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EXECUTIVE COMMITTEE MEETING ON PROPOSED TAX REFORM ACT OF 1986

WEDNESDAY, MARCH 26, 1985

U.S. Senate

Committee on Finance

Washington, D.C.

The committee met, pursuant to notice, at 9:30 a.m. in Room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood, Danforth, Chafee, Heinz, Durenberger, Armstrong, Symms, Grassley, Long, Bentsen, Matsunaga, Moynihan, Baucus, Boren, Bradley, Mitchell, Pryor.

Also Present: Richard Darman, Deputy Secretary of the Treasury; Roger Mentz, Deputy Assistant Secretary for Tax Policy; Denis Ross, Tax Legislative Counsel, Department of the Treasury.

Also Present: Bill Diefenderfer, Chief of Staff; David Brockway, Chief of Staff, Joint Committee on Taxation; John Colvin, Chief Counsel; Bill Wilkins, Minority Chief Counsel; Randy Hardock, Tax Counsel, Minority; Lindy Paul, Tax Counsel; Mel Thomas, Tax Counsel, Joint Committee on Taxation; Susan Taylor, Executive Assistant.

The Chairman. The Committee will come to order, please.

I have an announcement of some note, and it tells you how easily you can forget where you are. Secretary Mentz came up to me today and said the Administration has sent forth his appointment. And I thought he had been appointed Ambassador or something to some tax treaty haven where his knowledge of taxes would serve our government in good stead. It turns out all they are doing is sending forward his nomination for the position he has been acting in for the last three or four months, and I thought he had been official all this time.

So congratulations, Mr. Still Acting but soon to be confirmed, I hope, Secretary Mentz.

We are on the accounting section today. And many of these accounting provisions initiated with the Treasury, and I will be calling on Secretary Mentz in some cases to explain them. I have got a feeling, Roger, on occasion to defend them, with the comments I have heard from some of the members.

But let us simply start out with the simplified dollar value, LIFO method of certain small businesses. It is on Page 24. It is the first item, Item A.

This was not a provision that was in the Administration's proposal, as I recall. It is an administration that was put in the House, and it is one that we have put in. Unless the

Administration has objection, I think both the House and the Senate thought it was a good provision, but I would call upon the Treasury for comment.

Mr. Mentz. Certainly we do not have any objection to it. We were looking to an indexed FIFO rule in the Treasury 2 and were for reasons of revenue compelled to withdraw that in order to reach revenue neutrality at the end of August. But we certainly are sympathetic to the needs of small business to have a simpler rule that in effect takes inflation into account in inventories, and I think the FIFO rule does, as best I understand it.

The Chairman. What we tried to do between the FIFO and the LIFO procedures is to change it so that small business is protected from the ravages of inflation. I think by and large the House did a good job, and we have pretty much adopted what they had.

And I have heard no comment from anybody on the Committee about this particular section.

Senator Chafee. Mr. Chairman, I think it is important to note that this is a plus for small business. In other words, as we go through this in its totality, some might suggest that we have not done this and we have not done that for small business. I think it is important to put on the upside of the scale that this is definitely, this provision on Page 24, is a small business plus.

The Chairman. I do not think it is. And there are some other provisions in here including expensing, including small business being allowed to deduct half the cost of their health insurance if they are a sole proprietor -- they cannot deduct any of it now whereas corporations can. But as Senator Roth said yesterday, one of the major things that he is concerned with and the members are concerned with is job creation. And if there is any evidence that is overwhelming, it is new jobs are coming not from the Fortune 500, but they are coming from small business, and on many occasions, small, new business.

And I think anything we can do to encourage them, whether it is starting up with favorable stock options or a debenture proceeding we have in the bill or whether it is encouraging them to purchase more equipment by allowing them more generous expensing or to deduct part of their health insurance premiums -- if that helps small business, that is going to create jobs, more jobs, in this country.

Senator Chafee. Well, Mr. Chairman, I could not agree with you more. And I am singing in the choir. But I think it is important to register this as a pro-small business point.

The Chairman. Now let us move on to the cash method of accounting. The cash method of accounting per se is nothing new nor is accural, but in the Administration's provisions, they had a significant limitation on the cash method of accounting. The Administration's provision would have raised about $4 billion; the House's about $2.7 billion; and ours about $2.8 billion.

But I would like to call on Secretary Mentz because on this one, there has been some controversy as to whether or not we should be moving toward this proposal at all. So if you could tell us what is the abuse that Treasury wanted to correct by moving, for all practical purposes, with a few exceptions, to accrual accounting.

Mr. Mentz. Well, I think the original proposal would have been, as you indicated, much more sweeping. It would have picked up professional service organizations, lawyers, accountants. And the abuse that was our target is effectively the improper measurement of income.

In a perfect tax system, the matching of deductions and income is the basic goal. And a cash method of accounting will frequently mismeasure income by allowing deductions for salaries, for instance, or other expenses in a year before income is realized when cash is received from the service or good that is produced.

That is the kind of overall rationale for it. I think where we are in the Chairman's proposal -- it has been scaled back. It does not apply to farmers except for farm syndications, which, incidentally, the Administration supports and believes is a good rule.

But where we are, basically, is farmers are pretty well out of it.

The Chairman. Unless they are over a million dollars.

Mr. Mentz. Well, I don't -- or for corporations.

The Chairman. Isn't that correct? Yes, farm corporations.

Mr. Mentz. All right.

Senator Symms. For over a million dollars in what, sales?

Mr. Mentz. And there is a closely held exception so that if it is a family corporation, that is out of it.

The Chairman. Correct.

Mr. Mentz. Lawyers are out of it. Professional services, basically, out of it.

What it basically catches in its form as the Chairman's proposal and the House bill -- and maybe Mr. Brockway would like to amplify this -- but organizations such as hospitals, banks that are on the cash method, real estate businesses and other forms of professional services, such as perhaps architects, engineers. Are they not covered?

Mr. Brockway. Yes. Architects would not be, but the others are primary --

The Chairman. Could not hear you, Mr. Brockway.

Mr. Brockway. Architects would not be covered by the proposal, but banks and real estate, that type of activity, would be covered by it.

Mr. Mentz. And the main change between the House bill and your proposal, which is a change that the Administration supports, is that tax shelters would be not allowed to come under the cash method. That is a desirable rule because it effectively makes it much more difficult to have a cattle feeding type tax shelter where you feed the cattle in one year and sell them the next year and you get deductions in the first year and sometimes capital gain in the later year.

By forcing those types of organizations that are tax shelters into an accrual method of accounting, you force them into an inventory system that will basically have a desirable effect, at least from the Administration's standpoint.

The Chairman. Questions on cash accounting?

Senator Symms.

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

Other than the first year, what is the integrity to this?

Mr. Mentz. Well, Senator, I think there is a continuing integrity, not just of the cash method but some of these other accounting changes as well.

Senator Symms. After you go by the first year, though, you don't have any difference in the income.

Mr. Mentz. Well, yes, you do because as a business changes, as a business grows, as business conditions change, the correct measurement of income will produce the correct amount of tax. And that may work for or against a taxpayer. In a growing business, it will generally produce more revenue for the government.

But in any case, what the tax system is generally seeking is to match deductions and income. And I think that is the integrity of it. In effect, we are searching for a greater integrity, which I think this proposal does.

Senator Symms. Well, you are searching for it, but what you are saying is the government gets the money the first year; then the second year -- and this business is moving along -- there is no additional revenue the first year.

Mr. Mentz. Well, first of all, if you adopt this proposal, the changeover would effectively be spread over five years. It does not all happen in the first year.

But neglecting that for the moment, there will be a revenue effect, a benefit to the Treasury, for a business that is growing from year to year even beyond the five years where expenses that would otherwise be deducted, that are properly attributable to an inventory item, would be inventoried and effectively realized when the inventory is sold.

So there is a continuing advantage to it beyond the window period.

Senator Symms. Let me ask another more specific question. Did you say, Mr. Brockway, that our architecture firms are not affected by this?

Mr. Brockway. That is correct.

Senator Symms. What about an architect-engineering firm that would have another business, say a computer service?

Mr. Brockway. What you would do, Senator Symms, is you would split it between the two lines of businesses so that if you had a business that was a professional service business that is exempted under the proposal, could still stay on cash method, it would continue to do so. To the extent you also had a separate line of business that was required to be on the accrual method under the proposal, you would -- that would be measured as income on the accrual method.

Senator Symms. In other words, they would have to have two sets of books or --

Mr. Brockway. Essentially, you can do that right now. You can have a different method depending upon what your line of business. For example, right now all businesses that have inventories are required to use the accrual method right now for tax purposes. And they might keep that business right now on an accrual basis. And if they had a separate line of business, they could presently keep that on a cash basis. Just separately account for the two lines of businesses, if they wished to.

Senator Symms. All right.

I was told, Mr. Chairman, that Senator Armstrong might have an amendment affecting this section of the bill. I don't know whether he will or not. But we are not going to vote on amendments this morning, is that correct?

The Chairman. He is on his way, and he has some questions on this. We are not going to vote on this today.

Senator Symms. Mr. Chairman, if I could just inquire. Yesterday, Senator Baucus was asking: Just what are the rules here? Are we working on the Packwood proposal? Have we voted that that is the markup vehicle?

The Chairman. The Chairman's draft was accepted by the Committee a couple of days ago on the motion of Senator Bentsen. When we are all done with all the amendments, there will be amendments to the draft. And whatever is finally left one way or the other will then be put to the Committee for reporting out or not reporting out, as the case may be.

Senator Symms. All right.

The Chairman. And what I have tried to do, Steve, in fairness -- and I explained this to Senator Heinz yesterday -- initially when we started, the members had had this spread sheet only a few hours. We have now announced ahead of time what our schedule is going to be for the next five or six topics. There will be the recess in between. All the revenue estimates will be ready. So there is no reason why members that have amendments cannot have them.

And I understand even at the end -- and Senator Heinz raised the situation: What happens if we get to the end and somebody offers an amendment that loses $20 billion? Can we then go back and reopen things? And I said, obviously, yes. If you have dropped $20 billion, you can.

What I don't want to do is if we get down to the trust and the state section and somebody makes a minor amendment in the Clifford trust section which costs $500,000.00 or a million dollars, to use that as an excuse to come back and talk about depreciation.

Senator Symms. All right.

If I could just pursue one more question here. And I know that this morning is on accounting procedures and my question is related to accounting procedures. And that is -- I want to ask you, Mr. Mentz, this: How many companies under the, in your estimation -- in what sectors, like mining companies, manufacturing companies -- who is going to be hit by the minimum tax under the Chairman's proposal?

Let me tell you what my question is aimed at. In my state, we have a lot of companies that are struggling. They are marginal as to whether or not they are making a profit. I am told the way the minimum tax is written in the Chairman's draft that a lot of these companies will do all their accounting when they get through at the end, and then they have to do it again to see if they come under the minimum tax, and they will fall under the minimum tax. Have you had a chance to look at that?

Mr. Mentz. Well, Senator, that is not really an accounting question, but -- I will do my best to answer it, but it is a question of what is the profile of companies that will be under the alternative minimum tax rather than regular corporate tax.

It is hard -- maybe I could --

The Chairman. Roger, let me take a whirl at it because I think -- you are asking about the corporate minimum tax provision in the draft, aren't you?

Senator Symms. Correct.

The Chairman. Coming back again to what the members said. Now there were two or three exceptions who are opposed to minimum tax, so I am generalizing. But most of the members said they wanted a tough minimum tax, and especially a tough corporate minimum tax so that profit making corporations, profit making corporations, could not escape paying some tax.

Now if they are genuinely not profit making -- I don't mean accounting not profit making -- they are not making profits. I haven't heard many objections that they should not have to pay any tax. What we tried to do in the draft, what I tried to do, rather than going through and saying let us eliminate this deduction and pare back this exception, is to say this at least for public corporations, and public corporations are those that have to report to the Securities and Exchange Commission -- they are required in a uniform manner to report their profits that they report to the shareholders to the SEC. Those may not be profits that are taxable, depending upon how they structure their accounting and deductions, and they may not pay any taxes.

