevent totally nonsensical results.

Under the small producer exemption a taxpayer is a related person to another entity if he owns a 5 percent or more interest in that entity. Thus numerous independent producers became alarmed after the passage of the Tax Reduction Act of 1975 that they might be denied the small producer exemption by reason of interests in other businesses, perhaps as only passive investments, that operate retail establishments involving the sale of oil or gas products. For example, the ownership of a 5 percent interest in a clothing store by an independent producer could technically result in denial of the small producer exemption to him if the clothing store sold at retail synthetic materials derived from oil and gas products. The lack of any connection whatsoever between the taxpayer's production activity and the retail sales in question are technically irrelevant under the small producer exemption.

The Treasury Department in its proposed regulations attempted to limit the scope of the potential absurdities flowing from this statutory scheme by defining the term "any product derived from oil or natural gas" to include only "gasoline, kerosene, distillates (including Number 2 fuel oil), refined lubricating oils, diesel fuel, methane, butane, propane, and similar products which are recovered from petroleum refineries or field facilities." If this rule is adopted in the final regulations it would serve to prevent senseless results where synthetic materials or other secondary oil and gas products are sold at retail. It would not, however, be of any assistance to an independent producer who owns a small interest in a retail establishment which sells primary products derived from oil or natural gas such as machine oil, kerosene or other items, even though there is no connection whatsoever between such retail activity and the taxpayer's production activity and even though the quantity of retail sales is de minimis in relationship to the taxpayer's oil and gas production income.

Section 1317(a) of H.R. 10612 as adopted by this Committee would resolve these very troublesome questions by providing that the retailer exclusion has no application unless the combined gross receipts for the taxable year of all retail outlets taken into acocunt under the retailer exclusion do not exceed $5,000,000. This change would clearly remove the absurd result which could flow from de minimis and remote sales of primary products of oil or natural gas. It would also prevent potential litigation with respect to the Congressional intent and would provide taxpayers with needed certainty. It would, at the same time, preserve intact the original Congressional intent of denying the small producer exemption to producers who are integrated and operate significant marketing activities. In this regard it is consistent with the denial of the small producer exemption to refiners (which denial is not affected by the Committee's action) which applies only if the refinery runs of the taxpayer and the related person exceed 50,000 barrels on any day during the taxable year.

SECTION 1317(B)—THE TRANSFER RULE

New section 613A contains a provision designed to prevent transfers of producing oil and gas properties for the purpose of enlarging the total oil and gas income which comes within the quantity limitations of the small producer exemption. Subsection (c)(9) of section 613A provides that percentage depletion under the small producer exemption is denied with respect to a taxpayer's interest in an oil or gas property if that interest was transferred after December 31, 1974, and the property was a proven property at the date of the transfer. This rule applies to beneficial interests in oil or gas properties held in a partnership or trust as well as direct ownership interests. Two types of transfers are exempted from the application of this rule. The first is the transfer of a property at death. The second is a tax-free transfer to a controlled corporation but only if following this transfer the transferor and the transferee are required to share one small producer exemption under the other provisions of section 613A[1] limiting related taxpayers to a single, common small producer exemption.

[1] The so-called 'aggregation" provisions are contained in section 613A(c)(8).

The obvious purpose of the transfer rule, as stated in this Committee's report on H.R. 10612 (at page 425), is to prevent a proliferation of the amount of proven oil and gas reserves that might be eligible for percentage depletion under the small producer exemption. It was thought that absent such a transfer rule, producers holding production in excess of the quantity of production qualifying under the small producer exemption would transfer producing properties to other taxpayers who were still under their quantity limitations in order to qualify the production income from the transferred property under the small producer exemption of the transferee. In reality his fear was probably not realistic since the transfer of a producing property in a commercial transaction will normally result in a high cost basis to the transferee with the result that cost depletion would be more advantageous than percentage depletion to the transferee. Thus he would have no desire to claim percentage depletion under the small producer exemption with respect to income from the transferred property. In the case of gratuitous transfers where no increase in basis would result, the attribution rules requiring related parties to share a single small producer exemption would generally be applicable to prevent a proliferation of the amount of production qualifying under the small producer exemption.

This transfer rule, or perhaps more correctly described as an "anti-transfer rule" has caused considerable difficulty in normal financial planning in the oil and gas industry. For example, the difficulty of determining when a property is considered proven under this rule raises serious concerns whether a property which is the subject of a "farmout" arrangement might be ineligible for percentage depletion.[3] If the small producer exemption is lost by reason of a farmout, the economic benefits of this financing technique, through which a large percentage of exploratory wells are drilled in this country, would be drastically altered.

By the same token, estate planning by independent producers holding oil and gas properties is severely hampered by the transfer rule even though the transferee would ordinarily be a taxpayer who must share a single independent producer exemption with the transferor under the aggregation provision of section 613A(c)(8) mentioned earlier.

The proposed Treasury regulations provide rules which would solve some of these problems. For example, the proposed regulations state that a transfer is deemed to occur on the day on which a binding contract to make the transfer is executed, or if no such contract is executed, on the day on which the document which causes title to the property to pass is executed. This seems to be a correct rule. If the property was not proven on the date the original rights and obligations of the parties to make the transfer came into existence, then there is no opportunity for proliferation of the small producer exemption as long as those rights and obligations are not changed after the property is proven.

The amendment adopted by this Committee in H.R. 10612 would add a third exception to the anti-transfer rule. This exception would exclude from prohibited transfers any change of beneficiaries of a trust by reason of the death, birth or adoption of any beneficiary but only if the transferee was already a beneficiary of the trust or was a lineal descendant of the grantor of the trust or a lineal descendant of another beneficiary of the trust. The result which would be reached by this amendment is very obviously desirable. It would be tragic if a change in beneficiaries of a trust could result in loss of the small producer exemption to the new beneficiary where that change occurred by reason of a death, birth or adoption of a beneficiary.

I am concerned, however, about the effect an amendment of such limited scope might have on the Treasury's ability to fashion a general rule of reason for applying the transfer prohibition. As stated earlier, it seems quite reasonable to provide, as the proposed regulations do, that a transfer is deemed to occur on the date on which the document which causes title to the property to pass is executed. In the case of a trust, if an oil or gas property was not proven on the date it was transferred into the trust, then later transfers of beneficial interests mandated under the original provisions in the trust agreement predating the date the property became proven should relate back to the date of the instrument requiring such transfers to be made. This does not offer an oppor-

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[3] A farmout is a traditional method of sharing the tremendous financial risks involved in drilling exploratory oil and gas wells. It usually involves transfer of an interest in the oil or gas property to the persons who invest the money to drill the exploratory well with a retransfer of a smaller interest to the original owner when the exploration well has paid out the initial costs from production.

tunity for proliferation of the small producer exemption since such transfers could have clearly been effected on the date the instrument was executed as the property was not then proven.

It is submitted that the Committee should consider broadening the exemptions from the transfer rule to prevent the arbitrary results which flow from the straight-jacket approach of the present statutory provision. This could easily be accomplished by providing that the transfer rule will not be applied to cause loss of percentage depletion to the transferee of a proven oil or gas property if at the time of the transferor consents to a reduction of the maximum quantity of his remaining production which will qualify under the small producer exemption. To the extent of the reduction agreed to by the transferor, the transferee would be allowed depletion under the small producer exemption with respect to the transferred property (provided he was not otherwise disqualified to utilize the small producer exemption). I have prepared a draft which is attached to my testimony as Exhibit B which would effect this elective procedure. It would cause some recordkeeping problems, but they would not be substantially greater than the problems caused under present law. This approach would temper the inhibiting approach of the present transfer rule, and would at the same time absolutely prohibit proliferation of the small producer exemption since the transferor would automatically reduce his maximum production eligible under the small producer exemption by the amount allowed the transferee. The transferor would, however, be allowed to increase his production qualifying for the small producer exemption back up to the maximum allowed by law by further exploration activity on his part or by acquisitions in which his transferor elected under this provision.

COMPUTATION OF THE 65-PERCENT LIMITATION IN THE CASE OF TRUSTS

The 65 percent of taxable income limit on the depletion deduction allowed under the small producer exemption does not work correctly in the case of trusts and estates which establish a depletion reserve out of production income before distributions to beneficiaries are made. The taxable income of a trust or estate is the amount retained by the fiduciary after distributions to beneficiaries. However, in general the depletion deduction is allocated to the fiduciary to the extent he elects to, or is required to (under state law or the governing instrument), allocate production income to corpus. Thus there may be no depletion deduction allocable to the beneficiaries. In such an instance if most or all of the remaining income of the trust or estate is distributed to the beneficiaries, the trust or estate will have little or no taxable income and thus the 65-percent of taxable income limit, when imposed at the trust or estate level, will result in the denial of a portion of the depletion deduction to the fiduciary.[3]

As an example, if a trustee had $100,000 of oil and gas income (and no other income) and the governing instrument was silent, under the laws of the State of Texas the trustee would be required to allocate 27½% of the income, or $27,500, to corpus. The balance of $72,500 would be distributed to beneficiaries, leaving the trustee with taxable income of $27,500 less whatever depletion deduction is allowable. Under pre-1975 law the depletion deduction would be 22% of $100,000 (the total mineral income) or $22,000. If the 65% limit were applied after the deduction for distributions to beneficiaries, as is required under the 1975 legislation, the depletion deduction would be limited to 65% of the taxable income ($27,500), or $17,875. Thus $4,125 of the depletion deduction would not be allowed to either the trust or the beneficiaries. This obviously defeats the scheme of taxation under subchapter J of the Internal Revenue Code where all income is to be taxed, and all deductions are to be available, either to the trust or to the beneficiary.

The provision adopted by this Committee in section 1317(b) of H.R. 10612 would solve this problem quite simply by applying the 65 percent of taxable income limitation at the trust level *before* the deduction for any distributions to beneficiaries, rather than after such deduction. Thus in the example just given, the 65 percent limit would be 65 percent of $100,000, or $65,000, and the full depletion deduction of $22,000 would be allowed to the trust. This is the correct result since the depletion deduction does not have the effect in such a case of reducing

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[3] In addition, it may be technically impossible to determine taxable income of a trust or estate in such cases. Taxable income is dependent in these cases upon the amount of the 65-percent limit which determines the amount of the depletion deduction. The 65-percent limit cannot be computed until the deduction for distributions is determined, and the deduction for distributions cannot be determined until taxable income is computed.

the taxable income to zero. The deduction allowed the trust for distributions to beneficiaries is allowed because the amount distributed is taxable to the beneficiaries. Thus all of the income would be taxable, and all of the deductions would be allowed, either to the trust or to the beneficiaries under the Committee's approach.

While the solution adopted by this Committee is clearly sound, it is respectfully submitted that the rules should be also made applicable to estates. The problem is not as likely to occur in the case of an estate since in the usual case fiduciaries of an estate have more flexibility in determining what portion of the estate's income shall be retained and what portion shall be distributed to the estate's beneficiaries. However, where large income distributions are required by the will or are otherwise desirable, such distributions should not cause the loss of a portion fo the percentage depletion deduction.

SECTION 1317(C)—PARTNERSHIP RULES UNDER SECTION 613A OF THE TAX REDUCTION ACT OF 1975

Section 613A provides that percentage depletion under the small producer exemption is to be computed at the partner level rather than by the partnership. Since the law was silent with respect to depletion otherwise allowable to the partnership, it was not clear whether cost depletion or any depletion for natural gas (under the exemption for regulated or fixed contract gas provided in the 1975 amendment) would be computed by the partnership or the partner. Moreover, virtually insoluble technical problems are raised with respect to the basis of an oil or gas property in the hands of the partnership since the depletion claimed by each partner under the small prdoucer exemption would affect the partnership's basis without the partnership necessarily having the information to make the correct computation of its basis. This would cause difficulty, for example, in determining gain or loss on the sale of a partnership oil or gas property.

The Committee's amendment resolves these problems by providing that the partnership basis in oil or gas properties is allocated to the partners proportionately. Each partner would then be required to maintain an individual basis account and compute his own allowance for either percentage or cost depletion with respect to his proportionate part of any oil or gas properties held by the partnership. In addition, it was intended by the Committee that each partner will separately compute gain or loss on the proceeds from the sale or exchange of an oil or gas property.

It appears that the Committee's solution is a satisfactory one to a difficult technical problem caused by the 1975 law.

EXHIBIT A

Excerpts from Senate Floor Debates on Section 613A of the Internal Revenue Code (enacted by Public Law 94-12).

Excerpts from debate on the Senate bill, March 18, 1975:

[Senator BENTSEN.] What we are talking about here again is trying to save the independent oil producer, to see that he does not become an endangered species, and try to save him at a level where he is a true competitor for the major oil companies.

The major is in the position to pass the increased cost of production downstream. He can pas them on to the refiners and to his retail outlets. The independent is not in the position to do that. (S4271).

[Senator PEARSON.] I do not believe that retention of the depletion allowance for the major integrated oil companies is any longer necessary or desirable. On the other hand, I am convinced that keeping the depletion allowance for the independent unintegrated producers is definitely in the national interest.

The fact of the matter is that the industry is made up of two very different types of operation. The majors and the independents operate under different economic conditions and different rules. And it would be a great mistake, it seems to me in rewriting the Tax Code if we would fail to note this difference and take actions which would penalize the independents because we want to close a tax loophole that the major oil companies no longer need.

Mr. President, the major integrated oil companies, through their refineries and retail outlets and other sources of capital, simply do not need the depletion allowance to finance new exploration and development efforts. But the independents do. (S4277)

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[Senator LONG.] Now, for the big ten companies, and mind you, Mr. President, these are the companies that we would propose to deny depletion allowance, these are the ones the Cranston Amendment would take it from. (S4279)

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The [the major integrated oil companies] can make it back under their filling stations and their marketing operations. They have all kinds of places where they can make it back. A lot of it they can make back on the independent's oil, their competitor.

Excerpt from floor debate on the Conference Bill, March 26, 1975:

[Senator BAYH.] "First and foremost, after many years of trying, we were successful in passing a measure to eliminate the percentage oil depletion allowance for the large, integrated oil companies. This provision which for decades has permitted the oil companies to pay little or no taxes, did not belong in our tax code, and its repeal was one of the most significant victories for tax reform that I have seen since being elected to the Senate.

I would note that the Senate bill did allow independent producers to take percentage depletion on their first 2,000 barrels per day. It is the small independents who find the bulk of the oil in this country, and there is a real need for special treatment for them in order that they may attract the high risk capital needed for increased exploration and to permit them to retire debt incurred prior to this time. The complete elimination of percentage depletion for the independents would destroy them and serve to increase the grip of the major oil companies in the energy market. I am very pleased that the conference report retains a special exemption for these small independent producers whose efforts are vastly needed in the face of our current energy problems." Congressional Record, March 26, 1975, p. S5256.

[EXHIBIT B]

AMENDMENT

SEC. —. Depletion allowance changes to encourage production by independent producers.

Allowance of Depletion to Independent Transferees. Section 613A(c)(9) of the Internal Revenue Code of 1954 (relating to limitations on percentage depletion in the case of oil and gas wells) is amended—

(1) By striking out "in" in subparagraph (A) and inserting in lieu thereof, "Except as provided in subparagraph (B) and (C) in", and

(2) By adding at the end thereof the following new subparagraph:

"(C) If subsection (c) otherwise applies to both a transferor and transferee, subparagraph (A) shall not apply in the case of a transfer of an interest in any proven oil or gas property, if, at the time of such transfer, the transferor consents, in such manner as may be provided under regulations prescribed by the Secretary or his delegate, to a reduction in his depletable oil quantity. Beginning with the year of transfer, the effect of the consent described in the preceding sentence is as follows:

(i) the transferor shall reduce his tentative quantity of depletable oil for each year (as set forth in paragraph 3(B)) in an amount equal to the amount of reduction to which he consented; and

(ii) the transferee shall be allowed to take into account, for purposes of determining his average daily production of domestic crude oil and domestic natural gas, the production from the transferred property to the extent of the amount to which the transferor has consented.

"Provided, however, that a transferor who reduces his tentative quantity of depletable oil pursuant to clause (i) above shall be allowed in any year subsequent to the transfer to increase his tentative quantity of depletable oil up to the applicable amounts set forth in paragraph 3(B) by the amount of his average daily production in such year from any oil or gas property that was not a proven oil or gas property at the time of the transfer under which the transferor's tentative quantity of depletable oil was reduced, and from any oil or gas property acquired by him in a subsequent transfer to which this subparagraph applies."

STATEMENT OF JOHN E. CHAPOTON, JR., ON BEHALF OF DOMESTIC WILDCATTERS ASSOCIATION AND SMALL PRODUCERS FOR ENERGY INDEPENDENCE

Mr. CHAPOTON. Thank you. My name is John Chapoton. I am an attorney in Houston, Tex., representing Domestic Wildcatters As-

sociation, a group of independent producers located in Houston in Texas and Louisiana.

My statement will also represent the views of the Small Producers for Energy Independence, similarly headquartered in Kansas.

My purpose is to testify on section 1317, also of the bill, H.R. 10612, that makes amendments, mostly technical, in section 613A of the code. As already has been mentioned, and as you well know, section 613A was adopted as part of the Tax Reduction Act of 1975, repealing the percentage depletion for oil and gas with the exception of obtaining a limited amount of depletion on a limited amount of production for independent producers in the so-called small producers exemption.

Section 613A was adopted by a floor amendment without the opportunity for detailed drafting and analysis as usually given through the committee process, and as a result, from a technical standpoint, in some cases from an equitable standpoint, the section has several errors. Your amendments correct the most glaring of these errors.

I might mention, I think most of the amendments adopted by this committee would have been taken care of one way or the other through the Treasury's regulations. The Treasury, however, in 15 months since this legislation passed, has only proposed regulations, a very abbreviated set of regulations proposed in October 1975. They covered some of these problems, but they have not covered all of them. There was some question about just how far the Treasury thought it could go, so these amendments were certainly appropriate.

Four specific revisions in section 1317 I want to mention. The first one already has been mentioned, the exclusion or the treatment of retailers, specifically the exclusion of bulk sales to industrial and commercial consumers, adopted by this committee. Under the small producer exemption of section 613A, percentage depletion is denied to a taxpayer who directly or indirectly through a related person operates a retail outlet for the sale of oil or natural gas. The general usage of the term "retail sales" does not include large quantity sales pursuant to one contract covering a substantial period of time. All dictionary definitions of retail sales define it in terms of small quantity sales to the general public.

The proposed Treasury regulations have gone quite far and would have included bulk sales at the wellhead to be retail sales with the possible result that a producer of natural gas who made a direct sale to an industrial consumer could be considered a retailer, and therefore could be considered to be operating a retail outlet, I suppose, at the wellhead and could lose percentage depletion on all of his production to whomever sold and wherever located.

This committee's amendment would alter that result and exclude bulk sales from the definition of retail sales, and certainly it was a desirable result.

Also, in connection with retail sales, the committee adopted an exception for smaller retail sales, excluding altogether retailers who have gross sales of less than $5 million a year. This took care of a very difficult technical problem whereby any small amount of sales at the retail level, oil or natural gas, could result in the denial of percentage depletion of the producer who did that directly or had a lower than 5-percent investment in an activity that made retail sales.

We heard about cases where an oil and gas producer might have 5 percent interest or small interest in a dress shop that would sell syn-

thetic materials produced from oil and gas therefore, technically, would be related to a party who would be considered an operator of a retail outlet for the sale of oil or natural gas products.

There are many such absurd examples. The Treasury regulation evidently would have gone and carried these absurdities to their ultimate extreme. In no sense is such a producer integrated. In no sense does he operate both a producing and marketing function. Several solutions were put forward and discussed with the staff at the Treasury on this problem. This committee's solution, of course, is to exclude sales of more than $5 million, which is certainly a reasonable result.

The CHAIRMAN. I want to ask you one question with regard to the 65-percent limitation, and its applications to trusts.

Is that a problem that exists with regard to a considerable number of people around this country or just one or two?

Mr. CHAPOTON. That is a problem that exists in every State where oil and gas production is made. It is a problem that we had seen early in the legislation and had submitted comments on it to the Treasury Department in consideration of the proposed legislation, pointing out the legislation simply did not work from a technical standpoint, and technically it would be impossible to compute the amount, distribute the income of the trusts dependent upon the percentage depletion of the trusts, and would be dependent upon the depletion deduction of the trust. You could not compute depletion until you computed the amount of distribution. You could not compute the amount of distribution until you computed depletion.

The CHAIRMAN. Let me ask you something else. You were once a tax legislative counsel in Treasury, is that correct?

Mr. CHAPOTON. Yes, sir.

The CHAIRMAN. Would you mind explaining in general terms why it is that we sometimes need to have what has been described here as special interest amendments, to correct an inequitable situation or a situation involving a relatively small number of taxpayers compared to an amendment that may affect many millions?

Mr. CHAPOTON. I would be happy to. It is a situation, of course, that has existed, I am sure, since the Internal Revenue Code was adopted. In an economic society as complex as ours, the Internal Revenue Code is necessarily complex. Treasury and your committee's very able staff work very closely together, and try to reach proper technical results and reach proper, equitable results in adopting provisions. They seek views from anybody throughout the country as to how a specific provision will affect certain business enterprises and certain individuals. Unfortunately, views do not always come in on time. For various reasons people do not understand what a provision might do.

Once it is published, and more publicity is released, and technically it is interpreted by the Treasury, or simply by tax attorneys around the country in a certain manner, then a business or group of businesses that will be severely affected, certainly any reasonable interpretation of the law would have to conclude that Congress could not have intended that result.

Then those taxpayers ordinarily seek advice of legal counsel who in turn seek advice of the Treasury Department whether this was intended to exclude. In all cases of which I am familiar, the taxpayers involved, what the concern is, if it is a reasonable position, ordinarily

they get a sympathetic hearing, which is certainly what I thought the Government was supposed to do for its citizens. In such cases it is true that there are often relatively few taxpayers involved because, if there had been a great number of taxpayers involved, the problem would not have occurred in the first place.

Senator DOLE. Mr. Chairman.

The CHAIRMAN. Senator Dole.

Senator DOLE. You mentioned these were not integrated companies. That is important. Senator Kennedy and the public interest groups—presumably working out of the same office—have implied that the large integrated companies are going to get this big tax windfall if we did these things. I may say to the credit of the public citizen, they do not find anything wrong with these amendments. They just felt they should have been ventilated.

I do not have any quarrel with that. I am happy to have your testimony. It is very helpful.

Mr. CHAPOTON. These amendments actually have been ventilated through a staff discussion, both our staff and your staff for over a year.

The CHAIRMAN. I am pleased to hear from someone who knows something of the genesis of these provisions about which you testified.

Let me just ask you this. Have you and I ever before discussed this problem of all these trusts?

Mr. CHAPOTON. No, sir, we have not.

The CHAIRMAN. One reason is that I did not know it existed until a week ago. Since that time, one would get the impression I was the only person that did know it existed. It was merely a proposed Treasury regulation to deal with the situation you are talking about, where a taxpayer finds he is adversely affected by a proposed Treasury regulation, and he talks to somebody who is competent, like the witness sitting before us, and they say, well, this certainly could never have been intended. This gives us a ridiculous result.

What could be done about this?

Sometimes the way the statute is worded, even though it was a manifest error, the only way it can be corrected is for someone to bring it to the attention of Congress, is that right?

Mr. CHAPOTON. That is right. If it is impossible to correct with reasonably interpreted regulations, it has to be brought to Congress.

The CHAIRMAN. Thank you very much.

Next we will call Mr. Harold Scoggins, counsel, Independent Petroleum Association of America.

[The prepared statement of Mr. Jones follows:]

STATEMENT BY A. V. JONES, JR., PRESIDENT, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

SUMMARY

1. Independent producers account for most of the exploratory drilling for new crude oil and natural gas reserves in the United States.

2. Actions previously taken by Congress have severely hampered the ability of independents to generate sufficient capital for necessary exploration and drilling activities.

3. The Senate Committee on Finance has recognized some of the counterproductive features of previously-adopted legislation.

4. The Committee's proposed changes to the independent producer exemption to the repeal of percentage depletion contained in the Tax Reduction Act of 1975 are a step in the right direction.

5. Even if the bill as reported by the Senate Committee on Finance is adopted without substantial change, independent producers will still be confronted with serious obstacles in attracting and retaining the necessary capital for exploration and drilling activities.

STATEMENT

My name is A. V. Jones, Jr., an independent oil and natural gas producer of Albany, Texas. As President of the Independent Petroleum Association of America, I appear here today representing 4,000 independent oil and natural gas producers from every producing area of the United States who have a vital interest in the subject of these hearings.

We appreciate this opportunity to present testimony concerning those provisions of the bill previously adopted by the Committee. On March 25, 1976, we presented detailed testimony setting forth the basic facts which must be considered in evaluating the impact of any changes in the tax treatment of producers of crude oil and natural gas. At that time we recommended several specific actions particularly with regard to intangible drilling costs and percentage depletion which are absolutely essential if independent producer—who account for the bulk of exploratory drilling—are to be able to generate the capital necessary to continue their efforts at finding new supplies of crude oil and natural gas.

We commend the Committee for adopting several of our basic recommendations and would urge the full Senate to accept the Committee's recommendations. If the Committee bill is adopted, domestic producers will still be confronted with many serious obstacles in attracting and retaining the necessary capital, but some of the more severe unintended limitations arising from adoption of the Tax Reduction Act of 1975 will have been corrected.

We strongly support the amendments set forth in Sec. 1317 of the Committee bill. They will do much to alleviate the unduly harsh application of Code Section 613A. We do suggest, however, that in Sec. 1317 on page 829 at lines 16 and 17 of the Committee bill, the word "governmental" should be inserted in the parenthetical expression concerning bulk sales to commercial or industrial users.

Turning to specific provisions contained in the Committee bill, we wish to commend the Committee for recognizing several deficiencies in the partial exemption of independent producers from the repeal of percentage depletion enacted by Congress last year. Since the adoption of the 1975 Act, it has been our understanding (confirmed by a review of the legislative history and after detailed discussions with most members of Congress) that with regard to percentage depletion in the case of oil and gas wells, it was the intent to retain percentage depletion for independent producers who rely primarily on the sale of crude oil and natural gas at the wellhead for their major source of income. However, the exemption for independent producers contains several overly broad provisions which to a considerable extent negate the intended exemption. These provisions have been of even more concern to independent producers because the 1975 Act was made applicable retroactively to January 1, 1975 and therefore applied to many transactions entered into in good faith which would not have been undertaken had the parties known of the provisions of the Act.

Perhaps the overly broad application of some of the provisions of the 1975 Act can best be illustrated by specific example:

Example 1: Assume that Producer "A" is an independent producer engaged in no business other than exploration for and production of crude oil and natural gas. Producer "A," during 1975, had an average daily production of 50 barrels of oil and would seemingly be a classic example of the type of individual for whom the independent producer exemption was intended. However, Producer "A", like many independents, operates 24 hours a day, seven days a week, and for the sake of convenience and efficiency, maintains a gasoline storage tank and pump at his place of business to service his trucks and other vehicles necessary to the operation of his business. Producer "A" has, for many years as a matter of courtesy and convenience to his employees, permitted them to fill their personal automobiles with gasoline from his pump, charging them only his actual cost for the gasoline. Under the "Retailers Excluded" provisions of paragraph two of Section 613A(d) of the 1975 Act, Producer "A" may be defined as a "retailer" and as such be ineligible for percentage depletion on his income derived from oil and gas production.

Example 2: Producer "B" also would appear to be within the classic definition of independent producer because he has for many years been engaged full time in

the business of exploration for and production of crude oil and natural gas, and during 1975 had an average daily production of 120 barrels per day. However, Producer "B" is the owner of a ten percent interest in the office building in which his offices are located and the parking garage which is a part of the building has a retail gasoline pump for the convenience of parking patrons. Under the provisions of the 1975 Act, Producer "B" may find himself classified as a "retailer" and thus be ineligible for percentage depletion on his oil and gas production income.

These examples are just a small indication of how far-reaching the limitations within the independent producer and royalty owner exemption are when taken from the abstract and applied to actual situations within the industry. Other examples of unnecessarily broad application of many of the other provisions could be given, but will be omitted for the sake of brevity.

A substantial number of producers who could not be considered as anything other than "independents" under any common sense meaning of that term will not be eligible for percentage depletion because of these unforeseen limitations in the present independent producer exemption. We therefore support the Committee's amendments to the "Retailers Excluded" provision of Sec. 613A of the Code.

We support the Committee's amendment which would not penalize an independent producer who may have some financial interest in activity outside the United States. Certainly if we are to maximize domestic exploration and development, it makes no sense to reduce the exploration and drilling capital which would otherwise be available to a domestic independent producer. The real loss in such case is suffered by domestic consumers. Coupling this provision with a prohibition against exporting domestic crude oil and natural gas production is of further benefit to domestic consumers.

In our previous testimony to the Committee, in testimony and comments submitted to the Internal Revenue Service, and in numerous contacts by individual producers with members of Congress, the unnecessarily burdensome application of these provisions has been pointed out and numerous suggestions made for changes. We have repeatedly indicated that the intent of the legislation denying percentage depletion for integrated producers could be adequately accomplished without penalizing many independent producers.

The Committee's proposed amendment to the transfer rule set forth on page 830 of the Committee bill is in keeping with the spirit of recommendations made not only by IPAA, but numerous accounting groups and many individual producers. This Committee amendment will do much to alleviate undue hardship which would result from the denial of percentage depletion to producers who had in all good faith created trusts for estate planning or other purposes before the enactment of the 1975 Act. Certainly it does not in any way seem equitable to penalize taxpayers who would otherwise be eligible for percentage depletion merely because the legal title to the producing property is held in trust. The IPAA and many other industry representatives have recommended more extensive revision of the transfer rule than adopted by the Committee, but the Committee amendment is a substantial step in the right direction.

In 1969, Congress removed approximately $600 million from the domestic petroleum industry through the substantial reduction of percentage depletion. In 1975, the virtual repeal of percentage depletion effectively removed more than $2 billion that otherwise would have been available for exploration and development. Congress, through adoption of the Energy Policy and Conservation Act of 1975, has reduced by another $3 billion the revenues which would otherwise have been available this year for domestic exploration and drilling activity. As stated before, these actions already have been reflected in a substantial downturn in domestic drilling activity. As demonstrated by the Ture Economic Analysis which we previously furnished to the Committee, these actions are having substantial adverse effects on the general economy, particularly with regard to employment and reduction in gross national product, as well as a negative impact on tax revenues.

It is essential if we are to reverse our ever-increasing dependency on foreign crude oil and maintain our economic viability that we provide the domestic petroleum industry with every possible incentive to maximize domestic exploration and drilling activity. Consequently, we commend this Committee for the steps it has taken to minimize the negative impact of previously adopted adverse legislation. We urge the full Senate and Congress to recognize the necessity of these actions.

Thank you.

STATEMENT OF HAROLD B. SCOGGINS, JR., COUNSEL, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

Mr. SCOGGINS. Thank you, Mr. Chairman and members of the committee. We are prepared to submit our statement that I will summarize. I will ask our entire statement be included in the record. As a matter of fact, I think I will just deviate from our statement on this totally in view of some of the questions that have come out here.

I would say we do represent over 4,000 independent producers of crude oil and natural gas who operate in every producing area of the United States. We have been advocating some of these changes that are included in the committee bill for over a year, since the Tax Reduction Act of 1975 was adopted. We have advocated these changes publicly and openly, and the idea that they are only a small group of people involved just does not hold with the facts.

As I say, we represent over 4,000 members, who in turn represent several thousand partners and investors and independent oil and gas operations. Many of them are affected by some of the provisions in the Independent Producer Exemption Act after last year, that no one understood at the time would have the impact that they did.

Perhaps one or two examples might be helpful in addition to those you already had. Many independent producers operate in remote areas. They operate 24 hours a day, 7 days a week. Consequently a lot of them as a matter of convenience and almost necessity, maintain a gasoline storage tank and a gas pump to service their own vehicles that they use in their business. A lot of them as a matter of courtesy to their employees allow their employees to fill their personal automobiles with gasoline from the company-operated pump.

Under the independent producer exemption, they could be classified as a retailer and lose their eligibility for a percentage depletion. I do not think anyone ever intended for independents like that to be denied percentage depletion under the provisions of the act adopted last year.

We strongly support the amendments that are contained in the committee bill to correct some of these anomalies. We have advocated several other changes that unfortunately the committee did not see fit to adopt, but we do very strongly want to emphasize that these are broad general applications. They have been discussed among industry representatives, among associations such as ours. Many accounting groups have advocated the changes which have been made.

We have set forth our objections and our suggested changes in comments to the Treasury Department and in correspondence to this committee. Whoever intimated that these were narrow, special interest provisions did not do their homework and did not check into what the facts were.

Senator DOLE. They were not interested in the facts.

Mr. SCOGGINS. We would urge the committee to steadfastly stand behind the provisions that already have been adopted as amendments to the 1975 act, and which are incorporated as part of the committee bill now on the floor. Several of these provisions have already been debated and considered on the floor of the Senate as part of consideration of this bill. We think that it is extremely important for the full Senate and full Congress to adopt these amendments.

Independent producers are already operating under extremely severe restrictions on their ability to generate the capital necessary to expand their exploration and drilling activities. This is at a time when our imports of crude oil are increasing, our consumption of gasoline and other products is increasing. We are becoming more dependent on foreign oil. We ought to be doing everything possible to encourage investment in domestic exploration and development. Some of these provisions that the committee adopted will help to some degree to enable independent producers to generate the capital they so desperately need.

The CHAIRMAN. Thank you very much.

Next we will call Mr. Robert Belfer, president of Belco Petroleum Corp.

[The prepared statement of Mr. Robert Belfer follows:]

SUMMARY OF PRINCIPAL POINTS CONCERNING FOREIGN RETAIL ACTIVITY AND SECTION 613A OF THE INTERNAL REVENUE CODE

1. Belco Petroleum Corporation is an independent company engaged in the production of oil and gas in the United States and abroad.
2. Belco's sole retail activity in petroleum products is in the State of Israel and Belco does not engage in such retail activity in the United States. Belco's operations in Israel are in no way connected to its oil and gas activities in the U.S.
3. The Tax Reduction Act of 1975 preserved the depletion allowance for domestic oil and gas production for independents who were not retailers. However, this Act failed to state that what was meant was domestic, and not foreign, retail operations. Discussions with staff of the Senate Finance Committee and the Senate sponsors of the amendments creating the independents' depletion allowance show no intent to deprive a company such as Belco of depletion due solely to foreign retailing. Moreover, no one familiar with the situation has suggested that Belco should be so deprived.
4. Accordingly, Belco believes that Section 1317 of the Tax Reform Act of 1976 which restores depletion to Belco is a clearcut of remedying legislative oversight.

FOREIGN RETAIL ACTIVITY AND SECTION 613A OF THE INTERNAL REVENUE CODE

These comments are submitted on behalf of Belco Petroleum Corporation. Belco is an independent company engaged in exploration and production of oil and gas primarily in the Gulf Coast and Rocky Mountain areas. It produces approximately 6,000 barrels of oil per day (much of which is being recovered by secondary methods) and 70,000 mcf of gas a day in the United States. Belco does not engage in any retail activities in the United States and has no refinery capacity or pipelines. Belco has foreign oil operations in Canada, Peru and Israel and a coal operation in the United States. Belco through Sonol has also engaged, without success, in oil exploration in Israel, drilling five dry holes on shore and six dry holes off shore over the last five years with two deep tests in progress for this year. Belco is and has been for a number of years the chief foreign exploration company in Israel.

Belco submits the following comments with respect to the proposed amendment to Section 613A of the Internal Revenue Code ("Code") contained in Section 1317 of the Tax Reform Bill of 1976 (H.R. 10612).

The Tax Reduction Act of 1975, while denying the benefits of the depletion allowance to the major integrated oil companies, sought to preserve some of the incentives afforded by those benefits through the exemption for independent producers embodied in section 613A(c) of the Code.

"A taxpayer's foreign retail activities should not result in the loss of domestic depletion under the independent producers exemption."

Belco is the only sizable American petroleum company operating in Israel. Its Israeli subsidiary, Sonol Israel, Ltd. ("Sonol") markets refined products through retail outlets in Israel and is the seventh largest corporation in that country. Sonol does not have any refinery capacity. The marketing of petroleum products in Israel is strictly cost regulated by the Fuel Authority of the Israeli government which owns the only refineries in the country.

The exemption of independent producers from the repeal of percentage depletion for oil and gas allows depletion for limited quantities of domestic crude oil and domestic natural gas. The term "domestic" is defined in the statute as referring to production from an oil or gas well located in the United States or in a possession of the United States. Subsection 613A(d)(2) of the Code denies the independent producers exemption to any taxpayer who sells oil or natural gas, or any product derived therefrom, through a retail outlet operated by the taxpayer or a related person, but fails to repeat the word, "domestic," in relation to such retail sale. Nowhere does the record suggest, nor have discussions with anyone involved in drafting this legislation suggest, any reason why the word, "domestic," was left out. The reasonable inference is that the possibility of an independent producer having foreign retail sales, but not having domestic retail sales, was not considered.

Belco is apparently the only company in this unusual posture. Therefore, it is not surprising that this matter did not cross the minds of those drafting this legislation on the floor of the Senate. Had there been Committee hearings on the independent producers exemption containing the present language, Belco would certainly have called its unusual circumstances to the attention of the Committee. However, since Belco was not afforded such an opportunity at that time, it has been forced to embark upon an effort to correct this legislative oversight.

In short, Belco solely because of its ownership of Israeli marketing outlets will be deprived of its depletion allowance absent the adoption of Section 1317 of the Committee Bill. Section 1317 is required to insure that the operation of retail outlets located outside of the United States will not result in the loss of incentive depletion with respect to domestic production of crude oil and natural gas under the independent producer exemption. As Senators Kennedy and Hollings observed in their statement to this Committee when considering the Tax Reform Act of 1975:

"Most of the major oil companies are vertically integrated firms. They have an unfair competitive advantage, since they do not care which stage in the production of petroleum products generates their basic profits. In fact, the top 20 integrated now control 94% of known domestic oil reserves. In effect, the integrated firms are selling crude oil to themselves at artificially high prices, and thereby driving independent refiners and manufacturers out of business."

Belco does not possess any such attributes of integration. Belco does not market any of its domestic production through its Israeli outlets and, therefore, cannot shift its profits along a chain of distribution. But for Belco's Israeli marketing operations, Belco would qualify for the independent exemption.

Belco is apparently the only American company qualifying as an independent producer which has foreign retail outlets. To exclude Belco from the independent producers exemption due to its Israeli operations would be not only illogical and contrary to the overall statutory scheme, but also would have the extremely unfortunate result of placing an economic penalty on Belco's retail activities in Israel. This penalty could cause Belco to withdraw from Israel or to dispose of its retail operations there, both of which would be undesirable from the standpoint of the Israeli government and would obviously be an unintended consequence of the Tax Reduction Act of 1975.

CONCLUSION

Section 1317 of the proposed Bill states that retail outlets operated in foreign countries, where domestic production is not related to the foreign retail activity, will not exclude a taxpayer from the benefit of the independent exemption. Belco believes that this remedial section is required to prevent the inequity resulting from the hurried consideration and passage of the depletion provisions of the Tax Reduction Act of 1975.

Very truly yours,

BELCO PETROLEUM CORP.,
ROBERT A. BELFER,
President.

STATEMENT OF ROBERT BELFER, PRESIDENT, BELCO PETROLEUM CORP.

Mr. BELFER. Thank you, Mr. Chairman and members. I am the president of Belco Petroleum Co. I am appearing here in connection

with section 1317. I very much appreciate the chance of appearing here in order to be able to tell our story.

The Tax Reduction Act of 1975 addressed itself to percentage depletion relating to oil and gas. As Senator Pearson said concerning that act, "I do not believe that retention of the depletion allowance for the major integrated oil companies is any longer necessary or desirable. On the other hand, I am convinced that keeping the depletion allowance for the independent, unintegrated producers is definitely in the national interest."

What are the facts concerning Belco? Belco is an independent oil and gas producer. We do not engage in any marketing or refining in the United States. However, we do engage in the marketing of petroleum products, under close Government regulations, in the State of Israel. We find ourselves in the situation where section 613A(c), which preserved the depletion alowance for independents, specifically relates to domestically produced oil, domestically produced gas, but when part (d) was drafted, which excluded the retailers, the word "domestic" was left out.

Senator Kennedy, who I know has appeared before this committee, was quoted as saying, "In cases where special interest provisions have merit, it is because they are designed to alleviate an unintended hardship caused by the application of the general tax law to a particular situation."

I would suggest that Belco is a classic instance of such a matter. We do not question the general law, taking away depletion allowance for integrated companies. In no functional sense is Belco an integrated company. Rather, because of the drafting of the language, we find ourselves in the role of an unintended victim.

We can very well understand why the Congress did not recognize the situation since our research has shown that Belco is unique in the industry. In fact, if I did not know of the existence of Belco, I could hardly dream myself that a company exists that is engaged in foreign retailing but not domestic.

The purpose of section 1317 is to merely restore Belco's competitive position to that enjoyed by other independent oil and gas producers in the United States. I suggest that it would be a tribute to the legislative process of the United States if it would recognize the legitimate grievances of its citizens, no matter how narrow the application.

Thank you.

The CHAIRMAN. Thank you very much, sir.

Senator DOLE. Mr. Chairman.

The CHAIRMAN. Yes.

Senator DOLE. How large is your operation in Israel?

Mr. BELFER. We have close to 100 service stations in the State of Israel. The profit margins of our entire business in Israel is regulated by the Government and for reasons that probably do not need to be stated, Israel has particular problems in attracting foreign capital.

Senator DOLE. Somehow your amendment got into my amendment. I have already been given credit for it in the press, but I have never heard of it.

Mr. BELFER. Senator, I share your puzzlement as to why you were good enough to introduce it. I could only conclude that it was logically appropriate, since the members of the congressional staff had

reviewed both amendments and since they both relate to the retailers' exclusion, that for the purposes of drafting, they were struggling with the same paragraph. We appear as the last sentence in a paragraph that otherwise contains the so-called minimum rule relating to retail sales.

We appreciate your taking us on as excess baggage that I trust you will feel is well justified.

Senator DOLE. I just wanted to make the record clear, I never discussed this amendment with anyone from Belco. I am happy to meet you today.

The CHAIRMAN. I hope the Senator from Kansas will not completely divest himself of the credit to which he is entitled for helping Israel with its problems.

Senator DOLE. I think I am ready to come out for the amendment.

Senator HANSEN. Mr. Chairman, Mr. Belfer has some operations in my State of Wyoming. He is a very valued citizen insofar as the way he is regarded by the State of Wyoming. I was prepared to introduce this amendment. It occurred to me that the facts of this case clearly warranted the sort of specific individualized legislation to which you referred in the comments made by Senator Kennedy. I was prepared to do that. It was only because Senator Dole, who complains of the senior system, in which case I happen to outrank him, but he did get ahead of me.

The CHAIRMAN. I suppose that I can complete the record by stating that Mr. Larry Woodworth, who is the very talented, terribly hard working chief of staff of the Joint Committee, was asked during the course of the sessions to prepare an amendment that would take care of some of these unintended hardships, and having prepared the amendment to cure what he helped create to begin with, he was well aware of what they were, so he prepared the amendments so they included you. That just goes to show how sometimes what we are trying to take care of in every little situation, we sometimes do more good than would appear on the face of it.

It is also part of the problem because one of the biggest loopholes in the tax law that ever occurred was a provision that included one of the Driscoll heirs up in Philadelphia. Most of the people who were making more than $1 million and not paying their taxes, had come under that provision where they would dedicate all of their income to the Catholic Church or some other charitable organization. So a law for a Philadelphia nun created a huge loophole.

Thank you very much.

Senator BYRD. What is the price of gasoline at the pumps in Israel today?

Mr. BELFER. Approximately $2 a gallon. The price has been rapidly increasing because Israel continually devaluates its currency. The price has been reduced and jacked up again.

Senator BYRD. When I was last there, I recall the price was $1.50. It is about $2 now?

Mr. BELFER. That is correct, Senator.

Senator BYRD. Thank you.

The CHAIRMAN. Thank you very much, sir.

Next we will call Mr. Edward R. Healy, president, National Association of Water Companies.

[The prepared statement of Mr. Edward Healy follows:]

TESTIMONY OF MR. EDWARD HEALY, PRESIDENT, NATIONAL ASSOCIATION OF WATER COMPANIES

SUMMARY

1. 20% of the water companies in America are investor-owned.
2. For over 50 years the IRS and courts have allowed these companies to treat contributions in aid of construction as contributions to capital.
3. A recent IRS ruling changes this long-standing treatment; the IRS now considers contributions in aid of construction as income.
4. Effect will either drastically raise taxes of water companies, halt expansion of water service, or cause general rate increases.
5. The Finance Committee adopted an amendment reinstating, with stringent safeguards, the previous treatment of these contributions as contributions to capital.
6. The amendment is supported by the National Association of Regulatory Utility Commissioners.
7. The amendment is carefuly drawn to prevent abuses; the utilities will not be able to include contributed property in their rate base, take depreciation on it, or take the investment credit on such contributed property.
8. The amendment applies to the most capital intensive utilities, water and sewer companies, who need it the most.

STATEMENT

Mr. Chairman, and members of the Committee, I am Edward Healy, President of the National Association of Water Companies, the organization representing most of the investor-owned water utilities in the U.S. An amendment adopted during your consideration of H.R. 10612 relates to the 20% of the water companies in this country which are investor-owned, with the remaining 80% owned by municipalities and other governmental units. This 80% owned by governments is obviously exempt from any taxation by the Federal Government and is also in direct competition in many situations with the investor-owned water utilities which pay the regular corporate tax on any income they might have.

For over 50 years, investor-owned water utilities have treated the receipt of contributions in aid of construction as contributions to capital, not as income. This longstanding interpretation of the tax law was repeatedly affirmed by the courts and acquiesced in by the IRS. However, in 1975, the IRS abruptly reversed this longstanding interpretation, so that it now appears that these contributions may be treated as income to the water utilities. Since these contributions are an integral part of the providing of water service, this change (which particularly harms the smaller but expanding water utilities) has the effect of either significantly raising the taxes of investor-owned water utilities or halting the expansion of water service. To avoid curtailing any expansion of service, the water utilities would have to dramatically increase these contributions or secure a general rate increase affecting all their customers in order to recoup the tax increase.

To correct this problem the Committee on Finance adopted at § 1322, p. 839 of the Tax Reform Bill, an amendment to § 118 of the Code providing that these contributions in aid of construction made to a water or sewer utility be treated as contributions to capital, the same manner in which they have been treated for over 50 years. This amendment was advocated by the National Association of Regulatory Utility Commissioners before this Committee in order to prevent the utility rate increases, housing cost increases, and building moratoriums that could result from the IRS' reversal of its interpretation.

This provision does not provide a new tax break; it merely reaffirms a 50 year old policy that these regulated utilities have come to rely upon and base their operations around.

The Committee amendment is carefully drawn in order to prevent abuse by denying any depreciation on contributed property, by requiring that the property not be included in its rate base, and by denying the investment credit on contributed property. The reason why the technical staffs of Congress readily recommended adoption of this provision is that it simply prevents the bunching of income in a given year. Questions concerning this amendment apparently arise from failure to perceive the need for the amendment, the stringent safeguards included in its provisions, and the adverse impact on consumers that will occur if the amendment is not adopted forthwith.

Mr. Chairman, I want to point out that this change in law imposed by the Internal Revenue Service has created a situation where many investor-owned water utilities will have to significantly increase their revenues in order to just pay for the increase in taxes. One company in Alaska, for instance, would have to increase revenues well over 100% in order to just pay for this tax increase. Obviously, such a company has only a limited number of options available to it. It could ask for a general rate increase which probably would not be granted since the Utility Commission would say that these costs are attributable to only new customers, it could ask for an increase in contributions by the amount of the new taxes, or it could refuse to take new customers. Any of these alternatives are going to be inflationary and clearly detrimental to the customers of the company, the continued financial well-being of the company itself, and the economy of the area of Alaska served by this company.

Mr. Chairman, we believe that the water and the sewer companies to which the Committee directed its amendment, have a very meritorious case and have the most serious problem among the utilities with this change in interpretation of the tax law by the IRS. Considering the low rate of return for water and sewer companies, we are the most capital intensive of the utilities. This is another reason why this amendment is so crucial to us and why we need this reinstatement of prior law.

Mr. Chairman, and members of the Committee, thank you for this opportunity to appear before you and give you our views on § 1322.

STATEMENT OF EDWARD R. HEALY, PRESIDENT, NATIONAL ASSOCIATION OF WATER COMPANIES

Mr. HEALY. Mr. Chairman, and members of the committee, an amendment adopted during your consideration of H.R. 10612 relates to the 20 percent of the water companies in this country which are investor-owned, with the remaining 80 percent owned by municipalities and other governmental units. This 80 percent owned by governments is obviously exempt from any taxation by the Federal Government and is also in direct competition in any situations with the investor-owned water utilities which pay the regular corporate tax on any income they might have.

For over 50 years, investor-owned water utilities have treated the receipt of contributions in aid of construction as contributions to capital, not as income. This longstanding interpretation of the tax law was repeatedly affirmed by the courts and acquiesced in by the IRS. However, in 1975, the IRS abruptly reversed this longstanding interpretation, so that it now appears that these contributions may be treated as income to the water utilities. Since these contributions are an integral part of the providing of water service, this change, which particularly harms the smaller but expanding water utilities, has the effect of either significantly raising the taxes of investor-owned water utilities or halting the expansion of water service. To avoid curtailing any expansion of service, the water utilities would have to dramatically increase these contributions or secure a general rate increase affecting all their customers in order to recoup the tax increase.

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moratoriums that could result from the IRS reversal of its interpretation.

This provision does not provide a new tax break; it merely reaffirms a 50-year-old policy that these regulated utilities have come to rely upon and base their operations around.

The committee amendment is carefuly drawn in order to prevent abuse by denying any depreciation on contributed property, by requiring that the property not be included in its rate base, and by denying the investment credit on contributed property. The reason why the technical staffs of Congress readily recommended adoption of this provision is that it simply prevents the bunching of income in a given year. Questions concerning this amendment apparently arise from failure to perceive the need for the amendment, the stringent safeguards included in its provisions, and the adverse impact on consumers that will occur if the amendment is not adopted forthwith.

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The CHAIRMAN. Thank you very much. We will put your entire statement in the record.

Next we will call——

Senator CURTIS. Could I ask one question?

The CHAIRMAN. Yes.

Senator CURTIS. Do you have any objection to extending this provision of the bill to other utilities?

Mr. HEALY. I have no objection.

The CHAIRMAN. Next we will hear from Mr. W. Reid Thompson, chairman of the board and president of Potomac Electric Power Co.

[The prepared statement of Mr. Thompson follows:]

STATEMENT OF W. REID THOMPSON, CHAIRMAN OF THE BOARD AND PRESIDENT OF POTOMAC ELECTRIC POWER COMPANY, ON BEHALF OF EDISON ELECTRIC INSTITUTE

SUMMARY

We support the actions of the Senate Committee on Finance in adopting—

(1) Section 2001 dealing with residential insulation credits

(2) Section 2002 dealing with credits for the installation of residential heat pumps and solar or geothermal energy equipment and

(3) Section 2003 dealing with the business insulation credit

Mr. Chairman: I am appearing on behalf of the Edison Electric Institute, the principal national association of the investor owned electric utility industry. The Institute's member companies serve approximately 99% of the customers served by the nation's investor owned electric utility industry.

I have previously filed a statement dealing with three technical provisions in the Finance Committee's Bill, the most important being Section 1322 dealing with contributions to capital in aid of construction. The following comments supplement this statement and endorse the provisions of the Finance Committee's Bill dealing with certain energy-related matters.

These energy related provisions will make an important contribution to the national goals of fuel conservation and efficient use of our energy resources. By conserving fuel and reducing the financing requirements of the capital intensive electric utility industry through load growth control and reduction, these measures will be of material importance in progress towards national energy goals.

The provisions of Section 2001, 2002 and 2003 relating to insulation credits and credits for the installation of heat pumps and other energy conserving equipment will contribute to the long run success of our energy program, to easing the financing burdens of electric utilities and to curbing necessary increases in the utility bills of their customers.

Many electric utilities have adopted or are studying adoption of programs to encourage their customers to install energy-saving insulation, storm windows and heat pumps. The advantages of both are obvious and consistent with national energy goals. Adequate insulation equipment will effectively conserve all fuel sources. The heat pump, which now is proven as an effective and highly efficient source of space heating and cooling, at an efficiency level which is 30 to 50% greater than that of electric furnaces or resistance heating, will allow substitution of electric energy, which can be produced from non-petroleum sources, for scarce petroleum.

The expanded use of adequate insulation, heat pumps and other energy efficient devices will not only conserve fuel but will assist in utility load management programs which are of critical importance. Over time these programs will contribute to a managed and reduced rate of growth in demand for electricity which in turn will reduce capital requirements to construct generating and other facilities. The electric utility industry, which has encountered serious difficulties in competing for capital to meet its construction requirements, can through effective load management programs reduce construction requirements, ease cash and financing burdens and limit the need for utility rate increases.

Statement on Provisions of H.R. 10612 of Particular Interest to the Investor-Owned Electric Utility Industry

Summary

We support the actions of the Senate Commission on Finance in adopting:

(1) section 802, dealing with refunds of unutilized investment tax credits; and

(2) section 803, as it relates to expiring investment tax credits.

Section 1322, dealing with contributions to capital of regulated public utilities in aid of construction, should be amended to include contributions to capital of electric utilities. We would support section 1322 if so amended. No revenue loss would result from bringing electric utilities within the provisions of section 1322, since contributions in aid of construction have not heretofore been treated as taxable income. For over 50 years electric utilities have treated contributions in aid of construction as offsets to the capital costs of the facilities acquired with the contributions, with confirmation by the courts and acquiescence to by the Internal Revenue Service. Section 1322 should by statute specifically give recognition to this treatment.

Statement

Mr. Chairman: I am appearing before you today on behalf of the Edison Electric Institute, the principal national association of the investor-owned electric utility industry. The Institute's member companies serve approximately 99 percent of the customers served by the nation's investor-owned electric utility industry.

Three provisions of the Finance Committee's bill are of particular interest to members of our industry. They are:

Section 802, dealing with refunds of unutilized investment tax credits.

Section 803, as it relates to expiring investment tax credits.

Section 1322, dealing with contributions to capital of regulated public utilities in aid to construction.

I should like to discuss first section 1322, the provision of most immediate interest to us.

The electric utility industry endorses the intent of section 1322 but urges that it be amended so as to include the electric utility industry in its coverage.

No revenue loss would result from bringing electric utilities within the provisions of section 1322, since contributions in aid of construction have not heretofore been treated as taxable income.

For over 50 years, electric utilities have treated the receipt of a contribution in aid of construction as an offset to the capital cost of the facility acquired with the contribution. The treatment has been repeatedly confirmed by the courts and until 1975 acquiesced to by the Internal Revenue Service. However, in 1975 the Tax Court (*State* Farm Road Corp., 65 T.C. ——, No. 19) and the Internal Revenue Service (Revenue Ruling 75-557, 1975-2 C.B. 33) reversed this long-standing position with respect to certain contributions to sewer companies and water companies, respectively, and the Internal Revenue Service has indicated that it will apply these interpretations broadly to contributions to capital of electric and other utilities. Section 1322 removes the problem created by the above interpretations for only water and sewer companies.

Contributions in aid of construction to electric utilities are contributions in cash or other property received from its customers to defray all or a portion of specific construction costs. Contributions are received for construction of plant facilities which normally would not be built with the utility's own funds because the revenue to be earned would not justify the investment. If the utility were to construct such facilities without the benefit of the contributions in aid of construction, the cost thereof would, in effect, be borne in part by customers other than those receiving service from the facilities.

A utility is compelled by contract or regulatory requirements to use contributions for construction of facilities for which the contributions are received. Rules of the Federal Power Commission and of most state regulatory agencies require that the contributions be credited to a plant account. The property, or the portion thereof, constructed with such contributions, having no net cost to the electric utility, is executed from the rate base, with the result that the utility cannot earn on it.

No investment tax credit is taken or depreciation deducted for Federal income tax purposes with respect to such property. Clearly, no tax "loophole" or "gimmick" exists with respect to the exclusion from taxable income of such reimbursements.

Amounts received by an electric utility as contributions in aid of construction may be used only for the purposes for which the contributions are intended. For taxable income to be realized, the contributions should be received under a claim of right without restriction as to use. These contributions are received with a complete restriction as to use. They act as a reimbursement for captial costs. Inasmuch as regulatory commissions impose continuing restrictions upon the use, enjoyment and disposition of these contributions, the receipt of such contributions by electric utilities should not be regarded as taxable income.

If the utility is required to pay Federal income taxes on each dollar collected as a contribution in aid of construction, it must, of necessity, file for increased rate tariffs to recognize its increased revenue requirements. If the rate tariffs are not increased, additional cash and financing burdens will be placed on those electric utilities continuing to provide such construction at a time when they are already confronted with great difficulty in financing construction of new facilities. This is contrary to current Congressional and Administration policies of encouraging electric utility cash generation for necessary plant additions as a key element in solving the nation's energy problems.

The taxability of contributions in aid of construction was the subject of a thorough and prolonged study by the Internal Revenue Service in 1958. It was concluded that the treatment of excluding customers' contributions from taxable income is correct and this policy was announced in Revenue Ruling 58-555, 1958-2 C.B. 25. For the reasons stated above, we urge that this legislation be amended and enacted to make it clear that no change in this long standing practice be made.* We understand that considerations with respect to contributions in aid of construction for gas transmission and distribution properties are similar and should be treated similarly to properties of an electric utility.

In conclusion, I wish to advise further the electric utility industry strongly supports the actions of the Finance Committee in adopting sections 802 and 803 of the Bill. The Finance Committee is to be commended for reporting out these two provisions which expand on the concept of the use of investment credits.

Section 802, which provides for refunds of unutilized investment tax credits commencing in 1984 for qualified investments made after 1975, is a sound provision which will serve to make certain that the credit accomplishes its purpose of stimulating investment. Without such a provision, the credit will at times fail in

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*Revenue Ruling 75-557 specifically revokes Revenue Ruling 58-555.

its purpose and will be of no benefit to taxpayers that most need assistance in meeting their capital requirements. Long-range planning for capital expenditures, which is critical to our industry, may proceed with greater assurance with this change in law.

Section 803 provides that investment credits which would otherwise expire as carry-overs in 1976 may be carried over for two additional years, to 1977 and 1978. This provision is of limited application to our indsutry; however, it is important as it will provide assistance to those companies which may be in the most need of help.

STATEMENT OF W. REID THOMPSON, CHAIRMAN OF THE BOARD AND PRESIDENT, POTOMAC ELECTRIC POWER CO., ON BEHALF OF EDISON ELECTRIC INSTITUTE

Mr. THOMPSON. I represent today the Edison Electric Institute, a trade organization for investor-owned power companies. With your indulgence I would like to comment briefly on the six sections of the pending bill. The first two relate to the investment tax section, sections 802 and 803. We support those sections and urge this committee to keep those in the bill. They are important. If the intent of the investment tax credit is to be extended to those companies who would be in most need of it but would not be able to use it, because of the dire circumstances they would find themselves in. We endorse those sections.

Second, I would like to comment briefly about sections 2001, 2002, and 2003, relating to credits for installation, the installation of heat pumps, solar devices and the like in residential premises; also section 2003, in business premises.

We think those sections are very important to assist in meeting the national goal of conservation of energy, to assist also, in the case of heat pumps, in the case of installation, and cutdown on the use of the scarce oil resources, and in the case of heat pumps, Mr. Chairman and gentlemen, to the extent that heat pumps are installed as a result of these incentives, it would provide for the use of electricity that could be generated from other sources than scarce foreign oil.

For that power industry, the improvement of load factor that would result from the installation of these devices would have a substantial effect in the long run on our capital requirements. We strongly support those sections 2001, 2002, and 2003.

Mr. Chairman, in the remaining time I would like to comment on section 1322 that was just spoken about by Mr. Healy from the water company.

We would endorse everything Mr. Healy said and say it applies in full force to the electric power industry, and urge this committee to expand the provisions of section 1322 beyond the present inclusion of water and sewer companies, to also include the electric power industry.

I would like to make these comments about that provision. What we are dealing with here, Mr. Chairman, if the electric power industry is included in this provision to provide the contributions in aid of construction would not be treated as income. We are not dealing with a revenue loss in a true sense because it has never been so treated in the past 50 years when rulings were first issued by the IRS exempting such permits from revenues.

We are not talking about a revenue loss in present revenues of the Treasury. We are talking only about a prospective loss if in fact the IRS ruling is applied to the electric power industry, would be in

effect the enactment by the IRS of a new tax on the electric power industry costing upward of $100 million a year from this industry.

This is at a time when you and the members of this committee have been laboring with the problems confronting the electric power industry and the acquisition of capital. This is the means whereby some capital is generated internally and limits the need for the costly external generation of capital so hard to come by today.

We point out, too, Mr. Chairman, as said by the previous speaker, the present method of dealing with contributions and aid does not provide for depreciation on facilities bought with those contributions. There is no investment tax credit with respect to them, so there is no tax loophole in the sense that the word is often used.

Rather, in the uniform system of accounts of the Federal Power Commission, these credits are treated as a reduction of the capital costs of the utilities. Also, Mr. Chairman, they must be used for specific purposes, acquisition of specific facilities for which the contributions are made. They are not available for the general corporate purposes of the utility, as you expect income of a utility to be.

Finally, a significant point is a good deal of these contributions are made by governmental agencies; highways are often heavily involved in contributions because of relocation of facilities. In the case of my own company, some $50 million of contributions will be made to a relatively small company in the District of Columbia because of Metro construction requiring the relocation of our facilities. Those contributions could in no logical sense be treated as income for this utility.

So we would urge this committee to extend the provisions of section 1322 to include the electric power industry. If it is not done, Mr. Chairman, we have facing us in the coming year a new tax enacted by the Internal Revenue Service for which rates must be increased for all of our customers to cover the specific items built for the benefit of those who made the contributions.

So we respectfully urge this committee to expand that provision.

Senator CURTIS. Do you have any objection to including all utilities within the proposal?

Mr. THOMPSON. No. I do not. I think it is logical.

The CHAIRMAN. How much capital is the electric utility industry going to need, and how much can you presently predict under existing circumstances will be needed during the next 10 or 15 years?

Mr. THOMPSON. In the next 10 years or so, Mr. Chairman, we will need up to $300 billion.

The CHAIRMAN. $300 billion? To do what you predict will be needed.

Mr. THOMPSON. Yes, sir.

The CHAIRMAN. How much do you think you will raise right now?

Mr. THOMPSON. The question of capital formation is the paramount problem facing the electric utility industry. We hope in some fashion or another that circumstances will permit us to raise it all. Under the present conditions facing the industry, we cannot, Mr. Chairman, generate internally more than 40 percent; 60 percent of those funds would have to come from external sources.

The CHAIRMAN. How much of it do you confidently predict that you could raise right now?

Mr. THOMPSON. Mr. Chairman, we have great problems in confidently predicting the raising of all those funds. It is a problem that is addressed by this committee, by the administration, by people all over the country, of where capital funds are coming from. Only if the electric industry becomes strong and viable financially in respect to its earnings and interest requirements will we raise those funds. It must come from the private capital markets, from the savings of the American people.

We will require at least 15 percent of the savings of the American people over the next 10-year period if we are going to meet the service requirements of our customers with the facilities that are needed.

This measure that I am addressing here will be a blow in the opposite direction to impede the raising of that capital.

The CHAIRMAN. Thank you.

Senator CURTIS. One brief question.

If this section of the bill is not enacted into law, will it result in higher rates for consumers?

Mr. THOMPSON. It must necessarily do so, Senator Curtis, or if higher rates are not enacted, it will result in a lower rate of return that further impedes capital raising.

The CHAIRMAN. Thank you very much, sir.

Next we will hear from Mr. Richard Rosan on behalf of the American Gas Association, accompanied by Mr. David W. Richmond.

[The prepared statement of Mr. Richard A. Rosan follows:]

STATEMENT OF RICHARD A. ROSAN ON BEHALF OF THE AMERICAN GAS ASSOCIATION

SUMMARY

For almost fifty years, contributions in aid of construction to regulated public utilities have been excluded from income as contributions to capital. Recently, the Internal Revenue Service cast doubt on the continuance of this treatment for traditionally excluded types of contributions in aid of construction, such as contributions to gas utilities by governmental units in connection with gas line relocations required by road relocation and urban renewal projects and contributions by customers relating to line extensions.

The denial of capital contribution treatment to these traditionally excluded types of contributions in aid of construction (which do not include normal customer connection fees) would have a serious, adverse impact on gas utilities, but more important on gas customers in terms of higher rates.

We urge the Committee to continue by statute the long-standing exclusion of contributions in aid of construction to regulated gas utilities. This will involve no revenue loss since such contributions are not now and never have been subject to tax.

STATEMENT

Mr. Chairman, I am appearing before you today on behalf of the American Gas Association (A.G.A.) in support of § 1322 of the Tax Reform Act of 1976 and of an amendment to that section. The A.G.A. is composed of more than 300 member companies, including both gas distribution and gas transmission companies. A.G.A. member companies serve approximately 93 percent of the 43 million homes, businesses, and industrial facilities in the 50 states using natural gas, including some 160,000,000 of our population.

Under present law, contributions to the capital of a corporation, whether or not contributed by a shareholder, are not includible in the gross income of the corporation. This rule has been applied for almost fifty years to regulated public utilities which traditionally have obtained significant amounts of the capital for the construction of facilities through contributions in aid of construction. By a recent adminlstartive ruling, however, the Internal Revenue Service has cast doubt on whether these contributions may be excluded from gross income. The current proposal seeks to continue by legislation the long-standing rule

that contributions to regulated utilities in aid of construction are not includible in gross income.

On December 4, 1975, the Internal Revenue Service, without advance notice and the opportunity for public comment, announced the issuance of Rev. Rul. 75-557 which would include in income a "connection fee" charged the customer by regulated public utilities. We are concerned that the Ruling will be applied broadly to reach other contributions in aid of construction. In the case of gas utilities these include contributions by governmental units relating to the relocation of gas pipelines, both distribution and transmission, required by road relocation projects and urban renewal projects, and contributions by customers relating to line extensions.

The Service has cited as its sole authority for including customer contributions in the income of public utilities, a Supreme Court case which pertains to government subsidies paid to a railroad for certain signals and crossing facilities even though the case deals only with the issue of depreciable basis under the Internal Revenue Code of 1939 (which issue was statutorily resolved in the 1954 Code) and the Court expressly stated that the qualification of subsidies as income "is an issue not raised in this case, and we intimate no opinion with respect to it". U.S. v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401, 37 L.Ed.2d 30, 93 S.Ct. 2169 (1973).

The issuance of the administrative ruling by the Internal Revenue Service portends a change in almost 50 years of consistent administrative practice whereby contributions to public utilities in aid of construction have been excluded from gross income. The ruling challenges this 50-year practice notwithstanding that—

(1) The Service has long acquiesced in many court decisions holding such contributions to be excludable from the income of regulated utilities. (Since the contributions are excluded from income, they are not included in the basis for depreciation deductions.)

(2) The Service considered the problem carefully in the late 1950's, concluded that such contributions should continue to be excluded and published Rev. Rul. 58-555, 1958-2 C.B. 25, to that effect.

(3) In a letter dated May 20, 1960, the Commissioner of Internal Revenue told the A.G.A. that the Service had again "studied the problem thoroughly" and had decided that "no change will be made in its position" and "the matter is therefore concluded".

(4) The Federal Power Commission and many state regulatory commissions require the investments made with such contributions to be excluded from the utility's rate base and therefore no return thereon is earned and included in charges to customers.

The effect of the anticipated administrative change of concern may be demonstrated in an example by assuming that an urban renewal program will require the expenditure of $4,000,000 for relocation of gas distribution lines, or a road relocation program will require the expenditure of $4,000,000 for relocation of gas transmission lines. This capital expenditure of $4,000,000 will be contributed by a governmental agency. If this amount is included in gross income, the gas utility must raise at least an additional $2,000,000 to pay the tax and must charge the customers not only this tax but also a reasonable rate of return.

The additional $2,000,000 cannot be reflected in customer rates without a new rate determination. Thus, if this increase in income taxes becomes a stockholder burden [decreases return on equity] and decreases the overall rate of return, it will remain so until another rate determination. This lag in recovery of cost decreases the utility's earnings and adversely affects its ability to furnish other needed public service projects. When the regulatory commission adds the increased tax to cost of service, it becomes a burden to be passed on to customers. As a rule of thumb, the annual cost of capital in rates is about 20 percent. Thus the $2,000,000 of taxes will cost the ratepayers a minimum of $400,000 additional in their rates.

It is thus clear that any major change in the income tax treatment of any item of deduction or exclusion which will result in increased income taxes for regulated public utilities is an extremely serious matter. As public utilities operate under a regulatory philosophy of earning a return sufficient to maintain financial integrity and to enable the utilities to attract the capital necessary for the proper discharge of their public duties, the lost of tax deductions or exclusions previously used to reduce customer rates immediately becomes the stockholders' burden and reduces the net income of the utilities dollar for dollar

by the amount of the tax increase. This will trigger scores of applications and filings with regulatory agencies for immediate rate relief.

While we have no way of determining the exact amounts, it is obvious the rate increases would total millions of dollars and would add to the inflationary spiral. A recent informal survey of 22 natural gas companies indicates that in a single typical year, receipts of contributions in aid of construction totaled approxmiately $25,000,000. These companies are, of course, only a small segment of the total industry. For the entire natural gas industry, the amounts would probably exceed $125,000,000. Exposure in other regulated public utility industries would likewise be very heavy.

It should be noted that an increase in customer rates tends to hit the low income groups the hardest; on the other hand, if rate adjustments are not quickly forthcoming, the financial structures of the utilities themselves can be adversely affected, thereby further compounding the difficulties in development of gas supply.

Section 1322 of the bill would continue the prior, long-standing rule and provide that contributions in aid of construction would not be included in the gross income of regulated water and sewage disposal companies. We urge the Committee to extend the proposal to those contributions in aid of construction of gas distribution and gas transmission companies which traditionally have been excluded from income by the industry. These principally involve contributions by governmental units for gas line relocations in connection with urban renewal and road relocations and contributions by customers in connection with gas line extensions. They do not include normal customer connection fees and other service fees, which as a general practice have been included in income by the industry.

It has been suggested that this would result in an unacceptable revenue loss. This is not so because the government is not now collecting and never has collected taxes on contributions in aid of construction of regulated public utilities. To forego the collection of new taxes is not a revenue *loss*.

If these contributions become taxable, the utility must charge its customers $2 for every $1 needed for construction—$1 for actual construction and $1 to pay the tax. This further increase in customer bills would be most unfortunate.

Since there is no compelling need for the anticipated administrative change, we urge the Committee to continue by statute the long-standing rule of excluding contributions in aid of construction to regulated gas utilities. This can be done by enlarging § 1322 of the bill to include gas distribution and gas transmission companies. We also support the extension of § 1322 to electric utilities since it is our understanding that the practices of, and potential problems confronting, the electric and gas utilities in this regard are essentially the same.

STATEMENT OF DAVID W. ROSAN ON BEHALF OF THE AMERICAN GAS ASSOCIATION, ACCOMPANIED BY DAVID W. RICHMOND

Mr. Rosan. Good morning, Senators. I appreciate this opportunity to come and support Senator Curtis' amendment to section 1322 of your bill. I endorse heartily everything that has been said by Mr. Thompson before, and by Mr. Healy for the water companies.

I am somewhat shocked that the Treasury Department, in appearing before this group, this committee, has suggested a potential for a staggering loss of revenue. The fact is, as has been pointed out forcibly by the other two speakers, Treasury has never received revenue for capital contributions in the sense that we are talking about, so that there is no loss of revenue.

What this IRS ruling does, and the threat to the gas industry is that it would necessitate increasing rates. It would necessitate raising capital in order to pay the taxes, and the consumer has to pay it, so that we are here today, we are talking for 40 million homeowners, business establishments, and industrial facilities that use natural gas because these people would have to pay the tax.

That is what we are talking about. That is why this amendment, Senator Curtis, is so important.

Senator CURTIS. May I ask you this? This has considerable application throughout a small transaction sometimes. I live in an area that has a great deal of irrigation. We pump that water with natural gas. A line is run out of certain areas and the individual farmer makes a contribution to laying the pipe, so that his land can be reached.

Mr. ROSAN. That is correct.

Senator CURTIS. Under past practice, that is handled in such a way that it just lessens the amount of your capital needs, is that not right?

Mr. ROSAN. It lessens the capital that has to be raised by the particular utility.

Senator CURTIS. Taxwise it is just treated as the installation cost.

Mr. ROSAN. That is right.

Senator CURTIS. If we treat that as the Treasury has proposed, the farmer who makes the contribution will have to pay a higher rate ultimately.

Mr. ROSAN. That is right.

Senator CURTIS That is all, Mr. Chairman.

Mr. ROSAN. I would like to point out, one of the growing places where capital contributions are going to be made are in connection with these expensive facilities in offshore Louisiana and the Gulf of Mexico and probably in the Atlantic and Pacific. There the pipeline is putting in a facility and another pipeline says, when you enlarge that facility just a bit, would you haul some gas for us, and we say to them, yes we will enlarge it, put in more compression or make it a 42-inch line instead of 40 inch, but you have to contribute the additional capital that is needed to pay for that enlargement, and this is going on every day today. If we have to pay a tax on those contributions, it is just going to be staggering. A $10 million contribution has to be a $20 million contribution in order to pay the tax.

We are talking about a very significant effect on the gas industry and on the consumer if this legislation is not enacted. We talked about this road relocation that Mr. Thompson talked about. This is going on all over the country. In the case of my company alone, this year we are going to receive over $4 million of relocation money. We would have to pay a tax of $2 million on that if this IRS ruling is not clarified by this legislation.

For this reason, we are very hopeful that this committee and the Senate and the House will adopt Senator Curtis' amendment in section 1322.

Thank you very much.

The CHAIMAN. Thank you very much.

Next we will hear from Mr. David MacCallan, chairman of the board and chief executive officer of Adams Express Co. and Petroleum Corp. of America, and director of Association of Closed-End Investment Companies.

[The prepared statement of Mr. David MacCallan follows:]

STATEMENT OF THE ASSOCIATION OF CLOSED-END INVESTMENT COMPANIES

SUMMARYY

1. The purpose of Section 1505 is to eliminate the present discriminatory treatment of custodial accounts for employees of tax-exempt organizations and public school systems created by Subparagraph (C) of Section 403(b)(7) of the Internal Revenue Code of 1954, as amended. That discrimination results from

the unjustified limitation of investments by such custodial accounts to stock of "open-end" investment companies (commonly called mutual funds), rather than all regulated investment companies, including "closed-end" investment companies.

2. Section 1505 would permit custodial accounts for employees of tax-exempt organizations and public school systems to invest in all regulated investment companies, including closed-end investment companies. Thus, custodial accounts would be able to enjoy the same investment opportunities as do all other types of tax-qualified pension funds, including other custodial accounts. Section 1505 removes the present discrimination by deleting the provision "and which issues only redeemable stock" from the definition of a "regulated investment company" in Section 403(b)(7)(C) of the Internal Revenue Code of 1954, as amended.

3. The principal difference between mutual funds and closed-end investment companies is that mutual fund shares are redeemable at their prevailing value by the issuer, whereas the shares of closed-end investment companies are traded on established securities markets, such as the New York and American Stock Exchanges, in the same manner as stock of most other publicly held companies. Except for this difference, closed-end investment companies and mutual funds are substantially similar.

4. There is no basis for any suggestion that mutual funds as a group are any more or less suitable investments for such custodial accounts than closed-end investment companies. Both closed-end investment companies and mutual funds offer investors the opportunity of professional management of diversified investment portfolios. Both are engaged in competition for the same investment dollars and provide the same retirement benefits. To interfere with the competitive forces in the allocation of those investment dollars through discriminatory tax treatment in Section 403(b)(7) is inconsistent with the basic precepts of equal tax treatment generally accorded all regulated investment companies throughout the rest of the Internal Revenue Code and the Pension Reform Act.

STATEMENT

Mr. Chairman and Members of the Committee, my name is W. David MacCallan. I am Chairman of the Board and Chief Executive Officer of Adams Express Company and Petroleum Corporation of America which, despite their names, are closed-end investment companies registered with the Securities and Exchange Commission under the Investment Company Act of 1940. I am also a director of the Association of Closed-End Investment Companies. I am accompanied by Carl Frischling, Senior Vice President and General Counsel of American General Capital Management, Inc. of Houston, Texas. American General is investment advisor to American General Bond Fund, Inc., a closed-end investment company which is a member of the Association of Closed-End Investment Companies. The Association appreciates this opportunity to present its views concerning Section 1505 of H.R. 10612, the Tax Reform Act of 1976.

The Association of Closed-End Investment Companies is the national association of the United States closed-end investment company industry. The Association's membership includes 23 companies representing approximately $4 billion in assets and over 400,000 shareholders.

Purpose and effect of section 1505

The purpose of Section 1505 is to eliminate the present discriminatory treatment of custodial accounts for employees of tax-exempt organizations and public school systems created by Subparagraph (C) of Section 403(b)(7) of the Internal Revenue Code of 1954, as amended. That discrimination results from the unjustified limitation of investments by such custodial accounts to stock of "open-end" investment companies (commonly called mutual funds), rather than all regulated investment companies, including "closed-end" investment companies.

A custodial account holds pension funds for the benefit of employees. Section 1505 would permit custodial accounts for employees of tax-exempt organizations and public school systems to invest in all regulated investment companies, including closed-end investment companies. Thus, custodial accounts would be able to enjoy the same investment opportunities as do all other types of tax-qualified pension funds, including other custodial accounts. Section 1505 achieves this result by deleting the provision "and which issues only redeemable stock" from the definition of a "regulated investment company" in Section 403(b)(7)(C) of the Internal Revenue Code of 1954, as amended.

Reasons for section 1505

With only one single exception, the definition of regulated investment companies in the Pension Reform Act broadly includes all types of regulated investment companies, including both mutual funds and closed-end investment companies. The single exception, however, precludes custodial accounts of tax-exempt organizations and public school systems from investing in the stock of closed-end investment companies. Such a prohibition is without justification, and, indeed, no reason for such discrimination is expressed in the legislative history dealing with the Pension Reform Act.

The principal difference between mutual funds and closed-end investment companies is that mutual fund shares are redeemable at their underlying net value by the issuer, whereas the shares of closed-end investment companies are traded on established securities markets, such as the New York and American Stock Exchanges, in the same manner as stock of most other publicly held companies. Except for this difference, closed-end investment companies and mutual funds are substantially similar.

Closed-end investment companies provide investors the same degree and kind of professional management and investment diversification as do mutual funds.

Closed-end investment companies are subject to the same regulatory supervision by the Securities and Exchange Commission as mutual funds.

Tax-qualified closed-end investment companies must satisfy the same requirements and adhere to the same rules as tax-qualified mutual funds.

Closed-end investment companies provide investors with the same retirement benefits as mutual funds by providing stock redemption plans similar to those offered by mutual funds.

Conclusion

Section 403(b)(7) of the Internal Revenue Code of 1954, as amended, is designed to permit the establishment of custodial accounts to provide retirement benefits for employees of certain organizations. The only justification for precluding such accounts from investing in the stock of closed-end investment companies must be based upon investment suitability. We submit that there is no basis for any suggestion that mutual funds as a group are any more or less suitable investments for such custodial accounts than closed-end investment companies. Both closed-end investment companies and mutual funds offer investors the opportunity of professional management of diversified investment portfolios. Both are engaged in competition for the same investment dollars and provide the same retirement benefits. To interfere with the competitive forces in the allocation of those investment dollars through discriminatory tax treatment in Section 403(b)(7) is inconsistent with the basic precepts of equal tax treatment generally accorded all regulated investment companies throughout the rest of the Internal Revenue Code and the Pension Reform Act. Such an inconsistency should not be perpetuated. Consequently, we submit that Section 1505 should be adopted into law.

STATEMENT OF W. DAVID MacCALLAN, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, ADAMS EXPRESS CO. AND PETROLEUM CORP. OF AMERICA, AND DIRECTOR, ASSOCIATION OF CLOSED-END INVESTMENT COMPANIES

Mr. MacCallan. Mr. Chairman, members of the committee, my name is David MacCallan. I am chairman of the board and chief executive officer of the Adams Express Co. and Petroleum Corp. of America. These are two closed-end investment companies registered with the Securities and Exchange Commission under the Investment Company Act of 1940. I am here in my capacity as director of the Association of Closed-End Investment Companies.

I expected to have with me today Mr. Carl Frischling. Unfortunately he was unable to get here. Mr. Frischling is senior vice president and general counsel to American General Capital Management Co. His firm is investment adviser to a bond fund that is organized as a closed-end fund, and an internal member of the association. The as-

sociation is the National Organization of Closed-End Companies, has 23 members, and manages $4 billion for the benefit of 400,000 stockholders. You can see, with an average holding of $10,000 apiece, they are essentially small stockholders.

The association is pleased to be here today to talk about section 1505 of the act. Section 1505 appears to be a relatively small amendment, but it affects quite a broad segment of the population. We were very impressed with the attention given to it by the Joint Committee staff. It is designed to correct an inequity that we think is unwarranted, that derives from the wording in section 403(b)(7)(c) of the Internal Revenue Code of 1954. This section restricts the investment of custodial funds belonging to employees of tax-exempt organizations, and of public school systems, to share in open-end investment companies, commonly called mutual funds.

We believe that the type of management and the degree of regulation which is undergone by the closed-end companies renders their shares a suitable investment. The essential difference between an open-end company and a closed-end company is that closed-end companies do not redeem their shares themselves. Their shares are traded on established securities markets such as the New York Stock Exchange, American Stock Exchange, and otherwise the differences are negligible.

This is an amendment that does not involve any revenue loss to the Treasury at all. The association would be very pleased if the committee would support it, and we thank you for the opportunity to appear here today.

The CHAIRMAN. Thank you very much, sir.

Next we will hear from Mr. Blake T. Newton, president of the American Council of Life Insurance.

[The prepared statement of Mr. Blake T. Newton follows:]

STATEMENT OF THE AMERICAN COUNCIL OF INSURANCE PRESENTED BY BLAKE T. NEWTON, JR.

SUMMARY

I. *Continuous country branches of domestic insurance companies.*—The American Council of Life Insurance supports section 1043 of H.R. 10612 (as reported by the Committee) which would provide tax neutrality in the case of United States life insurance-company operations in contiguous countries.

II. *Pension fund investments in segregated asset accounts of life insurance companies.*—The Council proposed this provision (section 1506 of H.R. 10612, as reported by the Committee) and urges that it be retained in the bill. It would clarify the tax treatment of qualified pension contracts with reserves based on life insurance company segregated asset accounts.

III. *H.R. 10 plans.*—This amendment, which would correct a conflict between two provisions affecting the allowable pension contributions by self-employed individuals, was sponsored by the Council. It is urged that the Committee continue to recommend its inclusion in H.R. 10612.

STATEMENT

My name is Blake T. Newton, Jr., and I am President of the American Council of Life Insurance. I am accompanied by Mr. William B. Harman, Jr., Executive Vice President of the Council.

The Council has a membership of 435 life insurance companies which, in the aggregate, have 90 percent of the life insurance in force in the United States and hold 99 percent of the assets of insured pension plans.

My testimony will cover three of the provisions listed in the Committee's Press Release, dated July 8, 1976. Following my statement, Mr. Harman and I will be happy to attempt to answer any questions the Committee may have.

I. Contiguous country branches of domestic insurance companies (section 1043 of H.R. 10612, as reported by the committee)

Section 1043 of H.R. 10612 amends the Internal Revenue Code to remove the tax impediments to United States life insurance company operations in contiguous countries involving mutual or participating business. This section was initially added to the bill by the Ways and Means Committee and was in the bill as passed by the House. It was discussed by your Committee in its mark-up sessions and the provisions of the House bill, with a minor amendment, were adopted.

For reasons I will discuss, the Council supports the amendments contained in section 1043. My statement here today parallels the views set forth in our statement filed with the Committee on April 16, 1976.

Most of the foreign operations of domestic life insurance companies are in Canada, where U.S. companies have been doing business since around the beginning of the century. At present, Canadian branch life insurance operations are subject to a U.S. income tax that currently exceeds the comparable Canadian taxes payable by non-U.S. life insurance companies. Incorporation of branch operations is generally not a viable alternative for mutual companies.

This U.S. tax treatment of Canadian branch life insurance operations is inequitable because it has the effect of taxing foreign source income of nonresidents. This is because the income that is taxed is essentially generated by Canadian capital (derived from the premiums paid by Canadian policyholders), investments and underwriting experience, and such income inures to the benefit of Canadian policyholders. In these circumstances the burden of the higher U.S. tax inevitably falls on the Canadian policyholders.

Moreover, the added cost to U.S. companies (as compared to foreign insurers) resulting from the U.S. tax places these companies at a competitive disadvantage. This is particularly acute in the pension market. In this regard, the U.S. companies' share of the Canadian market has steadily declined over a period of time.

In evaluating the tax status of Canadian branch life insurance operations, it is important to note that such operations are not analogous to the branch or subsidiary operations of other types of U.S. businesses. This is because, under the concept of the mutual or participating insurance policy and the branch accounting required by the amendment, the income of the Canadian life insurance branch operations is dedicated to the Canadian customers, rather than intended for the eventual use of the company's U.S. operations.

The objective of Section 1043 is to remove the inequities described above by providing tax neutrality in the case of a U.S. life insurance company's branch operations in contiguous countries. In this regard, the Internal Revenue Code would be amended to exclude from the computation of a mutual life insurance company's taxable income all of the items relating to contracts insuring risks in connection with the lives or health of residents of contiguous countries through branches in those countries.

As I indicated, the Council supports this provision.

II. Pension fund investments in segregated asset accounts of life insurance companies (section 1056 of H.R. 10612, as reported by the committee)

This section would amend the Internal Revenue Code to clarify the tax treatment of qualified pension contracts with reserves based on life insurance company segregated asset accounts. The Council, which proposed this amendment, urges that it be retained in the bill. In this regard, I would note that about 120 life insurance companies presently maintain segregated asset accounts which include qualified plan funds.

I would now like to explain the background and nature of the amendment in more detail. My testimony parallels the substance of a letter, dated April 22, 1976, which we wrote to Senator Long for inclusion in the record of the Committee's hearings on H.R. 10612.

Life insurance companies are a major funding medium for qualified pension and profit-sharing plans. They issue contracts funding retirement benefits for individual retirement accounts, small businesses, major corporations and Taft-Hartley plans. These types of plans are also funded through tax-exempt trusts in which plan assets are managed by banks and investment advisors.

One form of life insurance company pension funding is through contracts with reserves based on segregated asset accounts. These contracts are used where the contract-holder wishes to participate directly in the investment experience of a segregated pool of investments.

In 1959 and 1962, Congress enacted provisions in the life insurance company income tax structure designed, in part, to exclude from tax income earned by life insurance companies on segregated asset account reserves held for qualified pension funds—thereby taxing life insurance company segregated asset accounts on a basis similar to that applied to banks and other pension funding agencies.

Under present law, one of the requirements that must be satisfied to qualify for this segregated asset account treatment is that the life insurance company must issue a "contract which provides for the payment of annuities". (Section 801(g)(1)(B)(ii).) This requirement has raised many questions of interpretation and has spawned protracted discussions and disagreements with the IRS over the exact nature of various contract provisions. For example, in several private rulings and in two published rulings, the Internal Revenue Service has taken the position that a contract does not qualify under this provision unless it contains permanent annuity purchase rate guarantees with respect to all separate account funds held under the contract. In fact, a qualified plan may wish to self-insure, either wholly (by not providing for annuity purchases at all) or during the active life of the employee, or to share the insurance risk with the life insurance company. Nevertheless, under the IRS position, the life insurance company may not issue a separate account contract to such a pension plan without inserting a rigid form of annuity purchase rate guarantees.

We believe that the type of annuity features, if any, included in life insurance company contracts should be left to the contracting parties and not dictated by the tax laws. In this regard, the presence or absence of such features would seem clearly irrelevant as a matter of tax policy. As long as the reserves the insurance company hold in the separate account are dedicated to a qualified plan, no tax should be imposed with respect to them.

Section 1506 would reflect this policy by removing the requirement in section 801(g) that a qualified plan contract "must provide for the payment of annuities" in order for the underlying separate account to qualify for taxation as a segregated asset account. Moreover, it would make clear that such a contract need not be held in trust.

The revenue effect from this amendment would be negligible. This is because the tax disadvantages to a separate account and its customers of failing to qualify for taxation under section 801(g) would be so great as to preclude their use of any significant extent.

III. H.R. 10 plans (page 8 of the press release announcing provisions approved by the committee on June 11, 1976)

This amendment would correct a conflict between two provisions in the Internal Revenue Code that has developed because of an IRS interpretation. The problem relates to the contributions that may be made by a self-employed individual to his firm's pension or profit-sharing plan. The amendment was proposed by the Council on behalf of the more than 240 of our members that underwrite H.R. 10 plans. It would allow self-employed individuals who contribute to over 80,000 H.R. 10 plans to maintain these plans without fear that they will be disqualified. This would be done without any revenue loss. We urge that the Committee continue to recommend its inclusion in H.R. 10612.

I would now like to explain the problem and nature of the amendment in more detail.

Since 1962, self-employed persons have been allowed to use level premium insurance contracts to fund their H.R. 10 plans even where, because of fluctuating income, the contract premiums may be greater in certain years than the allowable contributions under the H.R. 10 limitations. Under these provisions, an owner-employee may contribute the contract premiums to his H.R. 10 plan, where the premiums are based on his average earnings for the previous 3-year period. The owner employee's deductions are based on his current income, however, and not his 3-year average income. Thus, the 3-year averaging rule does not allow any increased tax deductions. It merely allows self-employed people to keep in force their insurance contracts in years when their incomes fluctuate. This provision was carried over in section 401(e) of the Code as amended by ERISA.

Recently proposed IRS regulations would provide that the new general limitations on contributions, contained in section 415 of the Internal Revenue Code (as added by ERISA), are to override this three-year averaging provision. (Proposed regulations 1.401(e)-4(a).) Under this interpretation, the payment of the level premium would disqualify the plan if, in any year, it exceeded 25 percent of the self-employed individual's earnings. If allowed to stand, this rule would severely limit the usefulness of the averaging provision—and, thus, level pre-

mium insurance contracts—without affecting, in any manner, the amount actually deductible. We do not believe this result was intended by the enactment of ERISA.

To remove this conflict and, in our opinion, clarify the original intent of Congress, the amendment would revise section 415 to provide that a level premium which meets the conditions of the 3-year averaging provision in section 401(e) is not to be considered to violate the 25 percent limitation under section 415. This provision would not be available in any year in which the owner-employee is an active participant in any defined benefit plan established in the same trade or business or by any other trade or business that he controls. It also would not be available if any current additions were made to his account under any defined contribution plan under the same, or any controlled, trade or business.

There will be no revenue gain or loss from this provision since the amount of tax deductible contributions, and tax-deferred earnings, will not be affected.

I appreciate this opportunity to express the Council's views on these important amendments and will be happy, along with Mr. Harman, to attempt to answer any questions you may have.

STATEMENT OF BLAKE T. NEWTON, JR., PRESIDENT, AMERICAN COUNCIL OF LIFE INSURANCE, ACCOMPANIED BY WILLIAM B. HARMAN, JR., EXECUTIVE VICE PRESIDENT, AMERICAN COUNCIL OF LIFE INSURANCE

Mr. NEWTON. Mr. Chairman, gentleman of the committee, my name is Blake T. Newton, Jr., and I am president of the American Council of Life Insurance. I am accompanied by Mr. William B. Harman, Jr., executive vice president of the council.

Our council has a membership of 435 life insurance companies which in the aggregate have 90 percent of the life insurance in force in the United States and hold 99 percent of the assets of insured pension plans.

My testimony will cover three of the provisions listed in the committee's press release, dated July 8, 1976. Following my statement, Mr. Harman and I will be happy to attempt to answer any questions the Committee may have.

Section 1043 of H.R. 10612 amends the Internal Revenue Code to remove the tax impediments to U.S. life insurance company operations in contiguous countries involving mutual or participating business. This section was initially added to the bill by the Ways and Means Committee and was in the bill as passed by the House. It was discussed by your committee in its markup sessions and the provisions of the House bill, with a minor amendment, were adopted.

My prepared statement discusses the background and reasons for the amendments in some detail. It parallels the views set forth in our statement filed with the committee on April 16, 1976.

The second provision, ~~section 1506~~ of H.R. 10612, would clarify the tax treatment of qualified pension contracts with reserves based on life insurance company segregated asset accounts. Essentially it would remove the necessity for including certain annuity features in pension contracts utilizing separate accounts where the contract holder does not desire or intend to use them.

The council supports this amendment and urges that it be retained in the bill. One hundred and twenty life insurance companies presently maintain segregated asset accounts that include qualified plan funds.

This amendment involves no revenue loss. The Treasury Department has stated that it has no objection to the amendment. We understand that the staff of the Joint Committee also has no objection.

Moreover, to our knowledge, no objection has been raised by any other person.

Again, my prepared statement discusses the background details of the amendment. It parallels the substance of the letter dated April 26, 1976. And we hope that the chairman will include it in the committee hearings on H.R. 16102.

The third provision approved by the committee on June 11 would correct a conflict between two provisions of the Internal Revenue Code relating to contributions that may be made by a self-employed individual to his firm's pension or profit-sharing plan. If not corrected, the IRS interpretation would jeopardize the tax qualification of more than 80,000 H.R. 10 plans utilizing level premium insurance contracts.

Although there is no issue of increased tax deduction on deferrals in bonds, the amendment was proposed by the council on behalf of the more than 240 of our members who underwrite H.R. 10 plans. We urge that the committee continue to recommend its inclusion in H.R. 10612.

As I indicated, this amendment has no revenue implications. It has not been objected to by the Treasury Department, the staff of the Joint Committee, or to our knowledge, by any other persons.

In summary, therefore, the three provisions I discussed are noncontroversial as far as we know. The beneficiaries represent a broad spectrum of possible stockholders, and we urge its adoption.

The CHAIRMAN. Thank you.

Next we will call Mr. Carroll J. Savage on behalf of Eastman Kodak Co. and Xerox Corp., accompanied by Mr. Herman E. Biegel, Profit Sharing Council of America, and Mr. Edwin S. Cohen, Irving Trust Co.

[The prepared statement of Mr. Carroll J. Savage follows:]

STATEMENT OF CARROLL J. SAVAGE, HERMAN C. BIEGEL AND EDWIN S. COHEN

SUMMARY

1. Section 1507 would extend for two years the time for Congress to study so-called "salary reduction," "cash or deferred profit sharing" and "cafeteria" plans. The study period, provided for in Section 2006 of ERISA, will otherwise expire on December 31, 1976.

2. This issue relates to the tax treatment of the employees participating in the plans of 100 or more companies, many of which have been in effect for over 15 years. It does not involve any tax consequences for the employers.

3. The staff of the Joint Committee on Internal Revenue Taxation is working on a permanent solution to this problem, but it appears that there will be insufficient time remaining this year for completion of this study and enactment of a permanent solution.

4. Unless the time for this study is extended, the tax treatment of over 100,000 employees will be thrown into question beginning January 1, 1977. Section 1507 is merely a technical amendment continuing the status quo pending formulation and enactment of a permanent solution.

STATEMENT

Section 1507 of H.R. 10612 would extend the existing tax treatment of so-called "salary reduction", "cash or deferred profit sharing" and "cafeteria" plans, presently set forth in Section 2006 of the Employee Retirement Income Security Act of 1974 ("ERISA"), from December 31, 1976, until December 31, 1978, pending further Congressional study of these plans.

Section 2006 of ERISA was added by the House-Senate Conference Committee in 1974 to provide time for Congress to study the question of the appropriate tax treatment of employees covered by these types of plans, which involves the issue of whether and under what circumstances employer contributions applied to a qualified profit sharing plan or to certain nontaxable fringe benefits should

nevertheless be taxed currently to the participant because of a prior right which the participant had to receive the contribution in cash or another taxable form, even though he had irrevocably elected not to exercise that right.

This issue relates solely to the tax consequences for employee participants and does not have any tax implications for employers. Well over 100,000 employees of more than 100 companies, many of which have had these plans in effect for fifteen years or more, are affected. It is a tax matter which is not involved in any way with those portions of ERISA falling under the jurisdiction of other committees.

Under existing practice, employees are not currently taxed on employer contributions to qualified profit sharing plans or cafeteria plans. However, in 1972, the Treasury proposed regulations which would have made employer contributions to salary reduction plans taxable, and discussion of that proposal called into the question the status of contributions to cash or deferred profit sharing and cafeteria plans.

The approach taken by the Conference Committee in Section 2006 of ERISA was to provide that employees covered by plans in effect on June 27, 1974, are to continue to be taxed under prior rules through December 31, 1976, but such treatment is not available to participants in new plans established during the period. ERISA provides that the regulations proposed in 1972 are to be disregarded and no further regulations are to be issued prior to January 1, 1977, the date by which Congres expected it would have adequately reviewed the matter and enacted legislation.

In the absence of the enactment of Section 1507, the tax treatment of the large number of employee participants in existing plans would be thrown into question beginning January 1, 1977. Moreover, although this issue does not have any tax implications for employers, the employers would be faced with most difficult decisions in designing plan changes by December 31, 1976 without knowing what permanent rules the Congress wishes to prescribe when it completes its study.

The undersigned attorneys, representing numerous employers affected, have had extensive discussions for some months with the staff of the Joint Committee on Interal Revenue Taxation concerning a permanent legislative solution. While we believe much progress has been made, it became apparent by May 1976 that with the heavy load of tax measures pending both in the House and Senate it was unlikely that the Congressional staff study could be completed in the present Congress in time to meet the present December 31, 1976 expiration date.

Accordingly, it seemed prudent for the Congress to extend the present expiration date until December 31, 1978 to permit the completion of the study and a permanent solution to be reached in the next Congress. The Finance Committee approved this in adopting Section 1507 on May 27, 1976. Senate Rep. No. 94-938, dated June 10, 1976, states (p. 453) this Committee's conclusion that "it is not possible to study adequately the questions involved in order to enact permanent legislation [on this subject] prior to the January 1, 1977 end of the temporary freeze of the status quo provided for in section 2006 of ERISA." The Treasury Department has publicly stated that it has no objection to this extension.

For these reasons, we urge the Finance Committee to retain Section 1507 in H.R. 10612.

STATEMENT OF CARROLL J. SAVAGE ON BEHALF OF EASTMAN KODAK CO. AND XEROX CORP., ACCOMPANIED BY HERMAN E. BIEGEL, PROFIT SHARING COUNCIL OF AMERICA, AND EDWIN S. COHEN, IRVING TRUST CO.

Mr. SAVAGE. I am Carroll Savage, representing Eastman Kodak Co. and Xerox Corp. In accordance with the chairman's request my statement will be a consolidation of the statements of several witnesses who requested to testify on section 1507 of your bill.

On my left is Mr. Herman E. Biegel who is counsel to the Profit Sharing Council of America. On my right is Mr. Edwin S. Cohen of the law firm of Covington & Burling, representing Irving Trust Co.

Mr. Chairman, section 2006 of the Employee Retirement Security

Act of 1974 provided for a congressional study of the tax treatment of certain kinds of employee benefit plans involving employee elections. These kinds of plans are variously referred to as salary reduction plans, cash deferred or profit-sharing plans, cafeteria plans. Pending completion of a congressional study called for by section 2006, the statute provided for a freeze of the legal status quo plans which were in existence at that time and continue to operate under the long-established IRS rules under which they previously operated. No plans of this type can be established during this freeze period.

ERISA provided that this freezing of the status quo would expire at the end of 1976.

Prior to that a congressional study was to be completed and a permanent solution was to be enacted. The staff of the Joint Committee on Internal Revenue Taxation is working on a permanent solution to this problem for presentation to this committee. Because of the large number of tax issues that are before the staff and the committee at this time, it has become apparent that it will not be possible to derive and enact a permanent solution before the freeze expires at the end of this year.

Section 1507 of your bill is merely a technical amendment that would make a substitution of the dates, and section 2006 of ERISA and operate to extend the freeze period and congressional study period for another 2 years until the end of 1978.

I want to stress that the issues here do not involve any tax consequences for the corporate employers. These issues relate entirely to the tax treatment of the individual plan participants.

We believe there are well over 100,000 such participants, and well over 100 plans, some of which have been in effect under published IRS guidelines for over 15 years.

These plans involve advance employee elections, highly complex, technical computer programing, SEC registration in many cases, and other complexities. A permanent solution must be well known in advance of its effective date to provide the necessary leadtime to permit an orderly changeover to the rules that may be imposed.

Therefore, unless enactment of a permanent solution is likely by early next year, a 2-year extension until the end of 1978, we believe, is the minimum time that would suffice for an orderly transition.

For these reasons, we respectfully request that section 1507 be retained in your bill.

The CHAIRMAN. Thank you very much, sir.

Next we will hear Mr. John P. Fishwick, chief executive officer, Norfolk & Western Railroad, Mr. James H. Evans, vice chairman, Union Pacific Railroad, and Mr. P. H. Mathews, vice president, Association of American Railroads.

[The prepared statement of Mr. John P. Fishwick follows:]

STATEMENT OF THE ASSOCIATION OF AMERICAN RAILROADS, JOHN P. FISHWICK, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NORFOLK & WESTERN RAILWAY CO., AND JAMES H. EVANS, VICE CHAIRMAN, UNION PACIFIC RAILROAD

On April 6, representatives of the railroad industry appeared before this committee to discuss the capital requirements of railroads and suggest ways in which this committee through tax legislation could contribute to the goal of developing an efficient transportation system. At that time we outlined a number of proposals which would better enable railroads to continue as a strong free enterprise segment of the American economy in preference to becoming a burden

on the country as a nationalized transportation industry. The proposals which the committee adopted were discussed at that time. Previously each proposal had been discussed with the staffs of the Joint Committee and the Finance Committee and had received the favorable endorsement of both offices. The revenue impact of the total package is minimal but is critically important to our industry.

The provisions constitute, we believe, sound and progressive ways of encouraging capital development and assisting our industry in improving its chronic cash flow shortages. Without being unnecessarily repetitive of what was covered in the earlier public hearing, we would like to summarize a few comments on the provisions included in H.R. 10612 as reported to the Senate.

1. 10-YEAR AMORTIZATION OF RAILROAD TRACK ADDITIONS (BILL SECTION 1702)

The railroad industry faces problems in building additional lines to reach undeveloped mineral deposits and upgrading existing track structure to accommodate heavier loads at reasonable speeds. The investment must be made from internally generated funds because the form of existing railroad mortgages generally precludes new financing for track. Under the retirement-replacement-betterment method of accounting for depreciation used for track, new investments are not now subject to tax recovery until the line is abandoned years in the future.

The 10-year amortization provision of the bill will permit a ratable recovery of new track investments against taxable income. It will provide the industry with internally generated cash, the only realistic private source of funds for adding to and upgrading track.

2. 50-YEAR AMORTIZATION OF RAILROAD GRADING AND TUNNEL BORES (BILL SECTION 1702)

Railroads have invested substantial sums in grading and tunnels, the foundation on which track is constructed—but have been unable to recover this investment by way of depreciation because of uncertainty about useful life. In the Tax Reform Act of 1969, the Senate passed legislation that would have permitted railroads the option of amortizing all railroad grading and tunnels over 50 years. However, this provision was amended in conference and limited to costs incurred after 1968. Thus, present law perpetuates the historical inequity of railroads' inability to recover their investment in these assets acquired before 1969. The railroad industry is unique in having such substantial frozen costs in business assets which cannot be recovered through tax deductions. Ironically, the counterparts of these assets—highways, airports, and waterways—are supplied to the railroads' competitors at public expense.

The bill permits 50-year amortization of pre-1969 investments and we believe that is a fair and long-needed provision.

3. PROPOSALS ON FULLER UTILIZATION OF THE INVESTMENT TAX CREDIT FOR RAILROAD PROPERTY (BILL SECTION 1701)

A. Utilization of carryover credits before currently generated credits

The railroad industry is one of the most capital intensive industries in the United States. As a result, all roads, even those which are marginal or loss roads, generate large investment tax credit. The present limitation of 50 percent of tax liability on use of the investment credit has rendered a substantial portion of the credit generated unusable to the railroads, particularly the marginal railroads. As a result the industry has some $328 million of investment credit carryover.

Under the bill taxpayers would be permitted to utilize the investment credit carryovers generated in the earliest carryover year ahead of the investment credit generated in the current year. This would salvage for the railroad industry investment credit that would otherwise expire and will keep in the industry the cash benefit of these credits which can be used for needed road and track improvement projects.

B. Increase in percentage limitation

As indicated earlier, the use of the investment tax credit in any taxable year is presently limited to 50 percent of the taxpayer's tax liability. In the Tax Reduction Act of 1975 the limitation for regulated public utilities was liberalized by an increase to 100 percent of tax liability for two years, reduced by 10 percent

each year until the 50 percent of tax liability level is again reached. The bill would make comparable treatment available to railroads. This proposal will enable our capital intensive industry to realize more rapid cash generation to assist in capital expenditures in badly needed projects.

4. 12 PERCENT INVESTMENT CREDIT FOR CERTAIN RAILROAD PROPERTY (BILL SECTION 2003)

The House in its version of the energy tax bill provided for 5-year amortization of new investment in rolling stock, railroad classification yards, communications and signal equipment and facilities for loading and unloading trailers and containers.

The Finance Committee concluded that an increase in investment credit, from 10 percent to 12 percent, would be a simpler and more desirable alternative to 5-year amortization.

The committee decision properly recognizes what an important tool investment credit can be in the railroads' effort to raise capital to acquire these badly needed assets and achieve productivity increases. It has immediate value not only to the profitable railroads but more importantly, through the use of leasing, to the marginal and loss roads.

The sound tax policy provisions of H.R. 10612 which we have outlined would enable our industry to meet its responsibilities as a viable free enterprise part of the American economy. Railroads are the most energy efficient form of transportation and as such can make a vital contribution to the nation's economic strength. The capital formation which will be made possible by railroad related tax provisions which we have mentioned will help do that. We hope the provisions as proposed by this committee in H.R. 10612 will be enacted. We would be happy to answer any questions members of the committee might have.

STATEMENT OF JOHN P. FISHWICK, CHIEF EXECUTIVE OFFICER, NORFOLK & WESTERN RAILROAD, AND JAMES H. EVANS, VICE CHAIRMAN, UNION PACIFIC RAILROAD, ACCOMPANIED BY P. H. MATHEWS, VICE PRESIDENT, ASSOCIATION OF AMERICAN RAILROADS

Mr. FISHWICK. Thank you, Mr. Chairman.

I want to summarize the statement that has been submitted on behalf of the American Association of Railroads, a proposal which the association, on behalf of the entire industry, made to this committee, would be helpful to the railroads in continuing as a strong, free enterprise, a segment of the American economy instead of becoming a burden on the country as a nationalized transportation industry.

Each proposal was discussed with committee staff and received favorable endorsement. The provisions which the committee subsequently adopted are, we believe, sound and progressive ways of encouraging capital development and helping industry to improve its chronic cash flow problems.

The provisions permitting 10-year amortization of track additions would encourage additional investment for lines to reach undeveloped mineral deposits and for additional track. Investments must be made from internally generated funds because existing railroad mortgages generally include new financing for track.

Also, the retirement-replacement method of accounting for depreciation used for track does not permit tax recovery on new investments until a line is abandoned, many years in the future.

Ten-year amortization of new track investment will help provide for internally generated cash, or adding upgraded track.

Railroads have invested substantial sums in grading, but have been unable to recover this investment by way of depreciation because of the

uncertainty about the useful life. In 1969, the Senate passed legislation that would have permitted railroads the option of amortizing all railroad grading and tunnels over 50 years. However, this provision was amended in conference and limited to costs incurred after 1968. Thus, railroads are still unable to recover their pre-1969 investment. Ironically, the counterparts of these assets, highways, airports, and waterways are supplied to the railroads' competitors at public expense.

The bill permits 50-year amortization of pre-1969 investments. We believe this is a fair and long-needed provision.

All railroads being capital intensive, generate large investment tax credits. The present 50-percent limitation on the use of the credit has made much of the credit generated unuseable, particularly the marginal railroads, resulting in large investment credit carryovers.

The bill would permit use of carryovers over internally generated credit. This would salvage investment credit that otherwise would expire and keep for the railroad industry the cash benefits of these credits which can be used for other purposes.

In 1975 the 50-percent tax limitation on use of the credit was liberalized for regulated public utilities by an increase to 100 percent on the tax for 2 years, reduced by 10 percent each subsequent year until the 50 percent of tax liability level is again reached. The bill would provide comparable treatment for the railroads, and help general cash for badly needed projects.

The House provided for 5-year amortization for new investment in rolling stock, railroad classification yards, communications and signal equipment, and unloading facilities.

This committee concluded that an increase in investment tax credit from 10 percent to 12 percent would be a simplier, more desirable alternative to 5-year amortization.

We agree with the committee's decision that recognizes what an important tool investment credit can be in the railroads' efforts to raise capital to acquire these badly needed assets. It has immediate value not only to the profitable railroads, but more importantly, through the use of leasing, to the marginal and loss roads.

There is one provision in the bill as reported by the committee that was not proposed by the Association of American Railroads on behalf of the entire industry. That deals with railroad ties. I understand that the companies are interested in that, and will testify with respect to that.

The CHAIRMAN. Thank you very much, gentlemen.

Next we will call Mr. W. L. Thornton, president, Florida East Coast Railway Co., accompanied by Mr. T. S. Carter, president, Kansas City Southern Lines.

[The prepared statements of Mr. Thornton and Mr. Carter follow:]

STATEMENT OF W. L. THORNTON, PRESIDENT, FLORIDA EAST COAST RAILWAY CO.

SUMMARY

1. Railroads in general, and the Florida East Coast in particular, have found it necessary to seek an acceptable alternative to the replacement of wooden crossties with wood. Approximately 50 percent of the almost 900 million crossties now in service on this nation's railroads will require replacement in the next 15 to 20 years. Federal legislation giving financial assistance to railroads to assist in their urgently needed rebuilding will probably result in unprecedented

demand for crosstie renewals in the immediate future, and there will be an insufficient supply of quality wood to meet this demand.

2. Thus an acceptable alternative must be found. However, the existing Internal Revenue Service position on tax accounting for such non-wooden alternatives severely frustrates, and could, if allowed to stand, bring an end to, efforts to develop substitutes for wooden ties.

3. While both the House and the Senate have recognized the need for change and have acted to provide some relief, very serious consideration should be given to the suggestion that the Senate version be amended to allow the same treatment as that afforded in the House provision.

4. The provision in the House bill as to the effective date be changed to make it applicable to all years open for tax purposes, in order to avoid discriminatory treatment of those railroads which installed the non-wooden ties with the understanding that they would be treated as wooden ties for tax purposes. It was not until 1968, several years after alternative ties were installed in significant numbers, that IRS published a ruling covering accounting for concrete ties which is genuinely believed to be contrary to tax accounting for every other component of railroad track structures. The IRS applied such ruling on a retroactive basis. If any action by the Congress is prospective only, it might be possible to imply that the previous position of the IRS, which we are contesting, was correct.

5. The proposed provision does not provide special favorable treatment for non-wooden ties; rather, it would only give them the same treatment given wooden ties. The ICC and governmental agencies other than the IRS treat concrete ties and wooden ties in the same manner for accounting and other purposes.

STATEMENT

Mr. Chairman, my name is W. L. Thornton, and I am President of the Florida East Coast Railway Company. I am appearing here today in support of a provision which will give equitable tax treatment to expenditures for non-wooden crossties. Non-wooden crossties have been tried sporadically for many years in this country. However, it is not until the early 1960's that any serious effort was made to substitute non-wooden for wooden ties. This project was undertaken primarily by our railroad, the Kansas City Southern and the Seaboard Coast Line. Other railroads have continued to experiment with alternatives to the wooden tie and are still conducting these experiments today; but as of December 31, 1974, the latest full-year figures available, out of 882,800,000 crossties in service in this country, only 1,048,000 were other than wooden, less than two-tenths of one percent of all ties.

Our decision to use a non-wooden tie was mandated by the shortage of good quality wooden ties and the consequent increase in the cost of wooden ties as well as by a desire to use raw materials available in our immediate area. In some instances, wooden ties became so scarce that railroads were trying to import them from other countries. We therefore, decided to try to replace our existing wooden ties with an acceptable alternative, concrete ties. Since we undertook this program in 1965, we have replaced through 1975 approximately 450,000 wooden ties, out of a total of 2,800,000, with concrete ties. While we expect that the concrete tie will one day be at least as durable as the creosote-impregnated hardwood tie, the results to date do not establish this. To demonstrate this fact, in the first 34 miles of concrete crossties installed by Florida East Coast during 1965 and 1966, some 22 percent had failed in service by 1971 and were replaced with new concrete ties. This would indicate a life expectancy for the entire 34 miles of far less than the life expectancy of between 29 and 42 years for creosoted wooden ties as reported by a recent Federal Railroad Administration study.

With this brief introduction, I would like to describe our tax problem with respect to concrete ties. Railroads are not allowed the typical depreciation method of deducting a stated percentage of capitalized cost each year over the life of the asset for any of the components of the track structure. Rather, these assets are capitalized without deduction until and unless they are replaced or completely abandoned. For example, if a stretch of track were to run from Washington to Richmond and was built 50 years ago, the entire cost of the ties, rail, spikes, ballast, etc., would be capitalized during the year of construction. If the stretch of track were taken out of service next year, 1977, the entire capitalized cost, less applicable salvage, would be deducted from income for that year. During the intervening 50 or so years, no deductions for depreciation on that capitalized cost would be allowable. However, during that 50 year period,

the various components would naturally suffer wear and have to be replaced. In the year of any such replacements, the entire cost of the replacement asset and the cost of labor associated with the replacement would be deductible from income as a proper operating expense item. If, however, the replacement asset is a betterment of the original asset, the portion of the cost attributable to the "betterment" is capitalized. A definition of "betterment" is something that either extends the life; increases the capacity; or increases the productivity of a particular asset.

For instance, if 80 pound rail is replaced with 100 pound rail, obviously a betterment has been effected due to increased capacity; and the difference in the current cost of 80 pound rail and that of the 100 pound rail is added to the capital account with the remainder expensed in the year of replacement. The Internal Revenue Service recognizes and applies this system as a valid method of accounting for depreciation of railroad track structure capital accounts. The difficulty, and the reason I am here today, is the manner in which the IRS has applied this system to concrete crossties replacing wooden crossties in existing tracks. In 1968, approximately three years after we began our replacement program, IRS issued a ruling which held that the cost of a concrete replacement tie and the cost of labor associated with replacement must be entirely capitalized. The ruling further held that he capitalized cost of a wooden tie and its installation cost must be written out of the capital account and expensed.

The effect of this ruling in the case of track many years old would be to allow an expense deduction of approximately $3 for the old tie and increase capitalization approximately $25 for each non-wood replacement tie, such amount remaining in the capital account until replaced or for possibly 25 years. Whereas if the non-wood replacement tie had been afforded the same treatment as a wooden tie (or any other element of the track structure, i.e., rail, ballast, fastenings, etc.) the full $25 cost would be charged immediately as an operating expense item. Clearly such tax treatment will eliminate consideration of alternate materials for crossties. I believe that there is unanimous agreement that the ruling is incorrect and not in accordance with the basic tenets of accounting for depreciation of railroad track structure capital accounts.

The question is how to treat concrete ties replacing wooden ties for tax purposes. It is our position that concrete ties replacing wooden ties should be treated exactly the same as wooden ties. This is the approach taken by the House of Representatives in H.R. 10612. Your Committee has, however, reported a provision which requires "betterment" treatment requiring the difference in current cost between wooden ties and concrete ties to be capitalized if in fact there is a betterment and the remainder to be deducted in the year of replacement. Neither in our experience nor in that of the industry, however, has the concrete crosstie met the standards of being a betterment. Since concrete ties do not meet any of the criteria for a "betterment," that is, the life is not extended nor is there increased capacity or productivity, we support the House provision and submit it should be made applicable to all open years for several reasons:

(1) It is consistent with interpretation by the Interstate Commerce Commission with respect to accounting for concrete ties which holds that concrete ties are not a betterment, and that all material and labor costs associated with the replacement of wooden ties with concrete ties shall be included in operating expenses. (A copy of this interpretation is attached.) To our knowledge, no Federal agency has taken a position that concrete ties constitute a betterment.

(2) It will encourage further development of an acceptable alternative for wooden ties in the future. As we all know, there is a massive amount of repair needed on our nation's railroads. Federal assistance and other legislative programs will soon result in an unprecedented and sudden demand for crossties, literally tens of millions. Wooden crossties cannot possibly meet this demand.

(3) Discriminatory tax treatment will discourage development of non-wooden ties.

(4) It will be consistent with the actual facts concerning concrete crossties wherein no betterment exists and will provide uniform tax treatment, for the entire period that concrete crossties have been installed, consistent with all other elements in the track structure.

(5) The revenue impact for future years will be the same under either the House provision or the Senate Finance Committee bill. The amount of the deduction is the same in both instances and only the timing of a portion of the deduction is treated differently.

Finally, let me discuss for a moment the modification to the House version which we desperately need. We have treated concrete ties as an expense item, based upon what we believe to be a valid assumption that we would be able to account for our costs in all respects as we did for all other elements of the track structure. The position taken by the IRS in 1968 was a great shock and we believe totally without foundation in fact or law. We, therefore, are contesting the ruling. Further, I would plead that the provision in this bill as to its effective date be changed. At this juncture, it is our firm opinion and belief that the Internal Revenue Service position requiring capitalization is totally wrong. We have long advocated this position even before 1968, when IRS first issued its ruling and stated its opinion and position that capitalization was required. The danger of inserting the currently prescribed effective date is a possible interpretation that the position of the Internal Revenue Service in prior years was a correct one. This, in truth, would be a serious potentially adverse step and, we believe, one unintended by your committee. We plead with you to clearly state that this bill is effective for all taxable years open for tax purposes. Accordingly, we suggest that the following change be made in Section 1701(b) of your Finance Committee bill:

"(g) Certain Railroad Ties—in the case of a domestic common carrier by rail (including a railroad switching or terminal company) which uses the retirement-replacement method of accounting for depreciation of its railroad track, expenditures for acquiring and installing replacement ties which are not made of wood (and fastenings related to such ties) shall be accorded the same tax accounting treatment as expenditures for replacement ties of wood (and fastenings related to such ties). This subsection shall apply to all taxable years for which an amended federal income tax return or claim for refund may be filed or for which a suit for refund may be or has been filed in which a final order has not been entered."

The revenue impact of this change is minimal since the use of concrete ties has, as outlined, been extremely minimal during any years which are open. What we request with respect to concrete or other non-wooden ties is not special treatment but exactly the same treatment now given wooden ties. We do not want an advantage, rather we do not want ot be disadvantaged.

Thank you for giving me this opportunity to appear before you. If you have any questions, I will be happy to answer them or submit additional information.

Attachment

Case 87

What is the proper accounting when wooden ties are replaced with concrete ties?

All costs associated with replacement of wooden ties with concrete ties shall be included in operating expense.

Case 88

What is the proper accounting for side track deposits under a refund agreement?

The cost of constructing the side track shall be charged to account 731, Road and Equipment Property, and the related deposit credited to account 782, Other Liabilities. Deposit amounts refunded shall be charged to account 782. Upon termination of the agreement period, any remaining balance in account 782 shall be cleared to account 731. If the side track is retired, the balance in account 731 shall be cleared and accounted for as if it represented the retirement of the property.

Case 89

Roads A, B and C file a joint tariff with the Commission with respect to the transportation of a certain commodity. Under a related pooling agreement, (1) Road A will use its equipment to perform the entire line-haul movement of the commodity, (2) Roads B and C will maintain, on a standby basis during the period of the agreement, sufficient equipment and track facilities to enable alternate movement of the commodity should Road A be unable or unwilling for any reason, to handle this traffic, and (3) Road A will allocate to the alternate routes of Roads B and C, and pay to these roads, a proportionate amount of the revenues it receives for performing the line-haul services based on an arbitrary determination as agreed between the parties. What is the proper accounting to be performed by the respective roads?

The payments by Road A to Roads B and C do not represent normal divisions of revenues since Roads B and C do not perform any portion of the line-haul movements. The payments are considered to represent a standby charge to compensate these roads for maintaining alternate track facilities and equipment which will be available to meet the shipper's needs, even though they are not used. Road A shall credit the entire revenues from the line-haul movement to account 101, Freight, and charge the amounts payable to Roads B and C to account 411, Other Expenses. Roads B and C shall credit their respective amounts receivable to account 143, Miscellaneous.

INTERSTATE COMMERCE COMMISSION,
BUREAU OF ACCOUNTS,
Washington, D.C. April 30, 1976.

ACCOUNTING SERIES CIRCULAR NO. 130, REVISED

To accounting officers of all railroad companies:

INTERPRETATIONS OF THE UNIFORM SYSTEM OF ACCOUNTS FOR RAILROAD COMPANIES

Enclosed is a copy of Accounting Series Circular No. 130, Revised, which reflects substantive changes to the initial issue of September 1, 1962. A summary of the revisions by case numbers is also enclosed.

The interpretations, which are effective immediately, express the views of the Bureau of Accounts concerning application of the Uniform System of Accounts for Railroad Companies.

Any questions or clarification of the above should be directed to the Bureau of Accounts in writing or by calling on 202-275-7448.

JOHN A. GRADY, *Director.*

STATEMENT OF THOMAS S. CARTER, PRESIDENT, THE KANSAS CITY SOUTHERN RAILWAY CO.

SUMMARY OF STATEMENT

Section 1701(b)—Railroad ties

1. The concrete tie is presently in use by seven different United States railroads; it is still in a largely experimental stage.
2. Present engineering estimates contained in the study of Thomas K. Dyer, Inc. for the Federal Railroad Administration indicate that the useful life of the concrete tie will be substantially the same as that of the treated-timber tie.
3. The use of steel ties on railroads in the United States is not feasible because it would preclude the effective operation of signal and centralized traffic control systems.
4. The engineering development of plastic ties is virtually nonexistent.
5. Usage of continuing fluctuations in market price between concrete ties and treated-timber ties does not constitute a sound legislative criteria for changing established retirement-replacement accounting rules.

Section 1702—Railroad grading

1. Pre-1969 railroad grading has a determinable useful life; the 50-year amortization for post-1969 grading costs should be extended to pre-1969 grading.

STATEMENT

My name is Thomas S. Carter. I am president of Kansas City Southern Railway Company and its subsidiary, Louisiana & Arkansas Railway Company, with principal offices in Kansas City, Missouri. I am here for the purpose of testifying with respect to the House Bill 10612 (Tax Reform Bill of 1976), as reported to the Senate on June 10, 1976, and specifically concerning Section 1701(b) relating to railroad ties and Section 1702 relating to railroad grading. I am a graduate civil engineer, and am licensed to practice engineering in six states. I have worked in the railway industry for over 30 years and have had a great deal of experience in connection with the operating characteristics of railroad ties and grading.

Sec. 1701(b)—Railroad ties

Kansas City Southern Railway Company serves six midwestern and southern states, namely, Missouri, Kansas, Arkansas, Oklahoma, Texas, and Louisiana. It

operates approximately 1,670 miles of main line track, principally from Kanas City to the Gulf of Mexico down through Louisiana and southern Texas.

Kansas City Southern Railway Company has approximately 7.1 million ties in service on its lines. Because of the extreme moisture conditions in the Gulf Coastal region, we have historically experienced difficulties with treated-timber ties on Kansas City Southern. Realizing that this condition exists, we have made several attempts to experiment with the use of concrete ties in lieu of treated-timber ties in an effort to bring our average tie life to at least that of the national average. The results to date do not indicate that the concrete tie is an effective solution to our problem.

Some of our competitors have imported foreign species of timber into this country and installed ties made of such timber in their tracks. Some railroads, including Kansas City Southern, looked to concrete ties as an alternative to treated-timber ties.

It may be helpful to discuss briefly the initial use of concrete ties in this country in the early 1900's. Early designs of concrete ties were based on the same dimensions as the treated-timber tie, but the concrete tie did not absorb impact to the same degree as the timber tie. As a result some of the early designs of concrete ties failed prematurely. This was discouraging to a number of the carriers. A major passenger train accident on the famous hairpin curve on the old Pennsylvania Railroad was caused by the failure of the hold-down device of the concrete tie. Thus, concrete ties in this country received a severe black eye which set the development back a number of years.

From 1930 to 1960 there was very little development of the concrete tie. During the period from the early thirties to World War II, the severe economic recession in the railroad industry, as well as in the country generally, resulted in a minimal number of cross-tie insertions. During the World War II years a substantial amount of tie-insertion work using timber ties was done by major railroads. A large number of such ties were insufficiently aged. Shortages of materials, particularly of creosote, resulted in many ties being insufficiently treated. Although a large number of replacement ties were inserted, their deficient quality resulted in operational problems that the railroad industry really is just getting over today.

As a result of these conditions, new focus was placed upon the development of alternative tie materials and a renewed look taken at the use of concrete ties. Several designs were made and tested in various laboratories, including those of the Portland Cement Association, the Association of American Railroads, and in some cases, private laboratories. From the designs that appeared feasible, concrete ties were manufactured and inserted in track at various locations by a number of railroads. On my own railroad, we have actually inserted concrete ties of three distinct designs and have used four different types of hold-down devices. We are now in the process of developing an additional design for the concrete tie and have done some work in the development of a new hold-down device. The first concrete cross ties were actually inserted in our track in 1966.

The Kansas City Southern Line is not the only railroad in the United States that has been experimenting with concrete ties. Some of the other carriers that are using concrete ties are the Southern; St. Louis-San Francisco; Norfolk and Western; Florida East Coast; Seaboard Coast Line; and Atchison, Topeka and Santa Fe Railroads.

The state-of-the-art in the development of the concrete tie at this time has not met the full expectations of the rail industry. It is my opinion that much more engineering work has to be done in the development of the concrete tie before it is uniformly accepted in the industry. The Department of Transportation, through its Research, Development, and Demonstration Program under the management of the Federal Railroad Administration, is experimenting with concrete ties at the High Speed Ground Transportation Test Center at Pueblo, Colorado. The Federal Ralroad Administration has also established a concrete tie study on a Santa Fe Railway test track in western Kansas. In addition to the development of the cross section design of the concrete tie, another serious problem has been the design of the hold-down or fastening device for such tie.

Under the Railroad Rehabilitation and Regulatory Reform Act of 1976, the Federal Railroad Administration engaged Thomas K. Dyer, Inc. to make an estimate of deferred maintenance in track materials for United States Class I Railroads. In his report, dated June 15, 1976, Mr. Dyer estimates that the average life of concrete ties for these railroads will be similar to that of treated-timber ties. His estimates of the useful life to the using railroads range from 29 to 42 years.

The Dyer report confirms my own opinion it is far too early in the state of the engineering development of concrete ties to reach the conclusion that such ties will have an appreciably longer life than the treated-timber ties.

Kansas City Southern has considered the use of steel cross ties. From a safety standpoint they are highly impractical for the reason that traffic on our main lines is controlled by our Signal and Centralized Traffic Control Systems. When a train occupies the track, the flow of electrical current goes from one rail through the wheels and axles of the cars and locomotives to the other rail and causes the signals to turn red. If steel ties were used, the signals would stay red all the time because the electrical current would continuously flow from one rail to the other rail through the steel tie. For this reason, the use of steel ties in Signal and Centralized Traffic Control Territories is not practical. Steel ties are used in a number of European railroads, but in each of those cases the railroads are electric railroads. The third rail, or overhead cantinary, together with the two rails, is used to activate their signal systems.

With respect to the application of plastic ties, we have no experience with the use of this product. We have yet to see a plastic tie that has sufficient amount of stress resistance to accommodate the load of the modern American diesel locomotive and heavy freight cars. If such a product becomes available, we would like to experiment with it also.

In my opinion steel and plastic ties do not in the foreseeable future constitute a viable alternative to the treated-timber tie.

Kansas City Southern uses the Uniform System of Accounts for Railroads as prescribed by the Interstate Commerce Commission. This means that it uses the so-called "retirement-replacement method" of accounting for Account No. 8, Ties. From the very first concrete tie that was inserted in our line in 1966, we have consistently followed the practice of charging the cost of the concrete ties and related fastenings and labor to insert such ties exactly the same way as we charge the same costs of a replacement treated-timber tie.

The present prices of concrete ties are quite high in relation to timber ties because so few are purchased annually. For the most part concrete ties have to be custom made. I look at the price of a concrete tie much like that of a pocket calculator. In the early development stage, the pocket calculator costs $100. With the advent of mass production it can be purchased for $10 today. With mass production in the United States, I am confident that the unit price of the concrete tie would come down to the range of the treated-timber tie. There is a very limited number of concrete tie manufacturers in this country, but once the state-of-the-art has produced a satisfactory degree of durability and mass use of such ties commences, then many more manufacturers of concrete ties will come into existence.

I can see no justification why the replacement concrete tie and related fastening costs should be given a different accounting treatment than the costs for replacement timber ties and related fasteners. If subsequent engineering developments and uses reduce the cost of the concrete tie below that of the treated-timber tie, then under the proposed language of Section 1701(b), the accounting treatment of the replacement concrete tie would be the same as that of the replacement treated-timber tie. My understanding is that there is no present provision of the Internal Revenue Code which makes the capital v. expense classification depend upon fluctuations in current market prices.

It is my opinion that if concrete ties and related fastenings are required to be capitalized as set out in the present language of Section 1701(b), then the incentive for further development of concrete ties will be severely hampered.

I recommend that favorable consideration be given to a provision which would treat the handling of concrete ties and related fastenings in the same manner as treated-timber ties for Federal income tax purposes for all open and future years.

Section 1702—Railroad Grading

Current Section 185 of the Internal Revenue Code of 1954 allows railroads to amortize over a fifty-year period railroad grading placed in service after December 31, 1968. Grading placed in service prior to that date has historically been treated as non-depreciable by the Internal Revenue Service and the Interstate Commerce Commission because of the assumption that grading has an indeterminable useful life for depreciation purposes. The current bill under consideration would allow grading placed in service prior to 1969 to be amortized over a fifty-year period, identical to the provision for grading placed in service after 1969 under the present Section 185.

Recently, Kansas City Southern litigated in the United States Tax Court the question of the useful life of its grading placed in service prior to 1969. We are awaiting a decision in this case. The Tax Court has decided this issue favorably to the taxpayer in Chesapeake & Ohio Rwy. Co., 64 T.C. 352 (1975). This issue is also before the United States Court of Claims in cases involving the Burlington Northern and Baltimore & Ohio railroads, and before the United States Tax Court in the Southern Pacific and Louisville & Nashville railroad cases.

In connection with the trial of the grading issue before the Tax Court, we presented extensive life analysis studies of grading placed in service by Kansas City Southern between 1917 and 1969. These studies, prepared by experts in the life analysis field, analyzed retirements from our grading accounts by year of original construction. The analyses conclusively established that pre-1969 grading has a determinable useful life to Kansas City Southern. This was the finding of the Tax Court in the *Chesapeake & Ohio* case, and in my opinion should be of universal application to all domestic railroads.

I recommend that favorable consideration be given to Section 1702 of the Bill, providing for the amortization of pre-1969 grading.

STATEMENT OF W. L. THORNTON, PRESIDENT, FLORIDA EAST COAST RAILWAY CO., ACCOMPANIED BY P. H. MATHEWS, VICE PRESIDENT, ASSOCIATION OF AMERICAN RAILROADS

Mr. THORNTON. Mr. Chairman, members of the committee, I am W. L. Thornton, president of the Florida East Coast Railway Co.

I have submitted a written statement that describes in detail our position.

The CHAIRMAN. For the record, if I may, I was born one block from the Kansas City switchyards. When my family had more success and we moved to a more affluent neighborhood, I could not go to sleep at night because I did not have the company of the Kansas City switchyards. It took me a long time to go to sleep at night without the accompanying music of the Kansas City switchyards.

Mr. THORNTON. We submitted a written report with you, and we fully support the provision to treat nonwooden crossties the same as wooden crossties.

I would like to emphasize several points. It is perfectly clear to everyone in the railroad industry that an alternative to wooden ties is essential. I would like to dispel the notion that only two railroads use other than wooden ties.

The latest figures that are available show that 13 railroads use such ties. The principal ones are the Seaboard Coastline, Southern, Delaware-Hudson, St. Louis, San Francisco, Atcheson, Topeka & Santa Fe, Kansas City Southern and ourselves.

We use concrete crossties simply because wooden crossties have become unavailable and increasingly expensive. We were shocked and dismayed that the Internal Revenue Service made retroactive the rule putting a substantial tax burden on the railroads who replace wooden ties with nonwooden ties.

There is no basis, in fact, in law, as we understand it, to treat concrete ties for test purposes any different. This will inhibit the development of nonwooden alternatives to the wooden ties, and therefore retard the desperately needed rehabilitation of roadbeds.

We are not asking for special treatment. The provisions we suggest do nothing more than give equitable treatment to nonwooden ties consistent with ICC accounting regulations.

The revenue impact provisions that we are supporting is minimal at best. The cost of concrete ties is rapidly approaching the cost of wooden ties.

We expect technological developments in the production of concrete ties which will eventually result in concrete ties being produced by a process equal to the price of the wooden tie in question.

I would like to state that I have addressed myself mainly to provisions pertaining to nonwooden ties. I wish to make it clearly understood that I support all of the provisions in this bill that were espoused by the Association of American Railroads.

These provisions would greatly enhance the quality of rail transportation in the United States, a goal set by the Congress and the Federal Government.

Thank you, for giving me this opportunity to appear. I would like to ask Mr. Carter, president of Kansas City Southern to make a few brief remarks on this issue.

Mr. CARTER. Thank you, Mr. Chairman. I am T. S. Carter, president, Kansas City Southern Lines. I did file my statement. I ask that you consider it.

I agree with the remarks that Mr. Thornton made with respect to ties. When we talk about nonwooden ties, we are talking about, in this country, concrete ties. Concrete tie development certainly has not reached perfection in this country, it is still in the experimental stage.

A recent study by the FRA indicated that the life of the timber tie and the concrete tie are virtually the same. Consequently, I think that they should be considered as a concept of betterment in the railroad industry, as based on the criteria that the Government evolved, material of a higher quality or a higher durability, should be considered because the price itself would be higher.

I have one other thing that I want to ask you to consider—that is, that you give your support for the 50-year amortization.

Thank you, very much.

The CHAIRMAN. Thank you, very much.

Senator NELSON. Does Treasury have a statement to make on why they treat concrete differently?

The CHAIRMAN. Treasury is going to testify in regard to all these amendments. We will have that information.

Next, we will hear from Mr. Paul W. Eggers, president of Geothermal Kinetics, Inc., accompanied by Dr. Carel Otte, vice president of Union Oil Co. of California.

[The prepared statement of Mr. Paul W. Eggers follows:]

TESTIMONY OF PAUL W. EGGERS, PRESIDENT, GEOTHERMAL KINETICS, INC.

SUMMARY

1. This is not special interest legislation, but is a provision of general applicability throughout the geothermal industry.
2. Similar legislation has been supported by the Federal Energy Administration, and was previously passed by the Senate in 1975.
3. Testimony was offered and statements submitted urging the enactment of geothermal tax legislation at hearings held by the Senate Finance Committee both on energy related tax provisions (H.R. 6860) and on H.R. 10612. No adverse testimony was received.

4. The legislation is consistent with existing court decisions and would eliminate uncertainty as to the tax treatment of geothermal resources.

5. The legislation is sorely needed to create a viable geothermal industry with great potential for future clean energy development from domestic resources.

STATEMENT

I am Paul W. Eggers, President of Geothermal Kinetics, Inc. I am accompanied by Dr. Carel Otte, Vice President and Manager of Geothermal Division of Union Oil Company of California. Dr. Otte is an eminent geologist and an expert in geothermal technology.

I am appearing on behalf of Geothermal Kinetics, Inc., and in support of Section 2004 of H.R. 10612, which clarifies that geothermal resources development should receive the same type of tax treatment as that provided other wasting assets. A number of other small companies engaged in geothermal development activities requested an opportunity to testify. Had they done so they would all have testified in favor of this section. These companies are Republic Geothermal, Inc., Magma Power Company, and Geothermal Resources International, Inc.

I should like to emphasize to the Committee that this is not so-called "special interest" legislation, nor was it enacted without full consideration by this Committee. Similar legislation has been endorsed by the Federal Energy Administration, and was passed previously by the Senate as part of the Tax Reduction Act of 1975, although unfortunately it was dropped in conference. On the present provision, hearings were held, testimony was offered, and statements were submitted for the record before the Committee acted.[1]

Furthermore, Section 2004 is not designed to benefit any single company, but has general applicability to all who engage in geothermal exploration or development. Enactment would, in our judgment, be a major factor in creating a viable new industry with vast potential for meeting future energy needs.

This legislation would be of greatest benefit to small, struggling geothermal companies which desperately need to raise capital if they are to survive. For example. Geothermal Kinetics, Inc. is a small independent operator which, together with its subsidiaries, has approximately 30 employees. It is engaged exclusively in geothermal research, exploration and development. It has spent approximately $5 million in acquiring leases and drilling geothermal wells, and it now has an interest in approximately 650,000 acres with geothermal prospects. In fully developing these prospects, it will be necessary to raise additional capital and to bring in outside investors. There is little likelihood that this can be done with the uncertainty of tax consequences now existing.

Mr. Chairman, what is at stake here is the development of an industry which has the potential for replacing almost one million barrels of daily oil production by 1985. Indeed, the Project Independence report set this approximate amount as a 1985 goal for the nation. But we are starting from scratch. Probably not more than 75 geothermal wells will be drilled during all of 1976. To create a viable industry and to come anywhere close to the target, we have to have this legislation.

The projected investment for achieving the 1985 goal includes the costs of drilling at least 800 exploratory wells and 6,000 development wells at a minimum cost of $500,000 per well, or a total of $3.4 billion in 1975 dollars in drilling costs alone. Depreciable investment in hook-up facilities will add another $2 billion. Moreover, some 2,000 replacement wells will be required, with the attendant depreciable investment, bringing the total investment requirement to about $10 billion. This type of capital simply cannot be raised without certainty as to the tax laws.

Given the current energy situation, this nation cannot afford to overlook the geothermal potential; nor to leave the tax treatment of geothermal development in the present state of uncertainty. Moreover, I emphasize that the industry is not asking for special treatment, but only that it be assured the tax treatment to which court decisions indicate it is now entitled—a type of tax treatment that has long been accorded mining and drilling industries.

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[1] See: 1. Hearings before the Subcommittee on Energy of the Committee on Finance, U.S. Senate, March 17, 1975, p. 85.

2. Hearings before the Committee on Finance, U.S. Senate, on H.R. 6860, relating to energy conservation and conversion, July 15, 16, 17, and 18, 1975, p. 936.

3. Statements submitted for insertion in the record of Hearings before the Committee on Finance, U.S. Senate, on H.R. 10612, by Geothermal Kinetics, Inc., Union Oil Co. of California, and Magma Power Co., 1976.

One last point, Mr. Chairman. Geothermal is primarily in competition in the West with strip-mined coal. To deny geothermal, a clean energy resource, similar tax incentives to those presently available to the coal mining industry simply makes no sense.