In the minimum corporate provision that I have in the bill, it simply says that one-half of those profits will be regarded as a preference item for the minimum tax. I hope that means, I hope it means, that any corporation that has profits will have to pay some tax.

Senator Symms. Now that is getting right down to the -- what has got my concern is that this Committee historically has decided what was -- has made the decision of what is income and what is taxable throughout the many years.

Now if we apply this rule to it, then you are going to say that the accounting board that has to file to the SEC decides what is income instead of this Committee.

The Chairman. Well, it isn't the accounting board in the sense that you mean it. But generically the answer is yes; the way that corporations report their profits -- and they are profits. These are genuine profits -- to their board of directors will be a determining factor in whether or not they are taxed under the minimum tax.

The only other way -- and we have never succeeded in doing it before. I don't know how long I have heard members on this Committee say they want an effective minimum tax. Every member that comes on here says they want an effective minimum tax. And so we try to go through the code. And a good example was the vote we had the other day on whether or not we would tax existing municipals. That is individual and corporate, both. We decided not to. That means that some people will escape and some corporations on that issue can escape paying the minimum tax.

If we go through and we say, you know, gee, we want a minimum tax; we don't want these corporations escaping taxation, but they can make the following deductions, A, B, C, D, E, F, G, H, then they have no taxable income and they don't pay any tax, and they get written up in the paper as having immense profits and paying no tax. And we go home and speak to our constituencies and they say why aren't they paying some share, let alone their fair share.

So we come back here again and say we have got to have a minimum tax. And there are only two ways you can do it that I can see. Either you can attempt to eliminate all the deductions and credits and exceptions that allow a corporation to get the no-taxable income, or you can say regardless of your exceptions and deductions and credits you are going to pay some tax anyway, if you are profitable. And I chose the latter way.

Senator Bentsen. Mr. Chairman, I don't see how else you do it. I don't think you can go through all the detail of each individual one. And if they are being honest with their shareholders --

The Chairman. They are required to be.

Senator Bentsen. -- which they are required to be, then how can they quarrel and say that they weren't making a profit when they report they are making a profit to shareholders and the SEC? So it seems to me an acceptable criterion by which to determine the minimum tax.

The Chairman. And I thank my good friend.

Mr. Mentz. Mr. Chairman?

The Chairman. Secretary Mentz and then Senator Chafee.

Mr. Mentz. Just to follow up on your specific request. After recess, we should have a profile of the companies that would be subject to the alternative minimum tax under the Chairman's proposal. So I will have that for you after recess. It requires some computer runs to get it, but I will have it for you.

Senator Symms. Thank you.

The Chairman. Senator Chafee.

Senator Chafee. Mr. Chairman, thank you.

Moving to Page 24(b), limitations on the use of the cash method of accounting. The exceptions under there --

The Chairman. Can I interrupt just a moment because several have asked about the meeting schedule? We will not meet tomorrow. Bob Dole is hoping, and I think most of us, that we finish Contra tonight, and if we do, we will be gone. And if not, I think we are going to meet so late that we won"t meet tomorrow anyway.

We will meet Tuesday after the recess; not Monday. And then it is my plan, with the exception of one day that we are going to have hearings on the proposed Canadian-American free trade agreement, that we will go 14 straight days on markup. Tuesday, Wednesday, Thursday, Friday of the first week and 10 days in the following two weeks, save one that we will set aside for that Canadian-U.S. free trade hearing.

Senator Baucus. Mr. Chairman, at this time could you give a rough approximation as to when that hearing will be held? What date?

The Chairman. Yes. I will find out for you right away.

Senator Baucus. Thank you.

The Chairman. Go ahead. I am sorry, John.

Senator Mitchell. Mr. Chairman, will you announce that to the full Committee?

The Chairman. In about two minutes. I just asked Bill to go get it.

Senator Mitchell. All right.

Senator Chafee. Mr. Chairman, on the limitations on the use of the cash method of accounting, exceptions are made for qualified personal service corporations. Now the question I have is: Qualified service corporations are required that the company be owned by the employees. Now I don"t understand that exception.

It means to me that if it is a personal service corporation with -- if it is, indeed, a personal service corporation, then it should be treated as an exception regardless of whether it is employee owned because you are liable to have the situation, as, indeed, we have in my state, where a personal, professional and technical services firm is required to go to the accrual method of accounting just because it is not employee owned, and you could well have an employee-owned competitor, a much larger, that is entitled to this benefit.

So I have trouble understand what seems to me to be an arbitrary discrimination for what reason I don't understand. Could you answer that?

Mr. Mentz. Senator Chafee, I think the reason was a -- it is the old story about a committee trying to design a horse and you end up with a camel. We were in the House side trying to craft a rule that would exclude from the mandatory accrual method -- I guess it was primarily lawyers and accountants. And the basis for the exclusion was typically your partnership of accountants or lawyers is owned by the persons who perform the services.

Now what type of personal service corporation are you particularly referring to? Perhaps we could figure out a way to design this to make it fit.

Senator Chafee. Well, this particular one is a -- what they call themselves is a professional and technical services firm. They are, I believe, primarily involved in advice on data processing and computer operations. And, obviously, they are not listed on the big board or anything like that, but it is an employee owned. And it is fairly substantial. They have in my state 200 people.

And so they write me and ask me why this exception.

Mr. Mentz. As I say, I think it is a somewhat arbitrary exception.

Is that situation -- who does own the stock? Obviously, all non-employees?

Senator Chafee. That is right. Some employees don't.

It seems to me, Mr. Chairman, what we have got here, as we all know, you are talking a personal services employee-owned corporation -- you are talking some that have as many as 2,000 partners in the large accounting firms. And somehow to have -- that gets out of the category of being a small business.

And I have difficulty understanding this arbitrary distinction between -- that has been drawn here in the House bill. Now I am raising that, and I will work with Mr. Mentz and see if we can come up with some satisfactory --

Mr. Mentz. Yes. Maybe there is another way of drawing the line. I think the problem with simply excluding all personal service organizations is obviously one of revenue. But maybe we can come up with a better design, design the camel with one hump instead of two, maybe.

Senator Chafee. Come out a lama.

(Laughter)

Mr. Mentz. Right.

Senator Chafee. All right. Thank you.

The Chairman. Let me announce that the hearing on the Canadian-U.S. free trade negotiations will be April 11th.

Senator Grassley. What day of the week?

The Chairman. What day of the week is April 11th? Who has got a calendar in front of them?

It is Friday, Friday morning.

Senator Long. Is that a hearing, Mr. Chairman?

The Chairman. Pardon me?

Senator Long. Is that a hearing?

The Chairman. Just a hearing on -- what we have to do if we want to prohibit the Administration from starting negotiations with Canada, we have to make our objections known then. If we can object; we can vote it down, they cannot go ahead. But if we do nothing, they can go ahead. So to the extent we want to hear what they are thinking about and make our objections known or things we are very concerned about, that is the morning to do it.

Senator Bentsen. Mr. Chairman?

The Chairman. Senator Bentsen.

Senator Bentsen. You had stated that you wanted us to give as much prior notice as we could as to amendments that we might offer. And I will be offering an amendment, working with your staff, on behalf of Senator Chiles concerning citrus and replanting of citrus. This is a situation where on citrus you have to capitalize the cost of planting and the growth of that up till production in five years. That is most unusual. Other types of trees don't have that kind of treatment.

It was done on behalf of the industry some years ago. Now you have had disastrous freezes, you have serious complications from Brazil. It is a very difficult thing getting the citrus replanted. And what this provision would do -- and it is asked by the Florida Citrus Association -- is to let minority owners -- when the farmer can't raise enough capital, to be able to bring in minority owners on his grove, and that they would have the charge off for the planting of those trees.

I think it would be a de minimis thing insofar as cost. And I will be offering it and discussing it with your staff.

The Chairman. Let me thank Senator Bentsen again. You had mentioned this to me yesterday. And one of the things that makes it infinitely easier to look at our schedule is if the members will give me some idea as to the amendments they want to offer.

But my experience has been in the past that half of them can be taken care of. Sitting down with Treasury and Joint Committee and Majority and Minority staff and the Senator, we can normally take care of a good many of them because as much as we would like to think so between the Administration, the House, the Joint Committee and myself, we haven't thought of everything that might be right or wrong in this bill.

Senator Armstrong yesterday indicated he may have an amendment, will have an amendment, on cash versus accrual accounting.

I told people there wouldn't be any votes today, but I was kind of delaying on this section until you got here. What I plan to do is go -- and I will emphasize once more for the members that weren't here. On the first day or two when these members only had the spread sheets for a few hours, I think it was unfair to say have your amendments today or that is it because they had only seen them.

We are now going to have an entire recess. In addition, I announced yesterday the order in which we would take at least the next six or seven topics. So it would be my assumption that we might go through hearings on seven or eight different sections, and at that stage say, okay, now I have had 49 amendments from 13 Senators; we have been able to compromise 22 of those; we have got 17 we are going to have to vote on, two of them apply to natural resources, three of them apply to accounting, one of them applies to depreciation; and we will go back to those sections in the next two days and bring up those amendments.

At that stage, with one exception, I would like to consider those sections closed. And that exception is if we get to the end of the markup and we have suddenly thrown about $20 or $25 billion on something. It would not be fair to attempt to find that against only the sections remaining open.

But I did indicate if what we have done is make a minor amendment in the Clifford trust section and it costs a million dollars, I don't want to use that as the excuse to go back and open up natural resources on something that costs billions of dollars.

So I will try to observe that generally, but if the members can do what Senator Bentsen is doing, what Senator Armstrong has done, many of these amendments can be compromised. Some of them can't. We will simply have to vote on them.

Senator Long. Mr. Chairman, I would hope that at some point before we report the bill it will be in order for senators to offer any amendments they feel like offering, I mean even if they haven't notified in advance. One could do it in the United States Senate, and I would think we'd want to rule as more severe than the Senate itself. After all, the Senate is more an inflexible body than the Senate Finance Committee. At least it has been in the past.

The Chairman. No. And my good friend from Louisiana has never prohibited even on the last day a major amendment being offered. All I am saying is I think it would make it easier for me and for the members if we can have advance notice.

I realize if someone has gone -- let us say we have gone through a section, a member offered an amendment, and he loses it 12 to eight. And the member is mad that he lost it. We get down to the last day and the member wants to offer it again. And he thinks he has changed two or three votes. I can't stop that.

But it would just make things a lot easier. And most of us as we look at these sections ahead of time, most of us know many of the amendments we want to offer. I mean we are not going to have to wait for Treasury's explanation or the Joint Committee. We have a pretty good idea either on our own knowledge or our constituents' interest. That is all I am asking.

Senator Long. Yes, sir. Well, I believe, Mr. Chairman, that what you said earlier will -- it will be the case. I think that things will fall into place after a while. You will see where the votes are. You may not have a unanimous committee, but usually -- it takes a majority vote to put anything in. It takes a majority vote to take anything out. And so over a period of time I think you will be left with something with a majority vote. I certainly hope so.

The Chairman. Well, I hope I am left with something.

Senator Armstrong, you want to talk about cash accounting?

Senator Armstrong. Well, Mr. Chairman, the issue is pretty simple. Cash accounting is a well-recognized and established method of accounting which has been used for a long time by some firms who find it convenient and the best measure for their operation and most fairly states their financial position.

As I understand the proposal that is pending before us, it simply says that unless you are less than $5 million you can't use the cash accounting method. And there is a one-time revenue pickup of a couple of billion dollars.

It may well be that we need the $2 billion, but just as a matter of taxation principles, I can't see any reason why we should preempt firms from using this method which in many cases probably is the best method. A lot of firms would not opt for it no matter what. They all want to be on accrual accounting anyway for reasons that are more related to their business practices than to their tax situation.

But I would be hopeful that the Committee would be willing to go back to the present law and just let the firms that are using cash accounting or wish to do so continue that.

I want to stress just three things. And I am not disposed to argue it particularly, but I hope my colleagues would go along.

First, the revenue gain is a one-time gain. It is not a continuing gain, as I understand it, although it is substantial. It is a couple billion dollars.

Second, there is no question about somebody escaping the payment of taxes. It is only a question of when they pay it, and the underlying notion of cash accounting is that you should not have to pay your taxes before you get the money.