We urge the Committee to retain Section 2004 as it appears in H.R. 10612.

Thank you.

FEDERAL ENERGY ADMINISTRATION,
Washington, D.C., June 13, 1975.

Mr. KARL S. LANDSTROM,
Arlington, Va.

DEAR MR. LANDSTROM: Mr. Zarb has asked me to thank you for your letter of April 14, 1975, regarding the tax treatment of income derived from geothermal resource exploitation.

We have determined that income derived from geothermal development should be accorded the same tax treatment as income derived from oil and gas exploration and development. Accordingly, we feel that the percentage depletion allowance should apply to geothermal resource exploration and development to the same extent it applies to oil and gas exploration and development.

By the same token, we have taken the position that intangible drilling and development costs for geothermal resource exploitation should obtain the same treatment accorded such costs in the case of oil and gas drilling and development. We have made our views in this area known both within and without the Administration. We hope that legislation will soon be passed putting the tax treatment of geothermal resource development on a par with the tax treatment of oil and gas drilling and development.

Thank you for your interest in these matters.

Sincerely,

DONALD B. CRAVEN,
Acting Assistant Administrator, Energy Resource Development.

STATEMENT OF PAUL W. EGGERS, PRESIDENT, GEOTHERMAL KINETICS, INC., ACCOMPANIED BY DR. CAREL OTTE, VICE PRESIDENT, UNION OIL CO., CALIFORNIA

Mr. EGGERS. I am Paul W. Eggers, president of Geothermal Kinetics, Inc. I am accompanied by Dr. Carel Otte, vice president and manager of Geothermal Division of Union Oil Co. of California. Dr. Otte is an eminent geologist and an expert in geothermal technology.

I am appearing on behalf of Geothermal Kinetics, Inc., and in support of section 2004 of H.R. 10612, which clarifies that geothermal resource development should receive the same type of tax treatment as that provided other wasting assets.

A number of other small companies engaged in geothermal development activities requested an opportunity to testify. Had they done so they would all have testified in favor of this section. These companies are Republic Geothermal, Inc., Magma Power Co., and Geothermal Resources International, Inc.

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Furthermore, section 2004 is not designed to benefit any single company, but has general applicability to all who engage in geothermal exploration or development. Enactment would, in our judgment, be a

major factor in creating a viable new industry with vast potential for meeting future energy needs.

This legislation would be of greatest benefit to small, struggling geothermal companies which desperately need to raise capital if they are able to survive.

For example, Geothermal Kinetics, Inc. is a small independent operator which, together with its subsidiaries, has approximately 30 employees. It is engaged exclusively in geothermal research, exploration, and development.

It has spent approximately $5 million in acquiring leases and drilling geothermal wells, and it now has an interest in approximately 650,000 acres with geothermal prospects. In fully developing these prospects, it will be necessary to raise additional capital and to bring in outside investors. There is little likelihood that this can be done with the uncertainty of tax consequences now existing.

Mr. Chairman, what is at stake here is the development of an industry which has the potential for replacing almost one million barrels of daily oil production by 1985. Indeed, the Project Independence report set this approximate amount at a 1985 goal for the Nation. But we are starting from scratch. Probably not more than 75 geothermal wells will be drilled during all of 1976. To create a viable industry and to come anywhere close to the target, we have to have this legislation.

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Moreover, some 2,000 replacement wells will be required, with the attendant depreciable investment, bringing the total investment requirement to about $10 billion. This type of capital simply cannot be raised without certainty as to the tax laws.

Given the current energy situation, this Nation cannot afford to overlook the geothermal potential; nor to leave the tax treatment of geothermal development in the present state of uncertainty.

Moreover, I emphasize that the industry is not asking for special treatment, but only that it be assured the tax treatment to which court decisions indicate it is now entitled—a type of tax treatment that has long been accorded mining and drilling industries.

One last point, Mr. Chairman. Geothermal is primarily in competition in the West with strip-mined coal. To deny geothermal, a clean energy resource, similar tax incentives to those presently available to the coal mining industry simply makes no sense.

We urge the committee to retain section 2004 as it appears in H.R. 10612.

That completes my statement, but I would like to comment on the Treasury position on section 2004 that I just received. Whoever prepared the Treasury report displayed ignorance of the geothermal industry, its present status, and its potential, the betterment to be derived by the Nation through enactment of this section.

In addition, Treasury has not done its homework on this legislation, because it completely and totally misstates the arguments. Obviously, Treasury did not read the statements that have been submitted to this committee in support of this legislation.

To my knowledge, no one has argued in favor of section 2004, that it is necessary to put geothermal energy reduction on the same footing as the oil and gas industry.

Having set up a strawman and then shooting it down, the Treasury report does not deal anywhere with the merits of this legislation, nor with the arguments presented by the proponents.

To my regret, as a former General Counsel to the Treasury Department, I have to say to this committee that I do not feel that the Treasury report is worthy of serious consideration.

Thank you.

The CHAIRMAN. Thank you, sir.

Senator FANNIN. For clarification, as to the uncertainty of the Treasury Department, I am not sure that we all understand what is involved.

As I have been told, the Treasury Department has not been willing to abide by the court decision.

Mr. EGGERS. That is correct.

We have the decision in favor of the taxpayers for intangible drilling and depletion in the Tax Court of the United States. The Ninth Circuit affirmed that decision. The Commissioner has nonacquiesced. He has made a taxpayer go to court on it, not following it.

With that type of treatment, we know that the investors will not come if they have to take the Internal Revenue Service on. It would be 10 years before we can get that thing into the Supreme Court and finally get it clarified as to what indeed the intent of Congress is.

We are here for one purpose, to find out what the intent of Congress is. It is useless—the report. The only thing we have standing in our way is the nonacquiesence.

Senator FANNIN. Thank you, Mr. Eggers.

The CHAIRMAN. Senator Bentsen.

Senator BENTSEN. When I was on the North Island of New Zealand, I found that 14 percent of the power was geothermal. I was pretty impressed with it.

Are we making some real headway?

Mr. EGGERS. That is where Treasury is wrong.

Right now, Geothermal Kinetics, Inc., has in southern Utah a well that we have drilled. North of it, about 30 miles, we have 34 geothermal steam wells. We are presently negotiating with the utility companies. Utility companies badly need this energy, a clean source of energy.

Senator BENTSEN. It has been very realistic in New Zealand. I do not know why we cannot do some of that in this country. Obviously, we need it badly.

The CHAIRMAN. Thank you very much, sir.

Next, we will hear from Mr. M. J. Migdoll, executive vice president, National Association of Recycling Industries, accompanied by Mr. Robert S. Kahn, president, Keystone Resources, Pittsburgh, Pa.; Harold Gershowitz, executive vice president, Waste Management, Inc., Oakbrook, Ill.; Richard Wand, administrative vice president, Bergstrom Paper Co., Neenah, Wis.; Harlan Carroll, South Wire Co., Carrollton, Ga., accompanied by Mr. Edward L. Merrigan, Washington Counsel for the National Association of Recycling Industries.

[The prepared statement of Mr. Migdoll and Mr. Wand follows:]

Consolidated Statement of National Association of Recycling Industries, Inc.

Summary of Principal Points

1. The 775 recycling firms represented by the National Association of Recycling Industries, as well as the U.S. Conference of Mayors, the National League of Cities, the National Governors Conference, the National Solid Waste Management Association and State Resource Recovery Boards and Authorities throughout the United States fully support the Recycling Tax Credit (Sect. 2006), and the Tunney-Gravel Amendment (No. 2017).

2. The baseless opposition registered by a few seemingly blind, selfish or misguided opponents must be branded as absolutely unjustified, totally misleading and exceedingly damaging to the best interests of the United States—in the critical areas of natural resource conservation, resource recovery and recycling; energy conservation, balance of payments, and solid waste management and disposal.

3. When the Senate recently overwhelmingly passed the Solid Waste Utilization Act of 1976, and committed hundreds of millions of dollars to finance new State and Municipal Resource Recovery Facilities, the Public Works Committee Report warned: "If new markets are not developed for these materials [to be recovered from garbage], resources recovered from municipal wastes will only succeed in substituting for existing secondary materials."

The Recycling Tax Credit is urgently needed to supplement the Solid Waste Utilization Act, or the latter is doomed to costly wasteful failure from the outset.

4. Environmental Action Coalition, contrary to the completely negative view espoused by Environmental Action's Washington lobbyist before this Committee, urges approval of the Recycling Tax Credit reported by the Senate Finance Committee.

5. The Recycling Tax Credit must continue, as it presently does, to cover all recyclable commodities, including wastepaper, aluminum, and copper. Each year, cities and states bury 44,300,000 tons of paper and 12,500,000 tons of metals, including 1,000,000 tons of aluminum—all of which is lost forever in landfills. No small segment of American industry, fearful of competition, should be permitted to impede full new recycling in all of these recyclable commodities.

6. The Recycling Tax Credit will not result in large revenue losses or windfalls to existing recyclers. Indeed, as the Committee Report states, properly administered by the Government, the Recycling Tax Credit should not result in any net revenue losses to the Treasury.

7. The base period and moving base period concepts embodied in the Recycling Tax Credit strictly limit and eliminate "windfalls" to existing recyclers.

8. The Tunney-Gravel amendment should be approved by the Committee or the Senate.

9. Passage of the Recycling Tax Credit will result in 100% increases in paper, aluminum, copper, lead and zinc recycling by 1986. Extension of the 5 percent Recycling Tax Credit to fuel produced from garbage residues, after all recyclables have been removed, will eliminate landfills and coupled with recycling of secondary materials, save the United States huge volumes of precious oil, gas and coal energy.

Statement

Mr. Chairman, my name is M. J. Migdoll, Executive Vice President of the National Association of Recycling Industries, Inc. (NARI). The Association's offices are located at 330 Madison Avenue, New York City, and our membership consists of more than 775 recycling firms located throughout the United States. Those firms are the leading collectors, processors and users of recyclable wastepaper, aluminum, copper, lead, zinc and textile solid waste materials.

I appear here today to testify on behalf of NARI and to present this consolidated statement on behalf of the above-named leaders of the national recycling and solid waste management industries who have traveled from many corners of the United States: (i) To support the *Recycling Tax Credit* provision contained in Section 2006 of the Tax Reform Act, as reported by the Senate Finance Committee; (ii) to support the Tunney-Gravel amendment to Section 2006; and (iii) to brand as absolutely unjustified, totally misleading and exceedingly damaging to the best interests of the United States—in the critical areas of natural resource conservation, resource recovery and recycling, energy conservation, balance of payments, and solid waste management and disposal—the baseless opposition registered against the Recycling Tax Credit provisions

by a few seemingly blind, selfish or misguided opponents who have either appeared before the Committee or registered written criticism.

It seems plain, we respectfully submit, that none of those critics even bothered to read the Committee Report in support of the Recycling Tax Credit [1], and of course, they must not have been present when the Committee held detailed public hearings on the Recycling Tax Credit in July 1975, when it considered the energy tax bill.

Anyone remotely familiar with the Recycling Tax Credit, as drafted and carefully restricted by this Committee and the staff of the Joint Committee on Internal Revenue Taxation, knows perfectly well that it is strenuously supported, not only by the national recycling industry as a whole, but also by the (1) U.S. Conference of Mayors; (2) National League of Cities; (3) National Governors' Conference; (4) National Solid Waste Management Association; and by (5) Resource Recovery Boards and Authorities in cities and states such as Connecticut, California, Massachusetts, Louisiana and Wisconsin.

On June 10, 1976, for example, the President of the U.S. Conference of Mayors, Moon Landrieu of New Orleans, and the President of the National League of Cities took the unusual step of addressing a joint personal letter to every member of the United States Senate urging them to support the Recycling Tax Credit. That letter reads as follows:

"DEAR SENATOR: We have been informed that the tax bill H.R. 10612 is scheduled to be taken up by the Senate today. As the President of the U.S. Conference of Mayors and the National League of Cities, we wish to call your attention to one provision placed in the bill by the Finance Committee which has the strong support of both our organizations.

"That provision phases in a modest tax expenditure over a period of three years for those who increase usage of secondary materials recovered from solid waste. *Nearly all of the solid waste involved would be municipal solid waste.* Cities throughout the nation are running out of space for landfills and are struggling to pay for modernization of incinerators while the United States simultaneously struggles to conserve its supplies of depletable natural resources and energy. The provision which will be before you is a small step in the direction of equalizing the economic incentives as between utilizing recycled or virgin materials. From the cities' viewpoint, it has the added advantage of expanding markets for the materials recovered by scores of municipal Resource Recovery Plants which are on line or under construction throughout the country. Expanded markets would improve the economic viability of these present and future facilities.

"*As the elected spokesmen of the Mayors and elected city officials throughout the nation, we are confident that the Mayors and City Council members of your state join us in urging your support for this brief provision in the tax measure.*" (Emphasis provided.) [2]

It is thus surprising and very regrettable indeed to find Senators such as Senator Kennedy of Massachusetts and Senator Gary Hart of Colorado apparently willing to carry their running vendetta against this Committee's version of the Tax Reform Act to the point of even opposing the Recycling Tax Credit provision of the bill.

Large urban centers in Massachusetts, like other municipalities throughout the United States, are becoming increasingly concerned with the problems of where and how to dispose of their growing mountains of solid waste. The answer, they believe, is resource recovery and recycling of garbage. Thus, Massachusetts plans to operate in the near future several Resource Recovery Plants similar to the one already in operation in Saugus, Massachusetts which produces saleable steam from garbage received from Boston and eleven adjacent communities, inhabited by a half million of Senator Kennedy's constituents.

But, if Senator Kennedy's opposition to the Recycling Tax Credit contained in this Committee's bill is successful, it is doubtful the additional Resource Recovery Plants now in the planning stage will be built; or if built, whether they can successfully operate and retire the bonds issued to finance their construction. Why? Because the viability of each municipal or state Resource Recovery Plant depends on its ability regularly and consistently to market the wastepaper, the metals, glass and energy materials it produces from garbage The

[1] Senate Finance Committee Report, pp. 575–578.

[2] The Committee, of course, has received similar communications of support from City and State Resource Recovery Authorities from several sections of the country.

Recycling Tax Credit adopted by this Committee is designed as an incentive to create new markets for those recyclable commodities and to guarantee sustained markets in the years ahead.

Certainly, Senator Gary Hart should understand this. He was one of the principal supporters of the Solid Waste Utilization Act of 1976, passed overwhelmingly by the Senate just before the last recess. That bill prohibits open dumping of garbage and authorizes the expenditure of hundreds of millions of dollars in federal grants and loan guarantees to create new state and municipal solid waste management and resource recovery programs.

But, the Senate Public Works Committee Report in support of that Act, so strenuously supported by Senator Hart, candidly recognizes, at page 5: [8]

"Evidence presented to the Committee indicates that demand for recycled or secondary materials is limited by factors *other* than supply availability. *Such materials are not viewed favorably as a resource supply by industry.* The relative value relations must be changed to improve acceptability. *If new markets are not developed for these materials, resources recovered from municipal wastes will only succeed in substituting for existing secondary materials.*" (Emphasis supplied.)

That, Senator Hart, is precisely why the Senate Finance Committee adopted the Recycling Tax Credit. Unless your Solid Waste Utilization Act is promptly supplemented by "recycling market incentives" and "tax parity" between competing virgin and recyclable materials, the hundreds of millions of federal dollars the Public Works Committee has earmarked for new solid waste management and resource recovery systems will, by the Committee Report's open admission, be doomed to wasteful failure. How then can you fairly join in a senseless, myopic attack on the Recycling Tax Credit?

Another truly amazing opponent of the Recycling Tax Credit is the Washington lobbyist for Environmental Action, Mr. Early. Many in the national environmental movement think he is running for top spot on his own organization's "Dirty Dozen" list. His position is simple: There are two ways to create "tax parity" between competing virgin and recyclable commodities and to create new markets for recyclables:

(i) One way, Mr. Early's way and Senator Haskell's way, is to repeal the percentage depletion allowance on virgin ores and timber and the capital gains treatment of profits derived from the cutting of trees. Those "virgin tax benefits" presently cost the Treasury $1.5 billion a year.

(ii) The other way is to enact a modest Recycling Tax Credit which would reduce the existing tax disparity against recyclables, and thus improve their marketability in competition with virgin ores and timber.

Mr. Early concedes Congress is not ready to repeal the virgin benefits—indeed this Committee twice defeated that proposal 12 to 2 in the last year—so Mr. Early contends new, effective recycling and the related national benefits of resource recovery, resource conservation, energy conservation, reduced air and water pollution and reduced solid waste disposal problems and costs should be held "hostage" until the Congress is ready to do the job exclusively his way and Senator Haskell's way.

Fortunately for our national environment, that stubborn "all or nothing" attitude is not widely shared by other environmentalists whose job is, not to sit here in Washington and oppose everything Congress attempts to do as Mr. Early does, but to cope day in and day out with real, constantly-mounting solid waste disposal problems. For example, in a letter dated June 29, 1976 addressed to Senator Javits of New York, the Environmental Action Coalition—the New York arm of Environmental Action—stated this far more realistic, reasonable position in support of this Committee's Recycling Tax Credit provision:

"Having since 1970 coordinated a network of community recycling centers in New York City, and having urged large scale municipal and industrial recycling programs, the Environmental Action Coalition (EAC) is acutely aware of the many government-fostered obstacles that have presented the natural expansion of recycling in this country. Most obvious of these obstacles are . . . tax incentives to the virgin materials industries in the form of depletion allowances and capital gains.

"Shortly to be considered by the Senate is the Tax Reform Act of 1976 (H.R. 10612). The section of the bill which provides a phased-in tax credit on purchases by a recycler of recyclable materials is a moderate step in the direction of

[8] Senate Report No. 94-988 (June 25, 1976).

equalizing the status in the marketplace of virgin and recycled products. *The Environmental Action Coalition supports this provision as an acceptable interim measure while the ultimate goal of total repeal of capital gains and depletion allowances is being pursued.*"

Moreover, the national recycling industry represented by the National Association of Recycling Industries—which consists of all the leading U.S. firms engaged in aluminum and copper recycling—must categorically reject the selfish short-sighted position taken before this Committee by the extremely tiny limited interest group known as the Aluminum Recycling Association. Three of the country's leading recyclers of aluminum and copper are here with me today to emphasize that it is vitally important to the nation for the Recycling Tax Credit to continue to cover—as it presently does—aluminum, copper, wastepaper and all the other heavy volume solid waste commodities.

The United States simply cannot afford, in a devastating period of dwindling domestic supplies and increased dependence on foreign cartels for more than 50 to 95 percent of the metals it so critically requires to carve out "business sanctuaries" or "no new competition preserves" for any particular recycling group. Furthermore, since the Recycling Tax Credit is aimed at assisting the cities and states to market the vast new volumes of recyclable materials their new Resource Recovery Facilities will extract from garbage, it is vitally important to note that, according to the 1975 Report to Congress of the President's Council on Environmental Quality, those recyclables each year will be drawn from—

Solid waste category	Current cycling rate (percent)	Present volume buried each year (tons)
Wastepaper (53,000,000 tons)	16.5	44,200,000
Metals (12,700,000 tons)	1.6	12,500,000
Glass (13,500,000 tons)	2.1	13,200,000
Plastics (5,000,000 tons)	0	5,000,000
Textiles (1,900,000 tons)	0	1,900,000

Plainly, therefore, all these recyclable commodities must continue to be included if the Recycling Tax Credit is to accomplish its intended goals of new recycling and conservation of scarce natural metal resources.

The recycling tax credit will not result in large revenue losses or windfalls to existing recyclers

As indicated above, anyone remotely familiar with the Committee Report in support of the Recycling Tax Credit knows that, as drawn by the Committee and Dr. Woodworth's staff, the Recycling Tax Credit will *not* result in either large revenue losses or unconscionable windfalls to manufacturers on their current recycling volumes.

(1) *Revenue Loss*

The Committee Report emphasizes that, because of the Recycling Tax Credit's "phase-in" provisions, the maximum estimated revenue loss for 1977 will be $9 million; and for 1978, $39 million.

It is vitally important to note, however, that both of those "estimates" are based on a projected 10 percent increase in recycling volume for all recyclable materials covered by the bill in 1977, and another 10 percent increase in each category in 1978.

If recycling volume in each category continues to increase by 10 percent a year in 1979, 1980, and 1981, the Joint Committee on Internal Revenue Taxation now projects the ultimate yearly revenue loss will rise, in 1981, to $228 million.[4]

But, as stated above, all these revenue loss estimates are predicated on resulting annual recycling increases of 10 percent in 1977, 1978, 1979, and 1980 and 1981. Thus, the critics of the Recycling Tax Credit are again dead wrong in their spurious claim: "This provision will eventually cost an estimated $345 million a year, but it will do little to promote any new recycling of solid wastes."

First, the Recycling Tax Credit will not eventually cost $345 million, as alleged by the "chronic complainers," and unless it increases recycling volume in all

[4] The Committee Report originally estimated an ultimate revenue loss of $345 million by 1981. The Joint Committee staff, however, admitted its calculation failed to take into account the "moving base period" in the bill, and thus corrected its estimate to $228 million in 1981.

commodity categories by 10 percent a year—that is, unless it promotes 10 percent "new recycling" each year from 1977 through 1981—it will not cost $9 million in 1977, or $39 million in 1978, or $228 million in 1981.

Furthermore, the Committee Report, at page 575, correctly underscores the fact that, even with these 10 percent-a-year new recycling increases projected by the Joint Committee staff, no revenue losses at all should actually result from the Recycling Tax Credit, properly administered by the Government. In this regard, the Committee Report states:

"The revenue loss from a recycling tax credit need not produce a *net decrease in budget receipts* [at all] if there is sufficient substitution of recycled materials for virgin materials to produce a decrease in revenue loss from percentage depletion allowances [currently claimed by users of virgin materials]."

In conclusion, therefore, when the Senate fairly weighs all the potential national benefits to be gained from the Recycling Tax Credit, together with the prospect it potentially can and should be administered without any net revenue loss to the Treasury, against the $1.5 billion per year in revenue losses attributable to the competing virgin commodity tax benefits, how can anyone seriously argue the Recycling Tax Credit should be rejected out of hand?

Moreover, how can Senator Gary Hart fairly oppose the Recycling Tax Credit as too expensive, even assuming a $9 million revenue loss in 1977 or $39 million in 1978, when his position on the Public Works Committee he recently helped push through the Senate a $35 million 1977 one-year authorization for the Office of Solid Waste Management of EPA whose function is simply to continue to study and theorize on possible resource recovery solutions and projects.

The Finance Committee's Recycling Tax Credit promises an immediate, effective 20 percent increase in recycling and resource recovery by the end of fiscal 1978—at just one-fourth the cost of the last mentioned EPA $35 million authorization for 1977, and at approximately the same maximum cost of that authorization for 1978.

(ii) *No Unconscionable Windfall To Existing Recyclers*

The opponents of the Recycling Tax Credit falsely allege: "What this tax credit will do, however, is provide a windfall to those who are already using recycled materials."

As the Committee surely knows, that is an outrageous misstatement.

The Recycling Tax Credit provision, carefully drawn by the staff of the Joint Committee on Internal Revenue Taxation, establishes both an original "base period", and then a "moving base period" to exclude from Recycling Tax Credit coverage 75 percent of all current recycling volume.

It allows a credit on only 25 percent of current recycling volume as a fair means of protecting existing recyclers from being caught "between the devil and the deep blue sea", so to speak.

As explained above, on one hand, large integrated companies already enjoy, on 100 percent of their utilization of competing virgin materials, either a depletion allowance or low 32 percent capital gains tax treatment of profits. Enactment of the Recycling Tax Credit, on the other hand, will undoubtedly bring many new firms into recycling, some of which will ultimately gain a recycling tax credit on a large portion of their new utilization of recyclable materials.

Thus, some fair economic protection must be afforded to existing recyclers, and this has been done by the Committee, but only to the extent of 25 percent of their 1973–75 average recycling volume.

Thus, the "base period" concept, and the "moving base period" concept embodied in the Recycling Tax Credit are far more stringent than the base period concepts overwhelmingly approved by the Senate in connection with the DISC provisions. And, since they are so strictly limited by the Committee draft, they guarantee no one will enjoy any so-called unconscionable windfall as a result of this portion of the bill.

The committee should approve the Tunney-Gravel amendment to the recycling tax credit

Before concluding, we want to urge the Senate Finance Committee to approve No. 2017 proposed by Senators Tunney and Gravel to the Recycling Tax Credit provisions of the bill.

That amendment would only slightly modify the original "base period" provisions to substitute "volume" of recyclables purchased during the 1973–75 base period for the "dollar value" of those base period purchases. The substitution of this base period test would not substantially increase the revenue loss projec-

tions, but it would guarantee that all recyclable metals and wastepaper would qualify for at least a small recycling tax incentive during the 1977-79 "phase-in" period. Indeed, the record indicates this was the Committee's real intention in the first place, and seemingly, the "dollar value" test was inserted exclusively during the staff's drafting process.

The amendment would also extend a 5-percent Recycling Tax Credit to purchasers of fuel, steam or other saleable products produced from garbage residues—after all recyclable wastepaper, metals, glass, textiles etc. are already recovered for recycling. This proposal promises to convert garbage residues which cannot otherwise be recycled into useful energy—as substitutes for precious oil, gas or coal. Plainly, the credit should be thus extended by the Committee or by the Senate as a whole.

Conclusion

The Recycling Tax Credit, as approved by this Committee and as amended by the Tunney-Gravel amendment, should be enacted into law at the earliest possible date.

Coupled with the Solid Waste Utilization Act, passed by the Senate a few weeks ago, it promises to produce dramatic increases in paper, aluminum, lead, zinc, copper and textile recycling in the years immediately ahead—as much as 100 percent increases by 1986.

At relatively no revenue cost to the Treasury in 1977 and 1978, or in the future for that matter, it will not create complete tax parity with virgin materials whose tax benefits total $1.5 billion a year. But, it does represent true tax reform in this area; a meaningful, effective change in direction from the days of tax encouragement of depletion of precious natural resources to the compelling days of tax incentives aimed at reaching new recycling goals.

As summarized by a report issued on June 30, 1976 by the House Committee on Government Operations entitled "Solid Waste-Materials and Energy Recovery",[5] at pages 6, 10:

"The solid waste problem in the United States—especially the municipal solid waste problem—is an environmental predicament of staggering dimensions. . . .

"A 1975 survey of Mayors and City Council members identified solid waste management as the *number one urban problem*. . . .

"If the millions of tons of municipal solid waste can be viewed, not negatively as a problem of disposal, but positively as a source of valuable material and energy, resource recovery can transform a major environmental, social and economic problem into a valuable resource. . . .

"What is the potential? In energy alone, the Environmental Protection Agency calculates that if all the municipal solid waste generated in our Standard Metropolitan Statistical Areas had been tapped for its energy content, 900 million BTUs would have been preserved in 1973. This is equivalent to the energy of 154 million barrels of oil per year. By 1980, the energy content of muncipal solid waste is expected to climb to 187 million barrels of oil per year."

To delay the passage of the recycling tax incentive here involved is thus roughly equivalent to "fiddling while Rome burns."

Statement by Richard W. Wand, Administrative Vice President, Bergstrom Paper Co.

My name is Richard Wand and I am the Administrative Vice President of the Bergstrom Paper Company. Bergstrom, with corporate offices in Neenah, Wisconsin, is a manufacturer of printing and writing papers utilizing recycled wastepaper as our primary raw material. Since the company's founding in 1904, wastepaper has been utilized in the production of its products. Bergstrom owns no timberlands and relies on wastepaper for approximately 70 percent of its total fiber requirements.

The company has two paper production facilities—one located in Neenah, Wisconsin, and one located in West Carrollton, Ohio. Together these mills are capable of producing approximately 250,000 tons of printing and writing papers per year, as well as annually consuming some 175,000 tons (350,000,000 pounds) of wastepaper in their deinking operations. With this capability, we are the nation's leading producer of printing and writing papers from recycled fiber and we are one of the major United States consumers of wastepaper.

[5] See H. Rep. No. 94-1319, 94th Cong., 2d Sess.

When operating at full capacity, we consume the equivalent of 14 railroad carloads of wastepaper each day, 350 days a year. At the present time, however, we are operating substantially below capacity by virtue of having to shut down our entire Ohio mill in April, 1975, due to severely depressed paper markets. We resumed operation of one of three paper machines at the Ohio mill in April of this year.

Though Bergstrom is the major producer of recycled printing paper, we are a relatively small company among the giants of the paper industry. Our premier position in recycled printing paper is possible only as a result of the fact that only about 4 percent of the printing papers manufactured in this country are produced by recycling of wastepaper. Indeed, the percentage of printing papers manufactured from wastepaper has declined steadily despite growing realization of the importance of conserving our natural resources by recycling. We sincerely believe that a major reason for the steady decline in wastepaper recycling has been the discriminatory tax policies of our Federal Government.

As a major recycler since 1904, our company has been a leader in promoting the use of recycled paper. We have also been in the forefront of technological developments to further the company's and the industry's ability to recycle wastepaper. with our long history of involvement in recycling, we believe that we have the advantage of a rather unique perspective on the future of recycling.

As the Environmental Protection Agency has stated, Americans discard more than 85 percent of the paper we purchase. Paper constitutes about one-third of our municipal waste, most of which is now buried, dumped on the land, burned in incinerators, or scattered as litter, at an annual cost of approximately $3.5 billion per year, adding substantial burden to the already strained municipal budget. And yet, while solid waste continues to be generated at rates three times faster than our population, our recovery rate of wastepaper is continuing to decline. The President's Citizens Advisory Committee on Environmental Quality reported last month that from a wartime high of 35.3 percent in 1944 it is estimated we are now recovering approximately 23 percent of our wastepaper as of 1975. We believe that our rate is closer to 18 percent which is one of the lowest recovery rates of industrialized countries.

It is quite clear to those of us at Bergstrom Paper Company that if the nation is to recover a greater portion of its recoverable rsources, thereby alleviating the massive problem of solid waste, action must be taken to remove the economic barriers to recycling. Foremost among these barriers is the difference in tax treatment between those mills using recyclable materials and those using virgin materials. If stimulus is to be given to the recycling industry, one of the first moves which must be made is that of providing tax treatment parity for recycled materials.

When the Chairman of this committee announced that hearings would be reopened on the Tax Reform Act of 1976, he stated that members of the committee had expressed the concern that some sections of this bill had not received sufficient public hearing. Let me assure you that since we first appeared before the House Ways & Means Committee in March of 1974, this issue has been receiving close scrutiny by congressional committees and your staffs. But in spite of all of the talk about the merits of recycling, we continue to find a reluctance on the part of the tax policy makers to adopt long overdue remedial legislation. One member of the President's Citizens Advisory Committee on Environmental Quality summed it up well when he stated, "The system is not working. It is not providing the recycling the people want. We have to look at the source of the problem which is that there isn't any incentive for people to go ahead. Without some incentive we'll go on the way we are—which is backwards."

For nearly six years, we have been hearing similar statements by not only the President's Citizens Advisory Council on Environmental Quality, but also the President's Council on Environmental Quality, the EPA, the National Materials Policy Commission, the National Science Foundation, the National League of Cities, the U.S. Conference of Mayors, and the National Governors' Conference.

One reason for the lack of incentive for increased recycling stems from the absence of markets for a vast supply of wastepaper. The market situation, however, stems from a number of complex factors, not the least of which is the lack of any economic incentive to build or expand recycling facilities. Market distortion results directly from federal tax policies which provide favorable treatment to the users of virgin materials, but not to the users of recycled materials. In view of the voluminous testimony which has been received previously on the recycling tax credit provisions of this bill, it would be our sincere

hope that the committee intends to reaffirm its earlier position in support of a recycling tax credit.

We feel that there are a number of strong arguments which can be made for adjusting federal tax policies to promote and stimulate increased recycling. As I have indicated earlier, problems related to solid waste are growing in magnitude and in the long term will likely overshadow the problems of air or water pollution. The cost to taxpayers for handling solid waste is staggering when disposition of these wastes is handled by landfill, dumping, or incineration. However, some 60 percent of the solid wastes being disposed of are paper products which, given an equitable economic base, could be profitably recycled for productive consumption rather than being thrown into the ever-growing solid waste stream for costly disposal. Our company feels that recycling deserves stimulus as one solution to the dilemma posed by the disposal of solid waste.

The record is also full of information to affirm that the production of paper products by recycling rather than utilizing virgin materials consumes substantially less energy. The President's Citizens Advisory Committee on Environmental Quality conservatively reported last month that the production of recycled paper requires from 25 to 50 percent less energy than production from virgin pulp.

And, while trees are a renewable resource, no one can deny that effective solid waste management programs help preserve our natural resources and reduce our reliance on foreign sources of raw material supply. At an average disposal cost of $26–$35 a ton, it simply makes good common sense for us to develop a national policy of encouraging the resource recovery and reutilization of our basic raw materials. A healthy recycling industry will create the necessary markets to make resource recovery programs work and to greatly reduce the cost of solid waste management burdens on local government.

We in the State of Wisconsin were proud to initiate one of the first statewide Solid Waste Recycling Authorities. Our company has worked diligently with the Wisconsin Authority, attempting to establish markets for the by-products of resource recovery. Given tax parity, we are convinced that more firms would make the necessary capital investments to expand recycling capability thereby providing the markets for municipal collection programs, and again, greatly reducing the solid waste disposal costs of our cities and states.

Finally, it has been charged that the recycling tax credit section of this bill merely creates another loophole through which existing recyclers will obtain an unjustified windfall. As members of the committee know, adequate safeguards have been written into the committee's original report. Our industry, along with the committee's staff, worked diligently to arrive at a fair and equitable recycling tax credit which would not only place companies who are recycling at parity with their competitors who receive special tax incentives, but more importantly would provide the manufacturer of recycled paper products a real incentive to increase his use of wastepaper. That increased use of wastepaper provides the wastepaper dealer with the incentive to increase his purchases from the public and private collectors and to sort these wastes in order that the wastepaper might be used at its highest economic value. Accommodation had to be made to avoid windfall situation while at the same time not to penalize those who have been recycling for a number of years. To apply the tax credit to new recycling operations only would have been severely damaging to existing recycling efforts. Such an approach ignores the fact that what is sought is tax equalization between scrap materials and virgin materials, not tax advantages. Some credit should be given to those already in the industry who are, by far, in the best position by virtue of technology, vendor relationships, and operational experience to enlarge or reactivate their recycling efforts. Through the establishment of a base period and a policy which would provide that the tax credit accrue only to those who increase their recycling over the base period, it seems to us that the committee has adequately protected the taxpayers from unjustified windfall profiteering.

Today, manufacturers who utilize recyclables as a rew material are already competing with integrated manufacturers who utilize virgin raw materials upon which they enjoy, without limitation, either a full depletion allowance or a low capital gains tax treatment. In comparison to such a policy, the proposed phasing-in of a recycling tax credit which is limited to only incremental increases in recycling over a base period will certainly protect the treasury while at the same time increase recycling rates. To argue that the credit is not substantial enough to increase recycling is to argue that it will have a minimal drain on the treasury since it would be impossible to have both huge

revenue losses and no perceptible increase in recycling the way the proposal has been drafted.

But perhaps more important to the question of potential revenue loss is the question of revenue savings because of increased recycling. Since only the user of recyclables qualifies for the credit, collectors, processors and transporters will not receive the direct credit. They will, however, experience increased recycling income upon which they will pay new taxes at the normal tax rate. Secondly, the purpose of the credit is to provide integrated manufacturers now married by the tax laws to virgin utilization the option of switching to recyclables. To the extent the manufacturer switches, there is simply a transfer of the virgin tax benefit to the recycling tax benefit with no net loss to the treasury. And, finally, every ton of solid waste recycled does not have to be disposed. The adoption of this tax credit will increase recycling and will save a major portion of the $3.5 billion our cities and states are spending annually to dispose of their wastes.

In earlier hearings in this recycling tax credit, you were advised that the recycling tax credit, if enacted, would increase wastepaper recycling 50 percent by 1980 and would duble it by 1985. Today we estimate that we are recycling as little as 18 percent of our wastepaper. Legislation is needed and needed now to achieve greater utilization of the nation's recoverable resources. Economic incentives must be provided as the principle basis for reversal of current trends in the usage of recyclable materials.

STATEMENT OF M. J. MIGDOLL, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF RECYCLING INDUSTRIES, ACCOMPANIED BY ROBERT S. KAHN, PRESIDENT, KEYSTONE RESOURCES OF PITTSBURGH, CLEVELAND, SAN FRANCISCO, NEW YORK CITY, GREENSBORO, AND GEORGIA; HAROLD GERSHOWITZ, EXECUTIVE VICE PRESIDENT, WASTE MANAGEMENT, INC., OAKBROOK, ILL.; RICHARD WAND, ADMINISTRATIVE VICE PRESIDENT, BERGSTROM PAPER CO., NEENAH, WIS., AND WEST CAROLLTON, OHIO; HARLAN CARROLL, SOUTH WIRE CO., CARROLTON, GA.; AND EDWARD L. MERRIGAN, WASHINGTON COUNSEL FOR NATIONAL ASSOCIATION OF RECYCLING INDUSTRIES

Mr. MIGDOLL. Thank you, Mr. Chairman. We are here to urge in the strongest possible terms the reaffirmation by this committee of its earlier decision to approve the proposed tax incentive provision in the tax reform bill, and in these few minutes, Mr. Chairman, to respond to the baseless, unjustified, myopic and often self-serving criticisms that have been unfairly leveled against this provision and its supporters.

The hearing record before this committee irrefutably documents the findings of scores of Government sources, and private organizations that say simply yes, a recycling incentive is needed, clearly and unquestionably needed.

This matter began in the Joint Economic Committee in 1971. In 1973 the National Commission on Materials Policy created by this Congress said, we recommend that the Federal Government give users of materials economic incentives in the form of tax credits for expanded use of recycled materials.

The National League of Cities, the U.S. Conference of Mayors, the Council of State Governments and endless numbers of organizations have come before this group and urged the same thing.

Mr. Chairman, the recycling tax provision this committee has approved is no overnight phenomenon. It is not narrow interest legis-

lation. It is not a windfall for recyclers. It is not a special advantage to the recycling industry. It is not of limited environmental importance. It is not a revenue loser.

Yet those are the specific criticisms that have been fallaciously thrust at the recycling tax proposal adopted by this committee. For instance, there are the environmental organizations that simply want to hold this industry and its activities hostage to fulfill its ambitions in removing the existing depletion allowances into capital gains benefits.

Your committee has overwhelmingly rejected the removal and reduction at this time of those allowances.

What about the critics who charge windfall? They must not have studied the committee's record on this and the provision in this bill. The facts are that the pending proposal, although an important initial step in providing recycling stimulus, will be fare from equitable tax treatment with virgin materials. The pending provision has limitations and controls so as to place the overwhelming proportion of the tax incentives on new and incremental recycling.

In fact, the committee report clearly states, and I quote, "The revenue loss from a recycling tax credit need not produce a net decrease in budget receipts."

And finally, what about the corporate critics who suggest that aluminum or copper or some other commodity be excluded? There must be a reason they do not want to be included. The reason is that this handful of companies prefer the status quo of the present industrial situation to an enlightened new era for recycling.

Mr. Chairman, we are here to plead with you and the committee to reject the insidious attempts to intimidate the sponsors of this proposal, to impugn their integrity and motives by falsely calling this provision special interest, where in fact the tax provision would be applicable to all who want to recycle, and is vital to the environmental future of America.

A few days ago the Senate overwhelmingly passed the Solid Waste Utilization Act, authorizing hundreds of thousands of dollars in grants and loans for municipal and State resource recovery programs which according to the committee report, Public Works Committee report, accompanying the bill, will not succeed unless new recycling markets are developed.

Ironically, there is no more important tax reform element in the entire tax bill than this recycling provision. It literally reforms our nation's materials policy objective. It does so without windfalls. It does after years of thorough and open studies of the problems of recycling.

The CHAIRMAN. Thank you very much for your statement.

I notice it indicates that the president of the U.S. Conference of Mayors, my dear friend, Moon Landrieu, who also was president of the National League of Cities, is strongly in favor of what you are saying.

Mr. MIGDOLL. Yes, Mr. Chairman.

If I may, the League of Cities and the Conference of Mayors asked me to be sure and bring to the committee's attention the most recent letter addressed, July 20, to the committee reinforcing the strong feelings of the Nation's cities in favor of this provision.

[The letter referred to follows:]

NATIONAL LEAGUE OF CITIES,
U.S. CONFERENCE OF MAYORS,
Washington, D.C., July 20, 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance,
Washington, D.C.

DEAR MR. CHAIRMAN: As you continue your hearings on the Tax Reform Act of 1976 we want to let you know of our organizations' strong support for the concepts embodied in Section 2006 (Recycling Tax Credits). Further, we would urge your adoption of Amendment No. 2107 proposed by Senators Gravel and Tunney which would further refine and improve this section to make it compatible with other national objectives contemplated in the legislation.

The recycling tax credit provisions are important to cities and to the nation as a whole. Over half of the larger communities in the country are expected to run out of landfill capacity within the next three years. Resource recovery is one alternative strategy which will greatly reduce the volume of solid waste cities have to dispose of. Presently, however, it is not possible for cities to get involved in resource recovery in any substantial fashion due to a number of factors. One of the most significant of these constraints is the unavailability of adequate markets for recycled materials.

We firmly believe that Section 2006 of the Tax Reform Act of 1976 as perfected by the Gravel/Tunney Amendment offers significant relief to this problem. Further, it represents a major first step in achieving a national objective we all support—the most efficient and effective use of materials and energy.

We urge you and your colleagues to adopt this measure.

Sincerely,

JOHN J. GUNTHER,
Executive Director, U.S. Conference of Mayors.
ALAN BEALS,
Executive Vice President, National League of Cities.

The CHAIRMAN. Thank you very much.

Next we will call on Mr. Arthur C. Kruetzer, vice president and general counsel of the National LP Gas Association.

[The prepared statement of Mr. Arthur C. Kruetzer follows:]

STATEMENT ON BEHALF OF THE NATIONAL LP-GAS ASSOCIATION BY ARTHUR C. KRUETZER, VICE PRESIDENT AND GENERAL COUNSEL

SUMMARY OF PRINCIPAL POINTS

1. The present method of taxation and handling of the motor fuel excise tax on use of propane in industrial lift trucks is inequitable and discriminatory, for the reason that equal or comparable tax is not imposed on competitive industrial lift trucks powered by electricity or diesel.
2. The favored tax position provided for electric powered lift trucks represents stimulation of an inefficient use of energy resources.
3. Conversion to use of propane in the desire to provide a cleaner working atmosphere should not be penalized.
4. Revision in tax handling will eliminate substantial confusion for the lift truck user, the fuel supplier, and the tax collector.
5. The amount of tax revenue involved is insignificant.

It is our recommendation that Sec. 4041 of the Internal Revenue Code be amended to limit the tax on liquefied petroleum gas (propane) to use in a highway motor vehicle. A suggested revision is attached to this statement.

INTERESTED PARTY AND PURPOSE

The National LP-Gas Association is a national trade association, having as members the producers of liquefied petroleum gas, the manufacturers of equipment and appliances using liquefied petroleum gas, and the distributors and dealers. LP-Gas is the common name used for our product. The Association has over 5,500 member companies and 43 affiliated states. The membership represents over 90% of the industry's volume of business. Its membership is predominantly at the distributor and dealer level. The Association's position as set out in this statement would also reflect the position of other industry companies. The more direct marketing impact of the tax discussed herein is felt by these distributors and dealers

who sell LP-gas at retail. The employment and economic well-being of over 75,000 employees is involved in the LP-gas dealer's business and the problem presented. The manufacturers of, and dealers in equipment utilizing LP-gas are also adversely affected. Again, to the degree indicated in this statement, this problem is of serious concern to thousands of users of LP-gas equipment.

Our purpose in appearing is to inform this Committee of the existing discriminatory tax treatment accorded LP-gas, as compared with competing fuels in their use for the same purposes, the adverse impact on other national goals, and to apprise you of the confusing, burdensome, and impractical administrative application and handling of the present tax on LP-gas in non-highway motor fuel use incurred by both the government and the user. In solution of these problems we recommend that the motor fuel tax on LP-gas be limited to use in a highway vehicle. This recommendation is also aimed at limiting the tax to those who receive the benefit.

PRODUCT AND TAX INVOLVED

LP-gas is composed of propane, butane, propylene, butylene, and their mixtures. It is an energy source, or fuel, and a small part[1] of total product usage is in motor fuel, principally off the highways. A portion of such motor fuel use is in industrial tractors, or industrial lift trucks. The tractor pulls or pushes a load and the lift truck carries it. It is herein that we encounter difficulties with federal excise tax administration and our statement is partially directed at that problem. In this usage LP-gas is a necessity in material handling and industrial processing, and its taxation becomes a business cost. To follow one step further, the tax burden on competitive products or business is not the same. It varies according to the means employed. Again, because of the diverse end products this tax impact cannot be evaluated.

The federal excise tax involved is the basic 2 cents a gallon tax on special motor fuel. (Sec. 4041) The additional gallonage taxes on highway vehicle use dedicated to the Highway Trust Fund are not involved. LP-gas is one of the special motor fuels subject to Sec. 4041. The others are benzol, benzine, naphtha, casinghead and natural gasoline, "or any other liquid". The other liquids that may be involved are unknown to us. The products, other than propane, have little, if any, motor fuel use.

Gasoline, or Sec. 4081 tax products, and kerosene, gas oil and fuel oil are specifically excluded, and diesel fuel is separately handled as will be later covered. The special fuel tax is imposed on use in a motor vehicle. A motor vehicle is defined by Treasury Department interpretation as a vehicle designed to carry or support a loan. Consequently, this tax applies on LP-gas use in an LP-gas powered industrial lift truck and this is our area of concern.

DEFECTS IN PRESENT TAXATION

1. The present special motor fuel tax is inequitable and creates discrimination, placing LP-gas at a competitive disadvantage

Competing electric battery powered or diesel fueled industrial lift trucks do not face similar fuel or power sources taxation. There is intense competition in this industrial tractor market and the LP-gas powered vehicle, and LP-gas use, is handicapped through unequal and discriminatory tax treatment that unfairly aids competition. Fuel cost is a substantial element in an industrial plant's decision on the type of lift truck to purchase and the 2 cents a gallon tax as reflected in total operating cost is many times the deciding factor.

Diesel fuel has a basic 2 cents a gallon federal excise tax but only on use in a highway vehicle. The tax is not imposed on use in an industrial plant nonhighway motor vehicle. A tax element of fuel cost is not faced when a diesel fueled industrial lift truck is purchased, or diesel fuel is used.

The electric or battery powered industrial lift truck does not face this tax, or any comparable tax, as an element of operating cost. Lower operating costs as a result of the tax favored position are a strong competitive sales argument used by electric lift truck suppliers in their advertising and promotional material. Competitive promotion of the electric lift truck emphasizes this tax advantage. Removal of the handicapping tax on LP-gas will not completely eliminate this cost differential, but it will place LP-gas on a more equitable and

[1] Total internal combustion use in 1974, the latest year available was 1,309,750,000 gallons or under 10 percent of total product use (U.S. Bureau of Mines Report). The major portion of this 10 percent is on the farm, for tractors, irrigation pumping, etc.

competitive plane. The effect of this promotion is demonstrated in the following statistical data compiled by NLPGA.

	1966	1971	1976
INDUSTRIAL TRUCKS IN USE			
Total	623,200	774,000	984,000
Electric walkers	79,600	111,100	162,300
Percent of total	(12.8)	(14.4)	(16.5)
Electric riders	76,200	121,100	182,100
Percent of total	(12.2)	(15.6)	(18.5)
LP-gas riders	289,800	335,900	396,600
Percent of total	(46.5)	(43.4)	(40.3)
Gasoline and diesel riders	177,600	205,900	243,000
Percent of total	(28.5)	(26.6)	(24.7)
	1965	1970	1975
SHIPMENTS			
Total	59,900	69,800	66,400
Electric walkers	8,200	13,800	14,400
Percent	(13.7)	(19.8)	(21.7)
Electric riders	10,000	14,800	19,000
Percent	(16.7)	(21.2)	(28.6)
LP-gas riders [1]	25,900	25,500	20,500
Percent	(43.2)	(36.5)	(30.9)
Gasoline and diesel [1]	15,800	15,700	12,500
Percent	(26.4)	(22.5)	(18.8)

[1] Revised to reflect field conversions.

It will be seen that the market share, in the ten year period, of Electric Walkers increased by 3.7 percent, the Electric Riders by 6.3 percent while the LP-gas lift truck lost 6.2 percent of the market. While Gasoline and Diesel Riders also decreased by 3.8 percent the loss is believed to be primarily in gasoline units that were converted to propane. Contrasting 1965 and 1975 shipments reveal a much greater market takeover by electric fuel vehicles where in riders, the principal competitive unit, electric units showed a 11.9 percent gain, and LP-gas units dropped 12.3 percent. Not only did LP-gas market shares drop, but there was an actual decrease of 5400 units.

To carry this element of discriminatory treatment between competing methods one step further, as a material handler the lift truck serves as a conveyor of materials. There is no comparable tax on the power that supplies conveyors of the many other types, such as a built-in belt conveying system. There are also material handlers or conveyors in electric powered pallets. The effect of this basic 2 cents a gallon federal excise tax on LP-gas as a special motor fuel is to create an inequitable and discriminatory tax that encourages tax free competition.

2. The tax favored position provided for electric powered lift trucks represents stimulation of an inefficient use of energy resources and impairs energy conservation

In a governmental report[2] it is estimated that the efficiencies in producing and delivering electricity range from 10 to 25 percent. In other words there is a loss of energy resource employed in the production of electricity of from 75 to 90 percent. The mentioned report further states that systems for providing fuels directly to the consumer are more efficient. "The greatest potential for energy conservation is often in the selection of the right energy system for a particular need".[2] The direct use of propane in an industrial lift truck is both a more efficient use of a natural resource, and the selection of the right energy system for a particular need. We submit that instead of penalizing use of propane through inequitable taxation, its use should be encouraged. Or to express it otherwise inefficient and wasteful use of energy resource should not be stimulated. These twin objectives can be met by removing the federal excise tax on use of propane in an industrial lift truck.

3. Conversion to use of propane in the desire to provide a cleaner working atmosphere should not be penalized

Many industrial plants bought LP-gas fuel or converted existing lift trucks using other fuels to use of propane with the objective of providing a more de-

[2] Energy—Environment and the Electric Power Prepared by the Council on Environmental Quality, August 1973.

sirable, or less polluted atmosphere through use of clean burning propane instead of fuels that place the worker in an atmosphere created by fuels with undesirable emissions. This upgrading of working environment should be encouraged by removal of any tax disincentive. National tax policy should encourage use of clean fuel. Propane is a clean burning gas, as contrasted with fuel used in other internal combustion engines. Some states with the objective of encouraging use of clean fuel have completely eliminated, or reduced, their highway motor fuel tax on propane. In this statement we are only requesting removal of the inequitable federal tax penalty.

4. Revision in tax handling will eliminate substantial confusion for the lift truck user, the fuel supplier, and the tax collector

The administration of the present law by IRS, and tax handling by the LP-gas fueled industrial lift truck user, is complex, confusing and costly. To appreciate the problems involved it should be first noted that the tax is applied to use in motor vehicles, defined by the Treasury Department as vehicles designed to carry or support a load. Use in a vehicle that pulls or pushes a load is not taxable. An industrial lift truck is in the first category. An industrial tractor is in the second category. Industrial operations commonly involve both types of vehicles. Consequently, we find in the same industrial plant, drawing from a common fuel source, the two types of vehicles. In addition the fuel may be used for other non-taxable purposes in the plant. The determination of how much fuel is used for taxable purpose and how much for non-taxable purpose presents problems of substantial difficulty both to the Government and to the taxpayers. Tax determination by the user and effective enforcement by the Government is costly.

Substantial confusion exists among users as to the tax application that understandably resists clarification when the complexity is recognized. This confusion is not limited to users. In the past we have seen differing interpretations from differing IRS District Offices. A simplification of tax bill will serve both Government and the taxpayer with little effect on tax income.

5. The tax revenue involved is insignificant

The tax dollars involved on special motor fuels under Sec. 4041 are not consequential. While as earlier mentioned, this tax applies to specified other liquids, their taxable use is de minimis insofar as we can ascertain. This tax, in addition to being on use in motor vehicles, applies to use in motorboats and airplanes. LP-gas is not so used, and we understand that use of other special motor fuels, if any, is insignificant.

LP–gas taxable use in motor vehicles, other than in highway vehicles, would largely be confined to the industrial lift truck. Our calculations based on the number of LP-gas powered lift trucks in use at the end of 1976 and the average usage indicate that the tax involved would approximately $9.3 million dollars a year.[3] Taxes would also fluctuate widely with industrial productivity.

SUMMARY AND RECOMMENDATION

Therefore, in the interest of competitive equity, efficient use of natural resources, encouragement of use of clean fuel, tax clarity, and administrative convenience we recommend that the existing special motor fuel tax law be modified to limit tax application to special motor fuel use in a highway vehicle, or if such proposal covers too broad a field of tax producing special fuels, which we consider unlikely, the motor fuel taxation of LP–gas be limited to use in a highway vehicle as is the present treatment provided for diesel.

While Sec. 2009(c)(2) of the Tax Reform Act of 1976 would create this equity through providing for a refund of tax when non-highway use was involved, we suggest that equity can be better accomplished, tax handling simplified, and cost to user and government alike eliminated through tax revision to remove initial imposition of this tax. Amendatory language is attached.

Respectfully submitted.

ARTHUR C. KREUTZER,
Executive Vice President and General Counsel,
National LP-Gas Association.

[3] 806,000 LP-Gas lift trucks in use with an average annual use of 1,200 gallons.

SUGGESTIVE TAX REVISON

Sec. 4041 Imposition of tax

(b) *Special motor fuels.*—There is hereby imposed a tax of 4 cents a gallon upon benzol, benzene, naphtha, liquefied petroleum gas, casinghead and natural gasoline or any other liquid (other than kerosene gas oil, or fuel oil, or any product taxable under Sec. 4081 or subsection (a) of the Section.

(1) Sold by any person to an owner, lessee or other operator of a highway motor vehicle or motorboat for use as a fuel in such highway motor vehicle or motorboat; or

(2) Used by any person as a fuel in a highway motor vehicle or motorboat unless there was a taxable sale of such liquid under paragraph (1).

(Strike remaining language of Sec. 4041).

STATEMENT OF ARTHUR C. KRUETZER, VICE PRESIDENT AND GENERAL COUNSEL, NATIONAL LP GAS ASSOCIATION

Mr. KRUETZER. Mr. Chairman, this statement supplements and summarizes the written statement previously delivered to the committee, and it relates to 2009(c)(2). It is requested that the filed statement become a part of the record with a correction on the last line of the proposed tax provision, strike the remaining language of section 4041(b).

We requested special tax revision covering the use of propane in other than a highway vehicle for the sole reason of correcting existing inequities and discrepancies, where taxation is not imposed on the competitive fuel similarly used.

This tax imposition is unfair both to the LP gas dealers supplying propane and the users. There are also related side benefits creating tax equality, an environmental improvement and energy conservation.

In view of Senator Kennedy's listing the requested tax relief as a special interest benefit, we have comments. It is apparent to us the Senator was misinformed when he relates benefits to this corporation. The only possible relation is the Eaton Corp. manufactures industrial lift trucks, but they are only one of several companies so engaged. Nine major manufacturers, including Eaton, make LP gas fuel lift trucks, but also make lift trucks powered by other fuels. It would profit none to have an inequitable tax paid by the user removed on one type fuel when it can easily sell its other fuels.

It is our viewpoint that in the bill sought to remove an existing inequity that confronts 5,000 LP gas dealers and uncounted thousands of industrial users of LP gas fueled lift trucks.

The committee action would well be viewed not as a tax benefit, but as the removal of an unjust policy. It would correct what we consider an unintended result of the original tax statute language and IRS interpretation of the term "motor vehicle" that was solidified before the LP lift truck was born.

Correction of this inequitay was urged in full sunshine and over an extended period. It was presented to this committee in a statement on April 13. However, we have presented this inequity at earlier times in the House Ways and Means Committee and to individual Members of Congress.

The House committee has not considered an excise provision recently. It has also been discussed with IRS and Treasury Department on several occasions. Neither has the tax effect been concealed, as outlined in our statement, and is not significant.

We therefore consider the tax reform provision fully justified in correcting existing inequities, and are grateful to the committee for so acting.

In the draft, this is accomplished by a refund on nonhighway use. We suggest in the interest of simplified handling and elimination of costs both to the user and government alike, initial imposition of the tax be limited to use in a highway motor vehicle similar to the diesel tax and provision rather than requiring the paperwork of refund. However, if there are reasons for not so handling, the committee revision is a big step in removing inequity.

Thank you, Mr. Chairman and gentlemen.

The CHAIRMAN. You had better explain for the record what LP gas is. Is it propane?

Mr. KRUETZER. Propane.

The CHAIRMAN. I know what propane is. I know what liquefied petroleum is. When you call it LP——

Senator CURTIS. I thought that was a long playing record.

Mr. KRUETZER. We hope that it will be a long playing record, Senator. That is what we seek to establish.

Senator FANNIN. I know that you are very familiar with this program. Do you feel, Mr. Kruetzer, that the extra work involved in filling out all of the forms, including the work both at the level of the supplier as the level of the user, both, that it offsets the revenues involved?

Mr. KRUETZER. I would think so, Senator.

Senator FANNIN. That is the important matter. It is very unfair if you use one fuel in that lift work. It is off the highway. It should not have a highway tax involved, if you use one fuel, propane, and you have to pay the tax, if you use another fuel or another energy source, then you do not have to pay the tax. I agree with you.

Thank you.

Mr. KRUETZER. Thank you.

The CHAIRMAN. We were to have heard from Mr. Halvorson. He testified earlier.

Therefore we will call Mr. Harold J. Heltzer on behalf of Richard Barrett, for Stackpole-Hall Foundation.

[The prepared statement of Mr. Barrett follows:]

STATEMENT OF RICHARD F. BARRETT, ESQ., ON BEHALF OF THE STACKPOLE-HALL FOUNDATION

SUMMARY

Section 4943 of the Internal Revenue Code requires private foundations to dispose of excess business holdings stock. In addition, Section 4941 imposes a penalty if a disposition is to a disqualified person. In order to promote the disposition of business holdings, Congress provided a transitional rule which permitted dispositions to qualified persons at fair market value without imposition of the penalty, if the transfer occurred prior to January 1, 1975.

The effective utilization of the transitional rule has been hampered because the fair market value of the stock is uncertain and without advance review by the Internal Revenue Service may subject disqualified persons, as prospective purchasers from a foundation, and the foundation managers with a penalty on the full fair market value as ultimately determined, plus reversal of the transaction. As a result, the intended beneficiaries of the transitional rule, who were supposed to be foundations holding stock of closely-held corporations, have been unable to utilize the benefits.

Section 2514 of the Bill (H.R. 10612) provides for an extension of the transitional rule to January 1, 1977. It is hoped that this extended period will afford private foundations, their managers and disqualified persons with the opportunity to engage in such transactions in a manner which will reduce the risk of penalty to a reasonable limit and, to the extent practicable, to obtain Treasury Department or Internal Revenue Service guidance in such matters. It is of important significance that this extension will afford those private foundations holding stock of closely-held corporations the same benefits as other private foundations owning publicly traded stock and who do not have to confront the very factual problem of the fair market value of their stock.

We urge your continued support of this amendment.

STATEMENT

In enacting section 4943 of the Internal Revenue Code of 1954 (the "Code"), Congress required private foundations to dispose of excess business holdings stock. Contemporaneously, Congress enacted section 4941 of the Code (the "self-dealing" provisions) which, under its general application, would impose a severe penalty if the disposition of the excess business holdings stock were to be to the only available market in most cases, i.e., to one or more disqualified persons, as defined in section 4946(a). Recognizing the desirability of promoting the disposition of excess business holdings stock, Congress enacted Public Law 91-172, § 101(1)(2) (the "transitional rule") to provide a transitional period in which disposition might be made to a disqualified person at fair market value without imposition of the section 4941 penalty.

The transitional rule had two major aspects: (1) the permitting of sale of excess business holdings owned on May 26, 1969, to a disqualified person at fair market value at any time until expiration of the "grace periods" under section 4943(c)(4)(B), and (2) the permitting of sale of business holdings owned May 26, 1969, which were not "excess" business holdings by reason of section 4943 (c)(4) prior to January 1, 1975, to a disqualified person at fair market value. It is the extension of this second aspect (2) to January 1, 1977, which section 2514 of the Bill would enact.

The effective utilization of the transitional rule to date has been limited because the fair market value of the stock of closely-held corporations is inherently uncertain and incapable of being established with precision in advance of review by the Internal Revenue Service. Accordingly, disqualified persons, as prospective purchasers from a foundation, and the foundation managers were faced with the risk of a section 4941 penalty on the full fair market value as ultimately determined, plus reversal of the transaction. Such a risk constituted a substantial deterrent to taxpayers seeking to come within the transitional rule; has prevented full utilization of the transitional rule; and thereby has frustrated the Congressional policy underlying its enactment.

The principal beneficiaries of the transitional rules have been those foundations holding publicly traded stock with established market values, not the intended beneficiaries, the foundations holding stock of closely-held family corporations with unlisted untraded stocks with no known market value. These foundations have found themselves in an Alice-in-Wonderland atmosphere which it was never Congress' intention to create. The Ford Foundation, as an interesting, contrasting example, is understood to have sold to the Ford Motor Company a very large amount of Class A non-voting Common shares, commencing with an initial sale of $150,000 in 1972 under transitional rule (2) above and the existence of an advance ruling dealing with market value of the Class A.

In addition, many private foundations were and still are faced with the problem of ascertaining the precise amount of their excess business holdings. This calculation rests, in many cases, on the determination of whether the corporations in which they hold stock are themselves disqualified persons by virtue of being substantial contributors as defined in section 507(d)(2) of the Code, a determination which rests substantially on the question of the fair market value of the stock at the applicable date of contribution. The Stackpole-Hall Foundation, the private foundation involved in this proposed legislation, is in the position of uncertainty as to its holdings.

The risk of imposing the self-dealing tax was partially reduced by the Treasury Department by the issuance of regulations in 1973 which provided that, if "good faith" efforts were made to determine the fair market value, the penalty would be limited to the excess of the fair market value of the stock transferred over the amount received by the foundation. However, the factual nature

of the "good faith" test and the absence of any other published guideline relative to the determination of fair market value still make it quite risky for a taxpayer to proceed with any firm assurance of compliance with the self-dealing provisions. As of this date, the undersigned is advised by the Internal Revenue Service that it will not issue advance rulings that a proposed procedure outlined by the taxpayer will meet the "good faith" test.

Accordingly, this Bill provides for an extension of the transitional rule to January 1, 1977. It is anticipated that this extended period will afford private foundations, their managers and disqualified persons with the opportunity to engage in such transactions in a manner which will reduce the risk of penalty to a reasonable limit and, to the extent practicable, to obtain Treasury Department or Internal Revenue Service guidance in such matters. It is of important significance that this extension will afford those private foundations holding stock of closely-held corporations the same benefits as other private foundations owning publicly traded and quoted stock which, by reason thereof, do not have to confront the very factual problem of the fair market value of their stock. It is, as has been stated, those private foundations which hold stock of closely-held corporations which should be the primary beneficiaries of the transitional rule but which have been unable to utilize it to date. To date, the effective use of the transitional rules by many private foundations has been stymied, a result not intended by Congress and which it can help geatly to avoid by enacting section 2514 of the Bill.

STATEMENT OF HAROLD J. HELTZER ON BEHALF OF RICHARD F. BARRETT FOR STACKPOLE-HALL FOUNDATION

Mr. HELTZER. Thank you. Mr. Chairman and gentlemen. I am testifying in place of Richard Barrett who could not be here today. He is ill. I am here to urge you to strongly support section 2414 of the bill that would provide an additional extension to January 1, 1977, of the transitional rule under which a private foundation could sell certain business holdings to a disqualified person without incurring the imposition of the self-dealing tax under section 4941 of the code.

Mr. Chairman, we are not talking about a new law or a new amendment, but a transitional rule that Congress focused upon and enacted in 1969. The purpose of the transitional rule that was enacted in 1969 was to permit foundations to sell nonexcess business holdings to disqualified persons, or to remove the foundation from the clutches of the disqualified corporation.

This amendment was reviewed in 1969 and enacted and has been thoroughly reviewed and discussed with the Joint Committee and with the staff of the Treasury Department. The Treasury Department has no objection to this proposal.

The reason why we are seeking an extension with regard to this transitional rule is simply that Congress did not foresee that the original transitional rule in 1969 would only assist large publicly held corporations, but that is who it did help, not the small, closely held corporations. The original purpose was to help the disposition of small business stock to disqualified persons, and has been frustrated because of the vagaries in valuing the securities involved.

Let me explain briefly. Section 4941 of the code inhibits self-dealing transactions by imposing upon a self-dealer a tax equal to 5 percent of the fair market value of the property transferred. In 1969, however, the transitional rule permitted private foundations to dispose of business holdings to the issuing corporation, even though the corporation was a disqualified person, and this was to foster the policy of limiting the involvement of private foundations in business enterprises.

However, the problem was and still is, if you sold the stock to a disqualified person before January 1, 1975, based upon what the foundation thought was a fair market value, and the foundation was wrong, it would have been subject to a self-dealing tax penalty equal to 5 percent of the amount of property transferred, not the amount that the foundation was short changed.

In addition, the transition was subject to reversal. It could have been corrected by return of the stock and the purchase price of the foundation. These rules severely limited the utilization of this particular transitional rule. Simply stated, the amendment which we are proposing today would provide for an additional extension of the transitional rule through January 1, 1977, and would permit a foundation to sell certain business holdings to related persons without incurring the self-dealing tax.

It is hoped that the Internal Revenue Service will use the additional time as a result of this amendment to promulgate clearer guidelines enabling foundations to make greater use of this transitional rule, and this certainly will enable and achieve and foster the purpose as originally envisioned by this Congress when it enacted the transitional rule in 1969.

As I indicated, the administration has no objection to this proposal, We urge this committee's support of this amendment.

Thank you.

The CHAIRMAN. Thank you very much.

Next we will call Mr. John S. Nolan on behalf of the estate of Charlotte M. O'Toole.

[The prepared statement of John S. Nolan follows:]

SUMMARY OF STATEMENT IN SUPPORT OF SECTION 2104 OF THE TAX REFORM ACT OF 1976

The Tax Reform Act of 1969 provided that a bequest or gift to charity of a remainder interest in trust could qualify for a charitable deduction only if rigid statutory requirements of a "charitable remainder trust" were satisfied. This was a radical departure from over 50 years of prior law. The reason for these provisions was to ensure that charity received its full remainder interest.

The Treasury Department in regulations issued without specific statutory authority allowed all trusts and wills to be amended to comply until December 31, 1972. As a relief measure, Congress added § 2055(e)(3) to the Code in 1974, thereby generally extending the termination date of the regulations transition rule to December 31, 1975, but only for instruments drafted before September 21, 1974. Under H.R. 9889 (passed by the House by voice vote on June 22, 1976), the benefits of § 2055(e)(3) would be further extended for an additional two years.

Section 2104 of the Tax Reform Act of 1976, as reported by the Senate Finance Committee, would also extend the transition rules of § 2055(e)(3) of the Code for an additional two years but would allow reformation with respect to all wills and trust instruments drafted before December 31, 1977. This is entirely proper; there is no reason to deny the relief based on the date the will or trust was executed. No one would have intentionally drafted a non-conforming will or trust. The purpose of § 2104 is to protect against unintentional failures to comply and thus to protect the charities.

Section 2104 is a measure which furthers the Congressional policy underlying the reforms enacted in 1969 by preventing a loss of the charitable deduction, a loss which will ordinarily fall on the charity, not the donor. Section 2104 does not exempt trusts from meeting the statutory requirements but in effect requires that non-qualifying instruments be amended to *comply* with the charitable remainder trust provisions. Providing a "last chance" to amend all non-qualifying wills or trust instruments ensures that § 2104, and the requirements of the Tax Reform Act of 1969, will be broadly publicized. Section 2104 is *not* a provision enacted by the Senate Finance Committee to assist only one or a few taxpayers. There are hundreds of noncomplying wills and trusts in existence, with a poten-

tial loss to charities that could be very substantial. The Senate Finance Committee has merely incorporated and improved a provision which was thoroughly considered by the House Ways and Means Committee and was passed by the House.

STATEMENT

Prior to the enactment of the Tax Reform Act of 1969, a charitable deduction was generally allowed to a decedent's estate for the present value of a bequest of a partial interest in property to a qualifying charity. Such gifts were commonly made in the form of a trust under which part or all of the income was payable to one or more individuals for life with the corpus of the trust to be paid over to one or more charitable institutions upon the termination of the life estates. Treasury regulations have recognized the deductibility of such a remainder interest in trust from the time that deductions for charitable gifts were first allowed by the Revenue Act of 1918. See Art. 53 of Regulations 37. The precise form such a remainder interest took was not important so long as the value of the interest was ascertainable and it was certain to be received by charity.

The Tax Reform Act of 1969, therefore, represented a radical departure from more than 50 years of prior law in providing that a remainder interest in trust could not qualify for a charitable deduction unless it was structured as a "charitable remainder annuity trust", a "charitable remainder unitrust" or a "pooled income fund." The statutory definition of each of these types of qualifying "charitable remainder trust" is highly restrictive and technical. Especially since the publication of final regulations interpreting these terms, there is no way a qualifying charitable remainder trust can be drafted without a detailed knowledge of the applicable provisions of the Code and regulations. In fact, the Service has rightly considered the area to be so complex that it has published sample clauses for wills and trusts which will be deemed to meet the Code's requirements. Rev. Rul. 72-395, 1972-2 C.B. 340.

For purposes of the estate tax, these new provisions of the Tax Reform Act of 1969 were generally made applicable to the estates of decedents dying after December 31, 1969. Congress recognized, however, that some transition period was necessary. Accordingly, trusts created under wills executed before October 9, 1969, and transfers in trust before that date, were exempted entirely from complying with the prescribed forms in the case of decedents dying before October 9, 1972, without having amended their will or trust or where the will and trust instrument could not be changed after October 9, 1969.

The provisions of the Tax Reform Act of 1969 regulating charitable remainder trusts were enacted to ensure that the charitable deduction allowed was consistent with the amount which charity would ultimately receive. Senate Report No. 91-552, 91st Conrgess, 1st Session 87 (1969). Notwithstanding this concern to preserve the charity's remainder interest in such trusts, it became apparent that it was the charity which would most frequently suffer from a remainder interest failing to qualify for the charitable deduction. Commonly, the increased tax burden on the decedent's estate would be borne by the principal of the trust estate, which is the portion the charity would ultimately receive.

In recognition of this counterproductive result, and the fact that the charitable remainder trust provisions were so novel and complex as to require additional time to alert the bar to their requirements, the Internal Revenue Service proposed a set of transition rules in addition to those provided by the statute. Under proposed regulations issued in 1970, post-October 9, 1969, trusts, whether established by will or under an inter-vivos instrument, could be amended into qualifying charitable remainder trusts so long as the necessary amendments were accomplished by January 1, 1971, or within 30 days after the conclusion of a court proceeding begun for that purpose before January 1, 1971. The Internal Revenue Service extended the January 1, 1971, date four times[1] and ultimately, under final regulations promulgated on August 22, 1972, fixed December 31, 1972, as the final date by which non-qualifying trusts must be amended or judicial proceedings to amend such trusts must be begun.

This administrative transition rule was adopted by the Internal Revenue Service without specific statutory authority and differs materially from the statutory transition rule in that the regulations do not exempt trusts from the charitable

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[1] T.I.R. 1060 (December 18, 1970) extended the date to June 30, 1971; T.I.R. 1085 (June 11, 1971) extended the date to December 31, 1971; T.I.R. 1120 (December 17, 1971) extended the date to June 30, 1972; and T.I.R. 1182 (June 29, 1972) extended the date to the ninetieth day after the final regulations were issued.

remainder trust provisions entirely but merely allow such trusts to be amended effective as of the date they were created. In contrast, a trust qualifying under the statutory transition rules need never be amended to conform to the restrictive requirements of a qualifying charitable remainder trust.

When the period of grace provided by the regulations ended on December 31, 1972, it became apparent from the number of non-qualifying post-1969 trusts which continued to come to light that the public was still not aware of the dramatic changes made by the Tax Reform Act of 1969. Also, because of the complicated nature of the statutory and regulatory requirements, many trusts were unable to make the necessary conforming amendments by the December 31, 1972, deadline. As a relief measure, therefore, the Senate in 1974 amended a House bill (H.R. 12035) to provide, in general, for the extension until December 31, 1975, of the transition provisions administratively adopted in the regulations. See Senate Report No. 93-1063, 93d Congress, 2d session 1 (1974). Like the regulations, the measure proposed by the Senate would apply to any will executed or trust created before the chosen termination date, in this case December 31, 1975.

In conference, the House conferees generally agreed to the Senate amendment but proposed that only trusts or wills then in existence should be eligible for relief. 120 Cong. Rec. H10509 (daily ed. Oct. 11, 1974). The Senate conferees agreed to this change and Public Law 93-483, as finally enacted, extended the transition rules of the regulations only with respect to trusts created or wills executed before September 21, 1974. As added by Public Law 93-483, section 2055 (e)(3) of the Code provides that the governing instruments of such pre-September 21, 1974, trusts and wills can be amended to conform to the charitable remainder trust provisions of the Code at any time prior to December 31, 1975, or 30 days after the termination of a judicial proceeding to reform an instrument begun before that date.

As noted in this Committee's report on the Tax Reform Act of 1976 (Senate Report No. 94-938, 94th Cong., 2d Sess. 600 (1976), notwithstanding that the provisions of the Tax Reform Act of 1969 governing charitable remainder trusts have been in effect for over six years, wills and trusts continue to be drafted by laymen and lawyers who are unaware of the restrictive statutory requirements. This is especially likely to occur in wills, because stability and continuity are traditionally recognized as being of particular importance in this branch of the law, and practitioners are not wary of radical changes. Also, a testator frequently makes very small changes to an existing instrument which will result in it being considered a new will for purposes of the transition rules under section 2055(e)(3) of the Code, but which may not be major enough to trigger the attorney's reappraisal of the entire instrument. There is a natural and understandable tendency to assume that a will drafted with care and precision once need not be reexamined in its entirety every time a minor change is made. Furthermore, there has never been a broad campaign to publicize the radical changes in this area brought about by the Tax Reform Act of 1969.

On September 29, 1975, Congressman Burke, of the House Ways and Means Committee, introduced H.R. 9889 to extend the transitional rule under section 2055(e)(3) of the Code by two additional years. H.R. 9889 would accomplish this by substituting December 31, 1977, for December 31, 1975, wherever the latter date appears in section 2055(e)(3) of the Code. The House Ways and Means Committee reported H.R. 9889 favorably (see H.R. Rept. No. 94-1268, 94th Cong., 2d Sess. (1976)), and H.R. 9889 was passed by the House by voice vote on June 22, 1976.

On November 3, 1975, Senator Curtis introduced an identical bill in the Senate as S. 2602. Section 2104 of the Tax Reform Act of 1976 (referred to as section 2106 in Senate Report No. 94-938, 94th Cong., 2d Sess. 599 (1976)) corresponds to S. 2602, with the Committee's changes to allow trusts created after September 21, 1974, and before December 31, 1977, to also qualify for amendment to conform to the requirements of the Tax Reform Act of 1969, and to allow otherwise expired claims to be reopened.

Section 2104 is a measure which will further the Congressional policy underlying the reforms enacted in 1969. As noted in this Committee's Report (Senate Report No. 94-938, at 600), it is frequently the charity which would bear the additional tax burden resulting from the loss of the charitable deduction due to the failure of an uninformed testator or his advisor to be aware of the rigid requirements for charitable remainder trusts. Penalizing the charitable remainderman in this way runs counter to the legislative purpose of protecting the charity's interest which underlies the charitable remainder trust provisions.

It is also significant that the transition rules under section 2055(e)(3) of the Code which would be extended by section 2104 do not exempt non-qualifying

trusts from the statutory requirements but rather enforce compliance by, in effect, requiring the amendment of the governing instrument. If a trust cannot be amended so as to become eligible for the charitable deduction, the charity may be penalized twice. Not only will the charity bear the burden of the increased Federal estate tax but, in addition, the trustee will not be circumscribed by the rigid rules applicable to qualifying trusts. Potentially, then, the charity could be penalized a second time by the trustee using its discretion to favor the life beneficiary, a result the charitable remainder trust provisions were designed to prevent.

Section 2104 differs from H.R. 9889 by allowing the reformation of all non-qualifying wills and trusts drafted before December 31, 1977. This is entirely appropriate, since the policy considerations for providing relief are equally compelling whether the non-qualifying instrument was drafted before or after September 21, 1974. In each case it is the charitable beneficiaries which suffer the loss resulting from the denial of the charitable deduction. This result runs directly counter to the legislative purpose underlying the charitable remainder trust provisions whatever the date of the will or trust instrument.

In limiting the relief offered by section 2055(e)(3) of the Code to trusts created or wills executed before September 21, the House conferees stated that instruments not yet drafted should not be covered. Upon analysis, however, it is difficult to see what legislative purpose is served by this distinction. Certainly denying relief prospectively did not promote compliance. It is inconceivable that any attorney or testator would consciously draft a trust or will which would not qualify as either a charitable remainder annuity trust or unitrust. Furthermore, if an attorney or testator were unaware of the fundamental rules governing this area, a subtle change in the transition rules would not have served to notify him of such requirements. This Committee's decision to have section 2104 apply to all non-qualifying instruments drafted before December 31, 1977, justifiably refuses to perpetuate an unwarranted distinction between similarly situated taxpayers.

This Committee has decided that the extension of the Code section 2055(e)(3) transition period until December 31, 1977, for all wills or trusts executed before that date will be the last such extension allowed. Accordingly, section 2104 does not represent a significant threat to the revenue. By offering a "last chance" to amend all non-qualifying instruments to conform to the charitable remainder trust provisions, section 2104 will command the attention of the bar and other testamentary advisors in a way in which the previous gradual extensions of the transition rules by the Internal Revenue Service (through regulations) and Congress (by enacting section 2055(e)(3) of the Code) did not. Thus the campaign to publicize the requirements of the Tax Reform Act of 1969 envisioned by this Committee (see Senate Report No. 94-938, at 600-601) will have the maximum potential for success.

It is important to note that section 2104 is not a provision enacted by this Committee to assist only one or a few taxpayers. There are hundreds of non-complying wills and trusts in existence, with a potential loss of charities that could be very substantial. This Committee has merely incorporated and improved a provision which was thoroughly considered by the House Ways and Means Committee and was passed by the House.

STATEMENT OF JOHN S. NOLAN ON BEHALF OF THE ESTATE OF CHARLOTTE M. O'TOOLE

Mr. NOLAN. Thank you, Mr. Chairman and members of the committee. I appear today on behalf of the estate of Charlotte M. O'Toole, in support of section 2104 of the bill that would permit charitable remainders of trusts to be amended and reformed to comply with certain technical requirements of the Internal Revenue Code. Without such opportunity to reform these trusts, hundreds of major charities, hospitals, universities and churches will suffer needlessly.

Section 2104 is unquestionably a sound provision and it should be continued in the bill. Section 2104 is in effect the adoption of a bill that has been sponsored by Senator Curtis, S. 2602, with certain improvements. A similar bill has been carefully considered by the House

Ways and Means Committee, favorably reported and passed by the House.

For the most part, section 2104 merely extends the time for reforming charitable trusts for 2 additional years beyond the time Congress has already allowed such trusts to be reformed, an action which this Committee took and Congress took in 1974.

The problem arises because of extremely complex requirements which Congress required in the Tax Reform Act of 1969, with respect to charitable remainder trusts. Such trusts must be in the form of either a so-called charitable remainder unitrust or charitable remainder annuity trust. No other form is permissible. This was a radical departure from more than 50 years of prior law.

Since these trusts are commonly included in wills which frequently are not reconsidered or changed, there are many wills in existence today that unknowingly contain charitable remainder trusts which do not satisfy the new law and which only come to light when the individuals who have executed such wills have died.

The new requirements were designed to protect the charity which is the remainder beneficiary. If the trust fails to meet the new technical requirements, however, it is the charity that normally suffers. That is, the charity bears the burden of the additional taxes that are imposed on the decedent's estate.

Section 2104 of the bill would do nothing more but allow the will, the charitable remainder trust to be amended, that is, to be reformed, to comply with the new law, and thereby protect the charity, consistent with the basic purposes of the law. This is not a narrow interest provision. It will protect hundreds of charities all over the United States.

The Shriners' Hospitals for Crippled Children strongly support it. The charity that would be hurt otherwise in my particular case would be the Little Sisters of the Poor.

I have been contacted by representatives of a broad group of Massachusetts charities who authorized me to register their strong support for this provision: the Massachusetts General Hospital, the Massachusetts Eye and Ear Infirmary, and many others.

Similarly, representatives of Michigan charities have similarly contacted me.

The Treasury Department has indicated that they have no objection to this provision, as I indicated. The main features of the provision have received careful consideration of the Ways and Means Committee and have been adopted by the House. The provision should be continued in the bill by this committee.

The CHAIRMAN. You are testifying in a different connection earlier this morning, and some people, particularly those of the press who were not here would be well-advised to hear what you said. It would save me the difficulty of enlightening many of those people by presenting them with your testimony, if you would just repeat in your own words why in some cases it is necessary to have narrowly drawn, special interest legislation such as this technical amendment that you are referring to here.

You served in the Treasury in the capacity of one who recommends such legislation, and who also recommends against it, depending on what the provision is.

Am I not right?

Mr. NOLAN. That is correct.

The CHAIRMAN. You worked with this committee as a representative of the Treasury, and theoreticaly as a representative of the President for a number of years and recommended both support for and opposition to various amendments offered similar in nature to that which you are describing now.

Mr. NOLAN. That is correct.

The CHAIRMAN. Would you explain to us why sometimes it is necessary, from time to time to have a special interest measure, a so-called special interest, limited tax provisions drafted such as you are now recommending?

Mr. NOLAN. The hearing ~~before this~~ committee for the past 3 days are the living proof of why that is necessary. We have an exceedingly complex economy. That in turn produces the necessity for an extremely complex tax law. When the committee decides to adopt various provisions, the committee and its staff, the joint committee staff, the Treasury Department, do everything they possibly can to foresee all the problems that will arise. It is impossible to foresee them all. The tendency, of course, is to draw the provisions as narrowly as possible in order that they do not grant unintended benefits. In the process of drawing them narrowly, it is frequently the case that unintentional burdens are created. People are inadvertently covered by a provision that does harm to them that was not intended or inadvertently omitted from a provision that they should have been included, in because again, the effort is to draw those provisions as narrowly as possible so as not to grant unintended benefits.

When those situations arise, where they can be corrected by regulations, the Treasury Department and the Internal Revenue Service do their best to do so. Frequently they cannot be corrected by regulations because the law is explicit, and the only recourse in those circumstances is to come back to the Congress, to the Ways and Means Committee and this committee, present the problem to them, and even though it may affect the interests of a very narrow class of taxpayers, or conceivably only one or two taxpayers, the principle may be 100 percent sound, and in those circumstances the Congress should act in granting appropriate relief.

The CHAIRMAN. Would you tell us—I have never discussed this with you before—the hazard of doing it the other way around. I would like you to tell us what you know, if you do know, about the history of the Philadelphia nun in regard to the charitable contribution deduction.

Mr. NOLAN. That is a perfect illustration of what can occur by drawing provisions too broadly. In that case the effort was to protect a nun who had taken a vow of poverty and transferred all her property to the order of which she had become a member, and she should not have been taxed on that income, so the provision was drawn—unfortunately it was drawn so broadly that it gave an opportunity to many wealthy people to give away appreciated securities in such a way that they could eliminate substantially all of their income tax year after year, in some cases all of their income tax. It was necessary for this committee in 1969 to go back and eliminate that provision, an action which would not have been necessary if it had been drawn very narrowly in the first place. If it had been drawn very narrowly, there may have been another nun or another priest or another person

who had taken a vow of poverty who was also entitled to relief. In that case it might have been necessary to amend the provision further, but the better course of legislative action is to draw the provisions narrowly in the first place, as narrowly as possible, if inquities arise or unintended benefits are granted, to correct those when they come to light.

The CHAIRMAN. When we began to work on the Tax Reform Act in 1969, I think you were helping with that, were you not?

Mr. NOLAN. That is correct.

The CHAIRMAN. At that time I was looking at a Treasury report which was a few years old that indicated that 23 percent of those persons who had adjusted gross income exceeding $5,000,000 were paying us no Federal income tax.

The principal reason was the little provision drafted for the benefit of that Philadelphia nun to say that she would not have to pay taxes which were completely unjust, when looking at this person who had taken a vow of poverty and dedicated all of her income to the good Lord.

It illustrates however, doing the best you can, sometimes you make a mistake in drawing a statute. Sometimes you fail to take into account the equally good cause of someone who has previously asked for relief and who has suffered an injustice without complaining about it.

Do you agree with me that insofar as anyone makes known the fact that he is being treated unfairly or discriminated against, we should try to do justice with regard to that taxpayer, be it a large or small number of taxpayers?

Mr. NOLAN. Certainly we should.

The CHAIRMAN. Thank you very much. Next we will call Mr. James P. Low. Mr. Low is president of the American Society of Association Executives, and Mr. R. William Taylor, executive vice president and general manager, Society of Manufacturing Engineers.

[The prepared statement of Mr. Low follows:]

STATEMENT SUBMITTED ON BEHALF OF THE AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES, BY JAMES P. LOW, PRESIDENT AND CHIEF ADMINISTRATIVE OFFICER

SUMMARY

1. The American Society of Association Executives strongly supports section 2106 of the Committee's Bill which eliminates the misapplication of the "unrelated business income" tax to tax-exempt societies and associations which sponsor trade shows.

2. One of the most important functions of a trade association or professional society is the sponsorship of trade shows, where members of the particular industry may display their products and techniques and where manufacturers of products used in the industry may display their products.

3. Often an industry is composed of many small to medium-sized producers which are not national in scope. Trade shows permit these producers to display their new products, improved products, technological advances, etc. Other firms in the industry see these products and upgrade and improve their own products to remain competitive.

4. The contribution of trade shows to the tax-exempt function of such organizations is undeniable. The contribution of such shows to our domestic and international economies, to the advance of technology, competition and employment, is also undeniable.

5. It is equally clear that application of the tax on "unrelated business income" is improper in the case of trade shows. The purpose of that tax is to preclude tax-exempt organizations engaging in business activity in competition with a taxable commercial enterprise. Trade shows do not compete with commercial activity.

6. Absent the Committee's Bill, imposition of the tax in accordance with recent rulings by the Internal Revenue Service, will disrupt all trade shows and threatens the Commerce Department's "Foreign Buyers Program" which was launched in 1974 to encourage foreign buyers to attend U.S. trade shows. The United States stands to lose millions of dollars in export sales and jobs. Other countries subsidize trade shows. Why should we penalize them. What logic is it for one part of the Federal government to encourage trade shows for a vital national economic purpose and another branch of the same government tax them in a way which is inconsistent with the basic framework and policy of the tax law.

7. As a result many associations are reconsidering future shows, especially those designed to attract foreign buyers. For example, the Society of the Plastics Industry, Inc., New York City, has recently cancelled joint plans with the Department of Commerce to invite 4,000 foreign buyers to attend its 1976 trade exposition.

8. Therefore, we strongly support and urge enactment of section 2106 of the Committee's Bill, although we also strongly urge that trade shows sponsored by scientific and educational organizations exempt under section 501(c)(3) of the Code also be covered. Such organizations clearly are within the policy and intention of section 2106 of the Bill and only a minor technical correction is required.

STATEMENT

This statement is submitted on behalf of the American Society of Association Executives by James P. Low, President and Chief Administrative Officer.

ASAE strongly supports the decision of this Committee to add section 2106 to H.R. 10612 to eliminate an intended and unfair burden on associations and other tax exempt organizations which conduct trade shows that are in furtherance of their tax exemptions and important to our overall domestic and international economies, export sales, technological advance, and employment in the United States.

In many cases, one of the most important functions of a professional society or trade association is the organization and operation of trade shows, where members of a particular industry may display their products and techniques, and where manufacturers and distributors of products used in the industry may display their products.

The primary purposes of trade shows are to provide a giant display window to enable the public and potential purchasers to view that industry's products and, at the same time, permit smaller members of that industry to become conversant with the ever-changing government standards for such products.

The contribution of trade shows to the exempt functions of the association is undeniable. The purpose of trade shows is to provide members of a particular industry or profession, whether or not members of the sponsoring organization, with a method of displaying industry products and services to the public and to other industries. Often, an industry is composed of a great many small to medium-sized producers which are not national in scope. The trade show provides such producers with an opportunity to display their products, new products, improved products, technological advances, etc. Other firms in the industry are forced to review their own products with a view to upgrading in order to remain competitive.

Trade shows began in order to fill a void, displaying the products of smaller industry members and assisting them to maintain an awareness of changing industry and government standards. Trade association-sponsored shows do not compete with other organizations, but merely foster competition within a particular industry or profession. It provides the little guy an opportunity to display his product side by side with the biggest member of the industry on a product basis without the intervention of national advertising or franchised dealerships. Further, it allows a person to expose his product to potential foreign buyers who, but for the show, would not even be aware of his existence.

Thus, the Committee is clearly correct in providing in section 2106 of the Bill that tax-exempt societies and associations will not be taxed for carrying on trade shows in furtherance of their tax-exempt purpose.

Trade shows are conducted in various ways, some of which result in receipts by the sponsoring organization. Section 2106 of the Bill provides that amounts received by the sponsoring organization will not be subject to the tax on "unrelated business taxable income" if appropriate standards are met. These standards are as follows:

First, it must be conducted in conjunction with an international, national, State, regional, or local convention or show;

Second, one of the purposes of the organization in sponsoring that activity must be the promotion and stimulation of interest in, and demand for, the industry's products and services in general; and

Third. the show must promote that purpose through the character of the exhibits and the extent of the industry products displayed.

We support these standards and strongly believe they will facilitate the appropriate conduct of trade shows by profssional societies and associations which play an important role in our domestic and international economies.

Application of the "unrelated business tax" to amounts received by the sponsoring organization is inappropriate and contrary to the basic purpose of that tax. The tax on "unrelated business income" in the Code is dsigned to deal with the situation in which a tax-exempt organization is carrying on a business activity in competition with a taxable commercial enterprise. But the conduct of a trade show under the Committee's standards is not such a situation. Taxable enterprises do not normally sponsor trade shows. Trade shows conducted under section 2106 of the Bill merely fill a void, not susceptible to commercial activity, and further the tax-exempt purpose of the organization to encourage economic development, competition, technological development and employment within the industry.

Therefore. the Committee is right in correcting a misapplication of the tax on "unrelated business income". We would, however, point out a further technical modification that needs to be made in section 2106 of the Bill which excludes from tax organizations exempt under sections 501(c) (5) or (6) of the Code, but does not exclude scientific, educational, etc., organizations which are exempt under section 501(c)(3) of the Code. Such organizations also conduct trade shows. An example is the Society of Manufacturing Engineers which consists of 45,000 engineers and which sponsors trade shows related to technological development and new products of interest to members. Moreover, it should be pointed out that another provision of section 2106 of the Bill eliminates the tax on such activities as county fairs and applies to organizations exempt under section 501(c)(3) of the Code. The same rule should be applied in the case of trade shows.

The decision of this Committee in eliminating the misapplication of the tax with respect to trade shows and similar activities is further supported by consideration of the alternative.

Under existing law, the Internal Revenue Service has felt it necessary to issue rulings that would impose the tax on a tax-exempt organization which sponsors a trade show even though the trade show is in furtherance of the exempt purpose and meets the Committee's standards. Under these rulings, the organization is required to enforce a "no selling" rule on exhibitors which is generally recognized as impractical and is not required to assure that trade shows will remain within the proper scope intended for tax-exempt organizations. Nevertheless, the Internal Revenue Service has felt constrained by present law to issue those rulings and impose the tax.

Not only will this tax be highly destructive of the proper activity of associations in furthering economic development which the Congress has long recognized as worthy of tax exemption, it threatens the Commerce Department's "Foreign Buyer Program" which was launched in 1974 to encourage foreign buyers to attend trade shows in the United States. Further, the United States stands to lose millions of dollars in export sales and jobs.

Foreign countries subsidize the organization and operation of trade shows. Why should we penalize U.S. associations and societies in their efforts to compete with foreign producers or professionals? To combat foreign competition, the Department of Commerce initiated a program of encouraging foreign nationals to attend U.S. trade shows and to buy products at U.S. shows. The "Foreign Buyers Program" of the Department of Commerce is in direct conflict with imposing a tax on trade shows.

Absent enactment of section 2106 of the Bill, many U.S. asociations are reconsidering plans for future trade shows, especially those to attract foreign buyers who purchase millions of dollars of U.S. products and services which, in turn result in jobs for many thousands of Americans. For example, the Society of the Plastics Industry, Inc., New York City, has recently cancelled joint plans with the Department of Commerce to invite 4,000 foreign buyers to attend its 1976 trade exposition. It seems incredible that one branch of our Federal government is restricting trade shows while another is encouraging foreign buying at U.S. trade shows.

Therefore, we reiterate our strong support for section 2106 of this Committee's Bill.

STATEMENT OF JAMES P. LOW, PRESIDENT, AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES, AND R. WILLIAM TAYLOR, EXECUTIVE VICE PRESIDENT AND GENERAL MANAGER, SOCIETY OF MANUFACTURING ENGINEERS

Mr. Low. Thank you, Mr. Chairman. My name is James Low. president of the American Society of Association Executives. We represent 6,500 executives who run the leading trade, professional, technical, and other nonprofit organizations in the United States.

We strongly support the previous committee action on section 2106 which alleviates the tax on associations sponsored trade shows and exhibits. We tried to testify previously on this the last time around but your busy schedule precluded that.

I will not take your time to reiterate all of the beneficial features of trade shows and exhibits to a community or to the country. I would, however, like to remind the committee of a couple of points.

Yesterday the Treasury Department stated that it had no opposition to relieving the tax on trade shows. I understand now that they have a concern over the retroactivity aspects back in 1969.

We are sympathetic to the Treasury's concern and we are only looking at the future and not the retroactivity aspects. Second, I would like to remind the committee that the Department of Commerce strongly supports this committee action.

This will help our balance of payments and the competition of goods and services with foreign countries. Labor also supports your committee actions because obviously they represent the workers who work in the convention hall, hotels, and meetings.

Obviously business has no concern in opposition to this feature because nonprofit trade shows are not in competition with the full profit activity. There is only one problem we see with the provision.

That is that it would inadvertently by a slip of the pencil overlook 501(c)(3), scientific and educational organizations. We hope they will be covered also. I would like to summarize by saying that in my 21 years of working for all of the associations, I have never seen an issue that has received more phone calls, more letters, more concern for the nonprofit community.

You will appreciate if this does not go through, if your provision is not enacted, we can look to the convention halls and exhibit halls, domes and all of the fine cities that house the exhibits to be turned into white elephants or skating arenas or something of that nature.

For my last minute, I would like to turn to Mr. Taylor who represents the 501(3)(c).

Mr. Taylor. My name is Bill Taylor, executive vice president and general manager of the Society of Manufacturing Engineers which headquarters in Dearborn, Mich.

SME is an organization exempt under paragraph 501(c)(3) of the Internal Revenue Code. Like other engineering societies we hold conventions. The engineer goes to technical sessions and hears about two new technical developments, then he goes on to the floor of the trade shows and sees these new technical developments with his own eyes and has an opportunity to learn better by seeing and hearing.

If we were taxed on these trade shows, we would be very damaged in our ability to carry forward in our mission. Societies and universities are exempted from taxation because of their service to the public

At the time the committee drafted the language as Jim has said, only 501(c)(6) and 501(c)(5) organizations were covered through oversight. I simply ask that 501(c)(3) organizations, which are very similar, be covered, also. Thank you.

The CHAIRMAN. Next we will hear from Mr. John A. Bradley, president, Federation of American Hospitals, accompanied by Michael D. Bromberg, director, National Offices Federation of American Hospitals.

STATEMENT OF JOHN A. BRADLEY, PRESIDENT, FEDERATION OF AMERICAN HOSPITALS, ACCOMPANIED BY MICHAEL D. BROMBERG, DIRECTOR, NATIONAL OFFICES FEDERATION OF AMERICAN HOSPITALS

Mr. BRADLEY. Mr. Chairman, members of the committee, I am John Bradley of San Antonio, Tex., president of the Federation of American Hospitals. We would ask permission to submit our full statement for the record and briefly summarize our position here this morning.

[The statement follows:]

SUMMARY

The Federation of American Hospitals recommends that the ceiling on issuance of industrial revenue bonds be increased from $5 million to $20 million for the construction of hospitals, as previously approved by the Senate Committee on Finance. Such an amendment would:

1. Recognize soaring inflation in hospital construction costs;
2. Help assure an adequate supply of health services in rural and inner-city areas of the country by providing needed capital financing for expansion and modernization;
3. Ease the burden on federal, state, and local budgets for providing health facilities in underserved areas; and
4. Help curb rising hospital costs and charges.

Passage of such legislation would not result in the construction of large numbers of hospitals through this financing mechanism. The use of industrial revenue bonds would be limited to construction of facilities with a certificate of need, as well as by the ability to obtain bond financing, and state legislation authorizing the use of such bonds.

STATEMENT OF JOHN A. BRADLEY, PH. D., PRESIDENT, FEDERATION OF AMERICAN HOSPITALS

I am John Bradley of San Antonio, Texas, President of the Federation of American Hospitals, the national trade association representing the 1,051 investor-owned hospitals in this country, as well as Vice President of American Medicorp, Inc. American Medicorp is a large multi-facility hospital company, owning and/or managing fifty-three hospitals with a total of 11,044 beds. Accompanying me today is Mr. Michael Bromberg, Director of the National Offices of the Federation.

I would like to thank the Committee for the opportunity to appear before you today, in order to lend our support to passage of a previously approved Committee amendment that would raise the ceiling on issuance of industrial revenue bonds for the construction of hospitals from $5 million to $20 million. Originally, we had sought to have hospitals added to the list of categories which are completely exempt from a ceiling on bond issues because of their public need and high construction cost. Senator Bentsen sponsored such legislation, and after discussion of the proposal on June 4, the Committee approved the compromise of a $20 million ceiling for hospitals.

The hospital bond amendment under consideration would not create a new usage for industrial bonds. Approximately twenty new hospitals have been

financed by this source since 1968, mostly in rural areas of the southern United States. The amendment would recognize the soaring inflation in hospital construction costs and adjust maximum bond issues for hospitals to $20 million. We are unaware of any new hospital projects using industrial bonds which have been initiated in the past two years, solely because the current $5 million limitation has made it impossible to continue to utilize that source of financing.

As Senator Bentsen has noted, liberalizing the use of industrial revenue bonds for the construction of hospitals, "is needed to assure an adequate supply of health services in rural and inner-city sections of the United States." Health care in this country is desperately in need of capital financing for facility expansion and modernization. The usual sources are not always open to hospitals. Non-taxable hospitals are presently able to market their own bonds bearing tax exempt interest. At the present time, non-profit hospitals finance over 40 percent of all new construction and/or modernization through the use of general revenue bonds. There is no limit on such issues, and last year they financed $4.3 billion in hospital projects.

In contrast, investor-owned hospitals must use industrial revenue bonds which are subject to a $5 million limit per issue. This limit applies to all capital expenditures related to the project which are made during the three years preceding and three years following the issuance of the bonds. The ability to finance construction and modernization projects in large part determines whether or not they will exist. Industrial development bonds figure prominently in underwriting the costs involved, and although the maximum issue adequately covered these costs in 1968, to build a similar 200 bed facility today would run over $12 million. Put another way, the $5 million limit will permit the construction of an 80 bed hospital at the present time, and generally speaking, such a small physical plant may be uneconomical unless it is a part of an integrated system.

Although the amendment already approved by this Committee to raise the ceiling on issuance of industrial revenue bonds from $5 to $20 million will still preclude the construction of larger facilities that could have been built with a total exemption, at least the amendment would provide some urgently needed relief. In 1974, investor-owned hospitals paid $46.3 million in property taxes and $125.8 million in state income taxes. Raising the ceiling to $20 million will provide a vital inflation adjustment factor that recognizes the fact that a bed which cost $25,000 to build several years ago now costs approximately $60,000.

One of the most important reasons for warranting the liberalized use of these bonds is the development of effective areawide planning authorities, largely through through the passage of Public Law 93–641, the Comprehensive Health Planning Law. This law, which requires state certificate of need programs as a condition for receiving federal planning funds, effectively limits future construction of projects to those which serve a demonstrated and proven need in the community. As a matter of course, bond underwriters normally require an extensive feasibility study to document the community needs before considering marketing the proposed bonds. Thus, to the extent that there are excessive beds in a geographic area, the expansion of industrial revenue bond financing will not result in the creation of additional beds—unneeded facilities simply will not be constructed due to the planning authorities.

It is the common desire of both Congress and the health care industry to provide high quality care in the most efficient manner possible. An expansion of the tax exempt industrial revenue bond financing mechanism would contribute directly and immediately to the lowering of hospital costs and charges. If construction of private hospitals was financed through tax exempt industrial revenue bonds (at least up to the proposed $20 million ceiling), the savings in annual interest cost would be approximately 30 percent. The annual savings that would result could be passed along to patients in terms of eventual lower costs.

In brief, we urge the Committee to once again support raising the ceiling on the issuance of industrial revenue bonds from $5 to $20 million for the construction of hospitals for the following reasons:

(1) To attract investment of private capital in needed hospital construction;

(2) To ease the burden on strained federal, state, and local budgets for construction of health facilities in underserved areas;

(3) To encourage necessary modernization of existing investor-owned hospitals;

(4) To provide relief for investor-owned hospitals which paid over $172 million in property and income taxes in 1974;

(5) To curb rising hospital costs and charges through general tax relief; and

(6) To provide greater capital resources to meet increasing demand for access to hospital care.

Since investor-owned hospitals are tax paying institutions, there would be an increase in federal tax revenues in cases where industrial bonds are utilized as opposed to projects in which general revenue bonds are made available for tax exempt hospitals. Private groups and companies also build facilities in areas where there is a real public need and in communities which cannot afford to finance hospital construction.

The Department of Health, Education, and Welfare has estimated that several billion dollars will be needed in the next decade to build needed new facilities and replace existing substandard ones. These projections have not even been adjusted for the impact of national health insurance. Even if the amendment that we support becomes law, we do not anticipate the construction of large numbers of hospitals through the use of industrial revenue bonds. Their use will still be limited to construction of facilities with a certificate of need, as well as by the ability to project sponsors to obtain bond financing, and appropriate state legislation authorizing such industrial bonds.

However, I believe that it is absolutely vital that this means of ready—if limited—financing be made available so that the investor-owned hospital industry is able to deliver quality health care to countless underserved areas across the country.

Mr. BRADLEY. I would like to thank the committee for the opportunity to appear before you today in order to lend our support to passage of a previously approved committee amendment that would raise the ceiling on the issuance of industrial revenue bonds of the construction of hospitals from $5,000,000 to $20,000,000.

Originally we had sought to have hospitals added to the list of categories which are completely exempt from the ceiling on bond issues because of their public need and high construction costs.

Senator Bentsen sponsored such legislation and after discussion of the proposal on June 4, the committee approved the compromise of a $20,000,000 ceiling for hospitals.

The hospital bond amendment under construction would not create a new usage for industrial bonds. Approximately 20 new hospitals have been financed by this source since 1968, mostly in rural areas of the southern United States.

The amendment would recognize the soaring inflation in hospital construction costs and adjust maximum bond issues for hospitals to $20,000,000. We are unaware of any new hospital projects using industrial bonds which have been initiated in the past 2 years, solely because the current $5,000,000 limitation has made it impossible to continue to utilize that source of financing.

As Senator Bentsen has noted, liberalizing the use of industrial revenue bonds for the construction of hospitals is needed to assure an adequate supply of health services in rural and inner-city sections of the United States.

At the present time, nonprofit hospitals finance over 40 percent of all new construction through the use of general revenue bonds. There is no limit on such issues.

In contrast, investor-owned hospitals must use industrial revenue bonds which are subject to a $5,000,000 limit per issue. Although the maximum issue will adequately cover these costs in 1968, a similar 200 bed facility today would cost over $12,000,000.

Raising the ceiling to $20,000,000 will provide a vital inflation adjustment factor that recognizes that a bed that costs $25,000 to build several years ago now costs approximately $60,000.

One of the most important reasons for warranting the liberalized use of these bonds is the development of effective areawide planing authorities, largely through the passage of Public Law 93-641, the Comprehensive Health Planning Act.

This law, which requires State certificate of need programs as a condition for receiving Federal planning funds, effectively limits future construction of projects to those which serve a demonstrated and proven need in the community.

Thus, to the extent that there are excessive beds in a geographic area, the expansion of industrial revenue bond financing will not result in the creation of additional beds—unneeded facilities simply will not be constructed due to the planning authorities.

It is the common desire of both Congress and the health care industry to provide high quality care in the most efficient manner possible. Expansion of the tax exempt industrial revenue bond financing mechanism would contribute directly and immediately to the lowering of hospital costs and charges.

If construction of private hospitals were financed through tax-exempt industrial revenue bonds, at least up to the proposed $20,000,000 ceiling, the savings in annual interest cost would be approximately 30 percent.

The annual savings that would result could be passed along to patients in terms of eventual lower costs. I believe it is absolutely vital that this ready means of financing, if limited, be made available so that the investor-owned hospital industry is able to deliver quality health care.

The CHAIRMAN. I will have to call time. You have a very able advocate on this committee in Senator Bentsen. Thank you very much.

Senator BENTSEN. Thank you very much for the compliment, Mr. Chairman. As far as my being an enthusiastic advocate, I know that some of the rural areas in the State of Texas will not get hospitals without this means.

I know further that they will not be built there unless they are needed because of the comprehensive health planning that would require that kind of certification and the State would buttress that kind of approach.

I am very pleased to support it. I understand that such a limitation is—I just happen to feel that I should support that.

Mr. BROMBERG. The only opposition, statement or comments received by this committee on legislation raising any questions, I believe, was from the Treasury Department. Their concern primarily was what about other health projects such as nursing homes, dentists offices, et cetera?

I would just like to comment that no other health facility costs as much money as a hospital which costs $60,000 and therefore, all other health facilities could be built within the present $5,000,000 limitation. That is why we are seeking special relief.

Mr. BRADLEY. Thank you.

The CHAIRMAN. Thank you for your statement. Next we will hear Ms. Sandy DeMent, executive director, National Consumer Center for Legal Services. We are happy to have you and we will be pleased to hear your statement.

STATEMENT OF SANDY DeMENT, EXECUTIVE DIRECTOR, NATIONAL CONSUMER CENTER FOR LEGAL SERVICES

Ms. DeMent. Thank you, Mr. Chairman. I appreciate the opportunity to be here. I want to make essentially five points today.

First of all, the purpose of these prepaid legal service plans, with which the committee is familiar, is essentially to assist employees, workers in the managing of cost of legal services and finding an attorney.

When the Congress enacted the Taft-Hartley amendment in 1973, they intended that employees be able to bargain for legal services or that employers be able to provide legal services as a fringe benefit.

The measure before us would eliminate the last barrier to these legal service plans by clarifying the tax treatment of employees. Unless this treatment is clarified, few employers or unions are going to negotiate legal services because they will not know the ultimate cost of the plans and the unions or employee associations themselves are going to be hesitant to proceed ahead because their members will be subject to substantial and unexpected tax losses.

I want to make my second point on revenue loss, based on the operating experiences of plans to date and based on the fact that there are 175,000 employees currently covered under these plans, greater loss can be expected to be approximately $1 million and no more than that.

We have heard a number of revenue loss estimates which are based on the assumption that the entire working population of this country will become covered under these legal service plans.

We consider this to be a wild exaggeration—especially since after 40 years, we have not yet attained universal health coverage for workers.

My third point, the next three points in fact, concern the present language of section 2309. It is very substantially changed from that which was voted on by the Senate Finance Committee a few weeks ago.

As originally drafted, the measure dealt with the tax consequences of these legal services plans to employees and employees only. As it is now before us, the measure contains a new section, subsection B on exempt status, which creates a new exempt organization section under 501(c) of the Internal Revenue Service Code which applies to trusts.

We object to inclusion of this new section. This new provision is first of all unnecessary, and second, it is likely to create considerable confusion among the plans as to their proper tax status.

That is on page 82 of the supplemental amendment, if you are looking for it.

Internal Revenue Service Code only contains already a number of sections under 501(c) which—where legal services may be offered presently in connection with their other permissible activities, including sections 501(c)(3), 501(c)(4), 501(c)(5), and 501(c)(9).

The creation of a new exempt organization section is unnecessary and it will only throw a cloud over the use of these other existing sections of 501(c). This is particularly so for bar-sponsored legal service plans, for example, the Texas Legal Service Protection Plan, because they are organized as nonprofit organizations and do not act as trusts, which is what this new section requires.

My fourth point concerns the language of section 120(c)(4) and 120(d)(6), which require that the Secretary should require the plan

to apply to the Secretary of Treasury for a recognition that it is a plan of qualified legal service.

This raises quetsions of whether or not that provision is intended to require prior approval of these filings, first of all, unclear as to what the purpose of the filing is.

We certainly hope, and in view of the fact that this would constitute a radical departure from the existing treatment of employee welfare benefit plans as well as from the existing treatment of exempt organizations, that this not be construed as the meaning of the section.

It should be clarified. Furthermore, these plans enjoy a certain measure of first amendment protection and we think that prior restraint would raise serious first amendment questions.

The CHAIRMAN. Thank you for your statement. Your time has expired. We will print in the entire statement.

[The statement follows:]

SUMMARY

Background.—In 1973, Congress amended the Taft-Hartley Act so that legal services could be a subject of collective bargaining just as health services are. No consideration was given at that time to the tax treatment of these prepaid legal service plans. Now, legal service plans are being established by employers and unions and their tax problems have become crucial.

Under Present Law.—(1) It is unclear whether the employer contribution to a legal service fund on behalf of the employee is taxable income to the employee; (2) The value of benefits received is definitely taxable income to the employee; and (3) For not reporting this "miscellaneous income", legal services funds and their trustees are liable to certain penalties.

This means that: (1) Employ*ers* are uncertain about the ultimate cost of the plan, since any withholding requirement would reduce the plan's assets accordingly; (2) Employ*ees* face unexpected and possibly sizeable tax bills because benefits presently constitute taxable income; and (3) Few employers or unions are willing to negotiate legal service plans under these circumstances.

Under the Proposed Amendment.—The proposed amendment would amend the Internal Revenue Code to exclude from employee taxable income the value of the benefit received under a legal service plan, and the contribution made to the plan in his behalf.

Revenue Loss.—There are approximately 75 prepaid legal service plans in operation, covering 175,000 employees. Estimates show present revenue loss to fall between $900,000 and $1.4 million per year. Even if, in future years, 10 million employees (roughly half of the unionized work force) are covered by such plans, the revenue loss would still only be between $50–$80 million.

The Status of the Amendment.—The Prepaid Legal Service Tax Amendment (the Packwood Amendment) is currently part of the Supplemental Amendments to the Tax Reform Act of 1976 (H.R. 10612). A vote is expected sometime during the week of July 19. The measure has the support of the AFL–CIO and other international unions, the American Bar Association and many state bar associations, as well as the support of insurance companies and consumer groups such as The Cooperative League of the U.S.A., the Consumer Federation of America, the National Student Association and others.

STATEMENT OF SANDY DEMENT, EXECUTIVE DIRECTOR NATIONAL CONSUMER CENTER FOR LEGAL SERVICES

The National Consumer Center for Legal Services is pleased to have the opportunity to offer additional testimony on the subject of the tax problems of prepaid legal services. The National Consumer Center for Legal Services, a coalition of consumer, labor and client organizations, strongly supports the prepaid legal services amendment. The American Federation of Labor and Congress of Industrial Organizations (AFL–CIO) and the United Auto Workers (UAW) support it. The American Bar Association supports it, as do the state bar associations of Connecticut, Georgia, Kansas, Louisiana, Michigan, New York, Ohio, Oregon, Texas and Wisconsin. A number of insurance companies support it, including Insurance Company of North America and Connecticut General.

Consumer organizations such as The Cooperative League of the U.S.A., the Consumer Federation of America and the National Student Association, among others, are supporters.

A BRIEF HISTORY OF PREPAID LEGAL SERVICE PLANS

Prepaid legal service plans grew directly from the growing realization by groups and by the organized bar that a sizeable proportion of the American population is not served at all by lawyers. The preliminary report of a massive study of legal needs conducted by the American Bar Foundation reveals that two-thirds of the population is "legally indigent." Of these, half have never seen a lawyer; half have seen a lawyer only *once* in their lives.[1]

Efforts to establish group legal plans date from the 1930's when automobile clubs attempted to offer auto-related legal assistance. The running battle between consumer groups seeking services for their members and state bar associations determined to stop these unorthodox arrangements continued until the 1960's, when the Supreme Court issued a series of four rulings which established "meaningful access to the courts" as a First Amendment right.[2] In the final case, *United Transportation Union* v. *Michigan State Bar*, Justice Black wrote:

> [T]he principle here involved cannot be limited to the facts of this case. At issue is the basic right to group legal action, a right first asserted in this Court by an association of Negroes seeking the protection of freedoms guaranteed by the Constitution. The common thread running through our decisions . . . is that collective activity undertaken to obtain meaningful access to the courts is a fundamental right within the protection of the First Amendment. However, that right would be a hollow promise if courts could deny associations of workers or others the means of enabling their members to meet the cost of legal representation.[3]

Soon after the UTU decision, steps were taken to amend Section 302 of the Taft-Hartley Act (Labor Management Relations Act of 1947) so that legal services could be negotiated as a fringe benefit. Passage in late 1973 was made possible by a working coalition that included the AFL-CIO, the UAW, the International Brotherhood of Teamsters, and a number of other unions; the American Bar Association; a number of major insurance companies such as Insurance Company of North America, Fireman's Fund, and others; and consumer groups, including the Consumer Federation of America, The Cooperative League of the U.S.A.

In 1974, a further step was taken when Congress included legal service plans as one of the employee welfare benefit plans Subject to Title I of the Employee Retirement Income Security Act. The impact of ERISA on legal service plans was principally to create a regulatory framework within which the plans are free to develop.

Unfortunately, Congress has not yet addressed the question of the tax treatment to be given to the contributions and benefits of such plans. Presently, there is great confusion as to whether the employer contribution to a legal service fund constitutes income to the employee. Several revenue rulings in analogous areas suggest that it is not. And, the unresolved question of the taxability of the benefits to the employee is 1) creating uncertainty as to the costs of such funds, 2) confusion as to the proper course to be followed in informing employees of their potential tax liability or in withholding for tax purposes, and 3) considerable reluctance on the part of employers and unions to proceed ahead under these conditions.

THE STRUCTURE AND OPERATIONS OF PREPAID LEGAL SERVICE PLANS

Section 302(c)(8) of the Taft-Hartley Act stipulates that prepaid legal service plans may not be used to sue either the employer or the union, nor may they be used for defense of union officials charged with violations of certain federal labor statutes. These plans are required, like other collectively-bargained bene-

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[1] Curren, Barbara A. and Spalding, Francis O., "The Legal Needs of the Public," American Bar Association and American Bar Foundation, Chicago: 1974.

[2] *NAACP* v. *Button*, 371 U.S. 415, 9 L. Ed. 2d 405, 83 S. Ct. 328 (1963); *Brotherhood of Railroad Trainmen* v. *Virginia ex rel. Virginia State Bar*, 377 U.S. 1, 12 L. Ed. 2d 89, 84 S. Ct. 1113 (1964); *United Mine Workers* v. *Illinois State Bar Association*, 389 U.S. 217, 19 L. Ed. 2d 426, 88 S. Ct. 353 (1967); *United Transportation Union* v. *The State Bar of Michigan*, 401 U.S. 576, 28 L. Ed. 2d 339, 91 S. Ct. (1971).

[3] *U.T.U.* v. *State Bar of Michigan*, note 2 supra, at 585–586.

fits, to be jointly administered by trustees selected by the employer and the union. Legal services funds established unilaterally by either the employer or the union are treated like other welfare funds; they are also subject to the reporting, disclosure and filing requirements of ERISA.

Services delivered under the plans may be administered internally by the trustees, who might hire a staff of attorneys or contract with outside law firms. The trustees might also contract with a bar association-sponsored plan; or might purchase a group policy of legal insurance. Whichever delivery system is selected, the plans are designed to deliver the routine, personal, nonbusiness legal services which the ordinary employee customarily faces. These include divorce and family matters, wills, real estate, consumer credit problems, traffic matters, and misdemeanors, etc. The Laborers Legal Service Plan in Washington, D.C., for example, reported the following cases: [4]

	Percent
Family problems	17
Consumer and creditor actions	17
Traffic cases	30
Housing matters	15
Criminal/juvenile cases	9
Other	12

However, there is no standard coverage; groups are free to shape the coverage to meet the special needs of their members. A large number of plans offer a "major litigation benefit" for members involved in more expensive litigation. Coverage ordinarily extends to dependents.

Prepaid legal service plans ordinarily are bargained at $.03-$.05 per hour, the higher figure being common in construction unions whose members may only work 1,000-1,200 hours per year. Thus costs per member per year range from $30-$100, the figure also depending on the size of the covered group. In two and a half years, approximately 75 prepaid legal service plans have been established, covering perhaps 175,000 employees. The utilization rate for the plans is typically low in the first year, usually around 10 percent. In later years, utilization climbs to 15 percent and in a very few plans, utilization rates of 20 percent have been achieved.

THE TAX PROBLEM

The Internal Revenue Code currently provides for the exclusion from employee gross income of premiums and benefits provided under accident and health plans. The prepaid legal services tax amendment would amend the Code so that parallel exclusions would exist for contributions paid to and benefits received through legal service plans. Legislation was introduced in both the House of Representatives and the Senate in 1975 to amend the Internal Revenue Code. H.R. 3025 was introduced by Representative Joseph Karth (D-Minnesota) and sixteen other members of the Ways and Means Committee. S. 2051 was introduced by Senators Jackson, Javits, Ribicoff, Taft and Williams. On June 4, 1976, the Senate Finance Committee adopted the measure as part of its Supplemental Amendments to the Tax Reform Act of 1976. The measure will soon be before the full Senate.

It should be made absolutely clear at this point that the tax treatment of the employer is not an issue here. Employer contributions to legal service plans are deductible as "ordinary and necessary expenses" of doing business under Section 162 of the Internal Revenue Code. Nor are we dealing here with the tax status of the funds themselves, although there are preplexing problems unresolved in that area. The prepaid legal services tax amendment pertains solely to the tax consequences to the employee.

Labor and management representatives interested in establishing a legal service plan face two distinct problems, both of which primarily concern the taxability of legal services contributions and benefits to employees: first is the question of the taxability of the contribution (premium) made to the fund on the employee's behalf, and second is the question of the taxability of the benefits themselves.

TAXABILITY OF THE CONTRIBUTION

With respect to contributions made to legal service funds on behalf of employees by the employer, considerable confusion exists as to whether or not these contributions would constitute income. Despite the fact that a number

[4] Laborer's Legal Services: A Progress Report, D.C. Laborer's Legal Services Plan, 1975.

of plans have filed requests for revenue rulings, none have been issued on which plans feel they may safely rely. Careful reading of revenue rulings on related questions suggests that the Internal Revenue Service would not consider these contributions to be taxable income to the employee because the employee has no vested right in the funds at the time the contribution is made. However, the prepaid legal services tax amendment would remove all question by granting an explicit exclusion of these contributions from employee gross income, comparable to the exclusion granted in Section 106 of the Internal Revenue Code to contributions to health and accident plans.

An amendment excluding the contribution from income would have an additional benefit: the guarantee of equal treatment between negotiated legal service plans and those paid for unilaterally by the employer or through individual insurance contract plans. In other words, the prepaid legal services tax amendment would accomplish equal tax treatment for employees, regardless of whether the legal service benefit is provided through collective bargaining, as an employer instituted benefit, or by employer-purchase of individual legal insurance contracts for employees.

The cost of the confusion concerning the taxability of the contribution is high. Employers are uncertain about the ultimate cost of a legal service plan, since any withholding requirement would reduce the plan's assets accordingly. Few employers or unions are willing to negotiate legal service plans under these circumstances.

TAXABILITY OF BENEFITS

With respect to the taxability to the employee of the value of the benefits received under such plans, the Internal Revenue Code language is clear: "Gross income includes income realized in any form, whether in money, property, or services." (Treasury regulation 1.61.1(a).) Without amendment, an employee might receive several thousand dollars in legal services benefits and face the prospect of having to pay taxes on those benefits as income. This could have a serious effect, particularly since prepaid legal service plans typically cover people whose earnings are between $5,000 and $15,000 per year. Employees would have to ask themselves whether they can afford to take advantage of their legal services benefit program.

There is also a more practical consequence of thus amending the Code: it avoids the difficult problem of assessing the value of services which may be provided by a panel of staff attorneys who do not bill on a fee-for-service basis. Even more difficult valuation problems loom with services which are related to legal services but do not constitute legal services per se, such as paralegal assistance, marital counseling and so on. Since the Supreme Court's recent decision in *Goldfarb*, it is unlikely that there will be any bar association minimum fee schedules on which to base such valuations. Furthermore, the valuation problem is not merely one of plans which do not bill for services provided, (i.e., one where members are entitled to a limited number of prepaid hours of service for staff attorneys) but even more seriously, of plans whose delivery mechanisms enable them to deliver services far less expensively than prevailing legal practice. The use of a market valuation system would now produce real injustices.

In the meantime, most employers and legal services trust funds are not reporting benefits as miscellaneous income. While they wait for Congress to deal with their dilemma, they risk incurring penalties of $25 per filing for their failure to file. A plan which serves 1000 members in a year has potentially built up a $25,000 fine, in addition to the risks taken by trustees whose fiduciary duties require strict compliance with law.

Finally, our experience suggests that both employers and employee organizations have some reluctance about participating in a program whose tax consequence to the employees are potentially so harsh. This result would defeat the very purpose of the Taft-Hartley Amendment and frustrate the intent of Congress to improve access to legal services.

REVENUE LOSS

This section attempts to touch briefly on the question of possible revenue loss, although it is an area subject to widely differing estimates. Employer contributions for comprehensive legal services range between $30 and $100, the bulk of them probably approximately $50. Tax counsel advise that these amounts would probably not now be considered income to the employee since the em-

ployee has no vested right in the fund at the time the contribution is made.[5] Therefore, if this advice is correct and if such amounts are not presently taxable, the simple clarification of their status will not generate any revenue loss.

As to benefit limits, most plans use either dollar amounts or hours-of-service, averaging 50 or fewer hours of service per year. Whether measured in dollar amounts or in hours, no plans now operating offers more than an equivalent of $4,000 in benefits per year.[6]

Figures from the Shreveport Laborer's plan, the oldest legal service plan currently in operation, suggest more accurate data for illustration.[7]

SHREVEPORT LEGAL SERVICE PLAN

Year	No claims	Utilization Rate (percent)	Average claim
1971	30	5	$212
1972	56	9	223
1973	65	11	243
1974	92	15	211

The utilization pattern for Shreveport seems to be fairly typical for new plans, although the first year utilization rate is low. Most plans average 8–10 percent use the first year. An established plan seems to average 15–20 percent utilization. For example, the Ohio Legal Services Fund serving employees of the City of Columbus, Ohio reported 15 percent utilization in its first 8 months of operation, averaging slightly more than $180 per claim. The Laborer's District Council (Washington, D.C.) plan, which handles 85 percent of its cases on a staff basis, and refers 15 percent to outside attorneys, pays an average of $210 per case to the outside attorneys. Cases handled on a staff basis probably average $150 per case.

Thus, in a hypothetical plan covering 100 workers (which is in actuality too small to effectively support a plan), assuming a 20 percent utilization rate, an average payout of $200, and a tax rate of 20 percent, the revenue loss if expressed on a per employee basis would amount to $8 per employee. On the other hand, if you assume a 15 percent utilization rate, a $175 payout rate and a tax rate of 20 percent, the revenue loss if expressed on a per employee basis would amount to $5.25 per employee. The figures could actually be lower or higher. Thus, for the 175,000 workers currently covered by such legal service plans, the revenue loss could be between $900,000 and $1.4 million.

All prepaid legal service plans now providing services limit benefits in some way. A worker who takes advantage of every possible benefit under a plan can still usually only receive services valued between $2,500 and $3,000. Thus fears of excessive usage are unwarranted. Further, most plans contain the standard ethics code language which allows attorneys to decline matters that are "frivolous or without merit." Even if they do not, attorneys serving the plan remain bound by the ethical code.

It is significant that income levels for the workers served by the plans are generally low, only rarely exceeding $15,000, and frequently ranging between $3,000 and $10,000 annually. Most workers served by these plans are married, with children. A sizeable proportion, therefore, will pay nominal or no taxes and thus would not contribute to a revenue loss at all.

It is difficult to make revenue loss estimates for the future when the popularity of legal services as a benefit cannot yet be guaged. However, even if 10 million employees are eventually covered by prepaid legal service plans, revenue loss still would only fall in the $50–$80 million range.

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[5] See the tax memorandum attached as Appendix A, prepared by John Hendricks, at the request of the Special Committee on Prepaid Legal Services of the American Bar Association.

[6] Such limits would be reached by a beneficiary only in the unusual situation where the employee claimed all possible benefits allowable in a claim year. For example, under a plan using a schedule of benefits, the employee would have to be divorced, sued by his neighbor, involved in a traffic accident, arrested for drunk driving, default on a loan, buy or sell a house and request a will, etc., etc.

[7] Lawyers for Laborers: The Shreveport Plan of Prepaid Legal Services After Four Years, The American Bar Association, Chicago: 1975.

SUPPLEMENT

Federal Income Tax Aspects for Employee-Participants in Group Legal Service Plans

A Memorandum discussing proposed amendments to sections 105 and 106 of the Internal Revenue Code of 1954.

(By John C. Hendricks[1])

In the past decade our society has come a long way in increasing the availability of legal services to a larger number of our citizens. The wealthy have always been able to afford counsel of their choice to meet their legal needs. Federally funded programs have provided legal assistance for many of the poor. However, the large class of moderate income Americans, having family incomes of between $5,000 and $15,000 per year, frequently does not have adequate counsel to meet its needs. Many knowledgeable individuals believe that group legal service plans will help fill this gap. Group legal service plans attempt to make available a wide-range of legal services in such areas as protection against consumer fraud, debtor-creditor, will preparation, adoptions, divorces, and real estate settlements, to name but a few. The concept of such legal service plans, like group medical insurance, involves spreading the cost among a large number of people to minimize the cost to the particular individual participant.

The use of group legal service plans is becoming more frequent with each passing month. It is anticipated that such group legal service plans will soon become a common employee fringe benefit. The employer's contributions made on behalf of his employees to a group legal service plan will be deductible from his gross income as an "ordinary and necessary expense" under Section 162 of the Internal Revenue Code of 1954. Treasury Regulations Section 1.162-10(a) states that:

> . . . Amounts paid or accrued within the taxable year for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or a sickness, accident, hospitalization, medical expense, recreational, welfare, or similar benefit plan, are deductible under Section 162(a) if they are ordinary and necessary expenses of the trade or business.

Thus the employer contributing to a group legal service plan will receive the same tax treatment for these expenditures as he does for employees' group medical insurance, unemployment benefits and other employee fringe benefits.

While the federal income tax treatment to the employer is clear, at the present time there are some uncertainties over the income tax treatment that may be expected by participants in such group legal service plans. Attached are proposed amendments to Sections 105 and 106 of the Internal Revenue Code of 1954. The purpose of these amendments is to insure that all participants in group legal service plans will have the same federal income tax treatment as participants in accident and health plans. The proposed amendment to Section 105 relates to the taxability of benefits rendered by such a group legal service plan, while the amendment to Section 106 concerns the taxability to the participating employee of an employer's contributions to the group legal service plan.

Taxability of benefit received—Section 105

As has been indicated, it is expected that employers will frequently pay all or part of the premium in group legal service plans for their employees as an additional fringe benefit. The following question immediately arises: Is the value of the benefit received or the amount of the reimbursement made includable in the gross income of the employee?

It is imperative to look at Section 61(a)(1) of the Internal Revenue Code, which defines gross income to include "compensation for services, including fees, commissions and similar items." Treasury Regulations Section 1.61-1(a) states that:

> Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash . . .

[1] Mr. Hendricks is associated with the firm of Ash, Bauersfeld, Burton & Mooers, Washington, D.C. The publication of this article has been made possible by a grant from the American Bar Endowment.

Thus, unless explicitly excluded by some section of the Internal Revenue Code, the provision of services or the reimbursement for expenses incurred in areas such as medical or legal services would be considered income.

In attempting to point out some of the special rules relating to particular items of income, Treasury Regulations Section 1.61-2(a)(3)(iii) states that amounts received under accident and health plans as set forth in Section 105 of the Code and the regulations thereunder are excluded from gross income. Unless specific legislation is enacted, similar amounts received under group legal service plans would be included in gross income simply because they have not been excluded by a specific Code section.

Should Section 105 of the Code not be amended, the value of the legal services to be included in the employee's gross income would equal the amount of the reimbursement in the case of reimbursement by the plan. If the plan were to provide the service directly to the employee rather than reimbursing him for his legal fees incurred, the amount includable in gross income would be the fair market value of the services rendered. Needless to say, there could be difficult valuation problems in attempting to place values on the broad scope of legal services which could be rendered under group legal service plans. Because of uncertainty as to the income tax consequences, the plans might not be utilized fully. In order to avoid this harsh result, Section 105(b) of the Internal Revenue Code should be amended to grant group legal service plans the same tax treatment as is presently accorded health and accident plans.

Section 105(b) indicates that gross income does not include any payments made to an employee through accident or health insurance plans for personal injuries or sickness if such amounts are paid, directly or indirectly, to the taxpayer to reimburse him for expenses incurred by him for the medical care of himself, his spouse, or his dependents. The statute itself clearly excludes from gross income the reimbursement of an individual by a group health plan for the medical expenses of himself, his spouse and his depedents. In amplifying the statute, the Regulations mention the payment of an individual's medical obligations by the health plan directly to the provider of the health services. Specifically, Treasury Regulations Section 1.105-2 states that "if the taxpayer incurs an obligation for medical care, payment to the obligee in discharge of such obligation shall constitute indirect payment to the taxpayer as reimbursement for medical care." For example, if a taxpayer incurs a doctor bill of $25.00 and his medical insurance plan pays the physician the $25.00 fee directly, without reimbursing the taxpayer and then having the taxpayer pay the physician, this is an indirect payment to the taxpayer.

Under Section 105(b) such a payment is not includable in the taxpayer's gross income. In addition to including direct and indirect reimbursement of an individual's legal costs, the proposed amendment to Section 105 also includes a group legal service plan's rendering services directly to an individual and insures that the value of such services would not be includable in gross income.

Since the concept behind group legal service plans is similar to that behind group medical plans, the same rationale should apply to the nontaxability of the benefits received. Section 105 of the Internal Revenue Code should therefore be amended to state that gross income includes neither benefits received by nor moneys paid to a taxpayer, directly or indirectly by a group legal service plan, to reimburse him for legal expenses he or his family have incurred.

Taxability to the employee of the employer contribution—Section 106

Section 61(a)(1) of the Internal Revenue Code of 1954 defines gross income to include "compensation for services, including fees, commissions, and similar items." Treasury Regulations Section 1.61-1(a) indicates that "gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock or other property, as well as in cash." When income takes some form other than cash, the fair market value of whatever is provided in lieu of cash is included in the recipient's gross income. For example, if as part of his overall compensation an individual receives the use of a house rent free and the fair market rental value of the house is $200 per month, the individual will ordinarily be deemed to have additional income in the amount of $200 per month as a result of his rent free use of the house.

It is envisioned that in the near future employers will begin making contributions to group legal service plans on behalf of their employees as an additional fringe benefit. If this occurs, will the employer's contribution to the group legal service plan be includable in the employee's gross income? In

discussing this question, it is important to note that most of such group legal service plans will arise either from collective bargaining or unilateral adoption by an employer for a group of his employees. This is in contrast to a small employer's covering only one or two employees with individual insurance contracts to provide some sort of prepaid legal service benefits.

With respect to collective bargaining for group legal service plans, legislation was enacted in 1973 adding group legal service plans to the list of fringe benefits which can be administered under the trust fund provisions of Section 302(c) of the Taft-Hartley Act. These trust funds are the common and usual way of administering fringe benefit programs for union members. The amendment is expected to generate a rapid increase in the number of group legal service plans in existence. Section 501(c)(9) of the Internal Revenue Code grants tax exempt status to such trust funds, designated as voluntary employees' beneficiary associations in the Code. It is anticipated that the Internal Revenue Service will issue new Treasury Regulations under Section 501(a)(9) relatively soon and that these Regulations will grant tax-exempt status to trust funds established to fund any fringe benefit designated in Section 302(c) of the Taft-Harley Act. When this occurs, it will be possible to administer group legal service plans through such a tax-exempt trust.

Insofar as the federal income tax treatment of such fringe benefits is concerned, it might be instructive to review some of the supplemental unemployment benefit plans. In Revenue Ruling 56-249, 1956-1 C.B. 488, an auto maker contributed to a trust fund, which was held and administered by an independent trustee, to pay supplemental unemployment benefits to its employees who were laid off. Its contribution was based upon a formula considering the total hours for which its eligible employees were paid during each pay period. No employee had any right, title, interest in or to the assets of the fund or in any company contribution to the fund until he qualified to receive a benefit therefrom. Thus if the employee ceased working for the auto maker prior to his being laid off, he would never derive any benefits from the fund. The amount of supplemental unemployment benefits to be received by a laid off employer was dependent upon many detailed criteria set forth in the plan. The Revenue Ruling held that the benefits paid to former employees did not constitute wages for purposes of the Federal Unemployment Tax Act, Federal Insurance Contributions Act, and the Collection of the Income Tax at Source on Wages. Nonetheless, the supplemental unemployment benefit payments did have to be included in the employee's gross income for federal income tax purposes in the year in which the benefits were received. Note, however, that no part of the contribution was included in the employee's income when the employer initially made the contribution to the trust fund.

The situation in Revenue Ruling 56-249, supra, is contrasted to another supplemental unemployment benefit plan where contributions were made by an employer to separate independently controlled trust accounts. There was a separate trust account for each participating employee. The purpose of this plan also was to furnish supplemental unemployment benefits to eligible employees. Since the contributions paid into the trust vested immediately and were non-forfeitable, the employee realized income in the year when the employer made the contributions. Revenue Ruling 57-37, 1957-1 C.B. 18.

In analysing these two Revenue Rulings, it appears that the determining factor is whether the employee has a vested and non-forfeitable right as a result of contributions made by the employer. If he is immediately vested and has a non-forfeitable right, the employee will have income in the year the contribution is made. Revenue Ruling 57-37, supra. If there is no vested interest and the employee must qualify for benefits in accordance with the criteria set forth in the plan, the employee will not have income in the year the employer contribution is made. Revenue Ruling 56-249, supra.

The importance of this distinction can also be seen by comparing two Revenue Ruling dealing with vacation benefit funds. See Revenue Ruling 57-316, 1957-2 C.B. 626, for a situation in which the employees had no right or interest in the vacation fund except as the trustees determined. In that case, tax liability was not incurred until payments were made from the vacation fund to the participating employees. In Revenue Ruling 67-351, 1967-2 C.B. 86, payments were made by the employer to such a vacation plan and trust. In this case, however, the individual employee's account was fully vested and nonforfeitable from the time the employer's contribution was made. These vacation fund contributions by the employer were considered as additional

compensation to the employee as soon as the employer made the payments to the trust. As the supplemental unemployment benefit plans and vacation fund plans have shown, so long as the employee-participants in a collective bargaining group legal service plan do not have a vested, nonforfeitable right, the employer's contribution to fund such a group legal service plan should not be income to the employees in the year made.

With respect to the federal income tax treatment for group legal service plans which are not a result of collective bargaining, again a review of the federal income tax treatment for contributions to supplemental unemployment benefit plans is instructive. As previously indicated, the Internal Revenue Service, in Revenue Ruling 56-249, supra, held that contributions from an employer to a supplemental unemployment benefit plan instituted as a result of collective bargaining would not be included in the employee's income until benefits were actually paid to the employee. In Revenue Ruling 58-128, 1958-1 C.B. 89, the Internal Revenue Service extended identical tax treatment to plans which were similar in all respects except that they were unilaterally instituted by the employer rather than resulting from collective bargaining.

With the Internal Revenue Service policy concerning the taxation of employee fringe benefits well established, all legal service plans for groups of employees of the same employers should receive the same tax treatment. No amount of the employer's contribution should be includable in the employee's gross income when the contribution is made.

By far the greatest number of participants in group legal service plans will be in plans which are a result of collective bargaining or other group plans unilaterally instituted by employers as opposed to employers purchasing individual contracts for their covered employees. There will probably be, however, a small number of individual contract group legal service employee benefit plans. With respect to this small category of individuals, it becomes necessary to look at the treatment accorded by the Internal Revenue Code with respect to employer contributions to accident and health plans.

Section 106 of the Internal Revenue Code deals with employer contributions to accident and health plans. This section states that "gross income does not include contributions by the employer to accident or health plans for compensation (through insurance or otherwise) to his employees for personal injuries or sickness." Treasury Regulations Section 1.106-1 indicates that "the employer may contribute to an accident or health plan either by paying the premium (or a portion of the premium) on a policy of accident or health insurance covering one or more of his employees, or by contributing to a separate trust or fund (including a fund referred to in § 105(e)) which provides accident or health benefits directly or through insurance to one or more of his employees." No amendments have been made to Section 106 of the Internal Revenue Code since its enactment in 1954.

Prior to the enactment of Section 106 in the Internal Revenue Code of 1954, whenever an employer paid premiums on individual policies for accident or sickness benefits to his employees, the premiums paid were includable in the gross income of the employees and were thus subject to the income tax. Revenue Ruling 210, 1953-2 C.B. 114 and Revenue Ruling 58-90, 1958-1 C.B. 88. The change in the taxability of premiums paid by the employer occurred because of the addition of Section 106 to the Internal Revenue Code of 1954. Revenue Ruling 58-90 underlines this point by saying that:

> The amount of the premiums paid by the corporation should be excluded from the gross income of the employee for taxable years beginning after December 31, 1953, and ending after August 16, 1954, under the provisions of Section 106 of the 1954 Code. The amount of premiums paid by the corporation in prior taxable years should be included in the gross income of the employee for the taxable year in which paid under the provisions of Section 39.22(a)-3 of Regulations 118.

Section 106 is very specific in its terms and applies only to employer contributions made to accident or health plans. Since tax laws are strictly construed and deductions and exclusions from income are matters of legislative grace, employer contributions to purchase individual contracts for his employees in a legal service plan will be includable in gross income under Section 61 of the Code unless a specific legislative provision excludes such payments from gross income.

It is desirable that all employees who are receiving a group legal service plan as an additional fringe benefit should receive the same type of federal income tax treatment. Whether a person receives this benefit as a result of collective

bargaining, an employer-instituted benefit, or an employer's purchase of an individual contract should have no bearing on the federal income tax treatment of the particular individual. Therefore, to insure that the employee for whom an individual contract is purchased receives the same tax treatment as a union member who receives his benefits as a result of collective bargaining, Internal Revenue Code Section 106 should be amended.