The Chairman. Well, I think the Administration's argument -- I am inclined to agree with you that, indeed, it is a one-time thing. The argument is, however, that it is a perpetual one-time speed up. You are always one year ahead until we get to the millennium. And then I don't suppose it matters which method we use in terms of accounting.

Senator Armstrong. Well, in the sense that you pick up the money and you always remain a year ahead, in that sense it is sort of like the withholding tax.

The Chairman. Exactly.

Senator Armstrong. It doesn't change anybody's tax liability, but it just one time speeds it up by nine to 12 months. And I can understand the desirability of that.

But I am also well aware of the fact that there is sort of a ingrained sense that it isn't entirely just to ask people to pay their taxes in cash before they have the cash in hand.

Now many companies that are on the accrual basis, in fact, do so. But for those firms that historically have opted to be on the cash basis, it seems to me this is perfectly reasonable.

I am not aware that this is directed to any particular abuse. I am not aware that it is any large problem. As far as I know, it is just a case where it was a place to pick up a couple of billion dollars.

The Chairman. Let met ask both the Treasury and Mr. Brockway this: There was an abuse in real estate tax shelters, as I recall, and I think we corrected that in 1984, did we not?

Mr. Mentz. You certainly went a long way to correcting it.

The Chairman. And has the abuse that we tried to correct been corrected or has it crept back in again?

Mr. Mentz. I think what you are referring to is the treatment of purchase of property where the purchaser puts purchase money mortage on the property and effectively steps up the basis and charges a lower rate of interest and effectively gets ACRS deductions which result in a mismatching of income. And I would say that is pretty well corrected.

The Chairman. And you had -- conspiratorial is a strong word, but you almost had that in the marketing, in the syndication, of tax shelters where the offer was made that you can be on one form of accounting and the syndication is on another form of accounting and everybody wins except the Treasury.

Mr. Mentz. That is exactly right.

The Chairman. And that, I think, we did correct.

Mr. Mentz. But let me say that that is not the only problem in the world of tax accounting.

And, Senator Armstrong, as I -- we touched on this a little bit before you joined us, but there is a problem of mismatching of expenses in income with the cash method. The cash method is not an allowable method under accounting principles. In other words, no CPA firm is going to certify financial statements that are put together on the basis of the cash method of accounting.

It is not to say that the cash method isn't an appropriate method for some small businesses or for some farmers. And I think the Chairman's proposal is basically tried -- has tried to take care of that. We are trying to walk a line here of picking up the revenue. And, by the way, it is more than just a one-time shot, because as businesses expand and grow, there is a revenue difference year to year. So it is more than just a deferral.

Senator Armstrong. Well, it is basically just a one-time deal. As the economy grows and as more firms come into the tax system, there would be some increase. But as I understand it, we are really talking about what is in essence, other than growth, a one-time deal.

Mr. Mentz. Well, that is right. But other than growth is a fairly important exception.

Senator Armstrong. Well, as long we reach a point of understanding.

Let me also just be sure that the Committee understands that while a CPA might, if he was auditing the report of a firm doing this, might have a comment to make about the use of cash accounting, that it is a widely used -- it is a proper accounting method, as you pointed out. And, in fact, many CPAs themselves in their professional practices and many tax lawyers --

Mr. Mentz. Indeed, most.

Senator Armstrong. Pardon me?

Mr. Mentz. Indeed most.

Senator Armstrong. Yes. Actually use this method of accounting themselves. So we would not want to leave the impression that somehow it is substandard or inaccurate or in any way a shady or unethical or homemade kind of an accounting principle.

It is literally -- it says that you record the income when you get the cash and you record the obligations when you pay it out. And it is actually, in many cases, just from the common sense standpoint a more accurate method of accounting than some kind of a more complex approach.

Mr. Mentz. I certainly didn't mean to leave the impression that it was shady.

Senator Armstrong. No, no, I know you didn't.

Could I also just make the point, too, Mr. Chairman -- I gather you don't want to take motions on this issue today, but let me just add the point that it is my understanding that under Section 446(d) that the IRS already has very substantial authority to go in and contest the accounting practices of firms if they feel it unfairly states the income and tax liability of these firms. So it is not a case, at least in my judgment, where we have an abuse. I guess it is partly a matter of theory and principle. But I think it is mostly a matter of picking up a couple of billion dollars. And while I am not insensitive to that at all, it just seems to me to do so in this way is unfair.

And once you start down this path, you end up with the kind of a situation that Senator Chafee mentioned earlier where some people qualify for the cash accounting basis and others do not in a way that really skews the system. It is really like loading the dice because if there is one form of ownership and you quality for cash accounting; if there is another form of ownership, you do not and so on and so on. The simple way it seems to me and the fair way really is simply not to make this change.

The Chairman. Further comments on cash accounting?

Senator Chafee. Yes, I do.

The Chairman. Senator Chafee and then Senator Grassley.

Senator Chafee. Well, go ahead.

The Chairman. Senator Grassley.

Senator Grassley. Mine deals with the difference between the House bill and the Chairman's proposal at the bottom of Page 24, the very last item where it appears in the House bill transactions that were made prior to a certain date, that that taxpayer then could elect to use cash accounting until those transactions ran out and the income actually came in.

Now it would seem to me that for people who legitimately entered into arrangements, you know, under current law and cash accounting was part of the economic decision in making that determination that we would not give them the same election in the Senate bill as the House bill. So I guess my main reason is the justification or the thought behind that. I suppose I would -- I don't know who to direct it to. I suppose to Joint Tax.

Mr. Brockway. Well, Senator Grassley, I think that the transactions involved in that last sentence are long-term lease transactions where one party was in the cash and another party was on accrual that were dealt with in the last year's legislation. These are transactions that were grandfathered -- not last year. In 1984 -- that under the proposal, both the Chairman's proposal and the Administration's proposal, those transactions, as all other transactions of the taxpayers involved, taxpayers would have to switch to the accrual method and then they would include in income the difference between cash and accrual over a five-year period.

What the House did was for certain of these transactions where there was a long-term lease said that for those specific transactions they would not require that amount to be brought in over five years, but they would allow it to continue to be treated under the cash method as under present law. The rest of the transaction of the taxpayer would switch over to the accrual.

But what is done in both the Chairman's proposal and in the Administration's proposal is that all transactions of the taxpayer both where it helps and hurts are switched over to the accrual basis, but then it is given a five-year period to bring that adjustment into income.

Senator Grassley. In other words, you are saying there is no justification for it. I mean don't you find yourself running up against people that make very legitimate business decisions without the intent of any revenue being lost. I mean they are going to pay the tax some day anyway. And I assume that these are fairly short transactions, a few years.

Mr. Brockway. I think with these transactions, where the bulk of them that I understand, were long-term leases where taxpayers were attempting to take advantage of the difference between the accrual basis for one taxpayer and the cash basis for another. So they were long-term leases involved. That is what the specific concern is.

Senator Grassley. How long?

Mr. Brockway. I think that some of them may have been 20, 25 years of so-called deferred rent transactions.

Senator Grassley. And you see those decisions made since the 1984 Act as just trying to get around --

Mr. Brockway. No, no. These were transactions that were entered into before the 1984 Act. The 1984 Act, I think that is one of the changes that the Chairman was referring to. The 1984 Act stopped taxpayers from being able to enter into that type of transaction because it is essentially a way of shifting income from one taxpayer to another, if I understand the transactions involved.

And these were transactions that were grandfathered under the 1984 Act for not being subject to the deferred rent rules there which require both parties in the transaction to be on the accrual basis.

But this proposal here is a generalized rule requiring the taxpayer for all activities to be on the accrual basis. And it would give a five-year spread; not just this one specific transaction.

Senator Grassley. But isn't the end result then that people that made business decisions based upon what the law was then as a result of this change per the Chairman's proposal then they are effectively not going to realize any return on their investment?

Mr. Brockway. They would certainly lose the advantage of using the cash method that they were attempting to benefit from when they entered into that transaction. However, they would also have -- in certain respects they might have some compensating advantage from using accrual.

But on balance, these particular transactions, if I understand them -- because typically what it was was a partnership set up precisely to be in between a transaction between an ultimate lessor and a user of a building, for example.

These transactions were, basically, structured around the ability to have one party being on the cash method and another party being on the accrual. So it was, you are correct, a very major part of the transaction, this ability to use the cash method. And I think these were tax-oriented transactions and it was significant to them.

Senator Grassley. I appreciate your explanation. I will take it into consideration.

But it seems to me like very unfair in these instances to change the rules in the middle of the game. But let us let that go and let me raise one question that would refer to the House proposal because I need an answer on it if I would intend to make the Senate proposal like the House proposal.

What would it do if we put in the last sentence in the House provision where it says loan leases and enter the word "contract" in there as another form of instrument? Does that change that in any particular way?

Mr. Brockway. In terms of revenue, our tentative reaction is that this provision in the House bill with a $600 million over the period, including contracts in there, long-term contracts, might be another $100 million on top of that. Treating it the same way.

Senator Grassley. All right.

Now that is just additional information, but that does not answer my question about contracts.

Mr. Brockway. I am saying that adding the contracts on might be another additional hundred million on.

The House provision relative --

Senator Grassley. All right. But I wonder if contracts wasn't left out for some reason other than $100 million or was that the reason it was left out?

Mr. Brockway. I think, Senator Grassley, simply that the taxpayers that came to the Ways and Means Committee had transactions which were long-term loans and leases, deferred rent transactions. And that is what their concern was. And so it just simply was not raised in that context, I think.

I do not think it was a policy decision that someone came in with a contract and the Ways and Means said, well, that was not appropriate. I think it just was not raised in that context.

Senator Grassley. Thank you, Mr. Chairman.

The Chairman. Senator Chafee and then Senator Symms.

Senator Chafee. Mr. Chairman, I appreciate that this whole accounting section is arcane and causes most of our eyes to glaze. But it is a section that involves a lot of money. If you look on Page 26, that item D is $18.4 billion.

The Chairman. The whole section is about $50 billion.

Senator Chafee. So it is an important area for us.

I would like to turn now to the installment sales on Page 25.

The Chairman. Wait a minute. I don't mind if you are going to turn, but I want to make sure that we are done with cash accounting. And Senator Symms wanted to ask questions.

Senator Chafee. Yes, I would defer if somebody else wants to finish cash accounting.

Senator Symms. Yes, Mr. Chairman, I want to pursue this point that Senator Grassley and Senator Armstrong made on the $2.3 billion. And I think that we agree that it is just a way for the government to reach out and scoop that money up in advance to what they otherwise would get.

But I want to refer to Item A and question you with respect to Item E. Aren't you doing just the opposite in Item E that you are in Item B? On Page 28, Item E, special treatment of certain reserves for bad debts, and then Section B -- excuse me, I said A -- limitations on the use of cash accounting.

On one hand, you are trying to limit people from using cash accounting because the government wants to get the money in advance. You go back to Item E, you want to change the treatment of bad debt reserves and put those people on a cash accounting basis. Is that correct? You want to make them pay it when -- you want to say that they cannot take the deduction until they pay off the claim or until they --

Mr. Mentz. No.

Senator Symms. What I am trying to ask is what is the integrity to this. You are saying it has more integrity, but it looks to me like you are just switching it back and forth to suit the government's --

Mr. Mentz. No, I don't -- I think it has a very solid integrity.

First, on the cash method, Treasury's revenue estimate -- Joint Committee may differ -- but Treasury's revenue estimate is that 10 to 20 percent of the revenue in the budget period relates to growth. In other words, not this one-time switch. So that there is a revenue effect here independent of the switch, and that revenue would continue. And, indeed, it would probably increase in the outyears.

We had a discussion the other day of voo-doo revenue and the possibility that this was not going to be revenue neutral in the outyears. I think you have to look at items that pick up revenue outside the budget period as well as those that lose revenue. And I would say that this is one that does just that.

Moving to your question as to the integrity of Item E, the general system of tax accounting that has been in place under the United States Internal Revenue laws since 1913, I suppose, is basically one of trying to measure income, as I indicated before, and realizing losses for tax purposes only when they are truly realized.

Now the reserve for bad debts is a concept that does not fit with that general proposition. A reserve for bad debts is a deduction taken by a business for an accounting adjustment into a bad debt reserve with respect to accounts receivable that have not become bad or worthless or partly worthless. They are expected and they may or may not become worthless in the future.

But the event of realization is the worthlessness of the asset. If you own an asset, some other asset, Goodwill, for instance, or a trademark, you only deduct a loss on that trademark when you abandon it, when it becomes worthless.

And yet if you are dealing with accounts receivable, the deduction is allowed up front. In Treasury's view, that is inconsistent with basic tax accounting, and that is the reason that the Administration, the President, proposed it as a change.

I believe that is the reason why the Ways and Means Committee and the Chairman basically agreed with that change.

Senator Symms. I want to come back to the point, though, that what you are basically saying is that you no longer can take a loss on your accounting procedures on an estimated bad debt on an accrual accounting system.

Mr. Mentz. You are only entitled to take your loss when it occurs.

Senator Symms. In other words, you want to put them on a cash basis.

Mr. Mentz. No.

Senator Symms. That is what I am trying to get to. They have to take the loss first.

Mr. Mentz. No. I want to put them on an accrual basis where they take the loss when it is realized.

The Chairman. What he is saying, I think, Steve, is from a theoretical accounting standpoint if accrual accounting is designed to accurately reflect what happens economically, his argument is -- and it is the same one you make in your proposal for all the banks -- that in terms of reality, reality, the economic loss occurs when the debt actually becomes worthless rather than it occurring when you set aside a certain portion of a reserve for an expected bad debt.

Do I phrase it, Mr. Secretary, roughly rightly?

Mr. Mentz. That is about right.

Senator Symms. All right. That is exactly what I am trying to say. There is no integrity in this. It is just a matter of trying to do the accounting so the government gets some money first. That is what the whole thing is. It is $62 billion worth of switching in accounting to get the money up front. Well, where are you after five years?

Mr. Mentz. Well, I would argue that the present system lacks integrity, and we are trying to move toward integrity with this proposal, the Chairman's proposals.

The Chairman. I wonder if we might do this, because, Steve, I understand where you are coming from. But let us move through the rest of these accounting procedures today so we can finish. You clearly have got a difference of opinion with the Treasury, and Bill does, and Bill is going to offer an amendment to go back to cash accounting.

Senator Symms. I am going to support it.

The Chairman. Let us go on to installment sales. And here you do have a significant difference between the Administration's proposal, which raises about $1.7 billion, and mine, which raises about $6.3 billion.

Senator Chafee.

Senator Chafee. Thank you, Mr. Chairman. Mr. Chairman, in the President's proposal and in the House bill, both have the provision that if you look in the columns in the House bill it is described as pledges of installment obligations received for property sold in the ordinary course of business and are treated the same as pledges otherwise.

Now as I understand, this works as follows: If a developer is going to put up 100 houses, and he takes back mortgages on those 100 houses, say a 30-year mortage on each, he knows what his income is going to be. If he takes those mortgages down and sells them, then he has a capital gain on the transaction. Is that right? Does he have a capital gain on ordinary income?

Mr. Mentz. He would have ordinary income. He would --

Senator Chafee. But he has to report it then.

Mr. Mentz. That is right.

Senator Chafee. That is the key point.

He has to report it that year. However, if he goes down and so-call pledges it, then he can take that income as installment income. Now that was in the President's bill, that was in the House bill, and that is not in the Chairman's proposal.

The Chairman. And I can tell you very specifically why. And it is an interesting switch of priorities. In the Administration's bill, they exempt retailers from this pledging of installment contracts. I think I understand the reason.

TRAK, the particular group that represents wholesalers and retailers and wants this bill, has many favorable provisions in the Administration bill where they are exempt where everybody else is hit. I, frankly, reversed the priorities. You can take a look at the article in Time Magazine this week on consumer debt and the ballooning of consumer debt.

And it was my hope that this would apply to retailers and wholesalers. And I exempted builder bonds because this Committee, over the past, has shown a preference toward wanting to build homes and own homes. And it is clearly a philosophical difference, but the builder bonds have become or are becoming the principal -- this is the situation you refer to -- have become the principal way that many builders are raising money to build more homes. They take the mortages, they pledge them, they get the money, they build more homes, they take the mortgages.

The Administration -- and I have said this to them before so it is not new -- the Administration, not just this one, the past Administration, I think, has a bias against the present investment priorities in the country. And they think we are overhoused and undermachined. And they want to tilt in the other direction of putting more money in machines and less money in houses.

Secondly, I think they have exempted retailers and wholesalers all the way through this particular accounting section in the hopes of holding their support for the bill by exempting them from the same things that we apply to everybody else.

Senator Chafee. Let us hear the Administration's argument for their proposal.

Mr. Mentz. Well, Senator Chafee, the reason that -- the tax policy reason for the President's proposal that would exempt 12 month or shorter obligations from the pledge rule is kind of a de minimis rule. The idea is that if you have a short-term obligation, there is not much deferral involved and rather than go through the complications of trying to trace -- remember, our rule was a specific pledge rule that involved tracing. We just sort of said let us cut it at 12 months.

The Chairman. De minimis, but it is about $5.5 to $6 billion de minimis.

Mr. Mentz. Well, we would suggest to you that there are other ways of getting the de minimis a little more de minimis.

But that is the one side of it. The other side of it on the builder bonds, the builder bonds was really sort of the tax policy problem that generated this whole proposal, the proposal being, as you, I think, very well articulated, the builder who if he were to dispose of the installment obligations would trigger income on which he would have to pay tax. He was effectively able to get around that by putting them into a trust and effectively have a financing where you have a pledge of those same obligations, resulting in the same cash flow to the builder but yet still deferring the tax.

That seemed to us to be objectionable from a tax policy standpoint. And that is really where this proposal started out.

(CONTINUED ON NEXT PAGE)

And that proposal was accepted in the House, likewise.

Mr. Mentz. That's right.

Senator Chafee. What are you talking about in that? Do you have any revenue estimates in that particular item?

Mr. Mentz. Which item?

Senator Chafee. Just that "Pledges of installment obligations received for property sold in the ordinary course of -- "

There are other things. I think it is unfair to label these "builder bonds," because that is a generic name you can call them by but there are other pledges that come under this other than solely builders.

Mr. Mentz. That is right.

Senator Chafee. And my question is, do you have a revenue estimate of what you lose by taking that out from the President's proposal?

Mr. Brockway. If you are talking about deleting from the proposal the dealing with real property, home builder; in the House bill it picks up roughly $2-2.5 billion, that portion.

The Chairman. From the builder bonds alone.

Mr. Brockway. From the builder bonds. Now, the House bill took a TEFRA approach, I believe, then the Administration. So, if you went the Administration's way, that's less revenue in the period.

Senator Chafee. Well, let me just review the bidding here a minute. On the builder bonds alone, you would say it is $2.5 billion.

Mr. Brockway. If you did it the method they used in the House bill, it would be roughly $2-2.5 billion, if you included the so-called "builder bonds" -- that is, the sales of homes.

Senator Chafee. But Mr. Mentz agreed that there are other categories of business that fall under this other than solely building homes.

Mr. Brockway. Well, yes. I mean, the Chairman's proposal picks up 6.3 from looking at, effectively, pledges of installment loans or indirect borrowing against installment loans. So, clearly, there is a substantial amount of revenue outside of that area.

Senator Chafee. And the Chairman's proposal keeps that?

Mr. Brockway. That's correct.

The Chairman. That's correct.

Senator Chafee. And just exempts the so-called "builder bonds." Is that right?

Mr. Brockway. Real property.

Senator Chafee. In other words, it just exempts the real property.

Mr. Brockway. That is correct.

The Chairman. John, I don't want to mislead you or disabuse you; it was deliberately designed to help home building, and it was deliberately designed this way because developers have discovered that they have lost a normal source of financing that they used to have, which was the savings and loans being able to put up a fair bundle of money all at once and say, "You go ahead and build these homes, and we'll loan you $100 million," or a million dollars, "to put up this tract of homes." That method of financing, for whatever reasons, has now been closed -- whether it is because the S&Ls got burned in the Seventies with high interest rates, or rather, they are in such a poor condition that they can't afford to do it, the builder bonds have become a substitute for the method that the home builders, and I am talking about large-tract developers, used to use by getting a commitment ahead of time from the S&Ls to put up the money to build the developments.

Senator Chafee. Mr. Chairman, what we are doing here through this period is exploring and trying to ascertain what is in this bill. Let not the word go out that I am opposed to home building. I am for it -- foursquare. But I think it is helpful for us to learn what is in this measure as we go through.

Senator Mitchell. Mr. Chairman, may I ask Mr. Mentz and Mr. Brockway to describe in a little bit more detail the nature of the transaction that has been referred to as the "builder bond"? The builder sells a number of individual homes, receives a mortgage note from the purchaser, then takes those mortgage notes in a group to a financial institution and engages in a transaction with the financial institution by which the builder receives money; but, since it is in the form of proceeds of a loan, it is not considered income subject to tax, as opposed to selling the notes. But what is the nature of the transaction between the builder and the bank? Is it a long-term loan? Is it a short-term loan? What happens to those, typically, if there is such a thing?

Mr. Brockway. It is a loan. Typically, the bank will put these obligations into a trust and syndicate them, so that, in effect --

Senator Mitchell. The builder pledges the mortgages, right?

Mr. Brockway. The builder pledges the mortgages.

The Chairman. He normally takes the money and goes out and develops more homes, sells them on mortgage, puts the mortgages on a pledge to the bank, the bank bundles them up and sells them out in small parcels.

Mr. Brockway. That's right.

The Chairman. So that the builder is rolling over his or her money and building more homes.

Senator Mitchell. At what point in the single transaction does the builder receive income subject to tax?

Mr. Mentz. Only as the mortgages are paid off.

Senator Mitchell. I see. In other words, as the actual payments are made, a portion is income, and that is subject to tax?

Mr. Mentz. That's right, under the normal installment sale rules, Senator.

Senator Mitchell. Even though the builder no longer is -- is he still the owner of the mortgage notes? He simply pledged them to the bank?

Mr. Mentz. Correct.

Senator Mitchell. The bank holds them in trust for the builder?

Mr. Mentz. Yes. Or, typically well sell syndications so that the bank may only act as trustee and there will be third parties who effectively own interest in the notes and mortgages.

Senator Mitchell. So, your problem, Mr. Mentz, is that, to the extent that the builder receives income at a date earlier than he would otherwise, under the installment payments, you think that income should be subject to tax?

Mr. Mentz. That is correct.

Senator Mitchell. And the builder would argue that, "It isn't income but is proceeds of a loan that I'm using," as the Chairman said, "to finance further home construction."

Mr. Mentz. That is right.

The Chairman. I think this is one, Senator Mitchell, that, when we come to a vote, the committee is simply going to have to vote on. I understand fully what I am trying to do, and that is to promote home building.

Senator Mitchell. Right.

The Chairman. And indeed, the way the Secretary describes the transaction is the way it works, and I think the committee has to make a decision.

Although, there is a second one in here, and that is wholesalers and retailers, which I have left in here.

Senator Mitchell. Right.

The Chairman. Which is about a $5.5 billion item; although these transactions all occur within 12 months. But they were exempt from the same process that they want to include the builder bonds on.

The Chairman. Right. But, as I understood, you very candidly stated that you felt that the legislation as it came out of the House was weighted in favor of wholesalers and retailers.

The Chairman. Oh, I think it came out of the Administration that way.

Senator Mitchell. The Administration. Right.

The Chairman. And I think I understand why, because they were the principal groups, initially, that were the business groups that supported the bill.

Senator Mitchell. Right.

The Chairman. They claimed they were -- and they were -- in a high tax situation, that they would be better off with the lower tax rates. And, therefore, they supported the bill. And you will find in a couple of more sections, as we go on, they have been exempted again from provisions that apply to everybody else.

I don't find that so much a philosophical choice; I think it was a political choice to leave them out. And I understand why the Administration did it, and I think that was a decision that was made before Secretary Mentz was even on board. He will defend it, but it wasn't his initial decision.

Whether or not you leave the builder bonds in or out I think is a question of policy, as to whether or not you want to encourage more building than I think you will otherwise get if you include them.

The Chairman. Senator Bradley, because he hasn't had a chance to speak today.