CONCLUSION

Section 105 and 106 of the Internal Revenue Code of 1954 should be amended to give similar income tax treatment to group legal service plan participants as is now given group health and accident plan participants. At the present time the income tax treatment of some participants in such group legal service plans is uncertain. The use of group legal service plans as fringe benefit is expected to increase dramatically, since Congress recently amended Section 302(c) of the Taft-Hartley Act to permit group legal service plans to be administered under the trust fund provisions of that Act. It is therefore imperative that Section 105 of the Code be amended to state that neither services rendered nor reimbursements made to individuals are to be considered gross income as that term is defined in Section 61(a)(1) of the Code. Moreover, Section 106 should be amended to state clearly that employer contributions to group legal service plans will not be includable in gross income of any participating employee.

AN ACT TO AMEND THE INTERNAL REVENUE CODE OF 1954

Section 1.—Part III of Subchapter B of Chapter I of the Internal Revenue Code of 1954 is amended by adding at the end of Section 105 the following new subsection (b) and redesignating the present subsections (a) through (g) as paragraphs (1) through (7) of subsection (a), Amounts Received under Accident and Health Plans and the present paragraphs of subsections (c) and (e) are redesignated as subparagraphs:

"Section 105, Amounts received under accident and health plans and legal services plans.

(a) Amounts Received under Accident and Health Plans.

(b) Services and Amounts Received under Legal Service Plans.

Gross income does not include:

(1) legal services provided by a group legal service plan to a taxpayer, his spouse, and his dependents (as defined in Section 152), or

(2) amounts paid, directly or indirectly, by a group legal service plan to a taxpayer ot reimburse the taxpayer for expenses incurred by him for the provision of legal services to the taxpayer, his spouse, and his dependents (as defined in Section 152).

Section 2.—Part III of Subchapter B of Chapter I of the Internal Revenue Code of 1954 is amended by adding at the end of Section 106 the following new subsection (b) and redesignating the present material in Section 106 as subsection (a):

"Section 106. Contributions by employer to accident and health plans and legal services plans.

"(a) Accident and Health Plans . . . .

"(b) *Legal Services Plans.*—Gross income does not include contributions by the employer to legal services plans for compensation (through insurance or otherwise) to his employees for the costs of legal services incurred by his employees, his employees' spouses, and his employees' dependents (as defined in Section 152)."

Section 3.—The amendments made by Sections 1 and 2 shall apply to taxable years beginning after December 31, 1973.

The CHAIRMAN. Let me say that I can understand for the first time why I have seemed to be in bad shape with the man who is the head of the State bar association who lives in Shreveport, La.

I notice Shreveport has the oldest plan of this sort. He had mentioned this matter to me and I did not fully understand it so when the matter came up for a vote, I was not realy familiar with it and I opposed it.

I would say the president of the bar association, hailing from Shreveport, which has the oldest plan, has me on his list right now. I hope we can work this matter out in an amicable fashion.

Ms. DEMENT. We will submit this afternoon, changes and a supplemental statement to our original statement. Thank you.

The CHAIRMAN. Thank you very much. Next we will hear from Mr. John E. Chapoton, Jr., on behalf of American General Capital Management, Inc., Boston Company Exchange Associates, Fidelity Exchange Fund, and State Street Exchange Fund. He is accompanied by Mr. Robert Lawrence, managing partner, State Street Exchange Fund, and Mr. M. Dozier Gardner.

STATEMENT OF JOHN E. CHAPOTON, JR., ON BEHALF OF THE AMERICAN GENERAL CAPITAL MANAGEMENT, INC., BOSTON COMPANY EXCHANGE ASSOCIATES, FIDELITY EXCHANGE FUND, STATE STREET EXCHANGE FUND; ACCOMPANIED BY ROBERT LAWRENCE, MANAGING PARTNER, STATE STREET EXCHANGE FUND, AND M. DOZIER GARDNER

Mr. CHAPOTON. I represent American General Capital Management, Inc., which is a subsidiary of the American General Insurance Co. headquartered in Houston, Tex. I am appearing today on behalf of four exchange funds, American General Exchange Fund. the Boston Company Exchange Associates, Fidelity Exchange Fund, the State Street Exchange Fund.

My interest in appearing before you today is the local exchange fund bill, H.R. 11920, provisions of which were added to H.R. 10612, section 2310 of that bill, on June 11 by this committee.

This bill would amend the present law and make a change of appreciated securities to a partnership taxable. The bill, as approved by the Ways and Means Committee and passed by the House, contains a transitional rule, exhibiting funds which have made certain filings before the date of introduction of legislation February 17, 1975, and which funds meet certain limitations as to size and time.

The transitional rule adopted by the House would have been broadened somewhat by the amendments adopted by this committee.

The four funds on whose behalf I am appearing today need transitional rules in both the House and committee version of this legislation. I would like to introduce Mr. Robert Lawrence who is managing general partner of the State Street Exchange Fund. He will go into some detail as to the background leading up to the adoption of this transitional rule.

We are accompanied by Mr. M. Dozier Gardner of Vance Sanders Exchange Fund. Mr. Gardner has filed a statement for consideration by the committee. Mr. Lawrence.

Mr. LAWRENCE. Mr. Chairman, members of the committee, there are three points which I want to make today. First, the legitimate reliance interest of the four funds which I represent fully justifies the inclusion in H.R. 10612 of a transition rule.

Second, exchange fund legislation, and especially a transition rule has received open and extensive consideration during the source of public hearings held by the Ways and Means Committee March 29, 1976.

Later, when it was debated on the House floor prior to its passage, it was H.R. 11920.

Third, if the substantial expenditures of time, money, and good faith between November 1975 and February 1976 are not to be totally wasted, prompt action on the exchange fund provision is essential.

In the connection with the first point which deals with what we consider to be the legitimate reliance interest of that areas funds, I would like to cite the following.

First, the exchange of appreciated securities for a partnership interest in an exchange fund is a nontaxable transaction under present law.

Second, that tax ruling issued by the Internal Revenue Service to Vance Sanders clearly confirms this. Third, between November 7, 1975, and my own funds' request for a tax ruling we delivered to the IRS on February 1976, we received repeated assurances from IRS officials that a favorable ruling would be issued.

On the strength of these assurances, my firm and its dealer-manager spent over $400,000 by February 7 when H.R. 11920 was introduced. I might add that our experience in this respect was typical of all of the other funds.

All of these facts were clearly taken into consideration when H.R. 11920 was amended to include transition rules that reflected our legitimate reliance interest. The amended bill was later debated on the floor and passed by a vote of 348 to 14.

When I mentioned the extensive and open consideration which the exchange fund legislation has received, I had this in mind. On March 29, 1976, the Ways and Means Committee held public hearings on H.R. 11920 at which the following individuals or groups of individuals and other interested parties appeared.

First, of course, were representatives of each sponsor of an exchange fund; second, the legislator-director of a public interest group known as Taxation with Representation, then the Treasury Department, which proposed a transition rule—with the following language and I will quote.

"In suggesting the foregoing grandfather clause, we have noted that the law on its face, that is, section 721 clearly supported the taxpayers requested rulings." The Vance Sanders ruling was issued in April 1975 and widely publicized and that the three other funds registered with the SEC had each received assurances from the Internal Revenue Service that a favorable ruling could be obtained.

The position of the Treasury in this respect, has not changed since then and in fact it was reconfirmed in a document entitled, "The Administration Position." I would just like to conclude with these thoughts.

The transition provisions of H.R. 11920 which are now a part of H.R. 10612, section 2310 grant relief to those funds which acted in good faith and on the strength of repeated assurances by IRS that a favorable ruling would be issued, proceeded with expensive and time-consuming effort involved in organizing this type of fund.

As a businessman, I can tell you that the delay we have already suffered has been costly and that in interest of simple justice, we should now be allowed to proceed promptly with the organization of our respective funds. Thank you for hearing my testimony.

The CHAIRMAN. Thank you, gentlemen.

Senator BYRD. If I may ask a question?

The CHAIRMAN. Yes.

Senator BYRD. Does IRS dispute your assertion that you have been given assurances of favorable action?

Mr. LAWRENCE. They have not disputed those assertions.

The CHAIRMAN. Thank you gentlemen. The next witness is Mr. Harrison Clarke, first vice president, Johnson, Lane, Space, Smith & Co., Inc., accompanied by Mr. David Johnson, president, Johnson, Lane, Space, Smith & Co., Inc.; Mr. Richard Boylan, executive vice president, Provident National Bank; Mr. David Robb, executive vice president, Provident National Bank; and Mr. Bruce McConnell, attorney, Chestnut Street Exchange Fund, Mr. Charles H. Morin on behalf of the Federated Exchange Fund, Mr. Mervin M. Wilf on behalf of Equity Exchange Fund.

STATEMENT OF HARRISON CLARKE, FIRST VICE PRESIDENT, JOHNSON, LANE, SPACE, SMITH & CO., INC., ACCOMPANIED BY DAVID JOHNSON, PRESIDENT, JOHNSON, LANE, SPACE, SMITH & CO., INC.; RICHARD BOYLAN, EXECUTIVE VICE PRESIDENT, PROVIDENT NATIONAL BANK; DAVID ROBB, EXECUTIVE VICE PRESIDENT, PROVIDENT NATIONAL BANK; AND BRUCE McCONNEL, ATTORNEY, CHESTNUT STREET EXCHANGE FUND; CHARLES H. MORIN ON BEHALF OF FEDERATED EXCHANGE FUND; AND MERVIN M. WILF, EQUITY EXCHANGE FUND

Mr. CLARKE. We appreciate the opportunity to appear before you and the Senate Committee on Finance in support of the committee amendment which provides extension of transitional rule in the House-passed H.R. 11920.

We support this extension because it gives relief as well as equal treatment to all exchange funds that to my knowledge have claimed their reliance interest. My name is Harrison Clarke and I am associated with the investment banking firm of Johnson, Lane, Space, Smith & Co., of Savannah, Ga.

Accompanying me today are Mr. Richard Boylan of Provident Bank of Philadelphia, Mr. Bruce McConnell, general counsel. We all are here on behalf of the Chestnut Street Exchange. In the interest of time, I will be very brief.

We first learned of the Vance Sanders tax ruling in 1975, of reliance and other existing laws and immediately began to form a similar exchange fund. We hoped to secure the services of the Provident National Bank as the funds investment adviser.

To this end, we entered negotiations with the Provident Bank, reached a tentative agreement in November 1975 and the agreement was finalized in December of 1975 and executed by both parties.

In late December of 1975 and January of 1976, we employed lawyers and accountants who were charged with the responsibility of preparing and filing an S-5 registration statement with the Securities and Exchange Commission, filing a request for tax ruling with the Internal Revenue Service and with forming a limited partnership under the California statutes.

Several drafting sessions were held during January and early February and mid-February, our registration statement and the IRS re-

quest were virtually ready for filing. This was a very large undertaking for our firm.

We had spent a tremendous amount of time and money prior to the introduction of H.R. 11920 by the House on February 17, 1976. We were in a state of shock, naturally, when we learned the provisions of this bill.

We stopped all activity and expense to evaluate our position. After a great deal of consideration, not the least of which was the $21,000 SEC nonrefundable filing fee, we decided to go ahead and complete our plans and our filing was made with the SEC and with the IRS in March of 1976.

If the grandfather provision of the House-passed bill works a great hardship on our firm and on the Chestnut Street Fund, it was only a matter of chance that we failed to file our registration statement and IRS request by the February 17 date.

We feel it unfair because we acted in good faith in the reliance of existing law and on the Vance Sanders tax ruling. We have spent considerable time and amounts of money in organizing and preparing to market a partnership exchange fund.

We feel that the facts set forth in our written testimony which I have briefly outlined fairly clearly demonstrate the Chestnut Street Exchange Fund was, as a matter of fact, in process of being formed on February 17, 1975, and that we were far enough along on the present law to claim a reliance interest.

In conclusion, we support the extension of the transitional as a provision of the committee amendment because it offers relief as well as equal treatment to all eight of these exchange funds that, to my knowledge, claim relief interests.

We now stand ready to answer questions by the committee and in this connection, we have at our table, Mr. Charles Morin on behalf of the Federated Exchange Fund and Mr. Mervin Wilf on behalf of Equity Exchange Fund.

Both of these gentlemen have filed, as we have, written statements with the committee and they stand ready to answer questions concerning the respective funds.

The CHAIRMAN. Let me say this to you gentlemen. I know you speak for some very fine Americans who have undertaken to organize these funds. I am sure that your participants are all good citizens, most of or all of whom I would be happy to associate with at any time.

I voted against this amendment because I wanted to see an end to swap funds. I will study your statement and perhaps you will pick up a vote as a result of these hearings.

A measure such as you are supporting here at this stage of the Congress can be killed very easily. I have seen a single Senator kill something like this many times by simply standing in the door and as a result, it did not have enough priority relevant to the other matters being considered to ever bring it to a vote.

I am perfectly content to let the Senate vote on this matter rather than deciding whether the committee should vote on this matter. I would point out that if anyone wants to make a determined effort, that could prevent this measure from being enacted and those of you who favor it are going to have to persevere in trying to insure that your matter is brought to a vote in the Senate.

You almost have to put your amendment on a bill like this which is headed for the President's desk and may have enough support to get there.

I take it you feel that an answer on this matter has been delayed long enough.

Mr. CLARKE. We would like to urge that the committee and the Senate move post haste to let us complete our transactions.

The CHAIRMAN. I will study your statement and reconsider my vote on this matter. You might need my vote on the floor, if not here. Thank you very much.

Mr. CLARKE. Thank you, sir.

Senator BYRD. Mr. Morin, on page 3 of your statement, you say arrangements have been made in February 1976 to deliver the registration statement to Washington. Do you have a date in February that those arrangements were made?

Mr. MORIN. I cannot give you the date, Mr. Byrd. I know that Mr. Donohue was in California early in the month. May I say that this committee has simply taken, I think, a judgment here as to what is fair and equitable and it differs somewhat from the House judgment.

I think of course traditionally that would be resolved in a conference between the two bodies. If you wish, Mr. Byrd, I will give you that date.

Senator BYRD. Thank you, sir.

The CHAIRMAN. Thank you very much, gentlemen.

[The prepared statements of Messrs. Clarke, Morin, and Hempstead follow:]

JOHNSON, LANE, SPACE, SMITH & CO., INC.,
Atlanta, Ga.

SUMMARY OF ATTACHED AFFIDAVIT DATED MAY 7, 1976

1. In September, 1975, Johnson, Lane, Space, Smith & Co., Inc. ("JLSS") learned that Vance, Sanders had received a tax ruling concerning a limited partnership exchange fund. In reliance of such ruling and other existing laws, JLSS immediately began to explore the feasibility of sponsoring a similar fund. JLSS hoped to secure the services of Provident National Bank ("Provident") of Philadelphia, Pennsylvania, as investment advisor to the fund.

2. During October, November, and December, representatives of JLSS were continually in contact with representatives of Provident. Numerous telephone and written communications were exchanged and three meetings were held in Philadelphia on November 12, 1975, December 2 and 3, 1975, and December 21 and 22, 1975. As a result of these extensive communications and meetings, an agreement in principle was reached, finalized and executed by both parties on December 22, 1975. Under the terms of this agreement, Provident will act as Investment Advisor to the Chestnut Street Exchange Fund and JLSS will act as Dealer-Manager.

3. During the period between the execution of the above agreement and continuing to February 17, 1976, JLSS continued to devote substantial time and effort in connection with the formation of the Fund. In late December, 1975, accountants and lawyers were employed to (i) form a California limited partnership (ii) request a ruling from the IRS and (iii) prepare and file an S-5 registration statement with the S.E.C. Several drafting sessions were held and by February 17, 1976, both the S-5 and the IRS requests were virtually ready for filing.

4. A meeting was scheduled for February 23, 1976, to finalize the Registration Statement and the IRS ruling request. This meeting was postponed on February 19, 1976, when JLSS and Provident were advised that H.R. 11920 had been introduced and that the IRS would issue no further rulings pending the outcome of the legislation.

5. In view of the substantial amount of time and money which JLSS had already invested in the project, a decision was made in March, 1976, to continue. The S-5 Registration Statement was then duly filed with the S.E.C. on March 25, 1976, and the tax ruling was filed with IRS on March 26, 1976.

6. As a result of its efforts in organizing the Fund, at May 7, 1976, JLSS had incurred expenses of about $80,000.00. Approximately half of these expenses were incurred prior to February 17, 1976.

But for the issuance of the April 28, 1975, ruling by the Internal Revenue Service to Vance, Sanders and the existing laws, upon which JLSS relied, the foregoing expenses would not have been incurred.

STATE OF GEORGIA, COUNTY OF FULTON

AFFIDAVIT

The undersigned Harrison Clarke, having been duly sworn, deposes and says:

1.

He is First Vice President of Johnson, Lane, Space, Smith & Co., Inc. (the "Company"), a registered broker-dealer under the Securities Exchange Act of 1934 with principal offices in Savannah and Atlanta, Georgia, and has held such position at all times relevant to the facts set forth in this Affidavit. Having held such position, he is familiar with the business of the Company and has personal knowledge of the facts set forth herein, all of which are true.

2.

In September, 1975 the Company was advised that the Vance, Sanders Exchange Fund ("Vance, Sanders"), a California limited partnership proposing to operate as an open-end diversified investment company, had on April 28, 1975 received a ruling from the Internal Revenue Service to the effect that:

(A) For Federal income tax purposes, Vance, Sanders would be characterized as a partnership and not an association taxable as a corporation.

(B) No gain or loss would be recognized to Vance, Sanders or to any of its limited partners on a contribution of stock or securities in exchange for an interest in Vance, Sanders.

(C) The basis of the partnership interest of the limited partners of Vance, Sanders would be the amount of any money and the adjusted basis of any property contributed at the time of the contribution.

(D) The basis of the property contributed to Vance, Sanders by limited partners would be the adjusted basis of such property to the limited partners at the time of contribution.

3.

In reliance on the Internal Revenue Service's ruling to Vance, Sanders and other existing laws, the Company immediately began to explore the feasibility of sponsoring a similar exchange fund, later designated the "Chestnut Street Exchange Fund" (the "Fund"), for which the Company would act as dealer-manager.

The Company hoped to secure the services of Provident National Bank ("Provident") of Philadelphia, Pennsylvania as investment advisor and transfer agent of the Fund, and, as hereinafter described, Provident agreed to serve in such capacities. Because of certain prohibitions under existing law, including the Glass-Steagall Act, all of the expenses incurred in organizing and registering the Fund were to be paid by the Company.

4.

Accordingly, during the remainder of 1975 and prior to February 17, 1976, the Company spent substantial time and money in organizing and preparing to market the Fund.

5.

During October, November and December, 1975, representatives of the Company were continually in contact with representatives of Provident. In addition to numerous telephone and written communications between representatives of

the Company and Provident during such period, the following meetings were held:

(A) A meeting attended by Mr. Richard M. Somers, Jr. of the Company and representatives of Provident was held on November 12, 1975 in Philadelphia;

(B) A meeting attended by Messrs. Somers and Reider A. Trosdal, Jr. and the undersigned on behalf of the Company and representatives of Provident was held in Philadelphia on December 2 and 3, 1975; and

(C) A third meeting was held in Philadelphia on December 21 and 22, 1975, which was attended by Mr. Somers and the undersigned on behalf of the Company and by representatives of Provident.

As a result of the above extensive communications and meetings, an agreement in principle was reached between the Company and Provident, and the agreement (the "Agreement") was finalized and executed by both parties on December 22, 1975.

6.

During the period commencing with the execution of the Agreement and continuing to February 17, 1976, the Company continued to devote substantial time and effort toward the formation of, and the preparation of marketing plans for the offering of interests in, the Fund. Shortly after the Agreement was executed, the Company employed accountants and lawyers who were instructed to form a California limited partnership, request a ruling from the Internal Revenue service as to the tax effects of investments in the Fund, and prepare and file with the Securities and Exchange Commission a Registration Statement on Form S-5. A detailed planning conference between the Company, Provident and their respective counsels was held on January 20, 1976 in Philadelphia to discuss the Fund and drafts of certain documents, including the Registration Statement on Form S-5 and the request for a ruling from the Internal Revenue Service, which had been prepared by counsel for the Company and to review and finalize the work assignment agenda. Counsel for the Company, together with employees of the Company, spent considerable time and effort prior and subsequent to the meeting, and prior to February 17, 1976, preparing, reviewing and revising these and other requisite documents.

7.

On February 19, 1976, the Company and Provident were advised that H.R. 11920 had been introduced and that the Internal Revenue Service would issue no further rulings pending the outcome of this legislation. Accordingly, a meeting, originally scheduled for February 23, 1976 to finalize the Registration Statement, the request for a ruling from the Internal Revenue Service and other related matters, was postponed. Notwithstanding such postponement, in view of the substantial amount of time and money which the Company had already invested in the project, a decision was made in March, 1976 to continue to proceed with the preparation of the Form S-5 Registration Statement, which was duly filed with the Securities and Exchange Commission on March 25, 1976, and the preparation of the request for a ruling from the Internal Revenue Service, which was filed on March 26, 1976.

8.

As a result of its efforts in organizing the Fund, the Company has incurred expenses which are as follows:

Category of expense	Prior to Feb. 17, 1976	Feb. 17 to April 30, 1976	Total
Travel	$2,770.74	$910.20	$3,680.94
Compensation to personnel	18,300.00	7,750.00	26,050.00
Telephone	1,134.75	276.50	1,411.25
Filing fees to the Securities and Exchange Commission		21,000.00	21,000.00
Miscellaneous	477.91	50.50	528.41
Total	22,683.40	29,987.20	52,670.60

In addition to the foregoing expenses, the Company has been advised by the law firms set forth below that the reasonable value of their services and the amount of expenses they have respectively incurred in connection with the Fund are as follows:

Law firm	Prior to Feb. 17, 1976	Feb. 17 to Apr. 30, 1976	Total
Drinker, Biddle & Reath (Philadelphia, Pa.):			
Fees	$10,300.00	$6,750.00	$17,050.00
Disbursements	1,000.00	1,900.00	2,900.00
Gibson, Dunn & Crutcher (Beverly Hills, Calif.):			
Fees	1,350.00	1,450.00	2,800.00
Disbursements	123.00	509.21	632.21
Kilpatrick, Cody, Rogers, McClatchey & Regenstein (Atlanta, Ga.):			
Fees	1,170.00	1,930.00	3,100.00
Disbursements	180.23	143.22	323.45
Total	14,123.23	12,682.43	26,805.66

The total expenses, therefore, incurred by the Company through April 30, 1976 in connection with the Fund are $79,376.26, of which $36,706.63 were incurred prior to February 17, 1976, and $42,669.63 were incurred after that date but on or prior to April 30, 1976.

9.

But for the issuance of the April 28, 1975 ruling by the Internal Revenue Service to Vance, Sanders and the existing laws, upon which the Company relied, the foregoing expenses would not have been incurred.

10.

This Affidavit is made for presentation to the House of Representatives and the Senate of the United States and any and all committees or members thereof in connection with their consideration of H.R. 11920 (94th Congress, 2d Session) or any other legislation during the current session relating to the taxation of partnership exchange funds.

In witness whereof, I have hereunto set my hand and seal this 7th of May, 1976.

HARRISON CLARKE. [SEAL]

Sworn to and subscribed before me this 7th day of May, 1976.

VICTORIA K. DUNCAN,
Notary Public.

STATEMENT OF CHARLES H. MOBIN ON BEHALF OF FEDERATED RESEARCH CORP. RELATING TO THE SWAP FUND AMENDMENT TO H.R. 10612

I am appearing today on behalf of Federated Research Corp. in support of the amendment to H.R. 10612 which was adopted by the Senate Finance Committee, relating to the prospective prohibition of tax-free transfers to limited partnership "swap funds."

On April 27, 1976, the Ways and Means Committee reported H.R. 11920, a Bill which terminates as of February 18, 1976, tax-free exchanges of securities for interests in limited partnerships. The Bill passed the House as H.R. 11920 and was approved as amended on June 4, 1976, as a Finance Committee amendment to H.R. 10612.

H.R. 11920 as passed by the House included a "grandfather clause" which allows tax-free transfers to partnerships which had filed Registration Statements with the Securities and Exchange Commission and Ruling Requests with the Internal Revenue Service on or before February 17, 1976, provided that certain other conditions were met. The February 17, 1976, date is the date the Bill was introduced in the House.

The effect of the House grandfather date was to allow tax-free exchanges of five swap funds and leave out three funds which were in the process of organizing limited partnerships at the time the Bill was introduced. Based on additional information submitted to the Finance Committee and the staff, the Finance Committee extended the grandfather provision in the House-passed Bill to include the three swap funds which were in the organizational process at the date the House Bill was reported out by the Ways and Means Committee.

In the specific case of Federated Research Corp., we respectfully submit that the change made to the grandfather provision by the Finance Committee is amply justified by the efforts and expenditures of Federated *prior* to the introduction

of H.R. 11920 in the House—actions which were based on an existing Internal Revenue Service Ruling.

Representatives of Federated Research Corp. had testified before the Ways and Means Committee as early as September, 1971, and again in March, 1971, in favor of an amendment to Section 351 of the Internal Revenue Code which would permit swap funds to be organized in corporate form. This testimony pointed out the revenue gain to be realized from such a course of action. No amendment was then introduced, primarily because of economic factors.

A tentative decision was made by Federated in October, 1975, to organize an exchange fund in limited partnership form and preparation of a Registration Statement was commenced. By December, 1975, the Registration Statement for Federated Exchange Fund was ready for filing, but filing was withheld pending the expected announcement by the Ways and Means Committee of capital gains tax hearings. By January, 1976, the executive committee of Federated made the decision to proceed with the filing of the Registration Statement and had made arrangements in February, 1976, to deliver the Registration Statement to Washington for filing with the S.E.C. At that time, the President of Federated, John F. Donahue, became ill with pneumonia, requiring that filing of the Statement be postponed until he was able to review and execute it. Coincidentally and unexpectedly, the House Bill (H.R. 11920) was introduced. Federated then filed its Registration Statement on March 3, 1976, within two weeks after the announcement of the filing of H.R. 11920. The determination to do this was based upon the opinion of counsel that the exchange contemplated by the Registration Statement would be tax free under then applicable law, subject to the final form of H.R. 11920.

Federated has obviously pursued an orderly and accepted method of statutory amendment since July 31, 1969, when it commenced communication with the Treasury Department. Its expenditures since July, 1970, when conferences were first held with the then Chairman of the Ways and Means Committee have exceeded $200,000 through 1975. Its expenditures in pursuing the limited partnership registration alone have exceeded $150,000. These expenditures were incurred in reviewing the special requirements of federal securities law, federal tax law, California statutes, Pennsylvania statutes, Blue Sky laws of the various states, preparation of the S.E.C. Registration Statement and matters related to legislative activities connected with the introduction of the House Bill. They also include extensive internal efforts in preparing drafts of agreements, statements and reports and Ruling Requests, as well as the extensive negotiations with proposed custodians and transfer agents, underwriters and members of the brokerage community. These internal expenses alone amounted to over $90,000.

Thus, more than any other registrant, Federated deserves to be included in any "grandfather clause" relief from the change in the law proposed in H.R. 11920.

We submit that the action taken by the Finance Committee in including the additional three companies was equitable and proper, and that the Committee amendment should be adopted by the Senate.

STATEMENT OF JOHN E. HEMPSTEAD, PARTNER BUTCHER & SINGER, PHILADELPHIA, PA.

To the Honorable Members of the Committee on Finance: My name is John E. Hempstead. I am a partner in the investment banking firm of Butcher & Singer, which has its principal office in Philadelphia, Pennsylvania. My remarks concern the effective date provisions of the Committee Amendment to H.R. 10612, which deal with so-called partnership swap funds. The substantive provisions of this particular legislation correspond to H.R. 11920, passed by the House of Representatives on May 3, 1976.

At the time of the hearings by the Ways & Means Committee on H.R. 11920 on March 29, 1976, there were eight swap funds which had been formed as partnerships. On February 17, 1976, the date on which H.R. 11920 was introduced, five funds had then been formed and the three other funds had not yet filed a request for ruling with the Internal Revenue Service or a registration statement with the Securities and Exchange Commission. One of those three funds is Equity Exchange Fund, sponsored by my firm.

I am here to support the action of the Finance Committee in recognizing the fairness and equity in permitting all eight funds to conclude the transactions for which they were formed.

On January 29, 1975, Butcher & Singer received a favorable tax ruling from the Internal Revenue Service concerning the establishment of a general partnership as an investment company. The importance of that January, 1975 ruling to the present situation is that the ruling established, in our opinion, a more desirable, economical and easier method of utilizing a partnership format as an investment company, as distinguished from the limited partnership format which then, and now, has been the usual method for a partnership investment company. When I heard about the Vance, Sanders Exchange Fund (which is a limited partnership) it occurred to me that the general partnership format of our January, 1975 ruling could be adapted for use in a swap fund context. Consequently, on Tuesday, November 18, 1975, I first met with our tax counsel to review with him the effect of organizing a swap fund utilizing the general partnership format of the January, 1975 ruling. From that conversation, it did become evident that there were certain advantages in utilizing the general partnership format for our swap fund, rather than the limited partnership format used by Vance, Sanders.

I immediately began to concentrate most of my activities to arranging the establishment of a swap fund which would utilize the general partnership format approved by the Internal Revenue in January, 1975, and would rely upon the policy of the Internal Revenue Service, as announced in the Vance, Sanders case, to issue favorable rulings to swap funds.

Butcher & Singer would prefer to have some other entity be the fund's investment adviser or manager, although we would be willing to perform that function if a suitable arrangement could not be made with an independent fund adviser or manager. For this reason, I spent considerable time in determining what entity would be a compatible participant with Butcher & Singer in the establishment and operation of its swap fund. These efforts resulted in numerous telephone calls with officers of Wellington Management Company, of Valley Forge, Pennsylvania during December, 1975. As a result of these calls, a meeting to discuss the management of the swap fund by Wellington Management was held on December 22, 1975. Attending that meeting were three officers of Wellington Management, our counsel, and myself. The result of that meeting is summarized in the "Proposal for an Exchange Fund" dated January 14, 1976 which was sent to William H. L. Sullivan, of Wellington Management Company. That memorandum, together with a separate memorandum of our counsel also dated January 14, 1976, summarizes the most important features of the general partnership exchange fund format. Although those memoranda were only summaries, they clearly show the substantial amount of the legal activity, and my activities, which had gone into this project from November 18th to that date. Copies of those memoranda are being made available to the Committee.

The letter to Mr. Sullivan was followed by a second meeting with officers of Wellington Management Company, held on February 2, 1976. Attending that meeting were three officers of Wellington Management, our counsel and myself. Those attending the meeting wanted to go forward with the project as soon as possible. As a result of those meetings, we authorized our counsel to draft what would be, in effect, a request for a supplemental ruling to our January, 1975 ruling regarding the use of the general partnership format for the swap fund. There is no question that our desire to use a more economical partnership format, rather than merely to "copy" the Vance, Sanders format, was the cause of delay in forming our swap fund. This required additional time to explain to Wellington Management the operation and legal aspects of that format. As it has developed, we now find it necessary to use the same limited partnership format as the other swap funds because of novel issues raised by the Securities and Exchange Commission which, in the opinion of our counsel, probably would not be resolved prior to the expiration of the 60-day period permitted by the bill to conclude solicitation of exchange securities. The use of the limited partnership format presents no delays for technical reasons with the Securities and Exchange Commission or with the Internal Revenue Service.

Shortly after that February 2, 1976 meeting with the officers of Wellington Management Company, our counsel and we had heard the rumors circulating in the investment community that the Internal Revenue Service was, for some unknown reason, putting a "hold" on the issuance of rulings for swap funds. It was only a few days later when, on February 17, 1976, H.R. 11920 was introduced and the Internal Revenue Service suspended rulings.

At the time the Service's "hold" position in issuing rulings was made known to the interested parties, we had already incurred considerable costs and effort on the matter. This is amply evidenced by the memoranda dated January 14, 1976 sent to Wellington Management. Ironically, had not the "hold" position been

taken by the Internal Revenue Service, I have been informed that our request for ruling would have probably been submitted to the Service before February 17, 1976.

In 1966, the Congress permitted swap funds to become effective for a short period after enactment of legislation which thereafter precluded corporate swap funds. After H.R. 11920 had been introduced, we recognized that the effective date provisions for the swap fund legislation might not be as liberal as those provided in the 1966 legislation. For this reason, we filed our request for ruling with the Service prior to the hearings held by the Ways and Means Committee, so that the Congress could enact a bill which would give fair treatment to us along with all the other swap funds which have relied upon the Service's position by filing a request for ruling or a registration statement prior to that cutoff date.

In conclusion, we believe that the Finance Committee has properly recognized that it is only fair and equitable that all eight swap funds be permitted to conclude the transactions for which they were created.

Thank you for your consideration.

The CHAIRMAN. We will next call Dr. Leo J. Gehrig, senior vice president, American Hospital Association.

STATEMENT OF DR. LEO J. GEHRIG, SENIOR VICE PRESIDENT, AMERICAN HOSPITAL ASSOCIATION

Dr. GEHRIG. Mr. Chairman, members of the committee, we appreciate this opportunity and I wish to support the amendment offered by Senator Ribicoff and offered by the committee which would authorize under section 501(e), in addition to existing authorities, cooperative activities in laundry and clinical services.

The American Hospital Association has for years urged hospitals to share services in order to hold down capital expenditures and to achieve the economic accessibility and quality advantages of such actions wherever they are feasible.

Let me explain that the objectives of such services are the improvement in the quality and cost in obtaining the quantities of skill that can be achieved by such joint activities.

The resultant cost savings can help to restrain charges to sell paid hospital patients and the third party payers including the Government. So far as we know, there has been no opposition to this amendment, save one by the Linen Supply Association of America which opposes the position of Senator Ribicoff's amendment related to provision of laundry services.

In fact, the administration's position on this bill has been supported as in the public interest as we have indicated in the past. My full statement, which I hope you will include in the record, relates to some of what we believe are inaccuracies of the statement provided to the committee by the Linen Supply Association.

We further have amplified our statement with specific examples of shared services in a number of areas of the country where the services have pointed up the fact that savings can be accomplished which can be reflected in terms of our charges to patients.

We believe this important step forward, and it has been advocated in other bills like the Comprehensive Health Planning Act, the advantages other than cost savings, however, can be realized by hospitals participating in such services.

I would only indicate these include the separate processing of linen which is contaminated, similarly articles of clothing, separate deal-

ing of linens from pediatric, obstetrical, and surgical areas, the provision of certain types of surgical floor and discharge packs that are important, doing this within the requirements of hospitals for the quality of the type of linen return.

Frankly, in general, the decision to use, as is the most common method now, that is in plant, services by hospitals versus using shared services, commercial laundry linen supplies will continue to be one that each hospital must be forced to determine in terms of quality and cost.

This provision provides an alternative which will be important in some areas, we urge Congress to retain a committee approved amendment. I would like to add that we strongly support Senator Curtis' amendment which would encourage nonprofit hospitals to provide certain services where they can be done effectively through other nonprofit health care institution services which otherwise would have to be provided by the individual institution.

We believe it offers similar advantages and will be important in the many areas. We thank you for this opportunity to appear before you.

Senator CURTIS. May I clarify the record just a little now? The provision offered by Senator Ribicoff is the one that has the laundry factor.

Mr. GEHRIG. That is right.

Senator CURTIS. As I understand it, existing law permits cooperatives to be set up by hospitals to carry out these things that they consider mutually advantageous.

My proposal looked only to small hospitals. It would permit them more or less exchange or share services. They did not have to set up the separate cooperatives. Is that your understanding?

Mr. GEHRIG. Exactly my understanding. As you indicated, the 501(e) authority of Senator Ribicoff does require institutions to set up separate organizations and there are institutions, many of which do not have any capital costs that would be related to such a cooperative venture.

Your amendment would provide one nonprofit organization to provide directly certain services to other nonprofit health care institutions and I think particularly in some of the rural areas, a limitation which is now present, and will continue to be present.

Senator CURTIS. But they are two separate propositions. The one I offered is not involved in the laundry controversy.

Mr. GEHRIG. Correct. I have heard no objection to yours.

Senator CURTIS. There is a disagreement in reference to the laundry situation.

Mr. GEHRIG. That is correct. As a matter of fact, this is not new. The opposition has occurred before but we believe at this point in time with a considerable concern on cost factors that this is a legitimate methodology which does not suggest an exclusive use of cooperative activities across the country.

As a matter of fact, it is not feasible and probably never will be used as a common method. There are many areas where cost savings can be achieved which will be important both to private patients and to the Government.

The CHAIRMAN. Thank you very much, sir.

Mr. GEHRIG. Thank you.
[The prepared statement of Dr. Gehrig follows:]

STATEMENT OF THE AMERICAN HOSPITAL ASSOCIATION

SUMMARY

1. In 1968 Congress enacted Section 501(e) of the Internal Revenue Code to authorize hospital shared services organizations to help nonprofit hospitals make cost savings that benefit self-pay patients and the government as purchaser of services under the Medicare and other Federal programs. Intensive lobbying at that time by the commercial laundry industry led to exclusion of laundry services from Section 501(e).

2. Senator Ribicoff's hospital shared services amendment which the Finance Committee approved June 11 would permit 501(e) shared services organizations to provide laundry services to their members.

3. Inconsistencies, inaccuracies, and self-serving and misleading statements raise serious questions as to the usefulness of a Position Paper of the Linen Supply Association of America which we have seen.

(A) Quotations from a magazine article give an incorrect impression of the author's views, and the position paper offers price comparisons without establishing that the costs cover the same range of services, a mistake the author of the article warned against.

(B) We cannot evaluate the validity of data presented in the LSAA position paper from a study by Michael Broadbent since we do not have access to the study.

(C) Instead of leading to unnecessary duplication of services and facilities claimed in the LSAA position paper, hospital shared services laundries, certificate-of-need laws, and P.L. 93-641 (the health planning law Congress enacted a couple of years ago) are best designed to reduce capital outlays through avoidance of unnecessary duplication of health facilities and services.

(D) The principal thesis of the LSAA position paper is that commercial laundries provide services to hospitals that are of acceptable quality at a lower cost than shared laundries, but verifiable cost data to support this claim is lacking.

4. Seven specific examples of hospital shared services laundries in different parts of the country are provided in the AHA's testimony, with the names and addresses of officials of the laundries who are prepared to substantiate the savings we have reported.

5. Other, sometimes more important, advantages of hospital shared services laundries include:

(A) Better quality control programs that often cannot or are not carried out by commercial laundries, such as separate handling of contaminated linen, surgical and obstetrical linen, special cleaning of delivery carts and vans, and use of special washing formula, temperature and time, to meet rigid hospital requirements.

(B) Commercial laundry service of acceptable quality is not everywhere available to hospitals.

Conclusion.—A hospital's decision to use an in-house laundry plant, shared services, or commercial laundry service is based on a comparison of available alternatives, their quality and cost. Making the option of shared laundry services under Section 501(e) available to hospitals does not suggest such services will be feasible or desirable in all areas. We believe, however, hospitals should have available to them the option of such shared services under 501(e) when cost savings and other advantages such as improved quality of services can be realized through cooperative arrangements.

We urge the Finance Committee to confirm its approval of the hospital shared services amendments, and the Congress to enact the amendments.

STATEMENT

I am Leo J. Gehrig, M.D., Senior Vice President of the American Hospital Association, which represents some 7,000 health care institutions and more than 21,000 personal members. I appreciate the opportunity to appear before this Committee in support of the hospital shared services amendments the Committee

has approved for incorporation in H.R. 10627, the tax reform bill now before the Senate.

In the Association's April 14, 1976, statement to the Finance Committee on tax reform issues, the AHA recommended that Section 501(e) of the Internal Revenue Code, which grants tax exempt status to organizations providing certain services on a cooperative basis to nonprofit hospitals, be amended to permit and encourage expansion of such shared services activities as a means of helping hospitals in their efforts to hold down increases in the cost of hospital care.

The amendment offered by Senator Ribicoff and approved by the Committee would authorize under Section 501(e), in addition to existing authorities, cooperative activities in laundry services and clinical services. Further, it would permit nonprofit skilled nursing facilities to participate along with nonprofit hospitals in the formation of such shared services organizations.

The American Hospital Association has for many years urged hospitals to share services in order to hold down capital expenditures and to achieve the economic accessibility and quality advantages of such action where feasible. The term "shared services" in the hospital field is widely understood to mean services provided as the result of two or more hospitals or other health care institutions combining resources to provide better or more econmical services for their patients. Such shared services can encompass both administrative and clinical functions. Let me emphasize that the objectives of such shared services are improvement in the accessibility and quality of care and economies of scale that can be attained through joint activities. Resultant cost-savings can help to restrain charges to self-pay hospital patients and third-party payors, including the government as the purchaser of services for beneficiaries of health programs.

As a result of the Section 501(e) hospital shared services authorization which Congress enacted in 1968, a variety of such shared services have been developed by hospitals that have made for more efficient provision of services than would be possible by institutions acting alone.

Intensive lobbying by the commercial laundry industry in 1968 led to the exclusion of laundry services from the list of activities that 501(e) hospital shared services organizations may perform for their members. The hospital field is now asking Congress to act to remedy this omission, and we were grateful when this Committee on June 11 approved both Senator Ribicoff's and Senator Curtis' hospital shared services amendments. So far as we know, the only opposition to these amendments has come from the Linen Supply Association of America which opposes a provision of Senator Ribicoff's amendment that would permit Section 501(a) shared services organizations to provide laundry services to their members.

Among the advantages hospital shared services offer are:

Savings of capital funds through avoidance of unnecessary duplication of facilities and services;

Lower operating costs through greater efficiency and economies of scale; and

Better quality controls and improved availability and accessibility of essential services.

Mr. Chairman, we have seen a paper prepared for the Linen Supply Association of America (LSAA) entitled "Position Paper in Opposition to the Senate Finance Committee" that on the one hand staes no public hearings were held on this issue, and on the other charges that the American Hospital Association has provided the Congress with incorrect data. Both statements are untrue. I have already pointed out that the AHA's recommendations for amending Section 501(e) were submited on April 14 and therefore have been a matter of public record for several months. Further, we have provided only accurate and verifiable data to the Committee.

I shall not attempt to deal with all of the inconsistencies, inaccuracies and self-serving and misleading statements in the LSAA position paper, but I would like to point to a few that raise serious questions as to the paper's usefulness:

1. References are made to an article written by Wilbur Stevens and published in the December 1975 issue of *Hospital Financial Management* magazine. Quotations from the article are presented to create the impression that the author is critical of hospital shared laundries. In fact, a careful reading of the article suggests that the author is merely pointing out that misconceptions arise in comparing costs of combined laundry (washing) services and linen supply serv-

ices with other operations that do not include the costs of similar combinations of services. The LSAA statement then goes on to present cost comparisions without assuring that the services being compared are substantially the same.

The Stevens article, in our view, actively supports the proposition that shared laundry services can effect cost savings through economies of scale, while emphasizing that accurate records must be kept of the elements of such services in order to measure savings.

2. We have not had access to the data collected by Michael Broadbent from 16 hospital laundry cooperatives as extensively quoted in the LSAA position paper. Therefore, we cannot evaluate the validity of the data and statements. I would point out, however, that more hospitals in this country perform both laundry and linen supply services for themselves than obtain such services through other arrangements. The motivation for a hospital to join with other institutions in the development of a shared laundry service is to obtain quality services more efficiently and economically than can be obtained by other means. Later in my testimony I shall cite examples involving a significant number of hospitals in which central cooperative laundries are providing high quality services to hospitals at lower costs than commercial laundries in their areas are charging :

3. In addition, the LSAA position paper discusses capital costs an duplication of facilities and arrives at inappropriate conclusions.

Capital costs can be minimized by the sharing of laundry services, where feasible, in lieu of a number of individual hospitals maintaining in-house laundries. The American Hospital Association has over the years strongly supported the development of certificate-of-need programs to avert unnecessary duplication of resources, and fully supported the legislation providing for such programs which became P.L. 93-641, The National Health Planning and Resources Development Act. We are convinced, in fact, that shared services can and do avoid unnecessary duplication in a variety of hospital activities and facilities.

Moreover, P.L. 93-641 specifically states that "*the development of multi-institutional arrangements for the sharing of support services necessary to all health service institutions*" is one of ten priority goals of federal, state, and area health and resources development programs. (Section 1502 of title XV of the Public Health Service Act, which is headed "National Health Planning and Development."

4. Throughout the LSAA position paper there is a suggestion that the amendment approved by the Committee would result in the development of cooperative shared laundries to serve all hospitals in the country. This would not be feasible, and it is completely erroneous to make such an assumption. The authority for shared laundry services under Section 501(e), as in the case of the authority for other shared services, would be used where such shared laundries could provide more accessible and economical services of acceptable quality.

Cooperative Laundry Services

Laundry services for hospitals are provided through a variety of arrangements. Data collected by the American Hospital Association in a 1975 special survey of selected hospital topics shows the following:

44.7 percent of 6,223 hospitals reporting processed their laundry in *in-house plants;*

10 percent of the hospitals had their laundry processed by *cooperative laundries;*

30.2 percent had their laundry processed by *commercial laundries;* and 10.6 percent used *linen rental services.*

(The remaining 4.5 percent were accounted for by various combinations of in-house, cooperative, and commercial laundry services, linen rental services, and a .2 percent nonresponse.)

Shared hospital laundry services are not authorized under Section 501(e) and this has impeded their development. However, some central hospital laundries have been formed despite their handicap and have demonstrated their value.

I believe it would be helpful to the Committee to cite specific exampl esof the achievements of some hospital shared services laundries in different parts of the country:

Western Kentucky Hospital Services, Inc., North Main Street, P.O. Box 486, Badisonville, Ky., Kenneth Alexander, executive vice president.

This laundry processes over 4 million pounds of laundry a year for its 12 hospitals, saving the participating institutions, in the aggregate, over $200,000 annually.

Central Services Corporation of Metropolitan New Jersey, 646 Frelinghuysen Avenue, Newark, N.J., Peter Bothyl, executive director.

In its four years of operation, this laundry has demonstrated it can rpovide participating hospitals efficient and economic laundry services. It processes 14.5 to 15 million pounds of laundry a year for its 21 hospitals at a cost of 19 cents per pound, which is approximately 1.5 cents per pound lower than commercial laundry rates in the service area. The laundry has the total support of the New Jersey State Department of Health as an activity that helps restrain hospital costs.

Virginia Hospital Laundry, Inc., 1601 North 17th Street, Richmond, Va., Thomas N. Vaughan, Jr., general manager.

This laundry began operating in February of this year and is now serving 4 hospitals, with another to be added very soon. It now handles approximately 110,000 pounds of laundry per week and estimates it will handle some 6.7 million pounds per year. At the present time its charge is 21 cents per pound as compared with a 28 cents per pound charge by commercial laundries in the area. This 7 cents per pound difference is expected to yield a savings of approximately $460,000 per year, and the 21 cents per pound charge will be further reduced after debt service has been retired.

Associated Hospital Services, Inc., 7639 Townsend Place, New Orleans, La., LeRoy D. Kohler, general manager.

This laundry processed over 2.6 million pounds of laundry in 1975 for 6 hospitals at a savings of 2.5 cents per pound, or over $65,000 for its member hospitals. Let me note, also, that the central laundry has many letters from hospitals about the high quality, convenience and reliability of the laundry services being provided.

Hospital Central Services, Inc., 2139 28th Street, Allentown, Pa., Kenneth R. Crowly, vice president.

The laundry serves 18 hospitals and processes over 11 million pounds of laundry per year at a cost-savings of 3 cents per pound. The annual savings for its members is $330,000.

Hospitals Laundry Association, Inc., 175 Ipswich Street, Boston, Mass., Samuel T. Church, General manager.

This laundry serves 28 hospitals (5,600 beds) and processes over 25 million pounds of laundry annually at an annual savings of some $250,000 for its member hospitals.

While the cost per pound of laundry varies, depending in part on the scope of services provided, these examples show that, contrary to the principal thesis of the position paper of the Linen Supply Association of America, *cooperative shared laundry services can and do bring cost savings to nonprofit hospitals that can be passed on to patients.*

In addition to cost savings from more efficient operations and the economies of scale, where such shared services are feasible, cost savings can be realized through the elimination of unnecessary duplication of hospital in-house laundries. For example, in Madison, Wisconsin, the Madison United Hospital Laundry, 1310 West Badger Road, was constructed at a cost of $1.7 million, whereas the estimated cost of renovating or constructing in-house laundries at the hospitals it serves was estimated at well over $2.5 million. Moreover, in this instnace, there was no commercial laundry service of acceptable quality available to the hospitals, nor a commercial laundry rate available to compare with the central laundry's estimated cost of 17.5 cents per pound.

Quality of Services

Advantages other than cost savings can be realized by hospitals participating in shared laundry activities. Among these are quality control programs that often cannot or are not provided by commercial laundries but which can be carried out by laundries that service only hospitals and other health care institutions. For example, separate processing of contaminated linen and articles of clothing, separate processing of obstetrical, pediatric and surgical linens; the use of approved washing formulae, temperature and time, to provide necessary levels of cleanliness required by hospitals; specialized cleaning of linen carts and delivery vans through germicidal fogging, steam cleaning, etc.; and the

preparation of special surgical packs, floor packs, discharge packs, and linen maintenance. Also, cooperative hospital laundries usually provide services six days a week so that hospitals can count on prompt delivery even on an emergency basis.

Availability of Services

At present, more hospitals obtain their laundry and linen supply services through house operations than by any other method. Further, in a number of instances the alternative of comparable commercial laundry services is not available.

As we indicated, hospitals must be concerned with the quality, cost and accessibility of these services. Several executives of hospital central laundries have verified that their cooperative laundries were initiated to more efficiently provide these services to groups of hospitals in areas where there were no commercial laundries willing or able to provide laundry services of acceptable quality.

In general, the decision to use an in-house plant, shared service, or commercial laundry is based on a comparison of available alternatives, their quality and cost. Making available the opportunity for hospitals to share laundry services under 501(e) does not suggest that such services will be either feasible or desirable in all areas. We believe, however, that hospitals should have the option under 501(e) of sharing laundry services when cost savings and other advantages such as improved quality of services can be realized through cooperative arrangements.

Mr. Chairman, amending the law to permit 501(e) hospital shared services organizations to provide laundry services to their members, would, in our view, be in the public interest and thus assist hospitals to deliver health care more efficiently and economically. The amendments approved by this Committee on June 11 would, we believe, lead to a more effective implementation of the original aim of Section 501(e). We urge the Congress to retain the Section 501(e) amendments your Committee has approved.

The CHAIRMAN. Mr. Leonard B. Farrell, director of government and industry relations of the Institute of Electrical Electronics Engineers, Inc., and acting chairman of the Joint Committee on Pensions, and Mr. Robert Saunders.

STATEMENT OF LEONARD B. FARRELL, DIRECTOR OF GOVERNMENT AND INDUSTRY RELATIONS OF THE INSTITUTE OF ELECTRICAL & ELECTRONICS ENGINEERS, INC., AND ACTING CHAIRMAN OF THE JOINT COMMITTEE ON PENSIONS, AND DR. ROBERT SAUNDERS

Mr. FARRELL. Thank you very much, Mr. Chairman. I am Leonard B. Farrell, acting chairman of the Joint Committee on Pensions for Engineers & Scientists. With me, is Dr. Robert Saunders, vice president of regional activities of the Institute of Electrical & Electronics Engineers, Inc.

Dr. Saunders is also professor of electrical engineering at the University of California at Irvine, Calif., and the former dean of engineering at the University of California at Irvine. He will present the testimony in behalf of the Joint Committee on Pensions. But before Dr. Saunders does so, I would like to indicate for the record that the interest we are demonstrating today in the two pension areas we shall discuss started some 8 months ago with the Senate Finance Committee.

We attempted to testify at your earlier hearings in April but the busy schedule of the committee precluded it. Since then I have had the opportunity to work with and discuss these several issues with a

number of your colleagues and, indeed, the staff members of most all members of the Senate Finance Committee.

Dr. Saunders.

Dr. SAUNDERS. Mr. Chairman, the Joint Committee on Pensions, which I represent today, appreciates the opportunity to focus your attention on this legislation in the several areas relating to pensions, that is, the Keogh plan, particularly what has been called the mini-Keogh and the limited employee retirement account—LERA.

We have a prepared statement which I would ask be placed in the record, and then I would like to make some informal remarks.

[The statement follows:]

TESTIMONY OF DR. ROBERT M. SAUNDERS ON BEHALF OF THE ENGINEERS' AND SCIENTISTS' JOINT COMMITTEE ON PENSIONS

SUMMARY

The engineering and scientific professional societies urge this Committee to modify section 1502 of the Senate amendments to H.R. 10612, amending section 415 of the Internal Revenue Code, to delete the $15,000 limit on access to the "Mini-Keogh" permitting contributions to a small Keogh plan up to an annual limit of $750 or 100 percent of self-employment income, whichever is less. In the alternative, the Joint Committee on Pensions asks that eligibility be raised at least to permit contributions by employees with up to $30,000 adjusted gross income. Such amendments are necessary to permit working professional engineers and scientists to use the Keogh amendment as a method of providing a limited amount of retirement income, in light of the fact that such professionals are so highly mobile that they very frequently do not vest under corporate pension plans, even as amended in accordance with ERISA.

IN SUPPORT OF RESTORATION OF THE "MINI-KEOGH" PROVISIONS OF THE INTERNAL REVENUE CODE

It is the position of the Joint Committee on Pensions of the several engineering and scientific professional societies that the pending Tax Reform Bill should include a restoration of the so-called "Mini-Keogh" provisions in § 404(e)(4) of the Code, intended to be included in ERISA, but *without* the proposed limits on access to those provisions presently included in § 1502 of the Senate amendment to H.R. 10612.

WHO WE ARE

The Joint Committee on Pensions represents the principal and largest professional engineering and scientific societies in the nation. The Institute of Electrical and Electronics Engineers ("IEEE") has over 140,000 U.S. members, and is the largest professional engineering society in the world. The American Society of Mechanical Engineers . . . the American Society of Civil Engineers . . . The American Institute of Chemists . . . The American Institute of Consulting Engineers . . . The American Institute of Chemical Engineers . . . The Engineers' Joint Council represent additional hundreds of thousands of engineers and scientists.

IN SUPPORT OF RESTORING THE ORIGINAL INTENT OF SECTION 404(e)(4) OF THE CODE

There is not the slightest doubt that Congress, in enacting ERISA and including a new section 404(e)(4) of the Code, intended to permit a person with some self-employment income to contribute the first $750 of that income to a Keogh plan, without regard to any otherwise applicable limit on that contribution. The current text of section 404(e)(4) reads as follows:

(4) *Limitations Cannot be Lower Than $750 or 100 Percent of Earned Income.*—The limitations of paragraph (1) and (2)(A) for any employee shall not be less than the lesser of—

(A) $750, or

(B) 100 percent of the earned income derived by such employee from the trades or businesses taken into account for purposes of paragraph (1) or (2)(A) as the case may be.

The heading of this subsection makes it clear that Congress intended that the first $750 of self-employment income could be contributed to a Keogh plan and that "the limitations cannot be lower" than that. But then there was still section 415, imposing an overall limit of 25 percent on earned income which is in conflict with 4(B) above.

We have no doubt that Congress simply forgot to exempt this small Keogh contribution from the otherwise applicable limits of section 415(c)(1)(B) of the Code ("25 percent of the participant's compensation"). Obviously, the term "100 percent" in section 404(e)(4)(B) must have been intended to have some meaning, and not to be a term to be wiped out utterly by another provision of the Code.

Nonetheless, this Committee, in its amendment, while recognizing the problem and seeking to correct it, has limited the benefit of its proposed correction, under section 1502 of the Committee amendment, by a proviso excluding any taxpayer whose adjusted gross income for the taxable year exceeds $15,000. It is that limitation which we oppose and we ask you to delete it, or substantially raise the limit, for otherwise the engineering and scientific community will virtually be excluded from participation.

We are not rich taxpayers looking for another loophole. We are ordinary working engineers and scientists, and not rich ones at that. And as we have told this Committee on a number of previous occasions, many of our engineers and scientists are among the most highly mobile of Americans, changing jobs more frequently than almost anyone else. Many are unlikely to vest under corporate pension plans—even plans revised in accordance with ERISA.

Nonetheless, we are trying to find a way to provide some retirement protection for our members. And in that connection, the "Mini-Keogh" intended by section 404(e)(4) may provide at least a minimal measure of protection for our members.

Many of our members do consulting and writing on the outside. That generates a small amount of self-employment income which could qualify for a Keogh. But 25 percent of such a small amount of income would generate a triviality of a pension; whereas 100 percent of the first $750 could add up to something real in the long run. It is for that reason that our members are most anxious to see the restoration of the 100 percent/$750 limit as Congress originally intended it.

Accordingly we ask this Committee to delete the $15,000 limit on adjusted gross income currently proposed in the Senate amendments to the pending Tax Reform Bill; or, if this Committee feels strongly that some limit must be included, we would suggest some increase—perhaps up to $30,000.

In addition, the Joint Committee on Pensions also strongly supports the Limited Employee Retirement Account (LERA) provided in section 1502 of the House version of H.R. 10612. As indicated above, our members often fail to vest under their corporate pension plans, even as amended in accordance with ERISA, because of high job mobility. With the LERA, our members would still be able to obtain a limited benefit with respect to their own contributions, either to an IRA or to their own corporate plan, on the assumption that employee contributions are always 100 percent vested.

Dr. SAUNDERS. The Joint Committee on Pensions represents about 1 million engineers and scientists in addition to their families. We are concerned with the pension problems and issues of this group.

It is interesting, Mr. Chairman, that in this week of major engineering achievements in space—the landing on Mars—and looking at a 7-year anniversary of another major achievement in space, the landing on the Moon, the engineers and scientists who made this all possible needed to come to Congress on two occasions to seek relief for our profession.

In connection with the space program, there are many of us who serve as temporary ad hoc support people, adding to the competence of the engineers and the scientists who man the regular programs.

We serve in a very simple fashion for a very short period of time for which we receive additional income. This employment qualifies under the Keogh plan even though we may be covered in our regular employment under regular pension programs.

Some of us are also active as authors of a variety of books and treatises. We seldom strike it rich. We do not very often make a big

pot of gold from these authorships. On the other hand, the income from that affords us an opportunity to augment our pension income which for many of us will be very low or nonexistent.

Some of us, like you, give lectures and we receive income or honoraria from such activities. These activities all represent income that qualifies under the Keogh plan but it is usually quite small.

For example, my supplemental income in the past 13 years has been only averaging around $3,000 per year, so it is strictly a supplemental proposition. It is inconceivable to my Joint Committee on Pensions that it was the intention of Congress to enact legislation allowing the first $750 of supplemental income only to nullify it later in the act (ERISA).

We therefore urge the committee to preserve the mini-Keogh provisions of ERISA allowing $750 or 100 percent of self-employed income, whichever is less.

My committee has noted that in correcting the previous oversight of the Congress which the finance committee has done; a proviso has been introduced, however, that would limit the $750 or 100 percent whichever is less provision, to those with an income of less than $15,000.

It is this limitation that causes us distress and concern since this would rule out of the use of the mini-Keogh plan for well over 90 percent of the members we represent. We are not rich taxpayers looking for another loophole. We are ordinary working engineers and not rich ones at that. As we have told this committee on a number of previous occasions, many of our engineers and scientists are among the most highly mobile of all Americans.

In developing this technology in our technology intensive society, we must move, change jobs quite frequently. On the average, at the present time, an engineer serves in one position for only 6½ year.

Nevertheless, we are trying to find a way to provide some retirement protection for our members.

Senator CURTIS. May I interrupt you right there? Are you saying that because of the moving factor that you do not get vesting rights in company pensions?

Dr. SAUNDERS. That is correct.

Senator CURTIS. Does that situation prevail with a sizable number of your members?

Dr. SAUNDERS. About 80 percent.

Senator CURTIS. That is all.

Dr. SAUNDERS. So, Mr. Chairman, we ask this committee to delete the $15,000 limit on adjusted gross income currently proposed in the Senate amendments to the pending tax reform bill or if this committee feels strongly that some limit must be included, we would suggest some increase perhaps up to $30,000.

In addition, the Joint Committee on Pensions also strongly supports the limited employee retirement account, the so-called LERA provided in section 1502 of the House version of H.R. 10612.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, sir. The next witness will be Mr. Myron B. Thompson, treasurer, board of trustees, Kamehameha Schools, Bernice Pauahi Bishop's estate, accompanied by Mr. William Warren.

[The prepared statement of Mr. Thompson follows:]

COMMITTEE ACTION ON JUNE 11, 1976—ACQUISITION INDEBTEDNESS

SUMMARY OF PRINCIPAL POINTS

My name is Myron B. Thompson of Honolulu, Hawaii. I am a Trustee of the Estate of Bernice P. Bishop, which operates the Kamehameha Schools in Hawaii. These Schools provide the education for over 2,600 Hawaiian boys and girls on a full-time basis, and provide supplementary educational programs in the public schools of Hawaii to over 20,000 public school students.

1. In the State of Hawaii the improvement of lands with streets, curbs, sidewalks, sewers, utilities and storm drains generally is financed through the issuance of long term bonds. These bonds are eventually redeemed by funds raised either through real estate taxes or through annual special assessments against the land benefited by the public improvements they financed. In the State of Hawaii these special assessments are known as improvement district assessments, Chapter 67, Hawaii Revised Statutes.

2. The Internal Revenue Service treats real estate taxes as acquisition indebtedness only when the tax becomes due and payable and is not paid when so due. The same treatment should be afforded the annual installments of special assessments. Both taxes and special assessments serve the identical political and economic purpose—to provide a public benefit. Plans for improvements financed by special assessments must be approved by a City Council, County Board or other governmental body. See, for example, Hawaii Revised Statutes, §§ 67-10, 11 and 12.

3. Organizations exempt from Federal income tax such as the Kamehameha Schools are nevertheless taxed on their income from property which is improved by means of acquisition indebtedness (defined in Section 514 of the Internal Revenue Code).

4. The purpose of Congress in enacting the acquisition indebtedness rule was to place tax-exempt organizations on a par with other taxpayers in the case of "bootstrap acquisitions". S. Rep. No. 2375, 81st Cong., 2nd Sess., 1950-2 Cum. Bull. 483, 506-508 (1950); H.R. Rep. No. 2319; 81st Cong., 2nd Sess., 1950-2 Cum. Bull. 380, 408-411 (1950); S. Rep. No. 91-552, 91st Cong., 1st Sess. 62-67 (1969); H.R. Rep. No. 91-413 (Part 1), 91st Cong., 1st Sess. 44-48 (1969).

5. The legislative background clearly illustrates that Congress never intended to treat the long term obligation to pay a special assessment in annual installments as acquisition indebtedness. However, the Internal Revenue Service feels constrained to interpret that definition technically, so as to treat such a long term obligation, even though payable in annual installments, as acquisition indebtedness.

6. Special assessments should be treated in the same manner as real estate taxes—as each annual installment of a special assessment becomes due and payable, it will be considered acquisition indebtedness only if it is not paid when so due. The Treasury Regulations take this position with respect to real estate taxes. Treas. Reg. § 1.54(c)-1(b)(2) provides that a lien for taxes does not become acquisition indebtedness until after the tax secured by the lien has become due and payable and the tax has not been paid when so due.

7. It is my understanding that the Treasury Department has no objection to this clarification, and that it considers it of a technical nature.

8. In conclusion, special assessments payable on an installment basis over a period of years should receive the same treatment as annual real estate taxes—such assessments should constitute acquisition indebtedness only at such time as an annual installment becomes due and payable and is not paid when so due.

Respectfully submitted,

MYRON B. THOMPSON.

STATEMENT OF MYRON B. THOMPSON, TREASURER, BOARD OF TRUSTEES, KAMEHAMEHA SCHOOLS, BERNICE PAUAHI BISHOP ESTATES, ACCOMPANIED BY WILLIAM WARREN

Mr. THOMPSON. Mr. Chairman, members of the committee, I am Myron B. Thompson from Honolulu, Hawaii. I am a trustee of the estate of Bernice Pauahi Bishop which operates the Kamehameha Schools in Hawaii.

We appear before you and to my left is Mr. William Warren who is the counsel for tax matters for the school. We appear before you to humbly urge reaffirmation of the committee's actions taken on June 11, 1976, in regard to section 514(c)(2) entitled, "Acquisition indebtedness."

With your permission, I would like to summarize the statement I have already submited to the committee. In the State of Hawaii the improvement of lands with streets, curbs, sidewalks, sewers, utilities, and storm drains generally is financed through the issuance of long-term bonds.

These bonds are eventually redeemed by funds raised either through real estate taxes or through annual special assessments against the land benefited by the public improvements they financed.

In the State of Hawaii these special asessments are known as improvement district asessments.

The Internal Revenue Service treats real estate taxes as acquisition indebtedness only when the tax becomes due and payable and is not paid when so due.

So we feel the same treatment could be afforded the annual installments of special assessments. Both taxes and special asessments serve the identical political and economic purpose, to provide a public benefit.

Transfer improvements financed by special assesments must be approved by city council, county board, or other governmental body.

The amendment before you clarifies the need to treat special improvement assessments in similar manner as real property taxes by the Internal Revenue Service. It is my understanding that the Treasury Department has no objection to the clarification and that it considers it of a technical nature.

Therefore, Mr. Chairman, we urge your reaffirmation of the action taken by this committee on June 11, 1976. Thank you.

Senator BYRD. Thank you. Senator Curtis.

Senator CURTIS. No questions.

Senator BYRD. Does the former dean of the Columbia Law School have anything to add?

Mr. WARREN. No. I think that this is an amendment that should be made because it really is not within the scope of the purpose—that Congress had when it enacted the provision back in 1951 and 1954 and then turned business lease indebtedness in 1969 into acquisition indebtedness.

Congress was really looking at charity that was trading on an exemption where it had a bootstrap operation. Here the indebtedness is imposed by a legislative body on the landowner and at times charities have objected to the imposition of the assessment.

However, the legislative body can impose it, whether it votes for it or not. It seems to me, therefore, that it is just like a real estate tax and the Treasury and the Internal Revenue Service have great trouble in trying to determine whether or not special assessments should be treated differently. Thank you.

Senator BYRD. Thank you, Mr. Thompson. The next witness will be Mr. Kent M. Klineman, Equipment Management Corp.

[The prepared statement of Mr. Klineman follows:]

SUMMARY OF STATEMENT OF KENT M. KLINEMAN

The attached statement of Kent M. Klineman pertains to the "at risk provisions" of the Senate Finance Committee's proposed tax reform bill as they retroactively relate to equipment leasing. The following is a summary of that statement:

1. Brief summary of Mr. Klineman's qualifications.
2. Brief description of the equipment leasing business.
3. An examination of the "at risk provisions" as they effect small business lessors of equipment and the possibility that adoption of these provisions will lessen competition in the equipment leasing business.
4. An examination of the retroactive effects of the proposed January 1, 1976 effective date for the "at risk provisions" as they pertain to equipment leasing.
5. Endorsement of Amendment 1986 as proposed by Senator Vance Hartke and co-sponsored by Senator Bennett Johnston, which Amendment fairly and properly eliminates the retroactive effect of the "at risk provisions" with respect to equipment leases entered into prior to July 1, 1976.

STATEMENT OF KENT M. KLINEMAN IN SUPPORT OF AMENDMENT NO. 1986 (HARTKE-JOHNSTON) TO REMOVE UNFAIR, DISASTROUS RETROACTIVE EFFECT OF EQUIPMENT LEASING AT RISK PROVISION

My name is Kent M. Klineman. I am a resident of the city and State of New York. I am a member of the New York Bar, a graduate of Harvard Law School and New York University Law School, from which I received a masters in taxation. I practiced law in New York City for over ten years. In 1972, I entered the equipment leasing business and I am extensively familiar with that business. I estimate that annually at least $5 billion of equipment, ranging from postage meters to airplanes and computers, is leased in the United States.

In many respects, the leasing business is similar to the banking business; however, there are several important differences. The lessor owns his property whereas, at most, the bank holds a lien on a borrower's property. Ownership entitles a lessor to a higher rate of return than a bank on an equivalent amount of money. The lessor's rate of return is not based upon simple interest calculations used by banks. Lease rates are based upon estimates of a property's future earning power together with the benefits available from current income tax deferrals which arise mainly from the use of accelerated depreciation. This tax deferral is available without regard to the lessor's source of funds and without regard to whether loans used by the lessor to purchase assets are recourse or non-recourse.

Another difference between a lessor and a bank is that generally a lessor borrows funds on a non-recourse basis whereas the bank remains responsible to its depositors. The practice of non-recourse borrowing is widespread in the leasing business. Lenders place emphasis upon the credit rating of the prospective lessee and the value of the lease property. The credit of the lessor is often not a factor in a bank's loan decision. In a non-recourse loan, the bank's only security is the lease receivable and the property. The lessor is not responsible for the loan.

Although income tax deferrals and non-recourse financing are two important aspects of the equipment leasing business, in the case of individuals and small business lessors, the "at risk provisions" of the Committee's draft of the tax reform bill, would change these traditional practices. In their present form, the "at risk provisions" will severely affect a small lessor's attempt to compete with the large lessors who are able to afford to carry on their business in a corporate form. In order to complete, a small lessor will be forced to either "go recourse" on his equipment financing loans or incorporate without the benefits afforded by Sub-Chapter S. If the small lessor is unwilling to take these steps, the "at risk provisions" will effectively operate to reduce or eliminate the small lessor from the equipment leasing business.

As a small businessman who has written a number of leases largely financed through non-recourse loans, I would, in similar situations, be unwilling to write the same leases if required to assume the added burden of recourse financing. If other small lessors throughout the country are also unwilling to assume this additional burden, the leasing business will become even more concentrated in the hands of the large lessors, including the banks, most of which have leasing company affiliates. The obvious lessening of competition will serve to increase

costs to not only prospective lessees but also equipment manufacturers since such manufacturers will have fewer leasing company outlets.

I have spent a few minutes of your Committee's valuable time to outline the basics of the equipment leasing business and to point out some of the problems raised for the small lessor by the "at risk provisions." However, I would like to add that it would be extremely unfair to the small lessor if the effective date of the "at risk provisions" is January 1, 1976, as proposed in the draft bill.

Amendment 1986, as proposed by Senator Vance Hartke of Indiana and as co-sponsored by Senator Bennett Johnston of Louisiana, would alleviate the retroactive effect of the present draft bill for leases entered into before July 1, 1976. If Amendment 1986 is not accepted, the small lessors will suffer irreparable harm from the imposition of an income tax burden which was not calculated in their lease rates. Because of the severe competition from the large leasing companies, including the banks, these lease rates frequently offer only a small return to the small business lessor, a return which would be even smaller or, in some cases, negative if current available tax deferral is retroactively eliminated.

The current draft of your Committee's bill affects all leases whether entered into prior to or subsequent to January 1, 1976 since the bill, as drafted, disallows *losses* arising subsequent to December 31, 1975 except to the extent of a lessor's equity investment in his property. A small businessman lessor who entered into a lease prior to 1976 and who used non-recourse financing will not be able to deduct losses arising from his leased property subsequent to December 31, 1975 except to the extent of his equity investment. Since he has probably already written off this investment, no tax benefits will be available from his leased property commencing after December 31, 1975. I would submit that this treatment is unfair and discriminatory to the small lessor.

Senators Hartke's and Johnston's Amendment 1986 eliminates the retroactive effect of the "at risk provisions" for leases entered into prior to July 1, 1976. Amendment 1986 is not a special interest amendment. It will benefit many small lessors who calculated rates under existing leases based upon existing laws. At minimum, the adoption of a July 1, 1976 cutoff date will give fair notice to the small businessman lessor that he can no longer calculate his lease rates based upon the use of the tax deferral permitted by present law.

I have been deeply involved in the study and application of the tax laws for more than 20 years. I have not seen Congress adopt a retroactive provision which has the unfair and discriminatory effect of the "at risk provisions" as they apply to equipment leases. Although I would agree that a retroactive tax law might be justifiable if it benefitted the economy as a whole, the "at risk provisions", with the exception of the small amount of revenue that it will produce, does not benefit the economy. Quite the opposite, it will probably, as pointed out above, have the effect of lessening competition in the leasing industry. At minimum, Amendment 1986, which continues the tax deferral provided under existing laws for leases entered into prior to July 1, 1976, has the desirable effect of putting a small business lessor on notice that commencing July 1, 1976 the rules of his business have been changed.

STATEMENT OF MR. KLINEMAN, EQUIPMENT MANAGEMENT CORP.

Mr. KLINEMAN. Mr. Chairman, I appreciate the opportunity to appear before you and the committee today. My name is Kent Klineman, and I am a tax attorney by training and practiced law in New York City for many years.

I am here as a small businessman to discuss with your committee the unfair effects of January 1, 1976, retroactive debt of the at risk provisions as they apply to equipment leasing and a remedy to that problem, which is offered by amendment 1986 proposed by Senator Vance Hartke of your committee and cosponsored by Senator Bennett Johnston of Louisiana.

In order to understand why this retroactive date will hurt the small businessmen I would like to briefly describe the equipment leasing business. As a lessor, we own our property.

The risk of ownership entitles us to a slightly greater return than a bánk might get for lending its money. Our return is based upon two factors, one an estimate of the owning power of the property and two, the tax deferral which is offered by existing law, mainly through the use of accelerated depreciations.

Many leases were written subsequent to January 1, 1976, where their rate calculation was based upon the use of this tax deferral.

In addition, a lessor generally borrows money to finance the use of his property. This loan is often nonrecourse. By that, I mean that the lender's only security for the repayment of the loan is the property and the accompanying lease.

The lessor's credit is not a factor. Although income tax referral and nonrecourse financing have been accepted factors in the equipment leasing business for many years, the at-risk provision of your committee's draft of the tax reform bill will change these practices with respect to individuals and small business lessors such as myself.

The at-risk provisions will severely affect the small businessman's or lessor's ability to compete with the larger lessors, including the banks who are able to carry on business in the corporate form.

In order to remain competitive, a small business lessor will either be forced to go recourse on his loans or incorporate his business without the benefits offered by subchapter S of the Internal Revenue Code.

If the small businessman lessor is unwilling to take these steps, the at risk provisions of your committee's bill will effectively operate to reduce or eliminate the small lessor from the equipment leasing business.

I, as a small lessor, have written a number of leases, which were largely financed through nonrecourse loans. I would be unwilling to write the same leases if required to assume the burden of recourse financing.

If other small lessors around the country are also unwilling to assume these burdens, the equipment leasing business will become even more concentrated in the hands of the large leasing companies, including the banks.

The lessening of competition will increase costs, not only to prospective lessees but also to equipment manufacturers since such equipment manufacturers will have fewer leasing company outlets to assist in the marketing of their products.

I have a spent a few minutes of your committee's valuable time to outline the leasing business and try to point out the problems raised for the small business lessor by the at-risk provisions.

I would like to state that it would be extremely unfair to the small lessor if the effective date of the at-risk provisions is made to be January 1, 1976, as proposed by the bill.

Amendment 1986 sponsored by Senators Hartke and Johnston would alleviate the retroactive effective of the at-risk provision for equipment leases which were entered into before July 1976.

Unless that amendment is adopted by your committee, the small lessor who set his rates based on the assumption of tax deferral will suffer irreparable harm because of severe competition in the leasing industry and his rates frequently only offer a small current return, a return which will become even smaller if the curent tax deferral is retroactively eliminated.

Senator BYRD. Your time has expired, Mr. Klineman.

Mr. KLINEMAN. I would just complete by saying that I have been deeply involved in the study of the tax law for more than 20 years.

I have never seen Congress adopt a retroactive provision which will have the effect of the at-risk provisions as they apply to this small lessor, although I agree that retroactive tax laws might be justifiable if they benefit the economy as a whole and I would question it in this case.

Quite the opposite, I believe that the lessee of competition will be of serious detriment to the economy. At the minimum, amendment 1986 will rectify this.

Senator BYRD. You will have to conclude, your time has expired.

Mr. KLINEMAN. I am finished, thank you.

Senator BYRD. Senator Johnston's proposal along with Senator Hartke is to change the effective date to July 1, 1976.

Mr. KLINEMAN. That is correct.

Senator BYRD. You feel that legislation would be fairer by a change of that date?

Mr. KLINEMAN. I think it will at least allow the people who set the rate, based upon the assumption of the tax deferral and on existing leases, to be on the same footing as the large leasing companies who were not affected by the adverse provisions.

Senator BYRD. Thank you. The next witness will be Mr. Douglas Snarr, president, Snarr Advertising Co.

[The prepared statement of Mr. Snarr follows:]

TESTIMONY OF DOUGLAS T. SNARR, PRESIDENT OF SNARR ADVERTISING, INC.

1. Implementation of the Highway Beautification Act of 1965 resulted in the condemnation and purchase of many non-conforming billboards and forced many small sign companies out of business.

2. In an effort to protect the injured small sign companies, Congress amended the Beautification Act in 1970 to permit the acquisition of billboards on a company-by-company basis and gave a preference to the small sign companies for early acquisition.

3. The small sign companies cannot reinvest the proceeds from condemned billboards in other billboards and qualify for tax-free reinvestment under IRC Section 1033(g) because (1) the Beautification Act prohibits new signs in rural areas; (2) the large sign companies control the conforming areas in cities and business locations; and (3) the condemnations have taken so many signs that the small companies can no longer conduct business.

4. At the time of the 1970 amendments, the small sign companies were assured by congressional delegations and their staffs that billboards were considered real property (a revenue ruling had been issued to that effect in 1968) and that Section 1033(g) of the IRC would permit the tax-free reinvestment of condemnation proceeds in other real property.

5. The small sign companies have treated the billboards as real property and have not claimed investment credit or accelerated depreciation. They have reinvested the condemnation proceeds in other real property.

6. The IRS now takes the position that billboards are personal property and that the proceeds of condemnation of billboards cannot be invested in real property under the protection of Section 1033(g). The small sign companies have thus lost the advantages of investment credit and accelerated depreciation, and are now being denied the opportunity of tax-free reinvestment of the condemned billboards.

7. The proposed amendment merely provides that sign companies who have treated billboards as real property for tax purposes and who have not claimed investment credit or accelerated depreciation, will be allowed to make a tax free conversion of the proceeds of condemned billboards into other real property under provisions of Section 1033(g). Sign companies who have treated the bill-

boards as personal property, will be required to continue to do so and will not be able to claim the benefits of Section 1033(g).

8. The proposed amendment would not result in a tax preference or loss of revenue, but will allow small sign companies to defer the recognition of gain resulting from the condemnation of their injuries.

STATEMENT

Honorable Chairman Long and members of the Committee on Finance. My name is Douglas T. Snarr and I am president of Snarr Advertising Company, a small sign company located in Salt Lake City, Utah. I appear before you today to testify concerning an amendment to H.R. 10612 which provides certain tax treatment for condemned billboards by amending Section 1033(g) of the Internal Revenue Code.

The problem which the proposed amendment on page 10 of the Committee Action of June 11, 1976, seeks to correct arises from the implementation of the Highway Beautification Act of 1965 whereby Congress sought to remove billboards from the interstate and primary highways and provide "just compensation" to the billboard and property owners. Pursuant to the provisions of the Highway Beautification Act of 1965, a large number of outdoor advertising signs have been purchased and removed by state governments with federal participation. However, in implementing the provisions of the act, it was found that there was a substantial difference in the effect of the act upon outdoor advertising companies which had billboards primarily concentrated in business districts and smaller companies which concentrate their advertising in rural areas.

During the initial implementation of the act it was determined that the large national sign companies and those located in the city business districts were not particularly affected by the provisions of the Highway Beautification Act. They merely took the proceeds of the sign condemnations and reinvested the proceeds in upgrading their conforming advertising structures in business or commercial areas. However, the small and medium size sign companies that operated primarily in rural areas were irreparably damaged by the Highway Beautification Act condemnations. Because the Highway Beautification Act prohibits the reinvestment of sign condemnation proceeds in other signs in non-conforming rural areas, the small and medium sized sign companies were unable to reinvest the monies received from condemnation in advertising structures and were thus effectively forced out of the outdoor advertising business.

This matter was brought to the attention of the Congress and hearings were held during two Congresses that resulted in amendments to the Highway Beautification Act of 1970 to alleviate the hardship being suffered by the small sign companies. The 1970 amendments allowed the Department of Transportation and the states to proceed to acquire signs on a company by company basis, rather than on an individual sign basis. The legislation further provided that the smaller and hardship sign companies were to be dealt with first. This legislation recognized that the small highway sign companies could not remain in business as outdoor sign companies because after the taking of their non-conforming highway signs, their remaining conforming signs were not sufficient to constitute an economic unit. The larger sign companies had moved quickly to secure control of the remaining conforming areas where signs could be placed and thus the small companies had no choice but to take the condemnation proceeds from the sale of their non-conforming signs, sell their few remaining conforming signs to the larger sign companies, and then try to establish a different type of business. There was in effect a forced removal of the small highway sign companies from the outdoor advertising business and a movement of the larger sign companies to an oligopolistic market.

The 1970 amendments to the Highway Beautification Act attempted to save the small sign companies by handling their cases first and by allowing them to move quickly into some other form of business. At the time of the 1970 amendments it was recognized that any reinvestment of sign condemnation proceeds would require reinvestment in real property and inquiry was therefore made of congressional leaders and committee staff as to whether or not an amendment would be required to I.R.C. 1033(g) to permit the reinvestment of sign condemnation proceeds in other real property. (Section 1033(g) allows the reinvestment of proceeds from condemned real property in other real property without imposition of an income tax on the involuntray conversion.) In a series of meetings held in early 1970 with staff of the Joint Committee on Internal Revenue Taxation,

it was decided that no additional tax legislation was required because of the published position of the Internal Revenue Service that billboards were real property. (Rev. Rul. 68-62, 1968-1 C.B. 365). It was clear at the time that had there been any question on the matter, legislation would have been introduced to assure the sign companies that they would receive the benefits to Section 1033(g). Being assured that such legislation was unnecessary, the small sign companies and operators promptly settled condemnation proceedings with the states, sold their remaining conforming signs to the larger interstate companies, and often even entered into covenants not to further compete. The small companies then purchased other real estate or real estate business with the proceeds of the sales. In all this, the small sign companies proceeded on the assumption that the reinvestment of the proceeds in real estate was a tax-free exchange and totally relied upon the existing stated attitude and rulings of he IRS.

However, in 1975, two major sign companies brought actions in the U.S. Court of Claims seeking a determination that billboards are "tangible personal property" and thus available for the investment credit. *Alabama Displays, Inc.*, 75-1 USTC 9116; *National Advertising Co.*, 75-1 USTC 9117. In these cases the U.S. Court of Claims held that the taxpayers were entitled to investment credit on billboards because billboards were "tangible personal property" for purposes of section 48(a)(1)(A) of the Internal Revenue Code. The position of the large sign companies in these cases is understandable. Because these companies are continuing in the sign business and are not liquidating, they prefer that signs be considered personal property so that they can qualify for investment credit and accelerated depreciation provisions.

In reliance upon these two cases, the IRS has reversed its previously announced position concerning billboards and now holds that they are "personal property" for the purposes of both Sections 48 and 1033 of the IRC. On March 25, 1976, the National Office of the IRS issued a technical memorandum in response to a request for a private ruling from Snarr Advertising, Inc. holding that billboards do not qualify as "real property" under IRC 1033(g).

It should be noted that in reliance on the prior rulings of the IRS, many of the small sign companies had always treated the billboards as real property. Thus, they had not claimed investment credit or certain types of accelerated depreciation available for qualified personal property. The net effect of the new position of the IRS is as follows:

1. Small sign companies who relied on prior rulings and treated the signs as real property have been denied the opportunity to claim investment credit on the signs.
2. Small sign companies who have been forced out of business under the Highway Beautification Act and have reinvested in other real property businesses in reliance upon the IRS position, will now be taxed on the voluntary conversions of their properties.
3. Small sign companies who have not yet reinvested will be encouraged to somehow invest in new billboards in opposition to the public policy stated by Congress in the 1965 Beautification Act.
4. Large sign companies will be unjustly enriched as they will be the only operators who will be able to effectively reinvest in like kind property.

It should also be noted that the private ruling confined itself to the Internal Revenue Code provisions as they presently exist and refused to take into consideration the Congressional intent concerning the enactment of the Beautification Act and subsequent amendments. The ruling states in part:

The Internal Revenue Code does not address itself specifically to billboards. Notwithstanding what may or may not have been the Congressional intent when the Highway Beautification Act was passed, the Service must rely on the present code and the regulations which, for purposes of Section 1033, conclude that the signs which were sold by Snarr under threat of condemnation did not constitute an interest in real property (page 5).

The position of the Internal Revenue Service is understandable only if we assume that the Service was fearful that sign companies would claim that billboards were personal property for purposes of investment credit and depreciation and real property for purposes of condemnation, thus receiving a double benefit. To avoid this possibility of double benefit, the Service opted in favor of the position taken by the large sign companies and has ignored the severe damage being done to small sign companies who are unable to extensively litigate the isue or protect themselves. (Actually, the provisions of Section 48 and 1033 are not mutually exclusive. Section 48 was drafted to encourage investment and by its

express terms covers types of property which under state law are deemed "real property".)

The proposed amendment does not affect the position of the large sign companies or the availability of the investment credit to electing sign companies. Instead, it gives sign companies an election as to how they wish to categorize and treat their billboards. If a sign company treats its billboards as "personal property" and takes investment credit and accelerated depreciation, then it cannot claim the benefits of tax-free reinvestment under Section 1033(g) IRC. However, if the sign company historically has treated its billboards as "real Property" and has not taken investment credit or accelerated depreciation, then the sign company may claim the benefits of reinvestment under Section 1033(g). It is extremely unfortunate that under the current position of the IRS, sign companies that have foregone the advantages of investment credit and accelerated depreciation available to personal property, are now denied the one remaining advantage of having treated the billboards as real property.

The proposed amendment does not give any tax preference or tax benefit. It merely makes the provisions of Section 1033(g) available to those companies who have historically treated their billboards as real property and thus foregone other tax advantages. It recognizes and implements the intent of Congress as set forth in the 1970 amendments to the Highway Beautification Act. Furthermore, it should be noted that Section 1033(g) itself is not a tax relief provision, but merely defers the tax on reinvestment of involuntary conversions of property.

We would hope that this Committee would recognize the terrible unfairness of the position the Service is taking with respect to the small sign companies. It was bad enough when we were forced out of our business and denied the opportunity to reinvest in a similar business. Now, we are told that because we didn't reinvest in other signs, we will be taxed on the involuntary conversion of our billboards. Fairness requires that we be given the opportunity to reinvest in real property businesses without the imposition of any further tax. Thank you.

STATEMENT OF DOUGLAS T. SNARR, PRESIDENT, SNARR ADVERTISING CO.

Mr. SNARR. Mr. Chairman, my name is Douglas T. Snarr and I am the president of Snarr Advertising, Inc., a small advertising company located in Salt Lake City, Utah. I appear before you to urge adoption of an amendment, the Tax Reform Act appearing on page 57 of the committee print on amendments on July 20, 1976, sponsored by Senator Ribicoff and supported by Senator Mondale and originally introduced by Senator Moss.

To correct an unfair tax situation arising from implementation of the Highway Beautification Act, 1965, implementation of the Beautification Act resulted in the condemnation and purchase of many nonconforming billboards and forced many small sign companies out of business.

These small companies received payment for their billboards but they cannot reinvest these funds in other billboards and qualify for tax reinvestment under IRS section 1033(a) because the Beautification Act prohibits new signs in rural areas, two, the large sign companies control the conforming areas in cities, and three, the condemnations have taken so many signs, the small sign companies could no longer operate their businesses.

Four, the small sign companies cannot buy signs from the big companies. At the time of the 1970 amendments to the Beautification Act, the Internal Revenue Service had a position on the classification of billboards for tax purpose which was that they were real property.

A revenue ruling had been issued to that effect in 1968 and that section 1033(g) of the code would permit the tax free investment of condemnation proceeds and other real property.

The small sign companies, having made the billboards as real property and not claimed investment or separated the depreciation, they have reinvested the proceeds of condemnation and other real property.

Recently, however, in response to certain cases and recent cases dealing with investment credits, and in absence of congressional intent, the IRS has apparently changed its earlier position and now takes the position that billboards are personal property and that proceeds of condemnation cannot be reinvested in real property under the protection of section 1033(g).

However, in its most recent private ruling, the IRS invited clarification of congressional intent on the subject. The small sign companies have thus been denied the advantages of claiming investment credit or accelerated appreciation, have had their signs and companies taken away and are now denied the opportunity of a tax free investment of the condemnation payments in other real property businesses.

The proposed amendment really provides sign companies who have treated billboards as real property for tax purposes and who have not claimed investment credit or accelerated the appreciation, will be allowed to make a tax reconversion of the proceeds of billboards into other real property under applicable provisions of section 1033(g).

Sign companies who had treated the billboards as personal property will be required to continue to do so and will not be able to claim the benefits of 1033(g). The amendment is thus equitable and fair to all sign companies and places small sign companies in the position they thought they occupied in 1970.

The current position of the IRS allows a large sign company to have it both ways. They treat billboards as personal property and claim investment credit and accelerated depreciation of their signs are condemned and can reinvest the proceeds in other billboards on qualified locations and obtain tax reconversion privileges under section 1033.

The small sign companies get no investment credit or accelerated depreciation and now they will not even get to reinvest condemnation proceeds without an imposition of tax.

The proposed amendment is fair because it recognizes the historic position of the small sign companies and does not penalize them for treating their billboards as real property. The proposed amendment does not result in a tax preference or loss of revenue but will allow small sign companies to defer their recognition work resulting in the condemnation for their companies. Thank you.

Senator BYRD. Thank you, Mr. Snarr. The next witness will be Mr. William M. Goldstein, Deputy Assistant Secretary for Tax Policy, Treasury Department.

[The prepared statement of Mr. Goldstein follows:]

ADMINISTRATION POSITION ON CERTAIN PROVISIONS OF THE TAX REFORM BILL (H.R. 10612)

On July 20, 1976 the Administration released its statement, "Administration Position: Hearings on Certain Provisions of the Tax Reform Bill (H.R. 10612)." The Administration is pleased to have the opportunity to comment in more detail on the specific provisions of the bill.

On June 15, 1976, the Administration issued a summary statement of its position on various sections of H.R. 10612 as reported by the Senate Finance Committee. The Administration's June 15 statement was prepared on the assumption that each Section in H.R. 10612 would be voted up or down by the

Senate, and that there would be little or no chance for perfecting amendments. Therefore, the pattern followed by the Administration was to state an overall judgement on each section. That judgment represented a consideration of the balance of merits and defects of the basic section and any special relief provisions it contained.

When Senator Long announced on July 8, 1976, that additional hearings would be held on certain sections, the Administration reexamined the bill with a view to evaluating the various provisions contained in each section. The merit of each provision was separately evaluated; the Administration did not feel confined to an evaluation of the section taken as a whole. The result is the July 20, 1976, statement, "Administration Position: Hearings on Certain Provisions of the Tax Reform Bill (H.R. 10612)." The July 20, 1976, statement was prepared with a view to a markup session by the Senate Finance Committee. Naturally, in a more detail analysis of the components of a section for purposes of a markup session, there will tend to emerge a number of positions which vary from the single decision which must be made in considering a "yes" or "no" vote on each section taken as a package The provisions are rated on the following scale: strongly support, support, do not oppose, oppose, strongly oppose. In a few cases, the Administration has changed its position on an entire section. In general, these changes reflect further reflection and evaluation, and additional comments from Departments and agencies other than Treasury.

In seeking these positions the Administration has relied on certain broad principles which have traditionally guided the Treasury in its examination of special relief provisions.

The Treasury does not object to reasonable transition rules, provided they are not drawn so narrowly that very few taxpayers benefit. If a transition rule has merit, it should be drawn to apply to a broad group of affected individuals and companies.

The Treasury opposes retroactive relief, except in cases of exceptional hardship. The time to enact relief measures is when the original legislation is passed. Retroactive relief typically benefits a narrow class of insistent taxpayers, while others injured by the same legislation may go unnoticed. Moreover, retroactive relief for publicly held companies often benefits a very different group of stock holders than those injured by the original legislation, some of whom have since sold their shares.

If an existing provision of the Code imposes an inequitable or unintended burden on certain taxpayers, then the relief provisions should be drafted to encompass all affected taxpayers, and not merely the small group of taxpayers which brings the provision to the attention of the Congress.

The special relief should not entail excessive revenue costs and should not impose undue administrative burdens on the Internal Revenue Service.

The special relief should not undermine nontax policies embodied in other legislation.

Set forth below is an explanation of the Administration's position on certain specific provisions with respect to which the position stated on July 20, 1976, differs from that stated on June 15, 1976. In addition, the attached table summarizes Administration positions on July 20, 1976 (focusing on individual provisions of each section) and June 15, 1976 (focusing on each section as a whole).

Apparent differences in the Administration position between its June 15, 1976, statement and its July 20, 1976, statement have been noted by some witnesses appearing before the Senate Finance Committee. The more important instances are noted below.

SECTION 1024. SHIPPING PROFITS OF FOREIGN CORPORATIONS

In the June 15, 1976 statement, the Administration did not object to Section 1024. The decision not to oppose the section reflected the judgment that it would amend the subpart F provisions with respect to shipping profits in one respect which the Administration considered important, namely the exclusion of income derived from operations within a single country in which the corporation is created and the vessel is registered. This exclusion conforms the treatment of shipping income to that of foreign base company sales and service income. Subpart F was not intended to affect income earned solely within the country of incorporation of the foreign corporation; on the contrary its principal thrust is to tax the income of foreign corporations which do business largely or entirely outside the country of incorporation. The Administration supported that change.

That change was accomplished by two other changes which the Administration does not support, but decided to accept rather than oppose the whole section. Those changes would exclude from the subpart F provisions certain income which is from international transport and which is consistent with the broadened scope of subpart F. One of the changes concerns income from the shipping of men and supplies from onshore to a continental shelf or any adjacent continental shelf. This could be a full time busiess, moving men and supplies from one area to another and servicing rigs on the continental shelf of one country or, as in the North Sea, of a number of countries with adjoining shelf areas. It is difficult to see why, other than tax advantages, a U.S. company would carry on this business through a foreign subsidiary. The second change would exclude income from chartering vessels to a related U.S. company under certain circumstances. Both cases represent income which properly falls within the scope of the subpart F shipping provisions.

The Administration does note that the subpart F shipping provisions may operate inequitably. The law provides an easy escape for taxpayers with growing shipping activities by excluding shipping profits reinvested in shipping, but taxpayers for which shipping is a constant, declining, or occasional activity do not enjoy the same relef. This aspect of the law is objectionable, but carving out special relief measures is not the way to solve it.

There is a fourth subsection to Section 1024 which the Administration also opposes, but on the grounds that it is not necessary, clutters up the law needlessly, and could be misleading. We are not aware of any criticism of this position as a change from the June 15 statement.

SECTION 1031. REQUIREMENT THAT FOREIGN TAX CREDIT BE DETERMINED ON OVERALL BASIS

The Administration position on the elimination of the per-country limitation has been consistently one of not opposing the change. However, the Administration does oppose the special three-year exception for mining companies on the grounds that if a provision is desirable it should be general and not apply only to a specific industry (in this case part of an industry) or group. That same reasoning might seem to apply to the three-year exclusion for possessions corporations, which the Administration does not oppose. However, the possessions corporatins represent a class of corporations, not limited to a particular activity, which Congress has chosen to set aside as a distinct class for historic reasons, and which it has chosen to maintain during various reconsiderations; so possessions corporations differ somewhat from the usual understanding of a special interest group. In addition, the three-year exception for possessions corporations is a cutback from the initial proposal of an unlimited exception; the more limited rule is a considerably less objectionable departure from the general principle of requiring the overall limitation.

SECTION 1035. FOREIGN OIL AND GAS EXTRACTION INCOME

The Administration opposes several subsections of Section 1035 which it did not single out for objection in the June 15th statement. The objections are primarily objections to trying to improve an unsatisfactory underlying provision by granting exceptions which are retroactive and/or limited to a narrow group of taxpayers.

SECTIONS 1035 (a) AND (b). TRANSITIONAL RULES FOR FOREIGN TAX CREDIT LIMIT AND THE RECAPTURE OF FOREIGN LOSSES

The Administration supports transitional rules in many cases and would have supported reasonable transition rules in these cases had they been considered and enacted along with the legislation which made the basic changes in policy (in this case the Tax Reduction Act of 1975). We think the practice of retroactive relief is objectionable and should not become a substitute for careful legislation. For that reason we oppose these specific provisions.

SECTIONS 1035 (C) (1) (B) AND (C) (3). DEFINITION OF OIL RELATED INCOME: GAIN FROM THE SALE OF STOCK AND CERTAIN PUBLIC UTILITY INCOME

The Administration objects to both of these provisions because of their narrow scope. In the first instance the principle is logically sound. We would not object if the provision were drafted in general terms; but we do not accept that a provision which is acceptable on its merits should be available only to certain corporations in continguous countries. In the second case we object to the pro-

vision because it says that income from the transportation and distribution of oil and gas, which clearly belongs in the category of oil and gas related income, is not oil and gas related income if derived by certain types of utilities; we oppose such narrow relief measures. Both of these measures illustrate the inevitable problems of isolating an "oil basket" of oil and gas income. There are bound to be hardships among some taxpayers who find their income put into that basket and others who find their income excluded from it. The solution is not to patch up the concept with exceptions but to replace it by a limitation of the credit for foreign taxes on oil and gas extraction income to 48 percent.

SECTION 1308. PERSONAL HOLDING COMPANY INCOME AMENDMENTS

After a careful and detailed analysis we concluded that the proposal would create an unwarranted technique for circumventing the personal holding company provisions. In addition, we concluded that the 1964 effective date was unwarranted. Accordingly, we changed our position from no objection to opposed.

SECTION 1311. FRANCHISE TRANSFERS

Section 1311 of the Bill contains two essentially unrelated provisions. Section 1311(a) eliminates a potential avenue of abuse under present law where a partnership transfers a franchise; we have consistently supported this provision. Section 1311(b) is a grandfather provision which is extremely narrow in applicability, and which we have concluded after careful consideration is totally unwarranted. We therefore clarified our position to indicate opposition to this latter provision.

SECTION 2106. INCOME FROM FAIRS, EXPOSITIONS AND TRADE SHOWS

The Administration would have no objection to the portion of the provision which provides an exemption for trade shows if the provision did not also change qualification requirements for exempt organizations. After further considering the retroactive effective date of the provision and its overly broad nature, as well as the change in qualification requirements, we changed our position from no objection to opposed.

COMPARISON OF ADMINISTRATION POSITION ON JUNE 15, 1976, AND JULY 20, 1976, ON CERTAIN SECTIONS OF TAX REFORM BILL (H.R. 10612)

Bill section	Brief description	June 15, 1976, administration position on the entire section (H.R. 10612 as reported by the Finance Committee to the Senate)	July 20, 1976, administration position on special relief parts of the section (H.R. 10612 reopened hearings)
1013 (f)	Foreign trusts with U.S. beneficiaries taxed currently to grantor.	Support	Strongly support provision but oppose delay in effective date.
1021	Amendment of provision relating to investment in U.S. property by controlled foreign corporations.	do	Support basic concept; oppose special relief provisions.
1024	Shipping profits of foreign corporations.	No objection	Support the 1st of 4 special relief provisions; oppose the other 3.
1025	Limitation on definition of foreign base company sales income in the case of certain agricultural products.	do	Prefer no special exception for agriculture, but if such an exception, Senate version better than present law or House version.
1031	Requirement that foreign tax credit be determined on overall basis.	do	No objection to basic concept; oppose special exception for mining companies.
1032	Recapture of foreign losses	Support	No objection.
1035	Foreign oil and gas extraction income.	No objection with modification.	
1035(a)	Foreign oil and gas extraction income; transitional rule for foreign tax credit limit.		No objection in principle; oppose because of retroactivity.
1035(b)	Foreign oil and gas extraction income; transitional rule for recapture of foreign oil related losses.		Oppose because of retroactivity; do not object in principle.
1035(c)(1) and (2)(A)	Foreign oil and gas extraction income; definition of oil related income.		No objection; but emphasize superiority of Treasury proposed 48 percent rule and difficulties inherent in "oil basket."

COMPARISON OF ADMINISTRATION POSITION ON JUNE 15, 1976, AND JULY 20, 1976, ON CERTAIN SECTIONS OF TAX REFORM BILL (H.R. 10612)—Continued

Bill section	Brief description	June 15, 1976, administration position on the entire section (H.R. 10612 as reported by the Finance Committee to the Senate)	July 20, 1976, administration position on special relief parts of the section (H.R. 10612 reopened hearings.)
1035(c)(1)(B)	Foreign oil and gas extraction income; definition of oil related income-gain from sale of stock.		Oppose because of narrow scope; would not oppose broader provision.
1035(c)(3)	Foreign oil and gas extraction income; certain public utility income.		Oppose because affected income appears to fall in "oil basket," but repeat superiority of Treasury proposed 48 percent rule.
1035(d)	Foreign oil and gas extraction income; foreign oil related income earned by individuals.		Support; analogous to Treasury proposed 48 percent rule for corporations.
1035(e)	Foreign oil and gas extraction income; certain payments not to be considered taxes.		Oppose; but would support a 5-yr, 20-percent rule.
1035(f)	Foreign oil and gas extraction income.		Oppose.
1036	Underwriting income	No objection	Support.
1041	Portfolio debt investments in United States of nonresident aliens and foreign corporations.	Support	Strongly support.
1042	Changes in ruling requirements under sec. 367; certain changes in sec. 1248.	do	Strongly support changes in sec. 367; strongly oppose retroactive special relief.
1043	Contiguous country branches of domestic life insurance companies.	No objection	No objection but should not be regarded as precedent.
1052	Western Hemisphere trade corporations.	Support	Support repeal of WHTC; oppose narrow transitional rule but would not oppose transitional rule in general.
1207	Treatment of certain individuals employed in fishing as self-employed individuals.	do	Oppose. In light of the committee amendment which would increase the number of crewmen to 10 we concluded that the provision would extend unwarranted relief to substantial businesses enterprises.
1307	Interest of original issue discount on certain obligations.	No objection	Oppose. The June 15 statement of no objection was an error.
1308	Personal holding company income amendments.	do	Oppose. (See discussion in attached memorandum.)
1310	Repeal of excise tax on light-duty truck parts.	do	Support.
1311	Franchise transfers	do	Support in part and oppose in part. (See discussion in attached memorandum.)
1314	Qualification of fishing organization as tax exempt agricultural organization.	No objection	The administration defers to the Postal Service on this provision which is intended to allow fishing organizations to obtain favorable postal rates.
1317	Amendments to rules relating to limitation on percentage depletion in case of oil and gas wells.	Support	Position clarified to indicate that the administration has no objection to 2 provisions of the section and supports the other 2 provisions of the section.
1321	Taxation of certain barges prohibited.	do	Oppose. This provision does not relate to Federal taxation; upon further reflection and consultation with OMB the administration position was changed.
1507	Study of salary reduction pension plans.	No objection	No objection to the freeze imposed by the provision. The administration, however, recommends that the period of the freeze not extend beyond Jan. 1, 1978, so that the issues involved in salary reduction plans can be promptly resolved.
1701	Railroad provisions	Oppose	The administration position has been clarified to indicate support for certain provisions of the section and opposition for others.
2106	Income from fairs, expositions and trade shows.	No objection	Opposed. (See discussion in attached memorandum).

STATEMENT OF WILLIAM M. GOLDSTEIN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, TREASURY DEPARTMENT

Mr. GOLDSTEIN. Thank you, Mr. Chairman. Unlike the other witnesses you have heard from, we are supposed to be knowledgeable about all 80 or so issues. I would like to make some very brief remarks.

We, of course, plan to be at your markup sessions and would be happy to comment on any issues as your committee moves through this portion of the bill.

I thought I would take a few minutes today to respond to some of the comments made about the Treasury's positions and procedures but not very much.

First of all, I do not think there was any implication on anyone's part that we have changed our pattern and our approach to these subjects. As far as I know every single issue that we have addressed ourselves to in our statement of administration position was approached on the sole basis of is it good or bad tax policy.

If it happens to benefit or hurt one taxpayer or thousands of taxpayers, that did not affect our decision. Furthermore as some of the witnesses have done, we have not made suggestions with regard to the procedure your committee has followed.

We have no interest in doing that. Our only position is that we be given the opportunity to comment whenever possible, if procedures can be established for us to have input in these matters, because we feel that we have a very competent staff of both lawyers and economists and that we could make a real contribution. In almost every instance, your committee has afforded us that opportunity.

Things did get a little hectic on the last 2 days of your markup sessions, but even then on most occasions we were asked for our view. We were not always prepared on every issue because we had not had the opportunity to consider them.

Also of course it is notable that those witnesses with whom we agree have good things to say about the Treasury while others condemn us. I guess those are the fortunes of war and there are no hard feelings on anybody's side.

We have been criticized and received some criticism in the past few days for changing our position on some issues based on a comparison of our memorandum of June 15 and our detailed memorandum on these specific items.

We have submitted for the record an explanation of the reasons why positions were changed giving fairly detailed explanations in a few cases and in others outlining the reasons.

Essentially, in the great majority of instances in which our position was changed, it was because, with regard to the June 15 memorandum, we felt we had to comment on an entire section. That is the way we understood the bill would be considered, with little chance for the kind of careful analysis that has been taking place the last few days.

There are many of these provisions where we approve of the general thrust of the provision but object to some of the special exceptions. That is by far the overwhelming majority of our changes.

There are one or two examples where we just made a mistake before and there are a few other examples where, with more time to reflect, we concluded that our earlier position should be modified.

Turning to the types of provisions to which we have indicated objection in our lengthy statement of position, they fall in several different categories. There are some as to which our objection is relatively mild but we feel should be made based upon the principles that we have stated for evaluating such proposals at pages 2 and 3 of the statement we submitted today.

For example, in the instance of section 1035 (a) and (b) of the bill, we noted that the grandfather clause would have been reasonable if included at the time of enactment. We state that but also state our formal objection in any event on the grounds that we disapprove of retroactive relief in almost any circumstance.

A second type of objection we have voiced is that in several instances, notably section 1035 (c)(1)(b) and section 1052, we feel that what is a good general principle has been narrowed to benefit only a few taxpayers. We would have supported such principle if it had been adopted by the committee in more general form.

Obviously our suggestion is that there be some more consideration at the markup session of expanding some of these provisions which would help not only the intended taxpayers but others similarly or closely situated as well.

There are some provisions on the other hand, without detailing all of them, that we do feel quite strongly about and are in opposition thereto. Brief mention could be made of the investment tax credit for capital construction fund ships.

This is a situation where you already have a very significant tax benefit, in effect a 100 percent writeoff in the first year. We believe it is not good tax policy to add on top of that an investment credit.

We also oppose what is now section 210(d) which is the provision which would limit a limited partner's losses to the amount of his actual contribution to the partnership and the cash used to pay off his share of the nonrecourse indebtedness as it is used.

We feel that either it will be too harsh—that is, that it will have an unduly adverse effect particularly on the real estate industry where the Senate and this committee in other instances recognized special circumstances—or, if ingenius tax lawyers and accountants are able to devise alternative means of doing the same type of financing, it will be ineffective.

In any event we think it is unwise to single out just one type of investment vehicle to modify the longstanding rule of the *Crane* case that nonrecourse debt can be added to a taxpayer's base is in the property.

We also strongly object to the provision that is designed to provide relief to the publishers from the normal audit procedures of the Internal Revenue Service. It was stated here this morning that the Revenue Ruling 73–375 is unfair.

Senator BYRD. Your time has expired.

Mr. GOLDSTEIN. It was my understanding, Mr. Chairman, that we were to have either a half hour which I do not want to use——

Senator CURTIS. I am very much in favor of the Treasury stating their position fully. I do think in light of the fact that we have been here since 8 o'clock and that most of our members and part of our staff have been assigned to other duties, that it might be just as effective if you submit it in writing.

Mr. GOLDSTEIN. Essentially, Senator Curtis, we have submitted our views in writing in considerable detail and I have no objection to that. What I would hope would be more effective as you consider in the markup sessions the individual provisions, if you think we will be helpful, is that you ask for our views and we would give them at that time.

Senator CURTIS. Very well. We have always tried in this committee, but the short commodity around here is time, to get the views of the Treasury representative. I know I have done this on many occasions and I have encouraged them to take the initiative and signify at a given point where there is something they feel can be brought out.
given point where there is something they feel can be brought out.
I assure you that is what we will be doing.

Mr. GOLDSTEIN. That is fine and as I say, I am sure you have available to you this 106 page document entitled, "Administration Position" and that does give, I think, a clear view of each of the issues.

Senator DOLE. I think you were asked in a couple of specific areas to comment. Maybe you covered them before I came in. I think the chairman asked yesterday if you were going to meet with some group and see if you could work out a difference.

There was a witness earlier this morning that indicated some difference with the Treasury. They were going to discuss that with you. Maybe you have not done that.

Mr. GOLDSTEIN. The chairman asked yesterday if we would help prepare a statement in support of the provision which would relieve certain foreign investors of the withholding tax.

I spoke with Mr. Horne and suggested to him that Secretary Simon covered that at length in his March 17 testimony and also put him in touch with our staff members, and we would fully agree with any submission he would make.

There were several places, Senator Dole, where witnesses suggested we either were not prepared or did not know what we were talking about. One of those did deal with the geothermal energy situation.

I do have my expert with me if you would like to hear from him. Essentially we would stand on what we said in our statement. I guess we just have an honest disagreement with the folks sponsoring the amendment.

Senator DOLE. Have you changed your position on anything you have in your July 20 statement?

Mr. GOLDSTEIN. No, sir. In a couple of areas, we have been, throughout the past 3 days, working with counsel for some of the affected taxpayers. One example of that is the provision—the proposed 5-year delay in the effectiveness of the Service's new position with regard to production-sharing agreements.

In discussions with counsel, they have indicated a willingness to modify their original proposals so that the new rules would apply essentially to 1978 and thereafter. We indicated that we thought that the present rule of the Service could have that same effect. We indicated we would not object to that.

I think that if they would modify their proposal so as to represent a substantial curtailment of what they had previously asked for, we would approve of that and it would give them the time they need to complete their negotiations.

Another example of that is the matter concerning Texas Optical Co. in the area of franchises, that is, whether or not they were entitled to rely on their contractual arrangements. We have been working with counsel since this morning's testimony to try to arrive at a provision that would be satisfactory to both sides.

Senator DOLE. I think Dr. Rogers raised that question earlier today.

Mr. GOLDSTEIN. There are a couple of others too.

Senator DOLE. You customarily discuss this with counsel for the people involved, right?

Mr. GOLDSTEIN. Yes, sir, we are very easy to talk to. Are we accessible? We surely are.

Senator DOLE. So are we. We sometimes are criticized for being available. I am glad you are not.

Mr. GOLDSTEIN. We are not sure. It depends on how it comes out.

The CHAIRMAN. Have you taken another look at the situation with regard to the offshore people who testified yesterday? They indicated that the Treasury changed its position and they thought the change of position was not justified and explained why.

The Treasury thought that there could be some unintended beneficiaries of that provision. They pointed out that under the Jones Act foreign companies with foreign shipping could not operate between two American ports. Are you familiar with that part of it?

Mr. GOLDSTEIN. Yes, sir. You do not mean the one about reinvestment portfolios, you mean the other that deals with the shipping profits, that there were two parts to? One dealt with Southern and then there is the more general provision?

The CHAIRMAN. That is right. I had in mind those who boats servicing offshore drilling rigs.

Mr. GOLDSTEIN. Let me ask Mr. Foster as our international counsel to answer that. It is also dealt with in the statement that we submitted.

The CHAIRMAN. I think that is section 1021, where the Treasury had changed its mind, concerning investment on the Continental Shelf.

Mr. GOLDSTEIN. Yes, I have spoken to Mr. Cohen about that one. The situation there was that when the House considered this provision, they voted to permit that investment to not require repatriation into the future and also went back and grandfather clause to certain past investments of that type.

When your committee considered it, you cut it off I believe at the end of this year. Under those circumstances, it seemed to us bad policy to permit retroactive relief in these circumstances where the committee is still maintaining that this particular investment would result in realization of income in the future.

Maybe everyone has mousetrapped, Senator Long, in this particular incidence. Usually, you decide to provide some relief going forward. The question is how much you should protect looking backward.

Here your committee decided that in going forward present law should be maintained, but it still would give some retroactive relief. Mr. Cohen did explain to me the negotiations and conversations he had over a period of 1½ or 2 years in anticipation that the law should be changed in the fashion that the House voted to change it.

The CHAIRMAN. We can discuss it further after we have had a chance to analyze it. You stated at the time you were in the room you would take another look at this situation.

Mr. GOLDSTEIN. Yes, sir.

The CHAIRMAN. It certainly leaves us in a difficult position, which is nothing new in politics or in government anywhere, I guess. When we act based on what your advice is and we think we are acting consistent with your advice and then you change your position, that in turn leaves us open to criticism, that we acted contrary to Treasury advice when we actually at the time we acted, had Treasury support for our position.

Mr. GOLDSTEIN. This particular case is a little different. When we filed our original memorandum, it indicated our support for this whole section of 1021. The approach of our June 15 memo was to give a position on the whole section even where there were some things we liked and did not like.

We have explained in the supplemental memo that we filed today that in many instances even though we approved of a section as a whole and if we had to vote yes or no, we would vote yes, there were aspects of it that we did not like. This provision is in that category.

Senator FANNIN. I did not hear your testimony and I was in the Interior Committee listening to the right arm of government, the Energy Research Development Administration. Dr. Seamans, the head of that, telling us of the great need for development of our energy resources, like solar, geothermal and for conservation programs.

I understand while I was gone that you had something to say about the geothermal provision in the bill.

Mr. GOLDSTEIN. I had not gotten to that, but I had planned to say something about it. As you know, this is one of the few areas where Treasury and yourself have had a running disagreement for the past several months.

Senator FANNIN. Are you still in on geothermal?

Mr. GOLDSTEIN. Yes, sir.

Senator FANNIN. Even after the court decision and everything that has been done and the tremendous need to develop that resource?

Mr. GOLDSTEIN. We are not opposed to developing the resource but to some extent, with regard to geothermal, we are reflecting the views, as part of the administration, of FEA which of course agrees with us.

We think that our proposal which is mentioned in our memorandum is both generous and appropriate. That is to give an immediate write-off of expenses as research and development expenses.

Senator FANNIN. But you have never come to a decision, you are not considering it as a depletable asset.

Mr. GOLDSTEIN. In effect, our proposal would be to defer that decision until more is known.

Senator FANNIN. The U.S. circuit court has certainly ruled that it is a depletable asset. How far do you have to go to the Supreme Court?

Mr. GOLDSTEIN. Before the IRS would follow the court decision as a technical matter, as far as audit policy goes, the Service does not need to feel bound by a circuit court decision.

Senator FANNIN. You said you wanted to do what was right, get more information, what more information could you have when it has gone through the courts?

Mr. GOLDSTEIN. As I say, there could still be a disagreement.

Senator FANNIN. That is right, there is a disagreement, but it is difficult to understand.

Mr. GOLDSTEIN. The point I am trying to make is that we are not unsympathetic to the development of geothermal resources. We have proposed a generous tax treatment for people investing in that area.

Senator FANNIN. Were you here this morning when the geothermal people testified that this is the great barrier they have in the path of their development?

Mr. GOLDSTEIN. Yes, sir. They did not have very nice things to say about our position.

Senator FANNIN. Thank you.

The CHAIRMAN. I know and frankly I heartily approve of the fact that people who hold your job do not stay at it. I think it is a good thing for the country that each administration seeks to bring in the brightest, most intelligent people they can find in the legal profession and in the business world to help us draft our revenue bills and help administer them.

Even though I from time to time am very critical of the Treasury, I still think that you people have the most able Department in the Government. I have said that. Also when I am critical of you, I think that you might take some solace in the fact that I still think you are the best of the gang.

Mr. GOLDSTEIN. Thank you, sir.

The CHAIRMAN. I know how this fiasco occurred with regard to the shipping problem. I was a manager in 1970 of what the administration thought was going to be just what the doctor ordered to revitalize the merchant marine and put it out there on the sea in all of its glory.

The key to all of that was a provision that related to revenue. I was the floor manager of the bill. That bill came out of the Commerce Committee. I was the chairman of a subcommittee of the Commerce Committee.

We gave a tax advantage by way of a tax deferral for constructing new ships. That was clearly intended to be a tax provision to revitalize that industry which was withering away.

It was clearly intended to provide something over and above what other industries get. I was also the floor manager of the revenue bill that we passed thereafter which reinstated the investment tax credit.

It is unfortunate but that is one of those things that happens, Mr. Larry Woodworth and his group, working on the restoration of the investment tax credit, in their cross-reference work, did not come across this provision which I had also managed to provide to rebuild the merchant marine.

The people on the Commerce Committee drafted that legislation. It was drafted in the Commerce Department rather than in the Treasury Department. In view of the fact that it did not fall in the Internal Revenue Code, they just did not come across it in their cross referencing.

That being the case, when we reinstituted the investment tax credit we failed to include this matter purely as a technical oversight. It does not happen all the time, but every now and then it does occur and that is why we have to meet again and pass more laws.

We failed to take into account the law that was to put the U.S. Merchant Marine back on the sea. The result is that the two bills failed to harmonize with the result that the Treasury contends that we should not have this provision or permit this tax deferral for the

benefit of new construction to anybody who is getting the investment tax credit, that if they get one, they do not get the other,

That was not the idea at all, it was never intended to be that way so we passed another bill out of the Commerce Committee and when we got to the House side, the House Merchant Marine Committee agreed with it but they said, we are sorry, we do not have jurisdiction, please try to take up the matter with the people on the Ways and Means Committee. All right, now we proceed to take up the same thing, we have already passed it one time, so we can go back to have someone else to talk to, with jurisdiction.

You know we get the impression that the House of Representatives is all one body but you get over there and find there is a whole bunch of bodies.

People complain, just a minute, this violates our sacred principles or some such thing as that. You had a chance to review that and see if you could reconcile your views with the committee's view with regard to the matter. In other words, the Commerce Committee thinks we ought to have the benefit for the merchant marine because it is intended to be an incentive over and above what others get because the merchant marine is in a very disadvantageous competitive position.

How do your people feel about it now?

Mr. GOLDSTEIN. I guess basically we have been looking at it from two different points of view. You and the Commerce Committee are looking at it from the point of view of what our merchant marine policy should be, what our needs are.

We have been looking at it from the point of view of tax policy where as you know we have had a disagreement even as to the regular investment credit. We would like to have a basis reduction in the amount of credit.

Here we are talking about 27 percent, not 10 percent. You have a situation where in effect you have an immediate 100-percent basis reduction because the availability of the capital construction fund.

Our view is that if you do not have a cost for tax purposes or if you allow an immediate writeoff which would be the equivalent, that it is not appropriate also to have the investment credit.

Our people calculate that the value in dollars of the fast writeoff, the immediate writeoff, is the equivalent of a 17-percent investment credit and therefore is better than any other industry.

What you are saying it seems to me——

The CHAIRMAN. It was never intended to be that. That is just what you are saying.

Mr. GOLDSTEIN. You are saying if the intention is to have a 27-percent investment credit to help this particular industry, at some point I guess the Treasury would have to defer to the people that know more about the shipping business.

The CHAIRMAN. The whole idea was that this was something we were going to do for the merchant marine and we approved it as something over and beyond what other industries get. It was going to be a special consideration, an additional consideration for the merchant marine.

When we reinstated the investment tax credit and failed to clearly allow the merchant marine to claim the investment tax credit it was to receive, then that had the effect of negating the whole intent of it.

I thought I had helped get the U.S. Merchant Marine back on the high seas again, then we find out that what we did accomplish was zero because one thing completely neutralized the other.

The embarrassing part of it is that I was the manager of both of those bills. It is very embarrassing to have to say that I was invited somewhere to speak about the merchant marine today to talk about what I did to get the U.S. Merchant Marine on the sea and find out thanks to the cooperation of the Treasury, who by the time it got through construing the two statutes, had it so we did not achieve anything at all.

I hope to live long enough to work out the result so that what this administration sought in the beginning is actually achieved. I certainly hope we pass some legislation before the 8 years of the Nixon and Ford administration terminate so we can actually have made effective and place in operation the very proud program that a lot of people worked on and tried to put into effect and told everybody would be in effect to restore the merchant marine to its previous status.

Mr. GOLDSTEIN. Obviously the will of Congress is going to decide this. The administration position I stated today is supposed to take into account maritime policy and I guess the majority vote would be negative but I understand there are some differences even within the administration.

The CHAIRMAN. That is a hiatus that could never have occurred if someone had cross-referenced this matter the way we cross-reference most revenue bills. It is our competent, able staff that does that, but in view of the fact that this was at some other place in the law and not in the Internal Revenue Code in their cross-reference work, they did not come across it.

I can assure you it would have been taken care of if they had.

Senator BYRD. Like Chairman Long I am a strong advocate of the merchant marine. I also want to work within the framework of tax structure.

I am not clear as to just what is your position on that section in 806 about which we are talking.

Mr. GOLDSTEIN. Yes, sir.

Senator BYRD. I am not clear as to just what your objections are.

Mr. GOLDSTEIN. Our position has been clear that we are not in favor of extending the investment credit to ships which already have the benefit of the capital construction funding provisions.

The reason is that in general the investment credit is based on the tax cost of a particular asset. Because of the fact that the owner of the ships is permitted to claim an immediate deduction for the amount placed in the capital construction fund, the tax costs of these ships is zero.

The investment credit, as a matter of tax policy, would not be appropriate, but the Congress is free to provide any level of tax credit for any asset or make exceptions from the general rule.

Senator BYRD. You favor the 10-percent investment tax credit, but you do not favor it in regard to the ships?

Mr. GOLDSTEIN. Yes, sir. We strongly favor the 10-percent investment credit, but the typical manufacturing companies or companies that build an asset will be required to recover its cost over some period of years and will also get the investment credit.

Senator BYRD. It is your point that the shipping industry gets 100 percent writeoff at the beginning?

Mr. GOLDSTEIN. Yes, sir, that is the distinction. As Senator Long said, it may be that the overall intent of Congress is that they get both benefits.

Senator BYRD. But the Treasury Department opposes giving them both?

Mr. GOLDSTEIN. Yes, sir.

Senator BYRD. Thank you.

The CHAIRMAN. Thank you very much.

Senator DOLE. I would just make an observation while the next witness is coming up. Yesterday I asked the question of the Public Citizen witness, according to the 1972, 1973, 1974 returns it is in excess, but they do not have the 1975 return.

According to the 1974 return, it is about $1,065,000 net worth, and they have about $980,000 in investments. My point was I think they are doing quite well as a small struggling interest group.

I am not certain where the money came from. It occurs to me that much of it probably came from organized labor and that if organized labor has been in this room to be against so many of these proposals, I just say as I did yesterday I think in fairness it would be helpful if we knew where their money came from.

If they are representing organized labor, then we ought to have that information. If they are representing public spirit, such as they indicate, that would be very helpful because they have indicated that there is sort of a yield of reference.

I would suggest that if they want to appear here as objective witnesses, I do not quarrel with that, we could better test that objectivity if we knew where their money came from.

The CHAIRMAN. Are you making that a request?

Senator DOLE. Well, I will give it to you but it is just a hope, not a strategy.

The CHAIRMAN. Mr. Scott P. Crampton, Assistant Attorney General, Tax Division, Department of Justice, accompanied by Richard C. Albrecht, General Counsel, Treasury Department.

STATEMENT OF SCOTT P. CRAMPTON, ASSISTANT ATTORNEY GENERAL, TAX DIVISION, DEPARTMENT OF JUSTICE, ACCOMPANIED BY RICHARD C. ALBRECHT, GENERAL COUNSEL

Mr. CRAMPTON. I have with me Richard Albrecht, general counsel of the Department of the Treasury and Mr. Carl Imlay, general counsel of the Administrative Office of the United States Courts.

We would like to discuss briefly with you the provisions of 1205 of the present bill. In that connection, there are letters sent to the committee by the Attorney General, by the Secretary of the Treasury, and by the Administrative Office of the United States Courts. We also have a detailed prepared statement. We would like to have those submitted as part of the record which sets forth our position.

The CHAIRMAN. The statement and accompanying papers will be made a part of the record.

[The statement follows:]

TESTIMONY OF SCOTT P. CRAMPTON, ASSISTANT ATTORNEY GENERAL, TAX DIVISION, DEPARTMENT OF STATE

My name is Scott P. Crampton and I am Assistant Attorney General in charge of the Tax Division, Department of Justice. We welcome the opportunity to present the views of the Department of Justice on Section 1205 of the Tax Reform Bill of 1976 captioned "Administrative Summons." This section would amend the Internal Revenue Code of 1954 by redesignating Section 7609 as 7611 and inserting new Sections 7609 and 7610. Proposed Section 7609 is entitled "Special Procedures for Third-Party Summonses" and proposed Section 7610 would provide for fees and costs of witnesses in these new procedures. We believe this proposal, if enacted, would seriously interfere with the enforcement of the tax laws, particularly in the organized crime and white-collar crime areas, and further overburden the federal judicial system.

In principal part and with certain exceptions, Section 1205 of the bill would require notice to the person, usually the taxpayer and hereinafter referred to as such, identified in a summons issued to a third-party record keeper by the Internal Revenue Service. The taxpayer would be given 14 days within which to notify the record keeper not to comply with the summons. Once the taxpayer thus barred compliance, the Government could only obtain enforcement through a court proceeding in which the taxpayer would have a right to intervene and to litigate the matter. A summons to require testimony relating to records would be treated as a summons to produce records. The civil and criminal statutes of limitations would be suspended during the period of such court action, including appeals, if the person barring compliance is the taxpayer. A John Doe summons could only be served after a court proceeding.

Under present law, a taxpayer or third party cannot intervene in a summons enforcement proceeding unless he has a legally protectable interest. *Reisman* v. *Caplin*, 375 U.S. 440 (1964). However, in *Donaldson, et al.* v. *United States*, 400 U.S. 517 (1971), the Supreme Court said this meant a significantly protectable interest. In that case, the Court held against the taxpayer because he had no "proprietary interest" in the records sought and they were not protected by an attorney-client or other legally recognized privilege. It is worth noting at this point that, although the district court had denied the intervention of the taxpayer in *Donaldson*, stays were granted pending appeal; that the summons were issued on September 12 and 13, 1968, with respect to tax liabilities for 1964 through 1967, inclusive, and that the date of the Supreme Court's opinion was January 25, 1971, or some two years and four months after issuance of the summonses. In this context, one can understand the concern the Supreme Court expressed by saying that to allow the taxpayer to intervene in such case would "stultify the Service's every investigatory move" (p. 531). We completely agree and believe that the word "stultify" was used in the dictionary sense: "to impair, invalidate, or reduce to futility."

As the Supreme Court pointed out in *Donaldson*, the statute (Section 7601, Internal Revenue Code of 1954) imposing the duty on Treasury Department officers to "proceed . . . and to inquire after and concerning" all persons "who may be liable to pay any internal revenue tax" has its roots in the first modern general income tax act, the Tariff Act of October 3, 1913, Sec. II, 38 Stat. 178, and, beyond that, in Section 3122 of the Revised Statutes of 1874. Thus, the express requirement that the Secretary or his delegates go to third-party sources to "canvass and to inquire," as the Supreme Court put it (p. 523, *supra*), is an historical procedure. The implied requirement or practice probably goes back to the beginning of the country. Never was it considered that a taxpayer could or should have the right to prevent this except where he had some legally protectable right in or to the papers at issue. As the late Justice Douglas put it in his concurring opinion in *Donaldson*, "it is difficult to see how the summoning of a third party, and the records of a third party, can violate the rights of the taxpayer."

Thus, the proposal would create a completely new legal right, which, we believe, would be used to frustrate fair and uniform enforcement of the revenue laws. Existing law is a necessary adjunct to the self-assessment system. Many millions of taxpayers are subject to withholding. Declarations of their incomes and the taxes withheld and paid over are routinely submitted to the Government by their employers as required by law. Their incomes are known and their ability to reduce their taxes is limited. Therefore, the proposed section would benefit, primarily, those taxpayers the major part of whose income is not subject to withholding. Congress has recognised that they may not always comply and has

enacted criminal sanctions for any person who willfully fails to keep any records or supply any information required by the statutes or the regulations thereunder (Section 7203, Title 26, U.S.C.). However, the Government cannot compel an individual to produce those records against a claim of self-incrimination under the Fifth Amendment. When the individual taxpayer fails to keep records or fails to produce or falsifies the records he has kept, the Government must go to third-party sources to determine the tax liability. Even under existing law, this is not something the Internal Revenue Service undertakes, other than as a last resort, for it is a tedious, time-consuming, and expensive process to reconstruct the income and the tax of an individual or corporation by third-party sources. In fairness to all other taxpayers, however, it is a statutory duty that must be carried out. But it is the breakdown, or alleged breakdown, of the self-assessment system that renders it necessary.

Apparently, the right to privacy is the principal consideration underlying this proposal; yet it would confer this right only on the person named in the summons. The necessity for this highly selective grant of a right to privacy was recognized in the Report of the Senate Finance Committee, fn. 3, p. 369, in the CCH Report, No. 28, dated June 16, 1976, where it is stated:

"Of course, the Service would not be required to send a notice to each person to whom the X corporation wrote a check during the period under examination; not only would this be impossible administratively, but the identity of these persons would not even be known by the Service until the records had been examined."

It might be questioned why the "privacy" of "X corporation" should be respected and that of the thousands of persons having transactions with it not be? And what about the privacy of other individuals in multi-party transactions, not named in the summons, whose status and interest in the records are identical to that of the one named? Therefore, it is highly likely that persons other than those named in the summons would attempt to intervene. It could be questioned whether the proposal offers equal protection of the laws to persons whose interests in a record are identical. A court conceivably could permit such persons to intervene.

The foregoing illustrates, and the Report of the Senate Finance Committee concedes, that it is not administratively possible to give equal protection to the "privacy" of all persons involved in commercial transactions. Thus, the effect of this provision would, primarily, be to protect the "privacy" of the individuals who had not complied with the requirements of the self-assessment system. It is true that, occasionally, what appear on their face to be adequate records are checked by reference to third-party sources. This is because, as the Supreme Court said in *Holland* v. *United States*, 348 U.S. 121 (1954), p. 132, some records are "more consistent than truthful" and Congress never intended a "set of blinders which prevents the Government from looking beyond the self-serving declarations in a taxpayer's books." It is important, then, to emphasize just whose "privacy" is being protected by this proposal. If neither the record keeper nor the taxpayer objects to the summons, the transactions of hundreds or even thousands of other individuals may be laid bare. Therefore, unlike the historically recognized privileges, there is no uniform standard for the proposed selectivity of persons whose privacy is to be legally protected. There is only the common denominator of being listed on a summons.

Aside from the unfairness of this provision to the millions of taxpayers who fully comply with the law and the highly selective "privacy" that would be protected, we have the following specific objections to the proposal:

1. The delays resulting from taxpayer intervention could effectively frustrate efforts of the Internal Revenue Service to reconstruct income and tax by resort to third-party records. Of the approximately 500 Special Agent summons cases handled by the Tax Division each year, it is most often some special relationship between the taxpayer and the record keeper that accounts for the failure of the latter to comply. If taxpayers are allowed to intervene of right, it could very well take two years for the agents to obtain the records of the first bank and the number of summons enforcement proceedings would only be limited by the number of record keepers involved, most of whom may not even be known until after the records of the first are obtained.

2. The already overburdened courts, in which some 1,100 summons enforcement cases are currently being brought (about 500 Special Agent summons cases and 600 Revenue Agent summons cases), would be further swamped at a time when the Speedy Trial Act means that criminal trials will be occupying more of the

courts' time. It would mean substantial increases in the number of agents and the number of lawyers handling such cases. A prime consideration would then be whether the investigation was administratively feasible. The areas most affected would be the organized crime and white-collar crime drives, because those categories of taxpayers have developed delay and noncompliance to a fine art. This proposal would further the process of turning the district courts into administrative tribunals.

Although the statute of limitations would not run when the taxpayer intervened, it would continue to run when the person named in the summons was the nominee of the taxpayer. This is commonly the case (the use of nominees) as to organized and white-collar crime figures. As stated earlier, it is possible that the courts would permit intervention of persons with identical relationships to the records at issue. If the taxpayer did not intervene, the statute of limitations would run. And, there is, of course, the problem that the statute would be running when the record keeper is contesting the summons alone.

4. There would probably be motions to suppress evidence in subsequent proceedings on the ground that there had been some failure on the part of the Government to comply with some aspect of this proposal.

Although we object to the subject proposals, we wish to assure you, Mr. Chairman, that we have a sincere concern with the privacy of individuals. In the sustained effort to comply with the Freedom of Information Act on the one hand and the Privacy Act on the other hand. we are constantly on guard against an inadvertent disclosure that would provide information to one at the expense of the privacy of another. We literally have to make a line-by-line, paragraph-by-paragraph analysis of many documents; and, because of the complex nature of the areas of law we administer, sometimes it takes an experienced tax lawyer to determine what should be turned over and what should be withheld. Knowledgeable defense counsel are now inundating us with requests under these two acts as discovery weapons in current criminal tax cases, including those under investigation by grand juries. This has increased the strain on our limited manpower resources, particularly on our trial attorneys, since the attorney handling the case must, of course. be consulted concerning the documents involved which may range in the thousands. In other words, F.O.I. and Privacy Act provisions are being used effectively and with resulting delay of criminal justice, both at the administrative and subsequent stages. We foresee the proposal here as providing another vehicle for the same result at the investigative stage.

Although we disagree with other aspects of the proposal, we think it may be advisable to have a statutory requirement of notice to a taxpayer that the Internal Revenue Service may be serving summonses on third parties. As noted earlier, there are circumstances when the taxpayer does have a right to intervene under the *Reisman* and *Donaldson* decisions of the Supreme Court. A notice was suggested by a committee of the Section of Taxation, A.B.A., see 26 The Tax Lawyer 591, in which the Committee on Civil and Criminal Tax Penalties discussed studying the advisability of registers in each Internal Revenue Service District or Federal Judicial District where such summons would be listed. We think it may be preferable to give the taxpayer notice directly rather than to make a public record at the investigative stage. This notice provides the taxpayer with a last opportunity to substantiate the items on his returns, and thus, to obviate the necessity (in most instances) for a summons. The taxpayer is then in the best position to safeguard his own privacy.

The following examples illustrate our concern about this provision as a means for delay:

1. Taxpayer is in an illegal business and refuses to substantiate the items on his returns. As direct evidence of specific items of income is unavailable, the Government undertakes to reconstruct his taxable income by the net worth method (see *Holland* v. *United States, supra*). A summons is issued to his only known bank (bank A); he intervenes in the ensuing court proceeding, and it takes from a year to eighteen months to gain access to the records of that bank. In going over the records of that bank, leads to banks or brokerage accounts B, C, and D are obtained, and it appears that property is held for him in the names of nominees. If only nominees intervene in summons proceedings, the statute of limitations is not suspended. At any rate, each proceeding, which could take from one to two years, results in the discovery of leads to additional record keepers, and so on. Obviously, if taxpayer has dealt with multiple institutions which become known through this unraveling process, it may not be feasible at all to develop this type case. Had this proposal been the law, many of the famous net

worth cases on prominent racketeers probably could never have been made. See, e.g., *Costello* v. *United States*, 350 U.S. 359 (1956).

2. In an audit of Contractor Jones, a revenue agent obtains documentary evidence, which Jones corroborates, of a bribe paid to Federal Procurement Officer Smith. Smith's return is audited to see if he reported the item. There are items on Smith's return which could include the bribe. Smith refuses to furnish his records from which the reported items may be checked; third-party summons are issued, and Smith intervenes. The agents foresee a year, or perhaps years, of litigation. In the meantime, the Title 18, U.S.C., offense has been referred to the Federal Bureau of Investigation and is soon ready for the grand jury. The alternatives, then, are: (1) to proceed with the Title 18 offense without the Title 26 offense, or (2) to investigate the Title 26 offense by grand jury. The result of the first choice is to weaken the case and to divide offenses which should be joined; the second choice bypasses the careful review process which is essential to uniform enforcement of the revenue laws. Often it is not a simple process to determine whether an item is or is not on a return: considerable investigation and expertise in tax law may be required.

In summary and in conclusion: This proposal would hamstring the investigative procedures of the Internal Revenue Service. It would require large manpower resources in the Internal Revenue Service, in the Tax Division, and in the Offices of the United States Attorneys. It would further overburden the Federal court system. And, most importantly, it would afford procedures whereby those who would thwart the self-assessment system could do so with impunity. Thank you, again, for permitting us to present the view of the Department of Justice on this matter.

OFFICE OF THE ATTORNEY GENERAL,
Washington, D.C., July 21, 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: We wish to express the Administration's opposition to Section 1205 of your Committee's version of H.R. 10612, the House-passed tax revision bill.

Section 1205 would add a new Section 7609 to the Code which would require notice to the taxpayer of a summons issued to a person whose business consists "in whole or in part" of keeping records of "business transactions or affairs of other persons." The taxpayer could stay compliance by the person summoned by giving him notice not to comply, forcing the Government to seek enforcement of the summons in a United States District Court where the taxpayer would intervene to challenge the enforcement of the summons. Exceptions are provided, *inter alia*, for summonses to discover assets for purposes of collecting assessments or judgments, or if there is reason to believe notice may lead to concealment or destruction of records, intimidation, or bribery. A so-called John Doe summons could only be served after court review.

Under present law, of course, a taxpayer or third party cannot intervene in a summons enforcement proceeding unless he has a legally protectable interest, *Reisman* v. *Caplin*, 375 U.S. 440 (1964); *Donaldson* v. *United States*, 400 U.S. 517 (1971).

Any valid objection that a taxpayer may have to a tax investigation may be asserted when the investigation results in proceedings against him. If the taxpayer were given the right to force summons enforcement proceedings and to intervene therein, the number of possible enforcement proceedings in any one case would only be limited by the number of record keepers. In a complex net worth case requiring the production of thousands of documents from hundreds of institutions, corporations, or individuals, we can envision litigation in hundreds of summons enforcement cases in multiple jurisdictions. Because investigators often encounter leads to additional financial institutions only through the records of others, and because the net worth method of proof requires that all leads be exhausted (see *Holland* v. *United States*, 348 U.S. 121 (1954)), the enactment of this proposal could well spell the end of the net worth and the bank deposits method of proof for determining the tax liability of an uncooperative taxpayer.

Although taxpayer intervention would toll the running of the statute of limitations, time would still be on the side of the taxpayer because witnesses die, their memories fade, and records are lost or destroyed. It should also be noted that the statute of limitations would not be tolled when the records sought were

in the names of nominees of the taxpayer and only those nominees, at the urging of the taxpayer, intervened.

Enactment of this proposal would have an immeasurable, adverse effect on the courts who would be forced to act as reviewing administrators for the taxpayers primarily benefited by this legislation—those well-financed litigants whose primary tactic is to retard the judicial process, delay the determination of their tax liability, and make litigation for the Government as expensive as possible. In our view, proposed Section 7609 would seriously impede Internal Revenue Service investigations and would degrade the quality of the criminal and civil tax cases that are presented to the courts for determination.