Senator Chafee. Could I just ask another question on this subject?

Senator Bradley. I am on this subject. I am going to continue. But certainly, Senator.

Senator Chafee. I just wanted to make one point, and that is, we are talking home builders, but I don't think that is quite a fair characterization, because it is not all home builders, is it, Mr. Mentz?

Mr. Mentz. It certainly doesn't have to be home builders.

Senator Chafee. It doesn't have to be home builders; it could be somebody building the Trump Tower.

Mr. Mentz. That could be considered a "home builder," I suppose.

Senator Chafee. Well, all right; we are taking care of America.

So, the Chairman has characterized it as "home building," but I think it could be commercial building -- a factory, or it could be other things.

Mr. Mentz. Sure, any kind of real property.

Senator Chafee. Any kind of real property.

The Chairman. Senator Bradley?

Senator Bradley. Mr. Mentz, I would like to know when was this thought to be a problem, the so-called "builder bonds"?

In looking at the issue of installment sales, no one is interested in affecting the normal installment sale process; what you are trying to do is to correct the abuses. Why is it the Treasury's view that builder bonds are an abuse?

Mr. Mentz. That determination was made certainly before I came to Treasury.

Senator Bradley. No, I don't mean who did what, but why, in your view, in accordance with good tax policy, are builder bonds abuses?

Mr. Mentz. Because the builder has the cash in his hands and does not pay any tax on it, sometimes for a very long period of time. I think that is abusive, because it does create a situation where the cash is there and yet there is no income tax liability for years to come.

I am not sure that I am responding to your question; maybe I misunderstood it.

Senator Bradley. Why would you draw a difference between that and the normal installment sale, where I would sell my home and take a mortgage, and the person who bought the home would pay me back over 10 years, and every year I would receive the income I would pay tax on it that year? Why are builder bonds different than that?

Mr. Mentz. I think if you went and pledged that mortgage to the bank and got the cash for it, for the value of it, I think I would tax you the same as I would a builder bond.

Senator Symms. Wouldn't he still be at risk, though? If he personally goes and guarantees a note at the bank, wouldn't that be different?

Mr. Mentz. Well, I think the builder is still at risk, Senator Symms.

Senator Bradley. So if I could just continue, you say the difference is that, with the builder bond you get a big chunk of cash that you don't pay tax on.

Mr. Mentz. That's right. It is a tax policy problem not limited to builder bonds, and the President's proposal covered not just builder bonds but any pledge of installment sale obligations. In other words, you could be selling personal property and take back paper. If you pledged that, it seemed to the Administration that that was an abusive situation, or at least a situation -- perhaps "abusive" is too loaded a term -- that would cause a tax-policy issue.

Senator Mitchell. May I just interject, Senator, to say that a table here indicates the effect, and I think it makes Mr. Mentz's case, for large builders, who, in 1984, without builder bond availability, would have paid approximately $25 million in taxes; with builder bonds, they actually receive $22 million in refunds, for a net effect of $47 million. That is, instead of having a tax liability of $25 million, they had a tax refund of $22 million. I think that is what you are talking about, isn't it, Mr. Mentz?

Mr. Mentz. That makes my point better than I could have made it, Senator Mitchell.

Senator Bradley. If I could, just to get the revenue number, what if we did not exclude builder bonds? How much more revenue would we get, Mr. Brockway?

Mr. Brockway. If you used the method that is in the House bill and followed in the Chairman's proposal, it would be between $2-2.5 billion.

Senator Bradley. Two and --

Mr. Brockway. Between two and two and a half billion over the period.

The Chairman. Above the 6.3 that we have already figured by including the wholesalers and retailers.

Mr. Brockway. That is correct.

Mr. Colvin. Senator Mitchell, if I could add a point to that, the minimum tax will have the significant effect in this situation.

Senator Mitchell. That is exactly right.

Mr. Colvin. I believe that number does not take into account the minimum tax effect.

Senator Mitchell. Oh, that is absolutely right. That is one of the arguments, I think, for the Chairman's position, is that it will be picked up in the minimum tax.

Senator Bradley. If I could, I would like to ask Mr. Mentz, also: In the Administration proposal, you did provide an exception to the revolving credit plans, where payment is due in 12 months.

Mr. Mentz. Correct.

Senator Bradley. Now, what is the substantive rationale for that?

Mr. Mentz. The substantive rationale for that, as I indicated, is a kind of de minimus rule, that if there is a case where your deferral is going to be maximum 12 months -- and, indeed, it isn't going to be the full 12 months, because with revolving credit you have payments every month -- it is not the same kind of a problem as a mortgage where you have maybe 20-30 years deferral.

The Chairman. Let's not, though, confuse this with the revolving credit issue that we are going to come to in a minute, where some of the major retailers are favored over smaller companies. It is a slightly different issue than specifically this issue.

Senator Bradley. Do you want to comment on that, Mr. Mentz?

Mr. Mentz. I am not sure.

Senator Bradley. I mean, what is the difference?

Mr. Mentz. I am not sure I know exactly what the Chairman is referring to, as to difference.

The Chairman. When you get to the revolving credit issue -- and I would have to look.

Mr. Colvin. That is also on the scrib sheet on page 25.

The Chairman. You get a special tax break for the revolving credit that you would get if you charge it on a major stores account -- on your Sears account, on your Sears credit card, or your Hecht's on a Hecht's credit card -- but you don't get it if you charge it on VISA. I mean, the store gets the benefit. And it is very unlikely that small stores have their own credit systems and their own credit cards. So, there is a tremendous advantage to large retailers with their own credit cards, where they are going to get a tax benefit that no one else will get. I think it is a slightly different issue than this one; I think they are both valid issues, but I think it is slightly different than this issue.

Senator Bradley. But the real question is, it is a different issue in that involves a different kind of installment sale. But the principle as to whether there is an abuse from the standpoint of tax reform, and there, as I understand the Treasury's position, the major point is when you take income into a taxable period. Isn't that correct? At what point, when you receive income, is it taxable?

Mr. Mentz. That's right. It really comes down to a question of liquidity. Normally when a person sells his home and takes back a mortgage, the theory for not recognizing income, the installment sale theory, is that he is really not in a liquid position, he doesn't have cash, and therefore it is inappropriate to tax him. If he pledges it and gets the cash, he is liquid, and therefore the tax is appropriate.

In the retailer case, the revolving credit situation, because the period is short -- the Administration position was

12 months, but it was a 12-month cliff. If you were over the 12 months, the exception didn't apply, and pledges of those revolving credit obligations triggered full tax.

I would suggest that maybe there is a way of fitting something back into the proposal, maybe even shorten it below 12 months, and have it so that if you are below, let's say six months, and it is revolving credit, you are eligible for installment sale treatment as per the Chairman's proposal, which is not full installment sale treatment, because if there is debt, there is an allocation of the debt among the assets, and to the extent the debt is allocated to the installment paper there is a cutback.

The Chairman. Well, let me ask you -- and, Mr. Colvin, correct me if I am wrong -- when we are talking about the installment sale rules, we are talking about the sale of an installment-receivable, whether it is a builder bond or whether it is Sears. Is that correct?

Mr. Colvin. That is correct.

The Chairman. And in the first issue, we simply say if the major department stores or anybody else who is selling has installment contracts, and they sell them and get money, they are going to be exempt, as long as it is within the 12-month transaction. That is one issue.

Now, the revolving issue is slightly different. You go into Sears and you buy $1000-worth of furniture, and you put it on your Sears credit card, and at the end of the month you pay Sears $500. And this gets back to what Senator Symms and Senator Armstrong are talking about in terms of accrual versus cash. Sears only has to count $500 in income. They don't count $1000, even though it is an obligation, even though under an accrual system they would have to count it. They haven't pledged this account to anybody; they are just, in essence, back on a cash system now.

Well, that is fine if your company has its own credit card. It doesn't apply if you happen to pay by Visa or Mastercharge or Choice. And for most small companies that do not have credit cards, they are going to go under the accrual system under the Administration's proposal, and they are going to pay, on the whole thousand dollars, even if they don't get any of it.

Mr. Mentz. Although, Mr. Chairman, where you have Visa or American Express, or what have you, in that case the seller gets the cash.

The Chairman. Less whatever the discount is that they pay to the card issuer.

Senator Mitchell. But that is a major difference, Mr. Chairman. The seller does in fact receive the cash under those circumstances.

The Chairman. Well, if a Visa is used, that's right; but, if you use their own credit card, then they are in essence going to be taxed on an accrual basis -- I mean on a cash basis, excuse me. On a cash basis.

Senator Mitchell. That's right. So in both cases, though, it is consistent with the principle that you pay tax when you receive the income.

The Chairman. Except on the installment sales. They are saying that, if any of these major companies that are taking installment contracts, and they are within 12 months, and they bundle them up and sell them, they are not going to have to pay taxes on it so long as it is within a 12-month period. Even though it lops over from year to year, and even though totally it is about a $4.7 billion item, they are exempt.

Mr. Mentz. If they sell them they are not exempt.

The Chairman. Pardon me -- if they pledge them. My mistake -- if they pledge them.

Senator Mitchell. But, Mr. Chairman, didn't Mr. Colvin say it goes under the minimum tax?

Mr. Colvin. That is correct. And if I could add, with respect to Senator Mitchell's comment, if the corner hardware store sells something and it is on the accrual method of accounting, it reports as income, whether or not it has received payment. So, if it were using Visa, it would receive payment.

Senator Mitchell. It would receive the payment, right.

Mr. Colvin. But not if it had made the sale but had not yet received payment. So, this is an opportunity for the companies that use the revolving method that is not available to the corner hardware store, in that case.

Senator Mitchell. All right.

Mr. Colvin. And if I could add, the difference between six months and nine months and 12 months is de minimus. Evidently they are making it up in volume. Because there is about $3 billion in this issue. That is an approximation.

Senator Mitchell. Mr. Mentz, do you want to comment on it?

Mr. Mentz. Well, I don't know that I see the comparison there; because, if the corner hardware store sells and gets cash, they've got the cash, and taxation is clearly appropriate. If they sell on credit, then they are eligible for installment sale treatment. So, maybe I am missing something, Mr. Colvin, but I don't see the difference.

Mr. Brockway. I think the difference is, as a general rule you would recognize income when you sell a property even if you sell it for a note, that you would have to recognize income. The installment method says you don't need to recognize the income right away if you receive a note in exchange. However, if you sell that note, then you do have to recognize income right away. If you sell it on American Express, then the bank is paying you cash in hand, and you have to recognize the income.

The whole theory of all of these proposals dealing with the pledging of installment sales is that, while we allow the installment method under present law because the taxpayer might have a liquidity problem -- he has only got a note and doesn't have the money, the cash -- if he borrows against that note, he pledges that he does have the cash, and he is effectively in the same situation as if he sold the note. He discounted the note. It is really not much different commercially if you either take your installment note and sell it to the bank, factor it, or if you give the note to the bank and borrow against the money; you have the cash and pretty much the same situation.

So, the notion of the overall proposal is that, since you are borrowing against these receivables, that is the same thing as if you received a cash payment. And attempting to put someone who sells the property and discounts it to a bank, essentially what happens with American Express when they pay you the money at a discount, and someone who sells the property on revolving credit, or not on revolving credit but simply in a short-term installment note, and gets money, effectively realizes the value of those receivables by borrowing against the note.

And what the Chairman's proposal does is, simply, it looks at the amount of the debt you have and sees how much of that is allocable to these receivables you have at the end of the year that under ordinary principles would be included in income. For book purposes it is included in income. It is an appropriate measure in accounting to include this receivable in income in the year of the sale, not in the year of the payment, and say that, to the extent you actually had cash, by virtue of the borrowing, well, then, you are going to be taxed under the year you received the cash.

Senator Mitchell. Yes, but see, everything you say is especially true with respect to these bonds, which really have all of the incidences of a sale but are characterized as "loans" for the very purpose being described here.

I think the Chairman is very clear in what he says; he thinks you are doing this to encourage home building. That's why he is creating an exemption for it.

The Chairman. I am not trying to pull the wool over anybody's eyes; it is a policy decision in terms of encouraging home building. And, again, I am trying to do everything I can, within reason, to limit what many members on this committee said they have wanted to limit, which was, by and large, consumption and consumption financing, and all kinds of devices where people can fly and buy and pay later.

There are a variety of things as we go through this where those areas are hit. Now, maybe the committee, when they come to them, won't want to do it. But mine was clearly a policy decision, and I think we are probably going to have a vote on it. I am not sure there is much point in spending much more time on this, because it is not a complicated issue; it is just a policy issue.

Senator Bradley. Mr. Chairman, I think you could characterize it that, if you are going to do the builder bonds, the reason you are doing it is to stimulate home building. If you are going to eliminate the revolving credit, then you are raising the price of credit to the consumer who has got to pay more for their washing machines or pay more for their stoves, or whatever.

The Chairman. Or they have to save a little more until they are in a position to either pay slightly more down or pay cash. Now, whether that is something we want to encourage or not is a legitimate philosophical question.

Senator Bradley. It sure is. And I think, to the consumer out there, the choice is, "Gee, do I have to look more for my home, and maybe not find as many out there, and maybe have to buy one that is already built, or do I have to pay more for my washing machine?"

Senator Durenberger. Mr. Chairman?

The Chairman. Senator Durenberger.

Senator Durenberger. I really appreciate the fact that you have reduced it to an issue of principles on which we can disagree.

(Laughter)

Senator Durenberger. And I think you have. I just will inform you that I will provide you with an opportunity to vote on the principles, both on the issue of installment method for sales on revolving credit plans and also on another issue that may seem a lot smaller, which the Administration has recommended, and that is on the uniform capitalization rules as they apply to retailers and wholesalers.

The Chairman. We are going to get to that in a minute.

Senator Durenberger. All right. I just thought I would let you know.

The Chairman. Senator Chafee and then Senator Symms.

Senator Chafee. Mr. Chairman, I think we have reduced this, but I think there is a further way we have got to define it, carefully, and that is that you have gone further than solely encourage the building of homes; you have gone as far as to encourage all real estate building.

Now, I don't know how this breaks down proportionately, dollarwise. You have given us a figure, Mr. Brockway, of $2-2.5 billion as involved in this exclusion from the Chairman's overall rule. You have separated out the so-called "builders bonds." But is there any way you can tell us how much of that is for homebuilding and how much is for other kinds of building? I suppose that is a pretty tough request.

Mr. Brockway. Well, Senator Chafee, my understanding is that the number we are carrying is predominately for personal residences. We will get back to you to see whether there is any additional amount being carried for other types of real property transactions.

The casual sales of real property are out of the provision, in any event, and I think largely what you are talking about is the standard transaction by home builders that that revenue is attributable to. But I will get back to you with further information.

Senator Chafee. Also, I would point out further what we are all going to recognize as we go through here, that home building has been treated rather generously, in the fact that the first mortgage for both your principal residence and your second residence is exempt from the interest rules.

And furthermore, I hope that we can include in here a provision I have, that I have discussed with you, Mr. Chairman, with the mortgage-backed securities, which Treasury has agreed to accept. I hope we can work that in. That will help home building.

Senator Mitchell. Mr. Chairman, may I ask one further question on this point?

The Chairman. Yes, and then Senator Symms, and then let's move on to the revised accounting on the capitalization. Go ahead.

Senator Mitchell. All right. I just want to have clarified one point, Mr. Mentz. Comments were made suggesting that the House bill somehow exempted retailers. As I understand it, the House bill hits retailers. The Chairman's bill hits them a little more. It is not a question of whether they are hit or not; it is a question of how much.

The Chairman. The House bill almost exempts them, doesn't it?

Mr. Mentz. Well, the House bill has a nine-month period where an installment, revolving credit obligation, would be effectively exempt from the pledge rule. And indeed, even if an obligation were longer than nine months, the first nine months would not be subject to it. So, in that instance there is some benefit to retailers.

Remember, the Administration's proposal was a de minimus rule, 12 months or shorter obligations don't get involved in the pledge rule at all. But if the obligation is more than 12 months, then you are under the regular pledge rule, and all the rules apply.

Senator Mitchell. Thank you, Mr. Chairman.

The Chairman. Senator Symms, and then let us move on to capitalization.

Senator Symms. Thank you, Mr. Chairman.

Mr. Chairman, this is a very interesting discussion that is going on here, and I think the point that John Colvin brought up here is the crux of this; this whole proposition of installment sales, builder bonds, the whole thing -- this is like giving a starving man a steak, and then just as he gets ready to take a bite from it you take it away from him; because, if you treat this as a preference item, and if I understand the bill correctly I think it is treated as a preference item, it falls back under the minimum tax. So, it is a whole separate accounting system. Isn't that correct?

The Chairman. Well, it is correct in the sense that, assuming that you have got regular income, and from that you have a variety of deductions that get you down below 20 percent, then you are going to consider an alternative minimum tax -- I often call it "an alternative maximum tax," on occasion -- but, yes. To the extent that you have enough deductions, exclusions, or whatever you want to call them, that under your normal accounting process you get down to very little or no taxable income, some of those items -- and in the case of a profitable corporation, half of its reported profits will be subject to reporting for the minimum tax.

Senator Symms. Well, the point I am trying to get at, though: Let's say, for example, the person is a developer. And he goes out here and develops a complex where people are going to live. And he has to spend a lot of money up front to get the central living area fixed -- the swimming pool or whatever it is -- that goes with the group that is going to attract people to buy the condominimums. And then they go take the money from the first section -- they take the notes, I mean -- and they go to the bank and they guarantee it and they borrow it. And then they use that money to go ahead and develop the rest of the whole thing. At the end they have been paying the taxes; it is an installment sale. That is the way business has been done. That is what has driven the development of some of these.

Now, if I understand this correctly, we are going to treat that under the minimum tax. Then let's say the deal goes south, it goes sour, and they lose the whole thing, and they guy goes under. He may found in his bankruptcy that the U.S. Treasury Department is still saying, "You owe money for this," under this minimum tax.

The Chairman. Well, not if he has no profits.

Senator Symms. If you treat that installment sale receipt as a preference item, he won't have a profit, but he will get to pay a tax on it. That is the problem I see. Now, that is one point, and I know the Chairman wants to go on.

I want to bring up another point. And I think that this whole discussion points to how complicated this is and how difficult it is to make decisions here on how we are going to treat the tax policy, when we are talking about some of the amendments that have been floated around here that cost billions of dollars, one way or the other.

Have we decided yet that we are actually going to impose this excise tax policy?

The Chairman. No.

Senator Symms. How can we make a decision on this until we know if we are going to raise the $60 billion on excise tax and what that impact is going to be on the economy?

The Chairman. All life is a trade off, Steve. When we get to the end of the bill, if we have lost $50-60 billion in one way or another, whether we change this section or cash-accounting or whatever, and we still want to have a bill and want it to be revenue neutral, then it seems to me we are faced with two or three alternatives: One, which I oppose, is that we can raise the rates, like the House did. And if you wanted to raise the individual rates from 35 to 38 and the corporate rates from 35 5o 38, as I recall, Mr. Colvin, that is about $60 billion, if you raise both. Now, that is one way you could do it. I wouldn't like that.

The second way you can do it is, we can go and undo everything we will hopefully do on depreciation, capital formation, and come up with a bill like the House bill, which in my mind decimates capital formation, and raise the money that way. Although, even that doesn't raise $60 billion.

Or, we can eliminate the decuction of the excises, which raises about $62 billion. There may be some other ways to do it; I haven't thought of any as of right now.

But this committee at the end is going to have to make a decision as to whether or not they want a bill that is revenue neutral, and if, in order to have the $2000 exemptions we have and the 35-percent rates we have and some other things we have in the bill, you want to somehow raise some revenues to pay for it.

Senator Symms. Well, I hear what you are saying, Mr. Chairman. I think this is causing enormous concern outside of Washington, D.C., around the country, just our meeting here, and all of these ideas. It is just causing the biggest disruption. I don't think we know what the impact on the economy would be if this proposition passed and actually got signed into law. It just seems to me like we are taking a huge gamble with our economy, and that the prudent course would be, since we have lost the initiative on simplicity, we have lost the initiative on capital formation, in a sense we are just transferring $140 billion -- that is what you are really saying, isn't it, that one way or another we are going to transfer this tax to somebody else to pay for lowering the rates?

There is just no integrity to the process. And I don't say that critical of you or the staff, but it is just that you have had a situation put on you that is impossible to do.

They say it has to be revenue neutral. So that means you have to tax somebody else to pay for lowering somebody else's taxes. It is that simple. That is really what we are doing.

The Chairman. Well, very good.

Senator Symms. And I think we would be a heck of a lot better off to adjourn this thing and vote this thing down right now. I bet you would have a shot in the economy.

The Chairman. Every time a group meets it upsets somebody. My hunch is, the Continental Congress upset the Parliament when they were meeting.

(Laughter)

Senator Symms. Well, I will just give you an example: I met with the athletic director of Boise State University Saturday, or Sunday, and he says that without the deduction for ticket sales, they will have to do away with track, womens athletics, all these things in school. The football pays for this, and business buys all the tickets. And the guy is going bonkers. He can't ask the legislature for more money.

(Laughter)

Senator Symms. I told him to calm down, there was still hope that Washington will --

The Chairman. Still hope that we won't pass any bills.

Senator Symms. Still hope. But it would certainly save his blood pressure a lot if we could settle it today.

The Chairman. You know, you make this presumption: if you like the current code and you think the current code is better than anything else we can do, then I understand why you don't want to change it.

In terms of capital formation, the Chairman's draft -- if Mr. Brockway's figures are right -- overall is slightly better for capital formation than the present law. It is not as good as the President's bill, not as good as Treasury-II, but better than the House and better than current law. But for every single person that likes the present law, whatever their industry is -- and I have had the same argument made by my athletic director at the University of Oregon. They want to build a covered stadium, which will, they hope, make the team draw better. It has not drawn well on a 1-and-9 record.

(Laugter)

The Chairman. But they will improve with a covered stadium, I am told.

(Laughter)

The Chairman. But the problem is that they cannot build a covered stadium unless the businesses can deduct the cost of the seats -- and these are little local businesses in the town of Eugene.

He may be right. He may be wrong. I wish it were all pure and simple, but everything we do is a trade-off. I think there are abuses in the present code. I like the idea of the lower rates, and I like the idea of shifting off of individuals. If I could get the rates to 25 percent for individuals and figure a way to do it, I would do it.

Senator Symms. I figured out a way to get it to 19 percent, Mr. Chairman, but nobody will accept it.

(Laughter)

Senator Symms. If you want to go simplification, let's do it. But this is just an absolute sham.

The Chairman. Well, I tell you, why don't we move on to capitalizing inventory and construction costs?

Senator Symms. That is a real interesting proposition.

(Laughter)

Senator Symms. I mean, they are going to actually capitalize some lady ironing a dress.

(Laughter)

The Chairman. Well, interestingly, in the Administration bill we are going to exempt the wholesalers and the retailers again from the capitalization.

Let's start with that section, Mr. Brockway and Mr. Secretary.

Mr. Brockway. It is on page 26, the rule dealing with capitalization of inventory, construction and development costs.

The Administration proposed that for taxpayers, manufacturers, that they would have to not only capitalize the cost, the direct cost, of producing their inventory goods, as they are required to under present law, and certain indirect costs which they are required to capitalize into the value of the inventory if they also capitalize them for financial accounting purposes.

The Administration proposal would have required manufacturers to capitalize into the value of the inventory of manufacturing a product, not only the direct costs but also the indirect costs associated with those products. And they would be capitalized into the inventory, and then you would get the deduction for those costs incurred in producing the goods at the time you sell the goods.

Under the Chairman's proposal, that rule would also be extended to wholesalers and retailers, with respect to purchasing, transporting, repackaging, and other similar product costs with respect to products that they purchase and then resell either as a wholesaler or a retailer.

The Chairman. Comments?

Senator Durenberger. Mr. Chairman, I wish Steve were still here, because he could make this fun. It is a normally boring process, unless you happen to be one of these little retailers or little wholesalers. I suppose we reduce it to the little people because there are so many more of them in business out there than there are the large companies.