We have no objection to a statutory requirement of notice to a taxpayer that the Internal Revenue Service will be serving summonses on third parties. Indeed, representatives of our Tax Division and the Internal Revenue Service met with members of the Staff of the Joint Committee on Internal Revenue Taxation and discussed such a proposal with them. This proposal included a 14-day period in which taxpayer could obviate the necessity for summonses on third parties by substantiating the items on his returns.

We understand that the Finance Committee will be holding hearings on this Bill during the week of July 20, 1976. In view of the importance of this subject to tax enforcement, it is requested that a time be reserved by the Committee to permit a representative of the Department to explain our position to the full Committee.

Sincerely,

EDWARD H. LEVI,
Attorney General.

ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS,
Washington, D.C., July 20, 1976.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate, Dirksen Senate Office Building, Washington, D.C.

I write to you today to express my concern in respect of the potential impact of Section 1205 of your Committee's version of the Tax Reform Bill of 1976, H.R. 10612, 94th Cong., 1st Sess., on the judicial branch of the federal government.

Pursuant to section 7602 of the Internal Revenue Code of 1954, the Secretary of Treasury or his delegate is authorized to issue what has been referred to as an administrative summons to require the production of books, papers, records, or other data for examination relevant to a lawful inquiry concerning any internal revenue tax return or liability. The summons may be directed to a taxpayer under investigation or to any third-party having possession, custody, or care of the materials sought for examination. Testimony of such persons, including testimony under oath, also may be required. The summons may be enforced by a United States district court pursuant to Int. Rev. Code of 1954, §§ 7604, 7402(b). Penalties for failure to obey a summons are provided in Int. Rev. Code of 1954, § 7210.

Section 1205 of the Tax Reform Bill of 1976, *supra*, if enacted will add a new section 7609 to Internal Revenue Code of 1954 [hereafter referred to as proposed section 7609]. Proposed section 7609 adds new procedural requirements in respect of an administrative summons served on a third-party who is a record keeper. If a record keeper is served with a section 7602 summons requiring the production of (or testimony with respect to) any portion of records made or kept of the business transactions or affairs of any individual [generally the taxpayer under investigation and hereinafter referred to as such] identified in such summons, notice shall be given to any taxpayer so identified, provided no notice is required if the summons is in aid of collection of the liability of any person against whom an assessment has been made or a judgment rendered. Notwithstanding any other law or rule of law, any taxpayer entitled to such notice shall have the right to intervene in any section 7604 enforcement proceeding and further, shall have the right to stay compliance with the summons by the third-party record keeper by giving the requisite written notice as prescribed in the proposed section. Action on the part of a taxpayer to stay compliance causes the tolling of statutes of limitations in respect of his liability for tax for past taxable years and to criminal prosecution. If the taxpayer gives the prescribed notice, absent his subsequent consent the government may not examine the records required to be produced pursuant to that summons prior to obtaining an

order of authorization to examine from a court of competent jurisdiction. Apparently jurisdiction over authorization proceedings is vested in the United States district courts pursuant to Int. Rev. Code of 1954, § 7402(a). In accordance with criteria prescribed in the proposed section, the government may petition the court in an ex parte proceeding for authorization to dispense with notice requirements in respect of a particular taxpayer. If the court grants the petition, the taxpayer further loses his right to stay compliance by the third-party record keeper. It is unclear whether he also loses the right to intervene in any enforcement proceeding. Any "John Doe" summons to be served on a third-party record keeper must be authorized in advance by a United States district court. Finally, proposed section 7609 requires that an enforcement proceeding and any "proceeding under this section" takes precedence on the docket over all other cases, except as to other cases the court considers of greater importance.

A summary of statistics relevant to civil caseloads in United States district courts is included in Attachment A to this letter. From these statistics, it is clear that there has been a dramatic and progressive nationwide increase in the civil filings in United States district courts. The number of civil cases pending at the close of each reporting period also continues to rise at an alarming rate. For example, in Fiscal Year 1975, the last full fiscal year for which figures are available, 117,320 civil cases were filed in federal district court. Of this total, 31,779 cases involved the United States as either plaintiff or defendant, and 1,673 of these were classified as tax suits. At the close of Fiscal Year 1974, 107,230 civil cases remained pending. The same figure for Fiscal Year 1975 is 119,767. At the close of the first half of Fiscal Year 1976, the number had risen to 133,775.

These figures should be compared with the estimated potential number of administrative summonses which would be subject to the procedural requirements of proposed section 7609. Using figures supplied by the Internal Revenue Service, Attachment B computations result in an estimate of 38,400 such summonses annually.

Under proposed section 7609, these summonses represent not only the potential for actions by the government to obtain authorization to examine records and actions in aid of enforcement of such summonses, but also a potential source of many types of spin-off litigation. Litigation which may be fostered by the proposed legislation includes actions to determine sufficiency of notice, to define "record keeper", to determine the rights which may be raised exclusively by the record keeper, to determine the propriety of exceptions-from-notice proceedings and John Doe authorization proceedings, and to determine if suppression is an appropriate remedy for failure of the government to comply with the requirements of proposed section 7609. In addition, it is likely that sources which formerly provided data without requiring a summons will begin requesting summonses in the future, thus causing the total number of summonses to increase.

It is clear from the sheer magnitude of this investigatory program that even if only a relatively small proportion of the summonses results in new litigation, the impact upon the federal judiciary will be staggering and could be crippling.

At the direction of the Judicial Conference of the United States, I transmitted on January 15, 1975, for the consideration of Congress two proposed bills to provide for, respectively, the creation of thirteen additional circuit judgeships for the United States Courts of Appeals, and the creation of fifty-two additional district judgeships for the United States District Courts. These proposals were based upon the then current civil and criminal caseloads of federal judges. Although the Senate has passed a bill providing for forty-four new district judgeships (S. 287 (April 1, 1976)) and a bill providing for seven new circuit judgeships (S. 286 (Oct. 2, 1975)), the fact remains that no new district judgeships have been created since 1970 and no new circuit judgeships have been created since 1968.

On January 3, 1975, the Speedy Trial Act of 1974, Pub. L. No. 93-619, 88 Stat. 2076 [hereinafter referred to as the Speedy Trial Act] became law. Title I of this act mandates specific time limits for many phases of the process of bringing criminal defendants to trial in federal district courts. When fully implemented, this legislation is expected to have a particularly heavy impact upon the work of the federal judiciary. Its effects already are being felt. Effective July 1, 1976, the first set of comprehensive time limits prescribed by 18 U.S.C. §§ 3161 (b), (c), (f), and (g) (Supp. IV, 1974), became operational. More stringent time limits become operational the first day of every July until July 1, 1979, when

the final, most strict time limits become effective. As a result of the implementation process, an ever-increasing proportion of judicial resources continues to be devoted to criminal trials. The pending civil caseload continues to grow as a consequence of both this fact and the accelerated rate of new filings. Our estimates in 1975 indicated that an additional fifteen to twenty judgeships, over and above the sixty-five requested in the proposed bills, would be necessary to cope with the demands of the Speedy Trial Act in respect of criminal cases and to permit the trial of civil cases to continue.

As Attachment A further indicates, the median time intervals from filing to disposition for civil cases involving trials all exceed one year. With the dedication of an ever-increasing proportion of judicial resources to criminal trials, these median times can be expected to increase. I can foresee only even greater time intervals between filing and disposition in civil cases.

These problems can only be exacerbated by new types of litigation. With new legislation, an evolutionary process usually takes place and caseloads usually grow gradually. In respect of proposed section 7609, however, direct, immediate, and substantial consequences can be anticipated unless the Internal Revenue Service abandons completely the administrative summons as an investigatory tool with respect to third-party record keepers. Furthermore, the impact will be not only on litigation involving the administrative summonses, but also on all types of civil litigation pending in federal district courts.

I note wth concern also the inclusion in proposed section 7609 of a provision giving priority to actions in respect of administrative summonses. In accordance with proposed subsection 7609(h)(2):

"Except as to cases the court considers of greater importance, a proceeding brought for the enforcement of any summons, or a proceeding under this section, and appeals, take precedence on the docket over all cases and shall be assigned for hearing and decided at the earliest practicable date."

If the priority provision of proposed section 7609 were enacted, it would constitute at least the thirtieth statute calling for the expediting of cases on the dockets of federal courts. Unfortunately, there is no general rule for the ordering of priorities in federal courts contained in the United States Code. Furthermore, for the most part there are no priorities among the priorities established by previous enactments.

The language contained in this proposed section is very similar to the priority provision of the Freedom of Information Act, 5 U.S.C. § 552(a)(3)(D) (Supp. IV, 1974). Although it provides priority over all cases, the provision is effective subject to the discretion of the court concerning cases of greater importance.

As a consequence of this clause invoking the discretion of the court, it would appear that priority afforded under proposed section 7609 will be inferior to priority granted civil actions arising under statutes mandating a first precedence. Furthermore, and more importantly, for the reasons set forth earlier detailing the necessity of dedicating a greater proportion of judicial resources to criminal trials to achieve compliance with the Speedy Trial Act, your Committee should take no comfort in any priority provision with respect to civil actions. Even for civil actions which are afforded priority status, it is evident that speedy trials will be impossible and that inordinate delays may be anticipated in all civil litigation.

The position of the Chief Justice of the United States concerning the creation of new judgeships is well known. In a recent address before the National Conference on the Administration of Justice in St. Paul, Minnesota, he stated that the sixty-five proposed judgeships were "desperately needed" to deal with the current workload of the federal judiciary.

It is with appreciation for these problems concerning court caseloads and workloads for individual judges that I analyze proposed section 7609. While I am concerned with the prospect of ever-increasing delays in the disposition of civil actions, I would be remiss if I failed to point out the premonition of the Supreme Court in *Donaldson* v. *United States*, 400 U.S. 517, (1971). This case articulates the Court's resolution of the problem of the right of a taxpayer to challenge a third-party administrative summons. In holding that a taxpayer may not intervene in an enforcement action unless he can articulate a "significantly protectable interest," the protection of which otherwise would be impaired or impeded, the Court stated that to hold otherwise and grant an absolute right to intervene would "stultify" the Internal Revenue Service's every investigative move. *Donaldson*, *supra*, 400 U.S. at 531 and 536.

One of the purposes of proposed section 7609 is to overrule the holding of the Supreme Court in *Donaldson* in respect of the taxpayer's right to intervene in an enforcement action. Proposed section 7609 would grant every taxpayer the absolute right to intervene regardless of the existence of a "significantly protectable interest," the protection of which otherwise would be impaired or impeded, and the "usual process of balancing opposing equities." *Donaldson, supra*, 400 U.S. at 531.

The report of your Commitee emphasizes that the administrative summons is a necessary investigation tool for the Internal Revenue Service. S. Rpt. No. 94–938, 94th Cong., 2d Sess. 367–374 (June 10, 1976). At the same time, it is the intent of your Committee to protect from unreasonable infringement the civil rights of taxpayers, including the right to privacy. The report makes clear that the Committee believes the approach taken will afford a "reasonable and *speedy*" means to challenge such summonses. S. Rpt. No. 94–938, *supra*, at 368 (emphasis added). Further, the Committee intends that any taxpayer still will be able to assert any defenses available to him with respect to any evidence obtained by summons in any later court action in which the taxpayer is involved, regardless of whether he waives his rights under proposed section 7609. S. Rpt. No. 94–938, *supra*, at 370. However, it is clear that these provisions are not intended to expand or create any new substantive rights of taxpayers. S. Rpt. No. 94–938, *supra*, at 370. Finally, the report states as follows:

"The Committee does not wish these procedures to so delay tax investigations by the [Internal Revenue] Service that they produce a problem for sound tax administration greater than the one they seek to solve. Accordingly, the Committee amendment provides that the disposition of court actions involved be heard on as expeditious a schedule as possible." S. Rpt. No. 94–938, *supra* at 371.

Since the Committee purports to grant no new substantive rights to taxpayers, it is important to question how the grant of an absolute right to intervene impacts upon normal judicial principles of standing. With respect to the doctrine of standing, it is inescapable that judicial policy determinations have blended with Constitutional limitations. *See Flast* v. *Cohen*, 392 U.S. 83 (1968). The doctrine of standing is related intimately to the Constitutional requirement that there must be a justiciable case or controversy before a federal court can act. *See Massachusetts* v. *Mellon*, 262 U.S. 447 (1923). A court must decide a judicial controversy, not assume a position of authority over the governmental acts of another and coequal branch, an authority not possessed by the federal judiciary. *Massachusetts* v. *Mellon, supra*. Court developed doctrines such as standing have been founded upon a recognition of the necessity, if government is to function constitutionally, for each branch to keep within its power, including the courts, and a recognition of the inherent limitations of the judicial process, arising especially from its largely negative character and limited resources of enforcement. *See Rescue Army* v. *Municipal Courts*, 331 U.S. 549 (1947).

My purpose in expressing my views on proposed section 7609 is not to offer an opinion in respect of matters which are of a legislative policy nature. At the same time, I believe it is imperative that Congress should have relevant information regarding the impact of new legislation upon the Judiciary's continuing ability to fulfill its responsibilities and perform its functions in our government.

For all of the reasons set forth above, I believe proposed section 7609 contains the potential for adding a staggering and devastating new element to the workload of federal district courts. At the present time when more and more judicial resources are being consumed by criminal trials, we operate under the fear that the caseloads of federal judges may reach the breaking point. We risk impairing the standards of justice and denying civil litigants their day in court.

I can foresee the possibility of the federal courts becoming the final arbiter of how and when administrative summonses may be used not as a consequence of decisional case law, but as a consequence of the failure of the judiciary to adjudicate in a timely manner the many actions pending on civil court calendars.

Sincerely,

ROWLAND F. KIRKS, *Director*.

Attachments.

ATTACHMENT A

US DISTRICT COURT STATISTICS

	Fiscal year—		
	1974	1975	1976 (1st half)
All civil cases:			
Filed	103,530	117,320	65,061
Terminated	97,633	104,783	51,053
Pending (at close)	107,230	119,767	133,775
U.S. civil cases:			
Filed	27,585	31,779	19,784
Terminated	26,702	27,949	14,677
Pending (at close)	22,325	26,155	31,262
U.S. civil tax cases:			
Filed	1,872	1,673	840
U.S. plaintiff	458	381	213
U.S. defendant	1,414	1,292	627
Terminated	1,706	1,761	740
Pending (at close)	2,415	2,327	2,427

MEDIAN TIME INTERVALS FROM FILING TO DISPOSITION

[In months]

	Fiscal year—		
	1974	1975	1976 (1st half)
All civil cases	9	9	8
No court action	7	7	6
Court action:			
Before pretrial	8	7	6
During or after pretrial	16	16	15
Trial	16	16	16
U.S. civil cases	6	6	6
No court action	4	4	4
Court action:			
Before pretrial	7	7	6
During or after pretrial	15	15	14
Trial	16	15	13
U.S. civil tax cases	12	12	12
No court action	9	11	9
Court action:			
Before pretrial	8	9	7
During or after pretrial	19	17	16
Trial	20	17	20

Excerpts from: (1) Annual report of the Director of the Administrative Office of the U.S. Courts 1975, app. I. (2) Semiannual report of the Director of the Administrative Office of the U.S. Courts 1976, appendix. (3) Annual report of the Director of the Administrative Office of the U.S. Courts 1974, app. I.

ATTACHMENT B

ADMINISTRATIVE SUMMONSES

[Computations based upon figures supplied by the Internal Revenue Service]

	February to May 1976	Estimate 12ow-period
Summonses issued:		
Total	28,500	85,500
3d party	20,500	61,500
Recordkeepers [1]	[2] 15,000	45,000
Other	5,500	16,500
Summonses issued in aid of collection:		
Total	5,500	16,500
3d party		
Recordkeepers	[3] 2,200	6,600
Other		
Summonses potentially subject to proposed sec. 7609 requirements [4]		38,400

[1] Defined as banks, savings and loan associations, credit unions, brokerage houses, insurance companies, and taxpayers representatives (including attorneys and accountants).

[2] Approximately 5,500 of 15,000 were issued by collection function of IRS. Of this total 60 percent (or 3,300) issued by collection function were not in aid of collection.

[3] Estimate.

[4] Computed as follows: Summonses issued to 3d-party recordkeepers (45,000) less summonses issued to 3d-party recordkeepers in aid of enforcement (6,600) equals 38,400. [Summonses issued to 3d-party recordkeepers in aid of enforcement equals 40 percent of summonses issued by collection function annualized—see footnote 2 (40 percent times 5,500 times 3 equals 6,600).]

THE SECRETARY OF THE TREASURY,
Washington, D.C., July 21, 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR RUSSELL: I have become quite concerned that one of the provisions of Title XII of H.R. 10612, Section 1205, dealing with procedures in the use of administrative summons by the Treasury, will turn out to have a serious unintended effect.

In general, and with limited exceptions, Section 1205 provides a taxpayer with a legal right to stop a summoned third party from giving information to the Internal Revenue Service from the summoned party's own records in the course of an IRS inquiry into suspected non-compliance with the revenue laws, a right to compel the government to institute a court action in order to obtain that information from the third party, a right to be a party to that action, and a right to appeal the court's decision if he does not like the outcome.

I support the Committee's purpose in protecting taxpayer privacy and limiting the opportunity for abuse in the use of the administrative summons. However, I believe the instances of actual abuse are rare, and the provisions adopted by the Committee will have the unintended result of seriously jeopardizing the ability of the IRS to administer the revenue laws in cases of noncompliance. Also, I am alarmed over the implications of the Committee's amendment on other enforcement efforts by the Treasury and the Department of Justice.

It is possible, in my view, to protect the individual taxpayer while not undermining the government's ability to enforce the laws against serious offenders. It is essential this matter again be considered and a modification made in the Committee's amendment.

I have instructed my staff to brief the staff of the Joint Committee on Internal Revenue Taxation on my concerns and to provide them our recommended change to this section of the bill. We are not suggesting any alterations in the protection afforded an individual under present law and current judicial decisions.

I believe you will agree a change is required.

Sincerely yours,

WILLIAM E. SIMON.

Mr. CRAMPTON. The effect of the proposed provision of section 1205 is to overrule a Supreme Court opinion in 1971 in the *Donaldson* case where it said that if you give a taxpayer standing, it would stultify the Internal Revenue Service's every investigatory move.

At the outset, I think it may be worthwhile to point out that as a practical matter, the proposed provision would have little or no effect upon the millions of taxpayers who keep reasonable records and produce them to substantiate their returns and which are relied upon by the Internal Revenue Service to do so.

This provision benefits those taxpayers who keep no records or deal in cash or falsify their records. If this were the law many years ago, it is very unlikely there would have been convictions in the cases against Al Capone and Frank Costello.

In such situations where there are no records or they are not correct, the Internal Revenue Service either uses the net worth or the bank deposits method to determine the correct tax liability of a particular taxpayer.

These theories of proof require a consideration of third party records. Section 1205 as presently drafted requires notice to a taxpayer when this is done, and as the Attorney General's letter states this presents no problem to us.

We are concerned, however, with giving the taxpayer standing and the right to intervene as this would apply to the so-called white collar crime cases.

In effect, this gives the taxpayers three additional defenses. First, it causes the Government to go to court as the moving party and in that situation, I am sure counsel for the taxpayers would argue that they can assume some ground for defense or why would Congress confer jurisdiction.

Second, there is a delay necessary in going to court to enforce a summons. If you do it in a series of instances, you have a domino effect that would be very important. In other words, we get certain information from a brokerage house that leads us to a bank that in turn might lead us to an insurance company or some other party.

If we had a delay to enforce every summons, I think the statute would run particularly in cases where the assets might be held in the name of a nominee or where the taxpayer does not intervene himself but simply provides counsel for the third party.

The third point I would like to make is that the result of this is that we would be faced with motions to suppress evidence because somewhere along the line there was some problem with the enforcement proceeding.

Lastly, as the letter from the administrative office of the U.S. courts points out, section 1205 would probably impose a very substantial burden on the district courts because they estimate it would increase the annual filings in the Federal district court by about 38,000 cases.

We do urge that the committee take a serious look at this. Thank you.

The CHAIRMAN. Thank you very much.

Senator DOLE. I think they had a visit with the staff this morning and the members of the subcommittee. I will be busy with the staff to see if we can comment on part of the request. I am not certain we can comment on all of it.

Mr. CRAMPTON. Yes; we have had several meetings. We hope something can be done.

Mr. ALBRECHT. I believe from Treasury's standpoint, it is expressed to the chairman, we would endorse the statement by Mr. Crampton and add that we recognize that the committee has concern for privacy and for the individual's interest in knowing when the Government is pursuing third party records that involve him or that we file information concerning his financial affairs.

However, we think the bill as drafted would have the unintended effect of converting the administrative summons into a summons which in many or if not most instances would require traditional enforcement proceedings and we think it was unintended and not necessary to deal with the basic privacy concern.

The CHAIRMAN. Any further questions?

Mr. IMLAY. I am Carl Imlay, general counsel for the administrative office of the U.S. court. The director, Roland Kurtz, has on July 20, submitted a detailed statement to the chairman showing the possible impact that this provision would lead into intervention and administrative summons procedures, and it would have on the caseload of the courts.

The courts are faced with an ever proliferating case load that has not been helped by any new judgeships although 4 years ago the need for judgeships was submitted to the Congress.

To date we have not had any new district judges appointed since 1970. We attached to the letter a statistic showing the ever mounting

caseloads in our district courts and also we have statistics showing the possibility that to this mounting caseload could be added a potential caseload of 38,400 administrative summons.

We are hopeful that the committee will take into account this letter of July 20 and we could offer as part of the record in this proceeding this letter. Thank you.

The CHAIRMAN. I would like to ask Mr. Larry Woodworth to take the chair. I would like to have him explain something for the record that he understands better than anyone.

STATEMENT OF LARRY WOODWORTH

The CHAIRMAN. Mr. Woodworth, you have heard the discussions in this room today and on previous occasions about the problems inadvertently created with regard to the 65-percent limitation involving the depletion allowance.

Would you explain to us how that came to be in the law and what has been done to modify that provision at this time?

Mr. WOODWORTH. I would be glad to do so. The joint committee staff was asked to prepare an amendment for Senator Cranston in 1975. That amendment contained a provision which provided that the deduction for percentage depletion may not reduce taxable income by more than 50 percent. Subsequently, in conference, this was increased to 65 percent.

There was included in the Cranston amendment the concept that if a taxpayer has retail outlets he would not be eligible for percentage depletion.

The CHAIRMAN. What was the purpose of that limitation, if you had retail outlets you would not be able to——

Mr. WOODWORTH. It was intended as a way of being sure that integrated companies, or the majors, were in no event to be eligible for any allowance for percentage depletion. That was my understanding of the purpose of it.

Staff members prepared this amendment for Senator Cranston. It contained no special provisions relating to trusts.

At first drafts often do, it probably needed subsequent refinement which we were not able to get at that time in part because of the fact that it was a floor amendment and not reviewed by the committee as is usually the case. As the Senator will recall——

The CHAIRMAN. That had to be drafted on short notice, did it not?

Mr. WOODWORTH. Yes; it did.

The CHAIRMAN. The reason was that the Senator wanted to offer it on the floor?

Mr. WOODWORTH. I believe it had to be available within a day or two of the time I was asked to prepare the draft. Also there was not any opportunity for the usual staff review of this particular provision.

In any event, it contained a number of problems which we have heard about since that time. In the ordinary course of events these would have been the kinds of problems which would have been brought out in hearings by those testifying before the Finance Committee.

There was no opportunity for that type of consideration of technical problems. In any event, almost as soon as the legislation was passed,

we began to hear about the problems with deminimis types of retail outlets.

I have heard about the problems of that type almost from the day the bill became law. As a result we knew that this was a problem area and we recognized that the tax committees probably would want us to try to work it out. In other words it did not appear to us to be within the intent of the Congress to cover cases of this type in this amendment.

The problem with respect to trusts, I did not hear about until quite recently. That was called to the attention of our staff by a member of a law firm here in town, Mr. J. D. Williams' law firm, who met with my staff. I was not at that particular meeting.

This problem was outlined and the staff went over the problem, thought that there was merit in the proposal and presented it to me. From my analysis it appeared to me that this treatment was in fact what was basically intended in the original legislation.

The 65-percent rule in the case of trusts has an unfortunate result in that in applying the limitation only the income which remains after the distributions to the beneficiaries is taken into account.

The effect of this is reduce the percentage depletion to almost nothing in those cases where most or all of the income is distributed to beneficiaries currently. The question with respect to the beneficiaries is whether there was an intent in the original legislation to prevent the advantages of percentage depletion from being passed through to the beneficiaries I do not believe there was any such intent.

The Dole amendment also contained a modification to the transfer rule under which no change of beneficiaries of a trust is to be considered a transfer if the change occurs because of the death, birth, or adoption of a beneficiary if the transferee was a beneficiary under the trust prior to the triggering event or is a lineal descendant of the grantor or any other beneficiary.

As a result of the conference my staff had with a member of Mr. J. D. Williams' firm and the subsequent staff study, I was prepared to analyze this problem when it came up before the Finance Committee. When it was presented before the committee by Senator Dole, I explained the provision and said that I thought it was a desirable technical provision. I did not at any time discuss it with you, Senator Long, prior to it coming up in the committee session.

The CHAIRMAN. When Mr. Dole brought up that matter, you explained it in this committee room, and I was here. You explained at that time that it, insofar as trusts were concerned, had to do with the adoption of someone or death.

I do not recall anything being said about that technical and complicated matter which I did not understand. It has to do with the fact that when a trust receives income which it distributes to the beneficiaries, it somehow winds up losing its depletion allowance, although the law never intended that.

I do not recall that being explained. It took me a long time to understand how anyone would be contending that any of my family could be affected by that. They are all young people and in robust health and I am not planning to adopt any children so I did not see how anything of that sort could possibly involve anyone in whom I am very much interested.

The same would be true with regard to my brother, sister, nieces, and nephews. Did you fail to mention the 65-percent limit and the technical problems involved with it which would cause a trust to lose its depletion allowance in connection with the intricacies of that provision?

Mr. WOODWORTH. I cannot remember how much of the provision I explained to the committee. As you will recall there were a number of provisions coming up fairly rapidly at that time.

I do not have any recollection as to exactly what I explained on this provision. I thought that I explained that feature. However, it may be that I unintentionally overlooked it. Certainly I should have explained it. If I did not do so, I erred in that respect.

The CHAIRMAN. The provision that this part of the Dole amendment is seeking to correct, if I understand your statement, was an inadvertent error. It was something that never would have been done in the first place if someone's attention had been directed to it. Isn't this the type of thing you ordinarily regard as a technical amendment to correct an unintentional error?

Mr. WOODWORTH. Yes, sir.

The CHAIRMAN. We have the statements here of Mr. Daniel Davis speaking for the American Banker's Association and I notice he was vice president of the First National Bank in Dallas. I assume they have a problem with this provision in Dallas, Tex., where those banks handle the affairs of people involved in the oil and gas industry.

We also have a statement here from a Mr. Carl W. Sebits of the Independent Oil and Gas Operators speaking for people who are similarly affected, representing 4,000 independent operators.

If you will permit me to say it, I had no knowledge whatsoever of this problem.

In fact I had no knowledge of the amendment before it was offered. I think Senator Dole can testify that I never discussed the matter with him, nor did I discuss it with anyone else, at any point prior to the time he offered that amendment.

Senator DOLE. Absolutely not. I just want to add to the list that it, of course, did have the approval of the Treasury Department which I think is important. This was a technical amendment.

Also the Tax Division of the Institute of Certified Public Accountants supported it. It was not limited to one State or one trust or one anything else. It had broad application and was a technical amendment.

I remember a brief discussion with Larry concerning it. I do not know how he handled the 65 percent provision in the committee but in any event, I think the chairman stated it accurately.

The CHAIRMAN. I just want to make it clear that as far as I am concerned, this is one of those many unintentional errors that creep into the law. That is one of the reasons why we are here, to correct things of that sort.

As far as I am concerned, I would not want to benefit from the provision, even if it corrects an unintentional error. I would like to ask you to see if you can prepare an amendment that in the event that this technical error, which does an injustice to taxpayers by discriminating against certain people, should become law that the injustice would

continue as far as anybody related to me is concerned.

Thank you very much.

[Whereupon, the hearing adjourned at 12:36 p.m.]

Appendix

Communications Received for the Record

STATEMENT OF U.S. SENATORS PETE V. DOMENICI AND JOSEPH M. MONTOYA

SECTION 1323 OF H.R. 10612

We appreciate the opportunity to express our views and those of the Governor of New Mexico, the Honorable Jerry Apodaca, on Section 1323 of H.R. 10612. In a word, Mr. Chairman, we are opposed to that section and we have today introduced an amendment to eliminate that section from the bill.

It is obvious that Section 1323 is a warmed-over version of S. 1957, a bill introduced by our distinguished colleague from Arizona, Senator Fannin, and on which a hearing was held by the Finance Committee's Subcommittee on Energy on March 8, 1976. That hearing was called at the request of Senator Fannin and chaired for the most part by Senator Fannin.

Both S. 1957 and Section 1323 of H.R. 10612 have as their primary purpose the intrusion of Federal power to invalidate a tax law of the State of New Mexico relating to electricity generated entirely within the State of New Mexico. S. 1957 attempts to achieve that intrusion by finding that "the generaion of electricity and its transmission from one state to another are integral parts of interstate commerce and the imposition of a state tax on the privilege of generating electricity in a state is an unreasonable burden on commerce among the states, to the extent that the electricity generated in the state is transmitted and consumed in another state." Title II of S. 1957 would then have prohibited state taxation of the kind characterized in Title I as "an unreasonable burden" on interstate commerce.

Section 1323 of H.R. 10612 is more streamlined and has dropped the findings section of S. 1957, including any reference to "unreasonable burden on commerce among the states." This section simply prohibits a tax which is "discriminatory" against consumers of electricity outside the state of generation. For purposes of this Section, a tax is declared to be discriminatory if it "either directly or indirectly results in the payment of a higher gross or net tax on electricity which is generated and transmitted in interstate commerce than on electricity which is generated and transmitted in intrastate commerce."

The report language makes it clear that the Committee has a preconceived notion about discriminatory taxation because under the report's paragraph entitled "Reasons for Change" the Committee tells us right up front that it "has learned that one state places a *discriminatory* tax upon the production of electricity within its boundaries for consumption outside its boundaries" (emphasis added). This statement omits the fact that similar tax structures exist in several states, including at least one state tax which operates much like New Mexico's. There is absolutely no explanation of how the Committee determined that the cited tax is discriminatory in the sense that Federal government action must be justified in order to prohibit "discrimination" by states. All that is said or implied, before the Committee offers makes its own declaration of what is discriminatory, is that the taxation structure utilized may produce different treatment for different entities affected by it. We all know that difference of treatment or effect is not alone enough to constitute discrimination ordinarily subject to remedial government action.

So, the Committee has conveniently closed the loop on its circuitous reasoning. First, it says in its report that the tax it has "learned of" is discriminatory because it effects different people differently. Then, it declares that such taxes will be prohibited by law, retroactive to June 30, 1975, since they are discriminatory, as defined by a phrase related solely to difference of effect. It is simply a poor job of legislative drafting to allow this reasoning to pull itself up by its own bootstraps.

My chief objection, however, relates not to quality of legislative workmanship, but to the manner in which this section would totally ignore judicial precedent and pending judicial action. This section conveniently wipes out established judicial precedent dealing with the question of jurisdiction to tax in circumstances similar to those at issue here. It also overlooks the fact that litigation is underway to determine whether the taxing structure the portion of the report relating to this provision declares to be discriminatory is in excess of state jurisdiction under established legal principles and under the Constitution. The U.S. Supreme Court has just recently dismissed an original suit filed by Arizona against New Mexico on the grounds that previously initiated litigation would answer all questions of constitutionality with ultimate appeal to the Supreme Court available to Arizona if it lost in the lower courts. As of this date, action in a lower court is proceeding, action which is good enough to satisfy the Supreme

Court. It appears to us that such action ought to be good enough to satisfy the Congress. That action would probably be rendered moot if this provision should be enacted into law, but this provision would be subject to serious Constitutional challenge, and, in our opinion, be held invalid.

Why do you suppose the proponents of this section are unwilling to have that judicial action run its normal course? Obviously, it is because there is more than a strong possibility that the courts will hold that the New Mexico electricity generating tax is not an unreasonable burden on interstate commerce, the only basis on which the Committee could justify its decription of this tax as "an example of discriminatory state taxation which is properly within the ability of Congress to prohbit."

This is no place, Mr. Chairman, for an extended legal argument about the powers of the Congress under the interstate commerce clause. It should be obvious, however, that any exercise of Federal government action intended to regulate interstate commerce must meet Constitutional tests. Likewise, Federal law restricting the exercise of otherwise permissible State action on the basis of discrimination, must also meet the Constitutional tests for discrimination, not just some definition inserted without notice and without hearings, hidden among dozens of other such special interest provisions on page 841 of a 1536-page bill. The proper test for discrimination is whether the State action exceeds its jurisdiction or intrudes unduly on the strictly limited powers specifically granted by the Constitution to the Federal government.

We feel, Mr. Chairman, that this is a shameful way to legislate, bordering on being deceitful, and we urge the Committee to agree to eliminate this provision and let the pending litigation proceed through the courts in orderly fashion, where everyone's rights under the Constitution and applicable laws will be fully and equally protected.

In closing, Mr. Chairman, please consider these final points on the issue of discriminatory treatment. It is clear that any State has the power to tax electricity manufactured within its borders regardless of where that electricity is sold or consumed. It is clear that the State of manufacture can devise a taxing structure which prevents double taxation on a product produced and consumed within its borders. It is equally clear that if a State other than the State of manufacture wanted to ensure that its citizens did not pay a higher total tax on that product sold within its orders, or ensure that the product was not taxed twice, its remedy is easy—that State can do as New Mexico has done. The most obvious step Arizona could take would be to allow a credit for the New Mexico manufacturing tax against the Arizona sales tax. The same New Mexico law that is in dispute here provides a credit for *any electricity-generating tax regardless of where that generating tax is applied*. Another avenue open to the State of Arizona is to lower its own sales taxes so that the aggregate of its sales (gross receipts) tax and the manufacturing tax does not exceed the aggregate tax paid by consumers in New Mexico. We have no idea what the sales tax is in Arizona and it may be that the aggregate tax is now lower than the 4% gross receipts tax in New Mexico, but that is beside the point here.

The point here is that Arizona and those representing that State in the Congress ought to allow their claim of "discrimination in interstate commerce" to be adjudicated in the ongoing court action. If Arizona loses there, then it has at least two means by which to ensure that its citizens do not pay a greater aggregate tax than citizens of New Mexico. That is the course Arizona ought in good conscience to follow—not come here and have its special interest tax provision inserted in what is advertised to be a "tax reform bill." If this, Mr. Chairman, is reform, we are all in trouble.

STATEMENT OF SENATOR THOMAS J. MCINTYRE

Mr. Chairman and members of the Committee, I previously submitted a very brief introductory statement along with the testimony of Sheldon Butt, President of the Solar Energy Industries Association (in lieu of giving an oral presentation today.)

This statement, which I will also keep brief, is an additional rationale for supporting the solar energy tax credit as originally reported by the Committee in H.R. 10612.

In deciding on whether the tax income of the United States Treasury should be reduced through a solar energy tax credit to residential and business buildings, there are two important questions to address:

First, do the American people at this point in time have enough faith in solar energy to justify a temporary, 5-year tax credit to stimulate the installation of solar heating, cooling and hot water equipment?

To answer that question, I can draw upon personal experience with my own constituents. Last April 10, I held a solar energy conference and equipment exposition in Manchester, New Hampshire. Two thousand people came to that symposium, thus answering the question for me. The people want solar energy. They believe it is becoming a valuable contribution to this Nation's energy supply—first in heating and cooling, and eventually in more sophisticated applications.

The second question is whether a solar energy tax credit is a worthwhile investment. Will it, in time, bring a return large enough to justify the initial loss of revenue to the Treasury?

We can't say how big the initial loss of revenue will be, because we do not know how many people will take advantage of the tax credit. The Solar Energy Industries Association, in its studies, has made estimates, which appear in Mr. Butt's testimony.

But the question still can be answered in a number of ways.

First, in its issue of last March, National Geographic noted that "at our current pace, we will consume in the next twenty-five years alone an amount equal to all the energy used by man in recorded history. If such consumption continues, obviously alternative sources must be found."

Second, Mr. Butt made a very interesting and important point in his testimony—that among those who make substantial investments in domestic energy production, only the residential energy producer, the person who installs solar energy at home, doesn't qualify for any kind of tax incentive. To the contrary, in most states, solar energy can be a tax liability because it is an "improvement", and thus subjects a home to higher property taxation.

We are often told that it is in the best economic interest of our country to depend on domestic rather than foreign sources of energy. Well, I submit that there is no source of energy more domestic than that which the homeowner installs atop his own house.

Solar energy technology is at a crossroads. Studies such as that conducted at the Thayer School of Engineering at Dartmouth University show that solar energy, without tax credits, when amortized over a twenty-year period, is already less expensive than electricity for heating and cooling a New Hampshire home, and not much more expensive than oil.

With a very few technological breakthroughs and mass marketing, solar energy can become substantially less expensive to install. Charles Burkhardt, Executive Vice President of the New England Fuel Institute, makes an interesting comparison on this point. During the late 1920's and early 1930's, when the technology of fuel oil burners was in its infancy, it cost a homeowner up to $3,000 (in the dollars of those days) to convert from a coal furnace to an oil burner. At the time, oil was far cheaper than coal, but only the rich could afford the luxury of converting. Today—because of mass production and advances in the technology—a conversion from a coal furnace to oil has dropped in cost to a mere $300.

Both the New England Fuel Institute and the New England Electric System have begun subsidizing the installation of solar water heaters in the homes of some of their customers, as demonstration projects. In other words, two private industries are putting the government to shame by stimulating advanced technology with dollars that they could otherwise retain as profits.

Finally, there is another, and more basic, economic argument in favor of the solar energy tax credit.

Unlike most sources of energy, solar energy is highly labor-intensive. That is, it produces a lot of jobs for the number of dollars spent. So part of the revenue that would be lost to the U.S. Treasury through solar energy tax credits would be gained back through income taxes paid by the engineers, architects and skilled workers who design and install solar energy equipment.

Furthermore, this growing solar energy market can be a valuable addition to this Nation's exports of technology and services to other countries. Thus we can recapture some of those energy dollars that we are now forced to send to the OPEC cartel.

I know for example, that Paul Cronin, a former Congressman and now the president of a solar energy company, Sunsav, is developing a market abroad. And it is well known that at least two of the oil-rich OPEC nations, Saudi Arabia and Iran are beginning to supply energy to rural villages, not with oil, but, interestingly enough, with solar energy.

In closing, I thank you for the opportunity to give this statement, and if you wish, I can provide additional backup information.

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STATEMENT OF SENATOR JOHN A. DURKIN

Mr. Chairman, I would like to make a brief statement in opposition to the tax credit for recycling, both as it appears in Section 2006 of the tax reform bill pending before the Senate and in the latest version in printed amendment No. 2016.

I am opposed for a very simple reason. What I understand to be the objectives of this legislation will not be accomplished through this tax credit. I agree with those objectives—to conserve natural resources and energy and to reduce pollution. I would support any legislation that has a reasonable and economical chance of accomplishing these goals. However, I have yet to see anything on this tax credit that persuades me that it is anything other than a bonanza for the scrap collectors and dealers. And while looking at the support for this tax credit, I have come across opposition to it from some unusual quarters.

Before getting to that, let me briefly discuss what I understand the legislation to be and what it would accomplish. A tax credit would be given to those users of recycled materials. The credit would be a percentage of depletion allowance or cost of the materials or a certain per unit amount. This is intended to increase the demand for these recycled materials with the beneficial results of conserving natural resources by using more wastes and conserving energy because recycling uses less energy than processing natural resources. The key to the whole proposal is the increase in recycling. Only if recycling is increased will the savings of resources and energy take place. If there is no increase in recycling, then it is very hard for me to see any justification for this tax credit.

The last argument of the proponents is that it will establish equity between the firms in the recycling industry and those in the virgin materials industries. Supposedly, the firms using virgin materials have an economic edge in that they receive either depletion allowances or capital gains treatment. The measure of this advantage is what will happen to the amount of wastes recycled when all of a sudden through this tax credit they become cheaper. If there is a meaningfully competitive advantage given to the virgin materials, then this tax credit ought to reduce it and to shift consumption away from virgin materials to recycled materials. Again, the measure of the stated objective of this provision, to establish equity, is what happened to the demand for recycled wastes.

Opponents argue that the tax advantages accorded to virgin materials are not significant in the overall cost of these materials and that the elimination of these advantages would not depress demand for virgin materials but only shift consumption from domestic to foreign sources.

What will happen to the demand for recycled wastes? How much more copper-based scrap will find its way into the recycling stream? How much waste paper, glass, aluminum and other wastes eligible for the tax credit will be recycled? Proponents have not furnished information that estimates or predicts the impact the credit has on the demand for recycling except to say that it would increase. But they don't say how much. However, one thing that must be kept in mind is the loss of revenue to the Treasury. That is a figure susceptible to rather accurate estimation. And for the bill now pending with the Senate, the Treasury estimates that the loss in revenues by 1981 will be $345 million annually. And under the new amendment, No. 2016, the cost is four times the figure of $345 million or $1.38 billion. Those numbers give me pause and I can hear the voters of New Hampshire saying to me—What do we get for spending that kind of money?—an undeniably reasonable and fair question.

I have one constituent who has asked himself that question and has answered it. He runs a recycling plant for copper-based scrap and would benefit from the tax credit. His product would be cheaper and more competitive with virgin-produced materials. What is his answer? "Don't, please don't pass this tax credit." Why? He says that all the copper-based scrap that is collectable is being collected and recycled—radiators from cars, copper tubing and wiring from torn down houses and buildings. He says that the amount of copper-based scrap in post-consumer wastes is very small and exceedingly hard to segregate out of the rest of the solid wastes. The tax credit would not increase the supply of copper-based scrap nor encourage the most economic use of this scrap. But that it would cause increases in the prices of scrap and dislocations in the market. Not to mention a tax loss of some $101 million over four years under the pending proposal and $277 million under the new amendment. His opinions are echoed, not surprisingly, by the Association of Brass and Bronze Ingot Institutes.

The copper-based scrap recyclers are not by themselves. The aluminum recyclers don't want the tax credit either.

Although a number of industry associations have not taken positions on the tax credit, companies within the industry have made known their opposition to my staff. For example, a large recycler of paper wastes expressed opposition to the committee's tax credit.

Opposition also comes from another unexpected quarter—the environmentalists. Their interest in two of the objectives of the bill would lead you to expect them to support this legislation. But they don't. Again for a very simple reason—this huge tax break won't produce a significant increase in recycling of solid wastes. So there won't be conservation of natural resources or energy, and it won't reduce pollution. Their evidence is based on two general conclusions that the supply and the demand for recycled wastes is, in the words of economists, inelastic. Lowering the price for the recycled materials will not increase the amount demanded, and making the price offered for recyclable wastes higher won't increase supplies. Given these two conclusions the tax credit will not affect the amount of wastes that will be recycled. The environmentalists present studies to support their conclusion. I find them persuasive, especially in the absence of any evidence to the contrary.

For me, the coup de grace to this tax "reform" proposal comes from the Treasury Department. They have set out their arguments against this provision. They conclude that virgin material subsidies do not discourage recycling that the small increment in recycling will be extremely costly and that the opportunities for cheating and getting tax credits under this provision will require more administration and regulation. In other words, more government at a time when the voters are asking us in Congress to justify what already exists—to see if we're getting what we want and our money's worth.

According to the estimates of revenue loss, by fiscal 1981, the newest tax credit proposal will cost every man, woman and child in this country $5 each. I find that I, as well as the proponents of this tax credit, can't tell those people in New Hampshire what they're getting for their $5.

Congress is taking measured and practical steps to deal with the problems of solid waste disposal, with environmental pollution, with conservation of natural resources. Only a few weeks ago we passed the Solid Waste Disposal Act. The cities do need help with waste disposal. We are addressing this problem and discharging our responsibility.

But I for one will not be answerable for this tax credit for recycling that does nothing more than spend huge amounts of money with no reasonable expectation of getting anything for it.

U.S. SENATE,
COMMITTEE ON LABOR AND PUBLIC WELFARE,
Washington, D.C., July 21, 1976.

Hon. RUSSELL B. LONG,
U.S. Senate,
Washington, D.C.

DEAR RUSSELL: I would like to direct your attention and the attention of the Finance Committee, to Amendment No. 1907 which I have sponsored as an amendment to H.R. 10612, the Tax Reform bill. I would appreciate it if this letter and the enclosed memorandum were made a part of the record of the hearings presently being held by the Finance Committee to review the Tax Reform bill.

The background of Amendment No. 1907 is as follows. Rank and file members of the National Association of Women's and Children's Apparel Salesmen Guild (NAWCAS), a labor organization, and beginning to withdraw their contributions from the union's pension fund, which is affiliated with and administered by the Distributive Workers of America (District 65) of New York City. The pension fund is financed entirely out of contributions made by the union's members: no employer contributes a dime. The reason they are withdrawing their contributions is in order to transfer them to I.R.A.s where they can get the annual $1,500 tax deduction. Because there is no I.R.A. tax deduction for union pension funds of this type, these withdrawals are bound to continue until the NAWCAS plan is no longer viable. When this happens, many of the older members and retirees, who were granted past service credit by the plan, will lose

their pensions because there will no longer be the flow of contributions necessary to maintain the promised benefits. To compound this misfortune, in the event the plan is compelled to terminate, it will not be covered by the insurance provided under ERISA by the Pension Benefit Guaranty Corporation because union plans of the NAWCAS type are excluded from coverage.

Amendment No. 1907 provides a set of technical amendments that would facilitate the continued viability of the NAWCAS type union pension plan. The amendment would allow union members participating in contributory pension plans similar to the NAWCAS plan to participate as well in a tax deductible I.R.A. plan established by the union. My staff has conferred with the staff of the Joint Committee on Internal Revenue Taxation on this matter, and it is my understanding that with some more perfecting changes, the amendment is acceptable.

Enclosed is a memorandum outlining this situation in greater detail. As co-author of the Employee Retirement Income Security Act of 1974 which brought pension reform to 35 million Americans I consider this another aspect of the continuing need to insure that pension promises made are pension promises kept. I would hope this amendment receives your favorable consideration.

With best wishes,

Sincerely,

JACOB K. JAVITS.

Enclosure.

MEMORANDUM

JULY 20, 1976.

Re amendment 1907: Treatment of employee association individual retirement accounts.

Rank and file members of the National Association of Women's and Children's Apparel Salesmen Guild (NAWCAS), a labor organization, are beginning to withdraw their contributions from the union's pension fund, which is affiliated with administered by the Distributive Workers of America (District 65) of New York City. The pension fund is financed entirely out of contributions made by the union's members; no employer contributes a dime. The reason they are withdrawing their contributions is in order to transfer them to I.R.A.s where they can get the annual $1,500 tax deduction. Because there is no I.R.A. tax deduction for union pension funds of this type, these withdrawals are bound to continue until the NAWCAS plan is no longer viable. When this happens, many of the older members and retirees, who were granted past service credit by the plan, will lose their pensions because ther will no longer be the flow of contributions necessary to maintain the promised benefits. To compound this misfortune, in the event the plan is compelled to terminate, it will be covered by the insurance provided under ERISA by the Pension Benefit Guaranty Corporation because union plans of the NAWCAS type are excluded from coverage.

There are over 2,000 enrolled members of the District 65–NAWCAS plan scattered throughout various parts of the United States, including New York, New Jersey, Louisiana, Florida, Texas, California, Arizona and Illinois. The modest pensions of older members (many of whom prior to the inception of the plan were compelled to work in their 70s because they could not afford to retire) could be in jeopardy if tne financial underpinning of the plan was impaired owing to membership withdrawals.

Significantly, when the individual retirement account provisions were enacted as part of ERISA in 1974, a specific section was adopted permitting labor unions to establish pooled I.R.A. plans for their members. I refer to section 408(c) of the Internal Revenue Code. Unfortunately, section 408(c) does not provide for cases where the union already covers its members with a pension plan financed exclusively from their contributions.

These union-funded retirement programs are very similar to the old fraternal benefit programs that existed in this country before the turn of the century. They resemble very closely the union I.R.A. plans permitted under section 408(c): Only union members contribute (i.e., there are no employer contributions as in the Taft-Hartley Funds) and the members have a non-forfeitable right to their contributions.

However, there is one significant difference. In order to provide recognition of the needs of older members or those who become disabled or die, the union retirement plans to which I refer, provide pension, disability or death benefits based on length of service or similar criteria. In effect, these programs are a form of social insurance with an actuarial element which each member finances through his contribution. Because of the social insurance aspect, these programs cannot now qualify under section 408(c) of the Internal Revenue Code as a union-established I.R.A. plan.

I do not believe it was the intent of Congress to disrupt established and otherwise viable union retirement programs through enactment of the I.R.A. tax provisions. In fact, I was given assurances at the Senate-House conference on ERISA in 1974 that the I.R.S. would find a way to permit these established union retirement programs to qualify in part as I.R.A. plans. I would like to quote from my remarks when the Senate enacted ERISA:

"It is my understanding that where a union currently sponsors a plan for its members financed exclusively from assessments levied on the membership, that all or part of the contributions made by the members through such assessments may qualify as an individual retirement account deducton if, subject to regulations of the Secretary of Treasury or his delegate, the plan is modified so as to permit a determination as to what amounts paid by the member could be treated as properly allocable to an individual retirement savings component of the plan." Sec. 130 Cong. Rec. S15750, August 22, 1974, 93rd Cong. 2nd Session, Vol. 120.

Regrettably, this understanding has not matured into an I.R.S. approved procedure for qualifying union-financed retirement programs as I.R.A. plans. Experts in I.R.S. believe that the technical wording in the Internal Revenue Code precludes establishing the type of procedure needed. I do not necessarily agree but the question is certainly not free from doubt and it would be resolved by legislative revisions of certain language in the Code.

THEORY OF AMENDMENT 1907

In order to qualify union pension plans like the District 65-NAWCAS trust for I.R.A. tax treatment, it is proposed that relevant provisions of IRC be amended technically to permit a portion of the assets of the I.R.A. funds established by unions to be used to fund non-I.R.A. benefits of a union's retirement program. The amendment would make clear that the allocation of I.R.A. assets to fund non-I.R.A. benefits would not cause the I.R.A. fund to lose favored tax treatment and that subject to certain restrictions, the union could combine I.R.A. funds with non-I.R.A. funds for purposes of investment and paying pensions to their members.

These technical amendments would enable the District 65-NAWCAS trust to continue the present plan as an I.R.A. plan, using a limited portion of plan assets to fund separately, subject to tax, the past service, disability and death benefits provided by the Union's retirement program. Members of the plan would get an I.R.A. tax deduction for their contributions, and the plan would be salvaged.

The following provisions of the Internal Revenue Code are the significant obstacles to permitting union retirement funds to qualify as I.R.A. funds:

1. Section 219(b)(2)(A)(i) of the Code which can be interpreted to prohibit an employee who is a member of a union retirement trust from participating in an I.R.A. plan.
2. Section 408(e) of the Code which can be interpreted to mean that using a portion of an I.R.A. to fund union retirement benefits is a prohibited transaction resulting in a taxable distribution of the I.R.A.
3. Section 408(f) of the Code which can be construed as requiring the imposition of the penalty tax for premature distributions of I.R.A.s if I.R.A.s are used in part to fund other union retirement benefits.
4. Section 408(e)(6) of the Code which permits I.R.A. funds to be co-mingled with employer pension funds but not with union pension funds.
5. Sections 408(a)(6) and 408(d)(1) which could be interpreted as precluding the distribution of I.R.A.s in the form of union pension benefits even if all other relevant I.R.A. requirements pertaining to distribution are met.

Amendments 1907 attached hereto would solve these problems.

IMPACT

It is estimated that less than one-half of one percent (i.e., less than .5 percent) of all the pension plans in the nation are plans which are financed exclusively by contributions from union members.* These plans come into existence only when a union does not have the economic strength to bargain for an employer-financed pension program.

To assure that it is not necessary to encourage the further expansion of union-financed plans in order to save plans like the District 65–NAWCAS trust, the Amendment is limited to union plans established prior to January 1, 1974. In any event, the budgetary impact of the amendment is negligible because if these plans were to be terminated the members would establish tax deductible I.R.A. plans anyway in lieu of being permitted to maintain their present plans.

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*As of April 1975, out of 453,000 pension plans registering with the U.S. Department of Labor, 1,801 were union pension plans to which only members of the union contribute.

Calendar No. 891

94TH CONGRESS
2D SESSION

H. R. 10612

IN THE SENATE OF THE UNITED STATES

JUNE 21 (legislative day, JUNE 18), 1976
Ordered to lie on the table and to be printed

AMENDMENT

Intended to be proposed by Mr. JAVITS to H.R. 10612, an Act to reform the tax laws of the United States, viz: on page 926 after line 11 add the following new section:

1 SEC. 1511. TREATMENT OF CERTAIN EMPLOYEE ASSOCIA-
2 TION INDIVIDUAL RETIREMENT ACCOUNTS,
3 ETC.
4 (a) Section 219(b)(2)(A)(i) of the Internal Reve-
5 nue Code of 1954 is amended to read as follows: "a plan
6 described in section 401(a) which includes a trust exempt
7 from tax under section 501(a), unless it is a group retire-
8 ment trust maintained by an employee association which is
9 financed exclusively by contributions of employees who are
10 members of such employee association and which was estab-
11 lished prior to January 1, 1974."

Amdt. No. 1907

1 (b) Section 408 (e) of the Internal Revenue Code of
2 1954 is amended by adding a new section as follows:
3 "(7) FUNDING OF OTHER RETIREMENT BENEFITS
4 BY ACCOUNTS ESTABLISHED BY ASSOCIATIONS OF EM-
5 PLOYEES.—If the assets of an individual retirement ac-
6 count established under a trust maintained by an associa-
7 tion of employees are used to fund certain past service
8 and disability retirement benefits and incidental death
9 benefits provided by a group retirement trust maintained
10 by the same association of employees as described in
11 section 219 (b) (2) (A) (i), then the assets so used, or
12 any portion thereof, shall be treated as distributed to the
13 individual for whose benefit the individual retirement
14 account was established, except that paragraphs (1)
15 and (2) of this subsection, and subsection (f) shall not
16 apply."
17 (c) Section 408 (e) (6) of the Internal Revenue Code
18 of 1954 is amended as follows:
19 "(6) COMMINGLING INDIVIDUAL RETIREMENT AC-
20 COUNT AMOUNTS IN CERTAIN COMMON TRUST FUNDS
21 AND COMMON INVESTMENT FUNDS.—Any common trust
22 fund or common investment fund of individual retire-
23 ment account assets which is exempt from taxation under
24 this subtitle does not cease to be exempt on account of the
25 participation or inclusion of assets of a trust exempt from

1 taxation under section 501 (a) which is described in
2 section 401 (a) or of a group retirement trust exempt
3 under section 501 (a) which is created or organized by
4 an association of employees as described in section 219
5 (b) (2) (A) (i)."
6 (d) Section 408 (a) of the Internal Revenue Code of
7 1954 is amended by adding a new paragraph as follows:
8 "(8) Nothing contained in this subtitle or any regu-
9 lations which have been or will be prescribed by the
10 Secretary or his delegate, shall preclude the distribution
11 of an individual's interest in an individual retirement
12 account in the form of pension, disability or death bene-
13 fits provided by a group retirement trust exempt under
14 section 501 (a) which was created or organized by an
15 association of employees and described in section 219
16 (b) (2) (A) (i), provided that the requirements of
17 paragraphs (4), (5), (6), and (7) are met."
18 (e) Section 408 (d) of the Internal Revenue Code of
19 1954 is amended by adding a new paragraph as follows:
20 "(7) DISTRIBUTION FROM INDIVIDUAL RETIRE-
21 MENT ACCOUNTS IN THE FORM OF CERTAIN BENEFITS
22 PROVIDED BY GROUP RETIREMENT TRUSTS OF EM-
23 PLOYEE ASSOCIATIONS.—To the extent that assets of an
24 individual retirement account established under a trust
25 maintained by an association of employees are distributed

1 in the form referred to in section 408 (a) (8), the bene-
2 fits so distributed shall be treated in accordance with
3 paragraph (1) until the amount of benefits paid equals
4 the amount of assets [attributable to the distribution of
5 such] in the individual retirement account."
6 (f) The first sentence of section 4974 (a) of the Internal
7 Revenue Code of 1954 is amended by striking the words
8 "or (7)," after "section 408 (a) (6)" and insert the fol-
9 lowing: "(7) or (8).", Section 4974 (b) of the Internal
10 Revenue Code of 1954 is amended in the same manner.
11 (g) Section 4975 (e) (3) of the Internal Revenue
12 Code of 1954 is amended by striking the words "section
13 408 (e) (4)" and inserting: "section 408 (e) (4) or section
14 408 (e) (7)."
15 (h) The amendments made by this section shall apply
16 to taxable years beginning January 1, 1976 and individual
17 retirement accounts established under a trust by an associa-
18 tion of employees at any time during calendar year 1976
19 shall be deemed to have been in effect since January 1, 1976.

Statement Submitted by Senator Richard (Dick) Stone

Proposed Amendment to HR 10612 to Extend for Five Years the Carry-Over Period for Cuban Expropriation Losses

Mr. Chairman, when the Senate considers Title III of the Tax Reform Act I intend to offer an amendment that would extend for an additional five years the carry-over period for Cuban expropriation losses sustained when individual business property was nationalized by the Castro government.

An original ten-year carry-over period was extended five years in 1971 by Public Law 91-677. At the time of this extension there was no indication that this five-year period had any special significance or that it should be the final extension. The Senate Finance Committee said in its 1971 Report:

It has come to the attention of the Committee that because of the magnitude of the losses sustained as a result of the Cuban expropriations, some taxpayers—particularly small businesses not generating large annual incomes—have been unable to offset their expropriation losses against their income in the ten year carryover period. Because of this, the committee believes that it is appropriate to extend the carryover period further in the case of Cuban expropriation losses.

The Internal Revenue Service estimates that there are a few hundred claims with losses remaining to be carried forward. These Cuban expropriation losses had to be claimed prior to December 31, 1965. They have been investigated and accepted by the Internal Revenue Service as actual losses. No new claims for losses would be allowed under the amendment which I am proposing.

The reason for the original extension was to permit the use of the losses sustained. It alleviated but it did not correct the inequity for people who sustained losses but who could not offset them because they were generating small annual incomes. Since there are still some people who have not had that chance, it is appropriate that an additional extension be provided.

This amendment would apply to a decreasing number of persons, and their losses were not among the largest of the Cuban expropriations. The amendment would therefore have only a slight impact on the tax structure. But it is surely unfair to permit large corporations with enormous incomes to use their entire losses while depriving those persons for whom the expropriations have been the most tragic and severe, the small businessman and private citizens, the same opportunity.

Mr. Chairman, I urge the Finance Committee to give its favorable consideration to this amendment which aids those individuals least able to reestablish themselves after suffering Cuban expropriation losses.

[H.R. 10612, 94th Cong. 2d Sess.]

Amendment

Intended to be proposed by Mr. Stone to S. ——, a bill H.R. 10612, an Act to reform the tax laws of the United States, viz: At the appropriate place, insert the following new section:

SEC. ——. EXTENSION OF CARRY-OVER PERIOD FOR CUBAN EXPROPRIATION LOSSES.

Subparagraph (D) of section 172(b)(1) (relating to years to which loss may be carried) is amended by striking out "15" and inserting in lieu thereof "20".

Excerpts of Remarks of Senator John L. McClellan

Mr. Chairman, I am pleased for this opportunity to bring to this Committee's attention a matter of importance to my State.

During the consideration of the Tax Reduction Act of 1975, the Congress provided for the termination of percentage depletion for natural gas. However, the Congress also provided an exemption from this termination in the case of small producers. Unfortunately for certain constituents of my State, the language of § 613A, (b)(2)(B) and 613A (d)(2), was imprecise in covering all those eligible small producers of natural gas under the exemption with the effect being to deny depletion to certain gas producers who otherwise would have been eligible. The result is an inequity in the exemption as it pertains to gas produced by utility companies in amounts small enough to qualify for the exemption and whose wellhead prices for such company produced gas are regulated by State Agencies, such as in Arkansas.

I am attaching to these remarks a statement for the record by Mr. Charles E. Scharbau of Arkansas Western Gas Co. which explains in detail the specifics of the unique situation in which his utility company finds itself.

I have previously brought this matter to the attention of the Chairman of the Finance Committee by letter on May 26, 1976. I have attached a copy of that letter, along with the response of the Chief of Staff of the Joint Committee on Revenue Taxation, Mr. Laurence Woodworth, which indicates that a change in the Code to accommodate Arkansas' unique situation would produce a minimal revenue impact.

STATEMENT OF CHARLES E. SCHARLAU BEFORE THE SENATE FINANCE COMMITTEE ON H.R. 10612

My name is Charles E. Scharlau. I am from Fayetteville, Arkansas, and hold the position of president of Arkansas Western Gas Company, which is a small, completely integrated natural gas public utility serving approximately 60,000 customers in 11 counties in Northwest Arkansas. The Company distributes gas at retail through local distribution systems and has its own transmission system. It source of gas comes from the eastern edge of the Arkoma Basin, which lies generally along the Arkansas River east of Fort Smith, Arkansas, principally in the counties of Franklin, Johnson and Crawford. The Company has its own transmission system from these producing areas to its distribution systems. Of its gas supply, it owns and produces approximately 55 percent of its requirements and purchases the balance from other producers at the wellhead in the same field or fields its Company-owned gas is produced from. The Company also has some small production in Oklahoma, which only amounts to 9.4 percent of its total revenues.

The Tax Reduction Act of 1975 eliminated the benefits of the percentage depletion allowance for Arkansas Western Gas Company. Section 501 of that Act removed the depletion allowance but allowed it to remain in effect for (A) regulated natural gas, (B) natural gas sold under a fixed contract, and (C) also saved a portion of the depletion allowance for certain independent producers and royalty owners.

Arkansas Western did not receive the benefit of the depletion allowance allowed for regulated natural gas because regulated natural gas was defined as gas produced and sold subject to the jurisdiction of the Federal Power Commission. Arkansas Western is wholly an intrastate company and, therefore, was not subject to Federal Power Commission jurisdiction. The amount it is allowed for its Company-produced gas is regulated by the Arkansas Public Service Commission through the State's fair field price law, which in essence requires the Arkansas Public Service Commission to allow as an operating expense in the rate making process the fair market value of the Company-produced gas. At present, the Company has been allowed a price for its Company-produced gas of 65 cents per Mcf. Percentage depletion was allowed to remain in effect for natural gas sold under a fixed contract, which the Act defines to mean domestic natural gas sold by the producer under a contract in effect on February 1, 1975. Since the gas owned by Arkansas Western Gas Company was used directly by it in its own system, it was not subject to a fixed contract. If the Company had held title to the gas reserves in a subsidiary and then had a contract between itself and the subsidiary, an arrangement used by many other companies, this would have saved the depletion allowance for the Company. As it turned out, there was no contract because such an arrangement was not used and the Company owned the gas it used itself.

The exemption for independent producers provided that percentage depletion could be used for those producing less than a certain defined amount of natural gas, which amount declines year by year, as does the applicable percentage that will be allowed. Arkansas Western would have been entitled to this provision for depletion except for the provision excluding retailers. The Tax Reduction Act of 1975 states that the independent producer exemption shall not apply in the case of any taxpayer who directly or through a related person sells oil or natural gas or any product derived from oil or natural gas through any retail outlet operated by the taxpayer or related person. Although our impression was that this retail exclusion was intended to cover the situation of the oil or gas producer who had service station outlets, because of the broad language, it apparently covers Arkansas Western Gas Company because it does sell gas at retail through its utility distribution system.

Arkansas Western Gas Company has been unfairly affected by the provisions of this law because of the unique situation in which it finds itself. Most every

other gas utility company provides their supply through purchases. Those who have their own Company-produced gas generally do not have a supply from those sources of more than 10 percent to 15 percent of the total requirements, compared to approximately 55 percent for Arkansas Western Gas Company. Most every other company with which we are acquainted uses a subsidiary to hold title to the gas and then has a contract between the subsidiary and the parent. Arkansas Western has never known the need or requirement for such an arrangement and, therefore, did not utilize it and was foreclosed from retaining the depletion allowance because of this. The combination of the unique situation of Arkansas Western and the wording of the Act effectively denied to it the percentage depletion allowed other companies exploring for natural gas and furnishing it to the public consumption. It deprives it of the depletion allowance allowed small producers, with which it ranks. These factors make us believe that inadvertently an injustice has been done to this Company. It is in the public utility business and has successfully for many years supplied Northwest Arkansas with natural gas by virtue of its own exploration efforts. We believe this situation warrants the continued benefits allowed others of the percentage depletion.

If the Committee agrees with this, we believe the Act could be amended to exclude from the definition of a retail outlet a natural gas public utility system. This would then allow Arkansas Western to have the same percentage depletion as do other independent producers.

The effect of such an amendment we believe would be minimal on the treasury. In the case of Arkansas Western Gas Company, it would have amounted to $215,000 in 1975. This is indeed a small amount, but it would have allowed us the funds necessary to drill one or two more wells in our search for additional gas supplies. It would have been an immense help to Arkansas Western and we believe to the people of Northwest Arkansas and would provide no revenue loss of consequence to the government.

U.S. SENATE,
Washington, D.C., May 26, 1976.

HON. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: I am informed by the Federal Power Commission that the consumer impact of an increase in income tax liability to natural gas companies, be they distributors, pipelines or gas producing companies, is almost twice the increase in tax liability. To illustrate, the FPC in establishing ceiling rates for flowing gas (Opinion No. 749 issued December 31, 1975) included an increment for income tax by applying a factor of 92.3% (48/52) to taxable income in lieu of the statutory rate of 48%. In essence the FPC's calculation adjusts the rate level to provide compensation for the 48% tax liability as well as the full allowance of a 15% rate of return which they found reasonable. I am informed that much the same result is obtained in most state-regulated utility rate proceedings. I believe that the consumer impact of tax increases may have been inadequaely weighed by the Congress it its deliberation, and that impact is exacerbated by inequities such as described below.

That inequity pertains to gas produced by utility companies whose wellhead sales are regulated by State Agencies, such as in Arkansas (which determines a "fair field price" for production of regulated gas companies), and not by the Federal Power Commission. The change in the Internal Revenue Code terminating percentage depletion includes an exemption for natural gas comapnies with wellhead prices regulated by the FPC, but does not give this exemption to companies regulated by State Agencies. I respectfully request that your staff estimate the tax revenue which the U.S. Treasury obtains from state-regulated gas producing utilities, particularly in Arkansas, as the result of this difference in treatment related specifically to the Tax Reduction Act of 1975, Sec. 613A, (b) (2) (B) and 613A (d) (2). It is my understanding of the 1975 Act that percentage depletion is available to FPC-regulated gas producers until such time that the FPC allows a tax liability. In FPC Opinion No. 749, a tax increment was allowed to be effective on July 1, 1976. I presume that state-regulated gas producing utilities did not obtain the same benefits prior to July 1, 1976. As I have requested above, how much additional tax revenue has the U.S. Treasury obtained by this unequal treatment of gas producing utilities in Arkansas as well as other States?

With best regards, I am
Sincerely yours,

JOHN L. MCCLELLAN.

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON INTERNAL TAXATION,
Washington, D.C., July 7, 1976.

HON. JOHN L. MCCLELLAN,
U.S. Senate,
Washington, D.C.

DEAR SENATOR MCCLELLAN: This refers to your letter of May 26, 1976, addressed to Chairman Long, in which you ask for an estimate of the additional tax revenue collected by the Treasury from State-regulated gas producing utilities because the percentage depletion on intrastate gas was repealed by the Tax Reduction Act of 1975. In the letter you also note that if the natural gas price had been controlled by the Federal Power Commission rather than by a State agency, the companies could have continued to claim percentage depletion through June 30, 1976.

In response to your request, we have asked officials in the major gas producing States whether the intra-state natural gas price at the well-head is regulated by a government agency in their State, and whether they know of any other State where such regulation takes place. From their answers, it appears that Arkansas is the only State where intra-state natural gas price at the well-head is regulated by a State agency.

We estimate that the Federal income tax liabilities of the Arkansas State regulated gas producing utilities would have been about $500,000 less had percentage depletion on their intrastate natural gas production not been repealed for the period January 1, 1975, through June 30, 1976.

Sincerely,

LAURENCE N. WOODWORTH.

STATEMENT OF CARL W. SEBITS, INDEPENDENT OIL AND GAS OPERATOR

SUMMARY OF PRINCIPAL POINTS

1. Pertains to "Retailer Exclusion" provision.
2. Pertains to Exception to Transfer Rule for Beneficiaries of Trust.

My name is Carl W. Sebits and my office is in Wichita, Kansas. I am a managing partner of Pickrell Drilling Company and I appear today in that capacity and as Chairman of the Tax Committee of the Independent Petroleum Association of America. I am also a member of the Executive Committee of that association.

RETAILER EXCLUSION

Pickrell Drilling Company is an exploration and oil and gas producing company with nearly all of its operations in the state of Kansas. Our company operates two rotary drilling rigs continuously, in a search for oil and gas, and also operates approximately 3000 barrels daily oil production. The company operates about 20 million cubic feet of gas per day.

For many years a small group of investors has participated with us in our exploration program as a part of their diversified business investment programs. They and we are quite naturally concerned about tax measures which would make exploration investment less attractive and this statement bears more specifically upon the "retailer exclusion" provision in the new tax proposals which would deny percentage depletion to a taxpayer who is classified as a "retailer" of oil or gas or products derived from oil or gas.

One of our investor-participants in our exploration program is a large grease manufacturer, and although nearly all of his sales are at the wholesale level, some small part of his sales would classify as retail sales of grease and related lubricant products.

Still another of our investor-participants is an owner-operator of retail stores handling western wear clothing and related items. Many of the items which he stocks and retails are manufactured from petroleum chemical derivatives, such as polyester suits and dress materials, and other retail items which have as their base material some kind of petroleum derived source. In fact it would be quite difficult for most retailers of general merchandise to avoid handling and selling products which did not in some way have their origin in petroleum derivatives, since petroleum chemicals have become so predominantly used in almost the entire gamut of consumer products manufacturing.

Still another of our investor-participants owns and either operates or leases out to lessees on a participation basis several retail gasoline filling stations, as

a part of his diversified business investment program. Whereas this man's operations could not in any way be compared to a major integrated oil company, the narrowness of definition of the "retailer excluded" provision would indoubtedly prevent this investor from the deduction of percentage depletion.

Each of the previously described investors has informed our company that in the event that a too-narrow interpretation of a "retailer" lessens the feasibility of investing in oil and gas exploration, since we all recognize it as a high-risk venture, then it is quite possible that they will withdraw from our program and in turn we will be forced to decrease the scope of our exploration effort. In time this could result in a complete shut-down of this program.

A provision exempting a taxpayer whose annual gross receipts from the retail sale of oil or gas or products derived therefrom would not exceed $5 million for the taxable year would surely be most helpful. It would eliminate a too-narrow definition of the "retailer excluded" provision and assure the above described investors that they could continue to spend their dollars in a search for more oil and gas production within the United States. We and our investor-participants are indeed hopeful that such an amendment will be given favorable consideration.

EXCEPTION TO TRANSFER RULE FOR BENEFICIARIES OF TRUSTS

The Committee on Finance of the United States Senate has added an additional exception to the transfer rule contained in paragraph (9) of Section 613A(c) of the Internal Revenue Code. This additional exception expands the exception provided by present law for transfers of oil and gas property at death. The new provision extends the exception to changes of beneficiaries of a trust if the change occurs by reason of the death, birth, or adoption of any beneficiary provided the transferee was a beneficiary of the trust prior to the event or is a lineal descendant of the grantor or any other beneficiary.

Such transfers by reason of death, birth or adoption obviously are not the type of transfers which the statute sought to prevent to avoid a proliferation of proven oil and gas reserves which when produced are eligible for percentage depletion. This exception is considered necessary to clarify the normal transfer of beneficial interests in trusts (as opposed to the sale of oil and gas property) to intended beneficiaries and to insure that the right to percentage depletion of property) to intended beneficiaries and to insure that the right to percentage depletion of property in the trust will continue to be enjoyed by the beneficiaries thereof.

WEBSTER & CHAMBERLAIN,
Washington, D.C., July 15, 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: This written statement is submitted on behalf of the Shriner's Hospitals for Crippled Children, 323 North Michigan Ave., Chicago, Illinois 60601 in connection with Section 1204 of the Tax Reform Act of 1976. Section 1204 of the Act represents an enlarged version of H.R. 9889, a bill to extend the time allowed estates to amend the governing instruments of certain charitable remainder trusts.

A. INTRODUCTION

On September 29, 1975, Mr. Burke, of Massachusetts, introduced H.R. 9889 to extend the date for reforming the governing instruments of certain unqualified charitable remainder trusts. Under existing law (IRC § 2055(e)(3)), a governing instrument of an unqualified charitable remainder trust could be amended to conform to the requirements of §§ 664 and 2055(e)(2) to permit the allowance of the charitable estate tax deduction and the exemption from federal income tax of the reconstituted trust. On December 10, 1975, the undersigned, together with Mr. Paul Ibach, assistant general counsel of Shriner's Hospitals for Crippled Children, testified before the Committee on Ways and Means on H.R. 9889. A copy for our written statement is appended to this statement for purposes of enlarging the Finance Committee's record on this matter.

On or about June 16, 1976, the Committee on Ways and Means reported H.R. 9889 and the bill report (H. Rep. 94–1268) was presented to the House, H.R. 9889 passed the House on June 22, 1976. See, Congressional Record June 22, 1976 at H. 6370 and H. 6371. H.R. 9889 is presently pending before the Finance Committee.

B. COMMENT ON SECTION 1204 OF THE ACT

Section 1204 of Tax Reform Act of 1976 (H.R. 10612), reported to the Senate on June 10, 1976 also contains an extension of the existing transitional rule to amend unqualified charitable remainder trusts. However, Section 1204 of the Tax Reform Action of 1976 is to be preferred over H.R. 9889 for two reasons. First, it permits otherwise expired claims to be re-opened by affected estates, or in the event the estate is closed, by the trustee of the succeeding charitable remainder trust or by the charity, if the intervening life estate has expired. Second, Section 1204 is better because it permits wills and trusts drafted after September 21, 1974 (a statutory cut-off date now contained in IRC Section 2055(e)(3)) to benefit.

A claim for refund or credit of the overpayment of estate tax might have existed if an executor or trustee had amended the instrument and filed a timely claim for refund. These otherwise expired claims will be treated as timely claims if the claim is filed by the appropriate party in interest not later than June 30, 1978, having first amended the trust. We think that this is an excellent provision because, in essence, it means additional funds will be available to charitable institutions should the trustees amend the instrument on a timely basis. The provision, Section 1204(b), is not mentioned in the committee report. See, S. Rep. 94–938 at p. 599–601. It would be helpful if, should a supplementary committee report be issued, that it be made clear that the Congress believes that the appropriate claimant of the refund is the residuary beneficiary, such as the uniqualified charitable remainder trust which, if amended, is entitled to the refund if the trust is amended or, if it is unnecessary to amend the trust because the income beneficiary's interest terminated prior to the due date for the filing of the estate tax, the charitable institution itself. While the Inernal Revenue Service has a general position on this matter (Rev. Rul. 72–428), it might be easier to deal with if the Committee report made some statement about who the proper claimant for refund is should the U.S. Department of Justice have a different opinion about the problem.

Section 1204 contains another improvement on H.R. 9889. Under existing law, a will or trust, as an object of amendment, had to be in existence on September 21, 1974, a wholly arbitrary date selected by House-Senate conferees. Under the Committee's provision the "effective date" for the will or trust has been extended to December 31, 1977. This means, for example, an unqualified trust drafted today, which upon the grantor's death, creates a nondeductable charitable remainder transfer can be amended by the executor or trustee to conform to the requirements of current law.

C. CONCLUSION

It is noted that the Committee's report provides that this particular extension is the last extension which will be granted by the Congress as to reforming unqualified charitable remainder trusts. We do not disagree with the philosophy behind such a statement because 8 years after the effective date of Section 664, will and trust draftsman ought to know the law. We believe, however, the underlying statute which required this extraordinary and extensive transitional rule is wrong and itself should be repealed. Section 664 has unnecessarily complicated the law of charitable giving, and had unnecessarily deprived charitable organizations of this form of philanthropy by confusing donors, counsel and benefited institutions themselves. Had more thought been given to the drafting and implementation of Section 664, we are sure that Congress, in its wisdom, would never have enacted such a provision (with the attendant complexity of the Internal Revenue Regulations). While we do not object to the IRC Chapter 42 excise taxes imposed upon such trusts, we believe that the rigid governing instrument rules create artificial barriers to the possible enjoyment of the income tax, estate or gift tax benefits which the tax laws are designed to provide.

Although Shriner's Hospitals for Crippled Children has been very instrumental in pushing for the enactment of section 2055(e)(3) and its extension, and agreed to abide with the Congress's decision not to further amend Section 2055(e)(3), we will not hesitate or limit our efforts to have Section 664 repealed or substantially simplified.

Very truly yours,

WILLIAM J. LEHRFELD.

Enclosure.

TESTIMONY OF SHRINERS HOSPITALS FOR CRIPPLED CHILDREN

A. INTRODUCTION

The Tax Reform Act of 1969 radically changed the forms for deferred gifts to charitable institutions. After 1969, for a bequest of a remainder in property (other than a farm or residence) to be deductible, the transfer must be in the form of a charitable remainder unitrust, charitable remainder annuity trust or a pooled income fund. See generally, Secs. 2055(e)(2), 664 and 642(c)(5) of the Internal Revenue Code. These complex provisions reversed over 50 years history by requiring these unusual types of trusts to be used in place of the prior, simpler format. Congress was apparently convinced that unless gifts of remainder interests in property were in the new, more complex format, such gifts would be open to possible manipulation or abuse by donors. Today, the failure of the decedent's will to expressly provide for the proper form for a charitable remainder bequest (see exhibit A) means the estate tax charitable deduction is not allowable and the charitable remainder trust itself is not exempt from federal income tax. Of deep concern to the charitable beneficiary is the fact that the disallowance of the estate tax charitable deduction reduces the value of property eventually passing to it since the charity's remainder interest normally bears the tax.

This is unlike the income or gift tax charitable deduction, where the donor, rather than the donee, directly benefits from the tax savings inherent in the allowance of the charitable deduction.

Because of the complexity of the new statute, and the delay encountered in promulgating definitve and explanatory regulations, the Treasury Department, on its own initiative, for 1970 through 1972, permitted wills and trusts with unqualified bequests to be revised, assuming local law permitted, so that if the reformed instrument was in the proper format, a deduction was allowable as if the bequest was properly drafted in the first place. Recognizng that many charities were adversely affected by the 1969 changes, Congress eventually supplemented the administrative relief and enacted Sec. 2055(e)(3) as part of Public Law 93-483. Under Sec. 2055(e)(3) unqualified transfers and dispositions may be reformed (thereby obtaining the charitable deduction) if done no later than December 31, 1975. However, the will or trust had to be in existence on September 21, 1974. There was no corresponding relief granted under the federal gift tax laws. This means in the case of an inter vivos transfer if a remainder is not in the proper format the federal gift tax would have to be paid on the value of the remainder passing to charity. See, I.R.C. § 2522(c)(2).

B. THE NEED

Shriners Hospitals for Crippled Children has come to the conclusion that the amount of time permitted to reform the unqualified wills and trusts is not sufficient to meet what it perceives to be a continuing need for a more extensive transitional rule. We see, almost on a daily basis, improperly drafted testamentary gifts coming to our attention necessitating the use of the relief provision. We estimate that, based on current experience, upwards of 100 wills or trusts will be brought to our attention in 1976 and 1977 which will contain unqualified remainder bequests. We estimate that our loss, measured in terms of increased estate taxes for these estates, will be upwards of $1 million.[1] Our loss will probably be considerably higher, unless the statute is extended, because these trusts will become subject to income tax on its capital gains (set aside for charity) rather than tax-exempt as would be the case if such trust could be reformed.

Although Public Law 93-483 was signed to President Ford on October 26, 1974, there have been no published rulings, revenue procedures or proposed regulations issued by the Internal Revenue Service or the Treasury Department implementing Sec. 2055(e)(3). This has caused considerable difficulty in handling reformation actions because all questions have had to have been handled on an *ad hoc* basis at the lowest levels of the Internal Revenue Service. A lack of clear and definitive guidelines explaining and implementing Public Law 93-483 has unduly hampered reformation actions and caused undue delay in having the benefits of this relief provision extended to those estates and charities which supposedly were to benefit. These problems will continue unless an extension is granted giving parties time to assure that once regulations are promulgated, reformation taken before their publication are in fact satisfactory.

[1] Stated in more human terms, upwards of 200 young people could receive our free orthopedic care for the amount of tax revenue unnecessarily passing to the Government.

Example: In one Eastern district, the head of the Estate and Gift Tax Group steadfastly refused to abide with a favorable technical advice memorandum, issued by the IRS National Office, because in his view, there was no "definitive regulations" supporting the legitimacy of reformation actions taken in his state. Several thousand dollars in additional legal fees were incurred by an Ohio college before the matter was finally resolved last summer.

Example: In one Western district, the Estate and Gift Group has propounded a theory that reformations under the relief provision are the same as a "disclaimer for consideration" causing loss of the charitable deduction. To our knowledge, this controversy continues and until a definitive regulation or ruling is published, certain reformation cases in that jurisdiction are apparently being suspended. Thus executors are unsure whether to proceed with judicial reformation proceedings because all they are sure of is an increased amount of legal fees and related expenses attributable to the court action.

Example: The Treasury Department regulations permitting reformation actions expired December 31, 1972. Prior to enactment of Sec. 2055(e)(3), executors of estates with unqualified gifts sought to "qualify" the transfers through partial disclaimers where the income beneficiary disclaimed an interest in the gifted property in excess of, for example, a unitrust amount. Whether these "disclaimers" can properly be reformed is now pending in another western district awaiting action by the IRS National Office.

Example: Section 2055(e)(3) deems certan trusts to be automatcally reformed if the income beneficiary dies prior to the due date for filing the estate tax return. Shriners Hospitals for Crippled Children is a beneficiary in two cases where the District office is holding up payment of the refund until it is clear to it that no reformation of any kind for any purpose is needed. When Congress permitted self-executing reformations it apparently did not figure that IRS employees would be so uncertain in their implementaion to require technical assistance from the National Office.

These and numerous questions and problems remain. Until charities are provided with clear and explict rules governing reformed trusts estate tax charitable deductions for these trusts may be still subject to attack. Unless the statute is extended to allow time for thoughtful and deliberate consideration of the major matters to be dealt with by regulations, a substantial part of the benefits Congress sought to bestow on charities may be lost.

C. THE RATIONALE

The Congress probably thought it was doing charitable organizations a favor when it enacted Sec. 664 in 1969. The statute would preserve and protect the corpus of the trust from overreaching by donors, trustees, etc. This particular provision was also aimed at assuring that the corpus of the charitable remainder trust, at its terminaiton, was reasonably close to the value of the charitable deduction granted to the testator, as discounted for the present value of the noncharitable income interest.

"[Today] the trust assets may be invested in a manner so as to maximize the income interest with the result there is little relation between the interest assumptions used in calculating present values and the amount received by the charity. For example, the trust corpus can be invested in high income, high risk assets. This enhances the value of the income interest but decreases the value of the charity's remainder interest.

"Your committee does not believe that a taxpayer should be allowed to obtain a charitable contribution deduction for a gift of a remainder interest in trust to a charity which is subsatntially in excess of the amount the charity may ultimately receive." H. Rep. 91-413 (Part 1), 91st Cong., Sess., at p. 58.

To assure that the value of the charitable deduction, which decreases Government revenues, was approximately the correlative of the present value of the property which would in fact reach the charitable beneficiary, Congress imposed the requirement that there be a minimum 5 percent payout to an income beneficiary through either a unitrust or an annuity trust. Using a stated or minimum required payout rate to the noncharitable beneficiary means the Government can better calculate what it actually "loses" through the charitable deduction. In theory, Sec. 664 makes a certain amount of sense. However, we believe that the draftsmen, acting on inadequate data or merely in hypothesis of potential abuses, drafted a statute, when applied to the estate tax laws, which had an extraordinarily adverse impact upon deferred givng. The regulations issued by the Internal Revenue Service in 1972 are so complex and so filled with mandatory governing instrument rules for each of the proper trust instruments, that we, and

many of our donors, are convinced that Congress should repeal or rewrite Sec. 664 and its deduction counterparts to reverse the downward trend in deferred giving for institutions. If the Congress had applied a scapel instead of a sledge hammer to correct any known or even hypothetical abuses, the charities would not be faced with a statute of almost Byzantine complexity. We simply do not understand why it is necessary for every donor who wishes to leave a remainder interest in trust for the benefit of a chariatble institution must seek out highly sophisticated tax counsel to draft a gift instrument to protect the charity from the donor. There should be a way of writing tax laws affecting charitable institutions which do not turn into, because of bureaucratic overreach in the regulation process, insuperable burdens.

Let us exemplify our opinion. Exhibit A to this testimony is a charitable remainder unitrust, income alternative, which we believe would give the donor an estate tax charitable deduction for the present value of the remainder held in trust. We cannot, of course, be entirely sure because it has been the practice of the Internal Revenue Service over the years not to issue rulings on ambulatory wills. In other words, even if a lawyer or donor thinks he has properly drafted a testamentary unitrust provision, he cannot get the assurance of a private letter ruling from the Internal Revenue Service until after the death of the testator. At that time, the trust instrument has to stand or fall, and the beneficiaries cannot, respectively, except pursuant to Sec. 2055(e)(3), alter the terms of the trust.[2] We have seen adverse rulings issued by the National Office on testamentary charitable remainder trusts and annuity trusts even though the wills or revisions were drafted pursuant to regulations and revenue rulings which purport to tell expectant donors and their lawyers what the ground rules are under Sec. 664. However, because the National Office has, since 1970, been taking an extremely narrow rulings position on all aspects of Sec 664 trusts, the rush toward reformation continues.

Our charitable organization would like to see Sec. 664 repealed or at least substantially altered so that the great potential for loss of charitable deduction is not present in philanthropic estate planning as it is today. We intend to make our case during Phase II of the tax reform. According to best estimates, we believe Phase II will not be completed until 1977 or 1978. Until Phase II gives us the opportunity to marshal our facts, to gather our arguments and put together a reasonable and concise presentation against the continuation of Sec. 664, we believe it only fair and reasonable that the reformation right, granted under Sec. 2055(e)(3), be continued. If the Congress, in its wisdom during Phase II tax reform decides to continue Sec. 664, we will, of course argue that there should be some continuing, open ended testamentary reformation rights, under appropriate guidelines, so that charitable institutions are not adversely affected by drafting errors in testamentary charitable remainder trusts.

Some may argue that there has been enough time allowed thus far to educate estate planners and lawyers and their clients on the proper, deductible form for a charitable remainder trust. Seven years (i.e., to December 31, 1977) may appear to be just too long a time to let the mistakes of estate planners and draftsmen be corrected. If these persons make a mistake, perhaps they should be surcharged for their error rather than asking Congress to continue this transitional rule. Such an argument we believe has little merit since it fails to appreciate the true complexity of the statute and the overkill inherent in the current administration of the law by the Internal Revenue Service. Also, it fails to recognize to whom the primary benefits of reformation flow. By not allowing reformation, it fails to recognize substantially all of the cost of the disallowed deduction and the nonexempt trust is borne by the charitable beneficiary, not to the private income beneficiary. The principal of the unqualified charitable remainder trust has to bear the estate tax out of its corpus (which later goes to charity). Next, the penalty of nonreformation substantially decreases the income tax to be paid by the private beneficiary since the four tier distribution scheme of Sec. 664(b) is inapplicable. On the other hand, the inability to reform increases the tax burden of the nonexempt trust since it gets no "set aside" deduction for net capital gains added to its corpus and destined for charitable uses.

There is one other important reason which argues for continuing the reformation right: By inducing unqualified trusts to reform, such trusts come under the foundation excise tax rules (I.R.C. Chapter 42) thereby protecting the charitable corpus from encroachment by disqualified persons, trustees and the like. If an

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[2] We would exclude, of course, complete or partial disclaimers over the offending portions of the trust or the future possibility of some administrative relief such as that provided for by Rev. Proc. 74-6, C.B. 1974-1, 417 for charitable remainder trusts created prior to 1969.

unqualified charitable remainder trust remains unreformed, then none of these foundation rules apply to the corpus and the charitable beneficiaries have no federal protection with respect to self dealing, etc.

There is always a question from a budgeting standpoint how much a relief provision like this costs. In our view, the revenue gain/loss factor is relatively balanced over the long run because the four tiered system for taxing the income of the income beneficiary of a Sec. 664 trust results in more tax being paid by them than if the trust remained under the old rules of Subchapter J. That increases taxes paid to the Government. The Government loses revenues in the allowance of the charitable deduction and through the exemption of the trust from income tax. While there is a revenue impact, it is not inherently predictable because the cash flows in both directions.[3]

D. CLOSING

We urge the Committee's support of H.R. 9889. Shriners Hospitals for Crippled Children is not the only charitable institution to have benefited by the reformation right. We know of numerous charitable institutions that have succeeded in saving money by seeking reformation of unqualified trusts including:

1. Salvation Army
2. Goodwill Industries
3. Episcopal Archdioceses of Washington, D.C.
4. Eisenhower Medical Center
5. Father Flanigan's Boys Town
6. University of Cincinnati
7. American Heart Association
8. American Cancer Society

Two years is not too much to ask in light of all the factors noted above.

EXHIBIT A.—Bequest of Residue of Estate to Charitable Remainder Unitrust, Income Alternative

I give, devise and bequeath the rest residue and remainder of my estate to my Trustees, to hold in trust as follows:

1. My Trustees shall pay to my wife in each taxable year of the trust during her life, a unitrust amount equal to the lesser of (a) the trust income for such taxable year (as defined in Internal Revenue Code Section 643(b) and the regulations thereunder) or (b) six percent of the net fair market value of the trust assets determined annually, decreased as elsewhere provided in the case where the taxable year is a short taxable year or is the taxable year in which my wife dies. If the trust income for any taxable year exceeds the amount determined under (b), the payment to my wife shall also include such excess income to the extent that the aggregate of the amounts paid to my wife in prior years is less than six percent of the aggregate net fair market value of the trust assets for such years. Payments to my wife shall be made in quarterly installments. Any income of the trust in excess of such payments shall be added to principal.

2. The obligation to pay the unitrust amount shall commence with the date of my death, but payment of the unitrust amount may be deferred from the date of my death to the end of the taxable year of the trust in which occurs the complete funding of the trust. Within a reasonable time after the occurrence of said event, my Trustees shall pay the amount determined under the method described in Section 1.664-1(a)(5)(ii) of the Federal Income Tax Regulations less the sum of any amounts previosuly distributed and interest thereon computed at 6 percent a year, compounded annually, from the date of distribution to the occurrence of said event.

3. In determining the unitrust amount, the trustees shall prorate the same on a daily basis, for a short taxable year and the taxable year of the death of my wife.

4. The taxable year of this trust shall be the calendar year.

5. No property other than that given, devised or bequeathed under this Article may be contributed to the trust herein established.

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[3] We note in passing another revenue producing factor favoring reformation: No interest is allowed on refunds prior to the expiration of 6 months after the refund claim has been filed.

6. The trust assets shall be valued on the last business day of the first month of the taxable year. Except as provided above, if no vaulation date occurs before the end of any taxable year of the trust, the trust assets shall be valued on the earlier of the last day of the taxable year of the trust or the date on which the noncharitable interest terminates.

7. If the net fair market value of the trust assets is incorrectly determined for any taxable year, then within a reasonable period after the final determination of the correct value, my Trustees shall pay to my wife in the case of an undervaluation or shall receive from my wife in the case of an overvaluation an amount equal to the difference between the unitrust amount properly payable and the unitrust amount actually paid.

8. For the purpose of this trust, the term "income" has the same meaning as it does under Internal Revenue Code Section 643(b) and regulations thereunder. Therefore the term "income" shall mean net income after payment of any expenses of administering the trust. Such expenses shall include reasonable investment, management, custodial, fiduciary, and like fees, provided, however, no fees or expenses shall reduce the unitrust amount required to be paid under paragraph (b) hereof. The following shall be treated as principal and not as "income":

(*a*) Gains and losses from the sale, exchange, redemption, or other disposition of investments;

(*b*) Stock dividends, stock splits, or similar distributions;

(*c*) Capital gain dividends of regulated investment companies (mutual funds); and

(*d*) Liquidating distributions.

9. Upon the death o fmy wife, my Trustees shall distribute all of the then principal and accumulated income, if any, of the trust, other than any unitrust amount due my wife, to Shriners Hospitals for Crippled Children, Chicago, Illinois, for its general charitable uses and purposes.

10. In the event the Shriners Hospitals for Cripple Children is not an organization described in Sections 170(c)(2) and 2055(a) of the Internal Revenue Code of 1954, at the time when any principal or income of the trust is to be distributed to it, my Trustees shall distribute such principal and/or income to or for the use of a charitable organization or organizations which are so described for hospital purposes.

11. It is my intention to create a charitable remainder unitrust within the meaning of Internal Revenue Code Section 664 and the regulations thereunder. All the provisions hereof shall be interpreted in a manner consistent with the regulations and rulings promulgated by the Internal Revenue Service with respect thereto. Otherwise, this trust shall be governed by the laws of the District of Columbia.

12. Except for the payment of the unitrust amount to my wife, my Trustees are prohibited from engaging in any taxable act of self-dealing described in Internal Revenue Code Section 4941(d) and from making any expenditures described in Section 4945(d) taxable under Section 4945(a).

13. Except as provided in this paragraph, this trust may be amended, altered, or modified at any time or from time to time, in writing, by my Trustees. In the event that an amendment affects the rights or obligations of my wife, the income beneficiary hereunder, such amendment shall not become effective until the first day of the calendar month following sixty days after a copy of such amendment shall have been mailed to her, certified, return receipt requested. If my wife shall file a written notice in person or by certified mail, return receipt requested, objecting to such amendment, and if such notice is received by my Trustees at least five days prior to the effective date of the amendment, such amendment shall be void. Notwithstanding the foregoing, my Trustees are authorized, in the case of any taxable year of the trust in which it is not exempt from federal income tax under Internal Revenue Code Section 664(c), to amend the trust to distribute income of the Trust, in excess of the unitrust amount described in paragraph 1, including the nondeductible portion of any net capital gain, to the remainder beneficiary named herein.

Notwithstanding any other provision of this paragraph, no amendment is authorized which amends this paragraph or which affects the irrevocable charitable remainder interest granted in all property held in the trust, or which otherwise affects the qualification of the trust as a charitable remainder unitrust within the meaning of Internal Revenue Code Section 664. In the case of any such unauthorized amendment, it shall be void and of no effect whatever.

14. My Trustees are authorized to continue investments of the trust in the assets which are the subject of this bequest or may sell said assets and reinvest the trust assets in any manner consistent with law, provided that my trustees shall not conduct any unrelated business activity and shall neither receive nor invest in any property which shall cause the trust to have any unrelated business taxable income within the meaning of Internal Revenue Code Section 512. Nothing in this trust instrument shall be construed to restrict my Trustees from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of the trust assets.

15. My Trustees shall be entitled to receive reasonable compensation for personal services rendered. No bond or other security shall be required.

16. Subject to the reservation set forth above, in addition to and not in limitation of any authority given to them by law, and without the necessity of obtaining the consent of any court, my Trustees shall have full discretionary powers of management and control, of sale and resale, in fee simple or otherwise, of mortgage, lease and pledge, of investment, reinvestment and exchange, and shall keep the trust estate invested in securities and other forms of property including real estate, corporate stocks, common and preferred, debenture bonds and other obligations whether or not secured, and my Trustees shall not be restricted to securities or property of the character now or hereafter authorized by law. My Trustees are further authorized to retain and continue to hold in their discretion, any property or investment transferred to it without liability for depreciation or loss occasioned by so doing and may carry securities in the name of a nominee, and to join in or oppose the merger, consolidation, reorganization or readjustment of the financial structure of any firm or corporation in which the trust estate may have an interest, and may take any action which in their judgment is necessary or desirable for the proper and advantageous management, investment and distribution of the trust estate, including leasing real estate for such terms as it may deem desirable even though such terms may extend beyond the period of the trust. Notwithstanding the above, my Trustees shall not exercise any power whether granted hereunder or by law in any manner inconsistent with the qualification of the trust as a charitable remainder unitrust under Internal Revenue Code Section 664 and the regulations and rulings of the Internal Revenue Service with respect thereto.

17. The interests of my wife in the trust income shall not in any way be voluntarily or involuntarily alienated or encumbered.

18. In the event of the death, disability, resignation of a trustee, the remaining trustee is authorized to appoint a successor trustee including a corporate fiduciary.

EXHIBIT B.—Bequest of Residue of Estate to Charitable Remainder Trust Prior to Tax Reform Act of 1969 (Enacting I.R.C. Secs. 664 and 2055(e)(2))

ARTICLE I

I give the residue of my estate to my Trustees, to hold in trust for the purposes herein set forth. My Trustees shall pay to or for the use of my wife, not less often than annually, during her lifetime, the entire net income of the trust. Upon the death of my wife, my Trustees shall distribute all of the then principal to Shriners Hospitals for Crippled Children for its general charitable uses and purposes.

[Telegram]

GEOTHERMAL RESOURCES COUNCIL,
Denver, Colo., July 19, 1976.

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

Mr. Chairman and committee members, the Geothermal Resources Council is composed of over four hundred members whose common interest is the rational utilization of the Nation's substantial geothermal energy resources.

On behalf of that organization, I respectfully urge that you sustain your earlier favorable consideration of the captioned legislation.

As you are no doubt aware, the fledgling geothermal industry is beset by numerous problems consequent to its comparative newness and its unique characteristics. Unfair tax treatment in relation to other natural resources ranks as the most detrimental of those problems.

Consequently, I submit that emergence of the legislation before you will hasten the Nation's enjoyment of the potentially substantial benefits of geothermal energy.

Respectfully,

W. M. DOLAN. *President.*

LAW OFFICES OF EISENSTAT & GOTTESMAN, P.C.,
New York, N.Y., July 13, 1976.

Re Section 2004—Business Deduction For Geothermal Energy Tax Reform Bill of 1976 (H.R. 10612).

MICHAEL STERN, *Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.*

DEAR MR. STERN: I am taking the liberty of writing to you pursuant to the press release issued by the Senate Finance Committee on July 8, 1976.

I am a practicing attorney who has engaged in the structuring of oil and gas drilling ventures over the past five years. In addition, I have participated personally and also on behalf of clients in the drilling of numerous oil and gas wells both in the United States and Canada.

Our experience has been most satisfactory and encouraging. In part, I submit, the results flow from our objective to find oil or gas—not to generate a tax deduction. We have examined our prospective projects on an economic basis not looking for a leverage write-off to shelter other income.

That is not to say the tax considerations were not relevant—they most certainly were. Our ability to deduct the intangible drilling costs and the tax "savings" which resulted therefrom considerably reduced our risk in drilling and permitted us to drill wells and establish production where we otherwise could not or would not have operated. In addition, the economics of a play became much more favorable when percentage depletion applied to production income.

This is not unique to us. One need only look to the hundreds of millions of dollars raised by public drilling funds each year in addition to the immeasurable sums raised through private drilling ventures. I am not suggesting that all is perfect in connection with drilling funds both public and private. I do submit that the tax consequences of drilling and producing oil and gas has generated significant risk capital for the independent explorer which has resulted in the discovery of significant reserves.

The pending proposal as contained in Sec. 2004 would provide the fledgling geothermal industry with risk capital that is so essential to the industry's growth and development. Were an investor assured of the tax consequences that would flow from his investments, he could then take the risks inherent in geothermal exploration.

This industry has one additional risk that the oil and gas industry does not have; i.e., the time lag between the first productive well and the ultimate flow of production income. Oil, if discovered, can be sold immediately; Gas, depending on the proximity to a pipeline, soon after discovery. But the geothermal resource must be proven to the point where a purchaser will construct a plant on site—thus delaying the generation of income considerably.

I submit that notwithstanding the risks, the economic potential of geothermal will generate the infusion of significant private capital to this industry were the tax consequences clear—and it is private capital which can and must develop the resource.

We have certain geothermal leases which we are very anxious to develop. We find it very difficult, however, to approach investors so long as the Internal Revenue Service non-acquiesces in the *Reich* case and attacks the applicability of the intangible drilling deduction and the depletion allowance to the geothermal resource. (In connection therewith, we are enclosing an article which we wrote on the tax consequences of geothermal exploration.)

The proposed legislation would finally resolve the uncertainty. It is what the industry must have if it is to grow and develop. This is no more a "special inter-

est" piece of legislation than is any other provision of the Code. Although there are a few major oil companies involved in the geothermal industry, small independents constitute the predominant interested parties. It is imperative that this provision be adopted and enacted into law so that the indusry can move forward and contribute to our nation's energy supply and hopefully its energy independence.

Thank you for your consideration.

Respectfully,

SAMUEL M. EISENSTAT.

Enclosure.

TAX TREATMENT OF EXPLORING AND DEVELOPING GEOTHERMAL RESOURCES

(By Samuel M. Eisenstat[1])

"Exploration and development of geothermal resources should be subject to same tax treatment as exploration and development of oil and gas."

INTRODUCTION

The exploration and development of properties for geothermal resources is no longer merely a theoretical topic of inconsequential practical significance. The increasing cost of fossil fuel coupled with the growing concern of the environmentalists has provided the setting for what should be a very active period for the development of this source of energy.

According to the often cited Hickel report,[2] geothermal resources in the United States have the capacity of producing 132 million kilowatts by the year 1985. Present total domestic energy production is 350 million kilowatts but it is estimated that power needs double every eight years.[3] Obviously, to develop this potential capacity will require the expenditure of considerable effort and financial resources and will result in the drilling of thousands of geothermal wells.[4]

TAX CONSIDERATIONS

As in the case of exploring and developing oil and gas properties, the tax consideration will play an important role. The risks inherent to the development of the geothermal resources will be reduced to the investor if he is able to receive the same tax treatment as he would were the drilling for oil and gas. There is absolutely no reason why comparable treatment should not be available to exploring for geothermal resources as exists for exploring for oil and gas. The purpose of this article is to examine the applicability of the provisions of Internal Revenue Code, Sections 263(c) and 611 relating respectively to the election to expense the intangible drilling and development costs and the depletion allowance to geothermal exploration and development.

There are two basic forms of geothermal energy: (1) Dry steam and (2) superheated water.

A successful well will pierce a geothermal reservoir and the steam or hot water will be used on the site to create electrical energy. The energy is then transported to the place of consumption. In the case of steam, the resource discovered is used to drive a turbine. In the cas of hot water, it is either flashed into steam which is used to drive a turbine or it is passed through a system where the heat from the water is transferred to a volatile substance which, when heated, expands into a gas and in turn drives the turbine.

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[1] Attorney at Law, New York City; LL.B.; LL.M. (Tax) New York University; formerly Assistant United States Attorney, S.D. N.Y. (Tax Section); presently member, Eisenstat & Gottesman, P.C., Attorneys at Law.

[2] Geothermal Energy, A National Proposal for Geothermal Resources Research, University of Alaska, 1972.

[3] Gottschalk, "Steam Below Ground Seen Giving Big Boost to U.S. Energy Supply." *Wall Street Journal*, p. 1, March 20, 1973. An excellent discussion of the geothermal resources can be found in the January 1972 issue of *Scientific American* in an article written by Joseph Barnea entitled "Geothermal Power" (page 70).

[4] According to Dr. Geoffrey Robson, Technical adviser in the Energy Section, Resource and Transport Division, United Nations, a minimum of 26,000 geothermal wells would have to be *successfully completed* between now and 1985 to reach the Hickel projected capacity. This assumes an average capacity per producing well of 5,000 kilowatts. From a paper delivered at a *Seminar on Geothermal Energy*, United Nations, Jan. 8, 1973.

PRIOR CASES

In *Arthur E. Reich*, 52 T.C. 700 (1969) *aff'd.* 454 F.2d 1157 (9th Cir. 1972), the Tax Court was faced with taxpayers who had drilled numerous geothermal wells both in the area of the Geysers[5] and also in other areas. There were two issues before the Court; i.e., whether the income from the successful steam wells at the Geysers was subject to percentage depletion and whether the intangible drilling and development costs of the wells drilled could be expensed.

The Court found in favor of the taxpayers on both issues. In a rather lengthy and detailed analysis, the Court found as follows:

(1) The geothermal resuorce at the Geysers is not merely the inexhaustible heat of the earth, but rather it is heat and water combined in such a way so as to create steam under pressure. It is the steam which is the source of the power, not merely the heat.

(2) Steam is gas for purposes of the percentage depletion provisions of the Code.[6] The Court looked to the normal use of the word gas and concluded that it would include steam. Nor would the Court accept the argument of the Government that steam is really water, and therefore not depletable under I.R.C. 613 (b) (7) (A).[7] The term water was used in its ordinary sense said the Court, and refers to water in its liquified state, not its gaseous state.

(3) Having determined that the steam was a gas, the Court next concluded that it was exhaustible and was depleting. The Court looked to the fact that the steam was enclosed in a reservoir which was not being recnarged. The drawing off of the steam to produce energy depleted the reservoir.

Therefore, since the steam was a "gas" which was depleting, it was subject to the percentage depletion provisions of the Code and likewise the election to expense intangibles drilled and development costs as applicable.[8]

Despite the feeling of the dissenting judges that the result of the majority was "eccentric," the Ninth circuit affirmed without dissent.

The only other reported case, *George D. Rowan*, 28 T.C.M. 797 (1969), involved the intangible drilling and development deduction. This was a companion case to *Reich, supra*, and the Court concluded that the deduction was valid and in so doing, it relied on *Reich, supra.*[9]

TREATMENT NOT CERTAIN

An initial reading of the cases would leave the impression that insofar as geothermal exploration and development is concerned, the favorable tax benefits of depletion and expensing intangibles will apply. Unfortunately, this is an erroneous conclusion.

Initially, the case law is truly sparse and insignificant. It is unreasonable to assume that the International Revenue Service will capitulate in light of one Ninth Circuit decision and two Tax Court decisions. To the contrary, the fact that the Internal Revenue Service has not published an acquiescence to the reported decisions could very well lead one to conclude that there will be further

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[5] The Geysers is located approximately 75 miles north of San Francisco. It is the only dry steam field presently producing in the United States. Its present capacity exceeds 300,000 kilowatts and projected capacity for 1976 is 600,000 kilowatts. Estimates of the field's potential run from 1 million to 4 million kilowatts.

[6] I.R.C. Sec. 611 provides in pertinent part as follows:

"(a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion. . . ."

Sec. 613(b) relating to percentage depletion rates provides in part as follows:

"(b) *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the percentages . . . are as follows:

(1) 22 percent.

(A) Oil and gas wells.

Thus having concluded steam was a gas, it would be subject to percentage depletion of gas—which today is 22 percent but for the years involved in *Reich, supra*, was 27½ percent.

[7] Under I.R.C. 613(b) (7) (A) water is specifically excluded from the percentage depletion provisions.

[8] Pursuant to the provisions of I.R.C. § 263(c), a taxpayer has the option to deduct as expenses the intangible drilling and development costs of *oil and gas wells*. After it was decided that the wells in question were gas wells, the expensing of intangibles applied.

[9] In *Rowan, supra*, the depletion issue was not before the Court as there apparently was no income from the wells in question.

resistance by the Government to the favorable tax treatment accorded geothermal drilling by the courts up until now.[10]

Furthermore, and more importantly, what will be the treatment of hot water geothermal prospects as distinct from steam prospects?

It is one thing to argue that steam is a gas—it is quite another, however, to argue that hot water in its liquid state is a gas. The taxpayer's position is complicated even further if a heat transfer process is used. The distinction, however, is not one of substance but merely the result of existing statutory language.

In connection with the intangible drilling and development costs, there is no reason why the tax treatment should be any different whether the geothermal power source is steam or hot water; the same techniques for exploration are involved and the expenditures are comparable.

The application of the depletion allowance is somewhat more complicated but, it is submitted, the source of power is being depleted and the allowance should be permitted.

The source of power is not the inexhaustible heat of the earth as the Government argued in *Reich, supra*. This heat alone could not, at least under present technology, serve as a source of power. The presence of heat *together with* a readily available carrier, i.e., water, combine to form the geothermal resource. As the carrier is consumed and the source of power utilized, it is depleted.

To permit certain tax treatment where the geothermal resource is steam and to deny comparable treatment when the geothermal resource is superheated water is without basis.[11]

CONCLUSION

It is clear, therefore, that the status of the tax treatment of geothermal exploration and development is anything but settled. The present favorable decisions serve as little more than a hopeful precedent as to favorable tax treatment. What is necessary, however, if this question is truly to be resolved, is immediate and unambiguous legislation providing that the same tax consequences which flow from exploring and developing for oil and gas prospects will also apply to the exploring and developing for geothermal resources.

LIVELY ARTS TAX SERVICE,
New York City, N.Y., July 19, 1976.

MICHAEL STERN,
Senate Finance Committee,
Dirksen Building, Washington, D.C.

SIRS: As I am unable to testify at the public hearing on July 20, 1976, I would like the attached letter to be part of the record of the hearing. This letter is one I wrote to Senator Long in April 1976. It states my feelings regarding section 601 of HR 10612. As a members of the performing arts and as a tax practitioner, I feel I can say it reflects the feelings of my fellows.

Yours truly,

RICHARD BRENDAN HANLON,
Associate Director.

Attachment.

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[10] In *Reich, supra,* the Government conceded that gas as used in Sec. 613(b)(1) of the Internal Revenue Code was not limited to hydrocarbonaceous products. The concurring opinion in the case points up this concession may have been without basis. In future tests, the Government may very well argue that gas for purposes of the percentage depletion provisions was intended by Congress to include only gas of a hydrocarbon nature—thereby excluding steam.

[11] Another interesting problems relates to disposal wells which are an integral part of any geothermal field. Once the energy has been used to turn the turbine, the remaining water must be disposed of. In light of the environmental problem, the water cannot be spewed out in the vicinity of the well. More likely than not, the water will be reinjected back into the ground and probably into the same formation (thereby avoiding potential subsidence). Query, whether the intangible drilling and development costs of the disposal well will qualify for treatment under 263(c) or whether the costs must be capitalized? See Rev. Rul. 70-414, 1970-2 C.B. 182 in which it is held that salt water disposal wells drilled in connection with an oil well were not related to production but rather to operations and therefore had to be capitalized.

LIVELY ARTS TAX SERVICE,
New York City, N.Y., April 29, 1976.

HON. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SIR: Section 601 of the Tax Reform Act of 1975 discriminates against performing artists in that it fails to recognize and provide for the special nature of working as a performer. Because of the regulations of the unions to which performers belong, they are technically "employees" since artistic producers are required to withhold taxes. In all real ways, however, performers operate like free-lange, self-employed individuals. No producer "requires" a musician, for example, or an actor, to "maintain an of[illegible]r studio in the home," but these artists do put in long hours practicing, rehe[illegible]ing, learning lines, doing what we call, in the business, "home work" (research reading, memorizing, etc.). Only the few very successful performers can afford to rent office or rehearsal space in addition to their homes. This is especially true in New York City. Producers may not specifically require their employees to maintain an office or studio, but the very nature of the profession does.

I respectfully urge you and your colleagues on the Senate Finance Committee to please give a break to a group of professionals who make many sacrifices of a material nature to provide society at large with so much pleasure and culture.

I feel the Act should also instruct IRS to allow apportionment basis on an 8-hour day as opposed to the 24-hour basis presently used by IRS. The 24-hour basis discriminates against those unable to afford outside rental space. The tax courts have historically favored the 8-hour basis.

Respectfully submitted.

RICHARD BRENDAN HANLON,
AEA, SAG, AFTRA, ASCAP.

PHILLIPS, LYTLE, HITCHCOCK, BLAINE & HUBER,
Buffalo, N.Y., July 20, 1976.

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: As counsel for Marine Midland Bank, a New York State banking corporation, we are submitting this letter concerning H.R. 11920, the so-called swap fund bill, as it may affect the merger or division of common trust funds. We request the inclusion of this letter in the printed record of the July 20 through July 22, 1976 hearings of the Committee on Finance concerning H.R. 10612, to which the swap fund bill has been added in the Senate.

Subsection (d) of the swap fund bill amends Section 584(e) of the Internal Revenue Code to provide that the admission of a participant to a common trust fund shall be treated with respect to the participant as the purchase of or exchange for the participating interest. This amendment is intended to require realization of gain or loss by a participant who contributes appreciated or depreciated property to a common trust fund, according to House Committee Report 94-1049 at page 9. Neither the bill nor the House Committee Report expressely addresses the question whether mergers or divisions of common trust funds should require realization of gain or loss to participating trusts. However, it is possible to construe the proposed amendment as requiring such realization, since participants in merging or dividing funds become participants in different common trust funds by reason of mergers or divisions. Marine Midland Bank is concerned to establish that Congress does not intend mergers or divisions of common trust funds to be considered as taxable events.

Marine Midland Bank, as trustee of various common trust funds, determined by resolutions dated December 17, 1975 to combine its common trust funds operating on a regional basis into a smaller number of common trust funds operating on a state-wide basis, to avoid duplication of services and to provide more efficient and economical administration as well as investment flexibility. As of April 30, 1976, the bank divided three legal common trust funds into three equity sub-funds and three taxable income sub-funds and then merged these sub-funds along with three other equity funds and three other taxable income funds into one continuing equity common trust fund and one continuing taxable income common trust fund. These transactions are set forth in greater detail

in the enclosed request for ruling dated September 4, 1975 and the enclosed ruling from the Internal Revenue Service dated November 25, 1975. The market value of the merging equity funds and sub-funds for purposes of the merger was $16,488,130.21 and the market value of the merging taxable income funds and sub-funds for purposes of the merger was $19,607,882.44.

We understand that in like manner The Bank of New York Co., Inc. merged its various regional subsidiary banks into a single state-wide bank, The Bank of New York, effective January 1, 1976. Thereafter on April 30, 1976 The Bank of New York divided one legal common trust fund into an equity sub-fund and a taxable income sub-fund and merged these sub-funds along with three other common trust funds formerly maintained by a regional subsidiary bank into continuing common trust funds of The Bank of New York. A ruling from the Internal Revenue Service with respect to these transactions was issued on March 14, 1976.

Subsection (d) of the swap fund bill amending Section 584(e) of the Internal Reveue Code was added to the bill in the House of Representatives after the March 29, 1976 hearings in the House. The bill has not been the subject of any hearings either in the House or the Senate. It is apparent that when this legislation was first proposed, Congress was not aware of any possible impact the bill might arguably have on the above described divisions and mergers of common trust funds of Marine Midland Bank and The Bank of New York. The swap fund bill appears admirably drafted with respect to its intended target—any transaction in which a taxpayer's principal interest is to obtain diversification of an undiversified portfolio of appreciated securities without having to pay taxes on capital gains. However, if the bill were also to have the apparently intended effect of causing capital gains to be realized by participating trusts of common trust funds by reason of mergers or divisions, the bill would work particular hardship upon the participating trusts of the common trust funds of both Marine Midland Bank and The Bank of New York which were involved in the above described divisions and mergers as of April 30, 1976 in accordance with prior rulings from the Internal Revenue Service that such divisions and mergers would not result in the realization of capital gains or losses to the participating trusts.

In opposition to such a result, it must be noted that mergers or divisions of common trust funds are not effectuated for the purposes of enabling participating trusts to obtain diversification of an undiversified holding of appreciated or depreciated securities. The very concept of a common trust fund is a portfolio already diversified for the benefit of participating trusts. In this connection Sections 9.18(b)(9)(i) and (ii) of the Regulations of The Comptroller of the Currency state that no participant in a common trust fund may have an interest exceeding 10% of the market value of the fund, and that no investment of a common trust fund issued or guaranteed by any one person, firm or corporation may exceed 10 percent of the market value of the fund. Moreover mergers and divisions of common trust funds are not transactions sought by participating trusts for the purpose of avoiding realization of capital gains or losses. Common trust fund mergers and divisions are generally sought by the bank administering the common trust fund fo- its own business reasons of efficiency and economy of operation, with no income tax consequence to the bank in any event.

It is clear, therefore, that the proposed amendment to Section 584(e) of the Internal Revenue Code should not be applied to mergers or divisions of common trust funds. Such a reading would be inconsistent with the express purpose of the bill, to prevent a taxpayer from obtaining diversification of an undiversified portfolio of appreciated securities without having to pay income taxes on capital gains.

This conclusion finds further support in the portion of the bill and the House Committee Report relating to corporate reorganizations. If common trust funds were considered as corporations, a merger of two or more common trust funds would not result in a realization of gain or loss by participating trusts under subsection (a) of the first section of the bill. The merging common trust funds would have not more than 25 percent of the value of their assets invested in the security of any one issuer and not more than 50 percent of the value of their assets invested in the security of five or fewer issuers. The merger of two or more such corporations remains tax free under the bill, according to new Section 368(a)(2)(F)(ii).

As the House Committee Report states at page 14:

"Also if two or more investment companies (or their shareholders) participate in an exchange with each other, the transaction will continue to be eligible for

taxfree reorganization treatment if both companies have diversified portfolios before the exchange".

And again at page 18:

"Under these rules, the bill will not change the tax free treatment available under present law where one or more regulated investment companies or real estate investment trusts merge (or otherwise reorganize) with each other".

If it is not the purpose of the bill to tax the merger of regulated investment companies or real estate investment trusts, there would seem to be no reason to tax the merger of common trust funds either.

And of course a division of a common trust fund into an equity sub-fund and a taxable income sub-fund is clearly not intended to obtain diversification of securities. The bill does not appear to be aimed at such a transaction.

It should be noted that in any event the regulations of The Comptroller of the Currency do not permit the transfer of securities to an existing common trust fund by a participant in exchange for units of participation. Presumably therefore the swap fund bill as it relates to common trust funds is intended only to apply to the initial funding of a common trust fund with securities, a practice which we understand the Comptroller has authorized. The bill would seem to require recognition of gain or loss by a participant in a newly created common trust fund, if the exhange of securities for units of participation in the common trust fund achieves a diversification of the participant's interest.

On the understanding that Congress does not intend to cause the above-described mergers or any such mergers of two or more already existing and diversified common trust funds to be considered as a taxable event, we are not requesting that a grandfather clause be added to the bill, exempting from the application of the act any merger of common trust funds pursuant to the approval of the Internal Revenue Service obtained prior to April 8, 1976.

This letter is submitted to clarify legislative intention with respect to the swap fund bill as it relates to common trust funds.

We appreciate the consideration of this matter by the Senate Finance Committee.

Very truly yours,

ARTHUR M. SHERWOOD.

SEPTEMBER 4, 1975.

Re proposed splits and mergers of common trust funds of subsidiary banks of Marine Midland Banks, Inc. by reason of the proposed merger of such subsidiary banks into a newly formed subsidiary, Marine Midland Bank.

COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C.
(Attention: Chief, Individual Income Tax Branch).

DEAR SIR: On behalf of Marine Midland Banks, Inc. ("Marine Midland") and its subsidiary banks, we respectfully request your ruling as to Federal income tax consequences of a proposed combination of eleven common trust funds of seven existing subsidiary banks into two common trust funds to be maintained by a newly formed subsidiary bank. The proposed transaction is occasioned by, and contingent upon, the proposed merger of the ten existing subsidiary banks of Marine Midland into a newly formed subsidiary bank named Midland Bank ("Marine").

Specificially, three balanced common trust funds are to be split into equity sub-funds and taxable income sub-funds. The three equity sub-funds are then to be merged along with three other equity funds into a continuing Marine Equity Fund, and the three taxable income sub-funds are to be merged along with three other taxable income funds into a continuing Marine Taxable Income Fund. The rulings requested are to the effect that the proposed splits and mergers will not result in the recognition of gain or loss to the various common trust funds or to their participants, and will not affect the adjusted basis or holding period of assets or units of participation in the various funds.

FACTS

Marine Midland

Marine Midland is a bank holding company having an office at One Marine Midland Center, Buffalo, New York 14203. Marine Midland owns a controlling interest in ten subsidiary commercial banks operating in various banking districts of the State of New York. As a result of an amendment to the New York Banking Law permitting banks after December 31, 1975 to branch and merge

anywhere in the state, Marine Midland proposes as of January 1, 1976 to merge its ten subsidiary banks into a single statewide bank, Marine. The principal office of Marine will also be at One Marine Midland Center, Buffalo, New York 14203. The proposed merger has been approved by the New York State Banking Board and has been submitted to the Board of Governors of the Federal Reserve System for approval. A request for ruling as to the Federal income tax consequences of the proposed merger of the subsidiary banks has been submitted to the Reorganization Branch of the National Office by letter dated August 8, 1975.

Common trust funds

Seven of the existing subsidiary banks maintain one or more common trust funds. The following schedule sets forth the names and cities of the principal offices of these banks, and the names, taxpayer identification numbers and the last month of the fiscal years of the eleven common trust funds involved in the proposed transaction.

I. Marine Midland Bank—New York (New York City):

1. Discretionary Equity Common Trust Fund (13-6063978) (October) ("New York Equity Fund").

2. Discretionary Fixed Income Common Trust Fund (13-6622709) (October) ("New York Taxable Income Fund").

II. Marine Midland Bank—Western (Buffalo):

3. Discretionary Common Trust Fund No. 1—The Stock Fund (16-6030970) (April) ("Western Equity Fund").

4. Discretionary Common Trust Fund No. 3—The Taxable Income Fund (16-6104803) (April) ("Western Taxable Income Fund").

III. Marine Midland Bank—Central (Syracuse):

5. Discretionary Common Trust Fund No. 1—The Stock Fund (16-6162376) (May) ("Central Equity Fund").

6. Discretionary Common Trust Fund No. 2—The Taxable Income Fund (16-6162375) (May) ("Central Taxable Income Fund").

IV. Marine Midland Bank—Rochester (Rochester):

7. Discretionary Common Trust Fund (16-6019456) (July) ("Rochester Equity Fund").

8. Legal Common Trust Fund (16-6019455) (July) ("Rochester Taxable Income Fund").

V. Marine Midland Bank—Southern (Elmira):

9. Legal Common Trust Fund (15-6016894) (October) ("Southern Fund")

VI. Marine Midland Bank—Northern (Watertown):

10. Legal Common Trust Fund (15-6016081) (January) ("Northern Fund").

VII. Marine Midland Bank—Eastern, N.A. (Troy):

11. Legal Common Trust Fund (14-6021744) (May) ("Eastern Fund").

In addition, Marine Midland Bank—Western maintains a fund named Discretionary Common Trust Fund No. 2—The Tax Exempt Income Fund, which is invested in nontaxable municipal bonds. This fund is not involved in the proposed transaction or in this request for ruling.

All of the funds have been maintained and operated in accordance with their respective plans of operation and with applicable provisions of the New York Banking Law and the Regulations of the Banking Board of the State of New York, the applicable Regulations of the Comptroller of the Currency, and prior to the assumption of jurisdiction of common trust funds by the Comptroller, in accordance with applicable Regulations of the Federal Reserve Board. All of the funds are common trust funds as defined in Section 584(a) of the Internal Revenue Code of 1954.

Although four of the funds are denominated as legal common trust funds and the other funds are discretionary common trust funds, all the funds are presently authorized by their respective plans of operation and the New York Banking Law to be invested in such investments as the trustees may select in its discretion. The equity funds have been invested primarily in common stocks. The taxable income funds have been invested primarily in preferred stocks and bonds. The Southern, Northern and Eastern funds have maintained a balance between common stocks and preferred stocks and bonds.

The following schedule sets forth the market values of the funds and their equity and taxable income portions rounded to the nearest thousand dollars, as of recent dates.

Fund	Equity portion	Taxable income portion	Total market value
1. New York Equity (July 31, 1975)	$2,522,000		$2,522,000
2. New Tork Taxable Income (July 31, 1975)		$3,267,000	3,267,000
3. Western Equity (July 31, 1975)	19,786,000		19,786,000
4. Western Taxable Income (July 31, 1975)		13,647,000	13,647,000
5. Central Equity (May 31, 1975)	5,663,000		5,663,000
6. Central Taxable Income (May 31, 1975)		6,940,000	6,940,000
7. Rochester Equity (July 31, 1975)	1,108,000		1,108,000
8. Rochester Taxable Income (July 31, 1975)		3,177,000	3,177,000
9. Southern (July 31, 1975)	1,078,000	1,336,000	2,414,000
10. Northern (July 31, 1975)	3,141,000	2,008,000	5,150,000
11. Eastern (May 31, 1975)	1,715,000	1,290,000	3,004,000

Upon completion of the proposed merger of the subsidiary banks on January 1, 1976, Marine will become successor Trustee of each of the existing common trust funds. The funds will thereupon be administered from Marine's Buffalo office, and will be subject to the audit jurisdiction of the Buffalo District Office of the Internal Revenue Service.

At present, the audit jurisdiction for the Western, Rochester, Central, Southern and Northern Funds is in the Buffalo District Office; the audit jurisdiction for the Eastern Fund is in the Albany District Office; and the audlit jurisdiction for the New York Funds is in the Manhattan District Office.

Business purpose

By reason of the merger of the banks, it has been determined to combine eleven common trust trust funds now operating on a regional basis into two funds—an equity fund and a taxable income fund—operating on a statewide basis. The resulting Marine funds should provide participants with greater investment flexibility and diversification as well as more economical and efficient administration. Duplication of services will be eliminated and costs reduced.

Preliminary resolutions

The Marine Board of Directors will adopt resolutions in December 1975, effective as of January 1976, to make the following necessary amendments to the Plans of Operation of the eleven funds:

(1) The Western Equity Fund will be renamed Marine Midland Bank—Diversified Investment Fund—Equity ("Marine Equity Fund"), and the Western Taxable Income Fund will be renamed Marine Midland Bank—Diversified Investment Fund—Taxable Income ("Marine Taxable Income Fund").

(2) The quarterly valuation dates of the Central Equity Fund, the Central Taxable Income Fund and the Eastern Fund will be changed from the last bank business day of February, May, August and November of each year to the last bank business day of January, April, July and October of each year, to conform the quarterly valuation dates of these three funds to the quarterly valuation dates of the other eight funds involved in the proposed transaction, including the two continuing funds.

(3) The proposed splits and mergers will be directed, as of a date to be selected by the trust investment committee after necessary approval by the New York State Banking Board.

The present plans of operation of each of the eleven funds involved in the proposed transaction are submitted herewith as Exhibits One through Eleven, and the proposed amendments to each of these plans are submitted herewith as Exhibits One A through Eleven A.

Proposed transaction

It is proposed that on January 31, 1976, or as soon thereafter as Marine deems it feasible, the Southern, Northern and Eastern funds will each be split into Equity and Taxable Income Sub-Funds. The respective Equity Sub-Funds will receive the equity securities and a portion of the cash in the Southern, Northern and Eastern Funds on that date, and the respective Taxable Income Sub-Funds will receive the taxable income securities and a portion of the cash in the Southern, Northern and Eastern Funds on that date.

Further it is proposed that on January 31, 1976, or as soon thereafter as Marine deems it feasible:

(1) The following Equity Funds and Sub-Funds will then merge into the Marine Equity Fund (formerly the Western Equity Fund): New York Equity

Fund, Central Equity Fund, Rochester Equity Fund, Southern Equity Sub-Fund, Northern Equity Sub-Fund, and Eastern Equity Sub-Fund.

(2) The following Taxable Income Funds and Sub-Funds will merge into the Marine Taxable Income Fund (formerly the Western Taxable Income Fund): New York Taxable Income Fund, Central Taxable Income Fund, Rochester Taxable Income Fund, Southern Taxable Income Sub-Fund, Northern Taxable Income Sub-Fund, and Eastern Taxable Income Sub-Fund.

Method of proposed splits

On the effective date of the split of the Southern, Northern and Eastern Funds into Equity Sub-Funds and Taxable Income Sub-Funds, each participant in the Southern, Northern or Eastern Fund will be issued the same number of units of participation in each of the Sub-Funds resulting from the split as the participant held in the Fund before the split. For example, a participant holding 100 units of participation in the Northern Fund will be issued 100 units of participation in the Northern Equity Sub-Fund and 100 units of participation in the Northern Taxable Income Sub-Fund.

Undoubtedly, there will be changes in the investment portfolios of the Southern, Northern and Eastern Funds prior to the anticipated date of the split on January 31, 1976, and so it cannot now be determined what the exact relationship of the fair market value and the adjusted basis of the equity and taxable income portions of these funds will be on the date of the split. It is anticipated, however, that the fair market value of the assets transferred from the Southern, Northern and Eastern Funds to one or the other of their respective Equity or Taxable Income Sub-Funds will be within three percent of the adjusted basis of such assets in the Funds on the date of the split. The fair market value and adjusted basis of the assets transferred to one or the other of the respective Equity or Taxable Income Sub-Funds will therefore be "very close", in accordance with the provisions of Revenue Ruling 68-77, 1968-1 C.B. 289.

As a result, it is proposed that the allocation of tax basis to the participants in the Southern, Northern and Eastern Funds, as between their units of participation in the Southern, Northern and Eastern Equity and Taxable Income Sub-Funds, be made in accordance with the so-called "subtraction" method, which has been approved by the Internal Revenue Service in similar situations. In accordance with this method, if the adjusted basis of the assets being transferred from a fund to a sub-fund is very close to the market value of such assets on the date of the split, a participant's adjusted basis for each of its units of the sub-fund is determined by dividing the adjusted basis of the assets of the sub-fund by the number of units in the sub-fund. By subtracting the participant's adjusted basis for a unit of the sub-fund, as so determined, from the participant's adjusted basis for each of its units of the fund before the split, the participant's adjusted basis for each such unit in the other sub-fund created by the split is then determined.

In this connection, since the Southern, Northern and Eastern Funds have maintained separate basis records for each lot of participating units purchased at any one time, the above described computations involving adjusted basis will be made on a per lot basis for the units of each participant in any of these Funds.

For example, if a participant has an adjusted basis of $40.50 in each of its units of participation in one lot of a splitting fund and an adjusted basis of $42.40 in each of its units of participation in a second lot of the splitting fund, and if the adjusted basis of each unit of one of the sub-funds is determined to be $19.80, then the adjusted basis of each unit of the other sub-fund attributable to the first lot is $20.70 and the adjusted basis of each unit of the other sub-fund attributable to the second lot is $22.60.

Method of proposed mergers

The property constituting the assets of the New York, Central and Rochester Equity Funds and the Southern, Northern and Eastern Equity Sub-Funds will be transferred to and become a part of the property constituting the Marine Equity Fund (formerly the Western Equity Fund). In like manner, the property constituting the assets of the New York, Central and Rochester Taxable Income Funds and the Southern, Northern and Eastern Taxable Income Sub-Funds will be transferred to and become a part of the property constituting the Marine Taxable Income Fund (formerly the Western Taxable Income Fund).

As a result of these mergers, participants in the merging Funds and Sub-Funds will receive units of participation in the receiving Marine Fund and cash equal to the fair market value of their total units of participation in the merging Funds

or Sub-Funds on the date of the merger. The unit value of participations in the receiving Marine Fund immediately prior to the merger will be the unit value of all participations in the Fund after the merger, including the participations to be issued to the participants in the merging funds. The number of units of participation of the receiving Marine Fund which each participant in a merging Fund or Sub-Fund will be entitled to receive will be determined by multiplying (1) a fraction the numerator of which will be the total value of the merging Fund or Sub-Fund and the denominator of which will be the value of a unit of participation in the receiving Marine Fund, by (2) a fraction, the numerator of which will be the number of units held by the particular participant in the merging Fund or Sub-Fund and the denominator of which will be the total number of units of participation in the merging Fund or Sub-Fund. Cash will be paid in lieu of fractional units of participation in the receiving Marine Fund.

All of the merging funds and sub-funds will have separate basis records for each lot of participating units purchased at any one time. Therefore for purposes of determining the adjusted basis of units in the receiving fund issued to each participant as a result of the merger, each lot will be treated as a separate participant. The total adjusted basis of the units held in each separate lot before the merger will be the total adjusted basis of corresponding units of the receiving fund attributable to the lot. Fractions of units of the receiving fund attributable to each separate lot for each participant in a merging fund or sub-fund will be aggregated in a new lot for each participant, with a weighted average adjusted basis derived from the adjusted basis of these fractions of units comprising the new lot.

For example, assume a participant in a merging fund is entitled to receive 41.65 units in the receiving fund, of which 11.9 units are attributable to one lot and 29.75 units are attributable to a second lot in the merging fund. The participant's adjusted basis in the first lot is allocated pro rata between the 11 whole units and the 0.9 fraction attributable to the lot. In like manner, the participant's adjusted basis in the second lot is allocated pro rata between the 29 whole units and the 0.75 fraction attributable to the lot. The 0.9 and 0.75 fractions of units are aggregated into a new individual lot of 1.65 units of the receiving fund, with a weighted average adjusted basis derived from the adjusted basis of each fraction. Thus if the adjusted basis allocated to the 0.9 fraction is $3.17 and the adjusted basis allocated to the 0.75 fraction is $3.43, the total adjusted basis for the new lot of 1.65 units would be $6.60, of which $4.00 is allocated to the whole unit and $2.60 is allocated to the 0.65 fractional unit. Only the 0.65 fractional unit would be redeemed for cash.

Any accrued income or liabilities attributable to the assets of any merging Fund or Sub-Fund at the date of transfer will attach to the receiving Marine Fund by reference to the items to which the accrued income or liability is attributable.

RULINGS REQUESTED

On the basis of the foregoing facts, you are respectfully requested to rule that if the proposed transaction and the underlying bank merger receive necessary regulatory approval and are carried through as proposed:

(1) The proposed splits of the Southern, Northern and Eastern Funds into their respective Equity Sub-Funds and Taxable Income Sub-Funds will not result in the recognition of gain or loss to these Funds or to their participants.

(2) The assets transferred to the Southern, Northern and Eastern Equity Sub-Funds and Taxable Income Sub-Funds will retain the same basis in those Sub-Funds as they had in the Southern, Northern or Eastern Funds immediately prior to the splits.

(3) The holding period for the assets received by the Southern, Northern and Eastern Equity Sub-Funds and Taxable Income Sub-Funds as a result of the splits of the Southern, Northern and Eastern Funds will include the periods during which such assets were held in the Southern, Northern or Eastern Funds respectively.

(4) The adjusted basis for each participant's units of participation in the respective Sub-Funds received as a result of the splits of the Southern, Northern and Eastern Funds into Equity Sub-Funds and Taxable Income Sub-Funds may be determined by the use of the "subtraction" method as described in Revenue Ruling 68-77, if the adjusted basis of the assets of these funds transferred to either their respective Equity Sub-Fund or Taxable Income Sub-Fund is very close to the fair market value of such assets on the effective date of the split of these Funds.

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(5) The holding period for each participant's units of participation in the Southern, Northern or Eastern Equity Sub-Funds and Taxable Income Sub-Funds received as a result of the splits of the Southern, Northern and Eastern Funds respectively, will include the period during which the participant held corresponding units of participation in the Southern, Northern or Eastern Funds respectively.

(6) The proposed merger of the New York, Central and Rochester Equity Funds and the Southern, Northern and Eastern Equity Sub-Funds into the Marine Equity Fund will not result in the recognition of gain or loss to these Funds and Sub-Funds or to their participants. In like manner, the proposed merger of the New York, Central and Rochester Taxable Income Funds and the Southern, Northern and Eastern Taxable Income Sub-Funds into the Marine Taxable Income Fund will not result in the recognition of gain or loss to these Funds and Sub-Funds or to their participants.

(7) For Federal income tax purposes, distributions of cash to participants in the merging Funds or Sub-Funds in order to eliminate fractional units of participation held by participants upon the mergers shall be treated as proceeds from the sale or exchange of such fractional units of participating interests.

(8) The adjusted basis of the assets received by Marine Equity Fund and Marine Taxable Income Fund as a result of the mergers will remain the same in these Funds as the adjusted basis of such assets in the various merging Equity Funds and Sub-Funds and Taxable Income Funds and Sub-Funds respectively.

(9) The holding period for the assets received by Marine Equity Fund and Marine Taxable Income Fund as a result of the mergers will include the periods during which such assets were held by the merged Equity Funds and Sub-Funds or the merged Taxable Income Funds and Sub-Funds respectively.

(10) The adjusted basis of each participant's units of participation in Marine Equity Fund and Marine Taxable Income Fund issued as a result of the mergers will be the same as the adjusted basis of the corresponding units of participation held by the participant in the merged Equity Funds or Sub-Funds or the merged Taxable Income Funds or Sub-Funds immediately prior to the margers, reduced by the amount of each participant's adjusted basis attributable to a fractional unit of Marine Equity Fund or Marine Taxable Income Fund which is eliminated.

(11) The holding period for each participant's units of participation in the Marine Equity Fund or Marine Taxable Income Fund received as a result of the mergers will include the period during which the participant held corresponding units of participation in the merged Equity Funds or Sub-Funds or the merged Taxable Income Funds or Sub-Funds respectively.

DISCUSSION

Splits

It is submitted that the Federal income tax consequences of the proposed splits of the Southern, Northern and Eastern Funds into Equity Sub-Funds and Taxable Income Sub-Funds are governed by the principles set forth in Revenue Ruling 68-77, 1968-1 C.B. 289 and Internal Revenue Code Section 1223(1). No gain or loss should be recognized by these funds or their participants by reason of these splits, and the adjusted basis and holding periods of assets and units of participation in these funds should be retained in the Sub-Funds and their corresponding units of participation created by the splits. See also letter of Lester W. Utter, Chief, Individual Income Tax Branch, dated April 12, 1972, in regard to the Bank of New York proposed splits and mergers of common trust funds, and letter of Lester W. Utter, dated March 18, 1969, in regard to proposed split of discretionary common trust fund of Marine Midland Trust Company of Western New York (now Western).

Mergers

Further, it is submitted that the Federal income tax consequences of the proposed mergers of the various equity funds and sub-funds into Marine Equity Fund and the proposed mergers of the various taxable income funds and subfunds into Marine Taxable Income Fund are governed by the principles set forth in Revenue Ruling 55-229, 1955-1 C.B. 402, as clarified by Revenue Ruling 60-240, 1960-1 C.B. 192, and Internal Revenue Code section 1223(1). No gain or loss should be recognized by any of the funds or sub-funds or their participants by reason of the mergers, and the adjusted basis and holding periods of assets and units of participation in the merging funds and sub-funds should be

retained in the receiving Marine Funds and their corresponding units of participation created by the mergers. See letter of Lester W. Utter dated April 12, 1972, supra.

Statements of counsel

In our opinion the proposed transaction and the amendments of the plans of operation of the funds incidental thereto, are in compliance with the New York State Baking Law and Regulations of the New York State Banking Board and the Regulations of the Comptroller of the Currency applicable to common trust funds. However, the proposed splits and mergers may be completed only if approval is obtained from the New York State Banking Board and the Comptroller of the Currency. Copies of this letter and the plans of operation and amendments are being submitted to the Banking Board and the Comptroller. It is anticipated that receipt of the rulings requested will be a prerequisite of the approvals by the Banking Board and the Comptroller. Upon completion of the proposed transaction, assuming approval from the Banking Board and the Comptroller, the Marine Equity Fund and Marine Taxable Income Fund will continue as common trust funds as defined in Internal Revenue Code Section 584(a).