But having been a fairly large manufacturer, I can understand why the application of these new rules to manufacturers can be handled; whether they like it or not, at least they have more sophisticated accounting departments and big computers, and a variety of those sorts of things, so they can allocate these depreciation costs, and the pension costs, and the fringe benefit costs, and so forth.

But when you get to the normal folks out there who are in the retail or wholesale business, I think you have an entirely different kind of a problem. I just suspect, without being able to describe it in gory detail, that we are asking ourselves for the same kind of problems we got into when we told everybody who drove a car more than 20,000 miles a year that they had to carry a little notebook with them and keep track of all of their mileage.

I don't know what money we raise by doing this, but my intention is to ask the committee not to go with the recommendation, which I understand is both from the Administration and incorporated into your bill that we include both wholesalers and retailers in this area.

The Chairman. The difference in revenue is about $5.5-6 billion between the President's proposal and mine.

Senator Baucus. Mr. Chairman?

The Chairman. Senator Baucus?

Senator Baucus. I have the same concerns as Senator Durenberger. For your information, Senator Mitchell and I are planning to offer an amendment that will exempt wholesalers and retailers with gross sales of under five million. There are smaller outfits that just will not be able to cope with all of this.

The Chairman. Five million?

Senator Baucus. Yes.

Senator Boren. Mr. Chairman, I share the same concern. I don't have an amendment formulated yet; I wlll look at those that have already been mentioned. But I do think, with smaller operations, especially with small businesses, that we are asking for a lot of trouble on how in the world they are going to keep these kinds of records and make these kinds of allocations. I don't know. So, I think that is something we ought to look at very, very carefully.

We are still reaping the whirlwind, as Senator Durenberger has said, of the logkeeping requirement, the contemporaneous record requirement. It is not even solved yet, as I understand. And I hope we will proceed cautiously on the kinds of burdens we put on the smaller business operations with both 1 and 2 on page 26.

Senator Chafee. Mr. Chairman?

The Chairman. Senator Chafee, and then Senator Grassley.

Senator Chafee. Mr. Chairman, I have the same view. I am just not exactly sure what we are doing here on this "D" on page 26. It picks up a lot of revenue from the President's proposal. And for some peculiar reason we haven't heard an awful lot -- at least, I haven't -- from those potentially affected, indicating either ignorance of what is in the provision or satisfaction; I suspect the first.

So, I think I will be interested in revisiting this as we go along.

The Chairman. The bulk of it -- Mr. Brockway, correct me if I am wrong -- the bulk of the difference is the inclusion of the wholesalers and retailers, isn't it?

Mr. Brockway. That is correct. One, you have some differences simply because you have different periods involved. But it is slightly less than $4 billion on the wholesalers and retailers, we assume, by extending to them the same rule that applied to manufacturers.

The Chairman. All right. Let's move on to the issue that Senator Symms -- oh, I'm sorry, Chuck. Yes.

Senator Grassley. You previously recognized me.

The Chairman. Yes.

Senator Grassley. Not only this provision, but I think of the last three or four items that we have talked about. I just wonder if it would be possible for us to get some estimates like from the Joint Committee and/or Treasury on the accounting provisions, as to which would be like one-time revenue pickups, and what revenue is raised in the outyears on a comparative basis.

Now, I think at the staff level we have already made that request, but just in case -- I don't mean my staff but I mean generally that information has been requested. I think we need to have that, maybe as a follow-up to the point that Senator Symms was making. And it shouldn't be too hard to get, should it?

The Chairman. Some are easier to get than others. If you take the cash accounting versus the accrual, and the Administration assumes a 15-20 percent growth, assuming the estimate is right, I think that is reasonably easy to come close to estimating.

When you start getting beyond five years and you are talking about capitalization versus deductions, I will be very happy if we can come within 1 or 2 or 3 percent accurate estimating within the five years.

Senator Grassley. That would serve my purpose. I am just saying could we have them divided up between those one-time versus what is going to happen in the outyears on the same thing.

Then, another point I think is necessary to follow up on. Let's say, for instance, we go the direction that Senator Baucus would have us go, of a $5 million cut-off, that businesses below that would be exempt and I presume would continue under present law over those that would go under the Chairman's proposal.

If in fact -- you know, this is very complicated for small business. Let me just bring up something that is in regard to big business. For instance, how would the president of General Motors or Chrysler -- how would his salary be allocated for inventory purposes? Or, if his isn't, then someplace there is a vice president's salary going to have to be allocated. How are you going to divide this up? And of course I am referring to big business. I don't want to be a defender of big business here, but this is something new and it seems to me to be very complicated. It seems to me we are going to be spending a dollar to get 10 cents worth of revenue. Have you thought about these details?

Mr. Mentz. I think the case you pose, Senator Grassley, where the president of a corporation is involved, I don't think his salary would be allocated to any particular inventory item that is being manufactured. I think you need some nexus -- at least that was the thrust of the President's proposal. It is a broader capitalization rule, but it doesn't mean that you just sort of allocate all costs willy-nilly.

Senator Grassley. But someplace in the administrative structure of a corpoation these costs are going to have to be allocable.

Mr. Mentz. Sure. And well, I think you will have a general G&A account, that maybe it is the president and the office of the chairman and so forth, that would not be allocated at all.

Corporations that I am familiar with have a kind of structure that might be organized where you have a consumer products division, and it is headed by let us say an executive vice president who is in charge of the products that are being manufactured and sold in that division. I think that is the kind of general and administrative expenses that would be allocated into the inventory under this greater-absorption inventory method.

I agree with Senator Durenberger that a manufacturing company, particularly a large one, is computerized enough already that it is not a task that they are going to find impossible to cope with to allocate those costs.

But again, to answer your question specifically, I don't think the president of a company is going to have his costs allocated.

Senator Grassley. On another matter, isn't there a difference, then, with these overhead charges for inventories, a difference in how they affect companies with fast turnover inventories versus slow turnover inventories? And shouldn't there be some recognition of that?

Mr. Mentz. Well, I guess that is true of any cost that goes into inventory. If a company turns over its inventory very quickly, it is going to recover those costs faster than if the product being manufactured and sold is slower.

So, I guess I would answer you Yes; but I am not sure that there is a reason for distinguishing these costs from direct manufacturing costs. I think the theory of it is that all of the costs belong to the inventory and get recovered under the inventory method that the company has.

Senator Grassley. But the only thing is, it seems to me whatever incentive we have in this, in our Tax Code, for helping certain businesses, then, by the application of these new provisions to different businesses that never had them before, then we are affecting the incentives of the Tax Code differently for those with slow inventories as opposed to those with fast inventories. And those incentives have worked to this point, and now they are going to be affected negatively, in the case of slow inventories, by these tax provisions.

Mr. Mentz. Well, I guess the overriding incentive, at least from the President's perspective, is the dramatically lower rates, and I think that obviously applies to all industry.

The Chairman. Senator Heinz?

Senator Heinz. Mr. Chairman, I have a question on page

26, item d(1), inventory.

The Chairman. Do you want to get it under the capitalization issue?

Senator Heinz. Yes. Is that premature?

The Chairman. We are going to start it right now. If that is the one you mean about the capitalization, we are just going to start it.

Senator Heinz. Then we want to stay on installment sales for a while?

The Chairman. I think we are about done and are about to go to this issue, unless you have a comment on installment sales.

Senator Heinz. I do have one question, and maybe it was answered while I was out of the room. I apologize; I had to go to the floor.

The Chairman. Senator Heinz, could I interrupt you for just a minute? Jay is going to leave the room.

For all of you who know Jay Morgan over here, Jay is going to be leaving us today and going off to the private sector, in what I hope is a more remunerative income than he is making at the committee now. But he has been with us for five years, and he had done literally everything to make the committee go smoothly in terms of the set-ups and everything else.

(Applause)

The Chairman. John?

Senator Heinz. You know, that applause will be a tough act for the tax-reform bill to follow.

(Laughter)

The Chairman. We are on C-Span. And properly spliced, they could think that was for your suggestion.

(Laughter)

Senator Heinz. Many of us will claim credit, there is no doubt.

(Laughter)

Senator Heinz. Mr. Chairman, regarding installment sales -- and as I say, I apologize if this was covered while I was over on the floor attending to the Water Resources Bill, which is of critical importance to my state.

The Chairman's proposal raises somewhat more revenue, about $600 million more over roughly five years, as I understand it, than the House bill, although in your proposal in the committee print we have, I think properly, made an appropriate judgment in favor of the housing industry and builder bonds.

May I ask you or the staff why there is that additional gain? Part of it, as I understand, does come from retailers and wholesalers. That I understand. But does that account for all of it?

Mr. Brockway. Retailers and wholesalers. And also, the way the rules work on the Chairman's proposal, it is a pro-ration rule assigning the debt to the installment notes that the business has on hand; where, in the House bill, you would essentially attempt to trace, and there would be a number of situations. It would really depend upon what your financial situation was, under the House bill, whether or not you would have the debt assigned to installment notes. A business that was required for credit purposes to put its installment notes in a separate financing sub and then borrow against those installment notes, under the House bill it would have the entire amount triggered. But if the taxpayer could hold the installment notes in the general corporate funds and then borrow under general credit, it would not be affected by the House rule, and this would be a straight pro-rata rule.

Senator Heinz. That I understand. And I am trying to put some numbers on what is happening here.

For example, one part of the Chairman's proposal that as I understand it is new compared to the House is the inclusion of sales of publicly-traded property. How much money is picked up by including that?

Mr. Brockway. I don't have a number right now. It is a relatively small part of the total, though.

Senator Heinz. What is that?

Mr. Brockway. Stocks and bonds, for example.

The transactions where people, instead of selling their stock on the market, they have an installment sale with their broker, who turns around and lends them the money.

The Chairman. They usually sell it to a pre-arranged middleman, and they know exactly what they are doing. And they put it on an installment basis with their pre-arranged broker and get it treated in a very favorable tax light.

Senator Heinz. Does this affect stock options in any way?

Mr. Brockway. Not that occurs to me. But let me get back to you on that.

Senator Heinz. All right.

Mr. Brockway. There are certain transactions that we are aware of large corporate takeovers where they have used the installment notes to defer the gain on the transactions.

Senator Heinz. As described, it sounds like an acceptable provision.

Thank you, Mr. Chairman.

The Chairman. Thank you.

Let us move on to the capitalization, which is on page 26. Here, again, the figures are not overwhelmingly -- well, they are in the first section of it. Ours is $18.4 billion and the President's is 12.9, and the House is 14. On the self-constructed property, not much difference. And on the other items not an overwhelming difference, but a fair amount on the first portion, the section 1.

Mr. Brockway?

Mr. Brockway. Yes, Mr. Chairman. On self-constructed properties, basically the Administration proposed to apply the same rules it is going to apply to inventory Both the direct and indirect costs of producing the property, that are related to producing the property, have to be capitalized into the basis of the asset and then recovered over time.

The Chairman. And again, basically, what I have tried to do in my draft is make the capitalization rules reasonably uniform among businesses. And I have included wholesalers and retailers in it, and that is where the principal difference on the pickup and the income comes.

Mr. Brockway. That is correct, on the inventories, including the wholesalers and the retailers.

The Chairman. Yes.

Questions? Steve?

Senator Symms. You are talking about page 26, item D?

Mr. Brockway. Item D, both 1 and 2.

Senator Symms. All right.

Mr. Brockway. You had earlier been discussing item 1 on that inventories.

Senator Symms. This is where I made the reference to let's say someone runs a retail store, and they order in a supply of goods. If I understand this correctly, then they put the goods on the shelf, and maybe they have to pay people to do this, and to pay people to arrange them and to display them, they are supposed to account this and capitalize that expense, what would now be ordinary expense?

Mr. Brockway. Under this proposal they would not capitalize the costs of putting the goods on the shelves and that type of thing.

Senator Symms. How about carrying it? How about freight, getting it there?

Mr. Brockway. The freight costs already are included in your costs of goods sold for a retailer. The costs that are picked up are purchasing costs, costs that are related to the purchasing of the assets, and the transporting of the asset, the repackaging of the asset if you do that, or if the retailer or wholesaler does some other --

Senator Symms. I am sorry to make the committee go back over it, but I think Senator Grassley -- did he ask you about how you allocate the costs?