To the best knowledge of the undersigned, the issues presented in this ruling application are not pending before any field office of the Service or any branch office of the Appellate Division.

If you have any questions with respect to this ruling application or if you require any additional information, you are authorized to telephone, collect, either the undersigned or Arthur M. Sherwood or Thomas M. Barney, all partners of Phillips, Lytle, Hitchcock, Blaine & Huber at (716) 847-8418; 8492 or 8430 respectively. Enclosed herewith is a power of attorney Form 2848 in duplicate on behalf of Marine Midland.

A conference is requested if any ruling not in accord with the rulings requested is contemplated.

Respectfully submitted.

WILLIAM A. BAIN, JR.,
Counsel for Marine Midland Banks, Inc.

NOVEMBER 25, 1975.

MARINE MIDLAND BANKS, INC.,
One Marine Midland Center,
Buffalo, N.Y.

GENTLEMEN: This is in response to a ruling request dated September 4, 1975, submitted upon your behalf by William A. Bain, Jr., Esq., concerning the Federal income tax consequences of a proposed combination of eleven common trust funds of seven existing subsidiary banks into two common trust funds to be maintained by a newly formed subsidiary bank. The proposed transaction is occasioned by, and contingent upon, the proposed merger of the ten existing subsidiary banks of Marine Midland into a newly formed subsidiary bank named Marine Midland Bank.

Specifically, three balanced common trust funds are to be split into equity sub-funds and taxable income sub-funds. The three equity sub-funds are then to be merged along with three other equity funds into a continuing Marine Equity Fund. The three taxable income sub-funds are to be merged along with three other taxable income funds into a continuing Marine Taxable Income Fund. The rulings requested are to the effect that the proposed splits and mergers will not result in the recognition of gain or loss to the various common trust funds or to their participants, and will not affect the adjusted basis or holding period of assets or units of participation in the various funds.

Marine Midland is a bank holding company, and owns a controlling interest in ten subsidiary commercial banks operating in various banking districts in the State of New York. As a result of an amendment to the New York Banking Law permitting banks, after December 31, 1975, to branch and merge anywhere in the state, Marine Midland proposes, as of January 1, 1976, to merge its ten subsidiary banks into a single statewide bank (Marine). The proposed merger has been approved by the New York State Banking Board, and has been submitted to the Board of Governors of the Federal Reserve System for approval. A request for ruling concerning the Federal income tax consequences of the proposed merger of the subsidiary banks has been submitted to the Reorganization Branch, by letter dated August 8, 1975.

Seven of the existing subsidiary banks maintain one or more common trust funds. The following is a listing of the names and cities of the principal offices of these banks, and the names, taxpayer identification numbers, and the last month of the fiscal years of the eleven common trust funds involved in the proposed transaction:

I. Marine Midland Bank—New York (New York City):

1. Discretionary Equity Common Trust Fund (13-6063978) (October) (New York Equity Fund).

2. Discretionary Fixed Income Common Trust Fund (13-6622709) (October) (New York Taxable Income Fund).

II. Marine Midland Bank—Western (Buffalo):

3. Discretionary Common Trust Fund No. 1—The Stock Fund (16-6030970) (April) (Western Equity Fund).

4. Discretionary Common Trust Fund No. 3—The Taxable Income Fund (16-6104803) (April) (Western Taxable Income Fund).

III. Marine Midland Bank—Central (Central Equity Fund):

5. Discretionary Common Trust Fund No. 1—The Stock Fund (16-6162376) (May) (Central Equity Fund).

6. Discretionary Common Trust Fund No. 2—The Taxable Income Fund (16-6162375) (May) (Central Taxable Income Fund).

IV. Marine Midland Bank—Rochester (Rochester):

7. Discretionary Common Trust Fund (16-6019456) (July) (Rochester Equity Fund).

8. Legal Common Trust Fund (16-6019455) (July). (Rochester Taxable Income Fund.

V. Marine Midland Bank—Southern (Elmira):

9. Legal Common Trust Fund (15-6016894) (October) (Southern Fund).

VI. Marine Midland Bank—Northern (Watertown):

10. Legal Common Trust Fund (15-6016081) (January) (Northern Fund).

VII. Marine Midland Bank—Eastern, N. A. (Troy):

11. Legal Common Trust Fund (14-6021744) (May) (Eastern Fund).

In addition, Marine Midland Bank—Western maintains a fund, named Discretionary Common Trust Fund No. 2—The Tax Exempt Income Fund, which is invested in tax exempt municipal bonds. This fund is not involved in the proposed transaction or in this request for ruling.

All of the funds have been maintained and operated in accordance with their respective plans of operation and with applicable provisions of the New York Banking Law and the Regulations of the Banking Board of the State of New York, the applicable Regulations of the Comptroller of the Currency, and, prior to the assumption of jurisdiction of common trust funds by the Comptroller, in accordance with applicable Regulations of the Federal Reserve Board. All of the funds are common trust funds, as defined in section 584(a) of the Internal Revenue Code of 1954.

Although four of the funds are denominated as legal common trust funds and the other funds are discretionary common trust funds, all of the funds are presently authorized by their respective plan of operation and the New York Banking Law to be invested in such investments as the trustee may select in its discretion. The equity funds have been invested primarily in common stocks. The taxable income funds have been invested primarily in preferred stocks and bonds. The Southern, Northern, and Eastern funds have maintained a balance between common stocks and preferred stocks and bonds.

Upon completion of the proposed merger of the subsidiary banks on January 1, 1976, Marine will become successor Trustee of each of the existing common trust funds. The funds will then be administered from Marine's Buffalo office, and will be subject to the audit jurisdiction of the Buffalo District Office of the Internal Revenue Service. At present, the Audit jurisdiction for the Western, Rochester, Central, Southern, and Northern Funds is in the Buffalo District Office; the audit jurisdiction for the Eastern Fund is in the Albany District Office; and audit jurisdiction for the New York Funds is in the Manhattan District Office.

The Marine Board of Directors will adopt resolutions in December, 1975, effective as of January, 1976, to make the following necessary amendments to the Plans of Operation of the eleven funds:

(1) The Western Equity Fund will be renamed Marine Midland Bank—Diversified Investment Fund—Equity (Marine Equity Fund), and the Western Taxable Income Fund will be renamed Marine Midland Banks—Diversified Investment Fund—Taxable Income (Marine Taxable Income Fund).

(2) The quarterly valuation dates of the Central Equity Fund, the Central Taxable Income Fund, and the Eastern Fund will be changed from the last bank business day of February, May, August, and November of each year to the last bank business day of January, April, July, and October of each year, to conform the quarterly valuation dates of these three funds to the quarterly valuation dates of the other eight funds involved in the proposed transaction, including the two continuing funds.

(3) The proposed splits and mergers will be directed, as of a date to be selected by the trust investment committee after necessary approval by the New York State Banking Board.

It is proposed that on January 31, 1976, or as soon thereafter as Marine deems it feasible, the Southern, Northern, and Eastern Funds will each be split into Equity and Taxable Income Sub-funds. The respective Equity Sub-funds will receive the equity securities and a portion of the cash in the Southern, Northern, and Eastern Funds on that date; and the respective Taxable Income Sub-funds will receive the taxable income securities and a portion of the cash in the Southern, Northern, and Eastern Funds on that date.

Further, it is proposed that on January 31, 1976, or as soon thereafter as Marine deems it feasible, the following Equity Funds and Sub-Funds will then merge into the Marine Equity Fund (formerly the Western Equity Fund): New York Equity Fund, Central Equity Fund, Rochester Equity Fund, Southern Equity Sub-Fund, Northern Equity Sub-Fund, and Eastern Equity Sub-Fund.

The following Taxable Income Funds and Sub-Funds will merge into the Marine Taxable Income Fund (formerly the Western Taxable Income Fund): New York Taxable Income Fund, Central Taxable Income Fund, Rochester Taxable Income Fund, Southern Taxable Income Sub-Fund, Northern Taxable Income Sub-Fund, and Eastern Taxable Income Sub-Fund.

On the effective date of the split of the Southern, Northern, and Eastern Funds into Euity Sub-Funds and Taxable Income Sub-Funds, each participant in the Southern, Northern, or Eastern Fund will be issued the same number of units of participation in each of the Sub-Funds resulting from the split as the participant held in the Fund before the split. For example, a participant holding 100 units of participation in the Northern Fund will be issued 100 units of participation in the Northern Equity Sub-Fund and 100 units of participation in the Northern Taxable Income Sub-Fund.

Since there will be changes in the investment portfolios of the Southern, Northern, and Eastern Funds prior to the anticipated date of the split on January 31, 1976, it cannot now be determined what the exact relationship of the fair market value and the adjusted basis of the equity and taxable income portions of these funds will be on the date of the split. However, it is anticipated that the fair market value of the assets transferred from the Southern, Northern, and Eastern Funds to one or the other of their respective Equity or Taxable Income Sub-Funds will be within three percent of the adjusted basis of such assets in the Funds on the date of the split. Thus, the fair market value and adjusted basis of the assets transferred to one or the other of the respective Equity or Taxable Income Sub-Funds will be "very close," in accordance with the provisions of Revenue Rulings 68-77, 1968-1 C. B. 280.

It is proposed that the allocation of tax basis to the participants in the Southern, Northern, and Eastern Funds, as between their units of participation in the Southern, Northern, and Eastern Equity and Taxable Income Sub-Funds, be made in accordance with the "subtraction" method. Pursuant to this method, if the adjusted basis of the assets being transferred from a fund to a sub-fund is very close to the market value of such assets on the date of the split, a participant's adjusted basis for each of its units of the sub-fund is determined by dividing the adjusted basis of the assets of the sub-fund by the number of units in the sub-fund. By subtracting the participant's adjusted basis for a unit of the sub-fund, as so determined, from the participant's adjusted basis for each of its units of the fund before the split; the participant's adjusted basis for each such unit in the other sub-fund created by the split is then determined. Since the Southern, Northern, and Eastern Funds have maintained separate basis records for each lot of participating units purchased at any one time, the above-described computation involving adjusted basis will be made on a per lot basis for the units of each participant in any of these Funds.

The property constituting the assets of the New York, Central, and Rochester Equity Funds and the Southern, Northern, and Eastern Equity Sub-Funds will be transferred to, and become a part of, the property constituting the Marine

Equity Fund (formerly the Western Equity Fund). In like manner, the property constituting the assets of the New York, Central, and Rochester Taxable Income Funds and the Southern, Northern, and Eastern Taxable Income Sub-Funds will be transferred to, and become a part of, the property constituting the Marine Taxable Income Fund (formerly the Western Taxable Income Fund).

As a result of these mergers, participants in the merging Funds and Sub-Funds will receive units of participation in the receiving Marine Fund and cash equal to the fair market value of their total units of participation in the merging Funds or Sub-Funds on the date of the merger. The unit value of participations in the receiving Marine Fund, immediately prior to the merger, will be the unit value of all participations in the Fund after the merger, including the participations to be issued to the participants in the merging funds. The number of units of participation of the receiving Marine Fund that each recipient in a merging Fund or Sub-Fund will be entitled to receive will be determined by multiplying (1) a fraction, the numerator of which will be the total value of the merging Fund or Sub-Fund and the denomination of which will be the value of a unit of participation in the receiving Marine Fund, by (2) a fraction, the numerator of which will be the number of units held by the particular participant in the merging Fund or Sub-Fund and the denominator of which will be the total number of units of participation in the merging Fund or Sub-Fund. Cash will be paid in lieu of fractional units of participation in the receiving Marine Fund.

All of the merging funds and sub-funds will have separate basis records for each lot of participating units purchased at any one time. Therefore, for purposes of determining the adjusted basis of units in the receiving fund issued to each participant as a result of the merger, each lot will be treated as a separate participant. The total adjusted basis of the units held in each separate lot before the merger will be the total adjusted basis of corresponding units of the receiving fund attributable to the lot. Fractions of units of the receiving fund attributable to each separate lot for each participant in a merging fund or sub-fund will be aggregated in a new lot for each participant, with a weighted average adjusted basis derived from the adjusted basis of these fractions of units comprising the new lot.

Any accrued income or liabilities attributable to the assets of any merging Fund or Sub-Fund at the date of the transfer will attach to the receiving Marine Fund by reference to the items to which the accrued income or liability is attributable.

Based upon the foregoing facts, and assuming that the proposed transaction and the underlying bank merger receive necessary regulatory approval and are carried out in the manner proposed, it is concluded as follows:

(1) The proposed splits of the Southern, Northern, and Eastern Funds into their respective Equity Sub-Funds and Taxable Income Sub-Funds will not result in the recognition of gain or loss to these Funds or to their participants. Rev. Rul. 68-77, 1968-1 C.B. 289.

(2) The assets transferred to the Southern, Northern, and Eastern Equity Sub-Funds and Taxable Income Sub-Funds will retain the same basis in those Sub-Funds as they had in the Southern, Northern, or Eastern Funds immediately prior to the splits. Rev. Rul. 68-77, 1968-1 C.B. 289.

(3) The holding period for the assets received by the Southern, Northern, and Eastern Equity Sub-Funds and Taxable Income Sub-Funds, as a result of the splits of the Southern, Northern, and Eastern Funds, will include the periods during which such assets were held in the Southern, Northern, or Eastern Funds, respectively, Rev. Rul. 68-77, 1968-1 C.B. 289.

(4) The adjusted basis for each participant's units of participation in the respective Sub-Funds, received as a result of the splits of the Southern. Northern, and Eastern Funds into Equity Sub-Funds and Taxable Income Sub-Funds, may be determined by the use of the "subtraction" method, as described in Revenue Ruling 68-77; if the adjusted basis of the assets of these Funds transferred to either of their respective Equity Sub-Fund or Taxable Income Sub-Fund is very close to the fair market value of such assets on the effective date of the split of these Funds. Rev. Rul. 68-77, 1968-1 C.B. 289.

(5) The holding period for each participant's units of participation in the Southern, Northern, or Eastern Equity Sub-Funds, received as a result of the splits of the Southern, Northern, and Eastern Funds, respectively, will include the period during which the participant held corresponding units of participation in the Southern, Northern, or Eastern Funds, respectively. Section 1223(1) of the Code.

(6) The proposed merger of the New York, Central, and Rochester Equity Funds and the Southern, Northern, and Eastern Equity Sub-Funds into the Marine Equity Fund will not result in the recognition of gain or loss to these Funds and Sub-Funds or to their participants. In like manner, the proposed merger of the New York, Central, and Rochester Taxable Income Sub-Funds into the Marine Taxable Income Fund will not result in the recognition of gain or loss to these Funds and Sub-Funds or to their participants. Rev. Rul. 55-299, 1955-1 C.B. 402.

(7) For Federal income tax purposes, distribution of cash to participants in the merging Funds or Sub-Funds in order to eliminate fractional units of participation held by participants upon the mergers shall be treated as proceeds from the sale or exchange of such fractional units of participating interests. Rev. Rul. 60-240, 1960-2 C.B. 192.

(8) The adjusted basis of the assets received by Marine Equity Fund and Marine Taxable Income Fund, as a result of the merger, will remain the name in these Funds as the adjusted basis of such assets in the various merging Equity Funds and Sub-Funds, and Taxable Income Funds and Sub-Funds, respectively. Rev. Rul. 55-299, 1955-1 C.B. 402.

(9) The holding period for the assets received by Marine Equity Fund and Marine Taxable Income, Fund as a result of the mergers, will include the periods during which such assets were held by the merged Equity Funds and Sub-Funds, or the merged Taxable Income Funds and Sub-Funds, respectively. Section 1223(1) of the Code.

(10) The adjusted basis of each participant's units of participation in Marine Equity Fund and Marine Taxable Income Fund, issued as a result of the mergers, will be the same as the adjusted basis of the corresponding units of participation held by the participant in the merged Equity Funds or Sub-Funds, or the merged Taxable Income Funds or Sub-Funds, immediately prior to the mergers, reduced by the amount of each participant's adjusted basis attributable to a fractional unit of Marine Equity Fund or Marine Taxable Income Fund that is eliminated. Rev. Rul. 55-299, 1955-1 C.B. 402.

(11) The holding period for each participant's units of participation in the Marine Equity Fund or Marine Taxable Income Fund, received as a result of the mergers, will include the period during which the participant held corresponding units of participation in the merged Equity Funds or Sub-Funds, or the merged Taxable Income Funds or Sub-Funds, respectively. Section 1223(1) of the Code.

No opinion is expressed concerning the Federal income tax consequences of the proposed transactions under the provisions of any section of the Code not specifically mentioned herein.

It is important that a copy of this letter be attached to the first return filed for the common trust funds involved. A copy is enclosed for that purpose.

Pursuant to a power of attorney on file in this office, a copy of this letter is being forwarded to William A. Bain, Jr., Esq.

Sincerely yours,

(Signed) BILLY HARGETT,
Chief, Individual Income Tax Branch.

AMERICAN GAS ASSOCIATION,
Arlington, Va., July 22, 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: The American Gas Association commends your Committee for its leadership in developing a National Energy Policy, as reflected in the Committee's Amendments to H.R. 10612. We believe certain modifications are essential to ensure that your continued goals of optimum energy resource development and optimum efficiency in energy resource utilization are realized.

We enclose, herewith, our statement and request that this be made a part of your proceedings. For your convenience, we have summarized its salient points in the briefing memorandum, also enclosed.

The American Gas Association urges:

(1) That our customer's capital contributions not be subject to dilution by taxation.

(2) That the tax credit provided for heat pumps (Section 2002) be expanded to provide an equal credit for installing new, more energy efficient gas and oil-fired furnaces; and,

(3) That the credit proposed for coal gasification equipment (Section 2003) is essential to the commercial development of coal gasification technology.

Your Bill contains important steps to ensure optimum development of our domestic fuel resources. We must also ensure that our consumers are encouraged to use the most energy efficient, least expensive, most environmentally sound heating systems available. The modifications we have proposed will make an important contribution to this goal.

Very truly yours,

GEORGE H. LAWRENCE.

PRINCIPAL POINTS JUSTIFYING GAS EQUIPMENT TAX INCENTIVES

1. With free market pricing policies for natural gas, a diligent energy research program, and a sound National Energy Policy, there are adequate potential gaseous energy supplies to meet our nation's needs well into the 21st Century—a 90 to 120 year supply at present consumption levels.

2. Gas-fired systems are the most energy efficient; for example, some 60% more energy efficient than electric heat, some 30% more energy efficient than oil furnaces.

3. The gas industry provides our most capital efficient energy system. Gas has a 9 to 1 capital efficiency advantage over electricity.

4. Gas is our most environmentally compatible fuel, universally acknowledged by government and environmental sources.

5. Section 2003 credits for coal gasification are the best investment our nation could make. Taxes from the wages from the jobs created in the construction and operation of the coal gas plants, alone, will more than offset the revenue loss from the credit, while plant output will reduce our foreign payments by as much as $3.7 billion annually by 1990. The incentive to move ahead with this most economic and efficient use of our vast domestic coal supplies offers an overwhelming justification.

6. Section 2002, as drafted, could *waste* as much as *44 quadrillion Btu's* annually; enough to heat 400,000 single family residences each year, by encouraging consumer shifts from more efficient gas furnaces to less efficient heat pump installations.

7. New gas-fired heating systems are 30 to 60% more energy efficient than the typical gas-fired heating installation of 20 or more years ago. The revenue loss in tax credit to encourage these investments is some $45 million.

8. The Committee Staff estimate of the revenue loss from the Section 2002 heat pump credit is significantly understated. *The Committee Staff estimates the revenue loss at $3 million* in the first year. *Our estimates show the potential revenue loss as high as $375 million.*

In view of the foregoing, it is the recommendation of the American Gas Association that the heat pump credit be limited to replacement of electric resistance heating only and expanding the credit to encourage replacement of gas and oil-fired systems with new, more energy efficient gas and oil-fired systems would result in less revenue loss ($177 million), and would produce significant energy savings.

TAX INCENTIVES ESSENTIAL TO IMPROVE ENERGY EFFICIENCIES AND SUPPLIES

The American Gas Association welcomes this opportunity to present its views on the provisions of the Senate Finance Committee Amendments to H.R. 10612. We have asked time to address this Committee to emphasize the need for tax incentives to help this country meet its growing energy supply crisis.

The American Gas Association (A.G.A.) is the national trade association representing some 300 natural gas distribution and transmission companies. A.G.A.'s member companies provide approximately 85 per cent of the nations natural gas utility sales to an estimated 160 million customers through a one-million mile pipeline network. The natural gas industry is the nation's sixth largest with an investment of some $50 billion in that pipeline system and related facilities.

A.G.A. stresses the urgent need to establish a sound National Energy Policy. It is with regret that we must report, candidly, that neither the Administration nor the Congress has as yet established a meaningful cohesive energy policy.

The tax bill you have reported, contains provisions that have the promise of a sound beginning; with minor modifications, it could provide this nation with the leadership in energy policy matters that is so sadly lacking.

The goals of a sound energy policy should be to encourage: greater discoveries and production of our domestic energy resources; development of new domestic energy resources, and greater efficiency in ou ruse of our energy resources. To achieve these goals, we must encourage private sector investment in discovery and production of new reserves, and in the development of new energy resources technologies' and, we must encourage the consumer to select the most efficient fuel to serve his energy needs and to select the most energy efficent equipment possible to utilize that fuel.

The current crisis of deliverable supplies of natural gas available to the interstate gas market tends to obscure the fact that when existing reserves, and potential new discoveries of new reserves are taken into consideration, natural gas is our second most plentiful fuel—second only to coal. When you recognize that we have the capability to make synthetic gas from coal commercially available, and you add to our energy resource base the gas supplies available from imported LNG, it is obvious that, with sound conservation practices, there are ample supplies of gaseous energy to meet the projected U.S. demand requirements well into the 21st century. Attached as Exhibit A is a study of our energy resource base, with emphasis on gas demand and supply availability through the year 2000.

In examining the needs of our National Energy Policy, the Committee must focus on the relative efficiencies of the alternate fuel systems which are available. It must ensure that its tax credit policies do not encourage inefficient use of our fuel resources. And, the Committee must focus upon the relative impacts which our alternate fuel systems have upon our ecology and our economy. If we do not respect these essential restraints, we run the risk of destroying the quality of our life in attempting to manage our energy resource needs.

There are three principal facts concerning gaseous energy that should be used as the cornerstones of our National Energy Policy:

1. GAS-FIRED SYSTEMS ARE THE MOST ENERGY EFFICIENT

It is an engineering fact that it takes fewer Btu's of energy from gas to serve our space heating requirements than any other energy form. The gas furnace is some 60 per cent more energy efficient than electric heat and some 30 per cent more energy efficient than the oil furnace. We invite your attention to Exhibit B which studies this fact in greater detail. Thus, utilizing gas to serve our space heating needs would have the equivalent effect of a 30 per cent increase in our domestic base, and could reduce our fuel import requirements by some 10 per cent or more.

2. GAS IS OUR MOST CAPITAL EFFICIENT ENERGY SYSTEM

Our natural gas industry, on a capital investment of $50 billion, serves more than 30 percent of the energy requirements of our country. In contrast, the electric utility industry, on a capital base of $132 billion, serves less than 10 per cent of our nation's energy needs. This is a 9–1 capital efficiency in favor of the gas industry. And, this capital efficiency advantage is extended to our consumers as well as our stockholders.

For example, while the costs of installation of a gas furnace as compared to an electric furnace are substantially the same, the electric furnace is significantly more costly to operate. Indeed, on the average, a gas furnace will save the consumer some $490 per year over the operating cost of an electric furnace, or some $130 per year over the operating cost of an oil furnace. When these savings are projected nationally, their impact can be fully appreciated. It would cost the nation's consumers $16.7 billion more annually if they were forced to switch to electric heating, or $10.9 billion if the heat pump is used—and this ignores the capital costs of conversion to the customer in switching heating systems. Thus, gas systems can be one of our most important inflation fighters. We can reduce the capital needed to serve our energy requirements, and at the same time, reduce our consumers' energy costs. Exhibit B and Exhibit C study these facts in greater detail for the Committee.

3. GAS IS OUR MOST ENVIRONMENTALLY COMPATIBLE FUEL

As we enter our third century as a nation, we are increasingly conscious of our responsibilities to our neighbors, as well as to future generations of Ameri-

cans. We recognize as an essential national priority, the necessity, to the maximum extent possible, of preserving our environment from further degradation. Natural gas—our nation's cleanest fuel resource—is an important tool in reducing the adverse impacts of our energy upon our environment.

The physical characteristics of natural gas are such that it is an environmenally superior fuel. Natural gas does not pollute land or water and offers the best hope for alleviating air pollution, especially in urban areas. The Council on Environmental Quality Report of August 1973, entitled "Energy and the Environment," states:

"Natural gas is by far the least environmentally damaging of the fossil fuel alternatives. There is essentially no water pollution other than thermal discharge, and total air pollution is less than 5 per cent of the emissions from a coal system and is significantly less than from an oil system. There are no solid wastes."

Natural gas is not subject to the limitations placed on certain fuel uses through national ambient air standards under the Clean Air Act of 1970. Natural gas is virtually free of sulphur and particulates. Primary and secondary standards for sulphur oxides, carbon monoxide, hydrocarbons, and nitrogen oxides have limited the use of coal and oil for energy in industrial processes. Consequently, low sulphur content fuels, such as natural gas, have been relied upon heavily as energy sources, with fuel oil and coal serving secondary or alternate roles, depending upon the use of fuel clean-up technology.

Natural gas provides the aesthetic benefit of a gas transmission system that consists of a million-mile network of pipes and mains laid underground. Natural gas pipelines are laid at a minimum depth of 24 inches regardless of the terrain, which allows the land to be used in the same manner as was customary prior to the introduction of the pipeline. Once a pipeline is placed underground, the landscape is fully restored to a natural or an acceptable man-made condition. Areas prone to high levels of erosion are terraced and seeded. Drainage systems, including construction of erosion control dams, are created where necessary. Key locations of the pipelines are marked as inconspicuously as possible. The natural gas industry has also been phasing out its large above-ground holders over the last decade. Large underground storage fields and underground high-pressure storage mains are being utilized in place of the above-ground gas tanks.

As Congress takes the needed steps toward meeting the nation's energy supply, the contribution that natural gas can make toward meeting our national environmental goals must be considered. We attach as Exhibits D, E and F, studies of the relative environmental impacts of alternate fuel systems. You will note that, even as we turn to a reliance on coal as a gaseous resource, gasification of coal, a chemical rather than burning process, is the least environmentally damaging means of converting the potential of coal into useable energy.

Thus, our gaseous energy production, transportation and consumption systems are an important tool in our nation's commitment to preserving a clean environment for future generations.

H.R. 10612, AS AMENDED BY THE SENATE FINANCE COMMITTEE CAN, WITH MINOR MODIFICATIONS, BE A SIGNIFICANT CORNERSTONE FOR A SOUND NATIONAL ENERGY POLICY

With these general principals recognized, I would like to turn to the specific provisions of the bill before you. At the outset I wish to reiterate our support for the need to protect our customers' contributions in-aid-of-construction from taxation. A previous witness has examined this in detail. We simply stress that in this period of capital shortage we must insure that tax policies do not unduly aggravate our self-help capital formation policies. Turning to the remaining provisions of H.R. 10612, I would like to discuss two provisions of special concern to us.

SECTION 2008—CREDITS ESSENTIAL TO COMMERCIAL DEMONSTRATION OF COAL GASIFICATION TECHNOLOGY

With all of the attributes favoring gaseous energy, it is important to our nation's economic vitality that we pursue those steps essential to the viability of the gas industry. Germaine to today's hearings is the provision of the Bill, Section 2008, to provide much needed tax credits to assist the industry in proving the commercial feasibility of the production of synthetic natural gas from coal.

The revenue loss which will result from this credit could well be the best investment opportunity our nation will ever have. Our projected coal gas developments will reduce our foreign payments deficit by $900 million, annually, by 1985, and this will grow to $3.7 billion per year by 1990. Coal gasification projects will add more than 1,100 operating jobs for each plant to the American economy, representing more than $23 million annually, per plant, in wages alone.

In addition, during peak construction periods, each plant will require 4,300 workers, representing a gross plant construction payroll of $200 million per plant. Thus, the five projected plants would add 5,500 new permanent jobs to our economy, representing $115 million, annually in new wages, plus $1 billion in construction labor expenses. The tax contribution of these wages would exceed $22 million, annually for operating personnel in 1985, plus $200 million from plant construction labor. Plainly, the annual taxes from employees' wages alone will more than offset the revenue loss from the proposed credit.

Surely such a wise incentive policy cannot be fairly characterized as "special interest legislation."

TAX CREDITS TO IMPROVE ENERGY EFFICIENCIES SOUND NATIONAL POLICY. AMENDMENTS ESSENTIAL TO ACHIEVE OPTIMUM ENERGY EFFICIENCIES

There are in the bill other provisions, specifically Sections 2001 and 2002, which reflect a step in the right direction towards a sound national energy policy. The concept of a tax credit to encourage consumer investments in more energy-efficient equipment is a sound national policy if we are to make meaningful progress in achieving more efficient use of our energy resources. However, the manner in which such credits are now limited are not only discriminatory, but fall far short of encouraging optimum efficiencies. Accordingly, we urge that Section 2002 of the bill be amended to extend the definition of equipment qualifying for the credit so as to include investments in new gas- or oil-fired central heating equipment which result in upgrading the energy efficiency of the existing heating system. And, we further urge amendment to Section 2001 to allow credits for investments in modifications of existing installations that improve the energy efficiencies of the system.

We commend the Committee for recognizing—in Sections 2001 and 2002 of the bill—the urgent need to improve the energy use efficiencies of our home heating systems in the United States. And, we concur with Committee's judgment that use of the tax credit incentives is an appropriate means to achieve this objective with minimum intrusion into the consumer's freedom of choice, minimum cost in terms of the government bureaucracy required to administer such a program, and, with maximum impact in terms of eligible citizens participating in the benefits of the program.

Critics have attacked the provisions of the bill as "special interest legislation." Surely they must be uninformed as to both the need, and as to the consequences of the bill.

The American Gas Association does believe that the bill in its present form is discriminatory. As presently drafted, the credit allowed by Section 2002 would be available only for qualified solar heating equipment or qualified heat pump equipment. Insofar as heat pump equipment is concerned, the typical commercially available heat pump equipment is the electrically-operated combined cooling and heating unit. It is widely recognized that such equipment provides significantly higher energy use efficiency than existing installed resistance type electric heating systems. However, such units are decidedly less energy efficient than gas-fired heating systems currently available to consumers. We attach hereto as Exhibit G, a detailed analysis of the comparative energy efficiencies of electric heat pumps and of gas-fired heating equipment.

The Committee must keep in mind one very important fact if it encourages conversion to heat pumps. Since the heat pump is by definition an air conditioning unit, limiting the availability of the credit to heat pumps will severely aggravate the summer air conditioning loads on our already over-burdened summer peaking electrical systems. The tax credit is an incentive for improving the energy efficiencies of our home heating systems could make a significant contribution to American energy independence. However, the Committee must encourage energy efficiency improvement, not merely consumer shifts from one resource to another. For example, the material presented to the Committee in support of the heat pump credit plainly shows that the electric heat pump is more energy efficient only when used to replace electric resistance type heating.

As the U.S. Council on Environmental Quality states in its August 1973 Report (Exhibit B-3), "Energy and the Environment—Electric Power:"

"The conversion of gas and electricity into useful work is the final step in two extensive energy systems that begin when the fuel is extracted and end at the point of use.

"When the total system is considerd, all the gas-fired appliances are more efficient than their electric-powered counterparts."

Critics assail the bill as "special interest legislation." As presently drafted, this may be a fair characterization. But, that can, and should be, easily corrected by expanding the availability of the credit to apply to all replacement furnaces which significantly improve the energy efficiency of an existing heating system. As presently drafted, the bill has the danger of encouraging the householder to convert from the more energy efficient gas- and oil-fired central heating to electric heat pump installations. If not corrected, this oversight could result in significant energy waste to the nation. For example, new gas-fired central heating systems are themselves some 30 to 60 percent more energy efficient than the typical gas heating installation in our homes 20 or more years ago. Thus, with appropriate incentives which the tax credit would provide, the householder could be encouraged to invest in the more accurately-sized, more energy efficient gas-fired systems available today.

The average annual replacement market for gas-fired home furnaces is estimated to be in the range of 1,000,000 units. Assuming a 40 percent energy use gain by installing new efficient systems, this would result in annual net energy savings of 44 quadrillion Btu per year, each year, enough to heat 400,000 single-family residences each year.

THE REVENUE IMPACT

We urge the Committee to correct the obvious errors in its assessment of the revenue impact resulting from the proposed credit.

The Finance Committee staff estimate of Revenue Impact—$3,000,000, in the first year—is significantly understated—our figures show a $375,000,000 revenue impact loss. For example:

(*a*) Committee staff used estimated cost of heat pump at $1,500; Treasury shows a cost of $2,500 per unit. GE puts the cost at $2,600.

(*b*) Staff estimated only 1,428 replacement units would qualify in the first year, doubling to 2,856 by the third year. ($3,000,000÷262.50=1,428) By contrast, the Treasury shows an estimated 250,000 units qualifying, annually. The revenue impact for this would be: 250,000/units=387.50 (assuming $2,500/unit cost) Credit/Unit×250,000=$96,875,000 or $100,000,000 if we accept GE's cost figures. And, this assumes that only electric resistance warm air systems replacements qualify for the credit.

(*c*) Since the bill would open up the entire replacement market of gas- and oil-fired equipment, assuming the validity of GE data, the potential market and resultant revenue loss would be: [Note we have assumed full replacement in the oil heat installation because of the advantage the credit would provide. In the gas market, we estimate only a 10 percent replacement because GE figures show gas is still more cost efficient.]

Oil-Fired Equipment

400,000 units annually. GE's estimate of average heat pump conversion cost: $3,850. Credit: $556.25=$222,500,000 Revenue Loss.

Gas Furnace Market

Total Annual Replacement Units: 1,000,000. Assume 10 percent Market Penetration: 100,000. Annual installation cost: $3,850 (from GE's presentation to Committee). Credit: $556.25. Revenue Impact: $55,625,000. Thus, the total potential revenue impact would be $375,000,000, annually, not the $3,000,000 estimated by staff.

In contrast, limiting the credit to replacement of resistance type heating for the heat pump, and replacement of oil- and gas-fired equipment with even more efficient gas- or oil-fired equipment would achieve significantly greater energy savings and less than half the revenue loss:

Heat pumps	$96, 000, 000
Gas furnaces	45, 000, 000
Oil furnaces	36, 000, 000
Total	177, 000, 000

Accordingly, A.G.A. urges that Section 2002 be further amended so as to insure that, to the maximum extent possible consistent with his freedom of choice, the consumer is encouraged to select the most energy efficient home heating system available to serve his particular needs. We recommend that Section 2002 of the bill be amended to extend the definition of equipment qualifying for the credit so as to include investments in new gas- or oil-fired central heating equipment which result in upgrading the energy efficiency of the existing heating system.

We further recommend that Section 2001 be amended to provide credits to consumers who invest in modification of their existing heating systems to improve the energy efficiency of those systems.

EXHIBIT A.—Analysis of Future Gas Supplies

With a sound national energy policy, including a free market pricing policy at point of production and sound energy conservation practices, there are adequate supplies of gaseous energy to serve our nation's needs well into the 21st Century.

At present rate of consumption—an 11-year supply of proven reserves. And, the phase out of boiler fuel usage of natural gas will stretch this supply for our high priority residential and process fuel users by as much as 30 percent.

Additonal potential reserves, as yet unproven in Alaska and lower 48 states and beneath our outer continental shelves, add another 40 to 50 years supply.

The use of advanced fracturing techniques to crack tightly held gas formations in the Rocky Mountains could add another 10 years supply.

Coal gasification—gas from coal supplies gives us at least another 20 years supply.

Liquified natural gas imports and synthetic gas from liquid hydrocarbons will supply 12 percent of our needs annually, by 1990.

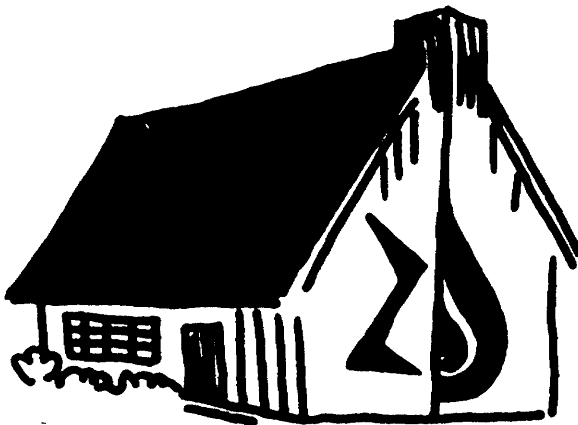
Thus, supplies and technology exist to serve the gaseous energy needs for the next 90 to 129 years.

EXHIBIT B-1

HEED* REPORT

the LIVING DIFFERENCE project

The *Living Difference Project*, a carefully monitored study of two identical homes—comparing the use of electricity and natural gas for space heating, water heating, cooking and clothes drying



Conducted by Nationwide Consumer Testing Institute
for
The East Ohio Gas Company

*HALT EXCESS ENERGY DRAIN

INTRODUCTION

The purpose of the Living Difference Test Home Project, originally conceived by the East Ohio Gas Company, was to compare two real homes under actual living conditions, both highly instrumented and rigidly controlled.

The project was a combined effort of research and marketing, with emphasis on conducting an unbiased study, which would provide accurate information to marketing management. The test was initiated before the "energy crisis" and was conducted during a period when "cleanliness, comfort and fuel cost savings" were major marketing efforts of gas utilities.

Although the study was never intended to be used as a comparative energy utilization study, either on a point-of-use or primary basis, the study results lend perfectly to this task of proving energy efficiency of natural gas for certain tasks. As an unbiased source, the study has provided data toward improving equipment performance and demonstrating actual advantages of using gas energy for specific tasks.

The test used two identically constructed, insulated and furnished homes, occupied by two similar families. One of the homes was heated by gas and had gas-fueled appliances. The other had electric heating and electric appliances. The energy requirements of each home were carefully measured.

Since consumer believability was one of the objectives, the Nationwide Consumer Testing Institute was engaged to conduct the project and to certify its results.

Test families were selected from over 600 newcomers to the Canton area. The Psychometrics Division of Nationwide conducted interviews and recommended four finalist families, two of which were chosen as test participants. The families were matched as closely as possible by age, family composition, background, taste and economic situation. In the electric home, Nationwide approved a heating system of electrical baseboard units, operated by individual room thermostats.

A central forced air system was selected for the gas home.

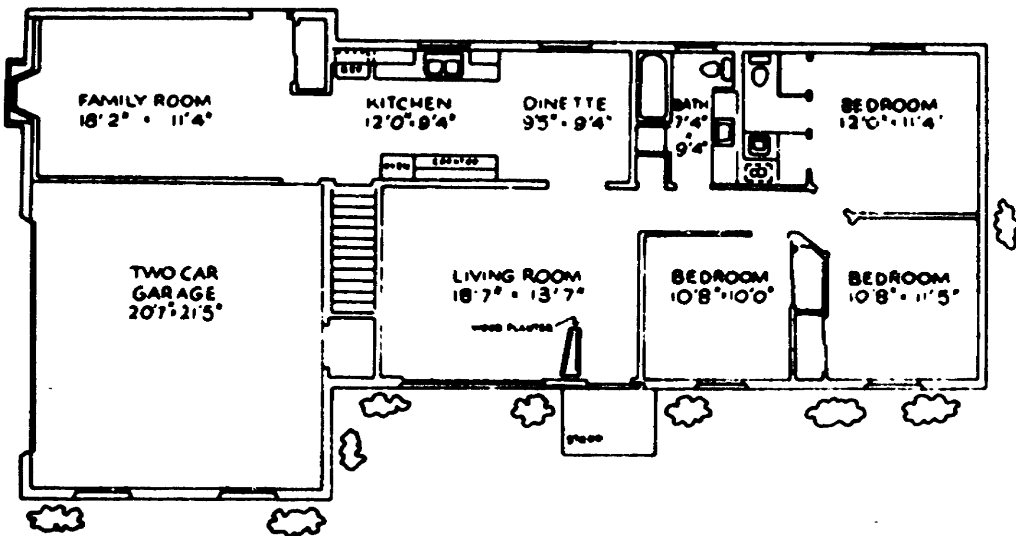
A single-story, 1,270 square foot, ranch-style home representative of the area was selected. The actual design consisted of three bedrooms and one and one-half baths (see floor plan).

Each house had six inches of blown insulation in the ceiling and four inches in the walls. In addition, both homes had storm windows and doors. The exteriors of both homes were identical in construction and color.

During the construction period, East Ohio and Nationwide Consumer Testing Institute maintained a rigid on-site inspection. Except for the fuel difference, both homes were identical down to the wall colors, the furniture, and even the type of telephone installed. The fuel choice appliances (stove, oven, clothes dryer and water heater) within each home were matched according to input features and styling. Appliances were individually metered and, when possible, counters and timers were used to check operating patterns. This preoccupation with appliance profile is important. Preliminary estimates indicated that one-sixth of each home's heating requirements would be supplied by internal heat gain from occupants, lighting and appliances; so it was necessary to have similar appliance operation. In order to evaluate temperature control in each home, equivalent heat-storage conditions had to be assured. Therefore, both families were provided with the same furniture, draperies, carpeting, etc.

Living Difference Test Home

Floor Plan



All thermostats were locked at 72½ degrees Fahrenheit. In addition, an electronic system monitored environmental conditions within both homes. The locations of temperature and humidity centers are shown on the floor plan and, although not pictured, outside temperature was also recorded. Each of these points was interrogated hourly by instrumentation housed on a vacant lot between the two homes. To be absolutely certain that the test results were unbiased, the families were switched between the two test homes to eliminate, as much as possible, the human factor in energy savings.

Given that introduction, here are details of the individual appliances and their consumption.

COOKING

Meal counts were obtained from daily logs and energy meters were read four times each month. The profile charts were used to determine data reliability and to signal trend changes. The monthly consumptions from Table One can be used to obtain an estimate of total annual cooking usage and the gas-to-electric energy ratio. The differences due to cooking habits and interpretation of "hot" meals were essentially equalized by performing two estimates, for the period of October 1965 to August 1966 and September 1966 to January 1967. These input values and results are tabulated below.

TABLE I—LIVING DIFFERENCE MONTHLY COOKING RESULTS

	Average "Hot" Meals[1]		Monthly Cooking Consumption		
			Electric	Gas Test Home	
Month	Electric	Gas	Test Home	Gas	Electric
October, 1965	2.42/Day	1.12/Day	76.3 KWH	621 CF	1.2 KWH
November	2.04	1.54	72.0	538	0.5
December	2.28	1.67	89.5	576	1.0
January, 1966	2.45	1.86	88.8	653	1.0
February	2.43	1.82	66.3	544	0.3
March	2.22	1.56	65.4	577	0.8
April	2.35	1.42	75.0	515	0.3
May	2.55	1.33	79.4	639	0.7
June	2.12	1.13	70.0	512	0.5
July	2.38	0.84	83.0	417	0.5
August[2]	1.52	1.03	66.6	497	0.5
September	1.15	2.47	54.8	701	0.6
October	1.25	2.25	67.8	653	0.9
November	1.09	2.06	59.5	737	0.8
December	0.93	1.97	60.7	670	0.3
January, 1967	0.94/Day	2.15/Day	76.0 KWH	771 CF	1.1 KWH

[1] As reported on daily log sheets.
[2] Families switched on August 17, 1966.

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Annual usage estimates were derived by multiplying average usage for the two periods, by the mean number of reported meals per year (644). For comparison purposes, other sources and estimates are listed below. Although the gas-to-electric energy ratios in these test homes agree reasonably well with other sources, overall cooking consumptions are usually lower. This reduction is attributed to the inclusion of fewer meals in the estimate base.

Period	Item	Meals	Total Cooking Consumption	Consumption Per Meal
Oct. '65 to Aug. '66	Gas Cooking	454	5592 CF	12.32 CF
	Elec. for Gas	"	6.8 KWH	0.014 KWH
	Elec. Cooking	710	765.7 KWH	1.078 KWH
Sept. '66 through Jan. '67	Gas Cooking	330	3532 CF	10.70 CF
	Elec. for Gas	"	3.7 KWH	0.011 KWH
	Elec. Cooking	162	318.8 KWH	1.967 KWH

A Comparison of the Living Difference Test Data To Other Published Information:

Source	Estimated Annual Cooking Consumption Gas	Electric	Energy Ratio
Living Difference Project	77.1 Therms +8 KWH	980 KWH	2.31
USDA-TB1073	109.1 Therms	1606 KWH	1.99
Zinder	103.2 Therms	1452 KWH	2.08
Ohio Power	——	840 KWH	—
A.G.A.	105.0 Therms	———	—

Comparison of Primary Energy Used:

Electric		Primary Energy Consumption
980 KWH × 11,765 BTU/KW	=	11,529,700 BTU/year
Gas		
77.1 Therms × 100,00 BTU/therm	=	7,710,000
8 KWH × 11,765 BTU/KW	=	94,120
		7,804,120 BTU/year

Conclusion: Cooking by electricity uses 1.48 times more primary energy than by natural gas.

CLOTHES DRYING

Clothes dryers were included in both test homes. Consumption and profile metering was attached to obtain good appliance data. The average load per day shows a reversal in trend after the family switched in August of 1966 (see Table Two). This again illustrates the effects of living habits.

TABLE II—LIVING DIFFERENCE MONTHLY CLOTHES DRYING RESULTS

	Average Loads[1] Per Day		Average Minutes Per Load		Monthly Clothes Drying Consumption		
					Electric	Gas Test Home	
Month	Elec.	Gas	Elec.	Gas	Test Home	Gas	Elec.
Oct., 1965	1.15	1.12	58.2	38.8	118.1 KWH	358 CF	7.0 KWH
Nov.	1.30	0.67	50.7	52.7	109.3	285	5.2
Dec.	1.18	0.82	64.9	38.7	136.7	276	5.0
Jan., 1966	1.28	0.76	48.5	50.9	104.5	292	5.7
Feb.	1.61	0.82	47.6	50.3	120.4	327	5.7
March	1.29	0.70	53.4	45.1	107.8	278	4.7
April	1.24	0.73	60.0	51.2	120.0	305	5.5
May	1.24	0.66	63.8	56.7	131.5	357	6.1
June	1.03	0.65	69.3	65.9	105.6	353	6.2
July	1.19	0.53	70.3	55.7	129.9	259	4.4
Aug.[2]	0.94	0.77	75.1	55.4	108.4	327	6.4
Sept.	0.56	1.11	92.9	50.5	81.4	415	8.0
Oct.	0.61	1.14	97.5	42.2	94.6	369	6.6
Nov.	0.65	1.23	92.2	41.7	104.9	480	8.5
Dec.	0.61	1.07	96.6	42.9	86.2	348	6.3
Jan., 1967	0.61	0.97	85.1	50.8	95.2 KWH	428 CF	7.9 KWH

[1] As reported on daily log sheets. Although not listed here, loads were also determined by electric counter attached to the clothes dryer.
[2] Families switched on August 17, 1966.

These consumptions are then averaged and multiplied by the mean test home usage of 338 loads per year to yield the following estimates.

ENERGY CONSUMED IN CLOTHES DRYING:

Period	Item	Loads	Total Clothes Drying Consumption	Consumption Per Load
Oct., '65 to Aug. '66	Gas Clothes Drying	228	3090 CF	13.55 CF
	" " "		55.5 KWH	0.243 KWH
	Elec. Clothes Drying	381	1183.8 KWH	3.107 KWH
Sept., '66 through Jan., '67	Gas Clothes Drying	168	2040 CF	12.14 CF
	" " "		37.3 KWH	0.222 KWH
	Elec. Clothes Drying	92	462.3 KWH	5.025 KWH

As with cooking, other sources have been included for comparison purposes. Although a general agreement exists on the magnitude of other published gas-to-electric energy ratios, there is a large divergence between annual consumption estimates. This, of course, results from the differences in load base used to secure the estimates.

ESTIMATED ANNUAL CLOTHES DRYING CONSUMPTION:

Source	Gas	Electric	Energy Ratio
Living Difference Project	45.2 Therms +89 KWH	1557 KWH	0.91
Zinder	44.4 Therms	1170 KWH	1.11
Ohio Power	———	900 KWH	—
A.G.A.	46.0 Therms	———	—

COMPARISON OF PRIMARY ENERGY USED:

		Primary Energy Consumption
Electric		
1557 KWH × 11,765 BTU/KW	=	18,318,105 BTU
Gas		
45.2 Therms × 100,000 BTU/Therm	=	4,520,000
89 KW × 11,765 BTU/KW	=	1,047,085
		5,567,085 BTU

Conclusion: Drying clothes by electricity used 3.29 times more primary energy to do the same job than natural gas.

WATER HEATING

As with the other appliances installed in the test homes, water heating consumption was submetered to obtain operating data. Both fuel input and hot water output were metered. Both units were set to deliver heated water at 140 degrees F., verified by on-site readings which have indicated ranges from 140 to 147 degrees F. Profile plots of cost of water use revealed little variation in operating patterns. As in the case of cooking and clothes drying, a reversal of use patterns occurred after the families were switched. For this reason, estimates will be compared as illustrated on the next page.

Because of the high summer water heater usage in the all electric house associated with family use of an outdoor wading pool, estimate periods were selected from March to June, 1966, and from September to January.

TABLE III—LIVING DIFFERENCE MONTHLY WATER HEATING RESULTS

	Daily Hot Water Usage				Monthly Water Heating Cnsump.	
Month	Electric		Gas		Electric	Gas
Oct., 1965	112.3 gal.	66.3 MBTU[1]	75.0 gal.	44.3 MBTU	873.2 KWH	3156 CF
Nov.	100.0	59.0	68.0	40.1	750.4	2835
Dec.	102.1	60.2	63.7	37.6	850.6	3109
Jan., 1966	99.6	58.7	78.2	46.1	730.2	3257
Feb.	104.5	61.7	73.5	43.4	732.6	2919
March	96.9	56.5	64.2	38.4	746.2	2834
April	104.4	61.3	70.9	41.2	773.9	2816
May	103.9	59.5	74.7	44.0	867.8	3354
June	132.2	66.0	75.2	43.0	836.0	2840
July	130.3	64.3	60.3	32.0	898.3	2483
Aug.[2]	92.6	48.8	57.7	31.8	814.5	2442
Sept.	74.4	40.8	105.2	60.0	488.9	3549
Oct.	69.2	36.4	99.6	56.5	544.4	3435
Nov.	68.2	35.1	96.9	52.8	639.0	4006
Dec.	70.5	37.4	97.3	54.4	550.6	3437
Jan., 1967	70.8 gal.	36.8 MBTU	96.2 gal.	50.7 MBTU	648.0 KWH	3827 CF

[1] Developed by using a "continuous" flow BTU meter. Results yield lower than actual temperature rise, but do verify similar usage and temperature patterns in both test homes.

[2] Families switched on August 17, 1966.

Period	Item	Gallons	Total	Per Gallon Basis
March '66 to June, '66	Gas Water Htg. Input	6450	9004 CF	1.396 CF
	Output		3798.0 MBTU	@0.589 MBTU
	Elec. Water Htg. Input	9370	2387.9 KWH	0.255 KWH
	Output		5437.5 MBTU	@0.580 MBTU
Sept., '66 through Jan., '67	Gas Water Htg. Input	15020	18254 CF	1.215 CF
	Output		8305.5 MBTU	@0.553 MBTU
	Elec. Water Htg. Input	10710	2870.9 KWH	0.268 KWH
	Output		5649.0 MBTU	@0.527 MBTU

These values are then averaged to yield corrected estimates based on equivalent BTU per gallon outputs. Analysis of the resultant BTU per gallon data yields lower than expected temperature rises. This abnormality is attributable to intermittent flow through the BTU meter. Since the usage pattern in both homes is similar, the resultant energy input estimates (shown on next page) are still considered valid.

	UNCORRECTED	CORRECTED
GAS	1.306 CF/Gal. @ 571 BTU/Gal.	1.288 CF/Gal. @ 563 BTU/Gal.
ELECTRIC	0.262 KWH/Gal. @ 554 BTU/Gal.	0.266 KWH/Gal. @ 563 BTU/Gal.

Multiplication of the corrected energy input estimates by the average test home hot water usage (85 gallons per day) yields the consumption estimate shown below. Other data sources are included for comparison purposes.

Although the test homes' consumption is rather high, reflecting higher hot water usage, their comparative energy ratios are in very close agreement with other published data.

ESTIMATED ANNUAL WATER HEATING CONSUMPTION

Source	Gas	Electric	Energy Ratio
Living Difference Project	446 Therms	8253 KWH	1.58
Zinder	292 Therms	5220 KWH	1.64
A.G.A.	288 Therms	—	—
Ohio Power	—	4880 KWH	—
Univ. of Illinois	—	—	1.46 to 1.60

COMPARISON OF PRIMARY ENERGY USED

Electric		Primary Energy
8253 KWH × 11,765 BTU/KW	=	97,096,545 BTU
Gas		
446 Therms × 100,000 BTU/Therms	=	44,600,000 BTU

Conclusion: Heating water with electricity uses 2.18 times more energy than with natural gas.

HEATING

A central forced air gas system and decentralized electric baseboard units were chosen as the heating systems to be compared. To eliminate any question of bias, the electric heating system was installed by an electric utility-approved heating contractor. Test degree days for the heating period totaled 6.077, which is only 3.1% above the normal 5,896. This indicates that the environmental conditions at the test site closely approximated a typical year.

TABLE IV—LIVING DIFFERENCE MONTHLY HEATING RESULTS

Month	Degree Days	Electric Test Home	Gas Test Home Gas	Gas Test Home Electric
Oct., 1965	462	2407.4 KWH	11.135 MCF	35.0 KWH
Nov.	689	3030.0	16.272	54.1
Dec.	911	3860.3	19.393	85.9
Jan., 1966	1315	4513.4	23.928	100.2
Feb.	991	4126.7	20.122	85.6
March	782	3411.6	16.132	68.5
April	559	2180.5	12.171	52.6
May	368	2123.8	9.734	43.9

Period	Item	Consumption
Oct., '65 to May, '66	Electric Heating	25,653.7 KWH
	Gas Heating	128.887 MCF +525 KWH

COMPARISON OF PRIMARY ENERGY USED

Electric		
25,653.7 × 11,765 BTU/KWH	=	301,815,781 BTU
Gas		
128.887 MCF	=	128,887,000
525.8 KWH × 11,765 BTU/KWH	=	6,186,037
		135,073,037 BTU

It was assumed that electric heating was 100% efficient. Seasonal utilization efficiency for gas heating is subject to variations in both gas furnace operating characteristics and heating requirements in the test homes. During the period from October, 1965, to May, 1966, the overall on-site gas heating utilization efficiency was 65.0% including the blower (with blower—65%; without blower—65.8%). Again, this is based on the identical heating requirements in both test homes and assumed electric efficiency of 100%.

Conclusion: Space heating with electricity uses 2.23 times more primary energy than with natural gas.

COMPOSITE RESULTS

The annual base cost for the electric home came to 36,444 KWH, while the gas home consumed 623 KWH and 1857.3 therms. Using the heat rate of 11,765 BTU/KWH for electric generation systems, the electric appliances consumed 428.76 (10^6) BTU's of primary energy to do the same job as with 192.33 (10^6) of natural gas. Therefore, electricity used approximately 2.23 times more BTU's of primary energy than did natural gas to supply a home with energy annually to cook, dry clothes, heat water, and heat the house.

This factor is used to convert the electric energy to its primary energy equivalent (the energy extracted from Mother Earth in its natural state). On a national average for every kilowatt hour of electricity delivered to the user, 11,765 BTU of energy must be extracted from the earth. This is equal to a 29% system efficiency.

EXHIBIT B-2.—Comparative Analysis, Energy Efficiencies of Alternate Central Heating Systems

TABLE 13-4.—SPACE HEATING EFFICIENCIES BY FUEL FOR THE RESIDENTIAL AND COMMERCIAL SECTOR

[In percent]

Fuel type	Residential	Commercial
Coal	55	70
Natural gas	75	77
Petroleum products	63	76
Electricity	95	95

Source: SRI, 1972: 153.

As shown in Table 13-4, coal efficiency is much higher for commercial establishments than for residences, primarily because of better equipment maintenance and adjustment. Conversely, the efficiency of the larger, more sophisticated commercial natural gas burners is only two percent greater than that of home furnaces. Oil efficiency in commercial establishments is substantially higher than in homes and approaches natural gas efficiency. The efficiencies of coal, gas, and oil heating units are limited primarily by economics. Additional heat exchangers necessary to extract all possible heat from the combustion gases would require substantial capital investment in the heating device.

As indicated in Table 13-4, electric heating is considered 95-percent efficient in both homes and businesses. However, this estimate applies only to the conversion of electricity to heat and does not take into account the conversion of fuel to electricity. In the U. S., the average efficiency for electric power generation plants is about 33 percent (see Chapter 12). Thus, if the efficiency for electrical resistance heating included electricity generation, the total system efficiency would be approximately 30 percent (SRI, 1972: 154).

EXHIBIT B-3.—Comparative Analysis, Alternative Energy Systems CEQ Report

* * * * * * *

Column 1 of Table 6 shows that for all these functions the gas-powered appliance consumes more energy directly than its electric counterpart. For example, an electric stove needs only 49 percent of the energy input of a gas stove.

But this is only part of the story. The conversion of gas and electricity into useful work is the final step in two extensive energy systems that begin when the fuel is extracted and end at the point of use. When the total system is considered, as may be seen in column 2 of Table 6, all the gas-fired appliances are more efficient than their electric-powered counterparts: 1.4 times as much energy is needed to run an electric stove than a gas stove. For home heating, gas is more than twice as efficient as electricity. The low overall efficiency of the electric-powered heating system results from the poor conversion efficiency at the power-plant and the significant transmission line losses.

At the same time that we inefficiently heat our homes and operate many appliances with electricity produced from natural gas, we are also inefficiently using gas to produce light. Almost 4 million gas lamps are lit in the United States, each using about twenty times more energy than its electric equivalent, a 25-watt bulb. The natural gas savings that could be realized by replacing gas lamps with electric bulbs would heat over 600,000 homes annually.

Home appliances consume large amounts of energy, particularly electricity, and there are big differences in the many products designed to do the same job. Yet information on these differences is not available to the consumer when he purchases these products. If it were, it could stimulate savings in energy and in energy bills.

Perhaps greater potential for energy savings can be found in the devices we use for space heating, water heating, and air conditioning. Raising home insulation standards would also be effective.

TABLE 6.—RELATIVE EFFICIENCIES OF RESIDENTIAL USE OF GAS AND ELECTRICITY

	Relative electric energy requirements [1]	
	At point of use	For total system [2]
Space heating	0.79	2.2
Water heating	.70	2.0
Cooking	.49	1.4
Clothes drying	.82	2.4
Central air conditioning	.60	1.8

[1] Gas=1.
[2] Based on Table A-7. The efficiency of delivery to the consumer of electricity vs. gas is 35 percent.

Source: Stanford Research Institute. 1972. "Patterns of Energy Consumption in the United States." Prepared for the President's Office of Science and Technology, Energy Policy Staff. Menlo Park, Calif.: S.R.I., pp. 59, 153.

COMPARATIVE OPERATING COSTS

	GAS	ELECTRIC
Ranges	34¢	$1.00
Dryers	17¢	$1.00
Water Heaters	24¢	$1.00
Space Heating	26¢	$1.00

EXHIBIT C-1

	ANNUAL SAVING		APPLIANCE LIFE (YEARS)		TOTAL SAVINGS
Ranges	$29.12	x	13	=	$378.56
Dryers	42.04	x	10	=	420.40
Water Heaters	139.10	x	10	=	1,391.00
Space Heating	490.87	x	17	=	8,344.79
	$701.13				$10,534.75

EXHIBIT C-2

ADDED COST FOR ELECTRIC

	UNITS IN USE (millions)		ANNUAL ADDITIONAL OPERATING COSTS		US ANNUAL ADDITIONAL OPERATION COSTS (millions)
Ranges	34.5	X	$29.12	=	$1,004.6
Clothes Dryers	~~10.0~~	~~X~~	42.04	=	420.4
Water Heaters	29.2	X	139.10	=	4,061.7
Space Heating	34.1	X	490.87	=	16,738.7
			$701.13		$22,225.4

EXHIBIT C-3

Table 13-6. Residuals for Space Heating Energy Use

End Use Sector	Water Pollutants (Tons/measure)										Air Pollutants (Tons/measure)										
	Acids	Bases	PO_4	NO_3	Total Dissolved Solids	Suspended Solids	Organics	BOD	COD	Thermal (Btu's/measure)	Particulates	NO_x	SO_x	Hydrocarbons	CO	Aldehydes	Solids (tons/measure)	Measure[a,b]	Energy Btu/measure	Multiplier	Multiplier Year
Residential End Use/Fuel																					
SPACE HEAT																					
Natural Gas	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	1.15 $\times 10^{-3}$	3.03 $\times 10^{-3}$	3.45 $\times 10^{-5}$	4.86 $\times 10^{-4}$	1.21 $\times 10^{-3}$	6.05 $\times 10^{-4}$	NA	Dwelling-year	1.25 $\times 10^{8}$	3.5 $\times 10^{7}$	1970
Liquid Petroleum Gas	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	1.21 $\times 10^{-3}$	3.92 $\times 10^{-3}$	7.06 $\times 10^{-4}$	4.9 $\times 10^{-3}$	1.28 $\times 10^{-3}$	6.22 $\times 10^{-4}$	NA	Dwelling-year	1.25 $\times 10^{8}$	3.81 $\times 10^{6}$	1970
Distillate	NA	NA	NA	NA	NA	NA	0	NA	NA	NA	5.01 $\times 10^{-3}$	6.01 $\times 10^{-3}$	1.62 $\times 10^{-2}$	1.5 $\times 10^{-3}$	2.5 $\times 10^{-3}$	.001	NA	Dwelling-year	1.39 $\times 10^{8}$	1.65 $\times 10^{7}$	1970
Electricity	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	Dwelling-year	1.45 $\times 10^{8}$	4.88 $\times 10^{6}$	1970
Commercial End Use/Fuel																					
SPACE HEAT																					
Natural Gas	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	2.32 $\times 10^{-6}$	1.23 $\times 10^{-5}$	7.15 $\times 10^{-8}$	9.78 $\times 10^{-7}$	2.45 $\times 10^{-6}$	1.23 $\times 10^{-6}$	NA	Square foot year	2.52 $\times 10^{5}$	7.37 $\times 10^{9}$	1970
Liquid Petroleum Gas	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	2.45 $\times 10^{-6}$	1.32 $\times 10^{-5}$	1.38 $\times 10^{-6}$	9.87 $\times 10^{-7}$	2.58 $\times 10^{-6}$	1.25 $\times 10^{-6}$	NA	Square foot year	2.52 $\times 10^{5}$	3.3 $\times 10^{8}$	1970
Distillate	NA	NA	NA	NA	NA	NA	0	NA	NA	NA	1.38 $\times 10^{-5}$	5.54 $\times 10^{-5}$	2.90 $\times 10^{-5}$	2.76 $\times 10^{-6}$	1.84 $\times 10^{-7}$	1.84 $\times 10^{-6}$	NA	Square foot year	2.55 $\times 10^{5}$	2.23 $\times 10^{9}$	1970
Residuals	NA	NA	NA	NA	NA	NA	0	NA	NA	NA	1.96 $\times 10^{-5}$	5.12 $\times 10^{-5}$	2.28 $\times 10^{-4}$	2.56 $\times 10^{-6}$	1.71 $\times 10^{-7}$	8.54 $\times 10^{-7}$	NA	Square foot year	2.55 $\times 10^{5}$	4.6 $\times 10^{9}$	1970
Coal	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	1.15 $\times 10^{-4}$	3.39 $\times 10^{-5}$	3.43 $\times 10^{-4}$	1.28 $\times 10^{-5}$	5.64 $\times 10^{-5}$	2.09 $\times 10^{-7}$	U	Square foot year	2.77 $\times 10^{5}$	1.54 $\times 10^{9}$	1970

NA = not applicable. NC = not considered. U = unknown.

[a] Dwelling-year is a heated and cooled typical residence operated for one year.

[b] Square foot-year is a heated and cooled typical square foot of commercial space over a period of one year.

Table 12-4. Residuals for Boiler-Fired Power Plants

SYSTEM	Water Pollutants (Tons/10^{12} Btu's)										Air Pollutants (Tons/10^{12} Btu's)							F/I[a]	Occupational Health 10^{12} Btu's		
	Acids	Bases	PO_4	NO_3	Total Dissolved Solids	Suspended Solids	Organics	BOD	COD	Thermal (Btu's/10^{12})	Particulates	NO_x	SO_x	Hydrocarbons	CO	Aldehydes	Solids (Tons/10^{12} Btu's)	Land Acre-year/10^{12} Btu's	Deaths	Injuries	Man-Days Lost
1 COAL																					
Conventional Steam No controls[b]	25.7	U	U	U	5.81	6.84	2.71	U	U	5.26 x10^{11}	82.2	369.	2020.	6.15	20.5	.103	5050.	8.49/0 8.49	.001	.0106	4.41
2 OIL																					
Conventional Steam No controls[b]	U	U	U	U	7.44	.709	.015	U	U	5.26 x10^{11}	27.2	357.	801.	6.81	.138	3.40	0	2.48/0 2.48	.0006	.06	2.5
3 GAS																					
Conventional Steam No controls[b]	U	U	U	U	7.44	.709	.016	U	U	5.26 x10^{11}	7.34	191.	.293	19.6	.190	3.43	0	1.42/0 1.42	.0026	.057	2.36
4 CENTRAL COAL																					
Atmospheric Fluidized Bed Controlled[b]	0	0	U	U	18.2	0	.003	U	U	0	11.3	70.	378.	242.	2.5	0	6990.	1.62/.18 4.28	U	U	U
5 NORTHERN APPALACHIAN COAL																					
Atmospheric Fluidized Bed Controlled[b]	0	0	U	U	18.2	0	.003	U	U	0	8.52	70.	167.	242.	2.5	0	5880.	1.62/.14 3.82	U	U	U
6 NORTHWEST COAL																					
Atmospheric Fluidized Bed Controlled[b]	0	0	U	U	18.2	0	.003	U	U	0	5.31	70.	56.8	242.	2.5	0	3990.	1.62/.1 3.10	U	U	U

Table 12-4. (Continued)

SYSTEM	Water Pollutants (Tons/10^{12} Btu's)										Air Pollutants (Tons/10^{12} Btu's)						Solids (Tons/10^{12} Btu's)	F/I[a]	Occupational Health 10^{12} Btu's		
	Acids	Bases	PO_4	NO_3	Total Dissolved Solids	Suspended Solids	Organics	BOD	COD	Thermal (Btu's/10^{12})	Particulates	NO_x	SO_x	Hydrocarbons	CO	Aldehydes		Land Acre-year/10^{12} Btu's	Deaths	Injuries	Man-Days Lost
7 EASTERN COAL																					
Conventional Boiler with wet limestone scrubbing[c]	0	NC	NC	NC	0	12.5	5.5	NC	NC	0	50.	300.	250.	6.5	21.	NC	1.49 x10^4	12.5/U 12.5	.0003	.014	5.1
8 EASTERN COAL																					
Conventional Boiler with MgO scrubbing[c]	0	NC	NC	NC	0	12.5	5.5	NC	NC	0	50.	300.	250.	6.5	21.	NC	6400.	12.5/U 12.5	.0003	.014	5.1
9 WESTERN COAL																					
Conventional Boiler with wet limestone scrubbing[c]	0	NC	NC	NC	0	12.5	5.5	NC	NC	0	35.	390.	80.	8.	27.	NC	7600.	12.5/U 12.5	.0002	.014	5.1
10 PHYSICALLY CLEANED EASTERN COAL																					
Conventional Boiler with limestone scrubbing[c]	0	NC	NC	NC	0	12.5	5.5	NC	NC	0	22.	275.	100.	5.5	19.	NC	6500.	12.5/U 12.5	.0003	.014	5.1
11 COAL																					
Steam Plant with controls[b]	0	0	U	U	18.2	0	.003	U	U	0	20.6	369.	202.	6.15	20.5	.103	1.46 x10^4	6.9/.2 11.5	.0002	.024	2.6

EXHIBIT E.—Environmental emissions, electric powerplants.

Table 12-4. (Continued)

SYSTEM	Water Pollutants (Tons/10^{12} Btu's)										Air Pollutants (Tons/10^{12} Btu's)						Solids (Tons/10^{12} Btu's)	F/I[a]	Occupational Health 10^{12} Btu's		
	Acids	Bases	PO_4	NO_3	Total Dissolved Solids	Suspended Solids	Organics	BOD	COD	Thermal (Btu's/10^{12})	Particulates	NO_x	SO_x	Hydrocarbons	CO	Aldehydes		Land Acre-year/10^{12} Btu's	Deaths	Injuries	Man-Days Lost
12 LOW-BTU GAS																					
(Central Coal, BuMines-Atmospheric) Boiler Plant with controls[b]	0	0	U	U	3.4	0	.003	U	U	0	125.	56.9	269.	0	0	0	0	.5/0 .5	.0002	.0188	2.08
13 LOW-BTU GAS																					
(Northern Appalachian Coal, BuMines-Atmospheric) Boiler Plant with controls[b]	0	0	U	U	3.4	0	.003	U	U	0	115.	6.63	488.	0	0	0	0	.48/0 .48	.0002	.0188	2.08
14 LOW-BTU GAS																					
(Northwest Coal BuMines-Atmospheric) Boiler Plant with controls[b]	0	0	U	U	3.4	0	.003	U	U	0	216.	7.76	15.6	0	0	0	0	.42/0 .42	.0002	.0188	2.08
15 RESIDUAL FUEL OIL																					
Steam Power Plant[d]	1.17	NC	.6	NC	66.	5.76	.94	.034	NC	NC	21.1	351.	531.	6.7	.13	3.3	110.	4.66/U U	U	U	U
16 NATURAL GAS																					
Steam Power Plant[d]	1.15	NC	.5	NC	71.	6.95	.925	.033	NC	NC	7.13	185.	.206	21.	NC	1.42	NC	4.66/U U	U	U	U
17 BITUMINOUS COAL																					
Steam Power Plant[d]	1.16	NC	.58	NC	71.	7.	.93	.034	NC	NC	NC	383.	808.	6.36	21.3	.1	5035.	17.8/U U	U	U	U
18 LOW-BTU GAS																					
Steam Power Plant[d]	1.16	NC	.58	NC	65.	7.	.92	.034	NC	NC	NC	168.	9.18	NC	NC	NC	NC	4.24/U U	U	U	U

NA = not applicable, NC = not considered, U = unknown.

[a] Fixed Land Requirement (Acre - year / 10^{12} Btu's) / Incremental Land Impact (Acres / 10^{12} Btu's).

[b] Hittman, 1974, 1975: Tables 4 and 26.

[c] Battelle, 1973: Tables A-13, A-14.

[d] Teknekron, 1973: Figures 3.1, 4.1, 5.1, and 7.1.

Table 1-45. Environmental Residuals for High-Btu Gasification

SYSTEM	Water Pollutants (Tons/10^{12} Btu's)										Air Pollutants (Tons/10^{12} Btu's)						Solids (Tons/10^{12} Btu's)	F/I[a]	Occupational Health 10^{12} Btu's		
	Acids	Bases	PO_4	NO_3	Total Dissolved Solids	Suspended Solids	Organics	BOD	COD	Thermal (Btu's/10^{12})	Particulates	NO_x	SO_x	Hydrocarbons	CO	Aldehydes		Land Acre-year / 10^{12} Btu's	Deaths	Injuries	Man-Days Lost
HIGH-BTU GASIFICATION																					
Central Coal																					
HYGAS-Steam-Oxygen	U	U	U	U	U	U	U	U	U	0	6.88	68.1	62.9	.895	3.35	.394	5250.	2.75/0 2.75	U	U	U
BIGAS	U	U	U	U	U	U	U	U	U	0	4.75	62.6	81.5	1.	3.35	.423	5340.	3.05/0 3.05	U	U	U
Synthane	U	U	U	U	U	U	U	U	U	0	14.7	111.	51.8	1.86	6.21	.465	5330.	2.67/0 2.67	U	U	U
Lurgi	U	U	U	U	43.1	.9	.426	U	U	0	3.65	73.3	36.8	1.22	4.07	.448	5270.	2.43/0 2.43	U	U	U
Northern Appalachian Coal																					
HYGAS-Steam-Oxygen[b]	U	U	U	U	U	U	U/ .03	U	U	0	3./ 91.	60./ 190.	20./ 400.	.8/ 1.1	2.92	.363	5500./ 24500.	2.53/0 2.53	U	U	U
BIGAS	U	U	U	U	U	U	U	U	U	0	3.66	54.4	17.5	.907	3.02	.409	6560.	2.96/0 2.96	U	U	U
Synthane	U	U	U	U	U	U	U	U	U	0	15.4	99.8	18.7	1.67	5.54	.43	6560.	2.46/0 2.46	U	U	U
Northwest Coal																					
HYGAS-Steam-Oxygen	0	0	0	0	0	0	0	0	0	0	5.71	68.3	5.9	1.15	3.8	.313	3730.	3.75/0 3.75	U	U	U
BIGAS	0	0	0	0	0	0	0	0	0	0	3.42	58.3	14.1	.928	3.1	.301	3840.	4.54/0 4.54	U	U	U
Synthane	0	0	0	0	0	0	0	0	0	0	13.	115.	9.63	1.91	6.37	.354	3830.	3.96/0 3.96	U	U	U
Lurgi	0	0	0	0	0	0	0	0	0	0	2.05	76.9	5.59	1.28	4.27	.292	3730.	3.78/0 3.78	U	U	U
CO_2 Acceptor	0	0	0	0	0	0	0	0	0	0	3.31	38.1	61.7	.595	1.98	.437	8610.	3.16/0 3.16	U	U	U

U = unknown.

[a]Fixed Land Requirement (Acre - year / 10^{12} Btu's) / Incremental Land Requirement (Acres / 10^{12} Btu's).

[b]Where two numbers occur, the second is taken from Battelle for a HYGAS unit using Eastern coal with an ash content of 14.4 percent and a sulfur content of 3 percent.

TABLE 1-46

SUMMARY OF HIGH-BTU GASIFICATION RESIDUALS

Process	Water	Air (tons per 10^{12} Btu's coal processed)					Solids (tons per 10^{12} Btu's)	Total Land[a] (acres)
		Particulates	Nitrogen Oxides	Sulfur Oxides	Hydrocarbons	Carbon Monoxide		
HYGAS	(Recycled or	3- 7	60- 68	6-63	1	3.5	3,700-6,500	350
BI-GAS	treatment	3- 5	54- 63	14-81	1	3.0	3,800-6,800	350
Synthane	to meet	13-15	100-115	10-52	2	5.0	3,800-6,600	350
Lurgi	standards	2- 4	73- 77	6-37	1	4.0	3,700-5,300	350
CO_2 Acceptor	[Table 1-44])	3	38	62	0.5	2.0	8,600	350

Source: Hittman, 1975: Vol. II, Table 2 and associated footnotes.

[a]Land required is for coal storage, preparation, gasification plant facilities, and evaporation ponds. No additional requirement is assumed for buffer areas surrounding plant facilities (although they would probably be included in a commercial facility, on the order of 1,500 acres).

EXHIBIT F.—Environmental emissions, high Btu coal gasification plants.

EXHIBIT G

ANALYSIS OF RELATIVE FUEL EFFICIENCY FROM POINT OF PRODUCTION TO POINT OF USE OF HEAT PUMPS VERSUS GAS FURNACES

System	Resource	Extraction	Processing	Transport	Conversion	Distribution	Heating utilization	Total	Utilization ratio
Electric furnace	Coal (surface mined)	79	92	98	32	91	100	20.7	1.71
Electric heat pump	do	79	92	98	32	91	180	37.3	.95
Gas furnace, typical installation	Natural gas	73	93	95			55	35.5	1.00
Gas furnace, good installation	do	73	93	95			65	41.9	.85
High efficiency gas furnace	do	73	93	95			95	61.3	.58
Gas heat pump	do	73	93	95			130	83.8	.42
Advanced supply:									
Advanced electric heat pump	Coal (surface mined)	79	92	98	38	91	220	54.2	1.15
Gas heat pump	do	79	92		70	95	130	62.8	1.00

Statement of Virginia Electric and Power Co.

Prohibition of Discriminatory State Taxes on Production and Consumption of Electricity

Sec. 1323 of H.R. 10612

Virginia Electric and Power Company (Vepco) opposes Section 1323 of H.R. 10612 Tax Reform Act of 1976, as presently written, which section would prohibit any state or political subdivision thereof from imposing or assessing a tax on or with respect to the generation of electricity for transmission in interstate commerce which tax is discriminatory against out of state manufacturers, producers, wholesales, retailers or consumers of such electricity. Current language would appear to allow a state to tax generation for transmission in interstate commerce at the same rate applicable to generation sold within the state of generation.

Under Section 1323, taxes on generation of electricity for transmission in interstate commerce would be deemed discriminatory where the payment thereof directly or indirectly results in a higher gross or net tax than the tax levied on electricity generated and transmitted intrastate.

Mr. Bill D. Johnson, Executive Manager—Accounting and Control for Vepco testified before the Senate Finance Subcommittee on Energy in support of Senate Bill 1957, which bill would prohibit taxation of electricity transmitted interstate. Vepco still supports the intent of Senate Bill 1957 which bill would prohibit such taxation. As Mr. Johnson related in his testimony, Vepco has been faced with the problem of taxation of electricity transmitted in interstate commerce for several years inasmuch as Vepco has operated and continues to operate a coal fired electric generating plant at Mount Storm in Grant County, West Virginia. This station supplies power to consumers in three states—Virginia, West Virginia, and North Carolina. Approximately 3% of the electricity generated at this plant is sold to West Virginia customers with the remaining 97 percent carried over high voltage transmission lines to service Vepco's customers in Virginia and North Carolina.

Vepco pays to the State of West Virginia a Business and Occupation Tax imposed upon electric utilities measured by the sales and demand charges as to electric power sold in West Virginia. The tax rates with respect to electric generation transmitted to residential and commercial and industrial consumers within the State of West Virginia are $5.72 per $100 of valuation and $4.29 per $100 of valuation, respectively. As to all other electricity generated at Mount Storm, and transmitted outside the State of West Virgina, Vepco pays the present Manufacturer's Tax of $.88 per $100 of valuation applicable to all manufactured, compounded or prepared for sale products. The magnitude of the tax for a given year depends to some degree upon the generation for that year. In 1976, we estimate this tax will approximate $1.5 million based on the current rate of $.88 per $100 of valuation.

When this tax was first imposed by the State of West Virginia upon Vepco, relief was sought in the Supreme Court of Appeals of West Virginia on the basis that the levy of such tax was a burden upon interstate commerce forbidden by the Constitution of the United States. After failing to get relief in that court, we sought relief in the United States Supreme Court, but that court declined to hear the case.

During the 1976 session of the West Virginia Legislature, a bill was proposed to change the current tax rate of $0.88 per $100 of valuation on electricity generated in West Virginia and transmitted outside the State to $5.72 per $100 of valuation, an increase of 550 percent in the tax rate. Following the appearance of Vepco and other utilities operating in West Virginia, in opposition to this bill (Senate Bill 572), it was amended to place the tax rate at $3 per $100 of valuation, an increase of 241 percent in the tax rate for generation transmitted in interstate commerce. Senate Billl 572 would also reduce the rate applicable to commercial and industrial sales within West Virginia from $4.29 per $100 to $3 per $100 and eliminate the tax on residential customers entirely. (Previously taxed at $5.72 per $100 of sales).

The result of the West Virginia proposed legislation, as we understand it, would be to reduce the cost of electricity to West Virginia consumers by reducing the West Virginia tax burden which is borne by West Virginia customers at the expense of consumers in the neighboring states. If such a tax method is permitted to continue, there is no limit as to what level the tax could be imposed on electricity users outside of the State at the will of the West Virginia Legislature.

It is clear that the West Virginia Business and Occupation Tax on electric power generated in that State discriminates against Vepco's customers in Virginia and North Carolina in favor of all electric customers in West Virginia, the majority of whom we do not serve. It places an undue burden on our Virginia and North Carolina customers since this generation is taxed again at 3½ percent of gross receipts when sold in Virginia and at a 6 percent tax rate on gross receipts when sold in North Carolina.

To subject the generation of electricity exported to a manufacturing tax rate of $8 per $100 of valuation while the rate applied to all other manufacturing in the State of West Virginia is $0.88 per $100 of valuation is discriminatory and a clear burden upon interstate commerce. Indeed, the proposal would appear to violate several provisions of the Federal Constitution as was pointed out by Vepco counsel appearing before the West Virginia Legislature in opposition to this proposal, as follows:

(1) It would seem to violate Clause 3, Section 8, Article I, which reserves to the Congress, alone, the power "to regulate commerce with Foreign Nations, and among the several states."

(2) It would seem to violate Section 10 of Article I, which provides that "no state shall, without the consent of Congress lay any imposts or duties on Imports or Exports."

(3) It would seem to violate the provisions of Article IV, Section 2, which provides that "the citizens of each State shall be entitled to all privileges and immunities of citizens in the several states."

(4) It would seem to violate the 14th Amendment to the United States Constitution which provides that no state shall deprive any person of life, liberty or property without due process of law; nor deny to any person within its jurisdiction the equal protection of the law.

As can readily be seen, under the proposed language of Section 1323, of H.B. 10612 interstate transmission of electricity presently taxed at $.88 per $100 of valuation by the State of West Virginia could be taxed at any rate up to $5.72 per $100 of valuation (Present Rate) while all other manufactured, compounded or prepared for sale products are taxed at the rate of $.88 per $100 of valuation.

Many cases could be cited where discriminatory taxes or restraints upon commerce, whatever their form, violate the purpose and intent of the Federal Constitution. The West Virginia proposal, in the guise of a tax, is nothing more than electric utility rate regulation by the West Virginia Legislature which would serve to reduce intrastate rates financed by an increase in the utility rates charged to citizens of neighboring states.

The New Mexico Legislature, in July, 1975, attempted to tax the generation of electricity exported which caused the State of Arizona to bring an action in the United States Supreme Court, invoking that court's original and exclusive jurisdiction, challenging the constitutionality of the New Mexico legislation. The Supreme Court refused to hear the case. There is at present another court case on this issue in the District Court of New Mexico.

Unless action is taken to prevent states from engaging in such activities, as here described, it is not difficult to look into the future and see the possible consequences that will result.

(1) Utilities will seek increased rates to reflect increased cost of services to their customers because of the tax structure of neighboring states.

(2) States may well follow the lead of Arizona and institute legal proceedings to enjoin collection of this discriminatory tax or seek refund thereof.

(3) Regulatory commissions may defer action on rate relief sought by utilities until the matter is settled by the courts.

(4) Citizens and legislators of one state may well become bitter and explore ways in which they can retaliate against their neighboring states either by government or private action.

(5) Throughout the long period of time the legal disputes are being resolved, electric utilities and their customers will be caught in the middle of this dispute which will injure the utilities' financial position and may well jeopardize their ability to render reliable service.

Therefore, the Senate Finance Committee is urged to enact legislation to the effect that generation of electricity transmitted from one state to another is an integral part of interstate commerce and the imposition of a state tax on the privilege of generating electricity in a state is an unreasonable burden on commerce among the states. If the Committee should decide that such privilege

should be subject to taxation, certainly the magnitude of such taxation should be limited to the state taxation of other manufacturing operations within such state.

STATEMENT OF KENNETH R. WAHLBERG ON BEHALF OF INVESTORS SYNDICATE OF AMERICA, INC.

For over fifty years, the holders of face-amount certificates have been taxed on the interest element in the certificates when they received the proceeds of the certificates either at maturity or earlier surrender.

The holder is typically a cash-basis taxpayer. It is sensible for him to pay the tax on the interest when he receives the interest.

The Internal Revenue Service considers that the 1969 Act changed the law to require these cash-basis taxpayers to pay tax each year on the interest in their certificates as it accrues. Requiring ratable payment will adversely affect the sale of face-amount certificates.

The Committee amendment clarifies the law to restore the long-standing treatment of taxing holders of face-amount certificates when they receive the proceeds of their certificates.

Mr. Chairman, My name is Kenneth R. Wahlberg. I am President of Investors Syndicate of America, Inc. whose headquarters are in Minneapolis, Minnesota.

Investors Syndicate of America, Inc. is engaged in the business of issuing face-amount certificates. Under an installment certificate, the certificate holder makes installment payments over a period of 30 years; upon maturity of the certificate, the holder is entitled to receive an amount equal to its face amount which is the cumulative installment payments plus an interest element.

At the present time Investors Syndicate of America, Inc. has face-amount certificates outstanding in the amount of $2.2 billion. At the end of 1975 there were approximately 250,000 persons holding these face-amount certificates. The sales of new certificates in 1975 equaled approximately $468 million in face amount.

From the time the 1954 Code was enacted until the 1969 Act, the tax treatment of payments by the issuing company to the holder of a face-amount certificate was very clear. The rule was that a face-amount certificate was to be treated for federal income tax purposes in the same way as an endowment contract under § 72 of the Code. This treatment is confirmed by the specific statement in § 72(1) that "the term 'endowment contract' includes a face-amount certificate." Consistent with § 72(1), it is provided in § 1232 that face-amount certificates are not to be treated as original issue discount paper under that Code provision; § 1232(d) states that "for special treatment of face-amount certificates on retirement, see section 72."

When the 1969 Act was enacted, there was nothing in the law itself or in its legislative history that indicated that Congress, in any respect, had in mind face-amount certificates when it made changes in § 1232 affecting original issue discount bonds. In fact, since the amendments to § 1232 did not expand the scope of that Code provision, nor change the language of § 72(1) and § 1232(d), it appears that Congress did not intend to change the taxation of face-amount certificates which historically have been separately defined and separately treated by the Code.

Our problem arises because the Treasury, relying upon the 1969 Act, amended its regulations to tax face-amount certificates under § 1232, thereby requiring a certificate holder to include in taxable income each year his ratable part of the interest element that he will not receive until the certificate matures at the end of 30 years.

Since Congress appeared to have no intent to change the treatment of face-amount certificates in the 1969 Act, we asked your Committee to confirm our understanding of the State of the law. We asked that the tax reform bill provide that the taxation of face-amount certificates is to continue as it had exised during the period 1954 through 1969.

The committee amendment clarifies § 1232(d) of the present law to provide that face-amount certificates are not subject to the rules under § 1232, but rather are to be taxed under § 72. As a result, the interest element in a face-amount certificate would not be ratably included in the gross income of the holder over the term of the certificate since a typical certificate holder is on a cash basis. Instead, the interest element would be included in the gross income of the holder

upon actual receipt by him, either at maturity of the certificate, or upon an earlier redemption.

JULY 22, 1976.

Re statement in opposition to section 1508 of H.R. 10612 (consolidated returns by life insurance and nonlife insurance companies).

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR LONG: My name is Victor T. Ehre and I am Chairman of the Board and Chief Executive Officer of the Utica Mutual Insurance Company and also President and Chief Executive Officer of the Graphic Arts Mutual Insurance Company. Both companies are property and casualty insurers with headquarters in the greater Utica area of Upstate New York.

I am filing this statement with the Senate Finance Committee in opposition to the provisions of Section 1508 of H.R. 10612 which would in the future permit the filing of consolidated federal income tax returns by life insurance companies and non-life insurance companies. From the standpoint of my company, this proposal will have seriously adverse competitive implications. Based on communications which I have had with others in the industry, I believe that I speak as well far all similarly situated small mutual property and casualty insurance companies.

A. INSURANCE INDUSTRY'S FINANCIAL SALVATION

An argument frequently raised in support of the captioned legislation is that the resulting decreased tax revenues will add to the depleted surpluses of the property and casualty insurance industry, thereby increasing the industry's capacity to provide insurance coverages. There is no question that in recent years numerous factors, including the recent recession and price inflation, have caused the property and casualty industry to suffer large losses (*e.g.*, the 1975 pre-tax statutory underwriting losses for the property and casualty industry is estimated at $4.247 billion).[1] However, it is difficult to conceptualize how a modest amount of future tax savings (1978, $25 million; 1979, $55 million; 1980, $49 million; and 1981, $40 million)[2] will have a meaningful effect on the industry's current financial dilemma. In large part, these benefits will flow to a segment of the insurance industry (*i.e.*, those large heavily capitalized property and casualty insurance companies affiliated with profitable life companies) that is best equipped to withstand the industry's current financial turbulance while the numerous small unaffiliated companies will derive no benefit from its enactment. Since many of these small unaffiliated companies are mutual companies, the possibility of their affiliating with profitable life or non-insurance operations is remote. If the purpose of the legislation is to provide government revenues to subsidize the property and casualty insurance industry, it would seem one could develop more equitable means for allocating such a subsidy.

B. TECHNICAL DIFFICULTIES

1. Immediate enactment of bill section 1508 is not advisable

Assuming arguendo that we have no quarrel with the basic philosophy underlying this bill, *i.e.*, the equity in lifting the ban on life insurance companies filing consolidated returns with other companies, we believe that the complexities of life insurance company taxation and the potential abuses to this special scheme of taxation[3] dictate that, before implementation of this proposed legislation, the entire matter should be the subject of further study and that public hearings should be held to give various interested parties an opportunity to be heard. Certainly, expedited passage of Section 1508 appears unjustified since the Senate Finance Committee has set the effective date of the legislation for taxable years beginning after December 31, 1977. Some of the above-mentioned complexities and potential abuses are discussed below.

[1] Best's Insurance News Digest, March 15, 1976.
[2] Report of the Committee of Finance of the United States Senate on H.R. 10612, page 457.
[3] This can be illustrated by the fact that in the seventeen years that elapsed since 1959, the Treasury has yet to issue regulations covering the consolidation of income of only life insurance companies—a much simpler task than would be involved in Section 1508.

2. Congressional concept under the Life Insurance Company Income Tax Act of 1959

Historically, life insurance companies have been taxed quite differently from other companies. In 1959, Congress, after lengthy deliberation, adopted a statutory formula for taxing life insurance companies. This formula is extremely complex in that it involves the application of unique calculations of both income and deductions. Certain of these deductions are subject to computed limitations. For example, a life insurance company's deductions for policyholders' dividends cannot, in effect, reduce its taxable investment income. Because of these special limitations, "Congress in the past has not allowed life insurance companies to file consolidated returns with other types of companies and in this manner offset their taxable investment income against losses realized from other types of operations." [4] Although the Committee Report states that the loss limitation mechanism of bill Section 1508(b)(3) preserves the Congressional concept underlying these limitations,[5] this bill would, in most instances, allow a part of a group's non-life insurance company's losses as an offset against its life insurance company taxable investment income generated in the loss year. In addition, the bill's carryforward provision (sec. 1508(c)) would permit the carryforward and ultimate absorption of virtually all of the remaining non-life losses which were not currently utilized.[6] This result is contrary to the Congressional intent underlying the limitation on special deductions contained in the 1959 Life Insurance Company Tax Act.

	Life company taxable income	Property and casualty taxable income (loss)	1978 property and casualty loss absorbed in consolidated return	Consolidated taxable income
1978	$200	($100)	($50.00)	$150.00
1979	200	0	(25.00)	175.00
1980	200	0	(12.50)	187.50
1981	200	0	(6.25)	193.75
1982	200	0	(3.13)	196.87
1983	200	0	(1.56)	198.44
Total	1,200		(98.44)	

Note: That, as prescribed under the proposed legislation, in 1978, the year of the loss, the life-nonlife affiliated group can only absorb 50 percent of the $100 property and casualty company loss. However, given a 5-yr loss carryforward an additional $48.44 is absorbed in the years 1979–83 leaving only $1.56 or about 1½ percent of the original $100 loss unabsorbed.

In addition, certain life insurance company limited deductions (*e.g.*, dividends to accident and health policyholders) can, in effect, be shifted to a non-life insurance company and through consolidation used as an offset of life insurance company taxable investment income. This not only represents a circumvention of the 1959 Life Insurance Company Tax Act but also rejects the philosophy of the consolidated return regulations in that it permits a life—non-life consolidated return group to report lower taxable income than it would have reported had all its insurance business been written in a single life insurance company.

Respectfully submitted.

VICTOR T. EHRE,
Chairman of the Board,
Utica Mutual Insurance Company.

[4] Report of the Committee of Finance of the United States Senate on H.R. 10612, page 454.
[5] *Ibid.*, p. 454.
[6] This can be illustrated by the following example:
Assume the following facts:
1. Life insurance company parent (P) files consolidated tax returns with its property casualty subsidiary (S) for the years 1978–1983 under the proposed bill.
2. P earns $200 of taxable income each year while S loses $100 in 1978 and breaks even in succeeding years.

AMERICAN PETROLEUM INSTITUTE,
Washington, D.C., July 22, 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance,
Washington, D.C.

DEAR MR. CHAIRMAN: This letter is written in behalf of the membership of the American Petroleum Institute with respect to matters that are before your distinguished Committee with the resumption of tax revision hearings which are currently in progress. It is noted that spokesmen for individual companies have been scheduled to testify on specific subjects or provisions of the pending tax bill. In the interest of avoiding duplicative oral testimony, we submit these comments for the record in the hope that they will assist in your deliberations.

While our comments will in particular relate to three provisions of the bill as it now pends before the Senate, we would like to commend the Committee for adopting constructive amendments relating to geothermal development, the correction of inequities arising from the 1975 changes in percentage depletion for oil and gas, and certain transitional treatment provided with respect to foreign source income. Provisions such as those to which reference has been made in the foregoing enumeration have been amply described and explained in the excellent Committee Report which accompanied H.R. 10612 and will not be the subject of further comment here. However, there are two provisions affecting foreign oil and gas extraction income which we believe merit additional comment to provide better understanding of the justification for their inclusion in H.R. 10612. There is a third provision on which we would like to comment that we believe should be deleted from the bill.

The first of these three provisions for specific comment would revise the definition of foreign oil related income to include interest from a qualified domestic corporation. The need for this amendment arises from a drafting inadvertence in the Tax Reduction Act of 1975. The 1975 statute in creating the new income category known as foreign oil related income included within the definition dividends and interest received from a foreign corporation but with respect to a domestic corporation included only dividends. The amendment contained in H.R. 10612 would correct this unintended omission so as to include both dividends and interest when received from either a foreign or a domestic corporation. The record is clear that this feature of the 1975 Act was not the intent of Congress at the time of the law's adoption. This legislative oversight should be corrected as provided in H.R. 10612 but it is submitted that the effective date of the correction should be January 1, 1975 (the effective date of the error), and not January 1, 1977, as provided in the pending bill.

The second provision of H.R. 10612 on which we would make specific comment is subsection 1035(e) prescribing the tax status of certain payments for oil and gas. Section 901(f) of the Internal Revenue Code, as added by the Tax Reduction Act of 1975, provides that foreign income taxes paid in connection with the purchase and sale of oil or gas in a foreign country are not to be creditable if the taxpayer has no economic interest in the oil or gas and either the purchase or the sale is at a price which differs from the fair market value for such oil or gas. Section 1035(e) of the reported version of H.R. 10612 would amend section 901(f) in order to prevent that section from operating inequitably in certain situations in which foreign countries nationalized the properties of U.S. companies operating in those countries.

A number of the oil producing countries throughout the world have either already nationalized the properties of U.S. taxpayers operating therein or have announced plans to do so. In some of the countries, in recognition of the nationalization of the properties, arrangements have been made or will be made to permit purchase of oil or gas at a price below fair market value followed by resale of the oil or gas at a profit subject to foreign income tax. The purpose of section 1035(e) is to provide that in such a situation the new arrangement will be regarded as essentially the continuation of the presently existing economic interest thus preventing inequitable application of section 901(f) to disallow creditability of the foreign income taxes paid. This proposed change presents a minimum solution to the problem presented by the necessity of making new arrangements upon nationalization by foreign governments. Whatever may have been the purpose of enactment of section 901(f) it does not seem to have been intended to prevent creditability of foreign income taxes paid by taxpayers who make investments in foreign countries and acquired economic

interests but suffered the misfortune of having their properties nationalized by the foreign governments involved.

Section 1035(e) provides for termination of the period over which the discount is allowed in the year 1986. It would seem more appropriate to put no limitation on the period of time since the arrangement, having arisen out of the economic interest of the taxpayer in the foreign country, should qualify for whatever period the arrangement may exist.

The third provision of H.R. 10612 on which we would make specific comment is Senate Floor Amendment Number 2043 offered by Senator Hartke and adopted by the Senate yesterday. We oppose this amendment. The amendment would place oil and gas extractive income on a per country basis, define certain income taxes as non-creditable royalties, and further restrict the allowable creditable income taxes.

In the Tax Reduction Act of 1975, petroleum companies alone were denied the option of using the per country method of limiting foreign tax credits. Further, petroleum companies were restricted even in the use of the overall method with respect to oil related income. Amendment Number 2043 would again single out the petroleum industry for further punitive treatment and force petroleum companies to use the per country method with respect to extractive income, completely reversing the concept contained in the Tax Reduction Act of 1975, which required that oil companies use the overall method of limiting foreign tax credits. With respect to this reversal of position, it is to be noted that further inconsistency can be found in the fact that H.R. 10612 would require all other taxpayers to use the overall method.

Under Amendment Number 2043 the Secretary of the Treasury is given extraordinary power to treat foreign income taxes as royalties. Canada, the United Kingdom, and the Netherlands, to name a few countries, have special income taxes on petroleum operations. If such taxes were treated as royalties, U.S. companies operating in these countries would be rendered totally noncompetitive.

Thus, in summary, the amendment would reverse fundamental tax policies adopted last year, erroneously classify income taxes as royalties, restrict basic foreign tax credit concepts, and impose international double taxation on U.S. taxpayers. It should not be retained in H.R. 10612.

In closing, it may be appropriate to note that there are numerous other Floor amendments to H.R. 10612 which, if adopted, would drastically and adversely affect the U.S. petroleum industry. Such unwise proposals which for the most part have not been subject to the committee hearing process would severely disadvantage the Nation's energy outlook at a time when the United States is already in trouble on energy. Currently U.S. oil and gas proved reserves are declining and reliance on imports is increasing. The United States is presently obliged to import about 45 percent of its liquid petroleum needs. There is an urgent necessity to replace our dwindling domestic reserves and to obtain diversified foreign sources of secure supplies. The capital requirements to attain these objectives are enormous and substantially exceed the industry's current cash flow. Higher tax burdens on the industry can only impair that already inadequate cash flow position and weaken the economic justification for committing the required capital amounts to the high risk undertaking of the search for oil and gas. Numerous studies have established that the petroleum industry is among the most heavily taxed industries. The imposition of additional punitive tax burdens on the petroleum industry can only detract from our efforts to improve the Nation's energy outlook. America's role of preeminence in international trade and the importance of that trade in providing jobs and economic progress are important considerations in evaluating the implications of tax amendments that are hostile to private enterprise.

I thank you for permitting the American Petroleum Institute to make this submission for the record of the Senate Committee on Finance's current tax revision hearings. If we can be of service to the Committee in supplying additional information, please do not hesitate to let us know.

Sincerely,

FRANK N. IKARD.

SUPPLEMENTAL STATEMENT OF MAGMA POWER COMPANY IN SUPPORT OF SECTION 2004

Magma Power Company did heretofore file with the Committee on Finance its statement dated February 27, 1976 in support of Senate Bill 2608, now substantially incorporated in the Tax Reform Act of 1976 as Section 2004 thereof. This statement is supplemental to the aforesaid statement.

In the Congressional Record of Senate proceedings on June 28, 1976 there appear statements by Senators Kennedy and Proxmire that the provisions of Section 2004 of the Tax Reform Act of 1976 with respect to geothermal resources are of principal benefit to Union Oil Company and Pacific Gas and Electric Company. We respectfully advise the Committee that these statements are based upon inadequate or erroneous information, and we further state that the provisions of Section 2004 are far more important to the independent geothermal developer, such as Magma Power Company and to those who are seeking outside capital in order to enter the geothermal field, than they are to Union Oil Company or to any other major oil company. Although Union Oil Company is very actively engaged in developing geothermal resources, the experience of Magma Power Company as a joint venturer with Union Oil Company at The Geysers area in northern California is that Union Oil Company has been a good and helpful partner and has made a major contribution in developing the resource. As to Pacific Gas and Electric Company, we do not see that the provisions of Section 2004 would be of any significant benefit. Pacific Gas and Electric purchases natural steam at The Geysers and utilizes natural steam in the generation of electric power at the site. The extent to which the subject tax incentives encourage accelerated development of the resource will, of course, affect the amount of such natural steam that will be available to Pacific Gas and Electric at The Geysers. That would obviously be a benefit.

The provisions of Section 2004 are essential in order to assist in the capital buildup necessary to develop proven areas and to explore and absorb the losses in other areas. Before income is obtained from geothermal resources it is necessary that exploration result in discovery of a field, that further drilling outline the extent of the resource, that a buyer of the resource must be found, a plant must be engineered, tailored to the resource, the plant must be built, and transmission lines must be brought to the plant. All of this consumes years of time during which there is no return on investment.

If it is in the public interest to develop supplemental or alternative energy sources, geothermal resources are one such energy source, and if the exploration for and development and use of the resource are to be encouraged, the tax incentives are critical. The industry has taken and has evidenced a willingness to take risks and not to impose them upon the public, but without tax incentives there will be little income to tax because the development of the resource will proceed at a snail's pace.

We can assure the Committee that without the tax incentives provided in Section 2004, it will be a long time before very attractive, large, but presently uneconomic geothermal resource areas will be explored, developed, or used. Aside from parts of the Imperial Valley, there are areas such as the Valles Caldera in New Mexico, the San Luis Valley area in south central Colorado, the Raft River region area in Idaho, the geo-pressurized areas of the Gulf Coast, the south central part of South Dakota and the west Yellowstone area of Montana which would be more likely to be explored and developed if the provisions of Section 2004 become law. There are also numerous marginal areas in Nevada and there are promising areas in Utah, Washington and Oregon that would be more readily developed.

We respectfully suggest that it is just plain, good common sense to encourage the expenditure of private capital to develop the resource at private risk by means of tax incentives at negligible cost to the public.

We also hope that the current disaffection with major oil companies not be the basis for defeating a proposal which is fundamentally in the public interest.

Respectfully submitted,

JOSEPH W. AIDLIN,
Vice President and General Counsel.

ENVICON DEVELOPMENT CORP.,
July 20, 1976.

COMMITTEE ON FINANCE,
U.S. Senate,
Washington, D.C.

GENTLEMEN: I have recently read the discussion and debate with respect to the Haskell Amendment.

I urge your reconsideration for two reasons.

First, this modification will hurt the real estate industry just when it is beginning to get back on its feet. The construction of new real estate, especially multi-family housing, is dependent upon the availability of tax benefits to investors. The time of developers being able to build a project for the amount of mortgage proceeds is no longer a reality. Therefore, the developer must have considerable cash equity to invest in his project. The source of this equity is usually outside investors, who contribute money to a partnership, which then develops the property. These outside investors look only to a return from tax savings during their first years of investment (there is no cash flow during the construction and subsequent rent-up periods).

The limitation of the losses proposed in the Haskell Amendment would drive away these investors and thereby seriously hamper new construction starts. This would hurt the building trade people most. The carpenters, electricians, plumbers, sheetrock workers, etc., many of whom have had little, if any, work in the last year are the people who benefit most from new construction. In addition, the continual upgrading of housing through the construction of new and better units will be hampered. In effect, the lack of these tax shelter deductions will cause the cost of rental housing to increase through a reduction in supply and a higher cost of new construction. And lastly, the investor will merely seek other outlets for such "tax shelters" which are more likely to be based on some accounting or tax loophole and thus not funnel his dollars into an area which is certainly within the area of public policy to encourage.

Second, the tax effect now in existence and the tax effect which the Haskell Amendment would promulgate was incorrectly explained by Mr. Kennedy. Using the hypothetical illustration suggested by Mr. Pastore (What happens if an investor puts up $20,000 on a $100,000 project and it fails?), the overall tax effect is the same under present law as it would be under the Haskell Amendment. On a net basis, the investor would be able to deduct only the $20,000 he had invested. Mr. Kennedy's statement that the deduction under present law would be $100,000 is wrong and must be based on a misunderstanding of the tax law as it exists.

The effect of the Haskell Amendment occurs in the way the investor arrives at the $20,000 loss. Under Haskell, the investor is limited to an aggregate of $20,000 at any time during the investment period. Under present law, the investor may, through depreciation, construction period interest and actual cash flow losses, deduct in excess of his $20,000. He may have deducted $40,000 or $50,000 before the project begins to show income and if it never shows income, theoretically his deduction could reach $100,000. However, at some time, when the property is disposed of, by sale, foreclosure or otherwise, the investor must "pay back" those losses in excess of his $20,000 investment as taxable income. The concept in tax law is called recapture. If for example, in Mr. Pastore's illustration, the investor who deducted $100,000 then had his project go bad, even though he received no cash, he would have taxable income of $80,000, thus recapturing his excess deductions and giving him a net loss of $20,000.

This is not merely a technical difference. The excess of deduction over investment is the very thing that induces the investor to come forward with the high risk front money which is needed to build new projects. These are the dollars that are most at risk. They are the first dollars in and the last dollars on which a return will be paid. If the developer is unable to offer a return on these invested dollars through tax savings, the major source of new construction seed money will dry up.

Please reconsider your position on the Haskell Amendment, and strike it from the proposed tax legislation.

Very truly yours,

DONALD A. GABY,
Director.

STATEMENT OF CLARK EQUIPMENT CO.

Section 1032(c)(3) of H.R. 10612

Recapture of Foreign Losses

Clark Equipment Company ("Clark") is a manufacturer of material handling equipment, construction machinery, truck trailers, and axles and transmissions. It has extensive foreign investments, operating in more than 100 countries around the world.

SUMMARY OF POSITION

This statement is being submitted in response to the Committee's request of July 8, 1976, for additional information that will enable the Committee and the full Senate better to evaluate the merits of a number of provisions of the Tax Reform Bill of 1976 (H.R. 10612) that were approved by the Committee under time pressure and with less than usual factual input. Specifically, Clark wishes to record its full support of Section 1032(c)(3) of H.R. 10612, a provision with which Clark has heretofore been in no way involved, but that has potential application to Clark and likely to a significant number of other taxpayers.

Section 1032(c)(3) would except from recapture those foreign losses of a taxpayer resulting from worthless stock or indebtedness of a corporation in which the taxpayer has a 10 percent or greater stock interest. The section recognizes that in economic terms these losses were sustained in prior years, and it accords them the equitable relief that is clearly merited.

DISCUSSION

Section 1032(a) of H.R. 10612 provides that the "overall foreign loss" realized by a taxpayer in one year is to be recaptured in subsequent years, thereby reducing the foreign tax credit limitation in those years. Subsection (c)(3) of Section 1032, entitled "Substantial Worthlessness Prior to Enactment", was not contained in the House bill. It would except from foreign loss recapture losses resulting from the worthlessness of stock or indebtedness of a corporation in which the taxpayer owns 10 percent or more of the stock. The corporation must have sustained losses in at least three of the last five years beginning before 1976 and must have sustained an overall loss for those five years. It is necessary that the corporation terminate all operations before 1977. A taxpayer meeting these tests would be free of the new foreign loss recapture rules on losses realized, in a tax sense, in a year after the effective date of Section 1032 (which applies to taxable years beginning after 1975).

Clark strongly supports this provision because it is based on economic good sense and is fully equitable. Section 1032(c)(3) recognizes that the losses in question were incurred in an economic sense in prior years. To subject such losses to recapture would unfairly give retroactive application to the new loss recapture rules.

Clark's views on this matter are grounded on actual experience. For roughly 10 years Clark has maintained an English subsidiary that manufactures and sells a large range of products in the United Kingdom. During that period the affiliate has suffered consistent and substantial losses. Reluctantly, Clark is now contemplating a liquidation of the English operation.

In point of economic fact, the U.K. losses have already been realized by Clark. To subject them to loss recapture when realized in terms of taxation would be an obvious inequity. Clark understands that a principal purpose of the recapture provisions is to restrict the tax advantages presently available through the use of a branch, rather than a local subsidiary, in foreign loss situations. Thus, it would be a harsh irony were Clark, having foregone those advantages by employing a local subsidiary in the United Kingdom, to face recapture of the English losses when it liquidates the subsidiary, a recapture it would have avoided had it operated through a U.K. branch. If loss recapture does occur, Clark can expect a significant reduction in its foreign tax credit in the years ahead, and most likely presently anticipated dividends from its foreign subsidiaries will have to be severely restricted.

Clark is aware of certain other corporations that face circumstances similar to its own and that would therefore be eligible for the equitable relief afforded by Section 1032(c)(3). Given the risks and vagaries of foreign business operations, this is surely a widespread condition. Accordingly, Clark is confident that Section 1032(c)(3) would not be narrowly limited in its application.

JOHN F. CREED,
Attorney, Baker & McKenzie.

Statement of the Texas Bankers Association Trust Division

(Prepared by Robert G. McKenzie, Republic National Bank of Dallas)

TECHNICAL AMENDMENT TO SECTION 613 (LIMITATIONS ON PERCENTAGE DEPLETION)

The Texas Bankers Association is a trade association with a membership of over 1,300 banks in the State of Texas. Of these, approximately 265 members of the Association exercise fiduciary powers and nearly all hold oil and gas interests in their Trust Departments. For this reason, the Trust Division of the Texas Bankers Association has an interest in the technical amendments added by the Senate Finance Committee to H.R. 10612 (Tax Reform Act of 1975), in Section 1317 of the Bill.

Section 613A, Limitations on Percentage Depletion in Case of Oil and Gas Wells, was added to the Internal Revenue Code in the Tax Reduction Act of 1975, effective January 1, 1975, and was applicable to taxable years ending after December 31, 1974.

The Tax Reduction Act of 1975 repealed the percentage depletion deduction for oil and gas except for "small producers". For any taxpayer who meets the "small producer exemption" definition, the statutory depletion deduction for any year cannot exceed 65 per cent of the taxpayer's taxable income. See Section 613A (d)(1) of the Internal Revenue Code.

Section 613A(c)(9) denies the small producer exemption to a transferee in the case of a transfer of the interest after December 31, 1974 (including an interest in a partnership or trust).

The above-mentioned subsections of Section 613A were inadvertently drawn to impact adversely certain types of trusts.

The Treasury Department and affected trustees realized the consequences immediately after the law was passed. Trusts compute net income by deducting the amounts distributed to beneficiaries. Tax is paid by the trust only on the amount of the current year's income retained and undistributed. The application of the 65 per cent limitation rule of (d)(1) leads to rather curious results. When a trustee distributes in his discretion or is required to distribute, all of the trust's net income except that part of oil and gas income required to be added to corpus under local law (for example in Texas, 27½ per cent is retained and added to corpus), a substantial part of the 22 per cent statutory depletion allowance is lost. This is so because 65 per cent of 27½ per cent of the oil and gas income is 17,875 per cent and will limit the depletion deduction rather than the 22 per cent deduction allowed all other taxpayers. On the other hand, when the trustee retains all of the trust income or a substantial part of the current years' income, the 22 per cent statutory depletion allowance will be fully deductible because 65 per cent of the trust's income will not be smaller than 22 per cent of the mineral income.

Section 613A(c)(9) could be read to preclude the continued use of the statutory depletion deduction when there was a change of beneficiaries under a trust through death or birth. The assumption was that the same rule should be applied to partnerships and trusts. Because these two types of entities are created, used and terminated for completely different reasons, the same rules on transfers cannot logically be applied to both.

Included in the technical amendments added by the Senate Finance Committee to H.R. 10612 (The Tax Reform Act of 1975) in section 1317 of the Bill are remedial amendments to Section 613A(c)(9) and (d)(1).

The Treasury Department and the Joint Committee Staff of Congress have both concurred in the amendments to Section 613A contained in Section 1317 of the Bill. The amendments simply cure the illogical results produced by Section 613A.

Section 613A(c)(9) is amended by adding a new clause to subparagraph (B):

"(iii) in the case of a change of beneficiaries of a trust by reason of the death, birth, or adoption of any beneficiary if the transferee was a beneficiary or is a lineal descendant of the grantor or any other beneficiary."

The adoption of this amendment will correct the unintended defects in Section 613A(c)(9).

Section 613A(d)(1) is amended by the Bill by the addition of a subparagraph to paragraph (1):

"(D) in the case of a trust, any distributions to its beneficiaries."

This amendment will place all trusts on an equal footing insofar as the statutory depletion allowance is concerned, and will place trusts on a parity with all other taxpayers. The 65 per cent limitation will be applied to a trust's net

income before the deduction taken for beneficiary distributions. This is the way the section should have originally been written. The initial failure to understand trust income tax computations caused the defect. The results of the original section were unintended.

These were clearly technical amendments and were most certainly not designed or sponsored by any individual who might have a personal interest in the amendments. The amendments will clear up a confusing situation. They are remedial and curative.

If the Association can be of assistance in any way to the Senate Finance Committee or its staff in the further consideration of this matter, please call on us.

NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS,
Washington, D.C., July 20, 1976.

Re Section 1322 of H.R. 10612 Concerning Contributions to Utilities in Aid of Construction.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR CHAIRMAN LONG: The National Association of Regulatory Utility Commissioners (NARUC), an organization whose members includes the governmental bodies of the fifty States and the District of Columbia engaged in the regulation of utilities and carriers, respectfully urges the Committee to adopt an amendment to the tax laws which would authorize contributions to regulated utilities in aid of construction to be treated as contributions to capital.

Section 1322 of H.R. 10612 would authorize such treatment for water and sewerage utilities. The NARUC supports the purpose of that Section, but would amend it so that its coverage extends to all regulated utilities.

NARUC's statement in support of the aim of Section 1322, along with a proposed amendment to broaden its coverage to regulated utilities other than water and sewer, is enclosed. I would most appreciate your having this statement printed as part of the record pertaining to H.R. 10612.

Thank you.

With warm personal regards and best wishes, I am

Sincerely yours,

JAMES MCGIRR KELLY, *President.*

STATEMENT OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

Mr. chairman and members of the committee: My name is James McGirr Kelly, and I am President of the National Association of Regulatory Utility Commissioners, commonly known as the "NARUC." I am also a member of the Pennsylvania Public Utility Commission and have served in such office since May 27, 1967.

I am joined in this statement by Paul Rodgers, NARUC General Counsel, Sumner Katz, NARUC Assistant General Counsel, and Albert J. Barr, NARUC Director of Congressional Relations.

The NARUC is a quasi-governmental, nonprofit organization founded in 1889. Within its membership are the governmental agencies of the fifty States and of the District of Columbia, Puerto Rico and the Virgin Islands engaged in the regulation of utilities and carriers. The mission of the NARUC is to improve the quality and effectiveness of public regulation for the benefit of the American consumer.

The members of the NARUC are pleased to have an opportunity to make their views known on H.R. 10612, an Act to reform the tax laws of the United States.

In particular, I will comment upon Section 1322 of the bill, which provides that contributions in aid of construction made to a public utility providing water or sewage disposal services shall be treated as contributions to capital and, therefore, not as taxable income.

The NARUC vigorously supports the purpose behind Section 1322, and urges this Committee to broaden its coverage so that it includes not only water and sewerage utilities, but also other regulated public utilities.

On April 30, 1976, I transmitted to members of this Committee a proposed amendment to clarify the tax laws to ensure that contributions in aid of construction made to regulated utilities would continue to be treated as contribu-

tions to capital. That proposal is set out as an Appendix to this statement. I urge its adoption by this Committee to replace the present Section 1322 of the bill.

I stressed the word "continue" above because contributions in aid of construction to utilities have been traditionally treated as contributions to capital. In other words, what I am requesting represents no new "tax break" for utilities and, thus, no loss of revenue which the government has been accustomed to receiving.

I am requesting only a return to the situation that existed for at least 50 years prior to February 1, 1976. On that date, Revenue Ruling 75-557 went into effect. That Ruling reversed the then-existing state of the law, recognizing formally in Revenue Ruling 58-555, by announcing that transactions with utilities involving contributions in aid of construction may be treated as taxable income.

The State regulatory commissions were very concerned with IRS' Ruling. It meant one new source for increasing the costs of utilities' services. When a utility's costs rise, it is the consuming public which eventually must "pay the piper," and it is that consuming public which has so vociferously resented the recent, dramatic increases in utility rates.

The Ruling also meant an increase in costs for new housing and other activities which would require an expansion of utility services. These increased costs would come at a time when the country is involved in a simultaneous effort of trying to dampen inflationary pressures and increase employment. The housing industry, for one, is hardly in a position to bear any additional cost constraints on its productivity.

We have petitioned the IRS to reconsider and revoke Ruling 75-557, but the IRS has refused to do so.

It is, then, up to this Committee and the Congress to restore the status quo that existed before February 1, 1976, by explicitly providing in the tax laws that contributions in aid of construction to regulate utilities shall not be treated as taxable income. We are pleased that the Commission has seen fit to do so in the case of water and sewerage companies, which will unquestionably be heavily burdened if no change in the IRS' present position is mandated. Home builders and developers have become primary sources of capital for those companies by making contributions to cover costly new connections. If such contributions will henceforth be taxable, they will have to be doubled to achieve the same productivity. Under those circumstances, developer contributions may dry up, forcing either a moratorium on construction or major increases in the bills of all ratepayers.

The situation with other utilities is similar. Long line extensions for gas and electric utilities may be financed by customer contributions in aid of construction, as may initial telephone installation costs. If these contributions are included in gross income, the public will have to pay for the additional costs through increased charges and rates.

The IRS stated in Revenue Ruling 75-557 that its decision to change the practice of excluding from taxable income contributions made to utilities in aid of construction was required by the Supreme Court's decision in *United States* v. *Chicago, B. & Q. R. Co.*, 412 U.S. 401 (1973). That argument cannot, however, withstand analysis. The case involved the question of whether rail-highway grade crossing facilities financed by government subsidies were depreciable assets under § 113(a)(8) of the Internal Revenue Code of 1939. The Court held they were not, and stated: "Whether the governmental subsidies qualified as income to the railroad is an issue not raised in this case, and we intimate no opinion with respect to it." Id., 412 U.S. at 408.

Thus, the IRS' decision in Revenue Ruling 75-557 to eradicate a 50-year history pertaining to the treatment of construction contributions to utilities was not required by the Supreme Court's decision in *United States* v. *Chicago, B. & Q. R. Co.*, *supra.* In addition, as discussed above, the inflationary impact of the Ruling is neither in the consumers' nor the country's interest. The IRS, however, has locked itself into the legal stance enunciated in 75-557 and has refused to change the Ruling. This Committee should, therefore, protect ratepayers from the consequences of a new source of taxation on utilities by supporting Section 1322, as amended in the Appendix to this statement to cover all regulated public utilities.

I want to thank you again for the opportunity to present to the Committee the views of the NARUC on Section 1322 of H.R. 10612.

NARUC PROPOSED AMENDMENT TO SECTION 1822 OF H.R. 10612 TO PROVIDE THAT CONTRIBUTIONS IN AID OF CONSTRUCTION ARE NOT TAXABLE AS INCOME

SEC. 1822. *Contributions in aid of construction*

(a) GENERAL RULE.—Section 118 (26 U.S.C., sec. 118) is amended by redesignating subsection (b) as subsection (c), and by inserting after subsection (a) the following new subsection.

"(b) CONTRIBUTIONS IN AID OF CONSTRUCTION.

"(1) GENERAL RULE.—For purposes of this subtitle, the term 'contribution to capital' includes any payment of money or transfer of other property made to or for the use of a regulated public utility [within the meaning of 26 U.S.C., section 7701(a)(33)(A), (B), (C) and (D)] as a contribution in aid of construction by a developer, an existing or potential customer, a governmental body, or any other person (whether or not a shareholder) if:

"(A) the money which is paid is used for (or is reimbursement for) the acquisition, construction, installation, extension, connection, or relocation of eligible property; or

"(B) the property which is transferred will, in the hands of the transferee, constitute eligible property.

"(2) ELIGIBLE PROPERTY.—For purposes of paragraph (1), the term 'eligible property' means property used predominantly in the trade or business of the furnishing or sale of services described in section 26 U.S.C., section 7701(a)(33)(A), (B), (C) and (D).

"(3) DISALLOWANCE OF DEDUCTIONS AND INVESTMENT CREDIT.—Notwithstanding any other provision of this subtitle, no deduction or credit shall be allowed for, or by reason of, the expenditure by or on behalf of a regulated public utility of any funds constituting a contribution to capital by reason of paragraph (1)."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to transactions entered into on or after February 1, 1976.

ALBRECHT, MAGUIRE, HEFFERN & GREGG,
Buffalo, N.Y., July 16, 1976.

Re Innocent spouse, Section 6013(e)

SENATE FINANCE COMMITTEE
Dirksen Senate Office Building
Washington, D.C.

GENTLEMEN: The explanation of the present status of the law and the reasons for the change appearing on page 423 of the Report of your Committee on the Tax Reform Act of 1976 is absolutely correct. Substantial injustice is still as unfair and inequitable as they were before 1971 in these cases.

Before the enactment of Section 6013(e) the courts expressed enormous regret at what they were doing to innocent spouses but said they were bound by the inflexible statute (joint and several liability). Since its enactment they express equally enormous regret but say they are bound by res judicata.

I have been trying for four years to protect Ruth N. Stetson, Batavia, New York, from losing the home she bought with her own money in 1927 and the rest of her life savings from her many years as a private secretary to relentless, merciless collection officers.

Mrs. Stetson is now eighty-four years of age, half blind and an invalid. She has been confined to her home for the last two years except for trips to the hospital. Her doctor fears for her mental as well as physical health because of the stress the government has put on her to make her pay for her deceased husband's mistakes.

The IRS is after her home, worth about $15,000.00 and the $20,000.00 or so that still remains of her savings (they have already seized the other $30,000.00).

The attorneys for the Department of Justice say they are sympathetic, but nevertheless obligated to take every advantage of the res judicata issue. The matter is still pending in our U.S. District Court because the judge expressed annoyance that the government should harass an old lady under these circumstances and wondered out loud if the government didn't have some other means of raising revenues than this.

Mrs. Stetson would get no relief from the provision in its present form because the years in which her husband fraudulently concealed income were 1949 through 1961. She would, if it were to be amended to read:

"For all taxable years to which Section 6013(e) applies".

This would make sense anyway because Section 6013(e) applies to all years to which the Internal Revenue Codes of 1939 and 1954 apply.

The Report of the Committee is also correct in estimating that this provision would involve only a negligible revenue loss. There are very few cases left relating back to the period from 1939 through 1961 that are not already closed by the statute of limitations. But there is no reason why justice should be denied in the few cases that still linger open.

The entire record in the Stetson case, both in the IRS files and in the Tax Court, shows that Mrs. Stetson fully qualified as an innocent spouse. She was virtually unrepresented in the Tax Court because there was nothing a lawyer could do, in 1969, to prevent the application of the inflexible rule of the statute that she was jointly and severally liable for her husband's misdeeds.

Her husband's attorney filed a petition in the Tax Court only to buy time to negotiate the amount and then stipulated to the entry of a decision against her as well as her husabnd. The IRS attributed all of the fraud and willful omissions to Howard Stetson and none to her. Yet, both the IRS and the Justice Department insist that they are duty-bound to take her property because of the last sentence in the Senate Committee Report in 1971.

The first court that heard the case could have said that Congress intended him to proceed on the theory that Subdivision (e) had been part of Section 6013 since 1939 and that if the issues as to the spouses participation in the fraud and whether or not she had significantly benefited had not previously been litigated (that she never had a day in court) the Tax Court decision would not be binding under any doctrine of res judicata. Unfortunately, however, the first court that considered the matter applied the strictest, narrowest interpretation of res judicata and the rest of them followed suit, deploring what they were doing but doing it anyway.

This is not the only way by which the IRS has been able to frustrate the clear intention of Congress to correct the inequities that arise out of the joint, several liability provisions. The IRS still promotes the filing of joint returns while, at the same time, by revenue rulings, regulations and the weight of its legal resources, constantly whittles away at the relief the subsection was intended to provide.

It is heartening, therefore, that the staff of your Committee has started to audit the situation.

I requested permission to testify to the foregoing effect at the hearings scheduled the week of July 19, 1976, but my request may have been too late. It would be greatly appreciated if this could be made part of the record.

Very truly yours,

RALPH J. GREGG.

STATEMENT OF CHARLES H. PRIDDY, PRESIDENT OF MAGNATEX CORP.

Section 1317(a) Concerning Rules Relating to Limitation on Percentage Depletion in Case of Oil and Gas Wells

Mr. Chairman and members of the committee: My name is Charles Priddy. I am President of Magnatex Corporation, a small, independent oil and gas producing firm located in Midland, Texas.

My statement is directed to a small part but, as far as we and many other small independent producers of oil and gas are concerned, a very important part, of the Tax Reform Act of 1976 as reported by your Committee and currently under consideration by the Senate. I am referring to the "retailer exclusion" provision—section 1317(a) of the bill—proposing changes to section 613A of the Internal Revenue Code in the form of certain "Amendments to Rule Relating to Limitation on Percentage Depletion in Case of Oil and Gas Wells."

We welcome and support wholeheartedly the Committee's clarifying changes to section 613A of the Code. Certain proposed Treasury regulations have made necessary the provision you recommend. Moreover, your reconsideration of section 1317(a) at this time offers us the chance to help dispel any doubt which may exist in some quarters about the public importance of retaining and clarifying this "retailer exclusion" provision in the final legislation.

Magnatex is a typical small, independent producer of oil and gas. We sell our production in bulk to others for resale. In this sense, we are wholesalers entitled to percentage depletion allowances afforded by the present section 613A of the Code.

But let me invite the Committee's attention to the following additional facts. We have a subsidiary company which owns 22 vehicles equipped to transport propane gas, and three trucks equipped to transport No. 2 diesel fuel. This subsidiary obtains product in bulk from unrelated sources and resells it in bulk quantities to industrial and commercial users at between 20 percent and 22 percent below retail prices. The Federal Energy Administration defines this subsidiary as a "wholesaler-purchaser-reseller." It is not a retailer. It maintain no retail sales premises or similar outlet of any kind. It has an office, and a storage facility to hold product during such times as its industrial customers are shut down or otherwise cannot take delivery.

The Code, as you know, excludes "retailers" from the benefit of certain percentage depletion allowances. Section 613A(d)(2) provides in part that "any taxpayer who directly, or through a related person, sells oil or natural gas * * * through any retail outlet operated by the taxpayer or a related person" is denied percentage depletion deductions.

The meaning of this "retailer exclusion" seems plain enough, and particularly so in light of its legislative history.

The lengthy Senate debate of early last year reveals that there were important policy and practical considerations for the provision. Many Senators believed strongly in repeal of percentage depletion entirely, others wished to retain it for independent producers. The Nation's large and growing energy needs—and the consequent need to stimulate new domestic exploration and production—were balanced against a view that the few largest oil companies represented an unhealthy concentration of economic power and that accordingly these largest firms did not need the added advantage of percentage depletion.

A basis for differentiating between the many small independents and the large integrated companies was reached. The "retailer" concept was fashioned as a means to repeal percentage depletion altogether for the large, vertically-integrated major oil companies while reducing it for the independents. The Congress recognized that the majors no longer require the benefits of percentage depletion, but the independent producers do.

The legislative intent evident here is salutory. Increase tax revenues promote competition in the oil industry and, most important, encourage (or at least not discourage) the search for and production, in the United States, of oil and gas among independents—who drill some 85 percent of our exploratory wells.

So far so good. But in October of last year the Treasury Department issued proposed regulations which, in part, run completely counter to the Congressional intent, legislative history and plain meaning of section 613A(d)(2). The Treasury's proposed definitions of "retailer" and "retail outlet" are clearly susceptible to the interpretation, if not actually intended to mean, that a company, such as ours, which has a subsidiary supplying bulk product to industrial and commercial users, must be considered a "retailer" ineligible for the limited percentage depletion allowances Congress intended for small independent producers.

This frustration of Congressional intent is accomplished in the proposed regulation § 1.613A-7 which, in pertinent part, defines a "retail outlet" as "any place where sales * * * are systematically made to any person or persons for any purpose other than for resale * * *" Such a sweeping definition can include any place where sales are made to one user frequently enough to be termed "systematic." Moreover, the failure of the proposed regulations to exempt bulk sales to industrial or commercial users is palpably contrary to the manifest intent of Congress that a "retail outlet" was meant to refer to filling stations owned or controlled by the major companies where gasoline was sold to the general public at retail.

I might note, in passing, that our company, like the vast majority of independent producers of which I am aware, has no need for the allowance of up to $5 million in retail sales which section 1317(a) provides. We, like most others, do not engage in any retail sales. That $5 million provision does, of course, provide a retailer of not inconsiderable size to continue to enjoy percentage depletion.

Your Committee Report noted, in the text related to section 1317 of the bill, that the retailer exclusion provision in the present law has been or could be subject to misinterpretation. Therefore, the Committee found it advisable to state its belief that "the retailer exclusion should be applied in the case of retail sales as that term is commonly used" and that "bulk sales of oil or natural gas directly to industrial or commercial users should not be treated as retail sales through a retail outlet." This reaffirmation of the original legislative intent, and

the statutory provision it supports, is welcome. In light of the proposed Treasury regulations to which I have referred, adoption of section 1317(a) of the bill is essential to insure that the intent of Congress is carried out and to prevent needless controversy with the Internal Revenue Service and very probable litigation.

Our company has found it necessary, too, to try to help clarify the law on this point by seeking administrative relief. We filed comprehensive comments with the Treasury Department in February on the proposed regulations. We believe the statute as written is clear, and its meaning made all the more clear by the Congressional debate on the subject. "Retail outlet" was meant to be understood as that term is commonly used. We think the Treasury's proposed regulations, insofar as they do not clearly differentiate bulk sales at wholesale prices to industrial users, on the one hand, from retail sales at a gasoline station on the other, bring about unnecessary confusion. Adoption of section 1317(a) by the Congress will remove whatever difficulty the Treasury Department may be encountering with the present statutory language and, of course, will settle this important definitional problem authoritatively.

As I have outlined, failure of the Congress to adopt section 1317(a) as reported by your Committee will not only contribute to the confusion already wrought at the regulation-writing level. It will, in the case of Magnatex, have the unintended possible result of causing the Internal Revenue Service to assert that our company—in all respects the typical small independent the Congress sought to differentiate from the majors—should be taxed as if it were Exxon, Gulf or Texaco.

Thank you, Mr. Chairman.

Statement by the Motor and Equipment Manufacturers Association

Section 1310

Mr. Chairman and members of the Senate Finance Committee, the Motor and Equipment Manufacturers Association (MEMA)—the national trade association of the automotive parts manufacturers—submits this statement in support of a proposed change in the committee-approved section 1310 of the Tax Reform Act of 1976 (H.R. 10612) dealing with a partial repeal of the 8 percent manufacturers excise tax on light-duty truck parts.

Under the present law, light-duty truck parts and accessories are exempt from the federal 8 percent manufacturers excise tax if they are installed by the vehicle manufacturer at the time the light-duty truck is manufactured. However, if the same part or accessory is installed by the vehicle dealer or an independent service center the product is subject to the 8 percent manufacturers excise tax.

During the earlier deliberations on the Tax Reform Act of 1976, the Senate Finance Committee recognized that the 8 percent excise tax on light-duty truck parts and accessories installed by the vehicle dealer discriminates against the vehicle dealer, the independent parts manufacturer and the consumer to the advantage of the vehicle manufacturer. This is particularly true when dealing with some parts which are more efficiently, easily and rapidly installed at the dealer level, such as heavy-duty bumpers. Recognizing the discrimination created by this section, the Senate Finance Committee agreed to repeal the 8 percent excise tax on light-duty truck parts sold in connection with—and at the time of—the original purchase of the tax-exempt light-duty truck. As an example of the type of purchase this amendment would cover the committee noted: the purchase of a heavy-duty bumper from a vehicle dealer when the bumper is added at the time of the original sale rather than by the truck manufacturer, would be tax exempt.

The MEMA strongly urges the Senate Finance Committee to reconsider this amendment and to re-amend the legislation to allow this time of original purchase of the light-duty truck provision to only apply to the sale and installation of heavy-duty bumpers. It is MEMA's—and its member companies—belief that if the committee-approved light-duty truck provision is allowed to stand as is, the law will create more problems for the automotive aftermarket parts manufacturers than it will solve. In addition, the committee-approved amendment will place the independent service centers at a competitive disadvantage.

Gentlemen, the nearly 2300 U.S. manufacturers of automotive aftermarket parts and accessories will face a real bureaucratic nightmare if this provision in the committee-approved bill is not amended.

The aftermarket parts manufacturer distributes his product through warehouses, distributors, wholesalers, jobbers, and other marketers, but he does not sell directly to the vehicle dealer. Therefore, the parts manufacturer does not know at the time of his original sale whether or not the part will eventually be tax-exempt. This means the parts manufacturer must pay to the Federal Government the excise tax on every part he manufacturers and sells, except those parts sold as original equipment to a vehicle manufacturer. Under the committee-approved amendment, when the vehicle dealer sells the parts manufacturer's product in connection with the original sale of the light-duty truck, he would have the right to request a refund of the 8 percent excise tax from the parts manufacturer.

This sort of situation will create a real administrative chaos for the aftermarket parts manufacturers and others in the distribution chain, since most of the refunding will be done in the form of credits from the manufacturers to his next link in the distribution chain and so on through the line. In addition, this type of a system will complicate the manufacturers' quarterly reports and payments to the Internal Revenue Service.

Such a system may also result in the manufacturers paying the excise tax on parts which are tax exempt, because some vehicle dealers may decide that it is too costly to process the paperwork involved in requesting a refund from the manufacturer so he may forego requesting the refund, thereby depriving the parts manufacturer of the opportunity of recapturing his funds from the Internal Revenue Service.

While it is more likely the vehicle dealer will seek the refund on such high-cost items as heavy-duty bumpers, the risk that he will not apply for a refund is greater when dealing with low-cost parts, such as some special lighting equipment, mirrors, mud-guards and many other parts and accessories which may be installed by the vehicle dealer at the time of the original purchase of the light-duty truck.

Although the automotive parts manufacturers would favor a complete repeal of the excise tax on light-duty truck parts and accessories—and have in the past filed many statements to this effect with the committee—and while the industry deeply appreciates the Senate Finance Committee's efforts to lift some of the industry's tax burdens, it is the considered opinion of the industry that, in view of the confusion and cumbersome system that this provision in the bill would create for a major segment of the industry, the industry would be better served, as will the American motorist, if this provision was only applied to the manufacturers of heavy-duty bumpers.

Therefore, the automotive aftermarket manufacturing industry through its trade association, MEMA, supports the amendment offered by Senator Carl T. Curtis of Nebraska which will eliminate the confusion which the Senate Finance Committee-approved amendment will create within the automotive aftermarket parts industry and to reduce the anti-competitive nature of the committee-approved amendment.

In closing it should be noted that the amendment proposed by Senator Curtis and supported by the MEMA will result in a minimal reduction in the funds the automotive parts manufacturing industry contributes to the Federal Highway Trust Fund.

CAST METALS FEDERATION,
Rocky River, Ohio, July 16, 1976.

Hon. RUSSELL B. LONG,
Senate Committee on Finance,
Washington, D.C.

DEAR SENATOR LONG: We have read in the press that the Senate Finance Committee is reconvening on July 20 for three days of additional hearings to examine the several sections of the tax bill which were added in committee "to accommodate problems of special interests."

Labelling a bill or a portion of a bill "special interest" legislation is frequently effective in killing a measure. Many times, however, such a label is erroneous.

We in the metalcasting industry believe it is a misnomer if the term "special interest" is used to apply to the Senate Finance Committee addition to H.R. 10612 which will provide tax credits on purchases of ferrous and non-ferrous scrap metals.

Tax actions such as these are essential to the effective utilization of U.S. raw material and energy resources through their promoting the development of adequate secondary metal at reasonable economics and favoring full use of this material by the cast metal as well as other metalworking industries.

Such utilization of raw material and energy resources will work to the benefit of all and are consonant with the policies of the United States.

We are enclosing a statement and documentation in support of this position.

We respectfully request that the Senate Finance Committee continue to recommend passage of the recycling tax credit.

Sincerely,

CHARLES T. SHEEHAN.

STATEMENT OF CHARLES T. SHEEHAN, VICE PRESIDENT, CAST METALS FEDERATION

This statement is submitted for and on behalf of the Cast Metals Federation in support of the Senate Finance Committee version of H.R. 10612 which would provide reasonable and necessary income tax incentives to encourage the utilization of recycled solid waste materials and to offset existing income tax advantages which promote depletion of virgin natural resources.

Participants in the Cast Metals Federation are the following trade associations: Investment Castings Institute; Iron Castings Society; National Foundry Association; Non-Ferrous Founders Society; and Steel Founders Society of America.

Foundries produce castings through a technique of pouring liquid metal into cavities of sand, metal or ceramic molds. Most frequently these metals are melted in electric furnaces or in cupolas. The resultant metal casting may weigh as little as a few ounces or as much as many tons.

Castings as a technological method is one of the oldest, most basic and least expensive ways employed to shape metal; other metal-shaping processes include forging, stamping and machining. Ninety percent (90%) of all durable goods manufactured required castings as end products or as component parts.

The foundry industry size is often measured on the basis of tons of castings shipped. It is usually compared with other industries on the basis of the dollar value added by manufacture. According to the latest data issued by the U.S. Department of Commerce, the foundry industry ranks sixth among all manufacturing industries. Only motor vehicles, blast furnaces and steel mills, aircraft, basic chemicals and communication equipment exceed the foundry industry in rank and in size by the value added by manufacture. The foundry industry is larger than metal working machinery and equipment, larger than fabricated structural and metal products, larger than the newspaper industry, and larger than the beverage industry.

The size of our industry is misleading because most foundries are either small, independent privately owned operations, or are captive foundries of large automotive or heavy equipment manufacturers. Of the roughly 4,500 foundries in the United States, employing over 390,000 workers, 82 percent employ less than 100 workers. The dollar value represented by casting production exceeds $15 billion and represents 22 million tons of casting each year. Sixty percent (60%) of the total industry output is produced by independent jobbing foundries.

It is an interesting paradox that while demand for castings is increasing at a rate of 6–7 percent per year, the number of foundries are decreasing each year. For example, in 1950 there were 3,000 gray and ductile iron foundries, by 1970 only 1,500, and it is estimated that as many as 500 more will close in the next five years. The primary reason is that metal casters have not traditionally generated the funds to modernize, expand, and equip. The anticipated increasing decline in number of foundries is due to lack of profits and to the need for capital to meet OSHA and environmental control standards.

Castings are vital to our economy—as vital as any raw material or component can be. As an example, these major industries buy castings from jobbing foundries: (1) Motor vehicles and trucks; (2) Industrial machinery; (3) Metal products, including heating and air conditioning equipment; (4) Machine tools; (5) Water pipe; (6) Railroads, (7) Electrical machinery; (8) Construction and farm machinery; (9) Engines and turbines; and (10) Household appliances.

The ten general industries summarized above actually encompass approximately 500 different industries.

Every time a ton of iron and steel scrap is recycled through a foundry, our natural resources are preserved by 1½ tons of iron ore, one ton of coke and ½ ton of limestone. In the non-ferrous metals, we find that 45 percent of the total

amount of copper, 1.8 million tons per year, is recycled. Similarly with lead—38 percent; with aluminum—20 percent; with zinc—20 percent.

Three long term trends in the foundry industry stand out. First, production tonnage of metal castings is increasing despite decreasing numbers of foundries in operation. Second, non-productive capital expenditure requirements of foundries for EPA and OSHA needs are increasingly difficult for foundries to meet. Third, the increasing scarcity of scrap metals and the resultant escalating costs of these metals is forcing the industry to study alternative materials to decrease its almost complete dependence on scrap as a means of retaining its markets from the inroads of competitive materials and imports.

As an example, the cost of typical grades of steel scrap have tripled since January, 1973.

The attached chart, Iron-Steel Distribution in U.S.A.; reprinted from the February, 1974 issue of Modern Castings magazine indicates that in 1972 ferrous foundries used 13.6 million tons of scrap generated by the iron and steel scrap industry. The basic steel industry consumed 29.7 tons in that year.

In the year 1973 the usage of ferrous scrap increased to approximately 60 million tons with the ferrous casting usage rising from 13.6 million tons to 16.2 million tons. At the same time iron and steel crap exports rose to 11.2 million tons despite a limited licensing procedure on exports imposed by the U.S. Department of Commerce in July, 1973.

We have been told on several occasions by the U.S. Department of Commerce and by other government spokesmen, including the President's Special Representative for Trade Negotiations, that we could not expect any further curtailment of ferrous scrap exports.

Inasmuch as the ferrous castings industry of the U.S. is severely harmed by this Government policy, we firmly believe that it is only equitable that a tax incentive such as that approved by the Senate Finance Committee be enacted into law.

The recycling tax credit amendment would provide greater incentive for the scrap industry to reclaim additional scrap; would serve to keep our costs in line; and further, provide incentive to our industry to continue to use substantial quantities of ferrous scrap and to revise our methods so that larger quantities of such scrap might be used.

It should be noted that for a period prior to 1973 there was a great shift from cupola melting to electric melting in foundries. Cupola melting used roughly 60 percent scrap plus pig iron, which came from virgin ore. Electric melting requires almost 100 percent scrap. Electric melting provided better, more efficient controls. The additional cost of electric furnaces over cupolas was offset by the fact that they were cleaner in operation and hence required less in the way of non-productive air pollution control equipment.

The scarcity and high cost of scrap today has reversed this trend toward electric melting.

The reprint from Modern Castings mentions the direct reduction of ore as an alternative to the use of scrap. This process is being seriously considered by the industry as the scarcity and expense of ferrous scrap increases.

Thus far in this statement ferrous scrap has been used as an example. Nonferrous scrap—aluminum, magnesium and copper—all are confronted with similar circumstances.

Scrap iron, steel, aluminum, and magnesium represent both a raw material and an energy resource. Efficient utilization needs to be encouraged. Our current estimates of the energy required to produce pig iron and primary aluminum and magnesium are shown in the attached figure. In producing castings using primary metals as melt stock, this energy must be added to the melting and superheating energy requirements to determine the total effect on energy reserves.

To produce magnesium die castings using primary metal for most of the charge—(the U.S. secondary magnesium market is very small), it is estimated that the product energy requirement is 164,300 Btu per pound. If a large automotive die casting operation, such as Volkswagen's, is considered, it is estimated that the magnesium product energy requirement would be 102,500 Btu per pound if 50 percent secondary alloy is used in the new feed.

Current vehicle fuel economy issues will promote the use of increased tonnages of aluminum and magnesium castings and aluminum sheet products. Vehicle weight reduction favors increased fuel economy. This will create new requirements:

1. The need for an improved secondary aluminum and magnesium market. The current secondary markets are small relative to potential automotive requirements. In addition, there is a 5–10 year lag between time of vehicle build and the time the vehicle becomes available on the scrap market;

2. A need for improved scrap processing techniques to separate ferrous and non-ferrous scrap.

Tax and export/import actions which promote the development of adequate secondary metal at reasonable economics and of good melting quality and favor full use of this material by the cast metals industry are essential to the effective utilization of U.S. raw material and energy resources.

Iron Flow in the United States—1972

The Charge Materials Committee (12–J) has updated the Iron and Steel Distribution Chart using 1972 data. The previous distribution chart published in the October 1972 issue of Modern Casting presented 1969 data and showed the flow of iron units in the U.S. marketplace. The year 1969 was used as a reference for the statistical presentation since there were no severe work stoppages or disruptive forces on the free flow of ferrous materials.

The major source of data is still the many industrial users and producers of the iron bearing products, plus the scrap processors and brokers. Data from these industries are collected and reported primarily by the U.S. Bureau of Census and the Bureau of Mines.

It is still not possible to balance the flow chart of ferrous materials primarily because of conflicting data and possibly incomplete reporting by parts of the ferrous industry. An understanding of how the information is reported as well as what is included in the numbers is needed when making comparisons. An example is the method of reporting the internal remelt or recirculating scrap in the steel and metal casting industry. In effect most of this stays in-house and is remelted and recirculated and could be considered an internal inventory.

The scrap that effectively ends up in the product can be considered outside purchases. The scrap consumption reported by the U.S. Bureau of Mines includes this internal inventory or remelt. The 1969 published iron flow chart for the metal casting industry did not make allowances for this so the 18.1 million tons of scrap shown for 1969 going into the metal casting industry included the remelt material. The 1972 chart shows only new scrap (13.6 million tons) going into the metal casting industry and the remelt is shown recirculating within the iron or steel casting group.

Metalcasting Industry

The metalcasting industry because of its dependence on scrap iron and steel has always been in interested in recycling and material conservation. The industry has co-operated closely with the secondary metals industry in developing new methods of using various raw materials. These efforts by the foundry industry have had a significant effect in maintaining a high product value for ferrous castings and has contributed to the increasing value of the industry products.

As most foundrymen are painfully aware, there is competition for iron units in world and domestic markets of a type which indicate that future constraints on production by the foundry industry may be the supply of raw materials as well as skilled manpower and usable plant capacity. Structural shifts in the flow of scrap iron and steel in the U.S. markets are indicated by the 1972 distribution when compared with the 1969 distribution chart.

For 1972 the ingot mold production of 3.0 million tons, is shown in the steel industry rather than the iron casting industry. The source of this iron is primarily from the steel industry and usually in molten form. Approximately 600,000 tons of ingot mold castings are shown in the iron industry to take care of those plants that do not get a major portion of their metal from a steel mill.

The metal casting industry consumed a total of 13.6 million tons of scarp generated from outside sources and 2.1 million tons of pig iron to produce a total of 1.6 million tons of steel casting and 13.3 million tons of iron castings (excluding the 3.0 million tons of ingot molds). This illustrates the magnitude of the casting industry and everyone including the government agencies should recognize its importance in terms of economics, employment, raw material, and energy requirements. The impact is even greater when the nonferrous industry is included.

Steel Industry

The U.S. steel industry, faced with serious competition in the domestic market, concentrated its new capital investments in the basic oxygen furnaces, continuous

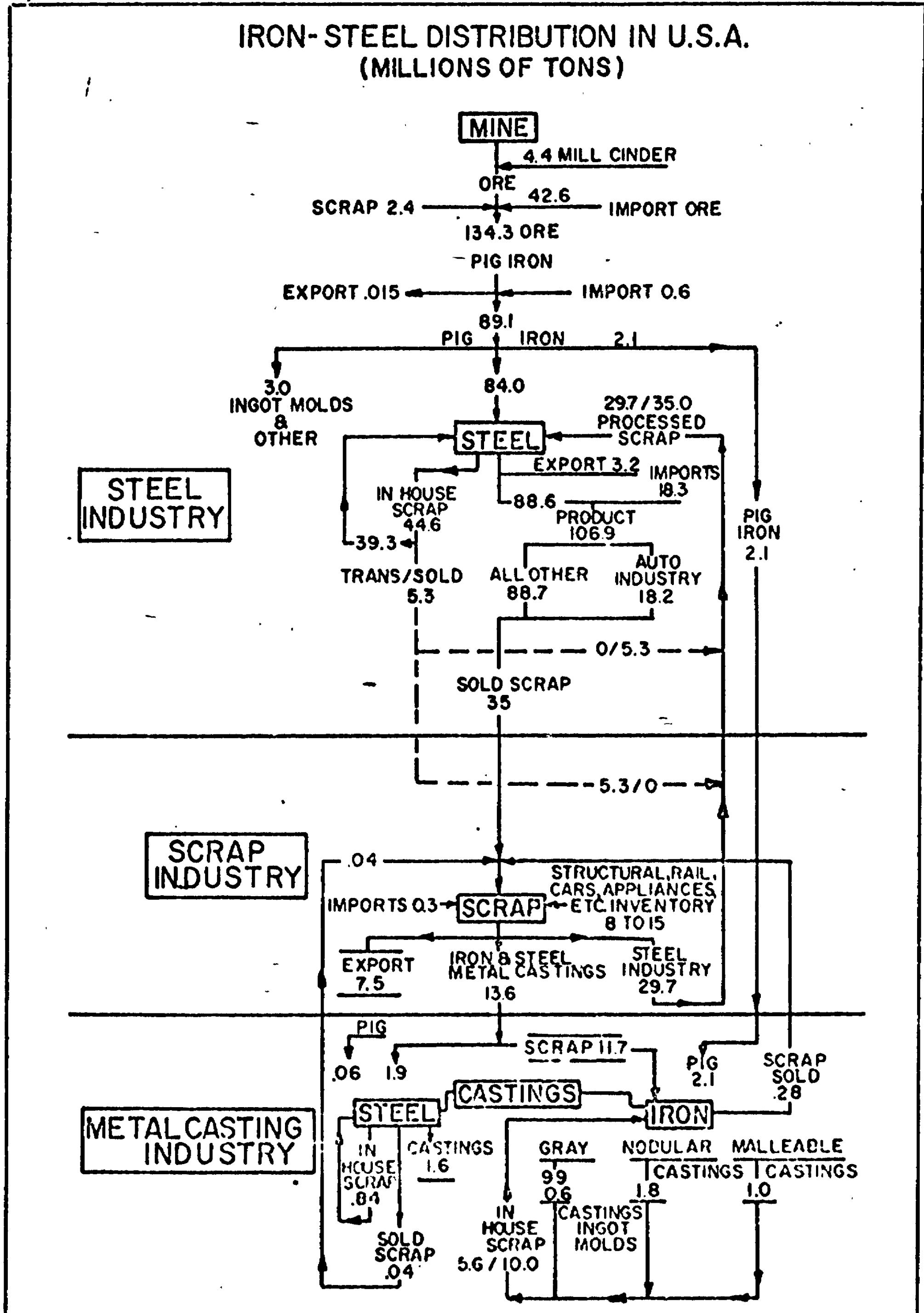
casting, and highly automated hot strip mills. Construction of new blast furnaces by the industry, has lagged the industry demand for molten iron. Production increases through improved technology reached a plateau in the late 1960s as the advantage of fuel injection and sized burden became standard practice at most facilities. New sources of iron units had to be found since the cost of a new blast furnace of modern design and production has reached a level of investment requiring joint ventures.

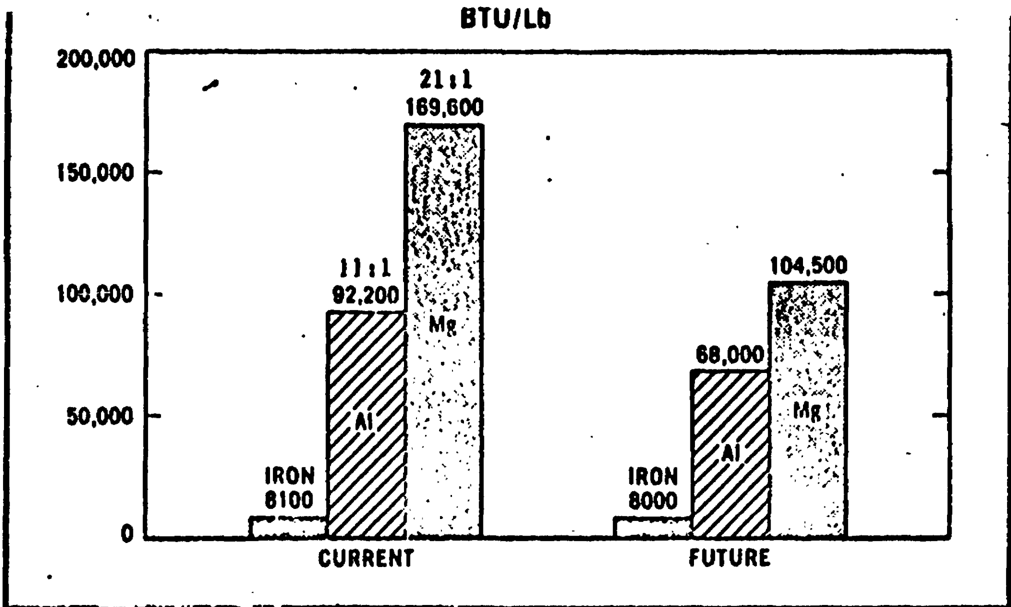
As a result, the steel industry turned to scrap preheating and electric arc furnaces. This increased the consumption of scrap steel in relation to the tonnage of molten iron consumed. The ratio between finished steel products and scrap consumption dropped from approximately 4.6 in 1969 to 3.1 or 2.6 (depending upon which number for 1972 is correct for new scrap consumption, 29.7 or 35.0 million tons shown on the chart).

This trend is expected to increase the demand on the supply sector for scrap as more electric furnaces and continuous casters are installed. Direct reduction of ore in the U.S. may alter this but only if a coal related process is used for reduction and this appears very slim for the next decade due to pressures for energy requirements elsewhere. There is, of course, a possible chance that prereduced ore can be imported but this will not occur for five to ten years.

Those nations that have ready access to both gas and ore could become major exporters of sponge iron. This *could* occur within five to ten years. It is the hope of the AFS Charge Materials Committee that this chart will illustrate graphically to everyone the importance of the metal casting industry in the flow of iron units and particularly scrap in the U.S. Approximately 27% of the iron units consumed by the steel industry is external scrap and 86% in the metal casting industry. Illustrating again the relative importance of scrap to each industry.

Any comments or additions to this attempt to summarize the ferrous cycle in the United States will be welcomed by the committee.


IRON-STEEL DISTRIBUTION IN U.S.A.
(MILLIONS OF TONS)
MINE
4.4 MILL CINDER
ORE
SCRAP 2.4
42.6
IMPORT ORE
134.3 ORE
PIG IRON
EXPORT .015
IMPORT 0.6
89.1
PIG IRON 2.1
3.0
INGOT MOLDS & OTHER
84.0
29.7 / 35.0
PROCESSED SCRAP
STEEL
EXPORT 3.2
IMPORTS 18.3
IN HOUSE SCRAP 44.6
88.6
PRODUCT 106.9
39.3
PIG IRON 2.1
TRANS/SOLD 5.3
ALL OTHER 88.7
AUTO INDUSTRY 18.2
0/5.3
SOLD SCRAP 35
STEEL INDUSTRY
5.3/0
SCRAP INDUSTRY
.04
STRUCTURAL, RAIL, CARS, APPLIANCES, ETC. INVENTORY 8 TO 15
IMPORTS 0.3
SCRAP
EXPORT 7.5
IRON & STEEL METAL CASTINGS 13.6
STEEL INDUSTRY 29.7
PIG
.06
1.9
SCRAP 11.7
PIG 2.1
SCRAP SOLD .28
CASTINGS
STEEL
IRON
METAL CASTING INDUSTRY
IN HOUSE SCRAP .84
CASTINGS 1.6
GRAY 9.9
0.6
NODULAR CASTINGS 1.8
MALLEABLE CASTINGS 1.0
SOLD SCRAP .04
IN HOUSE SCRAP 5.6 / 10.0
CASTINGS INGOT MOLDS



Current - Aluminum: 17% hydroelectric power, 33% electrical conversion factor, 50% Al_2O_3 Bauxite, 7 kwh/lb. cell requirement.

Magnesium: Dow process, 33% electrical conversion factor, 8.4 kwh/lb. cell requirement.

Pig Iron: 32.5% iron magnetic taconite.

Future - Aluminum: 17% hydroelectric power; 40% electrical conversion factor; 5.25 kwh/lb. cell requirement.

Magnesium: 40% electrical conversion factor, N. L. Industries type process.

STATEMENT OF WILLIAM NELSON UTZ, EXECUTIVE DIRECTOR, NATIONAL SHRIMP CONGRESS

Mister chairman and members of the Committee, I am William Nelson Utz, appearing here today as Executive Director of the National Shrimp Congress. The National Shrimp Congress is a non-profit trade association incorporated under the laws of the State of Delaware, with its principal offices in Washington, D.C. It is an Association comprised of regional Associations, State Associations and individual members of the shrimp industry, from South Carolina along the Atlantic coast, and all the States throughout the Gulf to Texas.

We are appearing in support of Section 1207 of H.R. 10612 (Tax Reform Act of 1976). Section 1207 would resolve what has come to be an extremely critical problem for the American fishing industry. The problem simply stated is that American fishing vessels have operated for years under an arrangement whereby the crew members of each fishing vessel took as compensation for their work effort a percentage of the catch of that vessel's trip. Under such arrangement, they considered themselves joint venturers or self-employed individuals. They received no guaranteed income for making a trip. If the trip was totally unsuccessful they received nothing for their efforts. When a trip was successful the boat owner took a certain percentage of the catch and was responsible for the operation and boat costs and his other overhead expenses.

The members of the crew took their percentage and were responsible for the food they consumed, and their personal equipment, such as slickers, boots, etc. which they used while working. This arrangement has worked satisfactorily for years, that is until the late 1960's when the Internal Revenue Service (IRS) began treating such individuals as regular employees of the boat owner, re-

quiring the boat owner to withhold taxes from the crew and to deduct and pay the taxes on these crew members under the Federal Insurance Contributions Act. Further, IRS has determined their decision (that such crew member/joint venturers are actually employees) should have retroactive application to the boat owner, and has required boat owners not only to begin deducting withholding, social security, and making matching social security payments, but has required that such deductions be paid retroactively. In some instances IRS has gone back three years and calculated withholdings, requiring the owners to come forward with lump sum payments for these withholdings on crew members, although the crew members themselves have, in fact, paid their taxes for those periods.

The fishing industry believes these crew members are clearly self employed—independent contractors who are undertaking a joint venture. If successful, they share in the benefits; if unsuccessful, they share in nothing. The crews that work on boats used in fishing are frequently made up of transitory personnel who go from boat to boat and fleet to fleet; while some individuals may be with one particular boat for months or years, many make only one trip and then move on to another fleet or boat operator, taking their percentage of the catch proceeds and signing on with a different Captain for the next voyage. Under these circumstances, it is difficult and impracticable for the boat operator to keep the necessary records and calculate his tax obligation as an employer, and it is equally difficult for him to withhold the appropriate taxes for payment. This is especially true when you recognize that boats do not necessarily put into the same location each time on returning from a fishing trip—the boat Captain as agent for the boat owner and crewmembers, sells the catch, divides the proceeds, and returns to fishing. He may make several trips without returning to the same unloading point, or returning to the home port. His crew make-up may change on each trip, thus returning home with an entirely different group of crewmembers than when he initially departed.

The situation I have just stated generally exists throughout the entire United States fishing industry, and my strong support for this provision of the Tax Reform Act is not just in behalf of the shrimp industry, but I am also speaking for the entire seafood producing industry of the United States. I am a member of the Executive Committee of the National Fishery Policy Conference which is composed of representatives of all segments of the fishing industry throughout the United States. They wholeheartedly support this provision. It is one which is desperately needed for the fishermen of the United States, and it is essential if we are to straighten out a most difficult administrative problem with the IRS. Under the present IRS interpretation, the boat owners, in effect, are being forced to accomplish IRS's job for them—i.e., make tax collections from self employed people. This is an administrative task with which these boat owners should not be burdened.

We are, therefore, requesting the Committee and the Congress to aid us by enacting into law Section 1207 of the Tax Reform Act which would remove a substantial administrative and paper work burden from the backs of the fishermen while having no substantial impact upon the tax revenues.

INLAND CONTAINER CORP.,
Indianapolis, Ind., July 15, 1976.

MR. MICHAEL STERN,
Staff Director, Committee on Finance,
Washington, D.C.

DEAR MR. STERN: I would like to strongly recommend that the Senate Finance Committee retain Section 2102 of the proposed amendments to the Internal Revenue Code. This pertains to the Modification of Transitional Rule for Sales of Property by Private Foundations.

Our Company, many years ago, established a lease arrangement between a private foundation and the company on an arm's length basis providing an attractive investment for the foundation. When the Tax Reform Act of 1969 was passed, we were placed in a very disadvantageous situation and forced to follow some economically, unsound practices to retain possession of one of our plants.

We do have another plant where we will be forced to follow similar procedures unless Section 2102 of the proposed bill is retained.

For these reasons and those set forth in the Committee's reports, which we believe are excellent and equitable, we strongly recommend retention and enact-

ment of the proposed new rules permitting sale of such facilities under specific conditions to so called "disqualified persons".

We respectfully request the Committee to retain the proposed Section 2102 in any 1976 tax reform.

Very truly yours,

U. L. UEBEHOER.

STATEMENT OF UNITED STATES INDEPENDENT TELEPHONE ASSOCIATION

SECTION 1322 OF THE TAX REFORM ACT OF 1976

This statement is submitted by the United States Independent Telephone Association (USITA) in response to the Senate Committee on Finance Press Release of July 8, 1976, in which the Committee announced further hearings on certain provisions of the Tax Reform Act of 1976 (H.R. 10612), including Section 1322 relating to contributions to capital of regulated public utilities in aid of construction.

USITA represents the independent (non-Bell) segment of the telephone industry of the United States. The independent telephone industry consists of 1,618 telephone operating companies serving over 26 million telephones through 11,000 exchanges in one-half of the served geographic areas of the nation. Independent telephone companies, together with the operating companies of the Bell System, provide exchange and inter-change telecommunications service through the integrated facilities of the telephone network.

USITA urges the Committee to modify Section 1322 on the Tax Reform Bill to provide that contributions to capital of regulated telephone companies which are used for qualified expenditures and which are not included in the rate base for rate making purposes by the regulatory body having rate-making jurisdiction will be treated as non-taxable contributions to the capital of such telephone companies.

Under present law, contributions to the capital of a corporation whether or not contributed by a shareholder, are not includable in the gross income of the corporation under Section 118 of the Internal Revenue Code. Under a long line of Board of Tax Appeals' decisions contributions in aid of construction of utilities' facilities have been considered to be contributions to capital. In 1958 the Internal Revenue Service announced that it would follow prior case law with respect to contributions in aid of construction but only with respect to regulated utilities (Rev. Rul. 58-535). Last year, the Internal Revenue Service issued Revenue Ruling 75-557 which held that amounts paid by the purchaser of a home in a new subdivision as a connection fee to obtain water services are includable in utilities income. The ruling effectively revoked the IRS's 1958 ruling.

Rev. Rul. 75-557 was apparently based on the Supreme Court's decision in the *United States* v. *Chicago, Burlington & Quincy Railroad Co.*, 412 U.S. 401 (1973). In that case the court held that governmental payments received for improvements in grade-crossings and intersections were not contributions to capital under the Internal Revenue Code of 1939. The court set forth the characteristics of a non-shareholder contribution for purposes of both the 1939 and 1959 Internal Revenue Code, indicating that the amounts received must not constitute payments for specific, quantifiable services.

Some USITA companies have taken the position that certain payments in aid of construction by customers are contributions to capital under the characteristics set forth in the Supreme Court case, notwithstanding Revenue Ruling 75-557. However, we believe that enactment of the present legislation would prejudice that position. We appreciate that the Committee has noted in its Report that in providing specific rules for water and sewage disposal companies "the Committee intends that no inference should be drawn as to proper treatment of such companies which are not water or sewage disposal utilities" (page 436).

When the Committee first considered the question of contributions in aid of construction during its deliberations, it voted to extend the special treatment to all regulated public utilities. That decision was subsequently modified and it was determined that the treatment should be extended only to water and sewage disposal utilities. It is USITA's position that no good reason exists for distinguishing between water and sewage disposal utilities and telephone companies.

At page 435 of its Report, the Committee sets forth the reasons in support of Section 1322. The Committee notes that Rev. Rul. 75-557 would increase sub-

stantially the taxes on those utilities which had previously treated all contributions in aid of construction as nontaxable contributions to capital. The Committee further noted that such increased taxes would ultimately result in higher charges to utility customers, and that since such increased charges must be approved by public utility commissions, the working capital of the utilities may be substantially reduced resulting in delays in furnishing service and curtailment of expansion of service. Finally, the Committee noted that the immediate inclusion of such contributions in income causes a mismatching of income and related expense since the utility must increase income in the year in which concontributions in aid of construction of water and sewage disposal utilities apply facilities will not arise until subsequent years.

All the reasons set forth by the Committee to justify special treatment for contributions in aid of construction of water and sewage disposal utilities apply equally to telephone companies, particularly smaller telephone companies operating in rural areas where construction costs are substantially higher than in urban centers. The problems that telephone companies have in meeting their growing construction requirements are detailed at some length in the testimony of John J. Douglas, formerly Executive Vice President, Finance, General Telephone & Electronics Corporation given on behalf of USITA before this Committee on April 1, 1976. The exclusion of the telephone companies from the tax treatment for contributions in aid of construction accorded in Section 1322 will simply add to the burdens of raising capital for construction recited by Mr. Douglas in his testimony.

For all the foregoing reasons, the Committee is respectfully requested to reconsider its prior action in limiting Section 1322 to water and sewage disposal utilities, and to specifically extend the tax benefits provided by the Section to telephone companies.

ECOSOL LTD.,
New York, N.Y., July 20, 1976.

MICHAEL STERN, Esq.,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: I understand that the Finance Committee is to hold hearings beginning today on certain provisions of the Tax Reform Bill that have been characterized by Senators Proxmire and Kennedy as "special interest amendments" benefiting only one or two companies. I notice that one of those provisions is Section 2002 of the Committee Bill providing a tax credit for the installation of residential heat pumps. According to the Congressional Record of June 28 ,1976, both Senators believe that this provision was "pushed by G.E. and Westinghouse" and therefore that it is intended to benefit primarily those two companies. I would like the printed record of the hearings to include my written statement that many companies, large and small, are currently manufacturing heat pumps in the United States. Specifically, the 1976 edition of The Mechanical Products Catalog contains 82 such companies and I attach hereto a list of them for inclusion in the record.

Very truly yours,

S. KEITH LINDEN,
Vice President.

LISTING OF HEAT PUMP MANUFACTURERS FROM THE 13TH EDITION OF THE 1976 MECHANICAL PRODUCTS CATALOG PUBLISHED BY HUTTON PUBLISHING CO., 450 PLANDOME RD., MANHASSET, NEW YORK

1. ACCO
2. ACME Industries, Inc.
3. American Gauge & Manufacturing Co.
4. Bard Manufacturing Co.
5. Brookstone Co.
6. C. M. Hoist. Division of Columbia McKinnon Corp.
7. Carrier Air Conditioning
8. Carteret Air Conditioning, Division of Singer Co.
9. Chance Co.
10. Chrysler Corp.—Airtemp Division
11. Climate Control. Division of Singer Co.
12. Dayton Electrical Manufacturing Co.

13. Dearborn Stove Co.
14. Duff-Norton Co.
15. Durant Tool Co.
16. Durban-Durco, Inc.
17. Eaton Corp.
18. Fedders Corp.
19. General Electric
20. General Machine Products, Division Philadelphiai Hoist
21. International Heating & Air Conditioning Co.
22. Lennox Industries, Inc.
23. Luxair, Inc.
24. Maasdam Power & Pull, Inc.
25. Red Tiger Products, Inc.
26. Roofing Tools & Equipment Co.
27. Sioux Steam Cleaner Corp.
28. Thor Power Tool Co.
29. Trane Co.
30. Vilter Manufacturing Corp.
31. Westinghouse Electric Corp.
32. York Division of Borg-Warner

STATEMENT OF JOHN E. HEMPSTEAD, PARTNER, BUTCHER & SINGER, PHILA., PA.

Honorable Members of the Committee on Finance, my name is John E. Hempstead. I am a partner in the investment banking firm of Butcher & Singer, which has its principal office in Philadelphia, Pennsylvania. My remarks concern the effective date provisions of the Committee Amendment to H.R. 10612, which deal with so-called partnership swap funds. The substantive provisions of this particular legislation correspond to H.R. 11920, passed by the House of Representatives on May 3, 1976.

At the time of the hearings by the Ways & Means Committee on H.R. 11920 on March 29, 1976, there were eight swap funds which had been formed as partnerships. On February 17, 1976, the date on which H.R. 11920 was introduced, five funds had then been formed and the three other funds had not yet filed a request for ruling with the Internal Revenue Service or a registration statement with the Securities and Exchange Commission. One of those three funds is Equity Exchange Fund, sponsored by my firm.

I am here to support the action of the Finance Committee in recognizing the fairness and equity in permitting all eight funds to conclude the transactions for which they were formed.

On January 29, 1975, Butcher & Singer received a favorable tax ruling from the Internal Revenue Service concerning the establishment of a general partnership as an investment company. The importance of that January, 1975 ruling to the present situation is that the ruling established, in our opinion, a more desirable, economical and easier method of utilizing a partnership format as an investment company, as distinguished from the limited partnership format which then, and now, has been the usual method for a partnership investment company. When I heard about the Vance, Sanders Exchange Fund (which is a limited partnership) it occurred to me that the general partnership format of our January, 1975 ruling could be adapted for use in a swap fund context. Consequently, on Tuesday, November 18, 1975, I first met with our tax counsel to review with him the effect of organizing a swap fund utilizing the general partnership format on the January, 1975 ruling. From that conversation, it did become evident that there were certain advantages in utilizing the general partnership format for our swap fund, rather than the limited partnership format used by Vance, Sanders.

I immediately began to concentrate most of my activities to arranging the establishment of a swap fund which would utilize the general partnership format approved by the Internal Revenue in January, 1975, and would rely upon the policy of the Internal Revenue Service, as announced in the Vance, Sanders case, to issue favorable rulings to swap funds.

Butcher & Singer would prefer to have some other entity be the fund's investment adviser or manager, although we would be willing to perform that func-

tion if a suitable arrangement could not be made with an independent fund adviser or manager. For this reason, I spent considerable time in determining what entity would be a compatible participant with Butcher & Singer in the establishment and operation of its swap fund. These efforts resulted in numerous telephone calls with officers of Wellington Management Company, of Valley Forge, Pennsylvania during December, 1975. As a result of these calls, a meeting to discuss the management of the swap fund by Wellington Management was held on December 22, 1975. Attending that meeting were three officers of Wellington Management, our counsel, and myself. The result of that meeting is summarized in the "Proposal for an Exchange Fund" dated January 14, 1976 which was sent to William H. L. Sullivan, of Wellington Management Company. That memorandum, together with a separate memorandum of our counsel also dated January 14, 1976, summarizes the most important features of the general partnership exchange fund format. Although those memoranda were only summaries, they clearly show the substantial amount of the legal activity, and my activities, which had gone into this project from November 18th to that date. Copies of those memoranda are being made available to the Committee.

The letter to Mr. Sullivan was followed by a second meeting with officers of Wellington Management Company, held on February 2, 1976. Attending that meeting were three officers of Wellington Management, our counsel and myself. Those attending the meeting wanted to go forward with the project as soon as possible. As a result of those meetings, we authorized our counsel to draft what would be, in effect, a request for a supplemental ruling to our January, 1975 ruling regarding the use of the general partnership format for the swap fund. There is no question that our desire to use a more economical partnership format, rather than merely to "copy" the Vance, Sanders format, was the cause of delay in forming our swap fund. This required additional time to explain to Wellington Management the operation and legal aspects of that format. As it has developed, we now find it necessary to use the same limited partnership format as the other swap funds because of novel issues raised by the Securities and exchange Commission which, in the opinion of our counsel, probably would not be resolved prior to the expiration of the 60-day period permitted by the bill to conclude solicitation of exchange securities. The use of the limited partnership format presents no delays for technical reasons with the Securities and Exchange Commission or with the Internal Revenue Service.

Shortly after that February 2, 1976 meeting with the officers of Wellington Management Company, our counsel and we had heard the rumors circulating in the investment community that the Internal Revenue Service was, for some unknown reason, putting a "hold" on the issuance of rulings for swap funds. It was only a few days later when, on February 17, 1976, H.R. 11920 was introduced and the Internal Revenue Service suspended rulings.

At the time the Service's "hold" position in issuing rulings was made known to the interested parties, we had already incurred considerable costs and effort on the matter. This is amply evidenced by the memoranda dated January 14, 1976 sent to Wellington Management. Ironically, had not the "hold" position been taken by the Internal Reveune Service, I have been informed that our request for ruling would have probably been submitted to the Service before February 17, 1976.

In 1966, the Congress permitted swap funds to become effective for a short period after enactment of legislation which thereafter precluded corporate swap funds. After H.R. 11920 had been introduced, we recognized that the effective date provisions for the swap fund legislation might not be as liberal as those provided in the 1966 legislation. For this reason, we filed our request for ruling with the Service prior to the hearings held by the Ways and Means Committee, so that the Congress could enact a bill which would give fair treatment to us along with all the other swap funds which have relied upon the Service's position by filing a request for ruling or a registration statement prior to that cutoff date.

In conclusion, we believe that the Finance Committee has properly recognized that it is only fair and equitable that all eight swap funds be permitted to conclude the transactions for which they were created.

Thank you for your consideration.

Memorandum.

JANUARY 14, 1976.

To: Butcher & Singer.
From: Hudson, Wilf & Kronfeld.
Re: General Partnership Exchange Fund.

I. THE PARTNERSHIP

A general partnership will be formed under the Uniform Partnership Act of an appropriate state. The Partnership will be registered as an open-end diversified management company, under the Investment Company Act of 1940.

One partner of the Partnership would be the XYZ Fund, a Unit Investment Trust ("UIT") represented by a bank serving as Trustee. At least two other General Partners would be necessary. On the basis of our informal discussions to date with the staff of the Internal Revenue Service, it is our opinion that these additional General Partners could all be corporations formed specifically for this purpose, and that, although they should have some meaningful amount of capital, their capitalization should not prove to be an obstacle.

It the management company-advisor wished to have a subsidiary serve as a corporate partner, it would be necessary that the other partner not be an "interested person" of the Partnership or the UIT.

The business of the Partnership would be managed by a managing committee of Partners which would include all Partners other than the UIT, with each managing Partner to have an equal vote. If the Managing Partners were corporations, they would, of course, act through their duly elected officers. (On this point, the SEC would no doubt want some undertakings from the corporations as to their director/officer composition between annual meetings of the Fund.)

The following items would be voted upon by all Partners (including the UIT), each Partner being entitled to cast a vote equal to the number of units of Partnership Participation held:

(1) Election or removal of managing Partners other than elections to fill vacancies;

(2) Approval of any investment advisory or underwriting contracts or actions to terminate any such existing contracts;

(3) Ratification, rejection or termination of the appointment of an independent public accountant retained to certify the financial statements of the Partnership;

(4) Approval of proposed changes in the nature of the Partnership's business or in the investment limitations contained in the Partnership Agreement;

(5) Amendments of the Partnership Agreement; and

(6) Any other matter on which Partners are entitled to vote in proportion to the respective partnership interests as required by the Investment Company Act of 1940.

The Partnership Agreement would provide, *inter alia*, the following:

(1) The Partnership shall continue until December 31, 2020, unless sooner terminated in accordance with the terms of the Partnership Agreement.

(2) In the event of the dissolution of the Partnership by reason of the withdrawal (whether voluntary or involuntary) of any Partner, the business of the Partnership will not be terminated and shall be continued by the remaining Partners.

(3) A Partner cannot transfer his Partnership interest, except by redemption.

(4) The UIT will contribute approved securities, and the other Partners will contribute such securities and/or cash to the Partnership in exchange for a proportionate Partnership interest, consisting of—

(*a*) A pro-rata interest in the capital of the Partnership, and

(*b*) A pro-rata distributive share of its profit and losses, hereinafter items (a) and (b) will be referred to as "Units of Partnership Participation").

II. THE UNIT INVESTMENT TRUST

The UIT will be formed and registered as an investment company under the Investment Company Act of 1940. As requirel by Section 4(2) of the 1940 Act, it will be organized under a contract with a bank as trustee. The UIT will issue only redeemable securities in the form of Units in the UIT. Each UIT unit will represent an equivalent Unit of Partnership Participation. The provisions of the trust creating the UIT would expressly prohibit an investor in the UIT from receiving a Unit of Partnership Participation on redemption of his UIT units

and restrict him to receiving cash and/or securities as the Partnership in turn paid the UIT when it redeemed the equivalent Unit of Partnership Participation.

Units of Partnership Participation will constitute the sole asset of the UIT, except for approved securities held pending purchase of Units of Partnership Participation or proceeds from the redemption of such Units pending distribution to the redeeming investor. UIT Units will be offered for sale under both "fully paid" (one payment), and periodic payment plans which provide for the regular periodic investment in Units of Partnership Participation held by the UIT.

The Trustee of the UIT will be required to "pass through" to record holders of UIT Units pro-rata voting rights on such matters as are submitted to the Partners of the Partnership. The Trustee will vote the Units of Partnership Participation held by the UIT in accordance with the directions of the holders of Units in the UIT.

III. THE PUBLIC OFFERING BY THE PARTNERSHIP'S UNIT INVESTMENT TRUST AND ITS OPERATION

The UIT will own virtually all of the Units of Partnership Participation in the Partnership. All securities received from the sale of UIT Units will be invested in Units of Partnership Participation in the Partnership. The net asset value of each Unit of Partnership Participation in the Partnership will at all times be equal to the net asset value of each Unit of the UIT since the Partnership will bear its own expenses and those incurred by the UIT. Additional purchases or redemptions of Units in the UIT by investors will affect the aggregate number and value of the Units of Partnership Participation held by the UIT, but will not affect the net asset value per unit which will fluctuate only as a result of the Partnership's net income (or loss), distributions of net investment income and capital gains, and changes in the market value of its investment portfolio.

Each Partner's distributive share of the Partnership's "net income distributions items" (i.e., income, gains or losses, deductions and credits) will be determined daily on a per unit of participation basis and allocated to each Partner during the Partnership's taxable year in accordance with such Partner's actual holding period for each such unit. The ownership of each of the UIT's Units of Partnership Participation is directly attributable to an investment by an investor in a unit of the UIT.

The Partnership Agreement would cover such matters as when distributions of income would be made; whether capital gains would be distributed and how such gains (or losses) would be allocated; the mode of payment of any distributions; the mode of payment of redemptions; etc.

IV. STATUS OF UIT AND UIT INVESTORS

Although we feel there is little doubt that the UIT would be recognized as a legal entity under state law with the power to serve as a General Partner in the Partnership, the further question must be faced as whether it would be held to be merely a "dry" or "passive" trust. It is our opinion that it probably would be so considered, and that the real parties in interest in the Partnership would therefore be deemed to be the investors in the UIT. (The bank as "Trustee" would be considered as their agent only, although the bank would, of course, have significant fiduciary responsibility.)

There is to our knowledge no direct legal authority on this general subject but it would probably follow, if the rare occurrence should arise when a creditor should attempt to assert liability against any of the General Partners (as opposed to the Fund), that the investors in the UIT would be held to be liable as General Partners.

Conversely, *in theory at least*, if such investors have liability as General Partners then they could be said to have authority to create obligations of the Partnership, whether in contract or tort. Their authority to bind the Partnership to any obligations or to create any liabilities is, however, in our opinion, far less clear and, in our opinion, would not exist.

In any event, if such an investor attempted to create any liabilities on behalf of the Partnership, the Partnership would no doubt have defenses which would prevail. For example, an alleged creditor would have to have dealt in good faith and, given the operation of a mutual fund, it is difficult to see how anyone, from a car rental agency to an investment firm, could deal with such an investor purporting to act on behalf of the Fund without making some reasonable inquiry. If no such inquiry was made, the creditor has little or no case. Furthermore, the

risk is actually no greater than that to which Massachusetts business trusts (as many mutual funds and REITS are organized), are exposed to in those jurisdictions which do not recognize them as legal entities protecting their shareholders against unlimited liability. Texas is a prime example, but this does not deter these funds and REITS from doing business there.

In short, althought there may be technical legal risks, as a practical matter, we consider these risks minimal.

Nevertheless, it would be prudent for the Fund to conduct its business in the manner that business trusts do, by having written contractual arrangements with everyone with whom the Fund does business which would require that such persons look only to the assets of the Fund in satisfaction of any claims or liabilities arising out of any transactions with or on behalf of the Fund.

In addition, we understand that insurance may be available at a reasonable cost to protect the General Partners (including the UIT investors if they should ever be so held to be) against all third party claims.

As a further precaution, the managing Partners should have the right to terminate the Fund if its assets fell below a level where they felt they might not be fully protected against third party claims.

BUTCHER & SINGER,
Philadelphia, Pa., January 14, 1976.

To: Wellington Management Co.
From: Butcher & Singer.
Subject: Proposal for an exchange fund.

Introduction

It is proposed that Wellington Management Company help bring into being and act as Invesetment Adviser to a new exchange fund (Fund). This Fund will be in some respects similar to the recently organized Vance, Sanders Exchange Fund except that instead of being a limited partnership, it will be structured as a general partnership combined with a Unit Investment Trust (see Structure, below). This format provides a number of important advantages, which will be discussed later.

Purpose of fund

The Fund will be an open-end diversified investment company. Its investment objective will be to seek long-term growth of capital and consequent long-term growth of income. It will provide an equity investment medium to investors holding blocks of individual equity securities with large unrealized appreciation who wish to exchange such holdings for shares of the Fund without thereby incurring Federal capital gains tax liability.

Shares of the Fund will be offered to prospective investors in exchange for equity securities meeting certain specified minimum criteria of quality and liquidity.

Redemption

Shares of the Fund will be at all times redeemable at Net Aset Value.

Distribution

Income will be distributed quarterly; capital gains annually.

Taxes

For purposes of Federal income taxes:

(*a*) The Fund will be treated as a partnership and thus will not itself be taxable.

(*b*) No gain or loss will be recognized to the Fund or its shareholders upon contribution of securities in exchange for an interest in the Fund.

(*c*) The tax basis of a shareholders Fund shareholdings will be the adjusted basis of the securities contributed in exchange for Fund shares at the time of the contribution.

The Fund will, after the exchange, in general hold securities where market values exceed their tax base on the Funds books. Fund investors will, in effect, have pooled their unrealized capital gains. Sale of portfolio securities, therefore, can give rise to the realization of capital gains by all Fund shareholders.

Structure

The Fund itself will be a general partnership with at least three general partners. One of the general partners will be a Unit Investment Trust (UIT). It is the shares of the Unit Investment Trust that will be offered to the public.

It is possible that the remaining general partners could be corporations rather than individuals.

The attached memorandum of Messrs. Hudson, Wilf & Kronfeld discusses the structure in greater detail and analyses its legal implications.

The advantage of the proposed structure over the Limited partnership form employed by Vance Sanders and American General are as follows:

Costs and mechanics of registration and transfer of shares will be greatly reduced. This permits an offering with a smaller minimum purchase, widening the Fund's potential market.

The Fund will be able to operate on an open-end basis and continuously offer UIT shares without the need to amend the partnership agreement each time a new shareholder is added.

Since the proposed Fund is not a limited partnership, managing general partners would not be required to maintain a 1 percent interest in the Fund or to meet the "safe harbor" requirements.

Sale of shares

An exchange offering of this type does not lend itself to an "underwriting" in the strict sense of the word.

The Fund will be marketed through the general broker-dealer community by means of a Soliciting Dealer-Dealer Manager arrangement.

Two alternate approaches to the orientation of the Dealer Manager team suggest themselves. First, Wellington and Butcher & Singer could act jointly as Dealer Managers, emphasizing in their marketing approach the traditional "Mutual Fund" sales channels. Alternatively, Butcher & Singer could put together, possibly with the assistance of one or more major bracket securities firm, a conventional soliciting dealer syndicate. Further thought and discussion are required in this area.

Timetable

Since Butcher & Singer has previously received an IRS ruling on an unrelated fund project that also employs the general partner-UIT structure; it is felt that receipt of a ruling on this project should be routine. If all goes well, a late spring offering might be feasible.

STATEMENT OF CARL D. KEITH, EXECUTIVE VICE PRESIDENT, ENGELHARD MINERALS & CHEMICALS CORPORATION REGARDING THE NEED TO EXTEND THE RECYCLING TAX CREDIT TO PLATINUM GROUP METALS USED FOR INDUSTRIAL PURPOSES

Platinum Group Metals are strategic and critical materials for the U.S. economy. They are essential catalytic agents in the manufacture of basic chemicals and in the refining of petroleum; they serve unique metallurgical requirements where high temperature stability and corrosion resistance are indispensable.

By the term Platinum Group Metals, is meant the metals platinum, palladium, rhodium, iridium, ruthenium, and osmium—all elements having similar chemical and physical properties and commonly occur in nature in combination with platinum.

There are virtually no U.S. sources of these materials since the only active mines at this time are those primarily in South Africa and the Soviet Union although Platinum Group Metals are derived as a byproduct of nickel/copper production in Canada and the Soviet Union. Fortunately, Platinum Group Metals are inherently recoverable in recycling processes, but the relatively low concentration of such metals utilized in many applications, other than jewelry, stresses the problem of economic feasibility.

It is for these reasons we respectfully request this Committee to consider revising the tax credit for recycling waste materials so as to eliminate the restriction in the present draft of these proposals which denies the availability of that credit to Platinum Group Metals.

Our Company is the leading U.S. supplier of Platinum Group Metals and products to U.S. industry. Our production facilities and refinery are located in Newark and Carteret, New Jersey and in Huntsville, Alabama. The demand for these materials occasionally outstrips available supplies and tends to limit potential applications in facilitating efficient production in a variety of domestic industries.

We have invested tens of millions of dollars in added facilities and improvements to our U.S. refinery to better meet this demand. However, the low concentration of metal in available industrial wastes and the extended procedures and time necessary to recover the Platinum Group Metal content prevents the treatment of substantial proportions of the available scarps, wastes, and residues of these metals. As a result, a considerable amount of metal content is being discarded. An important example of this problem is the use of plantinum and palladium, and possibly other Platinum Group Metals, in the production of automobile pollution control devices and the disposition of the scrap from these products. Automotive catalytic converters provide benefits to our total population in the form of cleaner air, and the Platinum Group Metals are not susceptible to being replaced by substitute materials. At the same time, the quantities of metal required for this application can delete an important portion of the available metal supply. The demand for these metals in automobile pollution control will eventually represent their largest single use.

About $6.00 worth of platinum and palladium is presently used in the manufacture of the catalytic devices for each car, but present estimates show that it would cost more than $6.00 to collect, recover, and recycle the precious metal from each automobile. Part of the difficulty of this problem is that the total use of precious metals in such devices is only about 1.5 grams or about 0.0033 lb. for an automobile weighing more than 3,000 lbs. Unless ways can be found, to make the recovery of metal from such devices economically feasible, the world will have irrevocably lost an important source of critical materials. No other application of these materials has historically ever resulted in such losses, and the effect of draining this available metal will in time have an extremely negative influence on essential industries in the U.S.A.

We respectfully suggest that one available way of helping alleviate this problem is for your Committee to allow the application of the tax credit for recycling waste materials to include the recycling of Platinum Group Metals from those industrial wastes where the Platinum Group Metal content is low. We emphasize that this would not provide a tax credit for the recycling of Platinum Group Metals found in jewelry or other similar articles which contain a high concentration of such metals and which accordingly would not need the assistance of the tax credit to make that recovery economically feasible. We believe the tax revenue loss by virtue of such a credit would not be significant since the amounts of those metals which would be involved would in the overall be small compared to other metals. We estimate that by 1980 when the recycling credit would become fully applicable, the tax cost would only be on the order of $10 million per year for conservation of Platinum Group Metals vital to industry.

In summary, while it is understandable that there may be little need to encourage the recycling of Platinum Group Metals contained in jewelry and other high metal concentration articles, those metals, which are contained in industrial products (such as the catalysts used to control pollution), are treated by potential recyclers just like any non-precious metal and will be recycled only if it is economically feasible to do so. Moreover, it is desirable to encourage secondary refining of Platium Group Metals, which are brought into this country for use by key industries, to assist the U.S. balance of payments and provide maximum domestic availability of these important metals. We submit that there is no sound basis for providing a tax credit for recycling base metals and at the same time excluding Platinum Group Metals found in industrial wastes.

We sincerely request that the Finance Committee extend the tax credit for recycling waste materials to include recycling of those small amounts of Platinum Group Metals found in industrial products.

Statement of Investment Company Institute

The Investment Company Institute files this statement concerning—

(*a*) H.R. 11920, relating to so-called "swap funds", which the Finance Committee on June 11, 1976 approved, with amendments for addition, to H.R. 10612, and

(*b*) Amendment No. 2035 to H.R. 10612 submitted by Senator Percy, relating to municipal bond mutual funds, a subject on which the Investment Company Institute has previously testified before the Committee.*

*The amendment is not reprinted in this volume.

The membership of the Institute consists of 383 regulated investment companies (known as "mutual funds"), their investment advisers and principal underwriters. The mutual fund members of the Institute have about 7.5 million shareholders and assets of approximately $46 billion, representing about 93% of the assets of all U.S. mutual funds. The average investment of each mutual fund shareholder is thus about $6,000.

I. H.R. 11920 ("SWAP FUNDS")

Robert L. Augenblick, President of the Investment Company Institute, and Edwin S. Cohen, Counsel, testified on behalf of the Institute on March 29, 1976 before the House Ways and Means Committee in its hearings on H.R. 11920. The testimony of the Institute related solely to section (a) of H.R. 11920, concerning mergers and other reorganizations under Section 368 of the Internal Revenue Code to which a "regulated investment company" (as defined in Section 851 of the Code) is a party.

The Institute presented to the Ways and Means Committee the results of a survey it had made, shortly after the introduction of H.R. 11920, of all the mergers or similar reorganizations to which its member mutual funds had been parties between January 1, 1970 and December 31, 1975, a period of six years. Based upon that survey the Institute respectfully submitted that section (a) of the bill as introduced be deleted, because it was unnecessary to the main purpose of the bill, namely, to terminate the possibility of the organization of "swap funds".

The Institute urged upon the Ways and Means Committee that if section (a) in modified form were retained in the bill, the Committee should in the public interest exclude from its operation mergers or other reorganizations of two or more regulated investment companies. The reasons for this recommendation were summarized in the Institute's statement of March 29, 1976 to that Committee. In section (a) of H.R. 11920, as revised by the Ways and Means Committee and passed by the House, such mergers and reorganizations have been excluded from its operation. The Institute urges the importance of retaining this exclusion of such transactions in Senate action on the bill.

The Institute also recommended to the Ways and Means Committee that, if section (a) of H.R. 11920 were retained in the bill in modified form, it should exclude from its operation mergers and other reorganizations between a regulated investment company and another investment company which, although not meeting all the requirements of a regulated investment company, has a diversified investment portfolio. In the bill as modified by the Ways and Means Committee and passed by the House, such transactions were also excluded from the scope of section (a) of the bill, and the Institute similarly urges that the Finance Committee retain this exclusion in the bill. While the test of diversification for this purpose in the bill passed by the House differs somewhat from those suggested by the Institute in its statement to the Ways and Means Committee, the Institute believes that the test presently in the bill will prove satisfactory.

Accordingly, while the Institute still believes subsection (a) to be an unnecessary and complex addition to Section 368 of the Code, it supports the provision in its present form.

II. MUNICIPAL BOND MUTUAL FUNDS—SENATOR PERCY'S AMENDMENT NO. 2035 TO H.R. 10612

In testimony presented by Mr. Augenblick and Mr. Cohen on behalf of the Institute before the Finance Committee on June 7, 1976, the Institute requested the Committee to approve a proposal to expand the market for tax-exempt state and local bonds by amending the Internal Revenue Code to permit regulated investment companies to be formed to invest in such bonds on a basis which preserves the tax-exempt character of the interest on the bonds when distributed currently to the shareholders of the companies. Attached to the statement of June 7, 1976 was a copy of a memorandum dated April 17, 1976 on the same subject, which had previously been filed by the Institute with the Finance Committee as a part of the original hearings on H.R. 10612.

On July 20, 1976, Senator Percy submitted Amendment No. 2035 to H.R. 10612 that would permit the establishment of such municipal bond mutual funds. (A copy of the excerpt from the Congressional Record of July 20, 1976, page S. 11897, is attached.) Senator Percy's amendment is substantially identical to bills previously introduced in the House of Representatives, referred to in

the Institute's earlier statements, and to H.R. 14683, introduced in the House on July 1, 1976 by Congressman Steiger on behalf of himself and nine other members of the Ways and Means Committee.

The proposal has the support of the National Governors Conference, the National Association of Counties, the Municipal Finance Officers Association and the American Federation of State, County and Municipal Employees. Chairman Hills of the Securities and Exchange Commission has announced the support of the SEC for the proposal.

The Institute respectfully urges the Finance Committee to approve Senator Percy's proposed amendment to H.R. 10612.

STATEMENT OF EDWARD A. MORGAN, ESQ., ALEXANDER & GREEN, NEW YORK, N.Y.

The purpose of this statement is to comment upon Section 1308 of H.R. 10612 as reported by the Senate Finance Committee, dealing with income from the lease of intangible property as personal holding company income.

This comment is submitted because of the concern that the Congress, in dealing with one narrowly focussed problem, might inadvertently aggrevate existing difficulties for a larger and more significant group of taxpayers. The concern herein is attributable to the general definitional concepts used in the bill and in the accompanying committee report (S. Rep. No. 94–938, 94th Cong., 2d Sess. (1976)).

The proposed amendment deals with the definitional concepts of personal holding company income—specifically "royalties" aund "rents"—in cases where corporate "property" is used by major shareholders. Int. Rev. Code of 1954, as amended (the "Code") § 543(a)(6). Section 1308(a)(4) of the bill provides that for such purpose—

". . . the term 'property' includes intangible property, if such intangible property and tangible property owned by the corporation are used by a person in the active conduct of a trade or business."

The committee report notes that the Internal Revenue Service has taken the position that amounts received for leasing intangible property are to be treated as ordinary "royalty" income. *Rev. Rul. 71–596*, 1971–2 Cum. Bull. 243; see S. Rep. No. 94–938, *supra*, at 409–410. The committee report then continues to state the purpose of Section 1308 of the bill as being in effect to provide that amounts received for leasing intangible personal property may be treated as rents for purposes of Section 543(a)(6) of the Code. The committee report also states—

"If the shareholder does not use the license or other intangible asset (along with tangible assets) in carrying on his business, the license payments received by the corporation *are to be treated as ordinary royalties* governed by the present rules of section 543(a)(1) or, if appropriate on the facts, under other rules relating to mineral, oil or gas royalties (sec. 543(a)(3)) or copyright royalties (sec. 543(a)(4))." *Id.* at 411 (emphasis supplied).

The sentence just quoted thus evidently adopts the position of *Rev. Rul. 71–596, supra*, with respect to payments outside of the scope of the proposed amendment.

The consequences of the "rent" or "royalty" classification under the 70 percent personal holding company tax can be dramatic. Royalties (other than certain mineral, oil, or gas royalties or copyright royalties) *always* constitute personal holding company income. Code § 543(a)(1); see also Code § 543(a)(3) and 543(a)(4). Rents *generally* constitute personal holding company income but may be excluded from that category if certain tests relating to active rental businesses, produced film rents or use of corporate property by major shareholders are met. Code § 542(a)(2); see also Code §§ 543(a)(5) and 543(a)(6). In other words, if an active business (not receiving or retaining substantial amounts of other possible personal holding company income) can establish that it receives "rents", it may conduct relatively normal corporate business operations, notwithstanding the personal holding company rules. No similar privilege is presently accorded if "royalties" are received.

Under present law, the distinctions between "rents" and "royalties" and other income categories are not in all instances clearly delineated.[1] Corporations con-

[1] The position of Rev. Rul. 71–596, supra, if viewed as an attempt at a general definition, is not clearly supported by any authorities therein cited or, on balance, by any other known authorities.

ducting active business operations, and needing to retain some earnings to finance business growth, therefore have at least two alternatives where they receive income in part related to technology or other intangibles. First, they may seek to establish that the payments constitute income other than rents or royalties because of the business activity involved, notwithstanding that the payments take a form which in the hands of taxpayers acting merely as investors would result in royalty characterization. Second, they may seek to have the payments for the use of technology, etc. characterized as "rent" and thus utilize Section 543(a)(2) of the Code to facilitate their normal business operations.

Experience in the area described indicates that the development and use of technology in the United States, as well as the creation of jobs in technology-oriented businesses, are often actively discouraged by the existence of these problems and the related possible exposure to personal holding company tax. The problem might eventually be solved through specific legislative approval of one of the existing techniques now believed available. Alternatively, depending upon the ultimately desired scope of the term "royalties", perhaps a personal holding company exception for royalties derived in certain active businesses might be framed in parallel with the exception for certain rents now set out in Section 543(a)(2) of the Code.

The purpose of this comment, however, is not to propose a comprehensive legislative solution at this late date in the history of H.R. 10612. While I do believe that relief legislation may merit serious cons 'eration by the Committee, action may await a future date when the matter can be more carefully studied. In conclusion, it is suggested that either (1) Section 1308 of the bill not be enacted until the entire situation can be more carefully studied, or (2) that the Congress in passing upon the subject of Section 1308 of the bill specifically leave open (as under existing law) the treatment of payments for technology and other intangibles to the extent outside of the scope of Section 543(a)(6) of the Code.

NATIONAL KNITTED OUTERWEAR ASSOCIATION,
New York, N.Y., July 16, 1976.

Mr. MICHAEL STERN,
Staff Director, Senate Finance Committee, Dirksen Senate Office Building, Washington, D.C.

DEAR SIR: In the tax bill before your Committee, the proposal in Sec. 1206 to amend Sec. 513 I.R.C. by adding (d) on trade shows, State fairs and similar exhibits should be clarified by the two changes in phraseology explained below:

I

The wording should be modified to make it clear that the new provisions apply to shows where exhibitors are suppliers to the sponsoring industry as well as to those which seek to promote the products of that industry.

It is obvious from discussions with those active in advancing this measure that there was no intention to limit this amendment only to trade shows conducted for the purpose of stimulating interest in products of the industry whose trade association sponsors the exhibiiton. The aim is to cover not only such shows but also suppliers shows, i.e., trade shows which display to the industry represented by the sponsoring trade association new technological developments in the machines it uses, improvements in the materials it consumes, and devices and techniques employed in its industrial art. That intention is, in fact, expressed in proposed 513(d)(3)(A) which refers to shows whose purpose it is "to educate persons engaged in this industry in the development of new products and services * * *."

However, in defining Qualified Convention and Trade Show Activity, Sec. 513(d)(3)(B) (line 3 on page 1529) refers only to shows whose purpose is "the promotion and stimulation of interest in, and demand for, the products and services of *that industry* * * * " (emphasis supplied). These words suggest a limitalton which, as indicated above, was not intended and can cause confusion.

Misinterpretation can be avoided by adding immediately after the words "that industry" the additional phrase "or its suppliers" and by adding this same phrase again to the end of (C); so that (B) and (C) will read as follows:

"(B) *Qualified Convention and Trade Show Activity.*—The term 'qualified convention and trade show activity' means a convention and trade show activity

carried out by a qualifying organization described in subparagraph (C) in conjunction with an international, national, State, regional, or local convention, annual meeting, or show conducted by an organization described in subparagraph (C) if one of the purposes of such organization in sponsoring the activity is the promotion and stimulation of interest in, and demand for, the products and services of that industry *or its suppliers* in general, and the show is designed to achieve such purposes through the character of the exhibits and the extent of the industry products displayed.

"(C) *Qualifying Organization.*—For purposes of this paragraph, the term 'qualifying organization' means an organization described in section 501(c) (5) or (6) which regularly conducts as one of its substantial exempt purposes a show which stimulates interest in, and demand for, the products of a particular industry or segment of such industry *or its suppliers.* (Words added are italicized)

Supplier shows particularly merit favorable consideration in this context. In distinguishing shows that are related to the tax-exempt purposes of the sponsoring organization from those that are not, a basic test is whether they provide a particular service or selling facility for the exhibitors or whether they serve to advance the interests of the industry as a whole. Viewed in this light, the supplier show is most unlikely to function as an individual selling facility for members of the sponsoring organization. Since the purpose of the supplier show is to present members with scientific and technological advances that they can use in their industrial art, its educational character is likely to predominate. Certainly, so far as the members of the sponsoring tax-exempt organization are concerned, supplier shows offer them no means for individual selling.

II

The repeated reference to conventions and to the holding of trade shows "in conjunction with" a convention or "annual meeting", is unnecessary. It is likely to be confusing and should be omitted.

Whether or not a trade show by its purpose and nature is substantially related to the tax-exempt purpose of the sponsoring organization really has nothing to do with whether or not it is held in conjunction with a convention or "annual meeting". True, it is not uncommon for trade shows to be held at the same time, in the same week or in more or less close sequence with conventions or meetings, "annual" or otherwise, of the sponsoring trade association. But that need not be determinative. A trade show may truly and clearly be related to the tax-exempt purposes of a qualified organization without necessarily being held "in conjunction with" a convention or annual meeting.

Moreover, the term "in conjuction with" is likely to raise difficulties in interpretation. Must the two be held at the same time? Will it meet the requirement if they are held in close sequence? How close? Will an intervening weekend or a change of locale in order to use more appropriate exhibition facilities destroy the "conjunction"?

Such questions can and should be avoided by removing the term "Convention and" from 513(d)(3)(A); by adding after the word "traditionally" in that same paragraph the phrase "but not necessarily"; and by making similar deletions of references to convention and annual meeting in (B).

We surmise that the references to the holding of shows in conjunction with conventions and annual meetings were inadvertently introduced by way of analogy to the conjoining of "Public Entertainment Activity" with State, regional or other fairs. The need of such conjunction in the latter case is apparent. But no such need exists in the case of trade shows and conventions.

* * * * * * *

Otherwise, the general purpose of this amendment has our complete support. It is wholly consistent with the basic tax theory that activities which serve to improve, foster and encourage a line of business in general or an industrial art are and deserve to be recognized as within the scope of tax-exempt activities of 501(c)(6) organizations.

Historically trade fairs have imparted great impetus to the rise of commerce even before the industrial revolution in Europe. So valuable were they for the general advancement of trade and for the stimulus of invention in the development of new offerings that it was not uncommon for them to enjoy the sponsorship of monarchs and other government authorities. For the encouragement of product improvement, it was at such fairs and expositions, precursors of the modern trade show, that awards by public authorities were often bestowed.

Reference to medals or other prizes can bee found on the labels of many older products still marketed today. Our own government recognizes the general economic benefit of industrial trade shows by special customs accommodation for products entering our country for display at such exhibitions.

Obviously trade shows can serve an important economic and public function. Congress has never directly addressed this need under our tax law, except to the extent that the Joint Committee on Internal Revenue Taxation referred to these matters in its general explanation of the Tax Reform Act of 1969. But it is now important that it do so more directly by means of the present bill. We urge that the bill be adopted with the minor changes proposed above.

Respectively submitted.

SIDNEY S. KORZENIK,
Executive Director and Counsel.

STATEMENT OF RONALD P. BALDWIN, PRESIDENT, GEOTHERMAL RESOURCES INTERNATIONAL, INC.

Mr. Chairman and Members of the Committee, we welcome the invitation of the Committee to appear and advise in accordance with the subject matter of these present hearings on tax reform.

We applaud the Committee's earlier decision to support the commercial development of geothermal energy in the United States by recommending to the Senate the enactment of provisions for the deduction for geothermal production and for the intangible drilling costs of geothermal steam and associated resources. (Sec. 2004 of the Committee amendment and proposed Sec. 191 of the Code).

We urge the Committee to stand by its earlier action and to persist in its present recommendation.

The case in favor of such action has been well stated in the Committee's report, pages 571–574. We subscribe fully to the report's conclusion that without this item in the law the Government's own Project Independence goals for geothermal energy will not be met.

May we respectfully advise, however, that the Committee staff appears to have overestimated the revenue effects that likely would flow from enactment of this item.

The report says that tax revenues might be reduced as much as $7 million in 1977, $15 million in 1978, and $21 million in 1981. We believe the impacts would be much less. For one thing, geothermal deductions can already be made under present law in the case of geothermal "steam". This being the case, enactment of the business deduction and the intangible costs treatment should cause no revenue effect in the case of "steam" wells; and "steam" is the only kind of geothermal energy which is now in production and is likely to be in production for some period of time. For another thing, development of the other kinds of geothermal wells is being held back, and likely will be held back for some time, on account of the absence of favorable income tax treatment. We do not see any chance that development of the non"steam" kinds of geothermal resources would produce the amounts of tax revenue estimated by the Committee's staff under an assumption that favorable tax treatment will not be provided. Hence we believe that any unfavorable revenue impact of the proposed legislation would be minimal. Certainly it would be unimportant in relation to the benefits to the public at large of supporting and development of geothermal energy in the United States.

Our general case in favor of enacting a positive income tax treatment for geothermal energy has been presented to the Committee heretofore (our statements and letters of March 12, 1975; July 9, 1975; January 19, 1976; and April 23, 1976). We have tried to emphasize that the present Tax Code discriminates against the non-"steam" kinds of geothermal resource and encourages the flow of capital resources into oil and gas, coal, uranium and oil shale, rather than into geothermal resources at an amount and pace commensurate with the Government's own Project Independence goals.

We have brought to the Committee's attention a determination made in the Federal Energy Administration to the effect that the tax treatment accorded to geothermal resources should correspond to the treatment being accorded to oil and gas. (Letter of June 13, 1975 from the Acting Administrator of FEA).

More recently the Department of the Treasury has announced its conclusion that the Tax Code should be amended for a period of ten years so that investment projects certified as research and experimental projects would be subject to being deducted, at the option of the taxpayer, as current costs rather than being capital-

ized and written-off when income from the project begins to flow. (Letter to the House Committee on Science and Technology, May 7, 1976). We concur in Treasury's findings that geothermal development is being deferred under the present Code provisions by the uncertainty which is arising from the application of income tax rules to a novel industry which is subject to a high degree of technological uncertainty. We believe, however, that the geothermal amendment included in the present Committee report should be enacted, rather than the mere limited Treasury proposal, because the Treasury proposal would leave in effect the basic discrimination against the non-"steam" kinds of geothermal resources and for the older kinds of energy resources such as oil and gas, coal, and uranium.

We recently noted with concern the fact that statements have been made on the Senate Floor or inserted in the Congressional Record which have challenged the Committee's present recommendation regarding the tax treatment of commercial geothermal energy. We have written to each of the Senators who were named as members of this particular group, and one of the Senators, Senator Hollings, has responded to us (his letter of June 29, 1976). In that letter Senator Hollings has advised that the so-called "reform package" advanced on behalf of this group does not, in fact, include reference to the geothermal energy item. Instead the geothermal item has been challenged only in the so-called "scorecard" which was offered on behalf of only one member of the group. We have expressed our appreciation to Senator Hollings for this clarification.

In conclusion, we want to thank the Committee for this opportunity to appear and its attention to our statement. We sincerely hope that the Committee will reconfirm is previous action on this item.

As Congressman John J. McFall has so well stated, the development of geothermal energy is not held back by technology or lack of adequate natural resource deposits. It is hindered particularly by inappropriate Tax Code provisions; and only if pr per tax incentives are provided will the geothermal industry be able adequately to develop so as to contribute significantly to America's energy requirements.

INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA,
Washington, D.C., July 19, 1976.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR: The Interstate Natural Gas Association of America (INGAA) is a non-profit national trade association whose membership includes virtually all of the major natural gas pipeline companies subject to the jurisdiction of the Federal Power Commission (FPC) under the Natural Gas Act (15 USC *et seq.*). INGAA is vitally interested in H.R. 10612.

Since 1958, the Internal Revenue Service has treated contributions in aid of construction received by a utility as non-shareholder contribution of capital. Rev. Rul. 75-557 reversed this policy and effective in 1976 the Service will treat such amounts as taxable income. Section 1322 of H.R. 10612 provides that such amounts received by water and sewer companies would not constitute taxable income.

Electric and gas distribution and transmission companies are often required to relocate existing facilities from under proposed buildings, roads, dams, etc. for the convenience and safety by customers, local, state and federal authorities. The net cost of this relocation, often after using the same material being removed, is paid for by these parties in the form of contributions in aid of construction. Regulatory authorities require that such amounts be deducted from the rate base, thus, companies cannot include in revenue amounts for depreciation or rate of return on such reimbursed costs regardless of the tax treatment. If, however, such contributions are taxed, this tax would increase the cost of service to the consumer. Under the circumstances it appears inappropriate to tax amounts received as contributions in aid of construction.

INGAA would vigorously urge that Section 1322 of H.R. 10612 be amended to include electric and gas distribution and transmission companies so that contribution in aid of construction would not be treated as taxable income; thus, a fair and equal treatment would be accorded privately owned utilities.

Yours very truly,

WALTER E. ROGERS, *President.*

STATEMENT OF FRANK L. GOFFIO, EXECUTIVE DIRECTOR, CARE, INC., ON RESTORATION OF A LIMITED TAX INCENTIVE FOR GIFTS OF INVENTORY TO CHARITIES

Mr. Chairman and Members of the Committee, the amendment on charitable contributions of inventory that the Committee adopted on June 11 would provide a badly needed stimulus to gifts of goods that organizations like ours need and use in their charitable work. Since the 1969 amendment to section 170(e) of the Internal Revenue Code took effect, these gifts have been drastically reduced.

Over the years, "contributions-in-kind"—gifts by American corporations from inventories—have represented a most important segment of CARE funding. These gifts have typically included such things as medical supplies, foodstuffs and clothing for people in need overseas; paper, pencils, books and other supplies for use in schools; and seeds, fertilizer, and equipment for CARE-sponsored self-help projects.

Some of these gifts have been unsolicited. Others have been actively sought by CARE. It is CARE's practice, for instance, to survey periodically the needs of its MEDICO teams in the field for drugs, medical supplies and equipment, and then to ask the manufacturers specifically for contributions of needed items.

All offers of inventory, solicited or unsolicited, are carefully screened by our Procurement Department. Goods are accepted only when there is a clearly identified need for their use in CARE projects. To CARE, these contributions are just as valuable as cash.

Unfortunately, one of the effects of the 1969 amendments was to reduce drastically our receipt of these needed gifts. Manufacturers tell us it is as economical for them to destroy merchandise as it is to give it to charitable organizations like CARE. Indeed, because we ask manufacturers to deliver goods to us at specific times and places, a gift to CARE tends to be more inconvenient and costly.

For a number of years before the 1969 Act was passed, CARE received approximately three and a half million dollars worth of gifts-in-kind each year. This was about a quarter of total contributions received by CARE each year. The figure took a precipitate upward jump just before the new law took effect (in CARE's 1970 fiscal year), and then fell to less than half of its former level. Since 1970, these contributions have been running at levels only one-third to one-half the pre-1969 rate.

A summary of CARE's experience in its last nine fiscal years is attached.

We believe that the Committee's amendment has been carefully drafted to eliminate the possibility of abuse by donors, and at the same time to provide a reasonable and limited tax incentive for the contributions-in-kind that are so important in the work of CARE and other voluntary organizations.

CONTRIBUTIONS OF INVENTORY TO CARE (FAIR MARKET VALUE, WHOLESALE)

Category	Fiscal years ending June 30—								
	1967	1968	1969	1970	1971	1972	1973	1974	1975
Food commodities	$2,006,167	$2,078,263	$443,704	$3,064,520	$748,666	$798,581	$278,301	$593,225	$178,852
Medical supplies	919,901	773,745	880,731	1,128,773	182,413	225,364	252,027	343,242	605,645
Clothing	318,005	128,390	347,045	596,765	229,120	166,629	202,554	33,492	173,168
Agricultural	177,936	163,567	172,832	133,760	346,990	129,822	182,952	0	29,178
Educational materials and miscellaneous	450,134	441,298	1,686,436	1,290,766	151,965	308,443	386,482	36,750	233,130
Total	3,872,143	3,585,263	3.530,748	6,214,584	1,659,154	1,628,839	1,302,316	1,006,709	1,219,973

STATEMENT OF JAMES J. NORRIS, CHAIRMAN, AMERICAN COUNCIL OF VOLUNTARY AGENCIES FOR FOREIGN SERVICE, INC., ON RESTORATION OF A LIMITED TAX INCENTIVE FOR GIFTS OF INVENTORY TO CHARITIES

Mr. Chairman and members of the Committee, the American Council of Voluntary Agencies for Foreign Service (ACVAFS) represents the largest and most widely-known voluntary agencies working in the field of humanitarian relief and development assistance overseas. These agencies also represent a broad spectrum of the major religious faiths, ethnic groups and non-sectarian organizations in the United States. A list of the members of the ACVAFS is attached at the end of this statement.

The Finance Committee at its meeting on June 11, 1976 approved and voted to send to the Floor an amendment increasing to a limited extent the deduction available to corporations for gifts of inventory to public charities. The amendment, we understand, incorporates the terms of Amendment No. 1612 to the proposed Tax Reform Act, offered in the Senate on April 27, 1976 by Senator Ribicoff.

This amendment is badly needed by the voluntary agencies to remedy the drastic decline in gifts "in kind" that followed enactment of the Tax Reform Act of 1969.

The need for gifts "in kind." The ability of private, charitable institutions to work effectviely in the field of international assistance, at times in concert with U.S. Government programs, depends to a great degree on contributions from the private sector. Not only does the charitable institution depend on its ability to stimulate cash contributions, but it must also depend on a wide range of gifts of commodities, equipment and medical supplies to help fulfill relief and development assistance needs overseas.

When a large quantity of a particular "gift-in-kind" item is required, the main source of supply is the manufacturer. The Tax Reform Act of 1969 limited deductions for contributions of inventory to the cost or other basis of the donated property. This amendment effectively constricted the flow of gifts of inventory to charitable organizations by removing the tax incentive that was present prior to 1969.

Currently, a manufacturer, having inventory items on hand which can be utilized by charitable institutions, can either throw them away and take a business deduction for cost, or give them to a charitable institution, without any significant change in tax result. In many instances, a decision to make a contribution to a charitable organization will be more costly than disposing of the commodity in other ways; generally, a manufacturer that gives goods to a charity also bears the costs of packaging and shipping the goods to the charity.

Our surveys of charitable organizations making use of contributions from inventory indicate that these kinds of gifts have fallen to half of their pre-1969 levels. Concurrently, additional staff time and effort have had to be expended to solicit a minimum of these kinds of supplies. In essence this means that charitable institutions are having to use more contributed funds for administrative costs to obtain minimum needed gift-in-kind items than was true prior to 1969. Private sector contributed funds which should be flowing into relief and development assistance programs overseas are being siphoned off to pay for more administrative costs to assure that needed contributions of inventory are available.

Proposed legislation. The Committee's amendment would restore a limited tax incentive for gifts of inventory by corporations. At the same time, the bill would continue to guard strictly against the possibilities of abuse at which the 1969 amendment was directed.

Under the Committee's amendment, the charitable deduction allowed for qualified gifts of inventory would be equal to the basis of the inventory plus one-half the difference between its basis and its fair market value. This increased deduction would be subject, however, to the following important limitation: in no event could the deduction exceed twice the basis of the goods. This limitation would mean (at corporate tax rates of 50 percent or less) that a corporation could not make an after-tax profit by manufacturing goods and then giving them to charity. A corporation would, in every case, incur an after-tax loss. The proposed amendment would reduce the amount of the loss, however, and would provide a financial incentive for a corporation to give the goods to charity, rather than destroy them.

The Committee's amendment contains, in addition, a further safeguard to insure that the donated property is put to chariable use. Under the amendment, a recipient organization (which must be a section 501(c)(3) organization that is not a private nonoperating foundation) would be required to certify that it will

use or distribute the property for the purposes for which its tax-exempt status was granted, and that such property will not be exchanged for money or other property.

The Committee's amendment is identical to a bill (H.R. 12356) introduced by a bi-partisan group of 13 members of the House Ways and Means Committee and now before that Committee. The amendment is technical and remedial in nature.

We sincerely hope that this badly needed legislation will be promptly enacted, so that the voluntary agencies may again be able to receive the support they need to carry out their programs for the ill and the needy.

AMERICAN COUNCIL OF VOLUNTARY AGENCIES FOR FOREIGN SERVICE, INC.

MEMBERSHIP LIST

American Council for Judaism Philanthropic Fund, Inc.
American Council for Nationalities Service
American Friends Service Committee, Inc.
American Foundation for Overseas Blind
American Fund for Czechoslovak Refugees, Inc.
American Jewish Joint Distribution Committee, Inc.
American Mizrachi Women
American National Committee to Aid Homeless Armenians
American ORT Federation, Inc.
Assemblies of God Foreign Service Committee
Baptist World Alliance
CARE, Inc.
Catholic Relief Services, U.S. Catholic Conference
Christian Reformed World Relief Committee
Church World Service
CODEL, Inc.
Community Development Foundation, Inc.
Foster Parents Plan
Foundation for the Peoples of the South Pacific, Inc.
Hadassah, The Women's Zionist Organization of America, Inc.
Heifer Project International
HIAS
Holt International Children's Service, Inc.
Interchurch Medical Assistance, Inc.
International Rescue Committee, Inc.
Lutheran Immigration and Refugee Service
Lutheran World Relief, Inc.
Medical Assistance Programs, Inc.
Mennonite Central Committee, Inc.
Migration and Refugee Services, U.S. Catholic Conference
Near East Foundation
PACT, Inc.
Project Concern, Inc.
Salvation Army
Save the Children Federation, Inc.
Seventh Day Adventist World Service, Inc.
Tolstoy Foundation, Inc.
Travellers Aid-International Social Service of America
United Israel Appeal, Inc.
United Lithuanian Relief Fund of America, Inc.
United Ukrainian American Relief Committee, Inc.
World University Service
Young Men's Christian Association, International Division
Young Women's Christian Association of the U.S.A.

STATEMENT OF CHARLES REYNOLDS, INTERNATIONAL SECRETARY, LUDHIANA CHRISTIAN MEDICAL COLLEGE BOARD, U.S.A.

RESTORATION OF A LIMITED TAX INCENTIVE FOR GIFTS OF INVENTORY TO CHARITIES

Mr. Chairman and Members of the Committee: I submit this statement, as International Secretary of the Ludhiana Christian Medical College, and also on

behalf of the Vellore Christian Medical College, and the Interchurch Medical Assistance, Inc., in support of the Committee's amendment on charitable contributions of inventory.

Interchurch Medical Assistance is a non-profit organization that serves as a facility for the collection and distribution of medical supplies for the overseas services of Protestant Churches of the United States. The following churches and agencies participate in IMA:

American Baptist Foreign Mission Society.
Division of Overseas Ministries of the Christian Church (Disciples of Christ).
Church of the Brethren.
Episcopal Church.
Ludhiana Christian Medical College Board.
Lutheran World Relief, Inc.
Mennonite Central Committee.
Moravian Church in America.
National Council of Churches of Christ—Church World Service.
Presbyterian Church in the United States.
Reformed Church in America.
Reorganized Church of Jesus Christ of Latter Day Saints.
Salvation Army.
Seventh-Day Adventist World Service, Inc.
United Church Board of World Ministries.
United Methodist Church.
United Presbyterian Church in the U.S.A.
Vellore Christian Medical College Board.
World Relief Commission, Inc.

The Committee's amendment seeks to remedy some of the hardships encountered by charitable voluntary agencies as a result of the enactment of the 1969 amendments to the Internal Revenue Code.

Income tax legislation is not our field of specialization, but the interpretation of human suffering and need falls within the realm of our competence, and it is from this point of view that we speak.

We are grieved and appalled when we survey the consequences of the 1969 reform of I.R.C. Section 170(e) on the medical work carried on throughout the world by church and other charitable voluntary agencies. The supplies so sorely needed for the operation of an effective program, which were previously donated by American corporations, have been reduced by as much as 70 percent from their previous level. This spells disaster for many of our small hospitals and dispensaries; it compounds the suffering of the sick and needy; basically, it is of benefit to no one; the Federal Government gains nothing; and the poor have lost a portion of the little they had.

The enactment of the Committee's proposed amendment of § 170(e) would restore the flow of donated supplies to a much higher level than at present, and would ensure the continuity of some of the most significant humanitarian work being carried on in various parts of the world.

The tragic events in history, such as the Nicaraguan earthquake of 1972, reveal the deficiency of prevailing policy. The whole world was jolted by this disaster, and offers of aid poured in from many directions. However, the Federal Government appealed through the mass media for everyone to work through the established charitable voluntary agencies—a recognition of the preparedness and efficiency of these agencies. Regrettably, the needed supplies were not readily available in the warehouses. The 1969 tax policy has resulted in the massive loss of contributed supplies, and the previous flood of donations had been reduced to a trickle. Consequently, the "emergency stockpile" which should be maintained by voluntary agencies for such disasters, was virtually non-existent, and supplies eamarked for programs in other nations had to be diverted. This situation must not be permitted to prevail in the highest interests of humanity.

When the northeastern states of the United States were swept by tropical storm Agnes in the summer of 1972, some of the human misery might have been averted if relief supplies had been more accessible, and if the prevailing law regarding "contributions-in-kind" had not been so restrictive. We feel that the provisions of the Committee amendment will help to alleviate some of this distress at home and abroad.

Under present law, any sizable donation of goods would have to be backed up by a monetary grant from the company to defray cost of handling, packing, transportation, etc. However, in spite of existing difficulties and restrictions, many

medical supply houses have continued their donations, and have been cooperative in response to specific requests.

The two main supply agencies for Protestant and Catholic medical work, viz Interchurch Medical Assistance and Catholic Medical Mission Board, reported a combined total of donated supplies to the value of $33 million in 1970 before the effects of the new legislation were felt. However, for 1972, they report a combined total of only $14 million—a loss to the ill and needy of $19 million worth of badly-needed contributed supplies for medical programs throughout the world. While this cut-back is tragic, we can only convey our gratitude and appreciation to these supply houses which did contribute the $14 million worth of goods.

A tight control system in the warehouses prevents any risk of a "dumping" of goods. Corporations are approached by the agencies with a list of supplies needed, and generally the corporations respond to this listing. Shipping agreements with host governments normally ensure duty-free entry of these medical relief supplies only if certain guidelines are observed, and this includes a specified time limitation of shipment of dated drugs and food supplies.

We strongly urge the Committee to adhere to its proposed amendment on contributions of inventory, so as to better help us carry on the crusade against disease and disability, to wage war on human suffering, and to alleviate situations of distress in natural disasters.

Statement of the General Electric Co.

In Support of the Heat Pump as an Energy-Saving Device in the Modernization or Retrofit Markets

SUMMARY

Rationale Supporting This Proposal

Space heating uses 18% of the nation's energy. The primary sources of heating energy used in existing dwellings are gas, oil, and electricity.

Gas is no longer available in many areas for new construction. This curtailment is spreading. (Chart No. 4)

The added use of electricity for heating can reduce dependence on home gas and oil usage.

The principal forms of electric heating are: Electric resistance and the heat pump.

Electric resistance systems cost less to install (Chart No. 1.)

Heat pump systems use 30 percent to 60 percent less energy than electric resistance systems (actual savings determined by climate and geography)

Over a five-year period, including first cost and operating cost, the heat pump system costs less than the electric resistance heating and cooling system. (Chart No. 2.)

As an energy saving device the heat pump could economically replace existing electric resistance heating equipment in many dwellings. In some cases, the heat pump could replace oil or gas fired equipment economically. In many cases the heat pump could economically replace electric resistance, gas or oil fired systems when significant repair or maintenance cost of the existing equipment is involved. (Chart No. 3.)

A modest financial incentive to support the heat pump in the residential modernization or retrofit market could be very effective in encouraging homeowners to install energy saving heat pumps in existing dwellings.

The final results would be an energy saving of from 30 percent to 60 percent (depending on climate and geography) over electric resistance heating and a freeing of gas and oil for more critical needs when these systems are replaced.

It is estimated that this financial incentive would cost the government $15.6 million over a four-year period. (Chart No. 5.)

As an item of interest, the same logic that supports this program for residential structures also supports the same type of heat pump program for commercial and industrial buildings.

Among the leading manufacturers of heat pump equipment in the U.S. are: Carrier, General Electric, Westinghouse, Fedders, Amana, Chrysler, Trane, Goettl, Friedrich, and others.

PROPOSAL DETAILS

The General Electric Company is working in many areas of energy conservation. The Company is developing new energy efficient products; working on

methods of converting coal and shale oil to more usable energy forms; working to improve the efficiency of electrical power generation and transmission systems; working with energy substitutes to conserve scarce reserves of natural gas and oil and developing new energy alternatives, including solar heating and cooling, wind generators, photovoltaics and solar thermal units. It is our belief that we must energetically move forward on all of our options to meet the nation's energy needs. This statement addresses the areas of new energy efficient products:

(1) Electric energy offers the opportunity to conserve scarce reserves of fossil fuels by substituting more available energy forms.

(*a*) The problem of dwindling reserves of natural gas and oil in the United States is well known. Our nation does possess great quantities of other forms of energy, such as coal. This fuel, along with the nation's technology leadership in nuclear power, provides a secure basis for electrical power generation. Broader and more efficient use of electrical power that is generated from these abundant local fuels is certainly a major step toward national energy independence.

(*b*) In 1973 18 percent of all energy used in the United States was used for space heating. The inventory of existing fuels used in 1973 for space heating divides approximately 45 percent oil, 45 percent gas, and 10 percent electricity. The actual use of electricity for heating newly constructed homes has been increasing very rapidly. In 1974 over 50 percent of all newly constructed dwellings were heated electrically. By far the largest percentage of these used the electric resistance system.

(*c*) There are two principal systems that can be employed to use electricity for space heating; one is the resistance heating system, and the other the heat pump. The purpose of this paper is to present the merits of the heat pump.

(2) The heat pump uses electrical energy efficiently—recovers 2 units of heat for every 1 unit of electrical energy used.

The heat pump is a refrigeration cycle which reverses to provide both cooling in warm weather and heating in cold weather. In the summertime the heat pump takes heat from inside the house and exhausts it outside. In the winter it takes heat from outdoors and brings it inside the home. Even when the outdoor temperature is below freezing there is still a lot of heat in the air and the heat pump is capable of extracting it from the air and bringing it indoors. In northern climates the heat pump is slightly less efficient than in southern climates; however, on the average nationally the heat pump delivers 2 units of heat for every 1 unit of electrical energy consumed. In other words, for every kilowatt of electrical energy that the heat pump consumes it extracts the equivalent of 2 KWs of heat energy from the air and transfers it to useful work. The electrical resistance type heating systems in popular use today deliver heat energy on a "1 for 1" basis. For every KW of electrical energy used the electrical resistance system delivers 1 KW of equivalent heat energy. On the average, the heat pump is twice as efficient as the electric resistance system; or, saying it another way, the heat pump will heat the home for one-half the fuel used by the electric resistance system. Even when compared to the burning of critical fuels directly in the home, such as gas or oil, the heat pump compares favorably. Because of its 2 for 1 recovery ratio, the heat pump makes up for much of the conversion losses of power generating systems.

(3) The first cost of heat pump systems is higher than electric resistance or some fossil fuel systems.

With the heat pump as attractive as it is from a fuel efficiency standpoint, one can't help but wonder why a financial incentive is desired to encourage its use. First, one must realize that speculative builders construct over 80 percent of all the single family houses in the U.S. These builders are highly competitive and are constantly working to keep the cost of their homes as low as possible and still comply with federal and state codes and standards. For a typical 2000 square foot house in the Philadelphia area a builder might install an electric resistance furnace with cooling equipment for approximately $1,800.[1] It might cost him about $2,600[1] to install a heat pump. (See chart No. 1 attached.) For a difference in his cost of about $800 there is great competitive pressure on the builder to install the lower cost system—the electric resistance furnace.

For the consumer who owns a home and desires to convert his heating system to the more efficient heat pump, this incentive would not pay the total cost but would be effective in encouraging him to make the conversion.

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[1] All cost data in this document and on the attached charts are rough estimates only. Actual costs will vary by brand, equipment, installer, etc.

(4) When considering owning costs, first cost plus heating fuel costs, heat pumps compare favorably.

The problem with the electric resistance system, however, is operating cost. Unfortunately, few home buyers really understand heating and cooling systems. They get a much better understanding of it after they pay the first winter's heating bills; then it is too late.

Chart No. 2 attached adds the cost of fuel for five years to the installed equipment cost. Now the gas furnace moves to first place, with the heat pump in second, and the electric resistance system last. This chart assumes five-year fuel costs as shown on chart No. 3.

This brings up the obvious question regarding the position of the gas furnace and electric cooling systems. Gas is no longer preferred as a heating fuel for new homes for several reasons. First, and critically important, gas is not available for new construction in many parts of the country. The shaded areas in the attached chart No. 4 indicate some of these areas. It is forecast that these restrictions will spread in the next few years. Second, gas is critically needed in industrial processes, making of fertilizer, plastics, medicine, etc. Third, if gas is deregulated, its price would increase significantly and become less attractive.

(5) Current status of the heat pump in new construction.

In 1975 there were 176,000 heat pumps sold in the United States. Due to gas restrictions and the favorable economics of electric heating with the heat pump, sales in 1976 will increase to about 300,000. Practically all of these units are being used in the new construction market.

(6) Modest financial incentive would encourage broader use of the heat pump in the replacement, modernization, and retrofit markets.

Each year there are over a million residential heating systems replaced due to equipment failures. If only a small percentage of these were converted to heat pumps, the combination of energy saving and conservation would be significant. Further, there are many residences currently heated with electric resistance heat where major energy savings would be effected if the system were adapted to the heat pump. In both cases, the cost to the home owner would have a long-term payback and this has been a definite deterrent to his making the change.

(7) A financial incentive of from $400 to $600 could provide an inducement for the home owner to convert to the heat pump rather than to simply replace the existing equipment in kind.

(8) This program would have a multiplying effect by calling attention to the energy conservation characteristics of the heat pump and demonstrating government endorsement of the heat pump as an energy saving product. This program would get a great deal of attention from heating and air conditioning dealers, home builders, and equipment suppliers.

The fact that financial incentives were being offered to the modernization segment of the market would encourage other market segments to seriously consider the energy saving heat pump. The "snowball" effect of this program could be very significant.

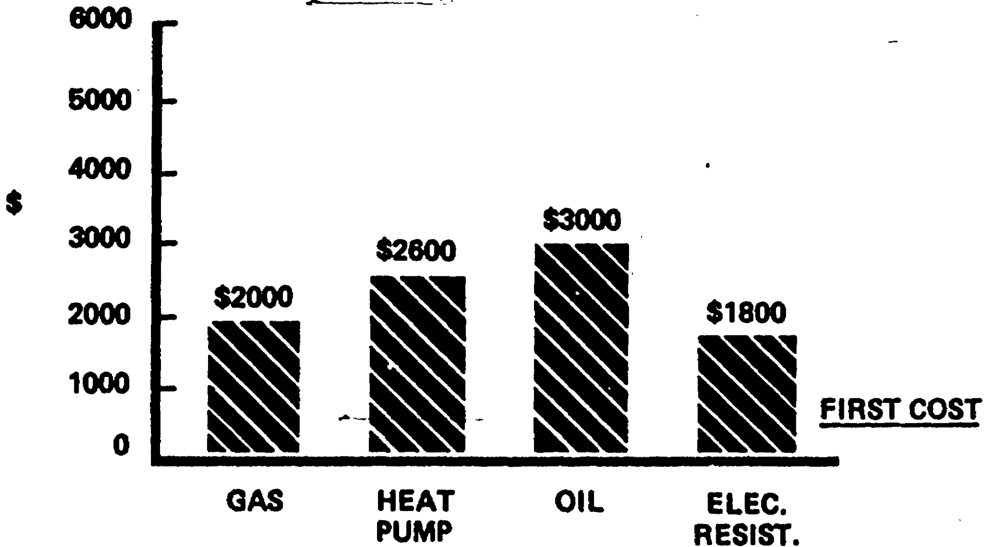
(9) Charts No. 6 and No. 7 present some cost data showing the economics of a conversion program for the homeowner. For these calculations we have assumed the home is properly insulated, both storm windows and attic insulation.

Chart No. 6 presents the data on the assumption that the existing heating equipment in the home is operating satisfactorily. Aided by an assumed $600 financial incentive, annual fuel cost savings justify converting from the electric resistance heating system to the heat pump. However, even with a $600 financial incentive, converting other systems to the heat pump is not economically justified in a reasonable period of time.

Chart No. 7 shows the same analysis, assuming that the existing heating plant has failed and needs to be replaced. The consumer is faced with this replacement cost anyway, so there is logic that he would consider converting his system to the heat pump. In this instance the economics of converting electric resistance heating systems is even better. However, from an economical standpoint, it would still be difficult to justify conversion of oil or gas-fired systems.

There are other factors that will encourage the homeowner to make this conversion, especially when faced with existing equipment replacement cost. For example, if both his heating and cooling equipment is eight to ten years old and his heating equipment has failed, he would be wise to replace the entire system. In this case he can economically justify replacing the system with a heat pump. This would give him a modern, up-to-date system, with a conventional five-year warranty, and can be quite attractive to a homeowner.

Beyond the economics of the study is the primary question of fuel availability. In areas where gas and oil are apt to become scarce, the electric heat pump becomes an ideal heating system.

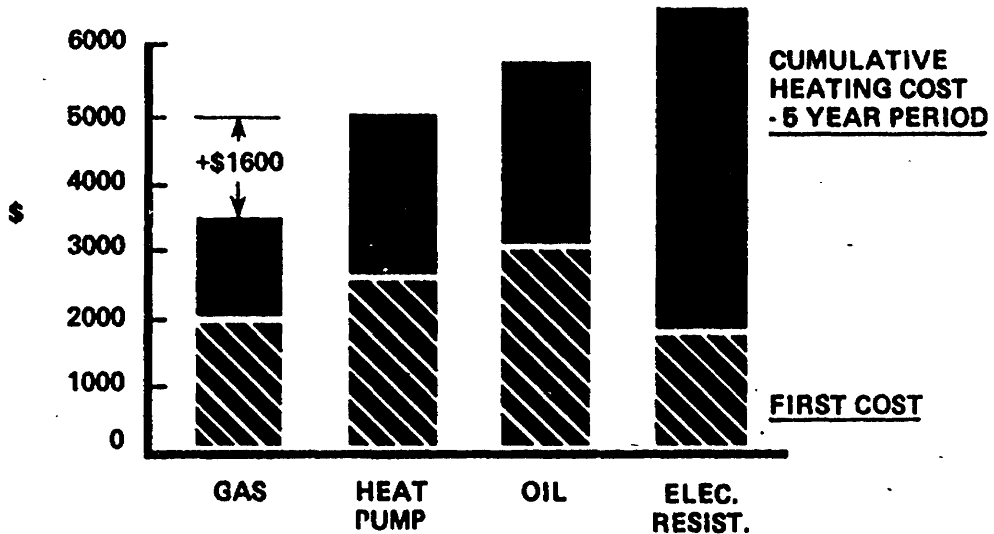


ABOVE COSTS INCLUDE HEATING & CENTRAL COOLING EQUIPMENT INSTALLED. COSTS DO NOT INCLUDE DUCTING, INSULATION, ETC.

CHART 1

TOTAL COST OF ALTERNATE HEATING AND COOLING SYSTEMS

(Includes final cost, chart # 1, plus heating energy costs only)



TO FIRST COST AS SHOWN ON CHART # 1 WE HAVE ADDED 5 YEAR CUMULATIVE HEATING ENERGY COSTS USING FUEL RATES SHOWN ON CHART # 3.

CHART 2

FUEL COST ASSUMPTIONS

	1974 PRICE	ESCALATION IN CONSTANT $
GAS	$ 1.50 KCF	+ 5%/YR.
ELECTRIC	3¢/KWH	+2.5 /YR.
OIL	38¢/GAL.	+ 4%/YR. (NO INCREASE 1978-1980)

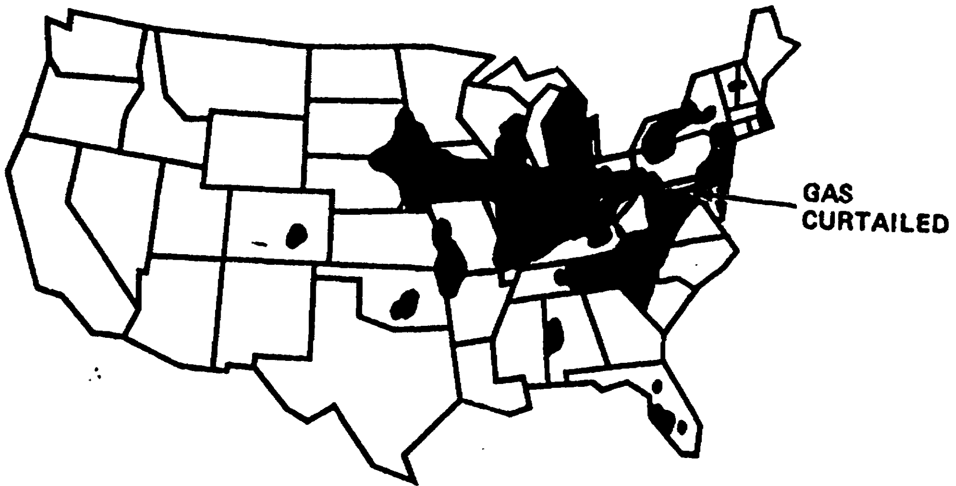
SOURCE: ARTHUR D. LITTLE CO. STATISTICS

HEAT PUMP CONVERSION OPPORTUNITIES

	GAS		OIL		ELECTRIC RESISTANCE	
	DUCTED	NON DUCTED	DUCTED	NON DUCTED	DUCTED	NON DUCTED
AIR CONDITIONED	YES		YES		YES	YES
NOT AIR CONDITIONED					YES	YES

CHART 3

1975 NATURAL GAS CURTAILMENT FOR NEW RESIDENTIAL CONSTRUCTION



GAS IS CURTAILED FOR NEW CONSTRUCTION IN SHADED AREAS.
CURTAILMENT IS SPREADING.

CHART 4

CHART 5

ESTIMATED FINANCIAL INCENTIVE, COST TO GOVERNMENT

	1977	1978	1979	1980
Estimated number of units installed in each year (units in thousands)	4	8	12	15
Tax cost each year at $400 a unit (millions)	$1.6	$3.2	$4.8	$6
Tax cost each year at $600 a unit (millions)	$2.4	$4.8	$7.2	$9

CHART 6

ESTIMATED COST TO CONVERT TO THE HEAT PUMP

Elements of cost	Present type of heating system					
	Electric resistance		Oil		Gas	
	Ducted furnace	Baseboard	Ducted furnace	Hydronic	Ducted furnace	Unit heaters
Item:						
Heat pump	$2,600	$2,600	$2,600	$2,600	$2,600	$2,600
Upgrade electric system			500	500	500	500
Add duct system		1,500		1,500		1,500
Upgrade duct system	200		200		200	
Estimated conversion cost	2,800	4,100	3,300	4,600	3,300	4,600
Less financial incentive	−325	−612	−487	−650	−487	−650
Cost to homeowner	2,475	3,488	2,813	3,950	2,813	3,950
Annual heating cost:						
Existing system	1,200		660		330	
Heat pump system	600		600		601	
Annual savings	600		60		−270	
Years to recover 1st cost	4	6	47	66		

CHART 7

Elements of cost	Present type of heating system					
	Electric resistance		Oil		Gas	
	Ducted furnace	Baseboard	Ducted furnace	Hydronic	Ducted furnace	Unit heaters
Cost to homeowner to install heat pump (from chart No. 6)	$2,475	$3,488	$2,813	$3,950	$2,813	$3,950
Replacement cost, existing furnace	650	[1]	1,000	1,200	650	[1]
Premium cost to install heat pump	1,825		1,813	2,750	2,163	
Annual fuel cost savings	600		60	60	−270	
Years to recover added 1st cost	3		30	46		

[1] Not applicable.

MEMORANDUM

EQUIPMENT LEASING

EFFECTIVE DATE, SECTION 2518, H.R. 10612

This statement is submitted on behalf of Computer Systems of America, Inc., 141 Milk Street, Boston, Massachusetts in response to the Committee's solicitation of views with respect to certain issues in supplementary hearings on H.R. 10612.

Section 2518, adopted by the Finance Committee in the extended markup, simply precludes retroactive application of the "at risk" provisions to equipment leases in effect on December 31, 1975. A grandfather clause is so obviously fair that little comment is required.

Indeed, it is with resigned frustration that we address the effective date issue at all, inasmuch as the basic application of the "at risk" concept (Section 202) to equipment leasing appears to be an unfortunate consequence of the time pressures under which this bill is being constructed. Equipment leasing has been a tag along issue in the tax shelter area. The Committee, by default, has foregone its explicit commitment with respect to this particular provision to rectify the impact on bona fide operations. For it is now recognized that the business

of firms, such as CSA, is computer leasing and servicing, not tax shelters, that real credit determinations are involved in their financing, and that no tax abuse is present.

Nonetheless, the Committee's press release of July 8 restricts consideration to the grandfather clause.

The application of "at risk" to equipment leasing did not appear in the House version of H.R. 10612. New transactions were constructed in light of the House provision and our first notice of the "at risk" application was the Finance Committee action with respect to leasing on April 30, 1976. Therefore, a grandfather clause is not only appropriate; it should protect leases at least up to April 30, 1976.

The particular complexity of computer leasing operations demands special attention to the applicable effective date. The staff of the Joint Committee on Internal Revenue Taxation is well aware of the long lead times involved in ordering the equipment, the capital acquisition aspects with independent financial institutions and equity investors, the rental and servicing arangements with a separate lessee, and the commitments entailed prior to actually signing the lease. This was recognized, for example, in the House version, with a set of special rules for the equipment leasing effective date.

An effective date provision that did not preclude retroactivity would have disastrous consequences for the independent computer leasing firms. These firms have many leases outstanding and, unlike most of the other transactions dealt with by the Committee, there is not a quick cash turnaround that enables these firms to recoup their investment and reorganize their operations.

In summary, a grandfather clause, keyed to the effective date of the lease, is absolutely essential to avoid compounding an already inequitable provision with respect to bona fide leasing firms.

STATEMENT BY ROBERT V. MAUDLIN, JOINT GOVERNMENT LIAISON COMMITTEE OF THE ASSOCIATION OF BRASS AND BRONZE INGOT MANUFACTURERS AND THE BRASS AND BRONZE INGOT INSTITUTE

RECYCLING TAX CREDIT SECTION 2006 OF H.R. 10612

Summary of statement

This statement, on behalf of the members of the Association of Brass and Bronze Ingot Manufacturers and the Brass and Bronze Ingot Institute, is in opposition to a recycling tax credit on copper base scrap as provided for in Section 2006 of the Tax Reform Act, H.R. 10612. The members of these two associations recycle thousands of tons of copper base scrap each week to produce over 90 percent of the brass and bronze ingot manufactured and consumed in the United States and would therefore be beneficiaries of the recycling tax credit. However, they recommend and urge that a tax credit for the use of copper base scrap be excluded from the recycling tax credit, as provided for in Senator Taft's amendment number 1931, for the following reasons:

1. Tax credit on copper base scrap would cause loss in tax revenues of $100 to $277 million during the first four years without any corresponding benefit;
2. Tax credit would cause severe dislocations in scrap market;
3. Copper base scrap prices are extremely sensitive to changes in demand and tax credit would increase price of scrap and articles produced from scrap;
4. Ultimate consumers of products produced from copper base scrap would not benefit from lower prices due to tax credit;
5. Large fluctuation in copper base scrap prices have not significantly affected the supply of scrap;
6. Tax credit does not assure most economic use of scrap versus alternate source of copper.

We support the amendment proposed by Senator Taft (Amdt. No. 1931) to exclude copper base scrap from the recycling tax provision.

* * * * * * *

My name is Robert V. Maudlin and I am executive director of the Joint Government Liaison Committee. The Committee is composed of the Association of Brass and Bronze Ingot Manufacturers and the Brass and Bronze Ingot Institute. The members of these two associations produce over 90 percent of the brass and bronze ingot manufactured and consumed in the United States. The brass and

bronze ingot industry has served an important role in the economy by recycling thousands of tons of copper base scrap each week. The industry justifies its existence by the fact that its members can produce ingot from copper base scrap at a cost lower than the same ingot could be produced from virgin metals. This is done through our free market system without windfalls and rip-offs.

Ingot is manufactured from copper base scrap, primarily old scrap, by scientifically controlled smelting and refining processes under the close supervision of trained metallurgists. Copper base scrap accounts for about 80 percent of the value of the finished product. Ingot is an economic raw material used by the nonferrous foundry industry to produce products used in the construction, automotive and many other industries.

No justification for recycling tax credit

Proponents of the recycling tax credit have attempted to justify a recycling tax credit on the basis that it would equalize certain tax advantages that producers of virgin materials have through tax preferences, such as depletion allowances and capital gains. The recycling tax credit is a credit against taxes due computed as a percentage of the price paid for scrap and waste materials that are recycled by the taxpayer. Therefore the value of the tax credit will be a function of the cost and quantity of scrap and waste materials consumed by a recycler.

Proponents of the recycling tax credit believe that the credit will increase the quantity of scrap and waste materials recycled and therefore, (1) conserve natural resources; (2) save energy; (3) reduce air and water pollution; and (4) reduce solid waste disposal costs.

The producers of brass and bronze ingot agree that all of these objectives are admirable but are opposed to a recycling tax credit on copper base scrap because it will not achieve any of the above desired results and will (1) cause loss in tax revenues; (2) increase copper base scrap prices; (3) cause severe dislocations in scrap markets; (4) not assure most economic use of scrap; and (5) not increase supply of copper base scrap.

No relationship between depletion allowance and recycling tax credit

There is no chemical or physical difference between copper produced from ore and copper recycled from scrap and therefore there is a direct relationship between primary and secondary copper. However, the economics of producing copper from ore is entirely different than producing copper and copper alloys from scrap. The cost of mining copper ore and the subsequent smelting and refining has no direct relationship to the cost of collecting, sorting, processing, smelting, and refining scrap. Therefore the fact that there are certain tax preferences available to producers of virgin copper does not justify similar tax preferences for recyclers.

The value of copper base scrap is a function of the world price of primary copper and the supply/demand situation in the copper market. The price of scrap must cover the cost of collecting and transporting it to a recycler for conversion into useable forms of copper and copper alloy. The value over this cost is the intrinsic value of the scrap which encourages its collection and recycling. The price of copper base scrap is and has been at a level to assure optimum recycling. Copper scrap is normally priced lower than primary copper by an amount at least equal to the recycling cost so that the recycled product can be sold competitively with primary copper.

Effect of price on supply of scrap

The price of copper base scrap is extremely sensitive to changes in demand. For example, the average monthly price of heavy yellow brass scrap, as reported by the Bureau of Labor Statistics, increased from 22 cents a pound in January 1973 to 54 cents a pound in May 1974. This increase was due to the operation of a free market and an increased demand for copper base scrap. However, even with the sharp increase in price of 145 percent, the supply of copper base scrap did not increase and copper recovered from scrap dropped 2 percent from 1973 to 1974. This experience clearly shows that if additional scrap is not collected and recycled with an increased price incentive of 145 percent, a recycling tax credit of 7½ percent would not increase the supply of scrap for recycling.

Copper scrap is being recycled

United States industry has been doing an excellent job in recycling copper base scrap. During 1974 1,323,248 tons of copper were recovered from purchased copper base scrap. This compares with production of 1,654,658 tons of primary refined

copper during the same year. Due to generally lower economic activity in 1975, both copper recovered from scrap and production of refined copper was lower than 1974. Copper recovered from purchased copper base scrap was 887,056 tons and production of primary refined copper was 1,443,378 tons in 1975.

The relatively high value of copper base scrap, as compared to ferrous scrap or waste paper, is an adequate inducement to collect copper base scrap for recycling. There is very little copper base scrap lost from the system and one of the first items reclaimed from a junked car is the brass radiator. The major factor limiting the amount of copper base scrap available for recycling is the increasing amounts of copper remaining in use in growing electric systems, additional cars on the road, and more copper used in construction. Once copper has served its useful purpose, it will find its way through normal collection channels to the recycler.

Tax credit would cause higher prices

As noted above, copper base scrap prices are extremely sensitive to changes in demand. A recycling tax credit on copper base scrap would increase the demand for scrap by bringing into the market buyers who are not now using scrap but who want to take advantage of the tax credit. This would cause severe dislocations in a market that has operated well over the years. Inasmuch as there would not be additional scrap available to meet the increased demand, the result would be higher scrap prices. These higher prices would be passed on to the ultimate consumer, adding to inflationary pressures.

Established vs. new recycler

The proposed recycling tax credit provision would create a major inequity between established recyclers and new recyclers. Section 2006 provides that the established recycler's credit would be based only on his consumption of scrap that is greater than 75 percent of his base period consumption. A new recycler, during his first year would compute his tax credit on all of his scrap consumption. During the second year his credit would be computed on consumption that was greater than 25 percent of his first year and the third year tax credit would be computed on consumption greater than one-third consumption during the first two years.

We realize the dilemma of trying to draft a proposal that will not provide a windfall for established recyclers and not give an advantage to a new recycler. We don't believe it is possible to achieve an equitable provision without making it so complex that it would not be possible to administer.

Loss in tax revenue

It is difficult to accurately forecast the loss in tax revenues caused by a recycling tax credit on copper base scrap because it will be a function of future consumption and price of scrap. As noted above, there have been large fluctuations in the price of copper base scrap. However, using conservative assumptions as to future consumption and prices (see appendix) we estimate that the loss in tax revenue caused only by the recycling tax credit on copper base scrap as reported by the Senate Finance Committee will be as follows during the first four years:

1977	$6,913,000
1978	15,936,000
1979	36,549,000
1980	41,670,000
Total	101,068,000

Senator Gravel had printed on July 2 an amendment he intends to propose (Amdt. No. 2016) that would liberalize the recycling tax credit provision and cause additional losses in tax revenues. The estimated loss in revenue that would result from Senator Gravel's amendment would be as follows:

1977	$27,652,000
1978	53,721,000
1979	82,451,000
1980	113,920,000
Total	277,744,000

As noted above, this loss in tax revenue is attributable only to copper base scrap and the total loss in revenue from the recycling tax credit would be much greater as it would also apply to waste paper, textiles, glass, plastics, iron and steel, aluminum, tin, lead, zinc and other metals.

On June 23 Senator Taft had printed an amendment he intends to propose (Amdt. No. 1931) to exclude copper base scrap from the recycling tax credit. This amendment is supported by consumers of copper base scrap who produce brass and bronze ingot. We urge the Senate Finance Committee to support the exclusion of copper base scrap from the recycling tax credit.

ESTIMATED TAX REVENUE LOSS RESULTING FROM THE PROPOSED RECYCLING TAX CREDIT ON COPPER BASE SCRAP

(Section 2006 of the tax reform bill, H.R. 10612)

The following analysis shows that during the first four years (1977–1980) a recycling tax credit on copper base scrap could cause a loss in tax revenue of $100 million to a quarter of a billion dollars. This loss in revenue is attributable only to copper base scrap and the total loss in revenue for the recycling tax credit would be much greater as it would also apply to waste paper, textiles, lass, plastics, iron and steel, aluminum, tin, lead, zinc and other metals.

Both the Finance Committee proposal (Section 2006) and the Gravel Amendment (Amdt. No. 2016) provide for a base period of three years, 1973–1975, in computing the tax credit. Consumption of copper base scrap during the base period as reported by the Bureau of Mines was as follows:

	Tons
1973	1,632,129
1974	1,777,529
1975	1,255,542

Therefore the average annual consumption during the base period was 1,632,067 tons.

In order to estimate the loss in tax revenue during the four year period 1977–1980 it is necessary to make estimates of copper base scrap consumption and prices during the period. The following assumptions on consumption and price are made:

1. Copper base scrap consumption in 1977 will be equal to the average consumption during 1970–1974 and after 1977 increase 3 percent per year. Consumption therefore is estimated at:

	Tons
1977	1,766,247
1978	1,819,234
1979	1,873,811
1980	1,930,025

2. The average price for copper base scrap during 1977 will be equal to the average price during 1972–1974 or 34 cents per pound ($680 per ton) and increase after 1977 at 5 percent per year. Price is therefore estimated at:

1977	34¢/lb or $680/ton.
1978	36¢/lb or $714/ton.
1979	37¢/lb or $750/ton.
1980	39¢/lb or $787/ton.

Both the Finance Committee proposal and Gravel Amendment provide for a tax credit equal to one-half the 15 percent depletion allowance for copper. Therefore the tax credit would be 7½ percent for copper base scrap.

The Finance Committee proposal provides that the tax credit be computed on the amount of scrap consumed that is greater than 75 percent of consumption during the base period (1973–1975). The credit would be phased in with one quarter of the amount being allowed in 1977, one half in 1978 and the full amount after 1978. The estimated loss in revenue is computed as follows:

[C−BP(.75)]×Pr×Cr×Pr=Loss in revenue

C=Consumption.
BP=Base Period Consumption.
Pr=Price.
Cr=Tax credit—7½ percent.
Pf=Phase in factor.

1977 [1,766,247−1,632,067(.75)]×680×.075×.25=$6,913,009.
1978 [1,819,234−1,632,067(.75)]×714×.075×.50=$15,936,045.
1979 [1,873,811−1,632,067(.75)]×750×.075=036,549,042.
1980 [1,930,025−1,632,067(.75)]×787×.075=$31,670,160.

The Gravel amendment provides that the tax credit be computed on the total amount of scrap consumed. The credit would be phased in by excluding 75 percent of the base period consumption during 1977, 50 percent during 1978 and 25 percent during 1979. The estimated loss in revenue from the Gravel amendment is computed as follows:

$$[C-BP(Pf)] \times Pr \times Cr = \text{Loss in revenue}$$

C=Consumption.
BP=Base Period Consumption.
Pr=Price.
Cr=Tax credit.
Pf=Phase in factor.

1977 [1,766,247−1,632,067(.75)]×680×.075=$27,652,034.
1978 [1,819,234−1,632,067(.50)]×714×.075=$53,721,387.
1979 [1,873,811−1,632,067(.25)]×750×.075=$82,450,927.
1980 1,930,025×787×.075=$113,919,726.

Statement of Charles L. Neumeyer on Behalf of Associated Gas Distributors, New York Gas Group, the East Tennessee Group, Concerning Section 1322

Honorable members of the Senate Finance Committee: My name is Charles L. Neumeyer, I am a Senior Vice President of The Brooklyn Union Gas Company. I am making this statement on behalf of (1) Associated Gas Distributors, an unincorporated association of forty-four vublic utility dompanies engaged in the distribution of gas in the Eastern United States, (2) the New York Gas Group, an unincorporated association of fourteen public utility companies engaged in the distribution of gas in New York State, and (3) the East Tennessee Group, a cooperative group of twenty-four private and municipal companies engaged in the distribution of gas in the State of Tennessee. Complete lists of the gas distributors which are included in these organizations are attached to this statement as Appendices A, B, and C. These companies provide yas service to several million consumers in the Eastern and Southern United States.

The purpose of my statement is to alert your Committee to what we believe is an unfortunate omission from Section 1322 of the Tax Reform Bill of 1976, which could unfairly discriminate abainst gas companies and their customers.

As you are aware, the genesis of the amendments to Section 118 of the Internal Revenue Code which are contained in Section 1322 of the Bill is the Internal Revenue Service's recent reversal, in Revenue Ruling 75–557, of its longstanding position with respect to contributions in aid of construction. The details of the IRS policy change and the impact of that change upon water and sewage disposal utilities are cogently documented at pages 434 and 435 of this Committee's report on the proposed legislation. My statement is directed to the potential impact of Revenue Ruling 75–557 upon gas utilities and their customers and the action which should be taken by this Committee to assure fair and even-handed treatment of customer contributions to the gas distribution industry.

It is undisputed that a severe shortage of domestic natural gas exists. All responsible studies indicate that this situation will continue to deteriorate in the foreseeable future. One of the principal causes of the current gas shortage is the inadequate level of capital funds devoted to the exploration and development of the domestic gas reserve base. The lack of adequate domestic gas supplies has adversely affected both the nation's economy and the environment.

The suggested solutions to this problem are numerous, and in many cases, extremely complex. However, given appropriate and nondiscriminatory tax treatment, we believe there is a relatively simple and effective means of providing the capital to finance the search for significant new natural gas supplies for the consuming public at the lowest possible cost. In response to the worsening gas shortage, many gas distribution companies, either individual or in groups, have proposed and are developing programs for gas rate surcharges to generate consumer contributed capital for exploration and development of new gas reserves. Most, if not all, of these gas rate surcharges are subject to approval and control by state or local regulatory agencies.

Gas distribution companies are ideally suited to effectuate this type of program for customer contributions in aid of natural gas exploration. This is because

gas distributors, unlike producers and pipelines, are subject to continuing state law and franchise obligations to provide adequate gas service to the consuming public. These service obligations provide the greatest possible incentive for the gas distribution utility to secure additional gas reserves and timely dedicate such reserves to supply the consuming public. Also, both the gas distributors and the consumers they serve have literally billions of dollars of investment in existing gas distribution and utilization systems. These systems comprise the most efficient means now available for delivery and utilization of energy in the United States. The fullest possible use of these systems should be a national priority, and, of course, makes good economic sense from the standpoint of both the consumer and the gas distributor. Finally, the gas distributor has a very real incentive, by reason of the fact that all of its sales are made in direct competition with other available forms of energy, to secure new gas supplies at the lowest possible costs. For each of these reasons, the gas distribution companies can be the most attractive and effective new entrants into the production phase of the gas business.

The existing operations of gas distribution companies are extremely capital intensive, and the capital-raising capabilities of these companies and their access to traditional capital markets has been severely tested in recent years. For this reason, gas distributors cannot rely on past sources of capital to supply the substantial capital funds needed to mount a meaningful gas exploration and development effort. Programs for customer contributions in aid of natural gas exploration provide the optimum vehicle for generation of the necessary capital funds.

In the type of program I have described, the gas distributor will receive and apply customer capital contributions to gas exploration projects, will not include such contributions in rate base, and will pay over to consumers, through a reduction in, or credit to, charges for gas service, any profits resulting from such projects. Thus, the gas distributor will receive no direct profit or monetary benefit from the exploration projects. Sound logic would indicate that customer capital contributions which are earmarked by state and local regulatory authorities for investment in gas exploration should not be considered income to the gas distributor. Moreover, we believe that Congress has never intended that the federal income tax be applied, at the outset, to capital investments. Both the original Section 1322 and the revisions here proposed are completely consistent with this basic proposition and would eliminate the inequities and inconsistencies inherent in Revenue Ruling 75–557.

It is, we believe, self-evident that the type of program described can not be conducted in an atmosphere of doubt as to the tax status of the customer contributions in aid of natural gas exploration. However, Revenue Ruling 75–557, although dealing specifically with customer contributions in aid of construction of water facilities, suggests that customer contributions in aid of natural gas exploration also may be claimed to be taxable income to a gas distribution company, notwithstanding the fact that the gas distributor under established regulatory policy will not be permitted to include such contributions in rate base and thus will not be permitted to profit from the use of the customer contributions in exploration and development projects. The same is true of any other customer capital contributed to the gas companies.

If the Internal Revenue Service takes the position that such contributions are taxable income to gas distributors, the impact upon distributor-sponsored exploration programs could be devastating. Such an interpretation would raise the possibility that consumer-contributed exploration capital would be diluted immediately by a factor of almost 50%, thereby destroying, for all practical purposes, the effectiveness of such programs. This prospect would have a "chilling" effect on the willingness and ability of both gas distributors and state regulatory agencies to pursue customer-funded exploration programs.

In its present form, Section 1322 does nothing to support and may even weaken the position that contributions in aid of natural gas exploration are not taxable income to a gas distributor. We do not believe that this result was intended by the framers of Section 1322 and urge this Committee to so indicate by adopting and recommending an appropriate amendment to dispell, for all time, any doubts as to the tax status of such contributions and to confirm basic Congressional policy concerning taxation of investment capital.

In order to clarify the tax status of these contributions, the following two modifications must be made to Section 1322(a):

1. the utilities to which Section 118, as amended, will apply should be expanded to include gas distribution utilites; and

2. the capital assets which qualify under the expenditure rule of proposed Section 118(b)(2)(A) should include intangible capital assets.

The reason for the first change is self-evident. The second change is required because the contributions in aid of natural gas exploration will be used, in substantial measure, by gas distributors to acquire intangible assets such as oil and gas leases.

Without intending to usurp the discretion of this Committee, we have prepared a revision of Section 1322(a) incorporating the language changes which we believe would accomplish the desired result. A copy of such revision with language changes underlined, has been attached to my prepared remarks as Appendix D.

Of understandable concern to this Committee is the effect which any proposed change in the Internal Revenue Code will have upon the revenues of the Treasury. We submit that the changes we have recommended to you will result in no loss of revenues to the Treasury. First, customer contributions in aid of construction of tangible capital assets currently represent an insignificant fraction of the total receipts of regulated gas distribution companies. Second, although the amount of customer contributions in aid of exploration may ultimately be significant, it is unlikely that gas distributors would propose or state regulatory agencies approve consumer-funded exploration programs if 50 percent of the capital raised went directly and immediately to the Treasury in the form of higher taxes. Stated another way, the type of program I have been discussing simply would not flourish in the absence of a fair and favorable tax climate.

On the other hand, if the proposed revisions to Section 1322(a) are adopted, exploration programs of the type I have described can be implemented and should provide a long-term stimulus to the economy through increased availability of new domestic gas supplies at relatively low cost and a related reduction in the need for imported oil.

In conclusion, we believe that the revisions here proposed are completely consistent with established Congressional policy on income taxation, and that the very substantial benefits of assuring even-handed tax treatment of capital contributions in aid of natural gas exploration which have been outlined are full and sufficient justification for the proposed revisions. Furthermore, when consideration is given to the significant adverse impacts upon consumers, the nation's environment, the goal of national energy independence, the economy, and the gas distributors, which would result if the development of programs for such capital contributions is stifled, we believe this Committee should and will conclude that the changes here recommended are in the best interests of the nation and the consuming public.

Appendix A

Members of Associated Gas Distributors

Atlanta Gas Light Co.
Bay State Gas Co.
The Berkshire Gas Co.
Boston Gas Co.
Bristol and Warren Gas Co.
Cape Cod Gas Co.
City of Holyoke, Mass. Gas and Electric Department
City of Westfield Gas and Electric Light Department
Commonwealth Gas Co.
Concord Natural Gas Corp.
The Connecticut Gas Co.
Connecticut Natural Gas Corp.
Fall River Gas Co.
Fitchburg Gas and Electric Light Co.
Gas Service, Inc.
The Hartford Electric Light Co.
Haverhill Gas Co.
Lowell Gas Co.
Manchester Gas Co.
New Bedford Gas and Edison Light Co.
North Attleboro Gas Co.
Northern Utilities, Inc.
The Pequot Gas Co.
Providence Gas Co.
South County Gas Co.
Southern Connecticut Gas Co.
Tiverton Gas Co.
Valley Gas Co.
The Brooklyn Union Gas Co.
Central Hudson Gas and Electric Corp.
Consolidated Edison Co. of New York, Inc.
Elizabethtown Gas Co.
Long Island Lighting Co.
New Jersey Natural Gas Co.
New York State Electric & Gas Corp.
North Carolina Natural Gas Corp.
Philadelphia Electric Co.
Philadelphia Gas Works
Piedmont Natural Gas Co., Inc.
Public Service Co. of North Carolina, Inc.
Public Service Electric and Gas Co.
Rochester Gas and Electric Corp.
UGI Corp.
Washington Gas Light Co.

Appendix B

Members of New York Gas Group

The Brooklyn Union Gas Co.
Central Hudson Gas and Electric Corp.
Columbia Gas of New York, Inc.
Consolidated Edison Co. of New York, Inc.
Corning Natural Gas Corp.
Long Island Lighting Co.
National Fuel Gas Distribution Corp.
New York State Electric & Gas Corp.
Niagara Mohawk Power Corp.
Orange & Rockland Utilities, Inc.
Pavilion Natural Gas Co.
Rochester Gas and Electric Corp.
St. Lawrence Gas Co., Inc.
Syracuse Suburban Gas Co., Inc.

Appendix C

Members of the East Tennessee Group

Knoxville Utilities Board.
Athens Utilities Board.
Citizens Gas Utility District.
Cookeville Gas Department.
The Elk River Public Utility District.
City of Etowah Utilities Department.
Fayetteville Gas System.
Gallatin Natural Gas System.
Harriman Utility Board.
Hawkins County Utility District.
Lenoir City Utilities Board.
Lewisburg Gas Department.
Loudon Utilities Board.
Madisonville Gas System.
First Utility District of Maury County.
Middle Tennessee Utility District.
Oakridge Utility District.
Rockwood Natural Gas Co.
Marion Natural Gas System.
Sweetwater Board of Public Utilities.
Jefferson-Cocke County Utility District.
Sevier County Utility District.
Volunteer Natural Gas Co.
United Cities Gas Co.

Appendix D

Sec. 1322. Contributions in Aid of Construction for Certain Utilities

[BILL SEC. 1322(a)]

(a) In General.—Section 118 (relating to contributions to the capital of a corporation) is amended by redesignating subsection (b) as subsection (c) and inserting immediately after subsection (a) the following new subsection:

"(b) Contributions In Aid of Construction.—

"(1) General Rule.—For purposes of this section, the terms 'contribution to the capital of the taxpayer' includes any amount of money or other property received from any person (whether or not a shareholder) by a regulated public utility which provides water, gas, or sewerage disposal services if—

"(A) such amount is a contribution in aid of construction,

"(B) where the contribution is in property which is other than water, gas, or sewerage disposal facilities, such amount meets requirements of the expenditure rule of paragraph (2), and

"(C) such amounts are not included in the rate base for rate-making purposes.

"(2) Expenditure Rule.—An amount meets the requirements of this paragraph if—

"(A) an amount equal to such amounts are expended for the acquisition or construction of tangible or intangible capital assets—

"(i) which was the purpose motivating the contribution, and

"(ii) which are used predominantly in the trade or business of furnishing of water and sewerage disposal services, and gas services and the provision of supply necessary thereto.

"(B) the expenditure referred to in subparagraph (A) occurs before the end of the second taxable year after the year in which such amount was received, and

"(C) accurate records are kept of the amounts contributed and expenditures made on the basis of the project for which the contribution was made and on the basis of the year of contribution or expenditure.

"(3) Definitions.—For purposes of this section—

"(A) Contributions In Aid of Construction.—The term 'contributions in aid of construction' shall be defined by regulations prescribed by the Secretary.

"(B) Predominantly.—The term 'predominantly' means 80 percent or more.

"(4) Disallowance of Deductions And Investment Credit; Adjusted Basis.—Not withstanding any other provision of this subtitle, no deduction or credit shall be allowed for, or by reason of, the expenditure which constitutes a contribution in aid of construction to which this subsection applies. The adjusted basis of the assets acquired with contributions in aid of construction to which this subsection applies shall be zero."

[No change is required in Bill Secs. 1322(b) and 1322(c)]

ORGANIZATION OF PROFESSIONAL EMPLOYEES
OF THE U.S. DEPARTMENT OF AGRICULTURE,
Washington, D.C., July 20, 1976.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: We appreciate very much the opportunity to offer, at this late date, our recommendations on HR-10612. First, we want to go on record as supporting actions taken by both the House and the Senate to improve the tax structure particularly those steps designed to close loop holes and to provide a more equitable tax structure. Along this line we support the principle that permits sick pay federal income tax deductions only for federal disability retirees who are totally disabled. We also support the maximum annual income limitation of $15,000. Under this proposal a total disabled federal annuitant with an annual income of $20,200 would not be eligible to claim sick pay tax exemption.

These two provisions (total disability and maximum income exclusion) insures that exemptions are permitted only where a definite need exists. There are some federal retirees who, because of total disability, are forced to retire before they could complete their federal career. As a result they are forced to live on a small and many times inadequate annuity. Some have annuities which approximate 40 percent of their high average salary. For them the sick pay income tax deduction is very important and essential. Under present regulations, this exemption is available until age 70—the compulsory retirement age.

The proposed provisions, as reported out by the House, provided for the continuation of sick pay deduction for the totally disabled annuitant until age 65. Most federal employees are not eligible for Social Security and the accompanying Medicare. After age 65, they can establish eligibility for Medicare by paying the applicable premium, much the same as other types of health insurance. However most, with limited annuity incomes, have decided not to assume this additional expense.

For the reasons stated above, we respectfully request that your Finance Committee amend the House proposal to provide that sick pay income tax exemption be available to age 70. We support the total disability requirement and the maximum income provision. Under these restrictions, only those federal annuitants with a definite need will be eligible. It will not involve a large expenditure of federal funds nor will it incur a large loss of income tax revenue.

The proposed amendment will meet a definite social need. It is a humanitarian approach and recognizes a problem facing those unfortunate federal employees who, because of total disability, were not able to complete their life's work or to provide adequately for their retirement.

We thank the Committee for permitting us to supply this information. We sincerely hope this appeal is included with the other changes now being considered by your Committee.

Sincerely,

GEORGE E. BRADLEY,
Executive Director, OPEDA.

STATEMENT OF THE NATIONAL FOREIGN COUNCIL, INC.

Tax Reform Proposals Relating to Foreign Income

SUMMARY

The National Foreign Trade Council has testified before the Committee on Ways and Means of the U.S. House of Representatives and your Committee with reference to the tax reform proposals and, to the extent appropriate in these hearings, would refer to such testimony.

The present method of taxing foreign source income, particularly the allowance of a foreign tax credit and taxation of foreign source income only when realized, has been essential to meet foreign competition abroad on equal terms.

As indicated in the accompanying detailed comments, we support the concepts set forth in the proposals relating to Investment in U.S. Property and Portfolio Investments.

Some other proposals for taxation of foreign source income noted herein; namely, Exemption for Investments in Less Developed Countries, Per Country Limitation, Western Hemisphere Trade Corporations, Foreign Loss Recapture and Income Earned Abroad would, in varying degrees, penalize foreign investment and impair the ability of U.S. companies to compete abroad jeopardizing their present position and future potential in the world marketplace, as well as adversely affecting capital formation requirements.

We continue to stress the importance of foreign direct investment to the U.S. economy, to U.S. employment, to U.S. exports and the U.S. balance of payments.

AMENDMENTS TO AND PROVISIONS OF H.R. 10612—FOREIGN INCOME

(All references are to the bill as reported to the Senate except as may be otherwise indicated.)

AMENDMENTS AFFECTING TAX TREATMENT OF CONTROLLED FOREIGN CORPORATIONS AND THEIR SHAREHOLDERS

Investment in U.S. property

The National Foreign Trade Council continues to support the complete repeal of Section 956 as an inducement to improvement of the balance of payments position of the U.S. The principal effect of the current provision, aside from operating as a trap for the unwary, is to encourage foreign corporations to invest abroad. Thus, a corporation in search of temporary investments for working capital is induced to purchase foreign short-term obligations rather than those of United States companies. The Council believes that present case law adequately protects the government against utilization of funds of foreign subsidiaries by U.S. shareholders in the form of disguised dividends without payment of tax thereon.

Accordingly, the Council supports the amendments to Section 956 of the Internal Revenue Code as set forth in Section 1021 of H.R. 10612 to the extent that they are consistent with these objectives.

Exemption for investments in less developed countries

H.R. 10612 would (a) repeal the present provision of Section 1248 under which gain realized upon disposition of shares of a less developed country corporation under certain circumstances is taxed as a capital gain rather than ordinary income and (b) amend the provisions of Section 902 to require gross-up of dividends received from less developed country corporations.

These provisions were enacted into law in the Tax Reform Act of 1962 only after careful consideration of their potential benefit to the economic development of less developed countries and to U.S. trade with such countries. The Council

submits that the considerations supporting the conclusions reached in 1962 are even more valid today. Furthermore, these provisions should be retained to better enable U.S. business to continue to participate in these developing economies on a more competitive basis with non-U.S. businesses. Other countries, such as Japan, have negotiated agreements with several less developed countries which provide for substantially more favorable home country tax treatment of income from investments in less developed countries than is accorded income from investments by U.S. businesses. The ability of U.S. business to compete worldwide with foreign-owned businesses should not be further impeded by changes to present law which has been relied upon in making long-range plans to meet foreign competition. Continued participation in the development of less developed countries which, in general, represent large economic growth potentials for U.S. trade, without further disadvantages is beneficial to U.S. trade and investment, including the export of U.S.-manufactured products and equipment, and would contribute to better international relations between the U.S. and such countries.

Per country limitation in computing foreign tax credit

Longstanding U.S. policy has recognized the primary right of a foreign country to tax income arising therein and has sought to promote tax neutrality through the foreign tax credit mechanism.

The flexibility now provided by the election to calculate a U.S. taxpayer's limitation on allowable foreign tax credits on either a per-country or overall basis is necessary to permit U.S. business to compete internationally with foreign companies. Loss of this flexibility would serve to aggravate their competitive disadvantage. This would be true particularly of less broad-based firms where a considerable part of their foreign operations consisted of risk ventures and firms wishing to expand their present operations in other areas but with serious risk of losses. Unless a taxpayer has the option of electing the per-country limitation method under these circumstances, the potential economic consequences, as contrasted with those of his foreign competitors who would not be burdened by the same tax consequences, could be a decision to forego the risk of any such venture, thus adversely affecting U.S. trade. This would affect primarily proposed ventures in less developed countries contrary to longstanding U.S. policy to assist in the development of such countries.

While Congress imposed certain punitive restrictions on the use of the per-country limitation in the Tax Reduction Act of 1975 in the case of oil-related income, any such restrictions should not be extended to other categories of income.

Portfolio debt investments in United States of non-resident aliens and foreign corporations

The Council wishes to express its support of Section 1041 of H.R. 10612 as ordered reported by the House Ways and Means Committee (subsequently deleted on the House floor). The Council also supports the amendment to Section 1041 made by the Finance Committee to exempt all interest paid to non-resident aliens and foreign corporations from the 30 percent withholding tax as well as the House bill provision making permanent the present exemption on bank deposit interest payments to non-resident aliens.

For the reason stated below, however, the Council would urge an extension of the exclusion to dividends paid to non-resident aliens and recommends that in implementing that decision is not adopt a narrow or restricted definition of "portfolio investments." This proposal would encourage U.S. business to use foreign capital markets as a source of funds for future capital requirements, thus contributing to a favorable balance of payments. Any restrictive definition, however, would only serve to reduce the full potential use of such foreign capital markets.

The Council also endorses the statement by Assistant Treasury Secretary Charles M. Walker before the Senate Finance Subcommittee on International Finance and Resources on March 1, 1976 setting forth in detail the position of the Treasury Department and the Administration that existing withholding taxes on dividends and interest payments by U.S. persons to non-resident aliens and foreign corporations should be eliminated.

Western Hemisphere Trade Corporations

The National Foreign Trade Council opposes elimination of the deduction allowed to Western Hemisphere Trade Corporations which was enacted in 1942 for the purpose of encouraging trade with Latin America and Canada. The provisions

have worked well for over thirty years permitting United States corporations to compete effectively with both foreign local corporations and with third country foreign corporations doing business in the countries of the Western Hemisphere.

The activities of the Western Hemisphere Trade Corporations are a substantial factor in maintaining a favorable balance of trade with these countries. In addition, it does not appear timely to make any change in this provision as it would adversely effect the competitive position of U.S. business in relation to foreign competitors, who enjoy export incentives granted by their own countries, pending conclusion of trade negotiations with foreign governments to eliminate or reduce present barriers to free and competitive trade.

Accordingly, the existing provisions must be retained if we wish to continue to maintain and implement our international policies with respect to investment in and trade with the nations of Latin America and Canada.

Foreign loss recapture

Although the modification of the recapture of foreign loss provisions by the Senate Finance Committee, as set forth in Section 1032 of the bill, does mitigate to some degree the adverse affects of the provision as it appeared in the bill passed by the House, the Council believes that recapturing foreign losses by carrying them forward to offset subsequent foreign income for foreign tax credit limitation purposes is undesirable.

American business already has a disadvantage in competing internationally with nationals of countries which do not tax foreign source income (e.g. France and The Netherlands). Recapturing foreign losses will extend the disadvantage to competing with nationals of countries which grant foreign tax credit without recapturing foreign losses (e.g. United Kingdom, West Germany, Canada and Japan).

Moreover, a recapture mechanism will unfairly discriminate against industries which must operate abroad in order to maintain or develop a market for their products which otherwise would be closed to them.

It should also be noted that as a general rule the tax laws of foreign countries allow tax benefit for start-up losses through amortization and/or loss carryovers. These deductions reduce the foreign tax paid and therefore the amount of creditable tax during the pay-out period. In any event, a taxpayer will not benefit from additional U.S. tax deduction once an excess credit position is achieved because foreign taxes can never be applied against U.S. tax on income from domestic sources.

Exclusion for income earned abroad by U.S. citizens living or residing abroad

While the Council does not oppose the proposal to permit individuals employed abroad to elect not to exclude $20,000 ($25,000 in certain cases) of the income earned abroad from taxable income, it would urge the Committee at this time to consider deleting Section 1011 of H.R. 10612 in its entirety. The effect of the amendments proposed by the Finance Committee and the restrictions upon this exclusion so severely restrict the benefits of Section 911 as to be tantamount to its repeal. Accordingly, these provisions would either discourage the employment of U.S. personnel abroad or increase the cost of employment of such individuals whose services are necessary to maintain proper management and other control over foreign operations of U.S. businesses. Either alternative would adversely affect the competitive position of U.S. businesses vis-a-vis their foreign competitors.

In order to roughly equate the living standards of U.S. employees overseas with their counterparts in the U.S., American companies typically provide allowances of various types to cover unusual expenses incurred abroad. These generally take the form of cost-of-living allowances (including recognition of the fact that foreign countries rely heavily for revenue on indirect taxes not qualifying as foreign tax credits), housing allowances, and tuition expense payments. The after-tax effect on the "take home" pay of the employee, giving consideration to the present exclusion under Section 911, is a factor in the determination of these foreign service allowances. Therefore, the elimination of the present earned income exclusion under Section 911 would only add to the cost of present allowances granted such employees, thus adversely affecting the competitive position of U.S. businesses abroad. While the U.S. taxes its citizens on a worldwide basis, even though they reside abroad, most competitive countries, such as Germany, U.K., Japan and France do not. Therefore, any increase in cost of employing U.S. nationals abroad would impact adversely on the competitive status of U.S. companies vis-a-vis foreign competitors.

In this connection, it should be observed that a U.S. person acceptaing a foreign assignment generally is at a unique tax disadvantage with respect to one accepting a new assignment within the U.S. Ordinarily, an employee transferred abroad is not able to defer recognition of taxable gain on the sale of his principal residence in the U.S. since, as a practical matter, he will occupy rental quarters while on foreign assignment. Thus, upon his return to the U.S., his principal amount available for purchase of a residence will have been reduced by the tax paid on the recognized gain on sale of his residence prior to foreign assignment.

It also should be noted that small and medium-sized concerns often use self-employed U.S. citizens residing abroad to act as independent commission agents in effecting export sales. To the extent that repeal or substantial modification of the present exclusion under Section 911 would reduce the presence of such persons abroad, the expansion or maintenance of present levels of U.S. exports could be adversely affected.

General

It is noted that in the notice of the current hearings there are included certain items with respect to the taxation of foreign source income which may require technical correction or the correcting of drafting error, as for example in Section 1035. Where they are not at issue and the intent of the Congress to carry them out seems clear, the Council supports the Senate Finance Committee decision to take legislative clarifying action where appropriate.

Statement of the American Mutual Insurance Alliance

SECTION 1508, H.R. 10612—CONSOLIDATED RETURNS FOR LIFE AND MUTUAL INSURANCE COMPANIES

The American Mutual Insurance Alliance is the major association of mutual casualty insurance companies. Its member companies write about 4-billion dollars in fire and casualty insurance for its policyholder members each year, and a member of the companies also write life insuurance through affiliates or subsidiaries.

The Alliance is strongly opposed to Section 1508 of H.R. 10612, a provision to allow the consolidation of returns between life insurance companies and casualty insurance companies. Our views in opposition were previously communicated to the Committee in a written statement which stressed the inappropriateness of consolidating dissimilar entities such as life insuruance companies on the one hand, and casualty insurance companies on the other, when they are subject to such diverse tax provisions.

We continue to believe that such consolidation makes for bad tax law. However, this statement will address two entirely different points which were not made in prior presentations to the Committee.

I. This amendment is not, as claimed a logical extension of the rule which presently allows noninsurance (sic) companies to file a consolidated return and thus offset casualty losses against other business income

The Committee Report states:

"If a stock casualty company and a noninsurance (sic) company are affiliated, they can file a consolidated return on which the losses of the casualty company are applied against the other company's profits.

"However, if the other company is a life insurance company, the losses of the casualty company can only be applied against the casualty company's income for other years (by means of loss carryovers and carrybacks); they cannot be applied against a life company's nicome."

This statement implies that the treatment of life insurance income under existign tax laws is unfair and works a hardship against life insurers. This just is not so.

While it is true that a life insurance company cannot consolidate its life insurance and its casualty insurance incomes and losses, it can consolidate the income of all of its affiliates similarly taxed under the Code. Thus, a casualty insurance company, a reinsurance company, a real estate company, a computer leasing company, etc., all owned by a life insurance company can consolidate their incomes just as though the parent life insurance company were a noninsurance entity.

Consider the case of a noninsurance company. It also can consolidate returns on a variety of affiliates including casualty insurance but it likewise cannot con-

solidate the returns of the life companies which it owns since they are taxed differently under the Code. Hence, the present Code does not, in any way, discriminate as between a non-life insurance company and a life insurance company. They can both consolidate returns of the individually owned affiliates, as long as they are similarly taxed.

Accordingly, it is submitted that this proposed amendment is not "a logical extension of the present rule." To the contrary, it is a major departure from the present rule because it would allow consolidation of returns of companies which are taxed in an entirely different manner under the Code.

II. Proposed Section 1508 Discriminates Against Casualty Insurance Companies

Proposed Section 1508 provides that a casualty company loss may be applied against the income of a life company affiliate, subject to two limitations. The amount of the loss which may be applied would be limited to the lesser of (i) 50 percent of the life company's income or (ii) 50 percent of the casualty company's loss.

The first of these limitations will discriminate against long-established casualty companies with life company subsidiaries in favor of large, long-established life companies with casualty subsidiaries. In the case of the large-long-established life companies, their incomes so greatly exceed their casualty subsidiary's losses, that this first limitation will seldom, if ever, become applicable. On the other hand, there are many casualty companies which own relatively small life companies. In their case, the casualty insurance operations dwarf their life insurance operations and unlike that of the life company parent, such first limitation will cut down on the amount of such casualty company's losses which can be used to shelter life company income.

As the Committe Report notes, "it is recognized that the recent recession and inflation in prices has caused many casualty insurance companies to incur large losses." These companies then are the ones in need of tax relief; yet, ironically, it will be the larger and more prosperous life companies, thru their casualty affiliates, which will be the primary beneficiaries. Section 1508 allows the large life insurers to absorb their casualty insurance losses while severely limiting the ability of companies which are basically casualty insurers to do likewise. The Section provides an incentive for life insurers to "enter" the casualty insurance field and a disincentive for a casualty insurer to enter the life insurance field. It is well recognized in the insurance business world that a new company, life or casualty, will incur substantial losses in its initial years of operation. Section 1508 would allow a life insurer to absorb through its life insurance income the losses generated from the initiation of a casualty operation. Casualty insurers, on the other hand, would be provided with very limited incentives to enter the life insurance field.

Finally, it should be noted that the second limitation, providing that the amount of casualty company loss which can be currently absorbed cannot exceed 50 percent of such loss, is relatively meaningless. Since that portion of the loss which exceeds 50 percent can be carried forward, 25 percent (i.e. 50 percent of the remaining 25 percent) the next year, etc., about 97 percent of the loss will have been fully applied against the life company's income in the short span of five years.

For the reasons stated above, as well as the reasons expressed in our initial statement to the Committee, we respectfully urge that Section 1508 be rejected.

THE BOEING COMPANY,
Seattle, Wash., July 21, 1976.

Chairman RUSSELL B. LONG,
Senate Finance Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: We at The Boeing Company are deeply concerned about the continuing ability of the U.S. airline industry to generate the ever-growing amount of capital required to keep this nation's essential air transport system the most efficient and productive in the world. Because of that concern I am writing to you to urge retention by the Senate Finance Committee of its tax provision dealing with refunds of Un-utilized Investment Tax Credits in H.R. 10612. I also urge inclusion of Amendment No. 1906 submitted by Senator Curtis which would extend to airlines the application of tax credit provision now applying to only the railroads.

The ability of our aircraft industry to develop future aviation technology and maintain the world aviation leadership we enjoy is dependent upon the airlines'

ability to make capital investments. The investment tax credit provisions in the Senate Finance Committee bill as amended by Senator Curtis are a necessary part of that capital formation process.

I regret I could not appear before your Committee in person during its current hearings and respectfully request this written statement be included in the printed record and copies be made available to Committee members.

Very truly yours,

T. A. WILSON.

STATEMENT BY L. NAPOLEON COOPER OF PROJECT 76—AN AMERICAN AFFAIRS-INC., A. P. ACTION & CO., INC., AND LARRY N. COOPER, INC.

A Reexamination of Provisions Earlier Approved by Committee for Incorporation in H.R. 10612, The Tax Reform Act and on Contributions of Inventory to Charitable Organizations, a Provision Approved by Committee After the Filing of Its Report

Pursuant to review of both provisions of the "Tax Reform Act" approved by Committee and contained in its report and such other provisions similarly approved after the filing of such report (i.e.-the Energy Investment Credit, Capital Formation and Charitable Contribution Provisions) it is my desire on behalf of myself, Project 76–An American Affair-Inc., A. P. Action & Co., Inc., and Cooper, Inc., to offer Constructive criticism and alternative proposals to the provision affecting Contributions of Inventory to Charitable organizations, the correlating relationship to the Committee's energy incentive outlined on page 11, the capital formation objectives similarly outlined on page 10, and its desire to improve income tax equity at all levels without interfering with efficiency and/or growth in the economy, as outlined on page 2 of the report.

The proposal upon which I intend to expound would in effect lead to an end of any need to federally tax the personal income of American citizens, doing so without reductions in social services and/or increases in business taxation.

My criticism is that a more effective route to capital formation, tax equity, energy production and economic stimulation can be found in the proposed bill submitted for the record with my original indication of desire to testify before this Committee.

The Committee provisions relative to energy do nothing to implement our goal of Energy Independence and at best affect negligibly a more thorough use of available resources.

Should such provisions be coordinated with the contribution provisions so outlined by the otherwise commendable Committee report the tax credit provisions would reflect contributions of inventory as Sales, thereby allowing the effected establishment to make investment decisions and/or expansion plans prudently in compliance with individual profit orientation. The net result of which would be the introduction of new industries, new products, additional employment, and real economic growth.

The economy, its capability to produce and/or its production will not be influenced by the investment credits as outlined. The limited growth in machine tool orders and expansion (the most crucial sector) is the result of prudent management decision-making processes.

It is thusly my purpose to criticize and to address a series of comments and resulting proposals. I suggest the coordination of the capital formation objective of the Tax Act with the contribution of inventory to Charitable Organizations thereby encouraging energy production. As they now stand, the tax credit proposal will affect energy availability negligibly and do absolutely nothing to achieve energy independence.

I suggest further that the Committee consolidate such credit allowing them to be reflected and/or implemented as inventory to Charitable Organizations thereby affecting sales figures (the only factor which realistically influences investment and employment).

As a consequence the establishments so effected would continue prudent reserve and their development and expansion, however the Charitable Organizations thereby also effected would gear their newly received assets toward the development of New Industry, New Jobs, and New Products independent of energy while also pursuing the development of hydrogen simplification thereby achieving continued economic stimulation, implementation of personal tax equity and raise additional short term revenue via the new production of goods and services.

STATEMENT OF THOMAS E. PECKHAM AND ROBERT C. POMEROY OF BOSTON, MASS. ON BEHALF OF VARIOUS NEW ENGLAND CHARITIES IN SUPPORT OF SECTION 2104 OF THE TAX REFORM BILL OF 1976

Section 2104(a) extends the time previously available for reforming, or instituting a court petition to reform, an instrument creating a nonqualifying charitable remainder interest from December 31, 1975 to December 31, 1977. If this extension were all Section 2104 accomplished, it would be identical to H.R. 9889, which has recently been approved by the House of Representatives. However Section 2104 makes two additional changes which make it a superior alternative to H.R. 9889 and which justify its retention in the Tax Reform Bill of 1976. The first such change is the extension of the date by which the governing instrument must have been executed or created from September 21, 1974 to December 31, 1977. The second such change, effected by Section 2104(b) of the Tax Reform Bill, is the provision for a special statute of limitations on refund claims which emanate from the application of IRC Section 2055(e)(3). Section 2104(b) of the Bill provides that notwithstanding the general rules applicable to refund claims imposed by IRC Section 6511(a), a refund claim arising under Section 2055 (e)(3) will be considered timely filed if filed no later than June 30, 1978.

The need for these two provisions is discussed below.

Extension of Dates to December 31, 1977

The most obvious effect of moving the dates within which the governing instrument must have been executed or created, and within which reformation must have been accomplished, or judicial proceedings for its accomplishment instituted, to December 31, 1977 is that it extends the aid provided by Section 2055 (e)(3) to charitable remaindermen that otherwise would have been unable to benefit from it. It is important to note that such an extension would not create a massive giveaway program or tax avoidance loophole. To the contrary, in order for an estate or trust to obtain the estate tax charitable deduction made possible by Section 2055(e)(3), the governing instrument creating the charitable remainder interest must be reformed so as to comply with the stringent requirements of the annuity trust or unitrust provisions of IRC Section 664, thereby increasing the likelihood that funds intended to pass to charity will in fact do so.

In addition to making the relief of Section 2055(e)(3) available to previously ineligible trusts, Section 2104(a), and particularly the extension of the September 21, 1974 date to December 31, 1977, would have the effect of remedying the unduly restrictive temporary and proposed regulations now applicable to Section 2055(e)(3).

Section 2055(e)(3) as it now exists provides that in order to qualify for relief a will must have been "executed," or a trust "created," prior to September 21, 1974. Temporary and proposed regulations have created another restriction that pertains only to the date of creation of inter vivos trusts, which is that these trusts must have been created, within the meaning of local law, after July 31, 1969. See proposed Regulations Section 20.2055 -2(g)(1)(i), -2(g)(3)(iii), -2 (g)(8)(i). This requirement is nowhere stated in Section 2055(e)(3). Its insertion is apparently attributable to statements in various committee reports (See for example, S. Rept. No. 93-1063, 3 U.S. Code, Cong. & Admis. News, 93d Cong., 2d Sess., 1974, p. 5985) that Section 2055(e)(3) was amended to extend the opportunities for reformation which had existed by administrative fiat in the Regulations under IRC Section 664. See Reg. Section 1.664-1(f)(3). Section 664, which imposes the unitrust and annuity trust requirements is applicable to transfers in trust after July 31, 1969. See P.L. 91-172, the Tax Reform Act of 1969, Section 201(g)(5). The Regulations under Section 664 erroneously translated this transfer in trust language to mean that only trusts created after July 31, 1969 were eligible for reformation.

Representative Burke of Massachusetts, floor manager of the bill which became Section 2055(e)(3), made specific reference to the fact that relief provided by this section was intended to extend to revocable inter vivos trusts created, within the meaning of local law, prior to July 31, 1969:

"There are some distinctions between the bill and the Treasury Department's regulations. Under the regulations, the original bequest or transfer had to be in trust and such trust had to be created as a revocable trust before that date.

"First, if the decedent created a revocable trust before July 31, 1969, which thereafter became an irrevocable charitable remainder trust includable in his estate under, for example, sections 2036 and 2038, no right of amendment was

permitted by the regulations to prevent loss of the deduction by section 2055(e).

"The bill deletes this requirement. The important dates are the date of death of the decedent, the date of the governing instrument—that is, prior to September 21, 1974—and the date on which amendment is effected or commenced—that is, by December 31, 1974. (This date was later extended to December 31, 1975.) 120 Congressional Record (daily edition, October 11, 1974) H 10510."

By seizing upon the Regulations' erroneous interpretation of the applicability of the unitrust and annuity trust provisions, the temporary and proposed regulations under Section 2055(e)(3) have perpetuated this error with unintended and unjust consequences, not the least of which is that it has been repeated in the Report of the Senate Finance Committee which purports to explain the amendments made to IRC Section 2055(e)(3). (It is interesting to note that apparently the draftsman of the Committee Report was not aware that a special provision concerning the statute of limitations on refund claims had been added to the Bill, as no mention of this amendment is contained in the report.) As a result of this misinterpretation, it is not at all unlikely that the estate of a decedent who chose to use a revocable inter vivos trust as part of his estate plan, and who created the trust prior to July 31, 1969, could not obtain relief under Section 2055(e)(3), whereas the estate of a decedent who had chosen to employ a testamentary trust under a will executed prior to July 31, 1969 would be eligible for relief.

It is our understanding that in at least one case a private ruling has been issued which has suggested the possibility that a revocable trust might be considered to be "created" on the date it becomes irrevocable. Although such a suggestion has superficial appeal in the case of decedents dying after July 31, 1969, under the current Section 2055(e)(3), which limits instruments eligible for reformation to those executed or created prior to September 31, 1974, decedents with revocable trusts dying after that date would still be in a worse position than decedents dying after that date who had utilized testamentary trusts. By extending both the date of execution or creation and the date for reformation to December 31, 1977, Section 2104(a) of the Tax Reform Bill of 1976, coupled with the concept that a trust, for the purposes of Section 2055(e)(3) is "created" on the date it becomes irrevocable (the position taken by the Committee Report) would largely eliminate this source of unfairness and potential litigation.

Special Statute of Limitations

Section 2055(e)(3) was enacted in large part because of the inadequate transitional provisions which applied to estates of decedents who died soon after December 31, 1969.

The final regulations under Section 664 did provide relief similar to that now provided by Section 2055(e)(3). To qualify for relief under these regulations, however, a trust would have had to have been reformed or a court proceeding for its reformation would have had to have been instituted by December 31, 1972. It should be noted that this regulatory relief was provided by income tax regulations, not estate tax regulations. It is also noteworthy that not until 1974, with the issuance of Revenue Ruling 74–288, 1974–1 CB 157 was there an official Internal Revenue Service pronouncement that an estate tax charitable deduction would be available for charitable remainder interests in trusts reformed in accordance with the income tax regulations.

Although a close reading of Regulations Sections 1.664–1(f)(3)(ii) and 1.664–1(a)(5)(i) would lead to the conclusion that an estate tax deduction would be available, these references, buried in maze of complex income tax regulations, could easily be overlooked, especially when it is considered that nothing in the statute indicates that such a regulation offering a period for reformation could exist.

The recognition, notably by Senator Hansen of Wyoming and Representative Burke of Massachusetts, that these regulatory provisions were not sufficient to prevent the diminution of funds flowing to charity from estates of decedents dying soon after 1969 prompted the introduction of bills in the Senate and the House to provide for an additional period of reformation.

On October 16, 1972, Senator Hansen, while introducing a bill essentially similar to the present Section 2055(e)(3), emphasized the complexity of the charitable remainder provisions and the need for additional time to comply with them:

"Because of the complexity of these rules, many non-conforming charitable remainder trusts are unable to meet this deadline (i.e., December 31, 1972) . . . I think it is also worth noting that it took the Treasury Department 30 months to provide a publication providing sample trust provisions which were to help

the public and the taxpayer in drafting these new instruments so that they will comply with the Act. If the public does not know what is expected of it, how can it comply with these laws?

"I would say the end objective of this amendment is to recognize the failure of the Treasury Department for 30 months' time to take the necessary steps that I feel were indicated so that taxpayers and those so inclined could make bequests of this kind, such as to hospitals. * * * I think with the passage of the Income Tax Act of 1969, it was incumbent on the Treasury to spell out what steps might be taken by the taxpayers. That was not done. It seems unfortunate we would lose—that the public and the nation would lose the help that otherwise would be going to institutions that have been so much the benefactors of all of us, because of the dereliction on the part of the Treasury in failing to come forward with a proper proposal. * * * Congressional Record (bound edition, October 16, 1972) 36655–36656.

This statement, made after the final regulations and sample trust provisions were available, makes it apparent that Senator Hansen was primarily concerned that estates of decedents dying prior to 1972 be given additional time to comply with the charitable remainder provisions.

Representative Burke introduced a similar provision in the 93rd Congress and had printed in the Congressional Record of October 25, 1973 (at H 9439 et seq. (daily edition)) a statement in support of this bill which he declared ably explained the policy behind the proposed extension of the reformation date. The statement, by retired judge Robert Gardiner Wilson, Jr. on behalf of the Shriners' Hospitals, pointed out the irony of Section 664's having had the result of preventing charities from receiving amounts that the charitable remainder provisions were intended to assure would be received. The proposed bill, it was submitted, would provide a statutory basis for reforming trusts that was lacking in the regulations, and would encourage trusts to subject themselves to the new requirements.

The Senate Finance Committee's Report on H.R 12035, the measure which finally became in part Section 2055(e)(3), emphasized again that it was trusts already in existence and unable to meet the December 31, 1972 deadline provided by the Regulations that were intended to be the primary beneficiaries:

"Because of the complexity of these rules, many non-conforming charitable remainder trust have been unable to meet this deadline . . . Accordingly, the Committee provision extends these transitional rules to December 31, 1975." (S. Rept. No. 93–1063 (on H.R. 12035), 93rd Cong., 2nd Session (August 1, 1974), reprinted at 3 U.S. Code, Congressional and Administrative News, 5985–5986.)

There appears to be ample evidence in the published legislative history of Section 2055(e)(3) to justify the conclusion that Congress was primarily interested in benefiting estates of decedents dying soon after December 31, 1969 when it passed this legislation. Ironically, however, if the statute of limitations on refund claims provided by IRC Section 6511(a) were narrowly applied, many of the estates intended to have been benefited by Section 2055(e)(3) would have been foreclosed from its relief even before it had been signed into law.

The same policies which justify extending the date for reformation to December 31, 1977 also favor adoption of the special statute of limitations provided by Section 2104(b) of the Tax Reform Bill of 1976. It is in the public interest that the unitrust or annuity trust rules be made applicable to the greatest possible number of nonqualifying charitable remainder trusts. However, the inducement provided by Section 2055(e)(3), even as amended by Section 2104(a) of the Tax Reform Bill of 1976, would be largely illusory unless the fiduciaries and remaindermen of the affected trusts are assured that in fact an estate tax refund will not be foreclosed by the statute of limitations on refund claims after reformation of the trust.

Conclusion

For the reason cited it is submitted that Section 2104 of the Tax Reform Bill of 1976 greatly improves upon the current IRC Section 2055(e)(3), and that Section 2104 is preferable to H.R. 9889 as passed by the House of Representatives. Therefore, we respectfully suggest that Section 2104 be retained as part of the Tax Reform Bill of Section 2104 without amendment and urge its speedy approval by the Senate.

STATEMENT BY JOHN DEARDOURFF, DOUGLAS BAILEY, AND CHARLES GUGGENHEIM

Section 1304—Tax Treatment of Certain Debts Owed by Political Parties to Accrual Basis Taxpayers

Section 271 of the Internal Revenue Code disallows the deduction from taxes of any bad debt owed by a political party to the taxpayer. Clearly, the law was intended to stop the deduction as a bad debt of a loan made to a political party. It was considered that such loans were only a disguise for non-deductible political contributions. However, at the time this section was enacted in 1952, there was no indication that it was intended to refer to a bad debt arising from a sale of goods or services to a political party.

And that is where the problem lies.

There are a number of people in the profession of providing political parties and candidates with goods and services. Some serve Republicans exclusively, others Democrats. We are political consultants, film producers, media strategists, pollsters, and campaign managers whose livelihood is derived from serving men and women who are running for political office. We are not large businessmen. We have small companies and our risks are great. Because of the tenuous nature of financing elections and the unpredictability of campaigns, political organizations sometimes find themselves unable to meet their financial obligations, and we in the business of serving candidates find ourselves with uncollectible debts. Under the present law, we cannot find even partial relief by writing off our losses. To our knowledge, we are the only business in America so discriminated against.

Today, our profession is accepted as a vital and legitimate part of every major political contest in America. And we think we have a right to serve and to do business without the financial threat imposed by an outdated Section 271.

Language to revise Section 271 was drafted by the House Ways and Means Committee and included in the Tax Reform Act as passed by the House of Representatives.

We feel this language makes it clear that Section 271 is still applicable in any case where the debt arising from the sale of goods and services was never intended to be collected or where the creditor is willing that his debt be placed at the bottom of the bills to be paid. At the same time, it provides that companies and individuals who supply legitimate goods and services on an arms' length basis to a political party not be subject to taxation on money they do not receive.

The language of the amendment as passed by the House of Representatives is preferable to the Senate version since it more fully remedies the inequities which Section 271 has imposed on many in our industry—an industry whose rapid growth during the past ten years could not have been anticipated at the time Section 271 of the Tax Code was enacted.

Those of us in the business of providing services to political parties are willing to pay taxes like every other business, but unlike them, we do not have the capacity to write off business losses arising from bad debts. That distinction is the margin of survival. Unless some relief is granted, the results could be extremely serious for our industry.

STATEMENT OF NATOMAS COMPANY

(Section 1035(a) of H.R. 10612)

The Tax Reform Bill as reported by the Committee on Ways and Means and passed by the House of Representatives, contained an amendment which corrects an unintended defect of the Tax Reduction Act of 1975. The amendment provides an averaging rule for three future years with respect to the provision limiting the foreign tax credit for foreign oil and gas income. This amendment was approved by the Ways and Means Committee after a full discussion of its purposes, as well as the taxpayers that would be affected. Moreover, there was a recorded Committee vote on the adoption of the amendment which was preceded by statements from the staff and the Treasury Department that they had no objection to the amendment.

The foreign tax professionals that have considered this amendment agree that it corrects a defect in the tax amendments adopted in 1975. The only criticism raised by these professionals is that the amendment, which is limited to certain future years, should not be so limited.

In view of the technical nature of the amendment, the lack of opposition, and the time pressures on the Committee, it was agreed that Natomas would not testify unless opposition to the amendment was raised. No such oppsition appeared and, therefore, Natomas filed the attached statement for the Committee's hearing record. In our view, we complied fully not only with the rules of the hearing notice but also with their spirit. Furthermore, as mentioned above, the amendment was thoroughly dicussed before the House Committee prior to adoption.

Currently, after the hearings had been concluded, objection to the amendment has been raised. This objection has not been directed at the merits of the amendment but rather implies that because it aids Natomas it is per se bad. We strongly resent the implication. The amendment is meritorious. The staff, the Treasury Department, the Ways and Means Committee, the House of Representatives, and finally, the Finance Committee have all recognized the merits of the amendment and it should not be discarded unless and until clear and convincing proof of deficiencies, on the merits, are demonstrated. We are confident that such a case against the amendment cannot be made.

The statement previously submitted for the Committee hearing is attached and resubmitted.

It should be noted that although the Treasury Department has publicly and in writing stated a position of no opposition before the Ways and Means Committee and the Senate Finance Committee and after the bill was reported by the Committee, the Treasury Department suddenly and without notice released a document stating opposition because the amendment is retroactive in that it amends a provision enacted in 1975. The years for which the amendment is operative are 1976, 1977, and 1978. It is not retroactive unless you accept the unreasonable view of the Treasury that anything that canges existing law is retroactive.

BACKGROUND

Last year the Congress determined that there was a difficulty in ascertaining whether payments made to foreign producing countries were taxes or royalties, and concluded that this difficulty led to a distortion of the foreign tax credit mechanism in the foreign oil and gas area. Accordingly the Congress enacted a provision which limited the foreign taxes on oil and gas extraction income which can be used to offset U.S. tax on foreign income to a tax rate just slightly higher than the U.S. rate. Therefore, to the extent that foreign taxes on oil and gas extraction exceeded that limit, they may not be used to offset U.S. tax on other low-taxed foreign income. Section 907 of the Code.

PROBLEM

Although the new percentage limitation of section 907 was intended to limit the amount of high-rate foreign taxes of an oil or gas production operation which could be used to offset other low-taxed nonproduction income, it also operates, in certain unusual cases, to limit the amount of creditable foreign taxes which can be used with respect to low-taxed production income, even where such income is solely from one country. This unusual result occurs where the tax laws of the U.S. and a foreign country provide different rules as to the timing of when income and deductions are taken into account. Thus, in one year a foreign producing operation can have a very high effective rate of tax (because U.S. tax concepts provided deductions not available in the producing country) and in the following year have a very low effective rate of tax (because the foreign country's alternative cost recovery system produces little tax on large amounts of income). It should be emphasized that this problem arises solely with respect to extraction income from the same country, and does not involve using foreign extraction tax credits to offset other types of income (i.e., shipping) or income from other countries.

Production sharing contracts are particularly vulnerable to these timing differences, since they employ completely different concepts of cost recovery than are used in the United States. The major disparity between the U.S. and foreign taxable income concept in a country employing production sharing concepts is that for U.S. purposes, intangible drilling costs are deductible when incurred, whereas under the production sharing contract, such costs are not deductible, but instead are compensated for by adjusting (increasing) the U.S. producer's share of future production. Therefore, in a year in which the taxpayer incurs large exploration and development costs and, in the same country, has significant

extraction income, the foreign tax paid on the extraction income, without any deductions, translates into a high rate of tax under U.S. concepts which permit deductions to reduce taxable income. As a result, the percentage limitation deems a significant portion of the foreign taxes for that year to be noncreditable. In a subsequent year or years, the opposite occurs, since in latter years the taxpayer is awarded "cost oil" (nontaxable in the foreign country) to compensate for the previously incurred expenditures. This cost oil is taxable in the U.S. and included in U.S. taxable income, which results in a determination that the foreign tax rate is low. However, since a determination that the foreign tax rate is imposed solely on an annual basis, it does not permit the distortions created by the mismatching of income and deductions to be ameliorated.

HOUSE AMENDMENT

Ordinarily, U.S. tax law resolves differences in the timing of income and tax by carryover and carryback rules. In fact, the foreign tax credit provisions contain such an averaging provision (sections 904(d) and 904(e)). However, the existing provisions of the new percentage limitation of section 907 have not been conformed to the foreign tax credit carryback and carryforward rules. There is no policy reason for not applying the new percentage limitation in concert with the carryback and carryforward rules, provided the basic objective of limiting the foreign tax rate to a certain percentage is maintained.

The Tax Reform Bill as approved by the Committee on Ways and Means and passed by the House of Representatives provides a special carryback during the transition period to any taxable year ending in 1975, 1976, and 1977. This carryback is to be computed by using the normal foreign tax credit carryback rules (sec. 904(c)). Thus, a carrybook is to be allowed only to the two preceding taxable years from which the tax is carried. Second, the extraction taxes which may be carried back may only be carried back against extraction income in the same country to which the extraction taxes were paid.

The amount which may be carried back to any taxable year is limited to the net U.S. tax liability on the extraction income from that country for a year after taking into account the foreign tax credit. Thus, the amount allowed as a carryback may not exceed an amount equal to the amount of the foreign oil and gas extraction income for the year multiplied by the sum of the normal tax and surtax rates for the year, less the amount of any creditable taxes which are paid or accrued with respect to the foreign oil and gas extraction income against which the credits are to be offset. The amount carried back is to be deemed tax paid or accrued on income from the extraction of foreign oil and gas in the year to which carried. For purposes of this provision, extraction taxes which may be carried back are the income taxes paid or accrued during a year with respect to foreign oil and gas extraction income which would be allowed as a foreign tax credit but for the special percentage limitations on foreign oil and gas extraction income.

REQUESTED ACTION

It is respectfully requested that the Senate Committee on Finance approve the above described House amendment.

WILLIAM D. BROWNLIE,
Boston, Mass., July 19, 1976.

Mr. MICHAEL STERN,
Staff Director, U.S. Senate Finance Committee,
New Senate Office Building, Washington, D.C.

My written testimony is specifically directed towards the Federal Estate Tax inequalities and PS-58 Federal Income Tax inconsistencies that presently exist and affect Keogh (HR-10) and Individual Retirement Accounts (I.R.A.) Plans.

I am submitting this testimony as a private citizen. I am not representing any specific clients nor do I represent any associations or organizations.

However, during my business career, I have been responsible for the creation and design of over 1000 Self-Employed Retirement Plans.

In addition, on March 17, 1976, I appeared as a public witness before the Committee on Ways and Means, United States House of Representatives to give oral testimony pertaining to the Federal Estate Tax inequalities that presently exist and affect Keogh (HR-10) and Individual Retirement Accounts (I.R.A.) Plans.

As in the case of the Committee on Ways and Means, I wish to inform you, the

Senate Finance Committee, that millions of Americans, who are investing their hard-earned dollars into either Keogh or I.R.A. Plans are not receiving the same tax considerations as those covered under Corporate Retirement Plans—particularly, in the area of Federal Estate Tax exemption.

The beneficial tax provisions of Corporate Retirement Plans have served both the country and its citizens well over a period of years. It goes without saying that Corporate Retirement Plans assets—amount to billions of dollars and are a constant source of revenue for investment in the economy of our country.

Unfortunately, these beneficial long-standing tax provisions available for Corporate Retirement Plans are not available for individuals investing into either Keogh (HR 10) or I.R.A. Plans.

Specifically, Section 2039 of the Internal Revenue Code states that Corporate Retirement Plans assets are not subject to the Federal Estate Tax when a participant dies, if such plan assets are payable to a named beneficiary, meaning spouse, children, parents or personal trust.

The Federal Estate Tax exemption which is available for beneficiaries of Corporate Retirement Plan participants is not allowed for beneficiaries of Keogh and I.R.A. Plan participants.

This is unfair and discriminatory, and I do not believe it was and is the intent of Congress to have it this way. A simple amendment to Section 2039 of the Internal Revenue Code would solve this severe inequity immediately.

With the above in mind, Congressman William A. Steiger, Republican from Wisconsin, Member, Committee on Ways and Means, has introduced an amendment to provide Keogh and I.R.A. Plans with the Federal Estate Tax exemption. As of this date, the Committee has tentatively voted to accept this amendment which will become part of the Committee's Estate Tax Bill.

Do you realize that if a 40 year old Self-Employment Individual invests $7500 each and every year in a Keogh Plan for 25 years, and earns 8% compound interest, a retirement fund of $592,158 will be created. However, if this individual should die at age 65, $592,158 will be subjected to the Federal Estate Tax under current law.

Conversely, not one penny of $592,158 would be subject to the Federal Estate Tax if the same results were achieved as part of a Corporate Retirement Plan.

This severe Federal Estate Tax inequity is further compounded for non-incorporated individuals because most states in our country impose their own Inheritance Tax in addition to the Federal Estate Tax.

When life insurance is used in a Retirement Plan, a percentage of the premium is subject to Federal Income Tax to all participants. This applies to Corporate, Keogh and I.R.A. Plans. This percentage of the premiums is referred to as Ruling Number 58 of the Pension Service of the Internal Revenue Service, commonly known as PS-58 cost.

However, under a Corporate Plan, when a participant retires, he is allowed a Federal Income Tax credit on the total percentage of premiums that were subject to Federal Income Tax during the life of his Plan, and his beneficiary is allowed the same Federal Income Tax credit should he die before retirement. This Federal Income Tax credit is the PS-58 cost.

Unfortunately, this favorable Federal Income Tax treatment of PS-58 cost is only allowed for Corporate Retirement Plans not Keogh or I.R.A. Plans.

The total area of tax inequalities and inconsistencies pertaining to retirement plans was published in great detail in the Boston Herald-American on Labor Day 1975 entitled, "Added Tax Reform Urged for Those Under Non-Corporate Retirement Plans."

A copy of the Boston Herald-American article is enclosed so that you will have a better frame of reference regarding other tax inequalities.

It is obvious that even with the liberalization of Keogh as to increased deductible amounts, and the creation of I.R.A. as part of The Pension Reform Act of 1974, Congress still has not given the Self-Employed and other individuals, not covered under a retirement plan, the BEST that is available under existing law.

I would like to direct some personal remarks to Senator Russell Long. It would be my hope, Senator Long, that as an advocate of Employee Stock Ownership Plan (ESOP) you would be instrumental in providing Keogh and I.R.A.

Retirement Plans with the same beneficial Federal Estate Tax exemption and PS-85 Federal Income Tax credit as in ESOP Corporate Retirement Plans.

I sincerely hope that my testimony will enable you, as a Committee, to recommend legislation to be introduced and passed, to end the severe discriminations and inequalities that affect Keogh and I.R.A. Plans.

Thank you.

[From the Boston Herald American, Sept. 1, 1975]

ADDED TAX REFORM URGED FOR THOSE UNDER NON-CORPORATE RETIREMENT PLANS

(By Richard Lamere)

Severe tax inconsistencies and other inequities militate against various types of retirement plans as opposed to "favorable treatment" for corporate retirement plans, a Boston life insurance executive charged yesterday.

On the anniversary of the enactment of the Pension Reform Act of 1974 in Washington, William D. Brownlie called for additional tax reform because "the self-employed and other individuals are not receiving the same beneficial tax treatment as their counterparts who are covered under corporate retirement plans.

"There is still much to be done, and this can only be accomplished in tax reform legislation," Brownlie declared.

The legislation enacted last year allowed for the tax deductible contribution to an individual retirement plan to be increased from $2500 to $7500 annually in the tax-sheltered Keogh-type deferred-compensation plans.

It also, for the first time, allowed employed individuals, not covered under any pension plan to have their own Individual Retirement Account referred to as IRA, and to be able to contribute a maximum deductible contribution of $1500 per year.

"Millions of Americans who are investing their tax-deductible dollars into either Keogh Plans or an Individual Retirement Plan for their own do-it-yourself retirement plan are not getting the same tax consideration as those covered under corporate-type plans," stated Brownlie.

"Now is the time for Congress to enact legislation to end discrimination and injustices that adversely affect millions of Americans each year."

Brownlie, who plans to testify as a private citizen at hearings before the House Ways and Means Committee in Washington, insists that severe discrimination and inequality exist among corporate retirement plans, Keogh and IRA plans in the following areas: federal estate tax treatment, federal income tax treatment, integration with Social Security and life insurance.

The first injustice, he said, occurs if a self-employed person such as an architect or pharmacist creates either a Keogh Plan or IRA Plan and dies before retirement "because the entire value of the plan is includable in his estate at the time of his demise."

On the other hand, Brownlie said not one penny of a corporate retirement plan is subject to the federal estate tax if payable to a named beneficiary, such as wife, children, parents, brothers, sisters or personal trust because of Section 2039 of the Internal Revenue Code.

This section provides federal estate tax exclusion for corporate plans, but does not provide it for the self-employed individual under the Keogh Plan or an IRA plan, Brownlie stressed.

Another inconsistency, Brownlie said, is that the employe of a self-employed individual, under a Keogh Plan, is entitled to federal estate tax exclusion. "What makes it right for the employe and wrong for the boss?" he asked.

Life insurance proceeds, which could amount to many thousands of dollars, are exempt from the federal estate tax for corporate plans. This federal estate tax exclusion is not available for Keogh or IRA plans.

"Because a Keogh Plan could be worth hundreds of thousands of dollars, it is essential for additional life insurance to be purchased for the sole purpose of providing money to pay federal estate taxes," Brownlie said.

Another injustice, he said, is that corporate retirement plans also provide for a $5000 income tax-free, death benefit, which is not available for either the Keogh or IRA plans.

A third injustice pertains to Social Security integration, said Brownlie, who for several years has stressed "tax inconsistencies in lectures and national con-

ferences and in his monthly column, "Insurance Tips," written for the publication, "Massachusetts Physician."

"Simply stated," Brownlie said, "a corporate employer can reduce the amount of money he contributes to a corporate retirement plan for his employes because he is allowed to take into consideration the fact he is already contributing on their behalf to the Social Security retirement system.

"This also is not available under the existing rules for a vast majority of Keogh plans."

A fourth injustice, Brownlie contended, pertains to the income tax treatment of life insurance premiums, which can be purchased on a tax-deductible basis as part of a corporate retirement plan, as well as part of a Keogh plan or IRA plan.

When life insurance is used in a retirement plan, a percentage of the premium is subject to federal income tax for all participants. This applies to corporate, Keogh and IRA plans.

However, under a purely corporate plan, when a participant retires, he gets an income tax credit on the total percentage of the premiums that were subject to federal income tax during the life of his plan, and his family gets the same income tax credit when he dies.

"This income tax credit, unfortunately, does not apply to Keogh or IRA plans, either at retirement or at death—another inconsistency," Brownlie stressed.

The most notable inconsistency pertaining to life insurance within retirement plans is found in the IRA plan, Brownlie said.

Under existing law, only an endowment type of life insurance policy can be used within IRA.

"This type of life insurance policy," contended Brownlie, "purchases very little insurance protection for the money spent. This is inconsistent with what is allowed for corporate and Keogh plans, wherein these plans allow for the typical cash value ordinary life policy or the economatic type policy, which purchases much higher life insurance protection for the same money spent.

"IRA plans should be changed to allow for the same type of life insurance protection that is permitted for corporate plans and Keogh plans."

Two months ago, Brownlie spoke on the subject of Keogh plans at the insurance industry's "Million Dollar Round Table" annual meeting in San Francisco, outlining his experiences designing and servicing such plans.

Statement of the International Council of Shopping Centers

Summary

ICSC opposes the inclusion in the Tax Reform Act of 1976 (H.R. 10612) of the Haskell-Kennedy Amendment which was added to the bill on the floor on June 22, 1976, and which applies an "at risk" limitation to limited partnerships, including real estate limited partnerships.

The effect of the adoption of the "at risk" amendment will be to substantially reduce the use of limited partnerships as a means for developing real estate. Limited partnerships are an important source of equity for real estate development and their curtailment will have a serious adverse effect on real estate investment, jobs, and allied activity.

The adverse impact on investment in real estate of this provision will occur at a time when construction in the shopping center industry is suffering a slowdown, and when the future development needs of the shopping center industry and those of the nonresidential development sector in general, cannot be fully met by today's primary market financial institutions.

The "at risk" amendments' distinction between recourse and nonrecourse financing did not seem significant to the Supreme Court in the case which is the basis of the current rule because of the Court's understanding that the owner of a property will satisfy the terms of a mortgage whether personally liable or not, in order to protect his equity.

A rule that limits the amount of basis to the equity invested in a property would be unfair since depreciation deductions would be limited to "a fraction of the cost of the corresponding physical exhaustion" of the property. A property wastes without regard to the method by which it is financed, and to limit depreciation because of such a distinction would be discriminatory and unreasonable.

Another consequence of the "at risk" rule would be to severely limit the ability of the small investor to participate in real estate development.

The result of such a situation will be to drive the small investor out of real estate investment and to increase the concentration in the real estate industry by putting ownership in the hands of the wealthy and the large corporations who can make cash investments.

The Senate should eliminate the Haskell-Kennedy Amendment from the Tax Reform Act of 1976. It is unfair, discriminatory and burdensome. It will have a serious adverse impact on real estate investment, jobs, and allied activity. It will drive the small investor out of real estate and increase concentration in the industry.

STATEMENT

The International Council of Shopping Centers (ICSC) is the trade association of the shopping center industry. Our members number nearly 5,000 and include owners and operators of shopping centers; retail tenants of shopping centers; and lending institutions and other business firms involved directly or indirectly in the development, ownership, and operation of shopping centers.

ICSC opposes the inclusion in the Tax Reform Act of 1976 (H.R. 10612) of the Haskell-Kennedy Amendment which was added to the bill on the floor on June 22, 1976, and which applies an "at risk" limitation to limited partnerships, including real estate limited partnerships.

In the case of a partnership, under present law, the amount of losses a partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership. Basis in a property may include nonrecourse indebtedness (a loan where there is no personal liability) attributable to that property, and where a partnership incurs a debt and none of the partners have personal liability on the loan, then all of the partners are treated for tax purposes as though they shared the liability in proportion to their profits interest in the partnership. This allows a limited partner to deduct his share of the partnership losses in excess of his actual cash investment in the partnership (the amount "at risk").

The Haskell-Kennedy Amendment would change the current rule so that the amount of losses that a limited partner could take would be limited to the capital contribution he has made, plus any current commitment to make further contributions, plus, perhaps, his share of the partners' personal liability on indebtedness (the provision and debate are unclear on this point).

This provision would apply to limited partnerships formed after June 30, 1976 (except where low income housing is involved in which case it would apply to partnerships formed after December 31, 1981).

The effect of the adoption of the "at risk" amendment will be to substantially reduce the use of limited partnerships as a means for developing real estate. Limited partnerships are an important source of equity for real estate development and their curtailment will have a serious adverse effect on real estate investment, jobs, and allied activity.

The impact of the "at risk" amendment must be considered in the context of the other provisions of the tax bill approved by the Senate,[1] which have a profound and detrimental impact on real estate development.

For example, Norman B. Ture, Inc., economic analysts, have estimated that the Haskell-Kennedy Amendment (assuming 15–33⅓ percent of all real estate partnerships are limited partnerships), plus the other real estate related provisions adopted by the Senate, will cost 540,000 to 890,000 jobs in the construction and real estate industries, $6 to $9 billion in federal tax revenues, $19 to $32 billion in real estate GNP, and $13 to $21 billion in real estate investment.

The seriousness of the impact of the "at risk" amendment projected by Ture is borne out by a study conducted for ICSC in 1973 by Dr. William L. Silber, Professor of Economics, the Graduate School of Business Administration, New York University (see Appendix). This study estimated what changes would have taken place in the level of investment in nonresidential construction and the Gross National Product during the 1967–71 period, had depreciation deductions for tax purposes (associated with real estate investment) been limited to an equity basis. Dr. Silber found (assuming either a 10 percent or 20 percent equity basis) that nonresidential construction (in real dollars) would have declined by about $9 billion or 43 percent per year over the five year period, and total GNP

[1] Thus, the Senate includes construction period interest as a tax preference item in its stepped-up, add-on minimum tax and includes as a tax preference item under the minimum tax the excess of investment interest over investment income. In the case of limited partnerships, that portion of each limited partner's loss representing investment interest over investment income from the partnership, whether or not such partnership is classified as conducting an active trade or business, would be treated as an item of tax preference.

(not real estate GNP as under Ture) would have declined on an average of $20.4 billion (1958 dollars) per year over the same period. Dr. Silber found that even if equity financing rose to 40 percent, the overall impact on the real estate sector and the general economy only would have been slightly blunted.

While the assumption of the Silber study (depreciation deductions limited to equity) and the provisions of the "at risk" amendment are not identical, they are similar enough so that the Silber study reinforces the conclusion of the Ture study that the "at risk" amendment will have a serious adverse impact on real estate investment, construction, and employment. In fact, an impact of the order of magnitude of that projected by Ture can reasonably be expected to occur.

The adverse impact on investment in real estate of all these provisions will occur at a time when construction in the shopping center industry is suffering a slowdown,[2] and when the future development needs of the shopping center industry and those of the nonresidential development sector in general, cannot be fully met by today's primary market financial institutions (the commercial banks, life insurance companies, mutual savings banks, savings and loan associations, mortgage companies and mortgage investments trusts). An analysis conducted by the ICSC Research Department on the relationship between the 1970-74 quarterly flow of construction loans (current dollar value of organizations) for nonresidential properties[3] and the current dollar value of nonresidential construction put-in-place[4] demonstrates that the dollar value of construction loans from these institutional sources of capital have been substantially less than the capital requirements of the private nonresidential development community.[5] These statistics also demonstrate the continuing need for substantial equity capital in order to undertake new nonresidential construction.

In addition, recent evidence[6] suggests that the internal liquidity of many new U.S. shopping center projects has deteriorated substantially when compared to the older projects which have lower building costs, better financing arrangements, lower interest rates, lower land prices, and increasing overage rental income.

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[2] An F. W. Dodge Survey presenting annual data on shopping center construction (GLA) for the period 1970 to 1974 indicates the following:

Shopping center GLA construction:	*Percentage change* [a]
1971 compared to 1970	+15.9
1972 compared to 1971	+32.3
1973 compared to 1972	+3.4
1974 compared to 1973	−21.6
1975 relative to 1974 [b]	−41

[a] F. W. Dodge.
[b] ICSC Research Department.

[3] The Supply of Mortgage Credit, 1970-1974, U.S. Department of HUD (Washington, D.C.), October 1975; p. 119, table 5-9.

[4] Construction Reports C30-745, U.S. Department of Commerce (Washington, D.C.), pp. 20-24, table 3.

[5] Dollar Value (Current) of Construction Loan Originations for Non-Residential Properties as a Percent of the Dollar Value (Current) of Non-Residential Private New Construction Put in Place: 1970-74.

[6] Funds After Debt Service and Before Income Taxes (New Cash Flow) for U.S. Shopping Centers, Classified by Age and Type. 1974 (Data Represent Median Values and Are in Terms of Current Dollars Per Square Foot of GLA)

Year:	[Col. 1] all buildings (*percent*)	[Col. 1] less industrial buildings (*percent*)	[Col. 1] less industrial and miscellaneous buildings [a] (*percent*)
1970	34.6	49.8	64.2
1971	42.9	56.6	72.1
1972	44.1	54.7	69.4
1973	50.6	65.4	81.6
1974	46.7	63.7	79.0

[a] Includes hospitals and institutions.

NOTE.—The data in this table is for illustrative purposes only, to show that the developer cannot be expected to rely completely on primary institutional sources of capital during the development and construction stages for nonresidential properties. Arnold H. Diamond of the U.S. Department of Housing and Urban Development has raised similar issues with respect to residential properties. "The Supply of Mortgage Credit 1970-74," U.S. Department of HUD, pp. 128-132. Source: Ibid., ICSC Research Department.

If the trend implicit in this evidence continues (and we strongly believe that it will), the shopping center developer could not rely on the internal cash flow from the more recent projects to provide for an increasing need for equity capital for future projects even if the current tax incentives are retained. Without them, of course, his capital problems will be even worse.

The "at risk" amendments' distinction between recourse and nonrecourse financing did not seem significant to the Supreme Court in the case which is the basis of the current rule[7] because of the Court's understanding that the owner of a property will satisfy the terms of a mortgage, whether personally liable or not, in order to protect his equity. The Court reasonably concluded that where the value of the property exceeds the amount of the mortgage, an owner will make the payments on the mortgage whether they are personally liable or not.[8]

The Tax Court expressed this same attitude in a recent case:

"The element of the lack of personal liability has little real significance due to common business practices. As we have indicated in our findings, it is not at all unusual in current mortgage financing of income-producing properties to limit liability to the property involved. Taxpayers who are not personally liable for encumbrances on property should be allowed depreciation deductions affording competitive equality with taxpayers who are personally liable for encumbrances or taxpayers who own unencumbered property.

"The effect of such a policy is to give the taxpayer an advance credit for the amount of the mortgage. This appears to be reasonable since it can be assumed that a capital investment in the amount of the mortgage will eventually occur despite the absence of personal liability." [9]

The Supreme Court in *Crane* indicated that a rule that limits the amount of basis to the equity invested in a property would be unfair since depreciation deductions would be limited to "a fraction of the cost of the corresponding physical exhaustion" of the property. The Court's reasoning is sound since a property wastes without regard to the method by which it is financed, and to limit depreciation because of such a distinction would be discriminatory and unreasonable.

Further, the Court said that such a rule would require the recomputation of basis with each payment on the mortgage, and such a shifting equity basis would impose an intolerable accounting burden on the taxpayer and the Government. Such a rule would distort income because in the early years of the property's life, the depreciation allowance would only be a fraction of the physical exhaustion, while in later years, it would exceed the actual amount.

Type of center	Period center opened		Funds after debt service	Current per as percent of prior period
Regional [a]	1971–73	(15)	$1.36	−15.0
	1968–70	(25)	1.60	−10.1
	1965–67	(16)	1.78	
Community [b]	1971–73	(22)	.36	−16.3
	1968–70	(18)	.43	−27.1
	1965–67	(20)	.59	
Neighborhood [c]	1971–73	(20)	.47	−32.9
	1968–70	(21)	.70	−29.3
	1965–67	(24)	.99	

Data in parentheses equal number in sample.

[a] Median total retail space equal to 546,500 square feet, with the lower and upper deciles equal to 308,935 and 840,654 square feet, respectively.

[b] Median total retail space equal to 153,500 square feet, with the lower and upper deciles equal to 79,500 and 271,000 square feet, respectively.

[c] Median total retail space equal to 52,000 square feet, with the lower and upper deciles equal to 24,300 and 101,000 square feet, respectively.

Source: The Urban Land Institute, 1975 edition of "Dollars and Cents of Shopping Centers," Section D, Fund After Debt Service; ICSC Research Department.

[7] *Crane* v. *Commissioner*, 331 U.S. 1 (1947).

[8] Under present law, when a taxpayer takes deductions beyond what is "at risk," he creates a negative capital account. When the property is sold or foreclosed, the negative capital account is taxable, notwithstanding the fact that the taxpayer may not receive any proceeds.

[9] *Manuel D. Mayerson*, 47 T.C. 340 at 351–52 (1966).

Another consequence of the "at risk" rule would be to severely limit the ability of the small investor to participate in real estate development. Under a limited partnership arrangement, an investor with limited funds, knowledge and time can safely and profitably participate in real estate development. With the "at risk" rule, the advantages of such activity would be greatly reduced. For a wealthy person who can invest directly, the advantages would remain.

The result of such a situation will be to drive the small investor out of real estate investment and to increase concentration in the real estate industry by puting ownership in the hands of the wealthy and the large corporations who can make cash investments.

The Senate should eliminate the Haskell-Kennedy Amendment from the Tax Reform Act of 1976. It is unfair, discriminatory and burdensome. It will have a serious adverse impact on real estate investment, jobs, and allied activity. It will drive the small investor out of real estate and increase concentration in the industry.

HARVEY, BATTEY, MACLOSKIE & BETHEA, P.A.,
Hilton Head Island, S.C., July 19, 1976.

DEAR MR. STERN: This is in response to your invitation to submit written statements for inclusion in the printed record of the hearings of the Senate Finance Committee with regard to 1976 Tax Reform Act. My comments shall be addressed solely to Committee Bill Section 1207 and proposed new Section 3121 (B) 20 of the Internal Revenue Code concerning tax treatment of certain individuals employed in fishing as self-employed.

Small fishermen, in the wake of Internal Revenue Service's Revenue Ruling 72–385 [1] as well as the *Webb* decision and its progeny [2] are being deluged not only with substantial bookkeeping requirements but also with Internal Revenue Service audits and notices of deficiency. The heretofore inconsistent enforcement of the Service's stated position on this issue adds to the woes of the fisherman.

Fishermen are by their very nature an independent lot and quite set in their ways. To have the onus of maintaining records for calculation of tax obligation of crew members thrust upon them is, in their eyes, incomprehensive and extremely impractical. The question arises whether the responsibility for maintaining such records should lie at all with the captain or the owner of a small fishing vessel. Here in the Low Country, a great number of the shrimp boats are owned and operated by individual and independent shrimpers. Crew members are, on the whole, paid no wages but are given a share of the catch at the end of the day or trip as the case may be. Therefore, if the trip is unsuccessful it is indeed possible that crew members would receive no remuneration whatsoever. Crew members provide their own gloves and boots which are usually the only items of equipment required for the trip. Other than the fact that a crew member would certainly be under the authority of the ship's captain while at sea, nearly all the common law characteristics of an independent contractor are fulfilled by that shipmate rather than those characteristics of an "employee". Moreover, as pointed out in the Commitee Report, the crews of shrimpers in this area are very seldom the same from one day or one week to the next. Crews are more or less selected on a daily or trip-by-trip basis. Individuals serving as crew members are also somewhat nomadic in their ways, this factor of course adding to the burden of maintaining business and tax records.

I support the proposed changes found in Section 1207 of the Committee Bill. Although the boat operator, under the terms of the Amendment, would still have some record keeping obligations as to the division of the share of the catch on each trip, I do feel that this is a workable and liveable compromise for both the Service and the fishing industry.

Since it is estimated that the proposed Amendment would have a little impact on tax revenues as a whole, I strongly urge its passage. The impact on each small fisherman will be great indeed.

Very truly yours,

CARY S. GRIFFIN.

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[1] Revenue Ruling 72-385, 1972-1 C.B. 535.

[2] *United States* v. *Webb, Inc.*, 402 F. 2d 956 (5th Circuit 1968); rev'd 397 U.S. 179, 90 5th Circuit 850 (1970); 424 F. 2d (5th Circuit 1970); *Anderson* v. *United States*, 450 F. 2d 567 (5th Circuit 1970); *T. L. Bishop* et al v. *United States per curiam*, 76 F. 2d 977 (5th Circuit 1973); *Elisabeth Ann Ino.* v. *United States per curiam*, 476 F. 2d 980 (5th Circuit 1973); *Carleen F. Ino.* v. *United States per curiam*, 476 F. 2d 981 (5th Circuit 1973); *Mayport Fisheries Company* v. *United States per curiam*, 476 F. 2d 981 (5th Cir. 1973).

INSTITUTE OF SCRAP IRON & STEEL, INC.,
Washington, D.C., July 26, 1976.

Re hearings on H.R. 10612, tax credit for recyclable commodities.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: This letter is submitted on behalf of the Institute of Scrap Iron and Steel, Inc., a national trade association representing approximately 1,460 processors, brokers and dealers of metallic scrap, and industry suppliers, in response to your request for further comment with respect to certain provisions in H.R. 10612 as reported by the Senate Finance Committee. These comments are directed to § 2006 which provides a tax credit for increased use of recyclable commodities. Because of the voluminous record already developed on this issue and because of the numerous other issues of concern to the committee, we are presenting our arguments in as concise a form as possible. The arguments presented herein we believe are compelling.

Preliminarily, it is important to stress that Institute members are not the direct beneficiaries of this tax credit. The persons entitled to claim the credit under § 2006 are the purchasers of ferrous scrap (mills and foundries), not the sellers (scrap processors). The Institute supports the provision because it believes that the tax credit will increase the utilization of recyclable commodities. The environmental benefits and energy savings from such increased recycling are well documented and can be achieved by the Congress through adoption of § 2006.

It must be recognized that the genesis of the recycling tax credit was the desire to achieve tax equity betwen virgin ores and recyclable commodities by offsetting the subsidy effect which exists through the operation of percentage depletion. This tax equity is approximated by granting the tax credit for purchases of recyclable commodities in excess of 75% of a base period amount up to the base period amount.

In addition to creating tax equity, § 2006 also creates an incentive for increased recycling. This is accomplished by granting the credit for purchases in excess of the base period amount. Such an incentive is extremely important in view of the benefits to society arising from increased recycling.

The revenue effect of § 2006 clearly is mitigated by using a rolling base period so that a scrap purchaser will lose the tax incentive over time unless it continues to increase its purchases of recyclable commodities.

Based on the foregoing considerations, we strongly urge the Committee to reaffirm its prior decision to include the recycling tax credit in the tax reform bill.

Sincerely,

HERSCHEL CUTLER.

SHELDON R. WAXMAN, J.D.,
Chicago, Ill., July 19, 1976.

Re Tax Reform Act of 1976.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: In view of Senator Hathaway's recent letter to the Chicago Daily News (a copy of which is attached) which expressed dissatisfaction of the media coverage of the attempts to obtain tax reform, I am attempting to express to you the urgent necessity for an immediate true tax reform. I share Senator Hathaway's upset over the malaise that exists with respect to this issue because I consider true tax reform to be the most vital single step necessary to create an atmosphere of cooperative enterprise between the citizenry and government that has far too long been absent. Unfortunately, it is not the type of "gut" issue about which the newspapers want to run stories.

Enclosed are various letters which I have written on this subject and articles suggesting a true reform of the law. Needless to say, my attempts over the last year to exert influence on government tax policy have been to little avail. The 1976 Tax Reform Act, although attempting to assist the "little" people, makes the law more complicated and subject to varying interpretations, particularly by the Internal Revenue Service.

I realize that I have not been alone in recommending the changes that I suggested in my September 8, 1975 letter to William E. Simon, Secretary of the Treasury. In particular, I commend to your reading the enclosed column by Robert J. Dulsky which appeared in the Chicago Tribune on April 14, 1976. Mr. Dulsky writes in favor of a flat rate tax, although if such were to be enacted, his business as a tax preparation consultant would be severely diminished.

I am also enclosing a copy of my brief on appeal to the United States Court of Appeals for the 7th Circuit in *U.S.* v. *Dema*, No. 75-1894. This brief described one man's dealings with the bureaucratic maze of the Internal Revenue Service. The Court has not yet ruled.

My client and I gave testimony before Senator Montoya's subcommittee which recently investigated Internal Revenue Service procedural abuses. I recognize that you may consider the procedural abuses of the Internal Revenue Service to be unconnected with your investigation into substantive tax changes. This, I believe, is a mistake because it is the very complexity of the substantive tax law which provides the Internal Revenue Service with the opportunity to engage in procedural abuses.

As I have stated, any law that is not understandable, even by experts, cannot provide the respect which is necessary to obtain voluntary compliance.

The current campaign by the Internal Revenue Service to eliminate independent contractors as a viable legal relationship in order to exact more taxes is yet another example of the abusive power of the Internal Revenue Service. Fortunately, more individuals and companies have decided to fight it. See, e.g., *Queen's-Way to Fashions, Inc.* v. *The United States*, No. 139-73, U.S. Court of Claims—opinion rendered 4-7-76.

If I can be of further assistance, please don't hesitate to contact me.

Very truly yours,

SHELDON R. WAXMAN.

SENATOR BEMOANS A "ROBBERY"

On June 10, 18 senators called a press conference in the Capitol and expressed dissatisfaction with the tax reform bill as it was reported by the Senate Finance Committee. They outlined their plans for amending it when floor debate began. The room was crowded with journalists, and the next day a brief story appeared in the nation's papers, anywhere from Page 8 to Page 60, mostly in the financial section. The broadcast media gave it similar coverage.

The Senate began debate on schedule, and in the face of intense corporate pressure, yielded billions of dollars back to corporate treasuries in the form of special tax benefits. This Bicentennial rip-off was again relegated to the back pages by our print journalists and hardly noted by our broadcast journalists.

The public, during this billion-dollar giveaway, was being whipped into a frenzy over the sex habits of a few members of Congress. An alleged $14,000-a-year mistress was being touted and made famous by the press, while several billions of dollars were being stripped from the Treasury with hardly more than a footnote. Why? Is the press so fascinated with sex that it ignores robbery?

There was no public outrage over this billion-dollar giveaway because the public was not informed as to what was going on here. The senators in the majority received few angry letters on their votes against tax reform, but hundreds of thousands of congressional moral habits. There is public pressure aplenty for Congress to clean up its petty cash box, but hardly a whisper on asking us to replenish the public treasury.

On the issue of tax reform, the media have failed the American people.

The national legislature is a pressure kettle of activity. Corporate lobbyists exert corporate pressure through letters, telegrams and phone calls, and state and local governments' lobbyists make their views known. Corporations and state and local governments pay people to keep them informed of the issue. The public depends on the press. If the public ingredient is missing, it is to be expected that the viewpoints of the others will be carried to the floor. And during this tax reform debate, there has been little if any public pressure to enact meaningful amendments to prevent the plunder of the national treasury through special-interest legislation.

WILLIAM D. HATHAWAY,
U.S. Senator (D-Maine).

SHELDON R. WAXMAN, J.D.,
Chicago, Ill., December 8, 1975.

Hon. WILLIAM E. SIMON,
Secretary of the Treasury, Department of the Treasury, Washington, D.C.

DEAR SECRETARY SIMON: I was pleased to read about your statement that you were "increasingly attracted" to a single progressive tax. Although we are of different political persuasions, our ideas are the same. This is a hopeful sign for our country, as it indicates that common sense is more important than ideological labels.

I have advocated this type of system for at least three (3) years, starting with my discussions with Department of Justice attorneys from the Tax Refund Section (some of the finest trial lawyers in the Department of Justice in my opinion) when I was an Assistant U.S. Attorney in Chicago. I have spoken to many groups about the plan and have been well received.

Additionally, I have been in correspondence with Congressman Al Ullman and Ab Mikva. Enclosed are copies of that correspondence. I believe Congressman Ullman could be turned around on the issue.

The following is my version of the new law:

"All individuals and other entities of whatever form shall pay a tax by April 15th of every year of a percentage of income they received for the prior calendar year, which percentage is to be determined by the Commissioner of the Internal Revenue Service with the consent of Congress by September 1st of the year prior to the payment date."

The issue of whether the tax should be flat or progressive and what national economic scale will be used for computation purposes are the only matters in need of serious debate. Statutory definition or regulations would be necessary to define "income", "received" and perhaps "entity". Prepayment, in the form of withholding and estimated tax should be based on the prior year payment and percentage. It would also be necessary to handle the personnel displacement within the I.R.S. by reallocating such personnel to other agencies in need of greater budgets and person power to carry out social programs.

It would not be difficult to sell this to the American public. They are sick and tired of having to fill out forms that grow more complicated; being required to keep records of everything; knowing that there is a great bureaucratic waste involved in the collection process; knowing that they can never be sure if they are criminals because of the complexity of the law; seeing lawyers and accountants making money off of the complexity; knowing that not everybody pays their fair share; knowing that loopholes closed only create more loopholes; seeing the Internal Revenue Code and the attendant regulations, rulings, operating instructions keep growing and growing more voluminous; etc.; etc.; etc.

Is it necessary that just because something makes sense that it becomes unacceptable to the "experts"? I quote also a portion of the decision in *Continental Ill. Nat. Bank & Trust Co. of Chicago* v. *United States*, 504 F. 2d 586 (7th Cir. 1974):

"Such an assumption (an interpretation of statutory language) is particularly warranted in the field of tax law where the decision is ordinarily determined by the language utilized and not necessarily by application of logical principles." Id at 590. "Does it make sense that our courts are required to interpret that which makes no sense?"

The power to include social policy in a taxing law is the power to destroy the concept of what a tax law is for. I hope you become an active advocate for the democratization of tax law. It is only through this separation process that will force Congress to deal with the social policies this country needs and will force them to know in advance what the cost for those programs will be and whether there will be money available to do what they propose.

I am taking the liberty of including some back-up material for your perusal and am sending a copy of this letter and enclosures to Donald Alexander, who. I believe, appears to be doing an excellent job dismantling the unlawful IRS intelligence apparatus. If I can be of any assistance to you please let me know.

The enactment of true tax reform would give great impetus to increasing the confidence of the electorate in our government, something which is sorely needed.

Very truly yours,

SHELDON R. WAXMAN.

P.S. I also believe that you should consider institution of the accounting system which has been proposed by Harvey Kapnick, Chairman of Arthur Anderson & Co. and which was recently submitted to U.S. Controller General Elmer B. Staats.

NATIONAL FISHERIES INSTITUTE, INC.,
Washington, D.C., July 19, 1976.

Hon. RUSSELL B. LONG,
Cahirman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The National Fisheries Institute (NFI), a trade association of more than 600 member companies which process and market fresh, frozen and cured seafood, understands that the Finance Committee will hold hearings this week on certain provisions of H.R. 10612, as reported by the Committee (Report No. 94-938). NFI is particularly interested in Section 1207(f) of the bill which would treat crewmen of fishing vessels as defined in the subsection as self-employed for the purposes of the Internal Revenue Code.

The Institute believes that this provision of the legislation will clarify the employment status of boat operators with small operating crews who engage in fishing or who harvest other forms of aquatic animal life. Neither the boat operator nor the crewmen are under the impression that they have entered into an employer-employee relationship. In most instances, the crews are informally selected and remuneration is frequently in the form of a portion of the catch of the boat.

While this arrangement has been satisfactory, it has been abrogated by Internal Revenue Service rulings which have held that Crewmen are regular employees and that operators of the fishing boats are required to withhold employment taxes from the wages of the crewmen and deduct and pay the taxes on employees and employers under the Social Security law. In many instances, the service has indicated an intent to assess these taxes retroactively for tax years still open under the statute of limitations and this action could result in bankruptcy for many boat operators.

The Institute believes that this action by the Internal Revenue Service will unduly injure an important segment of the industry and strongly supports the provisions of the legislation which would treat the boat crewman as self-employed. We believe that the language as drafted is appropriate and would limit the application of the provision to boat operators with small crews. However, the Institute suggests that the maximum number of crew members permitted should be increased to 10 individuals (including the captain). The Institute further suggests that the language should be clarified to insure that the crew members can receive their share of the boat's catch of fish or other forms of aquatic life in cash when that catch is sold by the boat operator upon returning to shore.

In summary, the Institute believes that such language is necessary to clarify the relationship between boat operators and crewmen in the fishing industry and to prevent undue economic hardship. For these reasons, we believe that the language with the above recommendations should be retained in the bill as reported by the Committee.

Sincerely yours,

GUSTAVE FRITSCHIE,
Director of Government Relations.

STATEMENT BY THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE AGENTS REGARDING SECTION 1508 OF H.R. 10612

The National Association of Mutual Insurance Agents, a national organization representing approximately 24,000 independent insurance agents, is opposed to the enactment of Section 1508 of H.R. 10612, the provision which would permit life insurance companies to file consolidated federal income tax returns with their affiliated non-life companies.

This provision would result in a significant reduction in the amount of federal income taxes paid by life insurance companies without a corresponding increase in the equity of taxation, which should be the goal of tax reform legislation.

Property-casualty insurance companies are taxed on their entire income; life insurance companies on a portion of their income. Because of the difference in the methods of taxation of the two kinds of companies, consolidation does not produce the same results as when companies which are taxed in the same manner file consolidated returns.

Consolidation in this case would result in substantial tax savings for the life carriers. This provision would benefit only a few large life insurance companies which control property-casualty insurers.

Moreover, if this provision becomes a part of our tax law, it can be expected to be an incentive to other large life carriers to acquire property-casualty subsidiaries.

This incentive would come at a particularly unfortunate time in our economic history. The unprecedented losses suffered by the property-casualty industry in 1974–75 have inflicted a serious blow on the surplus position of these companies and have inhibited their ability to attract new capital. The weakened financial position of the property-casualty companies in conjunction with the potential tax savings offered by this provision would constitute a powerful encouragement for more life companies to enter the property-casualty market.

Property-casualty subsidiaries could be permitted to operate at a loss with the assurance that these losses would result in significant tax advantages for the parent life carrier. The life carriers would be encouraged to market property-casualty insurance through these subsidiaries at inadequate rates in order to increase market share. The inevitable result would be increased concentration of the property-casualty insurance industry, now one of the least concentrated industries in our economy, in the hands of a few large life insurance companies. The resultant restriction of competition would not be in the public interest.

The strong surplus position and extensive sales force employed by the large life companies already places them in a strong position to aggressively market property and casualty coverages through property-casualty subsidiaries. Granting them a tax advantage for losses incurred in their property-casualty operations would place them in an even stronger position and constitutes an unfair competitive advantage over the majority of property-casualty insurers which provide essential insurance coverage to the public.

A major thrust of our government today is to promote competition in all sectors of the economy for the benefit of the public. Competition in the property-casualty insurance industry exists today primarily because of the number and variety of insurers in the market. The taxpayer should not be asked to finance increased concentration of such an important sector of our economy, a development which can only prove detrimental to him in the long run. Therefore, the National Association of Mutual Insurance Agents urges that Section 1508 of H.R. 10612 be deleted.

NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES,
Indianapolis, Ind., July 22, 1976.

MICHAEL STERN,
Staff Director, Senate Finance Committee, U.S. Capitol, Washington, D.C.

DEAR MR. STERN: The National Association of Mutual Insurance Companies is inalterably opposed to sec. 1508 of the proposed Tax Reduction Act of 1976.

Allowing companies with both life and non-life insurance to file a consolidated return gives them an unfair advantage over small mutual insurance companies which do not write life insurance. This disadvantage will ultimately affect the insureds.

Our association represents over one thousand (1,000) mutual insurance companies. The farm mutuals were formed because the large stock insurance companies would not write the risks the farmers faced. We have grown and have broaden our constituency considerably. We now write insurance for people in all walks of life.

If the large companies are permitted to compete unfairly with us by using the profits of the life companies to lower the rates of the casualty companies, the small mutuals will be forced out of business. If this occurs, rates will be increased and the insureds will again be the victims.

Thank you for the opportunity to make our views known and part of the record.

Sincerely,

JEROME P. MCGRANAGHAN,
Washington Counsel.

STATEMENT OF THE NEW YORK STOCK EXCHANGE, INC. ON ELIMINATION OF THE WITHHOLDING TAX ON FOREIGN PORTFOLIO INVESTMENT

SUMMARY

The New York Stock Exchange urges the Senate Finance Committee to reaffirm its prior action repealing the 30 percent withholding tax on interest paid to foreign investors on their U.S. portfolio investment. We also urge the Committee to again vote to make permanent the tax exemption now granted to interest on foreign deposits in U.S. commercial banks.

The withholding tax discourages foreign investment.—The present withholding tax acts as an impediment to foreign portfolio investment. Under present law, a 30 percent tax is imposed, at the source, on the gross amount of dividends and interest paid to foreign investors. Though tax treaties modify this basic rate somewhat, it is still higher than the rates in many other industrialized nations. It is little wonder that foreign investors will limit their participation in the U.S. securities markets as long as the withholding tax reduces the yield on U.S. corporate securities held by nonresidents.

Actions taken by other countries have altered investment capital flows.—Other countries have moved aggressively to attract foreign capital by reducing their withholding tax rates. With the exception of Germany, none of the Common Market countries has a withholding tax on interest; and among themselves, withholding on dividends is being eliminated. Japan enacted legislation early in 1974 which exempted from income taxation interest on foreign currency debt securities issued by Japanese corporations to nonresident investors, and Canada has exempted from the normal withholding tax interest paid to nonresidents on Canadian public and private debt securities.

A New York Stock Exchange study on U.S. capital needs foresees a capital shortage.—Exchange economists estimate that the present saving potential in the U.S. economy through 1985—from all domestic sources—is something over $4 trillion. Over this same period, private sector capital demands are likely to reach a cumulative total of $4.7 trillion. In other words, the domestic savings capacity of the economy may well be insufficient to finance the capital required to provide full employment for the U.S. labor force, adequate housing, modernize plant and machinery, develop domestic energy sources, and improve the environment. In our view, the withholding tax on foreign receipts from portfolio investments has become the wrong tax at the wrong time. In this period of long-term capital scarcity here, the U.S. should actively encourage the inflow of capital from abroad.

Overall gain to the economy from repeal of the withholding tax will be significant.—As greater income and profits are generated in the U.S. economy from expanded investment and employment in this country, income tax receipts will increase on a direct basis. If a 15 percent pretax rate of return on invested capital is assumed—the median rate of return in the manufacturing sector—then every

$1 billion of new investment capital generated from abroad could eventually produce about $150 million in additional profits every year, resulting in approximately $75 million in additional tax revenues to the U.S. Treasury. This gain in tax receipts is far greater than the estimated $15 million revenue loss that would result from having portfolio interest income exempt from withholding taxes. In addition, the added investment from abroad would have a beneficial impact on the U.S. balance of payments and improve the United States' position as the premier international financial market.

Arguments for retention of the withholding tax have little merit.—Though the House Ways and Means Committee approved repeal of the withholding tax in early October of last year, the full House subsequently voted against tis elimination. In the floor debate prior to the vote in the House, a number of arguments were raised by opponents of repeal. In our view, the validity of many of these arguments is questionable, and is discussed in detail in our statement.

CONCLUSION

The New York Stock Exchange joins with the Treasury and other concerned groups in urging repeal of the withholding tax on foreign portfolio investment. Elimination of the tax would promote foreign investment—adding to the nation's capital resources and buttressing the country's balance of payments. Furthermore, repeal would ease the way for U.S. corporations to raise capital abroad for use here or elsewhere—reducing their demand on domestic sources of funds. Enlarged tax receipts from the additional employment, profits and income generated by expanded foreign investment will more than offset any initial decline in tax proceeds from withholding—especially when the burdensome costs of collection are considered. Finally, elimination of the tax should strengthen the national financial community as U.S. securities become competitive with Eurodollar and Eurobond instruments.

STATEMENT

The New York Stock Exchange respectfully urges the Senate Finance Committee to reaffirm its prior actions making permanent the tax exemption on bank interest on foreign deposits and repealing the 30 percent withholding tax on interest paid to foreign investors on their U.S. portfolio investments.

U.S. NEED FOR ADDITIONAL FOREIGN CAPITAL INFLOWS

The New York Stock Exchange believes it is in the national interest to take all practicable steps toward encouraging the freer flow of capital among nations. But in addition to that broad objective, the United States now has a strong direct interest in reducing any obstacles to portfolio investment in this country on the part of foreigners. If the economy is going to be physically equipped to produce anywhere near the potential of its manpower, then enormous amounts of capital will have to be secured in the years ahead. We need foreign investment as well as our own savings to create the jobs that can push unemployment below the 7 percent or 8 percent levels that so many now take for granted—and to keep the fires of inflation from being fueled anew.

Because of its concern over the long-term capital requirements and savings prospects of the U.S., the New York Stock Exchange prepared the research report which is attached for the record. In this report, Exchange economists estimated that the saving potential in the U.S. economy through 1985—from all domestic sources—is something over $4 trillion. Over this same period, capital demands are likely to reach a cumulative total of nearly $4.7 trillion. In other words, the domestic saving capacity of the economy may well be insufficient to finance the capital required to provide full employment, adequate housing, modernize plant and machinery, develop domestic energy sources, and improve the environment.

The Exchange is not alone in focusing on the enormous financing needs facing this nation. Studies undertaken by the Treasury Department, the Department of

Commerce, the Brookings Institution, the National Planning Association, and the research departments of Data Resources, Inc., Chase Manhattan Bank, the General Electric Company and the Metropolitan Life Insurance Company confirm that this nation will be hard pressed to meet its future investment needs.

Clearly, one of the ways to help overcome any shortfall in domestic savings is to stimulate foreign investment, both direct investment in the form of new plant and equipment, and portfolio investment in the U.S. securities markets.

VALUE OF FOREIGN PORTFOLIO INVESTMENT TO U.S.

The value of foreign direct investment in generating increased employment opportunities and higher incomes for Americans is easily demonstrated. The importance of foreign portfolio investment in helping America meet its future capital needs is not as readily apparent, as it often does not involve an inflow of capital in the real sense. That is, if a foreigner purchases a U.S. security with dollars held on deposit with a U.S. bank (or acquired from a foreigner with such deposits) then all that has occurred is a "paper transfer," with no real effect on the nation's overall capital position.

This view overlooks the fact that the capital investment process involves many different kinds of investors, all of whom play a vital role. Portfolio investors, domestic and foreign, broaden the market for U.S. securities and increase the opportunities for U.S. firms to acquire the financing needed to increase capacity or to modernize existing plant and equipment. Even if foreigners never injected capital directly into U.S. firms by buying new security issues, their role would be no less beneficial since the market for new issues is directly dependent on a deep and liquid secondary market. The greater the participation in our capital markets, the more efficiently it serves the needs of our economy for investment capital. The participation of foreign investors serves this purpose, just as that of domestic investors does.

Economic theory predicts that the additional demand for securities in any segment of a capital market tends to raise prices and reduce yields on the type of securities demanded. Thus, foreign purchases of U.S. stocks and bonds help to reduce yields and, therefore, make the raising of capital relatively easier for domestic borrowers. This, in turn, tends to stimulate real investment and increase the output and productivity of the economy.

In light of this country's growing need for foreign capital—and the positive role that such capital inflows can play in the United States—removing unnecessary obstacles to foreign portfolio investment is imperative.

EXEMPTION OF BANK INTEREST ON FOREIGN DEPOSITS FROM WITHHOLDING TAX

While the Exchange is primarily interested in making additional foreign investments in the U.S. more attractive, it is important to insure that foreign funds already invested in this country remain in place.[1] In this connection, continuation of the exemption from withholding taxes granted to foreign non-official bank deposits is essential. This exemption is scheduled to expire at the end of 1976.

The threat of expiration means that deposits of five months' or more maturity cannot now be made with assurance of their non-tax status; nor can maturing deposits be confidently renewed for terms beyond the end of 1976. Consequently, this reversal of an existing tax policy must be avoided.

The Senate Finance Committee wisely voted to make the present exemption permanent, paralleling action taken in the House of Representatives. The Exchange urges the Committee to reaffirm this positive action.

EXEMPTION OF INTEREST INCOME FROM WITHHOLDING TAX

The Senate Finance Committee's vote to exempt from withholding taxes interest income paid to foreigners on their U.S. portfolio investments is also to be commended. The Exchange urges the Committee to reaffirm its decision on this matter.

The present withholding tax clearly acts as a major impediment to foreign investment in fixed-income securities. A bond yielding 8 percent per annum before tax yields only 5.6 percent when a 30-percent withholding rate is applied.

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[1] These deposits aggregate many billions of dollars—an estimated $6.5 billion in 1973, according to the American Bankers Association.

To be sure, the United States has tax treaties with a wide number of countries (see table, attached) which tend to limit the adverse impact of the withholding tax. However, the basic U.S. withholding rate is still higher than in most other nations. Most importantly, we have no tax treaties with the world's major source of potential investment capital—the oil-producing states of the Middle East. This factor alone has played a major part in diverting funds away from the U.S. capital markets. A recent Treasury Department study indicated that the U.S. share of OPEC investments fell from 19 percent to 15 percent last year.

Exemption of interest payments from the withholding tax should help to reverse the flow away from U.S. fixed-income securities. In the past, foreign investors have shown little, if any, interest in U.S. corporate debt—primarily because the withholding tax significantly reduced the after-tax yield on these issues. Interestingly, the bulk of foreign holdings of U.S. corporate debt is comprised of the withholding-tax-free Eurobond issues of major U.S. corporations. These issues were floated abroad as a consequence of the U.S. government's capital control and restraint programs during the mid-1960's to the early 1970's.

The Senate Finance Committee's own Report recommending exemption of interest payments made to foreign holders of U.S. fixed-income securities provides a clear analysis of the questions involved:

"The committee believes that the imposition of a withholding tax on obligations issued by U.S. persons can impair the ability of U.S. corporations to raise capital in foreign markets. International bond issues are often exempt from withholding taxes and estate taxes imposed by foreign governments. In contrast, the United States' withholding tax is generally imposed, although as indicated above there are numerous exceptions to the general rule depending upon the nature of the issuer or the residence of the recipient of the interest income. The lack of a broad exemption under present law has in some cases made it difficult to trade U.S. obligations in international bond markets, since holders of international obligations wish to be assured that there will be no withholding tax imposed on any interest income which they may derive. To satisfy this desire of foreign lenders, U.S. borrowers often have to agree to reimburse holders of its debt instruments for any U.S. withholding tax which may be due. This raises the cost which a U.S. borrower must incur when it goes into foreign markets to raise capital.

"Prior to the termination of the IET, U.S. borrowers were able to secure an exemption for foreign lenders by electing to have the U.S. obligations subject to the IET. In this way interest paid with respect to such obligations was exempt from the 30-percent withholding tax. However, the termination of the IET on June 30, 1974, has again made it more difficult for U.S. borrowers to obtain funds from foreign markets. In order to enable U.S. borrowers to obtain funds for their domestic as well as foreign capital needs your committee believes that an exemption should be provided for interest paid to foreign lenders (other than direct investors) except where the income is effectively connected with the conduct of a trade or business in the United States by the foreign lender." [2]

ACTIONS TAKEN BY OTHER COUNTRIES

Other countries have moved aggressively to attract foreign capital by reducing their withholding tax rates. With the exception of Germany, none of the Common Market countries has a withholding tax on interest; and among themselves, withholding on dividends is being eliminated. Japan, in legislation enacted on March 30, 1974, exempted from income taxation interest on foreign currency debt securities issued by Japanese corporations to nonresident investors. The Canadian government has enacted an exemption from the normal withholding tax on interest paid to nonresidents on Canadian public and private debt securities. Its Budget Report indicated that "The proposed relief from withholding tax is intended to increase the flexibility of Canadian business to plan long-term

[2] *Report of the Committee on Finance, United States Senate, on H.R. 10612,* Report No. 94-938, June 10, 1976, pp. 258, 259.

debt financing and facilitate access to funds in international capital markets." Many observers believe that enactment of this legislation has played a role in the rise of the Canadian dollar.

The German experience with withholding taxes provides confirmation, though in reverse, of the impact that withholding taxes can have on foreign investment flows. In 1969, when the deutsche mark was strengthening markedly and investment funds were flowing in, the German government levied a withholding tax on foreign-owned German bonds in order to reduce foreign inflows of capital. And the withholding tax did help to discourage foreign demand for German debt securities. It appears a reasonable deduction that the absence or elimination of such taxes will encourage foreign flows here at home.

SIGNIFICANT OVERALL GAIN TO U.S. ECONOMY

On the basis of the evidence available, the overall effect of eliminating the withholding tax on interest payments will undoubtedly more than exceed any loss in potential tax revenues. As greater employment, income and profits are generated in the U.S. economy from expanded investment in this country, income tax receipts will increase on a direct basis. If a 15 percent pretax rate of return on invested capital is assumed—the median rate of return in the manufacturing sector—then every $1 billion of new investment capital generated from abroad could eventually produce every year about $150 million in additional profits, resulting in approximately $75 million in additional tax revenues to the U.S. Treasury. This gain in tax receipts is far greater than the estimated $15 million revenue loss that would result from having portfolio interest income exempt from withholding taxes.

Many indirect benefits would also accrue as a result of elimination of the tax. The added investment from abroad would have a beneficial impact on the U.S. balance of payments, probably exceeding for many years to come any additional outflows in interest payments to foreigners. Also of importance would be the improvement of the United States' position as the premier international financial market, as U.S. securities would become competitive with Eurodollar and Eurobond instruments which are not, of course, subject to withholding tax. Removal of the tax would result in a significant stimulation to investment banking and brokerage firms and commercial banks in New York and, to a lesser extent, elsewhere in the U.S. Because of their experience in providing issuing, clearing, market making, trustee, and other services, such firms are uniquely placed to take advantage of an increase in international activity in the U.S. financial markets. The resulting expansion in earnings and employment would also benefit the U.S. economy, as well as the balance of payments.

DUBIOUS ARGUMENTS FOR RETENTION OF WITHHOLDING TAX

Though the House Ways and Means Committee approved repeal of the withholding tax in early October of last year, the full House subsequently voted against its elimination. In the floor debate prior to the vote in the House, a number of arguments were raised by opponents of repeal. As the validity of these arguments is open to question, it would be useful to examine critically the various assertions made by opponents of the repeal legislation.

They argued that repeal of the withholding tax would discriminate against American investors, who would continue to be subject to U.S. income taxes while foreigners would pay no tax on their U.S. investments. This was further embroidered to suggest that repeal of withholding would turn the United States into a "tax haven." However, this argument ignores the long accepted principle of international taxation—that individuals should be subject to tax in their own country of residence or nationality.

To be sure, tax treaties already in effect reduce or eliminate U.S. taxes for foreign residents in some countries. Tax treaties with Switzerland, for example, have reduced the levy on interest payments to 5 percent, but even then investors face cumbersome detailed reports and must submit claims for credits, which often take years to sort out. For the United Kingdom, and 12 other countries, treaties have completely eliminated all withholding tax on interest pay-

ments. And, of course, the United States does not tax capital gains (nor credit capital losses) realized by foreigners on stocks or bonds. But all of this represents a patchwork of discriminatory treatment. Elimination of the withholding tax would end the discrimination among foreign investors on the basis of their domicile.

In the House debate, opponents further argued that repeal would hurt the American taxpayer, because of an expected loss in revenue if the withholding tax were eliminated. However, as was previously noted, the immediate negligible revenue impact of repeal would very soon be more than made up by increased revenues resulting from higher domestic employment, incomes and profits generated by added foreign investment. Thereafter, we would continually enjoy a net gain.

The issue of "windfall gains" was also raised in the House debate. It was charged that repeal would provide foreign nationals with substantial tax savings and foreign governments with significant increases in tax revenues as they collected what was previously withheld here. However, to the extent that any windfall gains would remain with the taxpayer, they would not flow to his government, and vice versa. The critics cannot have both points—one excludes the other. To the extent that a foreign government does have an increase in its own revenues, and some may, that must simply be accepted as one by-product of getting a better system overall. And the net gain in the United States from greater capital availability here would far exceed any "loss" through the "windfall" route.

To be sure, as was argued in the House, the fact that much foreign investment is channeled through government agencies may to some extent limit the impact of repeal—especially as regards the OPEC states—but not appreciably and not for long. Foreign governments are only exempt for investments clearly "related to a governmental purpose." There is no blanket exemption and none that is automatic for a government corporation. Every foreign governmental entity claiming exemption from the withholding tax must prepare its case and apply for an exemption from the Internal Revenue Service. The final clearance of such applications largely accounted for the 1975 upsurge of about $1 billion in equity investments here by certain OPEC nations.

What better evidence is needed that full elimination of the withholding tax would indeed assure a sustained surge of added investment in the United States? To the extent that our tax laws reduce the attractiveness of the U.S. capital markets, moreover, foreign investment will simply be redirected elsewhere. With the partial exception of Germany, every country in the Common Market now has more accommodative tax treatment for foreign investors than is offered here. The United States, therefore, clearly has much to gain by moving toward a more receptive posture as concerns the treatment of portfolio investment from overseas.

Two other arguments raised during the House debate also require comment. Opponents argued that repeal would reduce the bargaining power of the U.S. in future double taxation treaty discussions, and that added foreign investment inflows would place future burdens on the economy in terms of payments that would be due to foreigners. As to the first, any number of details provide all the leverage, or self-interest, that either side needs in working toward agreed arrangements of mutual advantage. The withholding tax lever is relatively a trivial part of this larger set of detailed procedures and tax implications—ranging from customs practices to taxes on extractive industries and much more.

Regarding the future costs of foreign investment inflows, certainly for every dollar of inflow attracted in one year, we have to pay to the foreigner a continuous stream of interest over a longer period of years. However, such investment will increase the productive capacity of the economy. The resultant flow of additional employment and income will more than compensate for any future payments to foreigners. In short, inducement of additional foreign investment is a sound national economic policy decision both for today and for the future.

U.S. WITHHOLDING TAX RATES ON INTEREST AND DIVIDEND INCOME

[In percent]

Recipient	Dividends (portfolio)	Interest
Nontreaty nations	30	30.0
Treaty nations:		
Australia	15	30.0
Austria	15	0
Belgium	15	15.0
Canada	15	15.0
Denmark	15	0
Egypt	15	15.0
Finland	15	0
France	15	10.0
Germany	15	0
Greece	30	0
Iceland	15	0
Ireland	15	0
Israel	25	17.5
Italy	15	30.0
Japan	15	10.0
Luxembourg [1]	15	0
Netherlands	15	0
Netherlands Antilles [2]	15	0
New Zealand	15	30.0
Norway	15	0
Pakistan	30	30.0
South Africa	30	30.0
Sweden	15	0
Switzerland	15	5.0
Trinidad and Tobago	30	30.0
United Kingdom	15	0
United Kingdom overseas territories	15	30.0

[1] These rates are not applicable to Luxembourg holding companies.
[2] These rates are not applicable to holding companies unless certain elections are made.

THE CAPITAL NEEDS AND SAVINGS POTENTIAL OF THE U.S. ECONOMY

PROJECTIONS THROUGH 1985

Contents

Introduction.
Methodology: An Overview.
Section I: Base Case Scenario.
Section II: Alternative Scenarios.
Section III: Implications and Policy Recommendations.

INTRODUCTION

As the twin ogres of escalating inflation and soaring interest rates have tightened their grip on the U.S. economy, leading business, government and academic economists have made some dire predictions about what lies ahead for American business if the nation fails to develop and implement adequate corrective measures. Those predictions have flowed from a number of diverse statistical estimates and projections—some of them based on solid, authoritative research, others seemingly no more than guesses and intuitive musings. One thing is certain: the problems are real. President Ford has identified inflation and its attendant ills as the nation's major domestic problem, and has made the fight against inflation the highest priority task of the new national Administration.

At the New York Stock Exchange, we have become increasingly concerned about the supply and allocation of investment capital. And our concerns have deepened with the realization that a capital shortage is no longer a threat for the

future, but a fact of the present, as inflationary presures come to bear on the capital markets.

To develop a clearer understanding of the dimesions and implications of this problem, our research economists undertook a broad survey and study of the capital needs and savings potential of the U.S. economy through 1985. The study sought to develop realistic projections of capital supplies and demands in the economy over the next dozen years.

The basic findings can be expressed in this very simple bit of arithmetic:

$4,050,000,000,000
−4,700,000,000,000

(650,000,000,000)

Stated plainly, this means that the present estimated *saving* potential in the U.S. economy through 1985—from all domestic sources—is something over $4 trillion. Over the same period, capital demands are likely to reach a cumulative total of $4.7 trillion. That leaves an estimated capital gap of $650 billion.

Those figures are not very reassuring. They confirm the apprehensions of others, and they underscore the urgency of the problems confronting the American business community and the American people.

But it is our hope that while these projections present a harsh and disturbing picture, they also give us a clear opportunity to assess the prospective implications of the emerging capital problem—and to do something about it before it is too late.

The degree of intensity with which American business, American labor, American government—and the American people—attack this problem really holds the key to whether or not today's projections will become tomorrow's disruptions.

JAMES J. CREEDHAM, *Chairman.*

THE CAPITAL NEEDS AND SAVINGS POTENTIAL OF THE U.S. ECONOMY

PROJECTIONS THROUGH 1985

This report of the Capital Needs and Savings Potential of the U.S. Economy Through 1985 is divided into three sections. Section I presents the New York Stock Exchange's "Base Case" projections of investment and saving flows for the period 1974–1985. Section II develops alternative scenarios to test the sensitivity of the base case conclusions to changes in parameter values. Section III discusses the implications of a major investment capital shortfall and offers a number of general policy recommendations for bridging the gap.

METHODOLOGY: AN OVERVIEW

To assess the adequacy of future saving to finance anticipated investment, separate projections were made of gross private domestic investment, business and personal saving, and net government requirements for funds. These estimates took the form of ex ante forecasts of saving and investment flows—i.e., the projected values represent desired levels of investment and saving rather than actual or (ex post) values of those flows. This distinction is of critical importance. Ex post saving and investment must be equal at every point in time. Ex ante, the flows need not be equivalent, since corporations, households and other sectors of the economy carry out investment and saving planning independently of one another.

The study's emphasis on ex ante saving and investment requirements precluded the use of econometric models, in which saving is always equated with investment, primarily through changes in interest rates.

The need to use non-econometric techniques sacrifices some rigor. This is especially true in gauging the impact of alternative assumptions of investment demand and government budgetary policy on the economy as a whole. Economic variables are linked together in a complex pattern of multiple feedback loops, and it is difficult to trace the interactions among the variables without a well-specified model of system behavior.

To help overcome this difficulty, a scenario approach was used to assess the impact of changes in key parameters on the balance between the demand and supply of funds. A "base case" scenario was constructed, in which a "most likely" projection of investment and saving flows was detailed. Alternative scenarios were then developed to test the stability of the "base case" conclusions. The emphasis was placed, not so much on the precise values of saving and investment flows but on the more important issue of the relationship of those flows to each other—and, inferentially, to the economy as a whole.

I. Base Case Scenario

A. THE DEMAND FOR FUNDS

General Methodology

Gross Private Domestic Investment (GPDI) and net government financing operations (deficit financing and net borrowing from the public) comprise the total domestic demand for funds in the economy. The value of Gross Private Domestic Investment in the 1974–1985 period was derived by aggregating estimates of business plant and equipment expenditures, residential construction and investment spending by farms, non-business and non-profit institutions (including investment in inventories.) Estimates of the government sector were broken out between state and local government deficit financing and the net financing needs of the Federal government. It should be borne in mind that these projections represent desired levels of capital spending—what indusry and knowledgeable observers believe will be required in the 1974–1985 period.

The projections are consistent with an 8.6 percent annual rate of growth in Gross National Product, (5 percent annual rate of inflation, 3.6 percent annual rate of real growth).

1. The Components of Gross Private Domestic Investment

a. Plant and equipment spending

The "base case" projection of plan and equipment spending (which includes outlays for modernization and new capacity) was derived from specific industry forecasts and from projections made by other respected research organizations.[1] The various estimates were adjusted to insure comparability, and then consolidated to form a consensus projection of future capital requirements.

The industries selected were those included in the Department of Commerce series on new plant and equipment spending. For projection purposes, the industries were grouped into five broad categories:

1. The energy sector—mining,[2] petroleum, electric and gas utilities.
2. Basic material processors—iron and steel, non-ferrous metals, stone, clay, clay, glass, rubber, paper, and chemicals.
3. Transportation and transportation equipment manufacturers.
4. Communications and services.
5. All other.

Table 1 provides the consensus projection of growth rates in each of these categories. These rates (computed using 1973 as a base, the latest year for which complete data are available) reflect as assumed slowdown in the pace of new plant and equipment spending during the latter part of the estimating period, as it is unlikely that any investment boom would continue at a constant rate over a twelve-year interval.

TABLE 1.—AVERAGE ANNUAL RATE OF GROWTH IN NEW PLANT AND EQUIPMENT SPENDING, 1961–73 (ACTUAL), 1973–85 (PROJECTED)

[In percent]

	1973–85	1961–73
Energy sector	12.7	9.4
Basic materials	10.7	9.0
Transportation and transportation equipment	9.6	7.3
Communications and services	8.4	8.8
Other	9.9	9.4
Total plant and equipment spending	10.3	8.9

[1] Sources will be furnished upon request.

[2] The Department of Commerce does not break out mining data by commodity category. It is assumed that mining plant and equipment spending relates solely to the energy sector.

As Table 1 indicates, the energy and basic materials sectors will account for the greatest increase in capital spending.

On a cumulative basis, the energy sector will require roughly $820 billion in the 1974–1985 period. Electric utilities alone will require approximately $400 billion between 1974 and 1985 for increased generation, transmission and distribution facilities (assuming present environmental regulations).[3] The other energy industries (including gas utilities, petroleum, coal, synthetic fuels and nuclear) will need to spend in the range of $420 billion for primary energy needs, downstream petroleum investment (including tankers and environmetal protection equipment) and developmental costs for full-scale synthetic gas and oil shale production.[4] The likely imperatives of "Project Independence" suggest, however, that the latter estimate is probably conservative.

The basic materials industries will spend nearly $330 billion through 1985. The huge increase in capital spending will be needed to overcome the serious shortages of capacity now limiting output in the iron and steel, aluminum, paper, cement, glass and other industries.

The transportation sector (including transport equipment industries) will require $225 billion through 1985. This sum reflects growing concern over the nation's mass transit needs. High energy costs and public concern for improvements in environmental quality have prompted proposals to upgrade the nation's aging railroad system and to develop viable alternatives to highway transportation.

Significant increases in capital outlays will also be registered by the communication and services sector and by "other" manufacturing industries (including electrical and non-electrical machinery, food, textiles, and miscellaneous durable and non-durable manufactures). These sectors will require approximately $770 and $420 billion, respectively, in cumulative capital outlays to 1985.

b. Residential construction

The expected demand for new housing is related in large part to demographic factors. In the 1974–1985 period, the distribution of the U.S. population will shift toward a greater concentration in the 20–35-year age bracket, a group which has the highest rate for marriages and household formation. Conservative estimates suggest that by 1985, 3 million housing units a year may be required to meet the increased demand for housing. Included in this total are single-family and multi-family dwellings and mobile homes. An annual rate of 3 million housing starts by 1985 implies a 3.3 percent annual growth rate in housing starts over the period—somewhat higher than the 2.6 percent annual growth rate during 1962–1973.

In terms of dollars, assuming that construction costs advance in line with general inflation rates,[5] nearly $1.1 trillion will be required to meet America's housing needs.

c. Capital spending on inventories and by farm and nonprofit institutions

Investment spending in this sector should amount to $850 billion in the 1974–1985 period. This total includes $206 billion in cumulative farm expenditures (based on historical rates of investment), $83 billion in inventory investment (based on recent average values of the change in inventories of $6.9 billion per year), and $562 billion in capital spending by private educational institutions, hospitals and related non-profit organizations (again, predicated on historical data, modified to allow for reduced capital demands by colleges and universities, and a slowdown in the rate of hospital construction during the estimating period). This estimate should not be regarded as anything more than an order of magnitude projection, based on the diverse elements included within this "catch-all" category.

* * * * * * *

Aggregating the components of Gross Private Domestic Investment indicates that $4.5 trillion in private investment will be required over the 1974–1975

[3] "24th Annual Electrical Industry Forecast," Electrical World, September 15, 1973, p. 53.

[4] Forecasts for the petroleum and related energy industries vary widely. The figures used in this report are derived from "Energy Financing," a March 7, 1974 research study issued by Irving Trust Company; a revised National Petroleum Council estimate of future capital needs (released in 1973); and projections of electric utilities capital requirements presented in Electrical World, September 15, 1973.

[5] Five percent per annum, except in the case of multi-family units, where costs were assumed to rise at a 4 percent annual rate, reflecting greater use of modular construction techniques and related innovations.

period (Table 2). The percentage of Gross National Product devoted to capital formation would rise from 15.6 percent in 1973 to an average of 16.4 percent over that period. The average over the preceding 12 years was 15.3 percent. In constant 1973 dollars, cumulative Gross Private Domestic Investment equals approximately $3.2 trillion. This sum is still roughly 1.5 times the $2 trillion spent in the preceding twelve-year period (also stated in terms of 1973 dollars). Thus, even abstracting to account for the effects of inflation, the projected volume of domestic investment will clearly be enormous.

TABLE 2.—PROJECTIONS OF GROSS PRIVATE DOMESTIC INVESTMENT CUMULATIVE, 1974–85

	Current dollars	1973 dollars
Plant and equipment spending	$2,568	$1,799
Energy	824	571
Basic materials	328	230
Transportation and transport equipment	225	158
Communications and services	772	548
Other	419	292
Residential construction	1,085	771
Nonprofit, agriculture, and change in inventories	850	601
Total gross private domestic investment	4,503	3,171

2. *Government Financing Requirements:*

(a) *The Federal Sector:*

The Federal government's demand for funds is far too erratic to permit meaningful projections. Existing studies offer little practical guidance. For example, a recent study by the Brookings Institution projected the Federal budget to be in surplus by $93 billion (assuming a 5 percent rate of inflation and no new spending plans) in 1980.[6] However, as new programs and changes in existing programs appear quite likely—especially in the energy section and for a national health insurance program—the actual 1980 surplus could be far less than $93 billion. Indeed, the Federal budget may even be in deficit, depending on Congressional and Executive action—a possibility noted in the Brookings analysis. Historical experience shows government surpluses to be a rarity and to assume a surplus in the years ahead would be overly optimistic.

In view of these considerations, and with full recognition of the uncertainties involved, the Federal deficit is assumed to average $3.5 billion a year over the 1974–1985 period. This rather conservative assumption is based on the average Federal deficit during the non-war years of 1954–1963. The relatively large deficits during the late 1960s cannot be viewed as "most likely," as they reflect U.S. involvement in Viet Nam.

In addition to budgetary deficits, the off-budget demands of sponsored credit agencies have been growing apace in recent years, exceeding $19 billion in 1973.[7] This borrowing competes directly with private sector demands and represents a significant share of total credit market borrowing (10 percent in 1973). A Federal Financing Bank has recently been established to coordinate agency borrowing. And while it is too early to judge its impact, this new institution does offer the possibility of more rational government use of the credit markets. Again recognizing the substantial element of uncertainty involved, agency borrowing is assumed to average $8.6 billion a year during 1974–1985. This figure represents the average of such borrowing during the 1968–1973, prior to which credit agency borrowing was not a significant factor.

d. State and local government financing requirements

State and local governments have been running a sizeable surplus recently, but have been borrowing heavily (to the tune of $10–15 billion a year) to finance capital projects. Their net demands on the credit markets are assumed to average out to $2.5 billion a year over the next ten years. This estimate is based on a Tax Foundation study[8] which estimated that state and local governments will run

[6] Barry M. Blechman, et al., *Setting National Priorities, The 1975 Budget*, The Brookings Institution, Washington, D.C., 1974, p. 258.

[7] To some extent, Federal agency borrowing substitutes for private borrowing. This, however, does not materially affect our conclusions. Even if all Federal agency borrowing were excluded, the projected savings gap would still be huge.

[8] "The Financial Outlook for State and Local Government to 1980", Tax Foundation, Inc., New York, 1972, p. 96.

a cumulative surplus of about $78 billion in the 1974–1980 period, or approximately $11 billion a year, while debt requirements in the same period are expected to average under $14 billion a year. The difference of about $2.5 billion represents net credit demands. The 1974–1980 forecast is assumed to hold through 1985.

* * * * * * *

Table 3 indicates that combined Federal and state and local financing requirements will cumulate to $175 billion over 1974–1985.

TABLE 3.—*Governmental demand for funds cumulative, 1974–85*

[In billions of dollars]

Financing Federal deficits	$42
Net Federal credit agency borrowing	103
Net State and local government financing requirements	30
Total governmental demands for funds	175

B. THE SUPPLY OF SAVINGS

Business savings (capital consumption allowances and retained earnings adjusted for changes in inventory valuation), personal savings, and net foreign investment inflows constitute the sources of savings available to the economy.[9]

1. Business Saving

The projected value of business saving was derived from a regression of such savings on gross national product, using data from 1950–1973 (in order to provide sufficient observations over all phases of cyclical activity). The estimating equation is provided below:

$$\text{Business Saving} = 3.52459 + .10498\ \text{GNP}$$

The coefficient of the GNP variable was highly significant ("t" value=29.775) and the coefficient of determination (R^2) was an encouraging .976. For forecasting purposes, GNP was assumed to grow at 8.6 percent per annum, consistent with the GNP growth rate used in the projections of capital spending. It was also implicitly assumed that profit margins would not increase much beyond present levels, that accounting procedures (especially treatment of depreciation costs) would not change significantly and that corporation taxes would remain essentially unchanged.

The regression-based forecast indicates that more than $2.9 trillion will be saved by the business sector over the 1974–1985 period.

While any assumption that historical trends will continue should automatically be suspect, the stability of the relationship between business saving and GNP is quite pronounced. It has never fallen below 9.9 percent (reached only in the recession years of 1953 and 1970) and has only risen above 12 percent during the early years of the Viet Nam War (1964–1966).

Capital consumption allowances will account for the major portion of the nearly $3 trillion in business savings, cumulating to about $2.4 trillion over 1974–1985. The significant increase in the stock of capital projected for the period would necessarily generate large additional depreciation charges. The actual value of these write-offs was estimated by assuming that the capital consumption allowance/GPDI ratio would average 51.75 percent over the period. This percentage is below historic levels and reflects the assumed higher rate of growth in GPDI relative to the growth in depreciation charges.

Retained earnings were treated as a residual element in this analysis and are expected to accumulate to more than $560 billion. The relatively low growth rate projected over the period reflects the downward adjustment for inventory profits in the historical data. It should be noted that retained earnings in 1973 (even after adjustment for inventory profits) should not be used as a base for future projections. Cyclical factors and dividend controls made total retentions in 1973 far higher than would ordinarily be the case (i.e., if corporate retentions are viewed over the entire business cycle).

[9] The national income accounts do not include net increases in the money supply as a source of saving, as saving is defined in the accounts to equal income less spending.

2. Personal Saving

Personal saving represents a sizeable flow of funds to the capital markets—nearly $55 billion in 1973. As a percent of GNP, personal saving ranged between 3.4 percent and 5.8 percent during 1960–1973. At the close of 1973, however, the personal saving rate was 4.25 percent, well below the 5 percent average of the preceding five years.

Personal saving is expected to rise from $54.8 billion in 1973 to $135 billion by 1985, a cumulative total of more than $1.1 trillion. These projections assume that the ratio of personal saving to GNP will decline smoothly over the period—from 4.25 percent in 1973 to 3.9 percent in 1985 (based, in part, on shorter-term projections made by the Brookings Institution). The expected decline in the saving/GNP ratio is predicated on: (1) The shifting age distribution of the U.S. population toward the low-saving 20–35 age bracket, (2) mandated increases in social security contributions, which tend to be regressive, and (3) the possibility that the present high levels of inflation may change the historic propensity of consumers to maintain a constant real level of savings in relation to income. This does not imply an expectation that current rates of inflation will persist but, rather, that traditional consumer saving habits may be altered by the recent severe erosion of real household wealth.

3. Foreign Investment Flows

In addition to domestic sources of savings, an increasing flow of funds should become available from foreign sources. The greatest potential for such inflows clearly lies with the Arab states, which are expected to accumulate more than $500 billion as an investable surplus in the 1974–85 period. While a major portion of these funds will no doubt be recycled to other nations to finance their oil purchases, a significant volume should still be available for investment. The size and liquidity of the New York capital markets should attract a large share of these oil revenues, with investment probably being concentrated in government and high-grade corporate debt securities.

Unfortunately, however, no realistic basis exists from which to project the future volume of net foreign inflows of capital. Political considerations alone make projections extremely unreliable. Thus, while it may be hoped that sizeable foreign inflows can add to the pool of available savings, prudence dictates against relying on them.

C. A CAPITAL SHORTFALL

When the projections of ex ante demand and supply of capital funds are offset, it is clear that a cumulative saving gap of nearly $650 billion is in prospect. This capital shortfall, averaging $53.8 billion a year over the 1974–1985 period, represents approximately 13 percent of the average demand for funds over the period (Table 4).

TABLE 4.—Sources and uses of funds cumulative, 1974–85

[In billions of dollars]

Sources of funds:	
Business saving	$2,923
Capital consumption allowances	2,359
Corporate retained earnings	564
Personal saving	1,109
Total sources of funds	4,032
Uses of funds:	
Gross private domestic investment	$4,503
Plant and equipment	2,568
Residential construction	1,085
Other	850
Financing Federal deficits	42
Net State and local government financing requirements	30
Net sponsored credit agency borrowing	103
Total uses of funds	4,678
Saving gap	(646)

It should be stressed that this "base case" scenario presents a "most likely" outcome, based upon reasonable assumptions of future capital demands and savings availability.

However, from a policy viewpoint, the precise dimensions of a saving gap is not the issue. Whether the cumulative gap is $400 billion or $600 billion or $800 billion, the problem—and the policy implications—remain the same.

It is more important to know whether a different set of "reasonable" assumptions would develop projections that would eliminate the prospective gap, or reduce it to inconsequential or manageable proportions. The following section of this report demonstrates that this does not appear to be possible.

II. Alternative Scenarios

The alternative scenarios presented here assume no shift in tax policies and no major changes in the general business climate over the 1974–1985 period.

A. ALTERNATIVE NO. 1: HIGHER SAVING FLOWS

This scenario assumes that the base case projections may have underestimated business and personal saving. To adjust for this possibility:

1. Corporate capital consumption allowances were assumed to equal 54.25 percent of GPDI (based on the average percentage during the major expansions of the 1962–73 period) as opposed to the base case level of a 51.75 percent average.
2. Retained earnings (adjusted for inventory valuation) were assumed to equal 10 percent more than base case estimates (an arbitrary, but sizeable shift).
3. Personal saving rates were assumed not to fall, as in the base case, but to remain at the 1973 level of 4.25 percent of GNP. The rate of growth of nominal GNP was assumed to be 9.2 percent rather than the 8.6 percent rate used in the base case. This higher rate reflects the possibility that the projected levels of GPDI are consistent with a substantially higher rate of real economic growth than the 3.6 percent rate assumed in the base case scenario.

With these modifications (all other factors remaining the same) a sizeable, albeit reduced saving gap of $396 billion is still projected for the 1974–1985 period (Table A1).

TABLE A-1.—ALTERNATIVE NO. 1—HIGH SAVING—BASE CASE INVESTMENT, CUMULATIVE, 1974–85

[In billions of dollars]

	Base case	Alternative No. 1
Gross private domestic investment	(4,503)	4,503
Add:		
Depreciation allowances	2,359	2,443
Retained earnings	564	620
Personal saving	1,109	1,219
Private saving gap	(471)	(221)
Add Government demand for funds	(175)	(175)
Total saving gap	(646)	(396)

If cumulative governmental demand for funds is assumed at 50 percent of base case levels (i.e., at $87.5 billion) a saving gap of more than $300 billion still occurs.

In this scenario, the private saving gap is less than 50 percent of the base case projection. However, the assumptions upon which this "revised" gap is based are not particularly realistic. While the adjusted retained earnings projections appear to be reasonable, the depreciation to GPDI ratio is unlikely to remain constant at 54.25 percent when capital expenditures are increasing at a faster rate than depreciation charges. It is also doubtful, based upon previously noted demographic factors, that the personal saving/GNP ratio would remain at current levels. The 9.2 percent growth rate assumption is similarly extreme, given the general agreement in long-term econometric models as to the relationship between levels of capital expenditure and gross national product. Similarly,

it is unlikely that government demands would total only $87.5 billion through 1985—an eventuality for which there is simply no historical precedent.

B. ALTERNATIVE NO. 2: LOWER INVESTMENT AND HIGHER SAVING

This scenario goes one step beyond Alternative No. 1, assuming that the base case projections of aggregate GPDI were overstated, while saving flows were understated, as in the previous scenario. oT show the implications of such a set of assumptions:

1. The GPDI/GNP ratio was assumed at a constant rate of 16 percent in the 1974–1985 time-frame (it should be noted that every econometric model reviewed in the course of this study assumed a GPDI/GNP ratio above 16 percent). GNP was assumed to increase at 8.6 percent per annum, as in the base case (even though a lower GPDI/GNP ratio suggests that a slower rate of growth would be more appropriate).

2. Capital consumption allowances were computed at 54.25 percent of the lower GPDI estimate.

3. Retained earnings were assumed to cumulate to $620 billion, based on the Alternative No. 1 assumptions.

4. Personal saving was computed at 4.25 percent of nominal GNP. The lower level of investment spending assumed in this scenario suggests that the Alternative No. 1 assumption of a 9.2 percent rate of growth in nominal GNP would be too high. While econometric studies suggest that the base case rate of 8.6 percent would also be excessive, this rate is used for this scenario.

Table A2 shows that even with these assumptions, a significant saving gap of $404 billion develops. Again, even if the base case assumption regarding government spending is halved, the projected saving gap is still of major proportions.

TABLE A-2.—ALTERNATIVE NO. 2—LOW INVESTMENT AND HIGH SAVING, CUMULATIVE, 1974–85

[In billions of dollars]

	Base case	Alternative No. 2
Gross private domestic investment	(4,503)	(4,406)
Add:		
Depreciation allowances	2,359	2,388
Retained earnings	564	620
Personal savings	1,109	1,169
Private saving gap	(471)	(229)
Add Government demand for funds	(175)	(175)
Total saving gap	(646)	(404)

C. ALTERNATIVE NO. 3: HIGH INVESTMENT AND HIGH SAVING

The base case scenario was somewhat conservative in its projections of Gross Private Domestic Investment. For example, a number of respected research groups have estimated that the energy sector would require $900 billion in capital funds in the 1974–85 period, as compared with the $820 billion used in the base case analysis. (This higher estimate assumed the same rate of inflation—5 percent per annum—as the base case study.) To adjust for any possible underestimation of capital demands, the following assumptions were made:

1. Energy investment was assumed to cumulate to $900 billion in the 1974–1985 period.

2. Base case projections for other plant and equipment sectors were increased by 5 percent in each year (a relatively small upward adjustment).

3. Residential construction expenditures were recalculated assuming 3.2 million housing starts by 1985 instead of 3.0 million as in the base case. In addition, the 1 percent "technology" factor used in computing the inflation rate in residential construction costs was not applied here (all costs were postulated to increase at 5 percent per annum).

4. Non-business, non-profit capital investment was also increased by 5 percent in each forecasting period.

With these new assumptions, Gross Private Domestic Investment rises from $4,503 billion in the base case to $4,785 billion (Table A3).

TABLE A-3.—ALTERNATIVE NO. 3—GROSS PRIVATE DOMESTIC INVESTMENT, CUMULATIVE, 1974-85

[In billions of dollars]

	Base case	Alternative No. 3
Plant and equipment spending	2,568	2,731
Of which:		
Energy	(824)	(900)
Transport	(225)	(236)
Basic materials	(328)	(345)
Communication and services	(772)	(811)
Other	(419)	(439)
Residential construction	1,085	1,161
Other	850	893
Gross private domestic investment	4,503	4,785

On the saving side, it was assumed that:

1. Depreciation allowances would be calculated using the higher (and somewhat unrealistic) rate of 54.25 percent of GPDI.
2. Retained earnings would be computed assuming a 10 percent increase over base case levels (higher plant and equipment investment being associated with higher levels of retentions).
3. Personal saving would be estimated as in Alternative No. 1, on the basis of a 9.2 percent annual rate of growth in nominal GNP, with the personal saving/GNP ratio assumed at 4.25 percent. As previously indicated, this percentage probably overstates the volume of personal saving that will accumulate in the forecasting period.

Offsetting the projections of GPDI with estimated saving flows provides a saving gap of $525 billion (Table A3a). As before, changing assumptions regarding governmental financing needs will increase or reduce the total saving gap.

TABLE A-3a.—ALTERNATIVE NO. 3—HIGH INVESTMENT, HIGH SAVING, CUMULATIVE, 1974-85

[In billions of dollars]

	Base case	Alternative No. 3
Gross private domestic investment	(4,503)	(4,785)
Add:		
Depreciation allowances	2,359	2,596
Retained earnings	564	620
Personal savings	1,109	1,219
Private saving gap	(471)	(350)
Add Government demand for funds	(175)	(175)
Total saving gap	(646)	(525)

Note: D. Alternative No. 4: Increased Inflation.

The base case scenario assumed a 5 percent annual rate of inflation in the 1974-85 period. To test the impact of higher inflation on the saving gap, the base case estimates were recomputed assuming a 6 percent rate of inflation (the rate of growth of nominal GNP increasing from 8.6 percent to 9.6 percent). The results of this computation are provided in Table 4A.

TABLE A-4.—ALTERNATIVE NO. 4—INCREASED INFLATION, CUMULATIVE, 1974-85

[In billions of dollars]

	Base case	Alternative No. 4
Gross private domestic investment	(4,503)	(4,833)
Add:		
Depreciation allowances	2,359	2,536
Retained earnings	564	609
Personal savings	1,109	1,182
Private saving gap	(471)	(506)
Add Government demand for funds	(175)	(186)
Total saving gap	(646)	(692)

As shown in Table A4, higher inflation rates would only serve to widen the saving gap, though saving flows would also rise, based upon increases in the capital base and in the level of nominal income.

E. OTHER SCENARIOS

The preceding four scenarios illustrate that the base case conclusion of a sizeable cumulative saving gap stands up to fairly severe changes in parameter values. While it would certainly be possible to construct sets of assumptions that would eliminate the gap, the alternative scenarios presented here suggest that the reasonableness of more extreme scenarios would be open to serious question. And while it might be argued that the majority of business economists have overstated the nation's capital needs, it is extremely unlikely that the best-informed experts have seriously erred in their own areas of expertise.

The most reasonable conclusion from the alternative scenarios presented here is that they confirm the reasonableness of the base case projection of a sizeable capital shortfall over the period to 1985.

III. IMPLICATIONS AND POLICY RECOMMENDATIONS

The saving gap or capital shortfall projected in the base case scenarios represents a theoretical imbalance between investment capital demand and investment capital supply. The gap itself will never actually show up; rather, it will be evidenced ex post, or after the fact, by high interest rates—brought about by intensified competition for an inadequate supply of savings—and reduced credit availability. The projected shortage of capital will have a particularly severe impact on domestic business activity, on the position of the U.S. in international economic affairs and, ultimately, on the standard of living and quality of life in America.

A. IMPLICATIONS OF A CAPITAL SHORTFALL

1. Domestic business implications

Housing and other construction will be particularly hard hit by a capital shortfall. Skyrocketing interest rates have already severely constrained new housing starts. If present trends continue, the likely results may include decreased square footage in new homes and apartments and lower construction standards. Millions of Americans who dream of a home in the suburbs will have to forego their hopes and aspirations. Indeed, the very quality of life may be impaired, as the lack of suitable housing facilities leads to even more urban congestion and decay.

Small and medium-size businesses will find it increasingly difficult to obtain necessary financing. High interest charges will often preclude the possibility through commercial banks—to finance capital investment. But borrowing short of long-term financing, forcing them to rely on short-term borrowing—primarily for long-term purposes is not normally advisable, and bankers and other lenders are unlikely to continue to satisfy the demand—at any price—over an extended period. Moreover, as credit availability declines, lenders will increasingly put their funds with larger, "safer" borrowers with whom they have long-standing customer relationships. The largest and safest borrower, of course, is the Federal government. To the extent that funds are directed into government issues, additional strains will be placed on the private sector (as interest rates increase because of the flow of funds into such issues). The government could even become a center for the allocation of funds to business and consumers if Federal borrowing increased significantly beyond expected levels.

Even larger companies will feel the pinch. This is especially likely in the utility sector, where expansion plans are already being cut back because of financing problems. In addition to raising the possibility of frequent brownouts and blackouts, reduced capital spending in the energy sector would soon impact on other areas of the economy, notably in the construction and electrical machinery industries.

Overall, the capital markets may be unable to meet the essential financing needs of American industry. Along with a decline in bond financing, commercial paper may become unavailable as a source of funds to all but the major Aaa corporations. As lenders become increasingly wary, they will be likely to shy away from buying "high risk" paper unless the creditworthiness of the borrower is beyond

question. High rates of interest may adversely affect stock prices as investors shun equities because of the higher returns available elsewhere with less risk. Price-earnings ratios would continue under pressure. And since, with low P/E ratios would continue under pressure. And since, with low P/E ratios, corporations cannot float new stock without diluting the earnings of existing shareholders, it would become increasingly difficult to market new equity issues. (At a P/E ratio of 5, for example, a company would have to earn 20 percent on new equity to prevent earnings dilution.) If inflationary fires are dampened, a new equilibrium should be achieved between return on equities and interest rates, permitting stock valuts to resume their historic upward pattern. But the adjustment period could be prolonged.

Slow growth in stock prices could also increase pressures for higher dividend payouts. The danger here, of course, is that higher payouts would reduce retained earnings which constitute an important part of the internal funds available for corporate reinvestment.

2. International Implications

Reduced levels of capital investment, necessitated by a shortage of investment capital, may impede both the growth of the U.S. capital base and the corporate sector's ability to produce. America's position as the major world economic and military power could be endangered—particularly vis-a-vis the Eastern-bloc nations where government can tightly control the allocation of resources.

If investment projects are delayed or scrapped because of the unavailability of capital funds at reasonable rates, the nation's over-all productivity may decline, placing American exports at a marked disadvantage in world markets. Competitors with more efficient plant and equipment will be able to underprice U.S. goods. The impact on the nation's balance of payments would be particularly grave in light of the anticipated need to import substantial amounts of energy resources (and without sufficient energy resources, U.S. industry may be unable to produce up to expectations).

If stock prices remain depressed because of high interest rates and sluggish growth prospects, there may be increasing foreign interest in acquiring U.S. corporations. While this need not be alarming (especially as U.S. companies have invested heavily overseas, often by purchasing foreign facilities) domestic security and related implications must be considered. Especially in an era of capital scarcities, foreign investors, consistent with the national interest, should be accorded a welcome reception.

3. Implications for the American People

Slower growth at home, because of decreased investment spending, will mean higher levels of unemployment and reduced potential for advancement. This will place greater strains on already over-burdened social service facilities, particularly in the central cities. Minority groups will be particularly affected, as upward mobility becomes more difficult in a constrained economic environment.

Increased unemployment may permanently drive many skilled workers out of their specialties, reducing the available pool of skilled labor. Educational attainment may also decline, with dim economic prospects deterring millions from seeking college educations and advanced training. The long-term implications here are literally incalculable.

Declines in productivity, resulting from a shortage of capital, may further fuel inflationary fires. Prices will continue their upward climb as demand presses against inadequate supply capabilities.

The personal financial security of millions of Americans may also be endangered. Today, billions of dollars in pension funds are invested in common stocks. The recent malaise in the equity markets has reduced the value of pension fund portfolios so that employers are being forced to increase their contributions significantly above planned levels. Continued sluggishness in stock prices could exacerbate the drain on existing pension fund reserves.

In sum, the social fabric of this nation may be weakened if the economy cannot rise to meet the expectations of the American people. Fewer job opportunities, increased pressure on social services, reduced housing activity, and continued inflationary pressures will combine to lower standards of living and the overall quality of life. The Federal government may be unable to fill the vacuum. Declining tax revenues (resulting from reduced economic growth) will hamper the ability of government to meet the needs for mass transit, public housing, health care, urban renewal, energy research, and a host of other high-priority programs.

The squeeze on Federal revenues will tighten as reduced levels of economic activity require increased expenditures for income maintenance programs.

B. POLICY RECOMMENDATIONS

While the purpose of this report is to identify the dimensions of the prospective capital shortfall, rather than to suggest ways of avoiding it, a number of observations may still be appropriate.

The prospect of a savings shortfall suggests two distinct policy alternatives. One, which could be labeled a policy of benign neglect, would allow the economy to adjust to the shortage of capital through higher interest rates and slower economic growth. The implications of such a policy have already been discussed. The second option envisages the market mechanism playing a major role in closing the prospective capital gap in an environment of brisk economic activity—by encouraging saving and productive investment, discouraging excessive current consumption, and reducing existing roadblocks to foreign capital investment in the United States, subject to appropriate safeguards with respect to ownership of U.S. productive facilities.

Obviously, the first step in stimulating an economic environment in which saving flows will be adequate to meet projected investment needs, will be for government to bring inflation under control. To begin with, Federal expenditures should be significantly cut back; non-essential spending should be deferred, and marginal programs should be eliminated. These reductions should apply across all sectors of the budget, including non-essential defense spending. If inflation is not brought under control, rising priees will continue to eat away at the purchasing power of available savings.

To increase the flow of saving, especially by the business sector, a sweeping reform of U.S. tax laws is essential. Specifically, corporate tax rates should be adjusted to permit increased accumulation of funds for capital purposes, and current capital gains taxation should be modified by:

1. Creating incentives for individuals to realize—and reinvest—gains that are now "locked in" by tax considerations.
2. Liberalizing the entire capital gains tax structure to promote risk-taking and to stimulate additional saving.
3. Eliminating the distinction between long-term and short-term capital losses, and providing unlimited deductibility for losses.
4. Allowing for complete tax exemption for reasonable amounts of capital gains.

The double taxation of dividends should be ended. As a first step, the dividend exclusion from Federal income taxes should be increased.

The treatment of depreciation should be modified to reflect higher replacement costs resulting from inflationary trends, and to encourage quicker replacement with more efficient equipment. By using an "original cost" basis, depreciation charges cannot be sufficient to provide for the replacement of existing capital. As a result, the capital base is eroded as business ends up paying a higher effective tax rate because corporate profits are artificially bloated by the understatement of depreciation expenses.

The investment tax credit should not be used as a counter-cyclical control device, but should be incorporated into the tax structure as a permanent incentive for capital investment. Further, the allowances granted under the program should be raised to provide additional after-tax dollars for investment purposes.

It is fully recognized that these tax changes may reduce the revenues available to the Federal government in the short run. But higher investment spending and national output will, in turn, generate additional tax revenues. Moreover, if public expenditures are cut back to match any reduction in taxes, there is no reason to expect that the shortfall in tax receipts would result in increased deficit financing.

Business and government must also cooperate to use what capital is available more efficiently. To this end, excessive regulation and restrictive controls (especially in the utility industry) should be relaxed. If necessary, environmental standards should be modified, with target dates deferred, so that capital funds may be sued temporarily to increase productive capacity.

To attract additional foreign capital, the withholding tax on income from foreign-held securities should be repealed. This particularly applies to the Arab states, with which the U.S. does not have tax treaties. While increased inflows of foreign capital would help bridge the saving gap, such flows require continual monitoring to insure compatibility with domestic economic objectives.

Clearly, national policy must be directed toward increasing the ability of the economy to generate higher rates of saving. But this cannot be accomplished without at least some discomfort. Americans must be willing to make some relatively small sacrifices today—chiefly by cutting back somewhat on current consumption—to help assure that future generations will enjoy higher living standards and a better quality of life.

SYRACUSE UNIVERSITY,
THE MAXWELL SCHOOL OF CITIZENSHIP AND PUBLIC AFFAIRS,
INTERNATIONAL RELATIONS PROGRAM,
Syracuse, N.Y., July 20, 1976.

Hon. RUSSELL LONG,
U.S. Senate,
Washington, D.C.

THE HONORABLE RUSSELL LONG: It has come to my attention that the U.S. Congress is considering legislation sharply restricting the income tax deductions that academics may claim for home office space used in the course of their work. I know from my own experience and that of my colleagues that an office away from campus is a necessity for careful pursuance of both research and educational activities required to do a good job as a professor. Most on-campus offices are barely adequate, at best, as sites to continue the on-going administrative and educational activities that are part of our job, including, of course, the frequent and necessary duty of consulting with students. But few, if any campuses, have facilities where any sustained long-term work can be undertaken. Therefore, a home office is a virtual necessity.

Furthermore, those of us who have the opportunity to learn from and contribute to society through outside consulting and advisory work have both a practical and moral need for an office away from campus. Rarely is this outside work of sufficient magnitude to warrant acquiring additional office facilities. This is another reason for the importance of the income tax deduction for home office space.

Thank you for your consideration.

Sincerely,

MICHAEL K. O'LEARY,
Director.

STATEMENT OF CLARK EQUIPMENT CO.

SECTION 1032(C)(3) OF H.R. 10612—RECAPTURE OF FOREIGN LOSSES

Clark Equipment Company ("Clark") is a manufacturer of material handling equipment, construction machinery, truck trailers, and axles and transmissions. It has extensive foreign investments, operating in more than 100 countries around the world.

SUMMARY OF POSITION

This statement is being submitted in response to the Committee's request of July 8, 1976 for additional information that will enable the Committee and the full Senate better to evaluate the merits of a number of provisions of the Tax Reform Bill of 1976 (H.R. 10612) that were approved by the Committee under time pressure and with less than usual factual input. Specifically, Clark wishes to record its full support of Section 1032(c)(3) of H.R. 10612, a provision with which Clark has heretofore been in no way involved, but that has potential application to Clark and likely to a significant number of other taxpayers.

Section 1032(c)(3) would except from recapture those foreign losses of a taxpayer resulting from worthless stock of indebtedness of a corporation in which the taxpayer has a 10 percent or greater stock interest. The section recognizes that in *economic terms* these losses were sustained in prior years, and it accords them the equitable relief that is clearly merited.

DISCUSSION

Section 1032(a) of H.R. 10612 provides that the "overall foreign loss" realized by a taxpayer in one year is to be recaptured in subsequent years, thereby reducing the foreign tax credit limitation in those years. Subsection (c)(3) of Section 1032, entitled "Substantial Worthlessness Prior to Enactment", was not contained in the House bill. It would except from foreign loss recapture losses

resulting from the worthlessness of stock or indebtedness of a corporation in which the taxpayer owns 10 percent or more of the stock. The corporation must have sustained losses in at least three of the last five years beginning before 1976 and must have sustained an overall loss for those five years. It is necessary that the corporation terminate all operation before 1977. A taxpayer meeting these tests would be free of the new foreign loss recapture rules on losses realized, in a tax sense, in a year after the effective date of Section 1032 (which applies to taxable years beginning after 1975).

Clark strongly supports this provision because it is based on economic good sense and is fully equitable. Section 1032(c)(3) recognizes that the losses in question were incurred in an *economic* sense in prior years. To subject such losses to recapture would unfairly give retroactive application to the new loss recapture rules.

Clark's views on this matter are grounded on actual experience. For roughly 10 years Clark has maintained an English subsidiary that manufactures and sells a large range of products in the United Kingdom. During that period the affiliate has suffered consistent and substantial losses. Reluctantly, Clark is now contemplating a liquidation of the English operation.

In point of economic fact, the U.K. losses have already been realized by Clark. To subject them to loss recaputre when realized in terms of taxation would be an obvious inequity. Clark understands that a principal purpose of the recapture provisions is to restrict the tax advantages presently available through the use of a branch, rather than a local subsidiary, in foreign loss situations. Thus, it would be a harsh irony were Clark, having foregone those advantages by employing a local subsidiary in the United Kingdom, to face recapture of the English losses when it liquidates the subsidiary, a recapture it would have avoided had it operated through a U.K. branch. If loss recapture does occur, Clark can expect a significant reduction in its foreign tax credit in the years ahead, and most likely presently anticipated dividends from its foreign subsidiaries will have to be severely restricted.

Clark is aware of certain other corporations that face circumstances similar to its own and that would therefore be eligible for the equitable relief afforded by Section 1032(c)(3). Given the risks and vagaries of foreign business operations, this is surely a widespread condition. Accordingly, Clark is confident that Section 1032(c)(3) would not be narrowly limited in its application.

CLARK EQUIPMENT CO.
By JOHN F. CREED, *Attorney*
Baker & McKenzie.

STATEMENT OF EDWARD A. MORGAN, ESQ., ALEXANDER & GREEN, NEW YORK, N.Y.

The purpose of this statement is to comment upon Section 1308 of H.R. 10612 as reported by the Senate Finance Committee, dealing with income from the lease of intangible property as personal holding company income.

This comment is submitted because of the concern that the Congress, in dealing with one narrowly focused problem, might inadvertently aggravate existing difficulties for a larger and more significant group of taxpayers. The concern herein is attributable to the general definitional concepts used in the bill and in the accompanying committee report (S. Rept. No. 94–938, 94th Cong., 2d Sess. (1976)).

The proposed amendment deals with the definitional concepts of personal holding company income—specifically "royalties" and "rents"—in cases where corporate "property" is used by major shareholders. Int. Rev. Code of 1954, as amended (the "Code") § 543(a)(6). Section 1308(a)(4) of the bill provides that for such purpose—"* * * the term 'property' includes intangible property, if such intangible property and tangible property owned by the corporation are used by a person in the active conduct of a trade or business."

The committee report notes that the Internal Revenue Service has taken the position that amounts received for leasing intangible property are to be treated as ordinary "royalty" income. *Rev. Rul. 71–596*, 1971-2 CUM. BULL. 243; see S. Rep. No. 94–938, *supra*, at 409–410. The committee report then continues to state the purpose of Section 1308 of the bill as being in effect to provide that amounts received for leasing intangible personal property may be treated as rents for purposes of Section 543(a)(6) of the Code. The committee report also states—"If the shareholder does not use the license or other intangible asset (along with

tangible assets) in carrying on his business, the license payments received by the corporation *are to be treated as ordinary royalties* governed by the present rules of section 543(a) (1) or, if appropriate on the facts, under other rules relating to mineral, oil and gas royalties (sec. 543(a)(3)) or copyright royalties (sec. 543(a)(4))." *Id.* at 411 (emphasis supplied).

The sentence just quoted thus evidently adopts the position of *Rev. Rul. 71-596, supra*, with respect to payments outside of the scope of the proposed amendment.

The consequences of the "rent" or "royalty" classification under the 70% personal holding company tax can be dramatic. Royalties (other than certain mineral, oil, or gas royalties or copyright royalties) *always* constitute personal holding company income. Code § 543(a)(1); see also Code § 543(a)(3) and 543(a)(4). Rents *generally* constitute personal holding company income but may be excluded from that category if certain tests relating to active rental businesses, produced film rents or use of corporate property by major shareholders are met. Code § 542(a)(2); see also Code §§ 543(a)(5) and 543(a)(6). In other words, if an active business (not receiving or retaining substantial amounts o fother possible personal holding company income) can establish that it receives "rents", it may conduct relatively normal corporate business operations, notwithstanding the personal holding company rules. No similar privilege is presently accorded if "royalties" are received.

Under present law, the distinctions between "rents" and "royalties" and other income categories are not in all instances clearly delineated.[1] Corporations conducting active business operations, and needing to retain some earnings to finance business growth, therefore have at least two alternatives where they receive income in part related to technology or other intangibles. First, they may seek to establish that the payments constitute income other than rents or royalties because of the business activity involved, notwithstanding that the payments take a form which in the hands of taxpayers acting merely as investors would result in royalty characterization. Second, they may seek to have the payments for the use of technoogy, etc. characterized as "rent" and thus utilize Section 543(a)(2) of the Code to facilitate their normal business operations.

Experience in the area described indicates that the development and use of technology in the United States, as well as the creation of jobs in technology-oriented businesses, are often actively discouraged by the existence of these problems and the related possible exposure to personal holding company tax. The problem might eventually be solved through specific legislative approval of one of the existing techniques now believed available. Alternatively, depending upon the ultimately desired scope of the term "royalties", perhaps a personal holding company exception for royalties derived in certain active businesses might be framed in parallel with the exception for certain rents now set out in Section 543(a)(2) of the Code.

The purpose of this comment, however, is not to propose a comprehensive legislative solution at this late date in the history of H.R. 10612. While I do believe that relief legislation may merit serious consideration by the Committee, action may await a future date when the manner can be more carefully studied. In conclusion, it is suggested that either (1) Section 1308 of the bill not be enacted until the entire situation can be more carefully studied, or (2) that the Congress in passing upon the subject of Section 1308 of the bill specifically leave open (as under existing law) the treatment of payments for technology and other intangibles to the extent outside of the scope of Section 543(a)(6) of the Code.

Statement by Bruce Norton, of the Law Firm of Snell & Wilmer—General Counsel for Arizona Public Service Co.

AMENDMENT TO PUBLIC LAW 86-278, SECTION 1323

Mr. Chairman and members of the Committee, my name is Bruce Norton, an attorney with the law firm of Snell & Wilmer which represents Arizona Public Service Company, a utility whose corporate headquarters is located in Phoenix, Arizona. Arizona Public Service Company is the operating agent for

[1] The position of *Rev. Rul. 71-596, supra*, if viewed as an attempt at a general definition, is not clearly supported by any authorities therein cited or, on balance, by any other known authorities.

the Four Corners Power Plant near Farmington, New Mexico. The total generating capacity of Four Corners is 2,085,000 kilowatts. Almost 91% of the electricity generated at the plant is transmitted in interstate commerce from New Mexico to the states of Arizona, Texas and California.

Two other participants in this plant are the Salt River Project and Tucson Gas & Electric Company. Collectively, we provide electrical service to the vast majority of consumers of electrical energy in the State of Arizona during 1975.

It is on behalf of these consumers that I appear before you in support of the amendment to Public Law 86-273, Section 1323. This amendment would prohibit a state from imposing taxes on electricity which discriminates against out-of-state manufacturers, wholesalers, retailers or consumers of electricity.

Many of you are aware that the State of New Mexico recently enacted an electrical generation tax. The amount of the tax is four-tenths of a mill per kilowatt hour of electricity generated. A copy of this law is attached to copies of this statement as Exhibit A. The end result of the legislation is to tax all electricity generated in New Mexico which moves in interstate commerce and is consumed outside New Mexico and to exempt from the generating tax all of the electricity generated and consumed in New Mexico.

In addition, New Mexico collects a 4% gross receipts tax on all retail sales of electricity to that state's consumers (see Exhibit B). In order to relieve the New Mexico consumer of the added cost of the generation tax, each utility is allowed a credit against the 4% gross receipts tax in an amount equal to that paid on the generation tax. Section 72-16A-16.1(b) NMSA reads as follows: "On electricity generated inside this state and consumed in this state which was subject to the electrical energy tax, the amount of such tax paid may be credited against the gross receipts tax due this state." (See Exhibit C.)

Utilities which have no retail sales in New Mexico, as in the case of Arizona Public Service, Salt River Project. Tucson Gas & Electric and Southern California Edison Company, are unable to take any credits against generation taxes paid. The net effect then, is that the electric consumers in New Mexico pay no generation tax and electric consumers outside New Mexico pay the entire amount.

In the case of the Four Corners Power Plant, the effect of this tax is to increase the cost of the electricity which moves in interstate commerce from New Mexico by nearly five million dollars in 1976. Energy costs for the consumers of electricity from the three Arizona companies involved in Four Corners are increasing approximately three million dollars annually because of this tax.

The five non-New Mexico participants in the Four Corners Project have filed an action against the State of New Mexico in the State District Court in Santa Fe, New Mexico. A copy of this filing is attached as Exhibit D. While the District Court has held initial hearings in the matter, the case will take a minimum of several years to reach final determination.

While the New Mexico legislation provides for this tax to self-destruct in 1984, as a practical matter, we do not expect this to happen because of long-range expenditure commitments that were enacted and signed into law as companion legislation.

Chapter 145, Laws of 1975 of New Mexico, appropriates an amount not to exceed 32 million dollars from the revenues derived from proceeds of the generation tax for the construction or improvement of New Mexico highways and roads.

Section 13-20-1, *et seq.*, NMSA provides for an appropriation, pursuant to the New Mexico Utility Supplement Act to be used as follows: 13-20-2. Legislative intent—It is the intent of the Legislature that the Utility Supplement Act (13-20-1 to 13-20-9) be used to assist recipients of federal supplemental security income benefits and recipients of aid to families with dependent children in meeting increased costs for *gas and electrical utilities to the maximum extent possible*. The appropriation made in the Utility Supplement Act shall be used to generate those federal funds which may be available. (Emphasis added.)

In fact, without the revenues provided by the Electrical Energy Tax Act, the Utility Supplement Act becomes inoperative, as can be seen by reading Section 13-20-9 NMSA: 13-20-9. No payment during injunction—If the state should be sued by a party seeking to prohibit the collection of the tax provided for in the Electrical Energy Tax Act (72-34-1 to 72-34-6), no payments shall be made under the Utility Supplement Act (13-20-1 to 13-20-9) during the pendency of the suit and no payments shall be made if the Electrical Energy Tax Act is ultimately held invalid in any suit.

The tax has caused a great deal of concern and consternation in Arizona and has received much attention in the state legislature and in the press. If the New Mexico tax is allowed to stand, I think it would be safe to guess that the Arizona Legislature at some point in the future will retaliate by placing a similar tax on electrical energy exported from Arizona. While no one can say for certain, retaliation by other southwestern states that are presently affected seems likely, as the tax has also caused considerable concern among utilities and energy consumers in California and Texas.

As most of us are now aware, electricity is no longer a luxury anywhere in the country, but rather, a necessity. The economy of the entire nation is dependent on a dependable and sufficient supply of energy at the lowest reasonable cost.

In order to provide adequate supplies of energy at reasonable cost, a significant trend among utilities in the Southwest has been to develop large, joint-venture plants that serve consumers in several states.

These multi-state plants provide major economies of scale, but more important, they are an efficient way of making maximum use of the limited number of plant sites that are available in the Southwest that have adequate water supplies and nearby fuel resources. Our Four Corners Power Plant is just one example. Its largest units are owned jointly by six utilities that provide energy to four states on a regular basis (New Mexico, Texas, Arizona and California) and to two other states in times of emergency (Utah and Nevada). Another example is the Navajo plant in Page, Arizona. It is also owned by six utility participants that provide energy to three states. Another example is the Mohave plant in Eastern Nevada. Four utilities participate in that project, providing energy to three states.

Still more projects of this type are in advance stages of planning in the Southwest. For example, the Palo Verde Nuclear Power Plant in Central Arizona will have a capacity of more than 3,000,000 kilowatts. Its owners include six utilities that provide energy to consumers in Arizona, California, New Mexico and Texas.

Such examples make it clear that the opportunity exists for nearly every state in the Southwest to retaliate against taxes of the kind imposed by the State of New Mexico by passing similar tax laws. Such retaliation could make it impossible for the electric industry to continue with economical joint ventures in energy development. Energy producers in the Southwest would be forced to step backward in time by returning to a system of small, local generating plants that would in many cases be required to burn expensive imported oil as power plant fuel.

In conclusions, we believe most strongly that taxes such as the New Mexico generation tax are contrary to the public interest and should be prohibited. Mr. Chairman and members of the Committee, on behalf of the consumers of electrical energy in Arizona and the entire Southwest, we respectfully urge favorable and quick consideration of the amendment before you. Thank you.

Attachments.

[Exhibit A]

NEW MEXICO STATUTES ANNOTATED

REPLACEMENT VOLUME 10—PART 2

1975 Pocket Supplement

Published Under the Supervision of the New Mexico Compilation Commission

Amendments to Acts and New Laws Enacted by the Legislature Since Publication of Replacement Volume 10, Part 2, and Annotations Supplementing the Replacement Volume, and The Standards of Title Examination of the State Bar of New Mexico.

Edited by Larry E. Edmonson, A.B., J.D., and the Publishers' Editorial Staff, The Allen Smith Co., Publishers, Indianapolis, Ind.

72-33-11. Sale of property to pay tax.—A personal representative may sell so much of any property as is necessary to pay the taxes due under the Estate Tax Act [72-33-1 to 72-33-12]. A personal representative may sell so much of any property specifically bequeathed or devised as is necessary to pay the proportionate amount of the taxes due on the transfer of the property and the fees and expenses of the sale, unless the legatee or devisee pays the personal representative the proportionate amount of the taxes due. (History: Laws 1973, ch. 345, § 11.)

72-33-12. Liability for failure to pay tax before distribution or delivery.—A. Any personal representative who distributes any property without first paying, securing another's payment of, or furnishing security for payment of the taxes due under the Estate Tax Act [72-33-1 to 72-33-12] is personally liable for the taxes due to the extent of the value of any property that may come or may have come into his possession. Security for payment of the taxes due under the Estate Tax Act shall be in an amount equal to or greater than the value of all property that is or has come into the possession of such personal representative, as of the time such security is furnished.

B. Any person who has the control, custody or possession of any property and who delivers any of the property to the personal representative or legal representative of the decedent outside New Mexico without first paying, securing another's payment of, or furnishing security for payment of the taxes due under the Estate Tax Act is liable for the taxes due under the Estate Tax Act to the extent of the value of the property delivered. Security for payment of the taxes due under the Estate Tax Act shall be in an amount equal to or greater than the value of all property delivered to the personal representative or legal representative of the decedent outside New Mexico by such a person. (History: Laws 1973, ch. 345, § 12.)

Title of act

An act relating to taxation; providing for an estate tax with respect to decedents dying on or after July 1, 1973; enacting the Estate Tax Act; amending and repealing certain sections of the NMSA 1953.—Laws 1973, ch. 345.

Temporary Provision—Savings Clause

Section 15 of ch. 345, Laws 1973 read: "The Estate Tax Act does not apply to transfers of the net estates of decedents who die prior to July 1, 1973. Any taxes, the liability for payment of which was incurred by reason of events occurring prior to the effective date of the provisions of the Estate Tax Act, shall be paid, collected and enforced as provided by statutes in force at the time the events occurred."

ARTICLE 34—ELECTRICAL ENERGY TAX ACT

Section 72-34-1. Short title.
72-34-2. Definitions.
72-34-3. Imposition of tax—Rate—Renomination as electrical energy tax.
72-34-4. Measurement and recording of kilowatt hours of electricity.
72-34-5. Reports—Remittances.
72-34-6. Relief from other taxes.

72-34-1. Short title.—Sections 1 through 6 of this act [72-34-1 to 72-34-6] may be cited as the "Electrical Energy Tax Act." (History: Laws 1975, ch. 263, § 1.)

Compiler's notes

This act became effective July 1, 1975.

Title of act

An act relating to taxation; imposing a tax on the generation of electricity; amending sections 45-4-28 and 72-13-24 NMSA 1953 (being Laws 1939, chapter 47, section 28 and Laws 1965, chapter 248, section 12, as amended); enacting a new section 72-16A-16.1 NMSA 1953.—Laws 1975, ch. 263.

Cross-References

Tax Administration Act applicable, 72-13-14.

Utility Supplement Act payments withheld pending challenge to Electrical Energy Tax Act, 18-20-9.

72-34-2. Definitions.—As used in the Electrical Energy Tax Act [72-34-1 to 72-34-6]:

A. "bureau" means the New Mexico bureau of revenue;

B. "generation" includes manufacture and production;

C. "electricity" includes electrical energy and electrical power;

D. "person" means any individual, estate, trust, receiver, co-operative association, electric co-operative, club, corporation, company, firm partnership, joint venture, syndicate, association, irrigation district, electrical irrigation district and any utility owned or operated by a county or municipality, and also means to the extent permitted by law, any federal, state or other governmental unit or subdivision or an agency, department or instrumentality; and

E. "sale" means selling or transferring to any person for consumption, use or resale and includes barter and exchange. (History: Laws 1975, ch. 263, § 2.)

72-34-3. Imposition of tax—Rate—Denomination as electrical energy tax.—

A. For the privilege of generating electricity in this state for the purpose of sale, whether the sale takes place in this state or outside this state, there is imposed on any person generating electricity a temporary tax, applicable until July 1, 1984, of four-tenths of one mill ($.0004) on each net kilowatt hours of electricity generated in New Mexico.

B. The tax imposed by this section shall be referred to as the "electrical energy tax." (History: Laws 1975, ch. 263, § 3.)

72-34-4. Measurement and recording of kilowatt hours of electricity.—Persons subject to the imposition of the electrical energy tax shall maintain accurate measuring devices and records to measure and record the daily and cumulative monthly and yearly totals of kilowatt hours of electricity generated or distributed in this state. (History: Laws 1975, ch. 263, § 4.)

72-34-5. Reports—Remittances.—Each person subject to the imposition of the electrical energy tax shall file a return on forms provided by and with the information required by the bureau and shall pay the tax due on or before the twenty-fifth day of the second month following the month in which the taxable event occurs. (History: Laws 1975, ch. 263, § 5.)

72-34-6. Relief from other taxes.—Unless otherwise specified by statute the imposition of the electrical energy tax shall not act to relieve any person or activity from any other tax levied by the state of New Mexico or its political subdivisions. (History: Laws 1975, ch. 263, § 6.)

Nonseverability clause

Section 10 of ch. 263, Laws 1975 provided: "Legislative Intent.—It is the intent of the legislature that this entire 1975 act be considered not severable, and should any part thereof be declared unconstitutional, the entire act should be declared void."

[Exhibit B]

NEW MEXICO STATUTES ANNOTATED

REPLACEMENT VOLUME 10—PART 2

1975 Pocket Supplement

Published Under the Supervision of the New Mexico Compilation Commission

Amendments to Acts and New Laws Enacted by the Legislature Since Publication of Replacement Volume 10, Part 2, and Annotations Supplementing the Replacement Volume, and The Standards of Title Examination of the State Bar of New Mexico.

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The fact that there are only four block manufacturers who are customers of corporation leasing machinery does not make the transaction "occasional" or "isolated" under subsection G of 72-16-2 (since repealed), and a conclusion that the corporation was not "engaging" in business did not follow. Besser Co. v. Bureau of Revenue, 74 N. M. 377, 394 P. 2d 141, 146.

Legislative intent

The legislature in enacting the Emergency School Tax Act intended to tax the privilege of conducting businesses by miners, manufacturers, public utilities, contractors, operators of amusement enterprises, operators of business services, factors, brokers and agents and to exempt sales to United States, state agencies, societies, hospitals and fraternal and religious organizations not for profit. Dikewood Corp. v. Bureau of Revenue, 74 N. M. 75, 390 P. 2d 661, 664.

Although the legislature changed "full sale price" to "Full sale contract amount" in subsection F, it did not intend to tax that which was not received or never would be received as evidenced by the fact that the phrase "cash discount allowed and taken" is excluded from the definition of "gross receipts." Davis v. Commissioner of Revenue, 83 N. M. (App.) 152, 489 P. 2d 660.

Nature of tax

While the Emergency School Tax Act may be called a "sales tax," the legislature and the Supreme Court have properly called it a "privilege tax." Dikewood Corp. v. Bureau of Revenue, 74 N. M. 75, 390 P. 2d 661, 664.

Sales at retail

The receipts of a corporation, which leased machinery to four New Mexico users, were taxable as sales at retail within the meaning of subsection H of 72-16-2 (since repealed). Besser Co. v. Bureau of Revenue, 74 N. M. 377, 394 P. 2d 141, 145.

Sales for consumption

The definition of "consumption" contained in subsection I of 72-16-2 (since repealed) had no application where tax was imposed upon gross receipts from leasing of machinery. Besser Co. v. Bureau of Revenue, 74 N. M. 377, 394 P. 2d 141, 145.

Time-price differential

Where taxpayer made credit installment sales on contract, receiving a down payment and selling the contract to finance company which furnished the contract form and approved the credit of the purchasers before the contracts were executed and paid the taxpayer the total cash sales price minus the amount he received as a down payment, and the taxpayer did not receive and never would receive any time-price differential, such amount was not "gross receipts" to him. Davis v. Commissioner of Revenue, 83 N. M. (App.) 152, 489 P. 2d 660.

72-16A-4. Imposition and rate of tax—Denomination as "gross receipts tax."—A. For the privilege of engaging in business, an excise tax equal to four per cent [4%] of gross receipts is imposed on any person engaging in business in New Mexico.

B. The tax imposed by this section shall be referred to as the "gross receipts tax." (History: Laws 1966, ch. 47, § 4; 1969, ch. 144, § 2.)

Amendments

The 1969 amendment increased the tax imposed by subsection A from three per cent to four per cent of gross receipts.

Opinions of Attorney General

1967-68, Nos. 67-97, 67-135, 68-36.

Application

Where services performed for other banks' accounts were not reasonably necessary or incidental to functions or business of national banking association, state was not precluded from levying gross receipts tax on association's receipts collected for such services by federal law since association could pass tax on to banks for which it performed such services and therefore association was not real taxpayer. First Nat. Bank of Sante Fe v. Commissioner of Revenue, 80 N. M. (App.) 699, 460 P. 2d 64, cert. den. 80 N. M. 707, 460 P. 2d 72, appeal dismissed 397 U. S. 661, 25 L. Ed. 2d 643, 90 S. Ct. 1407.

Engaging in Business

Nonprofit corporate taxpayer which engaged in business for the benefit of members, but not for the benefit of corporation itself, was not engaging in business within the meaning of this statute. American Automobile Assn., Inc. v. Bureau of Revenue, 87 N. M. 330, 533 P. 2d 103, reversing 86 N. M. (App.) 569, 525 P. 2d 929.

[Exhibit C]

NEW MEXICO STATUTES ANNOTATED

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72-16A-16. Credit—Compensating tax.—A. If on property bought outside this state, a gross receipts, sales, compensating or similar tax has been levied by another state or political subdivision thereof on the transaction by which the person using the property in New Mexico acquired the property and such tax

has been paid, the amount of such tax paid may be credited against any compensating tax due this state on the same property.

B. When the receipts from the sale of real property constructed by a person in the ordinary course of his construction business are subject to the gross receipts tax, the amount of compensating tax previously paid by the person on materials which became an ingredient or component part of the construction project and on construction services performed upon the construction project, may be credited against the gross receipts tax due on the sale. (History: Laws 1966, ch. 7, § 16; 1973, ch. 342, § 1.)

Title of act

An act relating to taxation; amending section 72-16A-16 NMSA 1953 (being Laws 1966, chapter 47, section 16) to provide a credit against gross receipts taxes on receipts from the sale of certain real property for compensating taxes paid on certain construction materials and services furnished in connection with a construction project.—Laws 1973, ch. 342.

Amendments

The 1973 amendment designated the former section as subsection A and added subsection B.

Effective date

Section 2 of ch. 342, Laws 1973 read: "The effective date of the provisions of this act is July 1, 1973."

Saving clause

Section 18 of ch. 47, Laws 1966 read: "The Gross Receipts and Compensating Tax Act does not apply to any taxable event that occurred prior to its effective date. The payment, collection or enforcement of taxes, the liability for payment of which was incurred by reason of events occurring prior to the effective date of the Gross Receipts and Compensating Tax Act, is to be accomplished according to the provisions of the applicable statutes previously in force in every manner as though the Gross Receipts and Compensating Tax Act had not been enacted." Section 17 of ch. 47, Laws 1966 [72-16A-17] was repealed by Laws 1975, ch. 116, § 6.

72-16A-16.1. Credit—Gross receipts tax.—A. If on electricity generated outside this state and consumed in this state, an electrical energy tax or similar tax on such generation has been levied by another state or political subdivisions thereof, the amount of such tax paid may be credited against the gross receipts tax due this state.

B. On electricity generated inside this state and consumed in this state which was subject to the electrical energy tax, the amount of such tax paid may be credited against the gross receipts tax due this state.

C. The credit under subsections A or B of this section shall be assigned to the person selling the electricity for consumption in New Mexico on which New Mexico gross receipts tax is due, and the assignee will reimburse the assignor for the credit. (History: C, 153, § 72-16A-16.1 enacted by Laws 1975, ch. 263, § 9.)

Conseverability clause

Section 10 of ch. 263, Laws 1975 provide: "Legislative Intent.—It is the intent of the legislature that this entire 1975 act [72-34-1 to 72-34-6] be considered not severable, and should any part hereof be declared unconstitutional, the entire act should be declared void."

Effective date

Section 11 of ch. 263, Laws 1975 read: "The effective date of the provisions of this act is July 1, 1975."

72-16A-17. Repealed.—Section 72-16A-17 (Laws 1966, ch. 47, § 17), making it unlawful to advertise that tax was not a part of price of property or service sold, was repealed by Laws 1975, ch. 116, § 6.

72-16A-18. Cross references.—Any section of the New Mexico Statutes Annotated, 1953 Compilation, that refers to the emergency school tax, the Emergency School Tax Act, the compensating tax or the Compensating Tax Act of 1939 shall be construed to refer to the Gross Receipts and Compensating Tax Act [72-16A-1 to 72-16A-19], the Resources Excise Tax Act [72-16A-20 to 72-16A-29] or the Liquor Excise Tax Act [46-7-15 to 46-7-22], whichever is appropriate. (History: Laws 1966, ch. 47, § 19.)

72-16A-19. Compiling instructions.—The Gross Receipts and Compensating Tax Act [72-16A-1 to 72-16A-19] shall be compiled as Article 16(A) of Chapter 72 of the New Mexico Statutes Annotated. The Resources Excise Tax Act [72-16A-20 to 72-16A-29] shall be compiled in Article 16(A) of Chapter 72 of the New Mexico Statutes Annotated following the Gross Receipts and Compensating Tax Act. (History: Laws 1966, ch. 47, § 20.)

Separability clause

Section 21 of ch. 47, Laws 1966 read: "To insure orderly and efficient collection of the public revenue, if any part or application of the Gross Receipts and Compensating Tax Act is held invalid, the remainder of the Gross Receipts and Compensating Tax Act or its application to other situations or persons shall not be affected."

Repealing clause

Section 22 of ch. 47, Laws 166 repealed 72-16-2 through 72-16-19 and 72-17-1 through 72-17-7.1.

Effective date

Section 23 of ch. 47, Laws 1966 read: "The effective date of the Gross Receipts and Compensating Tax Act shall be July 1, 1967."

[Exhibit D]

STATE OF NEW MEXICO, COUNTY OF SANTA FE, IN THE DISTRICT COURT

ARIZONA PUBLIC SERVICE CO., EL PASO ELECTRIC CO., SALT RIVER PROJECT AGRICULTURAL IMPROVEMENT AND POWER DISTRICT, SOUTHERN CALIFORNIA EDISON CO., TUCSON GAS & ELECTRIC CO.,

PLAINTIFFS,

v.

FRED O'CHESKEY, COMMISSIONER OF REVENUE, BUREAU OF REVENUE, STATE OF NEW MEXICO,

DEFENDANTS

COMPLAINT

Plaintiffs bring this action for declaratory judgment pursuant to the New Mexico Declaratory Judgment Act, Chapter 340, Laws 1975, with respect to the constitutionality and validity of the Electrical Energy Tax Act, Chapter 263, Laws 1975, and for their complaint herein, state:

1. Arizona Public Service Company, an Arizona corporation, generates, transmits, distributes and sells electrical energy within the State of Arizona, and is regulated as a public service corporation by the Arizona Corporation Commission.

2. El Paso Electric Company, a Texas corporation, generates, transmits, distributes and sells electrical energy within the States of New Mexico and Texas, and is regulated as a public utility in New Mexico by the New Mexico Public Service Commission and in Texas by the cities of El Paso, Van Horn, Anthony and Clint.

3. Salt River Project Agricultural Improvement and Power District (hereinafter "Salt River Project"), a political subdivision of the State of Arizona, operating a federal reclamation project pursuant to contracts with the Secretary of the Interior, generates, transmits, distributes and sells electrical energy within the State of Arizona.

4. Southern California Edison Company, a California corporation, generates, transmits, distributes and sells electrical energy within the State of California, and its regulated as a public utility by the California Public Utilities Commission.

5. Tucson Gas & Electric Company, an Arizona corportation, generates, transmits, distributes and sells electrical energy within the State of Arizona, and is regulated as a public service corporation by the Arizona Corporation Commission.

6. Fred O'Cheskey is Commissioner of the Bureau of Revenue of the State of New Mexico. The Bureau of Revenue is the agency of state government charged with the administration and enforcement of the Electrical Energy Tax Act.

7. The Four Corners Power Plant is an electrical generating station composed

of five generating units and related facilities located on Indian lands leased from the Navajo Nation under Leases dated December 1, 1960 and July 1, 1966, duly approved by the Navajo Tribal Council and the Acting Secretary of the Interior.

8. Arizona Public Service Company owns and operates generating units Nos. 1, 2 and 3 at the Four Corners Power Plant. Arizona Public Service Company, El Paso Electric Company, Public Service Company of New Mexico, Southern California Edison Company and Tucson Gas & Electric Company each owns an undivided interest in generating units Nos. 4 and 5 at the Four Corners Power Plant.

9. The San Juan Generating Station is an electrical generating station composed of two generating units (one operational and one under construction) and related facilities located in San Juan County, near Waterflow, New Mexico.

10. Public Service Company of New Mexico and Tucson Gas & Electric Company each owns an undivided one-half (½) interest in the San Juan Generating Station.

11. Certain of the plaintiffs (Arizona Public Service Company and El Paso Electric Company) sell electrical energy generated from the Four Corners Power Plant to a foreign country, Mexico.

12. As shown on the Map of Principal Transmission Lines annexed hereto as Exhibit "A", the electrical system of each plaintiff is directly interconnected with the system of each other plaintiff and with the electrical systems of Public Service Company of New Mexico, the U.S. Bureau of Reclamation, and Utah Power and Light Company. Southern California Edison Company's system is also directly connected with San Diego Gas & Electric Company, the Department of Water and Power, City of Los Angeles, the Pasadena Department of Water and Power, and Pacific Gas & Electric Company; its system is indirectly but substantially interconnected with the several Pacific Northwest systems and through them to other utility systems in the western United States. The interconnected transmission lines thus constitute an interstate grid encompassing the West.

13. As a consequence of the system interconnections described in the preceding paragraph, the demand for electricity in the major urban centers served by the plaintiffs in Arizona, southern California, and the El Paso area of West Texas determines in substantial degree the amount of electrical energy generated at generating stations located in New Mexico (as well as those in other states). The electrical energy generated in New Mexico in response to such demand to which each plaintiff is entitled from its generation facilities is instantaneously transmitted over existing transmission lines to that plaintiffs' service area.

14. All of the plaintiffs' above-described transactions in the generation and transmission of electrical energy at the Four Corners Power Plant and the San Juan Generating Station, and the distribution and sales of such electrical energy, are in the course of commerce among the States and the Navajo Tribe of Indians, except for the aforesaid sales of electrical energy to Mexico, certain relatively insignificant sales made by Arizona Public Service Company within New Mexico to Utah International Inc., for operation of the Navajo Mine which provides the fuel for the Four Corners Power Plant, and for certain sales by El Paso Electric Company within its service area in the State of New Mexico. All other sales or exchanges of electrical energy in New Mexico by any plaintiff are wholesale sales to other electric utility companies on the interconnected systems in interstate commerce under the exclusive jurisdiction of the Federal Power Commission. Such interstate sales give rise to no New Mexico gross receipts tax liability under the New Mexico Gross Receipts and Compensating Tax Act.

15. Each plaintiff pays income, ad valorem, franchise and other taxes imposed by the State of New Mexico or its political subdivisions on it and other taxpayers similarly situated, and income, ad valorem, sales and use (or their equivalent), franchise, excise and other taxes imposed by the state of its incorporation on it and other taxpayers similarly situated.

16. Section 3 of the Electrical Energy Tax Act, Chapter 263, Laws 1975 (hereinafter the "Act"), purports to impose on persons generating electricity a privilege tax of four-tenths of one mill "on each net kilowatt hour of electricity generated in New Mexico" for the purpose of sale.

17. Subsection 9B of the Act provides that the electrical energy tax paid on electricity generated and consumed in New Mexico may be credited against the gross receipts tax due New Mexico. No credits of any type are provided with

respect to the electrical energy tax imposed upon electricity generated in New Mexico but transmitted and consumed outside New Mexico.

18. Subsection 9C of the Act directs that the credit for electrical energy tax paid on electricity generated and consumed in New Mexico shall be assigned to the person selling the electricity for consumption in New Mexico on which New Mexico gross receipts tax is due, and further requires the assignee of such credit to reimburse the assignor for the amount of the credit so assigned.

19. The practical operation and effect of Sections 3 and 9 of the Act is to tax the generation of electricity in New Mexico but shift the incidence of such tax to those who sell or consume that electricity outside New Mexico since the person generating and selling electricity for consumption in New Mexico receives either a credit (under Subsection 9B) against his gross receipts tax due New Mexico or a reimbursement (under Subsection 9C) in an amount equal to the electrical energy tax payable on such electricity.

20. Plaintiffs' retail sales of electrical energy transmitted from generating facilities in New Mexico to plaintiffs' respective services areas in Texas, Arizona and California are subject to certain taxes imposed by those states, or the political subdivisions thereof, or both. Such taxes are variously denominated as sales or other types of excise taxes, but are uniformly imposed upon, or passed on to consumers of electricity in those states.

21. There is no provision of law in Texas, Arizona or California whereby any of the plaintiffs are entitled to any credit, offset or rebate for the electrical energy tax imposed on them by New Mexico.

22. Public Service Company of New Mexico, an electric public utility regulated by the New Mexico Public Service Commission, with respect to its share of electrical energy generated at the Four Corners Power Plant and the San Juan Generating Station, will in practical effect sustain no additional tax burden under the Electrical Energy Tax Act due to the provisions of Subsections 9B and 9C of the Act permitting the amount of electrical energy tax paid to be assigned or credited against its gross receipts tax liability due the State of New Mexico.

23. El Paso Electric Company will in practical effect, sustain no additional tax burden under the Electrical Energy Tax Act with respect to the electrical energy generated in New Mexico and sold by it to consumers in New Mexico due to the provisions of Subsections 9B and 9C of the Act allowing the electrical energy tax to be credited against its New Mexico gross receipts tax liability.

24. Plains Electric Generation and Transmission Cooperative, a New Mexico corporation, generates electrical energy at its generating plant near Algodones, New Mexico, and transmits and sells electrical energy solely to New Mexico electric utilities which are its members; however, by reason of Subsections 9B and 9C of the Act, it will incur no additional tax burden due to the Electrical Energy Tax Act.

25. Plaintiffs are informed and believe, and therefore allege, that no additional tax liability under the Electrical Energy Tax Act is incurred by any other person (as defined in the Electrical Energy Tax Act) engaged in the same business as plaintiffs upon electrical energy generated and consumed in New Mexico, due to the availability of the crediting provisions provided for under Subsections 9B and 9C of the Act.

26. Plaintiffs are informed and believe, and therefore allege, that all, or virtually all, of the additional taxes claimed to be due under the Electrical Energy Tax Act, after application of Subsections 9B and 9C of the Act, will be borne by those persons, including plaintiffs, engaged in the generation of electricity in New Mexico which is transmitted across and consumed outside the boundaries of the State of New Mexico.

27. Plaintiffs are informed and believe, and therefore allege, that the Act was enacted for the purpose of and the view to placing the exclusive burden of paying additional tax revenues to the State of New Mexico upon transactions in commerce among the several states and with the Indian Tribes.

28. The language of the Act, coupled with the practical application of the tax, constitutes a tax on the privilege of engaging in commerce among the several states.

29. Plaintiffs contend that the Act is unconstitutional and void for each and every one of the following reasons:

A. The Electrical Energy Tax Act violates the Commerce Clause of Article I, Section 8 of the United States Constitution by deliberately and invidi-

ously discriminating against and imposing direct and multiple burdens upon each plaintiff's interstate commerce in the transmission and sale of electricity.

B. Application of the Electrical Energy Tax to these plaintiffs, measured by electricity generated in New Mexico for transmission and sale in interstate commerce, is arbitrary, capricious and unreasonable and denies to each plaintiff the equal protection of the law, and the rights, privileges and immunities enjoyed by other members of the class defined as persons generating electrical energy in New Mexico, in violation of Section 1 of the Fourteenth Amendment to the United States Constitution. and of Article II, Section 18, and Article IV, Section 26 of the New Mexico Constitution.

C. The Act deprives plaintiffs of property without due process of law in violation of Section 1 of the Fourteenth Amendment to the United States Constitution and Article II, Section 18 of the New Mexico Constitution.

D. The Act violates Article I, Section 8, Clause 3, and Article I, Section 10, Clause 2 of the United States Constitution.

30. Plaintiffs are informed and believe, and therefore allege, that defendants contend the Act is constitutional with respect to the matters set forth in paragraph No. 29 of this Complaint.

31. The plaintiffs, being persons whose rights, status or other legal relations are affected by the Act, request that the Court determine the questions of validity arising under the Act.

32. A genuine controversy exists between the plaintiffs and defendants with respect to the matters hereinbefore alleged; however, there is no controversy respecting the amount of the tax which would be payable by any plaintiff, if the Act is valid, nor with respect to the form or accuracy of any assessment of tax thereunder.

33. Due to the necessity to construe and apply provisions of the United States Constitution and the New Mexico Constitution in order to resolve the controversy between plaintiffs and defendants, plaintiffs have no other plain, speedy and adequate remedy.

34. All conditions precedent to the commencement and maintenance of this action have occurred or been met.

Wherefore, plaintiffs pray:

A. That this Court adjudge and declare the Electrical Energy Tax Act, Chapter 263, Laws 1975, to be unconstitutional and void.

B. That upon final hearing and determination the defendants be enjoined from enforcing the Electrical Energy Tax Act and plaintiffs have such other and further relief as may be proper in the premises.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., January 29, 1975.

Mr. SHELDON R. WAXMAN,
Feiwell, Galper & Lasky, Attorneys at Law,
Chicago, Ill.

DEAR MR. WAXMAN: Thank you very much for your kind letter and the enclosed copy of your letter to Congressman Ullman.

I could not agree more that the Internal Revenue Code should be totally reviewed and hopefully in the near future, re-written in such fashion as to serve as a revenue code, not a collection of policy and subsidy provisions. The stimulation of certain segments of the populace or of business, under the guise of the revenue law, results in policy distortions and large revenue losses to the Treasury.

Thank you for sharing your views.

Sincerely,

ABNER J. MIKVA,
U.S. Congressman,
10th District, Illinois.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., January 3, 1974.

MR. SHELDON R. WAXMAN,
Feiwell, Galpher & Lasky,
Chicago, Ill.

DEAR MR. WAXMAN: Thank you for your recent and very thoughtful letter regarding problems in the tax code.

In my judgment, it is not possible to separate taxing from tax policy. However, I believe that it is possible to have a simpler and less complex tax code, and that will be one of the goals of Ways and Means action in the upcoming Congress. Your analysis will be helpful in this effort, and I appreciate your taking the time to write.

With every good wish,

Sincerely,

AL ULLMAN,
Member of Congress.

IF I WERE THE TAX COLLECTOR . . .

(By Robert J. Dulsky)

When I suffer delusions of grandeur, they center sometimes on my occupying exactly the opposite side of the desk to the one where I now spend my working hours. That is, being the U.S. commissioner of the Internal Revenue Service instead of heading a tax preparation company. I find myself speculating: If I were the IRS commissioner, what might I do that they haven't been doing?

And the answer is—I would, at least, *try* quite a lot.

For the commissioner has the power not only to enforce tax laws but to influence them. He is viewed by Congress as the expert. He could therefore do his country an enormous amount of good by starting to lobby for some changes. Yet few if any of the recent commissioners have done so.

What's wrong with our present tax laws is that we have created a monster. It happens so frequently in government: over the years, to correct inequities and to meet social aims and to block loopholes and to solve problems, we have added endlessly until today the IRS requires thousands of enforcers and more thousands of interpreters. And individuals and businesses require millions of manhours satisfying the tax laws or the audits and disputes which result from them.

Who says it's wrong? I do; you probably do; and Treasury Secretary William Simon summed it up when he commented in a recent speech that the complexity of the present tax structure is "threatening to erode the basic faith in the fairness of the system. Many people believe taxes are being imposed upon them without their consent, that too many of their fellow taxpayers are escaping their responsibilities through dozens of loopholes, and the code itself has become a labyrinth of legal doubletalk."

For a solution, if I were commissioner of Internal Revenue, I would try posing a series of questions on the premise that you solve problems by first asking the right questions. And here is the main one:

Wouldn't an utterly simple flat tax, with no deductions, solve a lot of problems? If you collected 12 per cent of Americans' incomes today—not allowing any exemptions or deductions or other adjustments—you would collect about the same as the existing tax system does.

[This assumes leaving corporate taxes where they are and similarly not changing other taxes. If you adjusted these systems as well, then the 12 per cent figure could become some other percentage. It is also possible, of course, to graduate the 12 per cent to, say, a zero to 20 per cent system if you want to continue the present idea of lesser taxes for the poor and greater for the well-off.]

The flat tax system offers one immensely bright benefit: a much smaller IRS audit and legal arm. More than 80 per cent of all personal incomes are already reported to the government via W-2 and 1099 forms. Computers could rapidly

check for tax payments and mathematics for accuracy, and no auditors and enforcers would be needed except for the remaining 20 per cent or fewer taxpayers. Or you could turn the system around and let the government computer simply send the taxpayer a bill—along with, of course, a form for the taxpayer to register corrections where required.

Other questions are worth study. Might we eliminate the civil service mantle from more levels of IRS, so we might reward and encourage the courtesy-minded and service-minded personnel, and penalize and reduce the number of those who are antagonistic to the taxpayer? There are too many of the latter.

What about offering arbitration instead of the courts at the taxpayer's option in case of dispute; arbitration in which both sides agree in advance to be bound by the arbitrator's decisions, with no appeal possible?

Asking questions, of course, is easy, solutions are much more difficult and, in the case of the tax laws, also are confused by social issues because some of our tax law is designed to force what is considered to be desirable social change or pressure.

Yet the paradox of our system is that virtually all Americans are obeying a body of law which they no longer trust. The question is how long they will do so. and in that question lies a real threat to the system as it exists now.

IN THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

(No. 75-1894)

UNITED STATES OF AMERICA AND DAVID J. FEDDOR, REVENUE AGENT, INTERNAL REVENUE SERVICE,

APPELLANTS,

v.

J. RICHARD DEMA,

APPELLEE

ON APPEAL FROM THE ORDER OF THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLNOIS

BRIEF FOR THE APPELLEES—ISSUES

(1) Whether, under the facts of this case, the trial court had equitable jurisdiction in a proceeding brought by the Government seeking equitable enforcement of an IRS summons, to deny the IRS further access to those records.

(2) Whether, if this Court holds the "Anti-Injunction Act" applicable to the order of June 20, 1975, the taxpayer met the appropriate standards to obtain equitable relief.

(3) Whether the trial court had jurisdiction to reopen the case after it had been dismissed without prejudice.

(4) Whether the order entered by the lower Court was substantiated by the evidence and was sufficiently specific to proscribe future conduct.

STATEMENT OF THE CASE

The Appellee generally agrees with the "Statement of the Case" presented by the government with the following exceptions:

1. The government's Petition to Enforce IRS Summons was filed on May 10, 1974 and not June 6, 1974 as stated. (R.1). Government's Brief at page 2.[1]

2. On February 7, 1975, the trial Court quashed the Summons concerning the tax liability of J. Richard and Sally A. Dema for the years 1971 and 1972 which requested corporate records of the Subchapter S corporation, relating to its 1971 fiscal year, ending January 31, 1971, and did not quash a summons "for taxpayer's personal records", as stated. (R. 36). Government's Brief at page 3.

[1] It should be noted that the Summons relating to the tax liability of Tabcor, Inc. was admittedly a reinspection. See Exhibit D attached to the Petition (R. 1). However. the District Director's reinspection only was authorized for the first 3 quarters of 1970 and the first and fourth quarters of 1971. And, yet, the Summons (Exhibit A) requested all 4 quarters of 1971 and the Summons on the Dema's (Exhibit B) required Tabcor's documents for all 4 quarters of 1970.

3. The records requested by the IRS in order to resolve a clearly unfounded tax deficiency made in April, 1975 against the Demas required the production of records relating to Tabcor's 1971 fiscal year, ending January 31, 1971 on which the statute of limitations had expired on April 15, 1974. (R.40 and 43 at p. 4).

Although the government has studiously refrained from any reference to the testimony in this case, it is important for this Court to be familiar with that testimony.

J. RICHARD DEMA, FEBRUARY 7, 1975 (R.39)

In 1970 and 1971, IRS agents looked through Tabcor's books and records in connection with an audit of 1971 employment returns (941's). Tr. at 5. Tabcor's liability for those years were paid and those years were closed out in February and approximately June of 1973. Tr. at 5 and 8.

The IRS was only concerned with 941's and 11 quarters in total were involved—a couple in 1969, all of 1970 and 1971. Tr. at 9. The IRS did not challenge his practice with respect to independent contractors at that time. Tr. at 10.

IRS agent David Feddor, appellant herein, first contacted J. Richard Dema in February of 1973. Feddor wanted to examine the same books and records that the other IRS agents had seen and Feddor was told that there shouldn't be any need to review the same records. Tr. at 11.

Feddor stated that he was interested in confirming figures on the 1120-S return and that he wasn't, apparently, interested in reviewing the 941's. Tr. at 12–13.

Feddor came out to Tabcor at the end of March, 1973 and was given desk space and everything that he requested. He asked for Tabcor's cash receipts and disbursements journal, 1099's and 941's for fiscal 1971, which was the year for which Tabcor's liability had been paid. Tr. 14.

The next thing that happened was that people who had worked for Tabcor told Dema that Feddor had come to their homes to advise them that Tabcor was being investigated by the IRS. Tr. at 17.

In June, 1973, Tabcor's accountant had finished with Feddor and in August, 1973, Feddor returned to Tabcor and stated he wanted to "look at the same books" and records he had previously seen. Feddor had said that the figures on the 1120-S return were still irreconcilable and Feddor was allowed to again review the same books and records. Tr. at 19–20.

At a meeting, Feddor stated that he was pursuing Tabcor's liability for withholding taxes, but he asked for an extension on Dema's personal taxes. When the extension was not forthcoming, Feddor hit the Dema's with a $100.00 personal income tax deficiency for 1970, a foundationless tax determination. Tr. at 33.

Feddor was never refused anything but was told that Dema had supplied 941's for 1972 and 1973 to two other agents, since his last visit. Tr. at 35. "At no time did Mr. Feddor ask for anything to do with 1972 and 1973, books, records or anything, nor did I show him anything because he never asked until that subpoena (summons)." Tr. at 36.

". . . there is not one single quarter of 1972 or 1973 that I have not supplied at least three separate copies of to three separate agents in every quarter and I was asked on everyone of them." Tr. at 37.

For 1971, the IRS assessed Tabcor for withholding an amount equal to the total dollar volume of Tabcor for that year. Tr. at 55.

DAVID FEDDOR, FEBRUARY 7, 1975

Denies that previous agents looked at records for 1972 and 1973. Tr. at 39. He was an employment tax specialist. Tr. at 42. Appears to admit that he used the 1120–s question as a guise to get at Tabcor's records. Tr. at 43. He states he wasn't gathering information for any other agent of government, although he admitted other agent's do this. Tr. at 44. He caused an assessment to be made for 1970. He caused an assessment on Tabcor for 1970 941's, although they had been previously paid and he had examined all of Tabcor's records for 1971, which was over 125% of Tabcor's total gross revenue for that year. Tr. at 50 and 52.

TRIAL COURT, FEBRUARY 7, 1975

After the foregoing testimony in an attempt to reconcile the conflict, the trial court directed Dema to again provide certain records to Feddor and the summons directed personally to the Dema's was quashed. Tr. 53–64.

The records requested were turned over and the case dismissed without prejudice by agreement. (R. 38).

After dismissal of the case, Feddor issued a personal deficiency against the Demas for 1971. This was not contested by the government in argument before the Court. This deficiency was in addition to the unfounded deficiency of $100.00 previously issued against the Dema's for 1970 and Feddor refused to have this deficiency withdrawn without being given access to Tabcor's books and records going back to 1967 and records relating to Tabcor's fiscal year ending January 31, 1971, which was barred by the statute of limitations. (R. 40).

In response to the actions of the IRS subsequent to the dismissal on April 8, 1975, the trial court entered its order of June 20, 1975 (R. 42 and 43). The basis of that order is reflected by the following comment of the trial court: "I think there is a limitation, an absorption point, a saturation point in some of these things. They are just going far out of their way in this case." R. 43—Tr. at 7.

It is from the order of June 20, 1975 that the government has appealed.

ARGUMENT

I.

In an IRS summons enforcement proceedings brought by the Government where the trial court has determined there has been harassment, title 26 United States Code, Sec. 7421(a) is not applicable to the entry of an order prohibiting the IRS from requesting records it has already seen.

The single significant distinguishing fact between this case and those cases cited by the government is that the government initiated these proceedings, not the taxpayer. Once having invoked the equitable jurisdiction of the trial court, the government cannot complain when that court exercises its equitable jurisdiction against the IRS and in aid of the prevention of further future harassment of the taxpayer. This is not a suit for the purpose of restraining a tax and no restraint on the *assessment* or *collection* of a tax has been made.

In its brief, the government would have this Court believe that decisions support its view that the IRS can subject itself to the jurisdiction of the court by filing suit to enforce its summons, and, yet, not be bound by an adverse judgment or an order in aid of an adverse judgment. (See, cases cited at p. 10 of the government's brief with respect to IRS summonses).

Both *Anderson* v. *Internal Revenue Service*, 371 F. Supp. 1278 (U.S.D.C. D. Wyo. 1974) and *The Black Panther Party* v. *Alexander*, — F. Supp. —, 75–1 U.S.T.C. Par. 9376 (U.S.D.C. N.D. Calif. 1975) were suits *initiated* by the taxpayer to enjoin the enforcement of an IRS summons and were suits to stop the IRS from looking at records for the first time.

Moreover, in *Black Panther Party* the Court allowed the Plaintiff to proceed on a theory that agents of the IRS in issuing the summons had violated the taxpayer's civil rights, stating as follows:

> The court is not persuaded, however, that this prohibition divests it of jurisdiction to enjoin an alleged violation of Plaintiff's constitutional rights or deprive them of any right to seek damages for the precelved (sic) infringement of their rights. *Id.* —— F.Supp. ——, 75–1 U.S.T.C., Par. 9376 at 86, 916.

It would be bad precedent to allow the IRS to file suit to enforce an IRS Summons and then leave the trial court powerless to prevent the continuation of the harassment and improper purpose for the issuance of the summons which, as is the instant case, the court found. The IRS is not that different from any other litigant in the courts of the United States.

Here the taxpayer alleged harassment and improper duplication of record inspections; proved it to the trial court's satisfaction; had one summons quashed; provided additional records and then found themselves in the same situation with the IRS again demanding additional records by using the ruse of a phony deficiency to require the taxpayer to again bring in the same records which the IRS had seen before.

We submit that the trial court's order was not in violation of the "Anti-Injunction Act" because the appealed order resulted from the IRS' own actions and not from any suit brought by the taxpayer to enjoin those actions. The court acted well within the equity powers inherent in the United States District Court. The government can point to no case involving proceedings brought by the IRS to enforce its summons where, upon request by a taxpayer for relief after proof of multiple record inspections, the Court has denied relief. The cases cited by the government are all inapposite on this point.

II.

If the court determines that the "Anti-Injunction Act" applies to this case the requirements for injunctive relief have been met by appellee.

The recognition that the IRS will no longer be allowed to ride rough-shod on the rights of taxpayers has evidenced itself in recent Supreme Court decisions.

In *Laing* v. *U.S.* and *U.S.* v. *Hall*, — U.S. —, 44 U.S.L.W. 4035, (1-13-76) and *Commissioner of Internal Revenue* v. *Shapiro*, — U.S —, 44 US.L.W. 4313 (3-8-76), the Supreme Court has declared that the "Anti-Injunction Act" (Title 26 U.S.C. Sec. 7421) is not inviolate.

As stated in Mr. Justice Blackmun's dissent in *Alexander* v. *"Americans United" Inc.*, 416 U.S. 752 (1974), the crack in that Act has appeared because he is:

> * * * disturbingly aware of the overwhelming power of the Internal Revenue Service . . . I write primarily, therefore, to express what I feel is a needed word of caution about governmental power where the means to challenge that power are unfavorable, and unsatisfactory at best. *Id.* 416 U.S. 752 at 763.

Justice Blackmun's "word of caution" was adopted by the majority in the *Laing, Hall* and *Shapiro* cases.[2] As Mr. Justice Brennan stated in his concurring opinion in *Laing & Hall*:

> But it cannot be gainsaid that the risk of erroneous determinations by the Commissioner with consequent possibility of irreparable injury to a taxpayer is very real. This suffices to bring due process requirements into play. *Id.* — U.S. —, 44 U.S.L.W. at 4043.

And as Mr. Justice White stated for the majority in *Shapiro*:

> The taxpayer can never know, unless the Government tells him, what the basis for the assessment is and thus, that the Government will certainly be unable to prevail. *Id.* — U.S. — , 44 U.S.L.W. at 4317.

Enochs v. *Williams Packing Co.*, 370 U.S. 1 1962 requires that the taxpayer can obtain injunctive relief if it can prove to the trial court's satisfaction the following: (1) that the government could not ultimately prevail and (2) that the taxpayer would suffer irreparable harm unless he receives equitable relief.

Recognizing the unusual nature of this case, the government has apparently conceded that another standard may be applicable as to the first requirement of *Enochs*—namely, that "there are no facts upon which the Government could successfully demand the right to inspect books and records as to the specified years, . . ." Government's Brief at 12, fn. 6.

Keeping in mind that testimony was received in this case and the credibility of the witnesses weighed by the trial court, we must look for guidance to Judge Marovitz's remarks in order to determine whether these standards have been met. The following are excerpts from the hearing on July 20, 1975. (R. 43).

> So that there is no misunderstanding about the Court's attitude in this case, I think the government is entitled to pursue all the remedies they have against taxpayers. But I have had this witness (Feddor) on the stand. I have had this case up at least ten times. The records have been made available to not only Mr. Feddor but his associates. They had ample time to go back to 1970 records long before now. Tr. at 3.
>
> * * * * * * *
>
> I don't like to say this and I have a sign up here, "Don't make any gratuitous statements or unnecessary remarks," but I just think it has become a fettish with the agency in this particular case and I think it may be a personal vendetta as far as the agent is concerned.
>
> I think I have had these people in Court several times. With all the information they have had, and they have been in that place, they visited, there was a question about how much time they spent there. There is absolutely no reason for any further harassment of these people. So my attitude is clear, and I will hold somebody in contempt of Court if they violate this order. Tr. at 5.
>
> * * * * * * *
>
> I don't know anything about this man (Feddor) but I have heard him testify and I have watched what the operation is. I think it has become a personal vendetta for anybody to make the kind of evaluation that he did out of the clear blue sky and put the burden on the taxpayer to come in and

[2] See also *Rambo* v. *U.S.*, 492 F. 2d 1060, 1064 (6th Cir., 1974) and *Clark* v. *Campbell*, 501 F. 2d 108 (5th Cir. 1974).

try to offset it; in my judgment it is harassment. If he does that, I know what I would do if I were representing a client, I would sue him personally. Tr. at 6.

* * * * * * *

I think there is a limitation, an absorption point, a saturation point in some of these things. They are just going far out of their way in this case. I don't know what it is; I think these people maybe in the first instance may have been uncooperative. Since they have been in this Court and you have been here many times, Mike, in this case, everything I have directed them to do, they have done.

Here is a lawyer, I don't know what his fees are but he has been here at least ten times to my knowledge and the expenses involved, and these people have a small business—I think it merits what I have done in this case. Tr. at 7.

* * * * * * *

I have a simple cliche that has kept me out of trouble all of my life. Wherever I go I walk in with my self respect and I leave with it. If this young man (Feddor) is being told to do what he is doing he has to stand up and say, "Well, you go and do it yourself. You go and tell Judge Marovitz you want to do it."

So I would just take him (Feddor) off the spot. I want it understood what this order is and if there is a violation I will do something about it. Tr. at 8.

Clearly, the trial court was of the opinion that the relief met the appropriate standards, as the issue was raised by the government; therefore, we submit if this Court reverses the trial court on the issue of whether appropriate standards have been met, it can only do so on the basis that the order is contrary to the manifest weight of the evidence.

The government's argument that the order amounts to a declaration of the IRS' right to tax liabilities and is, therefore, precluded of Title 28 U.S.C., Section 2201 is specious. The order was entered only to preclude yet another inspection of the same records the Court concluded had been previously inspected by the IRS—no more and no less. There is nothing in the order about a declaration of rights.

The government's argument that since it may not need the records to *assess* liability that doesn't mean the IRS doesn't need them to *collect* the tax is likewise besides the point. Government's Brief at 13. The order was entered because the IRS has seen the records on a number of occasions; because the repeated requests were made to harass; and because there was a great likelihood that the IRS would continue the harassment, unless restrained.

The taxpayer has a right to have a deficiency withdrawn, if it was admittedly erroneous as here, and was made solely to obviate the court's finding of multiple inspections, and as another act of harassment. The taxpayer need not be forced to pay the deficiency and contest it in a refund suit and there obtain injunctive relief against harassment. See, *Bob Jones University* v. *Simon*, 416 U.S. 725, 748 fn. 22. The IRS must act reasonably, if only to deter a massive tax rebellion by the citizens of this country, who are tired of being pushed around. See, Jim Davidson, "Tired of Being Pushed Around Every April 15?", Vol. 23, No. 4—April, 1976, "Playboy Magazine" at p. 82.

Even the grand jury does not have the right to reinspect and reinspect the same records. We submit that a motion to quash would be sustained if a grand jury sent out multiple subpoena's duces tecum for the same records. Rule 17(c) of Federal Rules of Criminal Procedure.

The government states that there is an adequate remedy at law because the taxpayer can again contest further summons enforcement proceedings. Government's Brief at 15. This is an arrogant argument in view of the trial court's determination that the records sought have already been inspected many times.

The government admits that the trial court in a summons enforcement proceeding has a duty to make a "determination of all his (taxpayer's) defenses to inspection of his books and records." Government's Brief at 17. That is what the trial court did here. It found that the taxpayer had proper defenses. Summons enforcement procedure is an adequate remedy only if the trial court has the power to make the IRS desist.

III.

The Trial Court had the authority to re-open the case since it had previously been dismissed without prejudice and reinstatement had, in effect, been requested by appellee's contempt motion.

Although the trial court had been requested to make a contempt finding by the taxpayer on June 20, 1975, it chose, instead, to bar the IRS obtaining further reinspections of the taxpayer's records. This was a moderate approach by the Court. We do not argue that the trial Court's prior order was an injunction on the IRS, as suggested by the Government. Government's Brief at 13, fn. 18. The fact that there was no formal prior restraint on the government is the reason why no contempt finding was made by the Court.

It is only a matter of common sense that the taxpayer's motion for issuance of an order to show cause and for a contempt finding was a *de facto* request for reinstatement of the case, although inartfully drawn. Obviously, the Court treated it as such. Moreover, the government did not object to the reinstatement on grounds of the previous dismissal on April, 1975. This should constitute a waiver. *U.S.* v. *Gajewski*, 419 F.2d 1088 (8th Cir. 1969), *cert denied*, 397 U.S. 1040. A case that has been dismissed without prejudice can be reinstated, as long as the statute of limitations has not expired by the lapse of time. *De Long's Inc.* v. *Stupp Bros. Bridge & Iron Co.*, 40 F.R.D. 127 (D.C., Mo. 1965). No statute of limitations problem is presented here.

Rule 60 of the Federal Rules of Civil Procedure provides, in part, as follows:

> (b) On Motion and upon such terms as are just, the court may relieve a party or his legal representative from a final judgment, order, or proceeding for the following reasons: (1) mistake, inadvertence, surprise, or excusable neglect; (2) newly discovered evidence which by due diligence could not have been discovered in time to move for a new trial under Rule 59(b); (3) fraud (whether heretofore denominated intrinsic or extrinsic), misrepresentation, or other misconduct of an adverse party; (4) the judgment is void; (5) the judgment has been satisfied, released, or discharged, or a prior judgment upon which it is based has been reversed or otherwise vacated, or it is no longer equitable that the judgment should have prospective application; or (6) any other reason justifying relief from the operation of the judgment. The motion shall be made within a reasonable time, and for reasons (1), (2), and (3) not more than one year after the judgment, order or proceeding was entered or taken.

Obviously the trial court could have considered the taxpayer's contempt motion under this Rule. *Hodgson* v. *United Mine*, 473 F.2d 18 (D.C. Cir. 1972). This is a motion that is reserved to the sound discretion of the Court. *Pierce* v. *Cook and Co., Inc.* 518 F.2d 720 (10th Cir. 1975).

The order of June 20, 1975 did not result from an independent proceeding, although such a proceeding under similar facts has been permitted. *United States* v. *Howard*, 360 F.2d 373 (3rd Cir. 1966); *Application of Colton*, 291 F.2d 487 (2d Cir. 1961). Additionally, contrary to the suggestion of the government, the Supreme Court has permitted summary proceeding in related cases. *Hale* v. *Henkel*, 210 U.S. 43, (1906); *Go-Bart Importing Co.* v. *U.S.* 282 U.S. 344 (1930).

Morgan v. *Smith*, 174 F.2d 212 (7th Cir. 1949) and *U.S.* v. *Deaton*, 207 F.2d 726 (5th Cir. 1953) cited in the Government's brief at 18, fn. 14 are distinguishable on the facts. In *Deaton* the case had been dismissed without prejudice on the express condition that there was a right to reinstate it within 60 days. After the 60 days had elapsed, the Defendant moved to change the order to a dismissal with prejudice. This has no relationship to the facts here where the trial court exercised its discretion to reopen a case under Rule 60 of the Federal Rules of Civil Procedure. In *Morgan*, the court had entered an interlocutory order but thereafter dismissed the suit *with* prejudice pursuant to a *written agreement*, all matters in controversey having been settled. Five years later, the Plaintiffs sought to have the interlocutory order enforced. This decision has no bearing on the facts of this case.

The restraining order is specific in its terms; fully supported by the evidence; and the Government never requested a modification of its terms from the trial court.

The government suggests that since no findings were made by the trial court, which were reflected in the order of June 20, 1975, that the order is, therefore invalid.

Findings are only necessary to aid the Appellate Court by affording it a clear understanding of the basis of the trial court's decision. *U.S.* v. *F.D. Rich Co., Inc.*, 439 F.2d 895 (8th Cir. 1971); *In Re Metropolitan Realty Corporation*, 433 F.2d 676 (5th Cir. 1970). It cannot really be questioned what grounds underlay the trial court's order. His pronouncements from the bench made it very clear. To require senseless form to precede substance would work an additional injustice on the taxpayer. The government recognized this by not requesting modification or clarification of the order by the trial court.

Gregson v. IRS, 478 F.2d 237 (10th Cir. 1973), cited by the government in its brief at page 7, is inapposite. In *Gregson*, the taxpayer sought to enjoin issuance of an IRS summons and the trial court granted an injunction *prior* to a hearing. Instead of going to a hearing, the government appealed. The Appellate Court reversed and remanded for the hearing that the trial court had ordered. Interestingly enough, there was no discussion of the application of the "Anti-Injunction Act" in that case. Extensive hearings and briefings were conducted in this case which led to the entry of the order on appeal.

We submit that because of the extensive remarks of Judge Marovitz relating to his reasons for issuing the restraining order there is no need for this Court to conjecture as to what the reasons for the entry of the order were. It is our position that those remarks follow along with the order. However, if this Court determines that it was error not to formally incorporate those comments into the order, we submit it is only necessary for this Court to provide for a limited remand for the incorporation of supplemental findings. *Fidelity Gas Co. of New York* v. *Key Biscayne Bank*, 483 F.2 438 (5th Cir. 1973); *Alpha Distributing Co. of Cal.* v. *Jack Daniel Distillery*, 454 F.2d 442 (9th Cir. 1972).

CONCLUSION

For the foregoing reasons, the taxpayer, appellee, requests that the District Court's order of June 20, 1975 be affirmed.

Respectfully submitted,

J. RICHARD DEMA,
Appellee.
By SHELDON R. WAXMAN,
His Attorney.

TESTIMONY OF ALUMINUM RECYCLING ASSOCIATION

By Daniel M. Moenich, President

EXECUTIVE SUMMARY

The proposed recycling tax credit does not expand the aluminum recycling industry's market for its product and, therefore, does not expand the need for additional aluminum scrap.

There is excess aluminum recycling capacity to produce to meet the demand for product.

There is capacity to process all aluminum scrap generated by municipal waste systems.

Should the proposed aluminum recycling tax credit induce primary aluminum producers to enter the recycling industry, they would have the dual advantage of the tax credit and depletion allowances thereby defeating one of the bill's major objectives, i.e., to equalize the benefits to primary and secondary industries.

In the fourth year of the tax credit—after the base period phase out—the aluminum recycling industry at present levels of scrap consumption and average scrap prices would receive a tax credit equal to 7% of its gross annual sales dollars.

Primary aluminum alloy is neither the equivalent of, nor substitutable for, nor interchangeable with recycled aluminum alloy.

Current demand for aluminum scrap by primary, recycling and fabricating (self-recyclers) plants applies the greatest possible pressure upon scrap collectors and brokers to bring available scrap back into the industrial stream.

The demand of the aluminum recyclers' customers—the casting industry—dictates the amount of aluminum scrap required by our industry each year. Monies made available through a tax credit result only in enabling aluminum recyclers to bid increasingly higher prices for scrap thereby inflating the price of recycled ingot.

The aluminum recycling industry has demonstrated a constant capability, willingness and motivation to expand scrap producing capacity without government incentive. Within the past eight months, aluminum recycling production capacity

has increased 8% including the entrance of twelve new companies into the industry.

For all the foregoing reasons, the proposed recycling tax credit will not result in either the use of more aluminum scrap or the development of additional net scrap recycling capacity.

My name is Daniel M. Moenich. I am President of Apex International Alloys, Inc., Des Plains, Illinois and I am President of the Aluminum Recycling Association.

By its title and by its long history of operation in recycling aluminum, obviously ARA is strongly in favor of the concept of recylcling. We are, however, opposed to the application of a recycling tax credit to our industry as proposed in H.R. 10612 and therefore support Amendment No. 1931 of Senator Taft to exclude aluminum base scrap from the tax credit.

In a finite world concerned about steadily diminishing mineral reserves, there is great value in prolonging the useful life of materials. Minerals, and much of the energy used to refine them, can often be preserved for reuse by recycling. This process, the major concern of the member companies of the Aluminum Recycling Association, has been practiced by some of them for over seventy years.

Aluminum is too useful and too valuable not to be kept in use. Aluminum recycling today is an international industry, with metal and scrap traded daily in world markets. Recycled aluminum produced by U.S. firms to strict specifications for the castings processes goes into automobiles, heavy equipment, photo and optical equipment, electrical devices, major home applinaces, and hundreds of other products for consumer or industrial use.

The first company to recycle aluminum was founded in 1904, a scant 16 years after the first commercial production of primary aluminum in 1888. Today there are almost 100 aluminum recycling plants spread through the country in virtually every industrial center dedicated to reusing aluminum scrap in producing metal for further use in commercial, industrial and consumer products.

Annual sales of the industry are between $600,000,000 and $700,000,000. Aluminum recycling is recognized as an important source of metal and metal technology separate and distinct from the primary aluminum industry. The aluminum recycling industry has steadily increased capacity and production since it began.

To emphasize the long history of the industry we have attached as Exhibit A a year-by-year list of aluminum recycled from scrap from 1913 (the year records were first kept for our industry) through 1975. In those 62 years, more than 42 billion six hundred ninety thousands pounds of reycled aluminum have been produced from scrap.

Our industry was begun 71 years ago by men of vision who found a market for a product made from aluminum scrap.

Over the past seven decades, the aluminum recycling industry has become highly sophisticated in its production processes and in the methods by which it has utilized scrap purchased from primary producers, other fabricating processes, and from scrap yards and brokers. During all these many years we have provided specification aluminum alloy for the casting industry. With very minor exceptions, primary aluminum producers do not provide alloy for the castings industry. Indeed aluminum alloy is not substitutable for nor interchangable with recycled aluminum alloy because primary alloy is not made to meet castings specifications. There is little product or market competition between the primary and the recycling aluminum industries. Therefore, the proposed amendment cannot provide tax equity between the two industries.

It has been stated that a goal of the recycling tax credit is to "create a situation of equity between virgin natural resources and recyclable material" by granting users of recyclable material a tax credit equal to one half of the percentage of depletion allowances given to competing virgin natural resources. We find a great fallacy and a great contradiction in this proposition as it applies to aluminum base scrap because it would enable primary producers who today use increasing amounts of scrap for their operations to avail themselves not only of depletion allowances but also of a recycling tax credit.

It has been said by the President's Council on Environmental Quality in its 1975 report to Congress at page 93: "In the long run, increased recycling will depend upon a commitment by the major firms in the paper industry, for exam-

ple, to use wastepaper day to day rather than only when virgin fiber is unavailable. For them to do so, a fundamental shift in the economics of recycling is necessary."

Mr. Chairman, members of the Senate Finance Committee, this may well be true for the paper industry and we have no base of knowledge from which to challenge it, nor do we wish to challenge it. However, it is not true of aluminum recycling. The existing fundamentals in the economics of recycling aluminum for the past seven decades has resulted in a strong, healthy and growing recycling industry that provides over 20% of this country's aluminum each year.

If it is the intent of the tax credit to encourage recycling and conserve energy and natural resources, as applied to aluminum it is simply throwing tax money at a problem that does not exist in our industry. It is a costly and misdirected approach.

The demand for aluminum scrap for our industry is based entirely upon demand placed upon us by the casting industry for specification alloy to produce consumer components. The casting industry in turn responds to demand from the automobile, heavy equipment, home appliance, photo and electrical and many other industries.

When the economy is strong, this demand is high and so are our requirements for scrap. When the economy weakens, the reverse is true and we use less scrap. Unwanted monies freed by tax credits are a disruptive intrusion into the economics of an established industry. We believe government should not force an industry to deal with an external infusion of money it neither wants nor can readily absorb within the framework of its demand-supply cycles.

For example, at our current rate of production and scrap usage and using current average scrap prices, the recycling tax credit for our industry in the year following phase out of the base period could amount to $49,500,000. (Over 7% of the industry's gross sales income). Pumping this kind of money into the scrap stream, demand for which is defined by customer needs, can result only in increased prices for scrap as recycling companies bid against each other to obtain scrap for their furnaces.

Within the past 18 months the capacity of our industry to recycle aluminum has grown from an annual capability of 1.9 billion pounds to over 2.25 billion pounds. This has come about without a tax incentive and because of the strength of the economics of our industry. And from our knowledge of the industry, there are companies today expanding capacity of existing plants and planning to construct plants as new entrants to the industry. This is a natural, normal and thoroughly acceptable phenomenon of our competitive industrial society.

It has been said: "The cities and States must find ready stable markets for all the recyclable metals, paper and glass they will be recovering from garbage." With this we agree and we are a part of that stable market for aluminum base scrap today, and we need no tax incentive readily and economically to process such scrap. Perhaps it is the requirement of cities and States to be helped to generate usable scrap or perhaps it is the need of the scrap gatherers and distributors for an incentive to obtain more scrap. It is not our need and without reservation we reject a recycling tax credit as misplaced in its application to recycling companies that produce specification aluminum ingot from aluminum base scrap and alloying materials.

Mr. Chairman, members of the Committee, our Association represents over 80% of this country's capacity to produce recycled ingot sold in the marketplace. We do not beg the questions either of the conservation of increasingly scarce raw materials nor the conservation of diminishing energy. We have practiced the conservation and reuse of commodities and energy since the beginning of this century. We have heard no arguments, seen no figures, no mathematical nor economic formula that convinces us that a recycling tax credit as it is proposed in H.R. 10612 either will expand the amount of aluminum base scrap available or increase the use of aluminum base scrap and we strongly urge the Senate Finance Committee and the Senate to exempt aluminum base scrap from the proposed tax credit by supporting Mr. Taft's amendment.

Thank you for this opportunity to present our arguments.

[Exhibit A]

Aluminum recycled from scrap

Year	Amount	Year	Amount
1913	9,308,000	1946	556,000,000
1914	9,044,000	1947	690,000,000
1915	17,000,000	1948	574,000,000
1916	30,600,000	1949	362,000,000
1917	32,200,000	1950	486,000,000
1918	30,100,000	1951	594,000,000
1919	37,882,000	1952	608,000,000
1920	31,000,000	1953	736,000,000
1921	17,800,000	1954	626,000,000
1922	32,580,000	1955	828,000,000
1923	42,600,000	1956	856,000,000
1924	54,000,000	1957	880,000,000
1925	38,000,000	1958	708,000,000
1926	68,400,000	1959	898,000,000
1927	92,400,000	1960	876,000,000
1928	95,600,000	1961	970,000,000
1929	98,800,000	1962	1,164,000,000
1930	77,200,000	1963	1,308,000,000
1931	60,600,000	1964	1,414,000,000
1932	48,000,000	1965	1,658,000,000
1933	67,000,000	1966	1,774,000,000
1934	92,800,000	1967	1,756,000,000
1935	102,800,000	1968	1,944,000,000
1936	103,000,000	1969	2,300,000,000
1937	125,120,000	1970	2,000,000,000
1938	77,600,000	1971	2,100,000,000
1939	107,894,000	1972	2,252,000,000
1940	160,724,000	1973	2,470,000,000
1941	213,714,000	1974	2,564,000,000
1942	392,000,000	1975	2,364,000,000
1943	628,000,000		
1944	650,000,000	Total	42,692,466,000
1945	596,000,000		

Sources: Secondary Aluminum, R. J. Anderson (1931); Bureau of Mines; Aluminum Association; and BDC, Department of Commerce.

NATIONAL SOLID WASTES MANAGEMENT ASSOCIATION,
Washington, D.C., July 21, 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee, Russell Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: The National Solid Wastes Management Association as the professional industry organization representing the private solid waste management and resource recovery industry appreciates this opportunity to submit the following comments on H.R. 10612 "Tax Reform Act of 1976." This Association supports Amendment No. 2017 introduced by Senator Gravel and Senator Tunney as an important effort to eliminate economic disparity between virgin and secondary sources of energy and materials. We believe that a federal tax policy which encourages the use of energy and material recovered from the waste stream will do much to expand the development of resource recovery facilities and we commend the committee's efforts in addressing this important national issue.

The present language however is unclear as to whether or not energy conversion processes which utilize postconsumer waste material are eligible for the recycling tax credit. Our industry believes it essential that this amendment does not in-

advertently favor any particular technology. Therefore we ask that the Committee consider the following amendment to Amendment No. 2017 to assure clarification that energy conversion would be included under this recycling tax credit (A) (ii) Five percent of the amount paid or incurred by the taxpayer to purchase fuel or steam produced from solid waste processed by a resource recovery center *including both material and/or energy recovery.*

NSWMA believes that this amendment will clarify any disparities which may exist and urges the Committee to consider the adoption of this important piece of legislation.

Very truly yours,

WARREN T. GREGORY,
Director of Legislative Affairs.

STATEMENT BY ROBERT R. NATHAN, CHAIRMAN, COUNCIL ON NATIONAL PRIORITIES AND RESOURCES

The Council on National Priorities and Resources is a nonprofit association of organizations representing local governments, business and labor, educators and farmers, religious organizations, and minority groups. The member organizations include the Amalgamated Clothing Workers of America, AFL-CIO; American Federation of State, County and Municipal Employees, AFL-CIO; Americans for Democratic Action; National Education Association; National Farmers Union; Oil, Chemical and Atomic Workers, International Union, AFL-CIO; International Union, United Auto Workers; United Church Board for Homeland Ministries; United Mine Workers of America; United Presbyterian Church, USA; and the U.S. Conference of Mayors.

The Council on National Priorities and Resources is committed to comprehensive tax reform as an indispensable step in realigning national priorities. We believe that the Senate tax bill, however, does not constitute true reform. H.R. 10612 as reported by your committee falls more than one billion dollars short of even the modest tax reform recommendation of the Budget Committee that $2 billion in additional revenues be realized through reforms in fiscal 1977. Instead, losses due to new tax expenditures would snowball far into the future.

We understand that the focus of these hearings is on the members' narrow-interest amendments recently added to the bill. We believe that these amendments, rushed through the committee at the eleventh hour, detract substantially from the bill's reverse raising potential and exacerbate the glaring inequities of our tax system.

Taxpayers around the country are concerned about the lack of fairness in the federal tax system and the seeming inability of Congress to control or eliminate tax expenditures once enacted. The Senate's hasty passage of various tax loopholes, designed to benefit only a few select companies or individuals, reinforces and substantiates impressions about Congress's lack of concern for the average taxpayer. Public impressions are important; negative images of the tax system seriously undermine and erode the confidence of the American people in their government.

By recalling the tax bill for further committee consideration, this Committee is laudably demonstrating a willingness to confront important questions of tax reform. Hopefully, the committee's readiness to take a second look at some of the amendments added to H.R. 10612 will translate into an equal willingness to remedy the bill's shortcomings and to delete those narrow interest amendments that are inequitable or unjustified. We urge the Committee to subject each proposed new tax expenditure to careful examination to determine its impact on revenues, the legitimacy of its goals and the extent to which it would achieve those goals; whom it benefits and to what extent; its efficiency compared to other methods of achieving he same objective, and the extent to which it promotes or undermines the equity and progressivity of the tax structure.

Equally important in the present day and age, a new tax expenditure should not further complicate the tax code without strong justification for its enactment. The further complexities the hastily-adopted tax preferences introduce into an already confusing tax system spells further misunderstanding and frustration for our nation's taxpayers.

Scrutiny of these special tax preferences, and the elimination of many, is warranted on another ground as well—namely the importance of the new budget process. The Congress agreed in May on the desirability and the budget necessity

of raising $2 billion in revenues through the enactment of tax reforms. Yet, the Senate's version of H.R. 10612 comes nowhere near reaching that goal. Long-needed reforms are offset by the introduction of new exemptions, credits, exclusions and deductions. The "grab bag" of narrow-interest amendments further detracts from the possibility of attaining the Budget Committee's and the Congress's tax reform goal. The Council urges this Committee to make a good faith effort to meet the revenue targets of the first budget resolution for fiscal 1977.

We know from experience that once enacted, tax expenditures become virtually unchangeable and uncontrollable—and lock us into future revenue losses that are difficult to recapture. These additional revenue losses represent funds which could otherwise be used to finance desperately-needed government programs. At a time when the economic crisis gripping this country has already cut heavily into revenues, the adoption of new tax expenditures threatens to unduly tie the hands of a new Democratic Administration next year.

Most of us would agree that a tax system should not only be capable of raising sufficient revenues to finance government programs—the goal of the Congress in adopting the budget resolution. It should also be equitable and progressive. Stated simply, these notions require that persons in similar circumstances with similar incomes and assets should be taxed alike, and those who have more should pay more than those who have less. Yet, as we all know, our tax system flagrantly fails to achieve these goals of fairness. Nearly one fourth of all tax subsidies go to the wealthiest 1.2 percent of taxpayers. There are still more than 500 individuals with income over $100,000 who pay no federal income taxes whatever.

The Council thanks you for the opportunity to testify today. We have a longer statement of tax principles and recommended tax reforms, which we would be glad to supply to the members of you desire.

CAST METALS FEDERATION,
Rocky River, Ohio, July 16, 1976.

Hon. RUSSELL B. LONG,
Senate Committee on Finance,
Dirksen Building, Washington, D.C.
Subject: Tax reform bill.

DEAR SENATOR LONG: We have read in the press that the Senate Finance Committee is reconvening on July 20 for three days of additional hearings to examine the several sections of the tax bill which were added in committee "to accommodate problems of special interests".

Labelling a bill or a portion of a bill "special interest" legislation is frequently effective in killing a measure. Many times, however, such a label is erroneous.

We in the metalcasting industry believe it is a misnomer if the term "special interest" is used to apply to the Senate Finance Committee addition to H.R. 10612 which will provide tax credits on purchases of ferrous and non-ferrous scrap metals.

Tax actions such as these are essential to the effective utilization of U.S. raw material and energy resources through their promoting the development of adequate secondary metal at reasonable economics and favoring full use of this material by the cast metal s well s other metalworking industries.

Such utilization of raw material and energy resources will work to the benefit of all and are conosnant with the policies of the United States.

We are enclosing a statement and documentation in support of this position.

We respectfully request that the Senate Finance Committee continue to recommend passage of the recycling tax credit.

Sincerely,

CHARLES T. SHEEHAN,
Vice President.

Enclosure.

STATEMENT OF CHARLES T. SHEEHAN VICE PRESIDENT, CAST METALS FEDERATION

This statement is submitted for and on behalf of the Cast Metals Federation in support of the Senate Finance Committee version of H.R. 10612 which would provide reasonable and necessary income tax incentives to encourage the utilization of recycled solid waste materials and to offset existing income tax advantages which promote depletion of virgin natural resources.

Participants in the Cast Metals Federation are the following trade associations:

Investment Castings Institute
Iron Castings Society
National Foundry Association
Non-Ferrous Founders Society
Steel Founders Society of America

Foundries produce castings through a technique of pouring liquid metal into cavities of sand, metal or ceramic molds. Most frequently these metals are melted inn electric furnaces or in cupolas. The resultant metal casting may weigh as little as a few ounces or as much as many tons.

Castings as a technological method is one of the oldest, most basic and least expensive ways employed to shape metal; other metal-shaping processes include forging, stamping and machining. Ninety percent (90%) of all durable goods manufactured require castings as end products or as component parts.

The foundry industry size is often measured on the basis of tons of castings shipped. It is usually compared with other industries on the basis of the dollar value added by manufacture. According to the latest data issued by the U.S. Department of Commerce, the foundry industry ranks sixth among all manufacturing industries. Only motor vehicles, blast furnaces and steel mills, aircraft, basic chemicals and communication equipment exceed the foundry industry in rank and in size by the value added by manufacture. The foundry industry is larger than metal working machinery and equipment, larger than fabricated structural and metal products, larger than the newspaper industry, and larger than the beverage industry.

The size of our industry is misleading because most foundries are either small, independent privately owned operations, or are captive foundries of large automotive or heavy equipment manufacturers. Of the roughly 4,500 foundries in the United States, employing over 300,000 workers, *82% employ less than 100 workers.* The dollar value represented by casting production exceeds $15 billion and represents 22 million tons of castings each year. Sixty percent (60%) of the total industry output is produced by independent jobbing foundries.

It is an interesting paradox that while demand for castings is increasing at a rate of 6–7% per year, the number of foundries are decreasing each year. For example, in 1950 there were 3,000 gray and ductile iron foundries, but by 1970 only 1,500, and it is estimated that as many as 500 more will close in the next five years. The primary reason is that metal casters have not traditionally generated the funds to modernize, expand, and equip. The anticipated increasing decline in number of foundries is due to lack of profits and to the need for capital to meet OSHA and environmental control standards.

Castings are vital to our economy—as vital as any raw material or component can be. As an example, these major industries buy castings from jobbing foundries: (1) Motor vehicles and trucks; (2) Industrial machinery; (3) Metal products, including heating and air conditioning equipment; (4) Machine tools; (5) Water pipe; (6) Railroads; (7) Electrical machinery; (8) Construction and farm machinery; (9) Engines and turbines; and (10) Household appliances.

The ten general industries summarized above actually encompass approximately 500 different industries.

Every time a ton of iron and steel scrap is recycled through a foundry, our natural resources are preserved by 1½ tons of iron ore, one ton of coke and ½ ton of limestone. In the non-ferrous metals, we find that 45% of the total amount of copper, 1.8 millions tons per year, is recycled. Similarly with lead—38%; with aluminum—20%; with zinc—20%.

Three long term trends in the foundry industry stand out. First, production tonnage of metal castings is increasing despite decreasing numbers of foundries in operation. Second, non-productive capital expenditure requirements of foundries for EPA and OSHA needs are increasingly difficult for foundries to meet. *Third, the increasing scarcity of scrap metals and the resultant escalating costs of these metals is forcing the industry to study alternative materials to decrease its almost complete dependence on scrap as a means of retaning its markets from the inroads of competitive materials and imports.*

As an example, the cost of typical grades of steel scrap have tripled since January, 1973.

The attached chart, Iron-Steel Distribution in U.S.A.; reprinted from the February 1974 issue of *Modern Castings* magazine indicates that in 1972 ferrous foundries used 13.6 million tons of scrap generated by the iron and steel scrap industry. The basic steel industry consumed 29.7 tons in that year.

In the year 1973 the usage of ferrous scrap increased to approximately 60 million tons with the ferrous castings usage rising from 13.6 million tons to 16.2 million tons. At the same time iron and steel scrap exports rose to 11.2 million tons despite a limited licensing procedure on exports imposed by the U.S. Department of Commerce in July, 1973.

We have been told on several occasions by the U.S. Department of Commerce and by other government spokesmen, including the President's Special Representative for Trade Negotiations, that we could not expect any further curtailment of ferrous scrap exports.

Inasmuch as the ferrous castings industry of the U.S. is severly harmed by this Government policy, we firmly believe that it is only equitable that a tax incentive such as that approved by the Senate Finance Committee be enacted into law.

The recycling tax credit amendment would provide greater incentive for the scrap industry to reclaim additional scrap; would serve to keep our costs in line; and further, provide incentive to our industry to continue to use substantial quantities of ferrous scrap and to revise our methods so that larger quantities of such scrap might be used.

It should be noted that for a period prior to 1973 there was a great shift from cupola melting to electric melting in foundries. Cupola melting used roughly 60 percent scrap plus pig iron, which came from virgin ore. Electric melting requires almost 100 percent scrap. Electric melting provided better, more efficient controls. The additional cost of electric furnaces over cupolas was offset by the fact that they were cleaner in operation and hence required less in the way of non-productive air pollution control equipment.

The scarity and high cost of scrap today has reversed this trend toward electric melting.

The reprint from Modern Castings mentions the direct reduction of ore as an alternative to the use of scrap. This process is being seriously considered by the industry as the scarcity and expense of ferrous scrap increases.

Thus far in this statement ferrous scrap has been used as an example. Nonferrous scrap—aluminum, magnesium and copper—all are confronted with similar circumstances.

Scrap iron, steel, aluminum. and magnesium represent both a raw material and an energy resource. Efficient utilization needs to be encouraged. Our current estimates of the energy required to produce pig iron and primary aluminum and magnesium are shown in the attached figure. In producing castings using primary metals as melt stock, this energy must be added to the melting and superheating energy requirements to determine the total effect on energy reserves.

To produce magnesium die castings using primary metal for most of the charge—(the U.S. secondary magnesium market is very small), it is estimated that the product energy requirement is 164,300 BTU/lb. If a large automotive die casting operation, such as Volkswagen's, is considered, it is estimated that the magnesium product energy requirement would be 102.500 BTU/lb if 50% secondary alloy is used in the new feed.

Current vehicle fuel economy issues will promote the use of increased tonnages of aluminum and magnesium castings and aluminum sheet products. Vehicle weight reduction favors increased fuel economy. This will create new requirements:

(1) The need for an improved secondary aluminum and magnesium market. The current secondary markets are small relative to potential automotive requirements. In addition, there is a 5–10 year lag between time of vehicle build and the time the vehicle becomes available on the scrap market.

(2) A need for improved scrap processing techniques to separate ferrous and non-ferrous scrap.

Tax and export/import actions which promote the development of adequate secondary metal at reasonable economics and of good melting quality and favor full use of this material by the cast metals industry are essential to the effective utilization of U.S. raw material and energy resources.

Respectfully submitted

CHARLES T. SHEEHAN,
Vice-President.

IRON FLOW IN THE UNITED STATES—1972

The Charge Materials Committee (12–J) has updated the Iron and Steel Distribution Chart using 1972 data. The previous distribution chart published in

the October 1972 issue of MODERN CASTING presented 1969 data and showed the flow of iron units in the U.S. marketplace. The year 1969 was used as a reference for the statistical presentation since there were no severe work stoppages or disruptive forces on the free flow of ferrous materials.

The major source of data is still the many industrial users and producers of the iron bearing products, plus the scrap processors and brokers. Data from these industries are collected and reported primarily by the U.S. Bureau of Census and the Bureau of Mines.

It is still not possible to balance the flow chart of ferrous materials primarily because of conflicting data and possibly incomplete reporting by parts of the ferrous industry. An understanding of how the information is reported as well as what is included in the numbers is needed when making comparisons. An example is the method of reporting the internal remelt or recirculating scrap in the steel and metal casting industry. In effect most of this stays in-house and is remelted and recirculated and could be considered an internal inventory.

The scrap that effectively ends up in the product can be considered outside purchases. The scrap consumption reported by the U.S. Bureau of Mines includes this internal inventory or remelt. The 1969 published iron flow chart for the metal casting industry did not make allowances for this so the 18.1 million tons of scrap shown for 1969 going into the metal casting industry included the remelt material. The 1972 chart shows only new scrap (13.6 million tons) going into the metal casting industry and the remelt is shown recirculating within the iron or steel casting group.

METALCASTING INDUSTRY

The metalcasting industry because of its dependence on scrap iron and steel has always been interested in recycling and material conservation. The industry has co-operated closely with the secondary metals industry in developing new methods of using various raw materials. These efforts by the foundry industry have had a significant effect in maintaining a high product value for ferrous castings and has contributed to the increasing value of the industry products.

As most foundrymen are painfully aware, there is competition for iron units in world and domestic markets of a type which indicate that future constraints on production by the foundry industry may be the supply of raw materials as well as skilled manpower and usable plant capacity. Structural shifts in the flow of scrap iron and steel in the U.S. markets are indicated by the 1972 distribution when compared with the 1969 distribution chart.

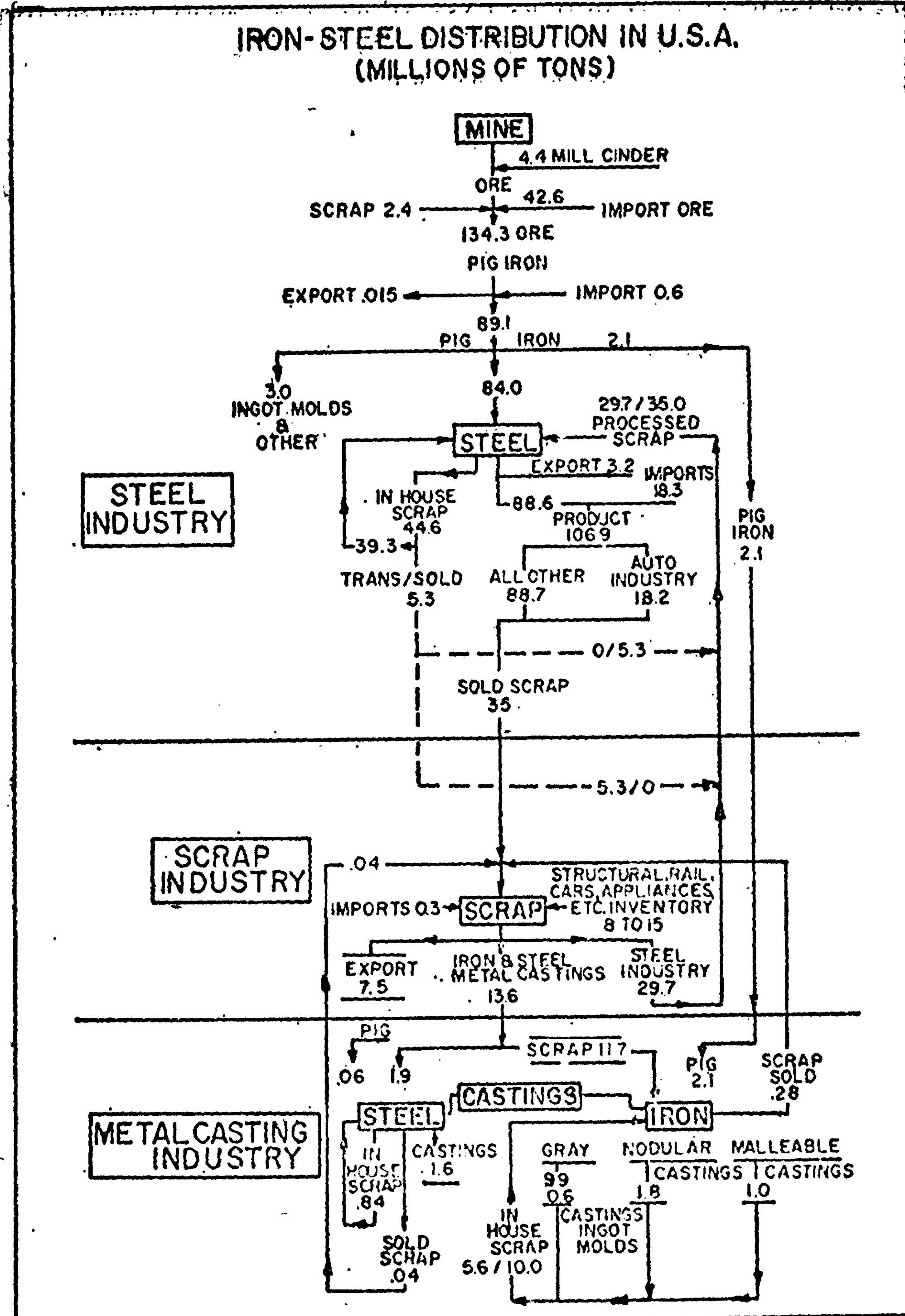
For 1972 the ingot mold production of 3.0 million tons, is shown in the steel industry rather than the iron casting industry. The source of this iron is primarily from the steel industry and usually in molten form. Approximately 600,000 tons of ingot mold castings are shown in the iron industry to take care of those plants that do not get a major portion of their metal from a steel mill.

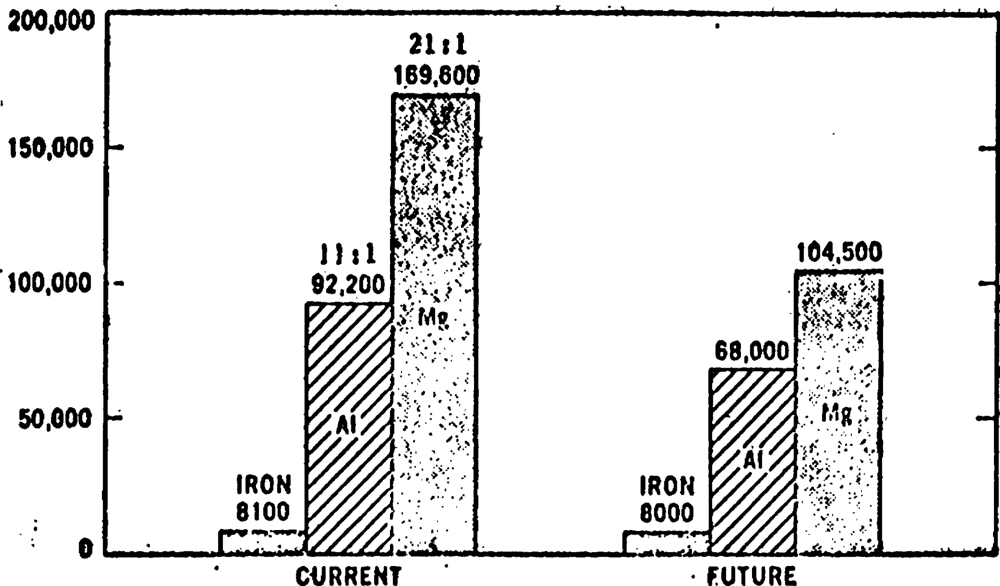
The metal casting industry consumed a total of 13.6 million tons of scrap generated from outside sources and 2.1 million tons of pig iron to produce a total of 1.6 million tons of steel castings and 13.3 million tons of iron castings (excluding the 3.0 million tons of ingot molds). This illustrates the magnitude of the casting industry and everyone including the government agencies should recognize its importance in terms of economics, employment, raw material, and energy requirements. The impact is even greater when the nonferrous industry is included.

STEEL INDUSTRY

The U.S. steel industry, faced with serious competition in the domestic market, concentrated its new capital investments in the basic oxygen furnaces, continuous casting, and highly automated hot strip mills. Construction of new blast furnaces by the industry, has lagged the industry demand for molten iron. Production increases through improved technology reached a plateau in the late 1960's as the advantage of fuel injection and sized burden became standard practice at most facilities. New sources of iron units had to be found since the cost of a new blast furnace of modern design and production has reached a level of investment requiring joint ventures.

As a result, the steel industry turned to scrap preheating and electric arc furnaces. This increased the consumption of scrap steel in relation to the tonnage of molten iron consumed. The ratio between finished steel products and scrap consumption dropped from approximately 4.6 in 1969 to 3.1 or 2.6 (depending upon which number for 1972 is correct for new scrap consumption, 29.7 or 35.0 million tons shown on the chart).


IRON-STEEL DISTRIBUTION IN U.S.A.
(MILLIONS OF TONS)
MINE
4.4 MILL CINDER
ORE
42.6
SCRAP 2.4
IMPORT ORE
134.3 ORE
PIG IRON
EXPORT .015
IMPORT 0.6
89.1
PIG IRON 2.1
3.0
INGOT MOLDS & OTHER
84.0
29.7 / 35.0
PROCESSED SCRAP
STEEL
EXPORT 3.2
IMPORTS 18.3
STEEL INDUSTRY
IN HOUSE SCRAP 44.6
88.6
PRODUCT 106.9
PIG IRON 2.1
39.3
TRANS/SOLD 5.3
ALL OTHER 88.7
AUTO INDUSTRY 18.2
0/5.3
SOLD SCRAP 35
5.3/0
SCRAP INDUSTRY
.04
STRUCTURAL, RAIL, CARS, APPLIANCES ETC. INVENTORY 8 TO 15
IMPORTS 0.3
SCRAP
EXPORT 7.5
IRON & STEEL METAL CASTINGS 13.6
STEEL INDUSTRY 29.7
PIG
SCRAP 11.7
.06
1.9
PIG 2.1
SCRAP SOLD .28
CASTINGS
STEEL
IRON
METAL CASTING INDUSTRY
IN HOUSE SCRAP .84
CASTINGS 1.6
GRAY 9.9
NODULAR CASTINGS 1.8
MALLEABLE CASTINGS 1.0
0.6
CASTINGS INGOT MOLDS
IN HOUSE SCRAP 5.6 / 10.0
SOLD SCRAP .04



This trend is expected to increase the demand on the supply sector for scrap as more electric furnaces and continuous casters are installed. Direct reduction of ore in the U.S. may alter this but only if a coal related process is used for reduction and this appears very slim for the next decade due to pressures for energy requirements elsewhere. There is, of course, a possible chance that prereduced ore can be imported but this will not occur for five to ten years.

Those nations that have ready access to both gas and ore could become major exporters of sponge iron. This *could* occur within five to ten years. It is the hope of the AFS Charge Materials Committee that this chart will illustrate graphically to everyone the importance of the metal casting industry in the flow of iron units and particularly scrap in the U.S. Approximately 27% of the iron units consumed by the steel industry is external scrap and 86% in the metal casting industry. Illustrating again, the relative importance of scrap to each industry.

Any comments or additions to this attempt to summarize the ferrous cycle in the United States will be welcomed by the committee.

Current—*Aluminum:* 17% hydroelectric power, 33% electrical conversion factor, 50% Al_2O_3 Bauxite, 7 kwh/lb. cell requirement. *Magnesium:* Dow process, 33% electrical conversion factor, 8.4 kwh/lb. cell requirement. *Pig Iron:* 32.5% iron magnetic taconite.

Future—*Aluminum:* 17% hydroelectric power; 40% electrical conversion factor; 5.25 kwh/lb. cell requirement. *Magnesium:* 40% electrical conversion factor, N.L. Industries type process.

LAW OFFICE OF PAUL H. DELANEY, JR.,
Washington, D.C., July 22, 1976.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate, Washington, D.C.

CARGILL INCORPORATED

DEAR MR. CHAIRMAN: In accordance with the Press Release of the Committee on Finance, United States Senate, dated July 8, 1976, entitled "Finance Committee to Hold Hearings on Certainn Committee Tax Provisions" and communications with the Staff Director of the Committee on Finance, we request that the following material be incorporated in the record of your hearings:

1. Summary of Comments on Third Market Country Exception for Sales of Agricultural Commodities in International Trade as Adopted by the Senate Finance Committee under Section 1025 of the Tax Reform Act of 1976;

2. Comments on Third Market Country Exception for Sales of Agricultural Commodities in International Trade as Adopted by the Senate Finance Committee under Section 1025 of the Tax Reform Act of 1976.

Recognizing that concern has been expressed in recent weeks about the alleged absence of opportunities for interested parties to comment on certain provisions of the Tax Reform Act of 1976 as reported by the Senate Finance Committee, we think it is particularly important for the United States Congress to take into account the following points regarding the legislative history of the agricultural commodities exception:

1. The agricultural commodities exception has been under active consideration by the United States Congress for the past eighteen months:

2. The initial agricultural commodities exception was enacted into law in early 1975 under provisions of the Tax Reduction Act of 1975 in order to preserve the competitive position of United States owned firms participating in international agricultural trade which prior to adoption of the Tax Reduction Act of 1975 had been on an equal tax footing with foreign owned firms participating in this trade;

3. In a committee print prepared in September 1975 by the staff of the Joint Committee on Internal Revenue Taxation for the use of the House Ways and Means Committee, the Joint Committee staff pointed out that the language of the agricultural commodities exception under the Tax Reduction Act of 1975 might require clarification and modification;

4. The agricultural commodities exception has been the subject of extensive consideration by the United States Congress, including open debate in mark-up sessions before both the House Ways and Means Committee and the Senate Finance Committee;

5. The Internal Revenue Service has issued Proposed Income Tax Regulations on the agricultural commodities exception and has invited comments from the public;

6. Based on administrative considerations, the United States Department of the Treasury has expressed its preference for the third market country approach;

7. The United States Department of Agriculture has expressed strong support for the third market country approach;

8. Both Houses of the United States Congress have determined that important United States national and international interests are served by preserving an ongoing opportunity for United States owned firms to participate in this important third market country international agricultural trade.

As is readily apparent from the legislative chronology related above, this issue has received extensive review over the past eighteen months by both Houses of the United States Congress. Furthermore, it is important to recognize that during the entire course of consideration of the agricultural commodities exception (including the most recent hearings of the Senate Finance Committee on July 20 through July 22, 1976), no analysis has been presented by interested parties in opposition to the merits of the third market country approach, nor has any party suggested that it would be contrary to United States national and international interests to preserve a competitive position for United States owned firms in third market country international agricultural trade.

Based on these considerations, we urge the United States Congress to adopt, as soon as possible, the third market country exception for sales of agricultural commodities in international trade recommended by the Senate Finance Committee.

Respectfully submitted,

PAUL H. DELANEY, Jr.,
Counsel for Cargill Inc.

COMMENTS ON THIRD MARKET COUNTRY EXCEPTION FOR SALES OF AGRICULTURAL COMMODITIES IN INTERNATIONAL TRADE AS ADOPTED BY THE SENATE FINANCE COMMITTEE UNDER SECTION 1025 OF THE TAX REFORM ACT OF 1976

SUMMARY

The effect of not adopting Section 1025 of the Tax Reform Act of 1976 as reported by the Senate Finance Committee would be to undermine the competitive position of United States owned firms which now participate in third market country international agricultural trade (agricultural commodities produced and consumed outside the United States) by transferring this business to foreign

owned firms beyond United States tax jurisdiction and control. It is submitted that this would be contrary to important United States national and international interests.

Under United States tax law, United States owned firms have for many years competed on an equal tax footing with foreign owned firms in world agricultural trade. As a result, United States owned firms now handle a significant portion of this trade. Unless United States owned firms can continue to defer taxes on such income, they cannot compete for this third market country international agricultural trade. No other country in the world taxes the earnings on this trade.

The Tax Reduction Act of 1975 repealed certain provisions under which United States owned firms were permitted to defer United States taxes on foreign earnings until repatriated to the United States, but based on the considerations noted herein provided an exception for sales of agricultural commodities in international trade.

As noted in both the House Ways and Means Committee report and the Senate Finance Committee report, it was necessary to provide such an exception for sales of agricultural commodities traded in third country markets in order for United States owned firms to continue to participate in this highly competitive business. Without such an exception, this business would be transferred to foreign owned firms beyond United States tax jurisdiction and control.

In the absence of an exception for third market country international agricultural trade, several disadvantages would obtain to the United States national and international interests:

1. United States owned firms would lose an opportunity to compete for trade in a market worth $80 to $100 billion each year;

2. Participation in this trade would be limited to firms beyond United States tax jurisdiction and control and would thereby preclude the United States from taxing profits on this trade which might otherwise be repatriated to the United States;

3. The United States Department of Agriculture would lose an important source of information about this third market trade;

4. United States owned firms with substantial investments in facilities in this country used in exporting United States agricultural products would lack both the knowledge and opportunity provided by their present position in third country trade to press for sales of United States produced commodities.

To avoid this result, the Senate Finance Committee recently adopted a limited agricultural commodities exception based on the third market country approach. In effect, the new provision would exempt from current taxation under Subpart F sales of agricultural commodities grown and sold for consumption, disposition or use outside the United States. The third market country exception has the strong support of the United States Department of Agriculture.

Based on these considerations, it is clear that the exception for sales of third market country international agricultural trade adopted by the Senate Finance Committee is important to United States national and international interests, and therefore it is urged that the United States Congress adopt the third market country approach recommended by the Senate Finance Committee.

INTRODUCTION

The following comments are submitted in support of the third market country exception adopted by the Senate Finance Committee under Section 1025 of the Tax Reform Act of 1976 as reported by the Senate Finance Committee. The Senate Finance Committee approach is designed to clarify and modify the present exception for sales of agricultural commodities in international trade under (1) Section 602(b) of the Tax Reduction Act of 1975, P.L. 94-12 (the "TRA"), and (2) the revision provided by Section 1025 of the House-passed Tax Reform Act of 1975, H.R. 10612 (the "1975 House bill").

It is important to recognize that although the language of the exception under present law could be interpreted to impose current United States taxation on most trade in agricultural commodities produced and used abroad, such an interpretation would be contrary to the intent of the United States Congress and would effectively transfer this business to firms beyond United States tax jurisdiction and control. Furthermore, this would severely limit the capacity of firms most interested in expanding commercial marketing of United States produced agricultural commodities.

When considering this issue, it is useful to review the legislative history of the agricultural commodities exception. As noted below, it is particularly important to recognize that both the House Ways and Means Committee and the Senate Finance Committee have expressed concern about the possibility that this exception might be construed narrowly so as to preclude United States based companies from participating in sales of international agricultural commodities.

Based on considerations related below, it is suggested that the United States Congress should adopt, as soon as possible, the third market country approach recommended by the Senate Finance Committee.

DISCUSSION

Legislative History and Administrative Considerations

Agricultural Commodities Exception Under Subpart F

The Revenue Act of 1962 added Subpart F to the Internal Revenue Code to deal with the problems of tax haven operations. Under Subpart F, United States shareholders of controlled foreign corporations are subject to current United States income taxation on certain forms of undistributed income (tax haven or Subpart F income), including income from the operations of foreign base sales companies. Limited exceptions to Subpart F continued the privilege of tax deferral for certain kinds of operations. Although the general thrust of the TRA was to eliminate or restrict these exceptions, the TRA created a new Subpart F exception for income derived from sales of agricultural products traded in international markets.

The decision to create a new exception for certain agricultural trade reflected an awareness that United States interests are not always served by taxing the operations of United States owned firms on a current basis. More specifically, the Congress recognized inherent differences between manufacturing and mining activities, on the one hand, and agricultural marketing activities on the other.

In the light of these considerations, the Congress recognized that important United States national and international interests would be served by continuing deferral for United States owned firms engaged in sales of agricultural commodities grown outside the United States.

Tax Reduction Act of 1975

Under the TRA, the Congress created a new exception for income derived from sales of agricultural commodities traded in international markets. The TRA language amending Section 954(d) of the Internal Revenue Code provided an exception for "agricultural commodities not produced in the United States in commercially marketable quantities."

1975 House Bill

The issue of the agricultural exception was raised again during proceedings of the House Ways and Means Committee in late 1975.[1] The clear consensus was that a technical amendment was probably needed to clarify the meaning of the TRA provision. The language incorporated in the 1975 House Bill to accomplish this purpose provided:[2]

"(a) IN GENERAL.—The last sentence of paragraph (1) of section 954(d) (relating to definition of foreign based company sales income) is amended to read as follows: 'For purposes of this subsection, personal property does not include agricultural commodities which are significantly different in grade or type from and are determined by Secretary of the Treasury after consultation with the Secretary of Agriculture not to be readily substitutable for (taking into account consumer preferences) agricultural products grown in the United States in commercially marketable quantities.' "

The House Ways and Means Committee advanced the following arguments in support of revising the language of the TRA:[3]

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[1] See Committee Print prepared for the use of the Committee on Ways and Means by the staff of the Joint Committee on Internal Revenue Taxation concerning U.S. Taxation of Foreign Source Income, p. 8, September 27, 1975.

[2] See Section 1025 of the Tax Reform Act of 1975 (concerning limitation on definition of foreign base company sales income in the case of certain agricultural products), H.R. 10612, p. 211 and 212, Rep. No. 94-658, 94th Cong., 1st Sess., November 12, 1975.

[3] See Report of the House Ways and Means Committee accompanying H.R. 10612, p. 221, Rep. No. 94-658, 94th Cong., 1st Sess., November 12, 1975.

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"* * * One of the categories of tax haven income subject to current taxation under the Subpart F provisions of the code is base company sales income. The Tax Reduction Act of 1975 contained an amendment which provides that base company sales income does not include the sale of agricultural commodities which are not grown in the United States in commercially marketable quantities. It has come to your committee's attention that questions have been raised as to the extent that this exclusion applies to agricultural products which are of a different grade or variety from the same product grown in the United States. Your committee believes that sales of foreign-grown agricultural products which are not readily substitutable for U.S.-grown agricultural products should not be included within the definition of foreign base company sales income in the case of sales made to the third countries. Your committee is aware that these sales are highly competitive and that if the profits on these sales were subject to U.S. tax on a current basis, U.S.-controlled foreign companies would have difficulty competing with foreign-controlled companies. Accordingly, your committee believes it is appropriate to permit this category of income to retain the tax advantages of deferral until the profits are repatriated to the United States."

In an attempt to explain its purpose in amending the agricultural exception, the Committee provided examples: [4]

"Your committee's bill provides that for purposes of the tax haven foreign base company sales rules of subpart F, personal property does not include agricultural commodities which are significantly different in grade or type from, and are determined by the Secretary of the Treasury after consultation with the Secretary of Agriculture not to be readily substitutable (taking into account consumer preferences) for, agricultural products grown in the United States in commercially marketable quantities. For example, if in country X a grade or variety of corn is grown which is used in country Y as chicken feed to obtain a particular quality and color of chicken meat which would be different than the quality and color of chicken meat which would be obtained from using corn grown in the United States, and if it is further found that consumer preferences in country Y demand the grade and color of chicken meat which can only be obtained from corn grown in country X, then the tax haven base company sales provision does not apply to sales of this grade or variety of corn for use as chicken feed in country X.

"In addition, products of a different type which are not competitive by reason of a substantial price differential are not to be treated as readily substitutable for each other. For example, it has been called to your committee's attention that manioc is often used in certain countries as a feedstock rather than corn. Since manioc is a significantly different product than corn, although they may have a similar use, it is your committee's intent that in determining whether entirely different products are readily substitutable for U.S.-grown products, the price differential, if so substantial that the U.S.-grown product cannot compete with the foreign-grown product, is to be taken into account in determining consumer preference.

"This section of the bill applies to taxable years of foreign corporations beginning after December 31, 1975, and to taxable years of U.S. shareholders within which, or with which the taxable years of the foreign corporations end."

Notwithstanding the clear concern of the House Ways and Means Committee that the United States owned companies be given a continuing opportunity to compete for this important business, it is possible that substantial complexity might be involved in interpreting this language as a consequence of inherently difficult constructions.

Although such an approach could require a year-by-year, case-by-case analysis involving an almost infinite variety of transactions in administering the law, this result would comport with neither the clear intention of the Congress to preserve competitive opportunities for United States owned firms nor the important objective of tax simplification.

1976 Tax Legislation before the Senate

On December 4, 1975, the full House passed the Tax Reform Act of 1975, H.R. 10612, and referred the bill to the Senate. Because of time constraints and other considerations, the Senate Finance Committee directed its immediate attention to the tax reduction provisions of the 1975 House Bill and did not undertake consideration of the tax reform provisions of the bill.

[4] See Id., p. 222.

During the month of December 1975, the House and Senate debated and acted on this legislation and then forwarded a bill to the President to exetnd tax reductions until June 30, 1976. The tax reform provisions of the 1975 House Bill, including the provision modifying the agricultural exception to Subpart F, were not considered by the Senate Finance Committee in 1975.

On February 5, 1976, Chairman Russell B. Long announced that the Senate Finance Committee would begin hearings in March 1976 on major tax revision proposals and extension of expiring tax cut provisions. Following these hearings, the Senate Finance Committee proceeded with mark-up of the subject tax legislation and reported out a bill for consideration of the full Senate on June 10, 1976.[5]

Treasury views and administrative considerations

Earlier this year, there were further discussions and communications on this matter, including Members and staff of the Senate Finance Committee, the staff of the Joint Committee on Internal Revenue Taxation, and the Assistant Secretary of the Treasury for Tax Policy. At that time, the United States Department of Agriculture expressed its views to the Senate Finance Committee, and subsequently to the House Ways and Means Committee, urging that the third market country approach be adopted to clarify this matter so as to preserve important United States national and international interests.[6]

In early May of 1976, the Treasury Department expressed its views on this matter to the Senate Finance Committee.[7]

"The Treasury Department has expressed concern that the provision in the House bill which would broaden the category of agricultural commodities the income from the sale of which will fall within the exception to current taxation under subpart F for agricultural commodities will not be administrable. Therefore, the Treasury Department recommends that if the committee wishes to exclude agricultural commodities from the foreign base company sales income provisions of subpart F then the exclusion should be broadened to include all agricultural commodities produced or grown abroad which are sold for use, consumption or disposition outside of the United States."

Tax Reform Act as reported by the Senate Finance Committee

Based on considerations noted above, the Senate Finance Committee adopted an agricultural commodities exception based on the third market country approach:[8]

"SEC. 1025. LIMITATION ON DEFINITION OF FOREIGN BASE COMPANY SALES INCOME IN THE CASE OF CERTAIN AGRICULTURAL PRODUCTS

(a) IN GENERAL.—The last sentence of paragraph (1) of section 954(d) (relating to definition of foreign base company sales income) is amended to read as follows: 'For purposes of this subsection. personal property does not include agricultural commodities grown or produced outside the United States if sold for use, consumption or disposition outside the United States.'

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years of foreign corporations beginning after December 31, 1975, and to taxable years of United States shareholders (within the meaning of section 951b) of the Internal Revenue Code of 1954) within which or with which such taxable years of such foreign corporation end." (Emphasis supplied.)

This approach provides a clear and easily administreed standard which would enable United States owned firms to compete for this important third country trade without significant doubts about the tax consequences under United States laws.

The following reasons for adopting this approach were noted in the Senate Finance Committee report.[9]

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[5] See Report of the Committee on Finance, United States Senate, accompanying H.R. 10612, Rep. No. 94-938, 94th Cong., 2d Sess., June 10, 1976.

[6] The United States Department of Agriculture communicated its views to the Chairman of the Senate Finance Committee and to the Chairman of the Ways and Means Committee.

[7] See Press Release of the Committee on Finance, United States Senate, concerning Foreign Tax Deferral, 94th Cong., 2d Sess., May 18, 1976, pp. 1 and 2.

[8] See H.R. 10612, Rep. No. 94-938, 94th Cong., 2d Sess., p. 471, June 10, 1976.

[9] See Report of the Committee on Finance, United States Senate, accompanying H.R. 10612, Rep. No. 94-938, 94th Cong., 2d Sess., pp. 232-233, June 10, 1976.

"CERTAIN AGRICULTURAL PRODUCTS

REASONS FOR CHANGE

As indicated above, one of the categories of tax haven income subject to current taxation under the subpart F provisions of the code is base company sales income. The Tax Reduction Act of 1975 contained an amendment which provides that base company sales income does not include the sale of agricultural commodities which are not grown in the United States in commercially marketable quantities. It has come to the committee's attention that questions have been raised as to the extent that this exclusion applies to agricultural products which are of a different grade or variety from the same product grown in the United States. The committee believes that sales of foreign-grown agricultural products for use, consumption, or disposition outside the United States should not be included within the definition of foreign base company sales income. The committee is aware that these sales are highly competitive and that if the profits on these sales were subject to U.S. tax on a current basis, U.S.-controlled foreign companies could have difficulty competing with foreign-controlled companies. Accordingly, the committee believes it is appropriate to permit this category of income to retain the tax advantages of deferral until the profits are repatriated to the United States.

EXPLANATION OF PROVISION

The committee's amendment provides that for purposes of the tax haven foreign base company sales rules of subpart F, personal property does not include agricultural commodities grown or produced outside the United States if sold for use, consumption. The committee believes that this rule will be easier for the Internal Revenue Service to administer than either the rule contained in present law or the rule contained in the House bill."

Proposed Treasury Income Tax Regulations

As noted above, Section 602(b) of the Tax Reduction Act of 1974 added a new sentence to Section 954(d)(1) of the Internal Rvenue Code (relating to the definition of foreign base company sales income which excluded from the definition of personal property, for purposes of computing foreign base company sales income, agricultural commodities which are not grown in the United States in commercially marketable quantities.

The Proposed Treasury Income Tax Regulations on the agricultural commodities exception designate different livestock and products and 81 different crops to be considered grown in the United States in commercially marketable quantities. Moreover, if derivatives or extracts of the commodities listed are taken into account, the number of commodities grown in the United States in commercially marketable quantities would probably reach a range from 200 to 400.

The exclusion added by Section 602(b) of the TRA would thus apply to only four commodities (perhaps five to ten including extracts). Based on considerations related above on the legislative history of this provision, it is clear that the Congress did not intend to provide such a limited exclusion. In point of fact, all indications suggest the contrary. The Congress has expressed concern that the exclusion might be interpreted so as to effectively preclude United States owned companies from continuing to participate in the important third market international trade of agricultural commodities and has specifically noted that United States national and international interests support the need for preserving the competitive position of United States owned firms in this trade.

POLICY CONSIDERATIONS

As noted in the House Ways and Means Committee report and the Senate Finance Committee report, it was necessary to provide such an exception for sales of agricultural commodities traded in third country markets in order for United States owned firms to continue to participate in this highly competitive

business. Without such an exception, this business would be transferred to foreign owned firms beyond United States tax jurisdiction and control.

In the absence of an exception for third market country international agricultural trade, several disadvantages would obtain to the United States national and international interests:

1. United States owned firms would lose an opportunity to compete for trade in a market worth $80 to $100 billion each year;

2. Participation in this trade would be limited to firms beyond United States tax jurisdiction and control and would thereby preclude the United States from taxing profits on this trade which might otherwise be repatriated to the United States;

3. The United States Department of Agriculture would lose an important source of information about this third market trade;

4. United States owned firms with substantial investments in facilities in this country used in exporting United States agricultural products would lack both the knowledge and opportunity provided by their present position in third country trade to press for sales of United States produced commodities.

To avoid this result, the Senate Finance Committee recently adopted a limited agricultural commodities exception based on the third market country approach. In effect, the new provision would exempt from current taxation under Subpart F sales of agricultural commodities grown and sold for consumption, disposition or use outside the United States. The third market country exception has the strong support of the United States Department of Agriculture.

CONCLUSION

Based on these considerations, it is clear that the exception for sales of third market country international agricultural trade recommended by the Senate Finance Committee is important to United States national and international interests, and therefore it is urged that the United States Congress adopt the third market country approach recommended by the Senate Finance Committee.

TESTIMONY OF GREGORY A. PALAST, DIRECTOR OF RESEARCH, ON BEHALF OF THE LABOR COALITION ON PUBLIC UTILITIES

Mr. Chairman: Section 802 of Bill #H10612 before this Committee, amending Section 46(b) of the Tax Code, would give to utilities and certain other corporations a cash grant out of the U.S. Treasury a sum equal to the excess of these corporations' tax credits over their tax liabilities if the excess credit remains after a carryover of seven years. (See Committee Report page 177.)

MIDWEST UNIONISTS OPPOSE NEW TAX LOOPHOLE FOR UTILITIES

The Midwest union leadership represented by the Labor Coalition on Public Utilities asks that this loophole be shut tight and rejected for the following reasons:

1. The provision would not accomplish its purported purposes; it would not aid those few utilities in financial trouble.

2. The provision will lead to higher permanent unemployment in the utility field and hamper economic recovery.

3. Left unadjusted, the cash grant would not at all help utility customers but rather add new and excessive charges to their bills.

4. This provision would give away to some of the wealthiest corporations in America $300 million to $500 million per year beginning in 1984. At a time when the Presidential Candidate of the majority party has charged that tax reform "has been a joke," his own party members may well make him the fool with passage of this give-away provision.

CLOSE THE LOOPHOLE WITHIN THE LOOPHOLE—REQUIRE REGULATORY "FLOW-THROUGH" OF GRANT, PROHIBIT NORMALIZATION

If the public interest is flaunted and this give-away provision is passed, then, at least, the loophole-within-the-loophole must be sealed off.

Presently, either on their own initiative or under Section 46(f) of the Tax Code, many public utilities "normalize" their tax credit savings—that is, pocket

the tax savings for their stockholders while charging their customers as if no tax credit accrued.

The danger lurking quietly in this bill is that state and federal regulatory agencies will allow utilities to normalize this tax grant. This would lead to an enormous windfall for the most profitable utilities, with none of the savings passed through to their customers. However, our recommendation that normalizing the tax grant be prohibited would not in the least harm those utilities truly in need of financial assistance i.e. those not earning their allowed rates of return.

We strongly recommend that if this inequitable provision is adopted, that at least its most blatant inequity be removed: we recommend that the Congress prohibit normalized accounting of the cash grant for regulatory purposes in language which would exactly mirror and reverse the language of Section 46(f) of the Tax Code. Note that such an amendment would not effect the sum of cash grant but WOULD LOWER the bills of the utilities' customers.

Passage of this provision without this change would result in a gross inequity—utilities would charge their customers for "taxes" while the utility is actually receiving tax money.

PROVISION WILL NOT ACCOMPLISH ITS PURPOSE

The cash grant in Section 802 is designed to help utilities and other industries in serious financial trouble. However, this cash refund will hardly accomplish this objective: for it will be inaccessible to many troubled utilities while enriching stockholders of some of the most profitable.

On one hand, those utilities in financial straits have lacked the financing for proper expansion. Hence, they have obtained few of the tax credits which come from expansion. Ironically then, it is these very utilities, for whom the assistance is intended, who will get very little of the cash grant.

On the other hand, the most profitable utilities have accrued the bulk of the tax credits through their enormous plant expansion. Their rapid expansions have allowed them enormous funds from accelerated depreciation. While large accelerated depreciation funds provide a large cash flow and hence financial strength, these same accelerated depreciation funds sharply reduce taxable income. Thus, the other half of the irony is that these wealthiest of utilities will receive the bulk of the cash grants. The cash grant mocks its own purpose.

THE CASH GRANT PROVISION WILL CAUSE UNEMPLOYMENT AND HAMPER ECONOMIC RECOVERY

First, the employment record of the utility industry is shameless. Bell Telephone permanently laid off 56,000 workers in 1975. Since the demand for utility services is determined by the general level of economic activity, excessive investment credits subsidize wasteful automation. For this reason, utilities had, until 1975, been wisely limited to an investment credit only half that allowed other industries.

Second, this cash grant rewards those utilities which practice reckless, unnecessary expansion. Such reckless expansion is already reflected in bloated electric and phone bills. These same hard-hit customers would be charged again on their tax bills through provision 802.

Third, this cash grant could well hinder economic recovery. A dollar spent on utility investment creates less than one-fourth the number of jobs created by a dollar of investment in other industries. If it is true that capital is in short supply then certainly the last place our dollars should go is in the pockets of utility stockholders.

LABOR DEMANDS FAIR TREATMENT

The Labor Coalition on Public Utilities, representing the leadership of twenty-six Midwest labor unions, in shops and union halls hears constantly from workingpeople fed up with outrageous utility bills and an unfair tax structure. No one has proposed that, like utilities, workers unemployed by reimbursed their full foregone salaries after seven years. Our people hear of utilities pocketing their tax money and they are angry.

Through our union newsletters, at our conventions and gatherings, a half million Midwest workingpeople will learn how they have been treated—for good or for bad—by this Committee, its members and Congress.

FURTHER HEARINGS REQUESTED

Only the special interests groups have been given adequate time to prepare for these hearings.

We strongly believe that this bill is an idea whose time is never. We request an opportunity to appear before this Committee in person for the purpose of expanding our testimony on this matter—which has been given only cursory examination by the Committee though its cost is in the billions.

A list of our membership is enclosed as part of this testimony.

Labor Coalition on Public Utilities, 204 South Ashland Boulevard, Chicago, Illinois 60607. Harry E. Conlon, President; Theodore Smolarek, Secretary-Treasurer.

John Van Eyck, Midwest Regional Director, Actors Equity Association, AFL-CIO.

Patrick E. Gorman, International Secretary-Treasurer, Amalgamated Meat Cutters and Butcher Workmen of North America, AFL-CIO.

Charles Hayes, International Vice President and Director, District #12, Amalgamated Meat Cutters and Butcher Workmen of North America, AFL-CIO.

Sol Brandzel, Manager, Chicago and Midwest Region Joint Boards, Amalgamated Clothing Workers of America, AFL-CIO.

Don Jones, President, Local #1395, American Federation of Government Employees, AFL-CIO.

Neal Bratcher, Director, District #19, American Federation of State, County and Municipal Employees, AFL-CIO.

Tommy Briscoe, President, Chicago Local, American Postal Workers Union, AFL-CIO.

Maxie Hill, Corresponding Secretary, Local #1, Bakery and Confectionary Workers International Union of America, AFL-CIO.

C. L. Dennis, President, Brotherhood of Railway, Airline and Steamship Clerks, AFL-CIO.

Mollie West, Executive Committee, Chicago Typographical Union #16, AFL-CIO.

Barbara Merrill, President, Chicago Chapter, Coalition of Labor Union Women.

Lucille McGown, President, Local #18-B, Furniture and Bedding Workers Union, AFL-CIO.

George K. Gundersen, President, Chicago Local #245, Graphic Arts International Union, AFL-CIO.

Elena Marcheschi, Business Representative, Local #350, International Brotherhood of Painters and Allied Trades, AFL-CIO.

William Joyce, Secretary-Treasurer, Local #710, International Brotherhood of Teamsters.

John McKnight, Vice President, Local #738, International Brotherhood of Teamsters.

Harold Schwartz, Manager, Chicago Joint Board, International Ladies Garment Workers Union, AFL-CIO.

Richard D. Watson, Director, District #7, Oil, Chemical and Atomic Workers International Union, AFL-CIO.

Henry Anderson, President, Chicago Joint Board, Retail, Wholesale and Department Store Union, AFL-CIO.

Ronald McCantz, Secretary, Civil Rights and Community Services Committee, Local #777, Seafarer's International Union, AFL-CIO.

Edward Todd, Assistant to the International President, Textile Workers Union of America, AFL-CIO.

Robert Johnston, Director, Region IV, United Auto Workers of America.

Thomas Miechur, President, United Cement, Lime and Gypsum Workers International Union, AFL-CIO.

Frank Rosen, General Vice President, United Electrical, Radio and Machine Workers of America (UE).

Mark Pitt, Illinois Director, United Farm Workers, AFL-CIO.

Jack Spiegel, Director, Lake States District, United Shoe Workers of America, AFL-CIO.

Edward Sadlowski, Director, District #31, United Steel Workers of America, AFL-CIO.

MAP INTERNATIONAL,
Wheaton, Ill., July 21, 1976.

Re H.R. 10612, Senator Ribicoff's amendment 1612, gifts of inventory.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: On behalf of the 136 mission agencies and their 1,000 doctors and dentists providing charitable health care for the medically impoverished in 84 Third World nations, MAP International favors enactment of the committee's amendment (1612) to 170 E of the code that will restore a needed incentive for gifts of supplies.

Most cordially,

JOHN H. STUCKY,
Vice President/Development.

Enclosure.

SAMPLE QUOTES FROM DOCTORS OVERSEAS, RE GIFTS OF INVENTORY

SENATOR RIBICOFF'S AMENDMENT 1612

"There must be a less lethal way of tax reform." "These drugs have been of tremendous value in the treatment of these people whose means are so meager and whose need is so great." "It does seem criminal when companies report that it costs more to donate the drugs than to destroy them." American Lutheran Church medical missionaries in Madagascar.

From India Dr. DeVol reported, "Medicines contributed by drug companies in the U.S. through Medical Assistance Programs have been a tremendous help to us and to the people we serve in this area. Of late these services have been drastically curtailed because of the 1969 Tax Reform. When we cannot get these drugs to give free to patients who are doing well to have one square meal a day, you can understand our concern that this bill be passed."

"The supply of vital antibotics has virtually ended." Charles VanderSloot, Korea. He continued, "While the severe reduction in donated medicines has not ruined our efforts, it has undoubtedly restricted the type of medical care we offer."

"Drugs that have been made available to us have diminished in a most discouraging fashion, necessitating the purchase of many pharmaceuticals at world market prices, which our patients can ill afford to pay on an average income of $125.00 per year." Stan Quanbeck, M.D. serves a 200,000 population.

In India the report is, "Although we have always had difficulty making ends meet financially, the situation has grown more severe . . . We are now buying drugs on the Indian market for distribution to the poor, but we cannot continue to do so for long."

"Come and see * * * whole pygmy villages with ulcerated bodies, we can show them to you. Penicillin would do the trick and clear the whole village of infection. We have all we can do to pay the transportation of medicines to this corner of the world where they are so badly needed."

Dr. Adolph appealed for his 25,000 patients, "The help we can give this part of the world, Ethiopia, in great measure depends on the passage of this bill."

From Zaire Tom Cairns, M.D., "Without this source of drugs our work would have to be severely curtailed."

"Supplies available to us have decreased. However, the number of patients continues to increase. I see no way to minister adequately to these medically deprived people." LaVerne Miley, M.D., Ivory Coast.

In Paraguay the report is, "Of necessity we must reduce services offered."

Even from Japan James Saterwhite, M.D. pled with Congressmen, "Here in Japan we do not need such help, but our hospitals in Kenya, Nigeria, Indonesia, Thailand, Bangladesh and India are doing a real job of sharing that should be allowed to be our American helping hand where it really counts, on the personal level."

"Needless to say, the effect as we see it in developing countries is heartbreaking." S. C. Topple, M.D., Korea.

"The donated medicines gave us the opportunity to use many drugs which could not have been used on our limited mission budget." Howard Hamlin, M.D., Republic of South Africa.

Eleanor Soltau, M.D., Jordan, "These donated drugs many times meant the difference between life and death to patients under our care . . . We find it so refreshing to see such genuine appreciation for any medical help they have received. Most of the bedouins are desperately poor."

Nazareth Hospital, Israel, "I know from my own experience how valuable medications can be in my own practice and in the practices of hundreds of other doctors like myself serving in many parts of the world," R. W. Martin, M.D.

Donald McDowell, M.D., Paraguay, "I believe this is one of the best ways that the United States can show its friendship and its concern for the underdeveloped nations."

G. R. Chapman, M.D., Hong Kong, "Without these donations our operation is decidedly handicapped."

Pakistan, David Williams, M.D., concerning the loss of donated medicines writes, "In light of the medical needs in Pakistan alone this is tragic. In our institution, budget does not allow us to purchase large quantities of drugs at market prices to use for the large number of patients seen annually who cannot pay their way. In the past these donated drugs have enabled us to see that the indigent patient gets proper medicines despite his income level."

"It is a marvelous thing to tell the parents of a dying child, 'your child will recover because people in America are concerned enough to send good medicine to cure this illness.' I know of no other more effective way to neutralize so much bad propaganda so loudly voiced about Americans." Lorne Brown, M.D., Kenya.

"Always we are short of supplies," William Gaventa, M.D., Nigeria.

"We feel it is a tragedy that our laws should discourage sharing overproduction with medically destitute people."

AMERICAN PETROLEUM INSTITUTE,
Washington, D.C., July 22, 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: This letter is written in behalf of the membership of the American Petroleum Institute with respect to matters that are before your distinguished Committee with the resumption of tax revision hearings which are currently in progress. It is noted that spokesmen for individual companies have been scheduled to testify on specific subjects or provisions of the pending tax bill. In the interest of avoiding duplicative oral testimony, we submit these comments for the record in the hope that they will assist in your deliberations.

While our comments will in particular relate to three provisions of the bill as it now pends before the Senate, we would like to commend the Committee for adopting constructive amendments relating to geothermal development, the correction of inequities arising from the 1975 changes in percentage depletion for oil and gas, and certain transitional treatment provided with respect to foreign source income. Provisions such as those to which reference has been made in the foregoing enumeration have been amply described and explained in the excellent Committee Report which accompanied H.R. 10612 and will not be the subject of further comment here. However, there are two provisions affecting foreign oil and gas extraction income which we believe merit additional comment to provide better understanding of the justification for their inclusion in H.R. 10612. There is a third provision on which we would like to comment that we believe should be deleted from the bill.

The first of these three provisions for specific comment would revise the definition of foreign oil related income to include interest from a qualified domestic corporation. The need for this amendment arises from a drafting inadvertence in the Tax Reduction Act of 1975. The 1975 statute in creating the new income category known as foreign oil related income included within the definition dividends and interest received from a foreign corporation but with respect to a domestic corporation included only dividends. The amendment contained in H.R. 10612 would correct this unintended omission so as to include both dividends and interest when received from either a foreign or a domestic corporation. The record is clear that this feature of the 1975 Act was not the intent of Congress at the time of the law's adoption. This legislative oversight should be corrected as provided in H.R. 10612 but it is submitted that the effective date of

the correction should be January 1, 1975 (the effective date of the error), and not January 1, 1977, as provided in the pending bill.

The second provision of H.R. 10612 on which we would make specific comment is subsection 1035(e) prescribing the tax status of certain payments for oil and gas. Section 901(f) of the Internal Revenue Code, as added by the Tax Reduction Act of 1975, provides that foreign income taxes paid in connection with the purchase and sale of oil or gas in a foreign country are not to be creditable if the taxpayer has no economic interest in the oil or gas and either the purchase or the sale is at a price which differs from the fair market value for such oil or gas. Section 1035(e) of the reported version of H.R. 10612 would amend section 901(f) in order to prevent that section from operating inequitably in certain situations in which foreign countries nationalized the properties of U.S. companies operating in those countries.

A number of the oil producing countries throughout the world have either already nationalized the properties of U.S. taxpayers operating therein or have announced plans to do so. In some of the countries, in recognition of the nationalization of the properties, arrangements have been made or will be made to permit purchase of oil or gas at a price below fair market value followed by resale of the oil or gas at a profit subject to foreign income tax. The purpose of section 1035(e) is to provide that in such a situation the new arrangement will be regarded as essentially the continuation of the presently existing economic interest thus preventing inequitable application of section 901(f) to disallow creditability of the foreign income taxes paid. This proposed change presents a minimum solution to the problem presented by the necessity of making new arrangements upon nationalization by foreign governments. Whatever may have been the purpose of enactment of section 901(f) it does not seem to have been intended to prevent creditability of foreign income taxes paid by taxpayers who made investments in foreign countries and acquired economic interests but suffered the misfortune of having their properties nationalized by the foreign governments involved.

Section 1035(e) provides for termination of the period over which the discount is allowed in the year 1986. It would seem more appropriate to put no limitation on the period of time since the arrangement, having arisen out of the economic interest of the taxpayer in the foreign country, should qualify for whatever period the arrangement may exist.

The third provision of H.R. 10612 on which we would make specfic comment is Senate Floor Amendment Number 2043 offered by Senator Hartke and adopted by the Senate yesterday. We oppose this amendment. The amendment would place oil and gas extractive income on a per country basis, define certain income taxes as non-creditable royalties, and further restrict the allowable creditable income taxes.

In the Tax Reduction Act of 1975, petroleum companies alone were denied the option of using the per country method of limiting foreign tax credits. Further, petroleum companies were restricted even in the use of the overall method with respect to oil related income. Amendment Number 2043 would again single out the petroleum industry for further punitive treatment and force petroleum companies to use the per country method with respect to extractive income, completely reversing the concept contained in the Tax Reduction Act of 1975, which required that oil companies use the overall method of limiting foreign tax credits. With respect to this reversal of position, it is to be noted that further inconsistency can be found in the fact that H.R. 10612 would require all other taxpayers to use the overall method.

Under Amendment Number 2043 the Secretary of Treasury is given extraordinary power to treat foreign income taxes as royalties. Canada, the United Kingdom, and the Netherlands, to name a few countries, have special income taxes on petroleum operations. If such taxes were treated as royalties, U.S. companies operating in these countries would be rendered totally noncompetitive.

Thus, in summary, the amendment would reverse fundamental tax policies adopted last year, erroneously classify income taxes as royalties, restrict basic foreign tax credit concepts, and impose international double taxation on U.S. taxpayers. It should not be retained in H.R. 10612.

In closing, it may be appropriate to note that there are numerous other floor amendments to H.R. 10612 which, if adopted, would drastically and adversely affect the U.S. petroleum industry. Such unwise proposals which for the most part have not been subject to the committee hearing process would severely disadvantage the Nation's energy outlook at a time when the United States is already

in trouble on energy. Currently U.S. oil and gas proved reserves are declining and reliance on imports is increasing. The United States is presently obliged to import about 45 percent of its liquid petroleum needs. There is an urgent necessity to replace our dwindling domestic reserves and to obtain diversified foreign sources of secure supplies. The capital requirements to attain these objectives are enormous and substantially exceed the industry's current cash flow. Higher tax burdens on the industry can only impair that already inadequate cash flow position and weaken the economic justification for committing the required capital amounts to the high risk undertaking of the search for oil and gas. Numerous studies have established that the petroleum industry is among the most heavily taxed industries. The imposition of additional punitive tax burdens on the petroleum industry can only detract from our efforts to improve the Nation's energy outlook. America's role of preeminence in international trade and the importance of that trade in providing jobs and economic progress are important considerations in evaluating the implications of tax amendments that are hostile to private enterprise.

I thank you for permitting the American Petroleum Institute to make this submission for the record of the Senate Committee on Finance's current tax revision hearings. If we can be of service to the Committee in supplying additional information, please do not hesitate to let us know.

Sincerely,

FRANK N. IKARD.

GATX CORP.,
Chicago, Ill., July 22, 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: The following is submitted for consideration by the Committee on Finance in response to the invitation contained in Senator Long's press release dated July 8, 1976, announcing hearings on certain tax provisions approved by the Committee for incorporation in H.R. 10612.

SUMMARY

We support the Committee's proposed amendment with respect to the investment credit in the case of vessels constructed from funds withdrawn from a capital construction fund (Sec. 806 of the bill) with the exception of the effective date. We believe the effective date should be "with respect to investment credits claimed in years beginning after March 31, 1970".

STATEMENT

The Committee indicated in its Report (pages 196 and 197) that the reasons for the proposal include the fact that the investment credit was not in effect at the time the Merchant Marine Act was revised in 1970 and that, when the credit was subsequently restored, Congress did not consider whether or not the credit should be available in the case of a vessel constructed with funds withdrawn from a capital construction fund. The Committee, after studying this problem, believes that it is undesirable to reduce the incentive effect of the capital construction fund by denying the investment credit in the case of monies withdrawn from such a fund for ship construction while the credit is available for other forms of capital investment. With this in mind it seems only appropriate to permit the effect of the legislation to apply to all credits resulting from the construction of vessels under the 1970 legislation and not to correct the problem only for the future. To do less than this leaves open the question as to whether or not the credit applies in years prior to 1976. If the legislation is to be fair it should apply with respect to all credits for vessels constructed from amounts withdrawn from funds subsequent to the effective dates of the 1970 amendment to the Merchant Marine Act and to the restoration of the investment credit by the 1971 Revenue Act. The suggested effective date would, we believe, do this.

Very truly yours,

HENRY J. NORO,
Executive Vice President.

UTICA MUTUAL INSURANCE CO.,
July 23, 1976.

Re addendum to statement in opposition to section 1508 of H.R. 10612 (consolidated returns by life insurance and non-life-insurance companies).[1]

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Russell Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: This addendum to the statement of Utica Mutual Insurance Company of yesterday is submitted to take into account one aspect of the statement of John H. Filer, Chairman of Aetna Life and Casualty Co. for ad hoc group of twelve stock and mutual life insurance companies.

Mr. Filer has submitted that the chronology of the genesis of section 1508 would "dispel any doubts regarding" the full and complete consideration by the Congressional Tax Committees. The chronology consists of oral and written statements made to the House and Senate Finance Committees in Hearings on Tax Reform and statements submitted to the staffs of the Treasury and Joint Committee.

Utica believes that the doubts remain greater than ever.

The chronology indicates that the proponents of the legislation have been trying since 1973[2] to obtain some interest from the Congressional Committees on their proposal for consolidated returns. They did not obtain a favorable response until the Committee decision of May 27, 1976.

Utica is sympathetic to the problem of the Senate Finance Committee to recommend enactment, without public hearings, of a limited remedial provision, such as a change in effective date. But the life insurance area is a complicated area, in which revenue considerations have been paramount. The complexity is illustrated by the lapse of seventeen years since the enactment of the present life insurance provisions in 1959, but the Treasury has yet to issue legislative regulations covering consolidated returns of income of only life insurance companies. Permitting life insurance companies to consolidate with non-life insurance companies may be infinitely more complicated and involve the very heart of the present income tax provisions, as Utica's statement of yesterday indicates. Accordingly, therefore, public hearings on the proposal are almost a must.

Public hearings involve more than ex parte statements by proponents of legislation to Committees and its staffs. The present provisions on the taxation of life insurance companies were initiated by public hearings before the Ways and Means Committee on November 17, 1958, but the legislation was not enacted until June 25, 1959. During the interim, there was consistent analysis and decision by the Congressional Committees after substantial public hearings and after adequate public notice. This was after the Treasury had spent years formulating the proposal on which the public hearings were held. Legislation enacted so painstakingly and after such detailed study should not be subjected to the possibility of serious adverse effects of a proposal enacted without public hearings and adequate notice of the specific provisions, and without adequate time for staff study.

The inadequacy of the consideration given the proposal is indicated by the brevity of the Treasury report, which did not analyze the proposal at all insofar as its effect on the life insurance company taxing provisions—perhaps because of inadequate time.

Moreover, the revenue estimates remain high even after deferral of the effective date to 1978 and the 50% limit on the deductibility of current losses. The Treasury's estimates of revenue losses is "approximately twice as high" as the Joint Committee staff estimates, or more than $300 million, and despite the limitations, are only slightly less than the Treasury's previous revenue estimates.

Given the serious competitive impact of the proposal on small casualty insurance companies, the substantial loss of revenue, and the complexity of the provisions, we believe that a thorough study of the effect of the proposal on the entire system of taxing life insurance companies is necessary before the pro-

[1] Copy of the original statement is attached.

[2] Proposals for consolidation of life and non-life companies were rejected by Congress a number of times and as early as the Revenue Act of 1928. The 1959 legislation taxed only one-half of the underwriting income of life insurance companies and adopted special limitations to insure a minimum of revenues from those companies. Hence it is not enough to state, as the proponents and the Treasury have said, that life insurance companies are taxable on all their income since 1959.

posal is adopted. Since the proposal would be effective in 1978, the proponents can hardly claim that such a study would be prejudicial.

Respectfully submitted,

VICTOR T. EHRE,
Chairman of the Board.

Attachment.

UTICA MUTUAL INSURANCE CO.,
July 22, 1976.

Re statement in opposition to section 1508 of H.R. 10612 (consolidated returns by life insurance and non-life-insurance companies).

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee, Russell Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: My name is Victor T. Ehre and I am Chairman of the Board and Chief Executive Officer of the Utica Mutual Insurance Company and also President and Chief Executive Officer of the Graphic Arts Mutual Insurance Company. Both companies are property and casualty insurers with headquarters in the greater Utica area of Upstate New York.

I am filing this statement with the Senate Finance Committee in opposition to the provisions of Section 1508 of H.R. 10612 which would in the future permit the filing of consolidated federal income tax returns by life insurance companies and non-life insurance companies. From the standpoint of my company, this proposal will have seriously adverse competitive implications. Based on communications which I have had with others in the industry, I believe that I speak as well for all similarly situated small mutual property and casualty insurance companies.

A. INSURANCE INDUSTRY'S FINANCIAL SALVATION

An argument frequently raised in support of the captioned legislation is that the resulting decreased tax revenues will add to the depleted surpluses of the property and casualty insurance industry, thereby increasing the industry's capacity to provide insurance coverages. There is no question that in recent years numerous factors, including the recent recession and price inflation, have caused the property and casualty industry to suffer large losses (*e.g.*, the 1975 pre-tax statutory underwriting losses for the property and casualty industry is estimated at $4.247 billion).[1] However, it is difficult to conceptualize how a modest amount of future tax savings (1978, $25 million; 1979, $55 million; 1980, $49 million; and 1981, $40 million)[2] will have a meaningful effect on the industry's current financial dilemma. In large part, these benefits will flow to a segment of the insurance industry (*i.e.*, those large heavily capitalized property and casualty insurance companies affiliated with profitable life companies) that is best equipped to withstand the industry's current financial turbulence while the numerous small unaffiliated companies will derive no benefit from its enactment. Since many of these small unaffiliated companies are mutual companies, the possibility of their affiliating with profitable life or non-insurance operations is remote. If the purpose of the legislation is to provide government revenues to subsidize the property and casualty insurance industry, it would seem one could develop more equitable means for allocating such a subsidy.

B. TECHNICAL DIFFICULTIES

1. Immediate Enactment of Bill Section 1508 Is Not Advisable

Assuming arguendo that we have no quarrel with the basic philosophy underlying this bill, *i.e.*, the equity in lifting the ban on life insurance companies filing consolidated returns with other companies, we believe that the complexities of life insurance company taxation and the potential abuses to this special scheme of taxation[3] dictate that, before implementation of this proposed legislation, the entire matter should be the subject of further study and that public hearings

[1] Best's Insurance News Digest, March 15, 1976.

[2] Report of the Committee on Finance of the United States Senate on H.R. 10612, page 457.

[3] This can be illustrated by the fact that in the seventeen years that elapsed since 1959, the Treasury has yet to issue regulations covering the consolidation of income of only life insurance companies—a much simpler task than would be involved in Section 1508.

should be held to give various interested parties an opportunity to be heard. Certainly, expedited passage of Section 1508 appears unjustified since the Senate Finance Committee has set the effective date of the legislation for taxable years beginning after December 31, 1977. Some of the above-mentioned complexities and potential abuses are discussed below.

2. Congressional Concept Under the Life Insurance Company Income Tax Act of 1959

Historically, life insurance companies have been taxed quite differently from other companies. In 1959, Congress, after lengthy deliberation, adopted a statutory formula for taxing life insurance companies. This formula is extremely complex in that it involves the application of unique calculations of both income and deductions. Certain of these deductions are subject to computed limitations. For example, a life insurance company's deductions for policyholders' dividends cannot, in effect, reduce its taxable investment income. Because of these special limitations, "Congress in the past has not allowed life insurance companies to file consolidated returns with other types of companies and in this manner offset their taxable investment income against losses realized from other types of operations."[4] Although the Committee Report states that the loss limitation mechanism of bill Section 1508(b)(3) preserves the Congressional concept underlying these limitations,[5] this bill would, in most instances, allow a part of a group's non-life insurance company's losses as an offset against its life insurance company taxable investment income generated in the loss year. In addition, the bill's carryforward provision (sec. 1508(c)) would permit the carryforward and ultimate absorption of virtually all of the remaining non-life losses which were not currently utilized.[6] This result is contrary to the Congressional intent underlying the limitation on special deductions contained in the 1959 Life Insurance Company Tax Act.

	Life company taxable income	Property and casualty taxable income (loss)	1978 property and casualty loss absorbed in consolidated return	Consolidated taxable income
1978	$200	($100)	($50.00)	$150.00
1979	200	0	(25.00)	175.00
1980	200	0	(12.50)	187.50
1981	200	0	(6.25)	193.75
1982	200	0	(3.13)	196.87
1983	200	0	(1.56)	198.44
Total	1,200		(98.44)	

Note that, as prescribed under the proposed legislation, in 1978, the year of the loss, the life—non-life affiliated group can only absorb 50 percent of the $100 property and casualty company loss. However, given a five year loss carryforward an additional $48.44 is absorbed in the years 1979–1983 leaving only $1.56 or about one and one-half percent of the original $100 loss unabsorbed.

In addition, certain life insurance company limited deductions (e.g., dividends to accident and health policyholders) can, in effect, be shifted to a non-life insurance company and through consolidation used as an offset of life insurance company taxable investment income. This not only represents a circumvention of the 1959 Life Insurance Company Tax Act but also rejects the philosophy of the consolidated return regulations in that it permits a life—non-life consolidated return group to report lower taxable income than it would have reported had all its insurance business been written in a single life insurance company.

Respectfully submitted.

VICTOR T. EHRE,
Chairman of the Board.

[4] Report of the Committee on Finance of the United States Senate on H.R. 10612, page 454.

[5] *Ibid*, p. 454.

[6] This can be illustrated by the following example:

Assume the following facts:

1. Life insurance company parent (P) files consolidated tax returns with its property casualty subsidiary (S) for the years 1978–1983 under the proposed bill.
2. P earns $200 of taxable income each year while S loses $100 in 1978 and breaks even in succeeding years.

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