Mr. Brockway. Well, that was a question generally about I think this area as well as item 1. It was, "How does a corporation allocate its costs? How does it decide to assign it on the question of whether they are related to the activity or not.

Senator Symms. I would just like to say, Mr. Chairman, on this issue, we on this committee went through this thing on auto-log reporting, and I think this will be auto-log reporting times every small retailer in the United States who will be in here if we pass this like this without some corrections, that next year we can be sure we will be in here trying to correct it again, because we will be trying to explain why it is that the -- it is also just an open invitation, in my view, for people just to ignore the law.

Senator Heinz. Would the Senator yield?

Senator Symms. I would just yield the floor.

Senator Heinz. The Senator brings up precisely the question that concerns me. I would like to ask Mr. Brockway, if I may, Mr. Chairman, the extent to which he believes this will introduce any complexity into recordkeeping by businesses, large or small.

Mr. Brockway. Well, I think any time you require additional costs to be identified and capitalized there will be additional accounting complexity involved, as compared to a straightforward expensing of all of your costs. You have a trade-off between whether or not you are having a more accurate reflection of the income of the taxpayer or whether you have a simpler system. The more simple the system you have, the more likely the taxpayer will deduct his costs in an earlier period and defer the income until a later period. But the more you go into the process of requiring taxpayers, as we now require manufacturers, to identify costs that are attributable to producing their goods and assigning to those goods, there certainly will be additional accounting complexities.

Senator Heinz. So you are saying that this does introduce an element of complexity. Would you consider it little in the way of complexity, a great deal, or something in between in the way of complexity for the average?

Mr. Brockway. Part of it, as with all of these accounting rules, it turns on the size of hte taxpayer.

Senator Heinz. Suppose the taxpayer, as most of them are, is small?

Mr. Brockway. I think, in that situation, the complexity relative to dollars involved probably is much larger than a large taxpayer.

We have been in the process of meeting with wholesalers and retailers, attempting to explore with them what they point out to be the difficulties in switching to this type of method, if they are not already on the method, and trying to learn more about what difficulties might be occasioned by this, and if any modifications might be appropriate.

Senator Heinz. I can't help but recall your conversation with Senator Danforth on how awful it would be to give taxpayers the opportunity to figure out their car miles as a proportion of a 70,000 or x-hundred thousand mile life of a car or a truck, and how you strongly opposed his suggestion on the grounds that it would add a terrible element of complexity here.

I hope that if you do feel that this adds a significant, or as you say "perhaps a major element" of complexity to retailers and wholesalers, particularly the small ones, that you will be consistent in working something out here.

Steve Symms, I think, said the magic word: this, if we are not careful, could turn out to be the contemporaneous recordkeeping act of 1986. It took us far too long to get the 1984 Act off the books. But thanks to Senator Abnor and others we were able to do that.

Mr. Brockway. Senator Heinz, when Senator Danforth raised the question of whether you could do it that way, in fact I think my response was that, if you were to use mileage, it would probably be a more accurate reflection of the income. And it was simply a trade-off of whether you used that or whether you used the averaging method, that probably, on average, reach the same result.

When you get into this area, clearly there will be additional accounting difficulties for taxpayers to assign the costs. But under present law, if you don't capitalize the costs you will have a different answer than you will if you do capitalize it. It is not simply a matter of which one, whether one is more precise and the other one on average roughly reaches the same answer but less precisely; here one approach defers income. The simpler method defers income. It is easier, but it does defer income. The more complex one produces a different answer. So, you just have that trade-off.

Senator Heinz. Let me ask you a question of tax policy, on what it is that we believe is important to address. What are the specific costs that are not now included as inventory costs, that I gather are at issue here, and that we want to somehow include in inventory costs, and in effect require the merchant or manufacturer to capitalize?

Mr. Brockway. Well, with respect to the retailer and the wholesaler, the purchasing, transporting, repackaging, other processing, or storage of the goods. And for a retailer it is only if it is offsite storage of the goods. For example Sears, where it has retail stores and also has warehouses. It would be the warehouse costs that would be assigned to its inventory, but not storage within the retail store itself.

Senator Heinz. Now, why is that a logical distinction to make? Why should it make any difference whether it is stored at Sears where he pays for it, or when he doesn't have adequate capacity to store it on-premises? Why is that a logical distinction to make?

Mr. Brockway. I think it is the exact point that you have been raising all along, that at some point there is a tradeoff between how much additional complexity and administrative difficulty you want to force taxpayers to go through in order to get an accurate statement of anything.

Senator Heinz. That is true. That is a constraint that we face, but that is not really a tax policy issue. The tax policy issue I am trying to get at is, is there any other basis than complexity for making that distinction?

Mr. Brockway. Well, I think it would be that a smaller retailer would not be as likely to have offsite storage, and he would be acquiring his products from a wholesaler where you would, in effect, have the cost recapitalized. Whereas, the larger retailer might have its own, in effect, warehousing itself. And attempting to separate the two functions I think is --

Senator Heinz. Well, let's take a for-instance: The so-called "mom and pop" grocery stores. And there still are thousands of them. They typically belong to cooperatives, many of them, the IGA group,for example, where they aren't integrated backward and don't have their own wholesale distribution network. Whereas, a chain store has a central warehouse and presumably would not be subject to these capitalization rules in the same way that independent stores using either a distributor or a cooperative warehouse would.

Mr. Brockway. I think the way it would work, an independent store that just had a retail outlet and that's it, when it buys the goods from the wholesaler, it effectively doesn't get a deduction for all of those warehousing costs. That is the cost of goods sold, and it does not get to expense it right away; it has to be held until it sells the goods.

If you are integrated and have both the retail store plus a warehouse, for your storage costs, in present law, depending on your method of accounting, you might be able to deduct currently those costs of storing the goods, even though you won't sell them until the later year. And what this proposal would attempt to do is attempt to require that integrated producer to capitalize his cost of storage, essentially putting them in the same position as a retailer that did not have both the storage function and the retailing function.

Senator Heinz. But only if the storage was operated by somebody else?

Mr. Brockway. No, no. It is just whether the storage is not at the place of the retail store.

Senator Heinz. All right.

Mr. Brockway. If they have both, then it will require the capitalizztion of the warehousing costs.

Senator Heinz. Thank you. That is very helpful.

Senator Grassley. Mr. Chairman, could I pick up on something that he asked about?

The Chairman. Senator Grassley.

Senator Grassley. In regard to the complexity of this situation as it applies to wholesalers and retailers, is that any different, from the standpoint and measure of complexity, different than the complexity as it would apply to the manufacturers that the House bill hits? It is my understanding that we are adding to that, right? As a matter of equity, and also to bring in some more revenue? That as long as the manufacturers are treated that way, the wholesalers and retailers ought to be treated that way?

Mr. Brockway. I think the general theory is that the same rule should apply to both the wholesalers, retailers, that also apply to manufacturers.

In discussing this with taxpayers in the wholesaling and retailing trades, they make the argument that, whereas manufacturers right now use the full-absorption method of accounting, where many of these costs are required to be put into inventory right now and they are used to it, and maybe manufacturers typically are larger, some of the wholesalers and retailers are making the argument that they don't currently use this method. And so, for them, you have the additional complexity of having to switch to a more complicated set of accounting. But that is one of the issues that they have raised.

Senator Grassley. All right. But for manufacturers of about the same size, is it any more or less complex for the wholesalers and retailers versus the manufacturers?

The Chairman. I don't think so.

Senator Grassley. All right. Then, I think you have made a point that I want to make. If members of this committee are concerned about how this applies negatively to certain smaller wholesalers and retailers, maybe we ought to look at whether or not the House provision has a negative impact upon small manufacturers or not.

The Chairman. Chuck, my hunch would be that Allied Department Stores would not have difficulty complying with this provision, and a small retailer might. And we have often made exceptions for small retailers. But that is not the reason they were initially left out of this bill; I think they were left out of this bill to buy support, that it was a political decision. I put them back in as a matter of equity.

I am open to talking about size standards; we do it all the time. But the argument that they cannot figure it out and could not comply I think is a specious argument.

Senator Grassley. Well, of course, I didn't make that particular argument.

In regard to the fact that some manufacturers already, through the absorption rules, have this applicable -- and you estimate $5.5 billion from this point of view -- would it be possible that the revenue estimators neglected to note that wholesalers and retailers capitalize no depreciation costs as cost of inventory at present, and hence came out with a number that is smaller than it would otherwise be, comparing this to what was already the case for manufacturers?

Mr. Brockway. The estimate we are carrying for this is slightly less than four billion. Part of the difference here, the five and a half, is simply a different revenue-estimating window, looking at the Administration proposal and the Chairman's.

With respect to your question on how the estimate was constructed and the treatment of depreciation, I really don't know at the moment. It is something that we are discussing right now, generally, the impact of this on the industry. We have started to have some meetings, and I will be able to respond to that later.

Senator Grassley. But you do have some doubt about whether or not the revenue estimate, then, for this category is very accurate?

Mr. Brockway. Well, I think you will want to review all of the estimates as being preliminary. But this one in particular. As for other proposals that have not had an opportunity for the taxpayers to react, they come and tell us how they think it is going to affect their industry. And we can always get a much better estimate for you after we have had a significant amount of time to discuss with the affected industry how the provision would affect them.

Senator Grassley. You said, "This one in particular."

Mr. Brockway. Well, it is just that this was an item that was not in the House bill or in the Administration proposal, extending it to wholesalers and retailers. So, these taxpayers haven't come forward to date in the process, until the Chairman's proposal was released; this is the first time they have come forward with information as to how the proposal might affect them. Because, obviously they didn't know the proposal was around.

Senator Grassley. The fact that wholesalers and retailers presently, today, capitalize no depreciation costs, wouldn't that in and of itself, if you didn't take that into consideration, make a big difference in these estimates that you have here? Compared to the manufacturers, I mean, that presently do that.

Mr. Brockway. I am very hesitant to get into how that might affect the revenue. In fact, it might take the revenues to be a larger revenu pickup with this proposal. But it is a matter of sitting down with the industry as we go through the process, and going through with them on how this would affect them, to get you a more precise answer to that.

When we first do the analysis, we just go on published data or private data that the Administration or the Fed might have to construct the estimate. But it is always very helpful for us to deal with the affected industry and for them to give us their insights as to how it is going to affect them. And we are engaged in that process right now.

The Chairman. Further comments on this section?

(No response)

The Chairman. If not, let's move on to the repealing of the reserve method for bad debt deductions, because I know a number of people had questions about that earlier. It is the same method that the Administration suggested for all banks. This is not a bank provision, but it is a bad-debt provision. The Administration favors it, the House, and we did, also.

Comments?

Senator Bradley?

Senator Bradley. Mr. Chairman, I think this is something that we want to look at from the tax policy perspective and also look at from the perspective of the stability of the banking system now.

The Chairman. This particular one is not the banking provision. It is identical.

Senator Bradley. Oh.

The Chairman. But, Mr. Secretary, it is identical to the banking provision, is it not, in terms of the way you handle bad-debt reserves?

Mr. Mentz. Yes, that's true, although the difference is, of course, that banks are in the business of making loans so that the loans are, in effect -- well, I guess the short answer is Yes, it is identical.

(Laughter)

Mr. Mentz. I am not going to try to make that distinction.

The Chairman. All right.

Senator Bradley. Mr. Chairman, I will withhold until we get to that one.

The Chairman. All right. Basically, it is the same method for non-bank people that we apply to banks.

Any questions on this section? Senator Chafee?

Senator Chafee. No, not on this section.

The Chairman. Let us go on to the special accounting rules for banks.

Senator Pryor. Mr. Chairman?

The Chairman. I'm sorry, David.

Senator Pryor. That's quite all right. Did we pass the long-term contract section?

The Chairman. Yes.

Senator Pryor. And are we going to revisit this? I will have some questions about the exemption on that, but I will wait. I will stay in hibernation until after Easter. How's that? Thank you.

The Chairman. Well, let me go through two other sections. But if you want to raise it, come back to it today, because I am hoping that at least the questions that the members want to raise they can raise while we are going through these sessions. When we come back, in the reconsideration of them, I have asked the members to have their amendments ready ahead of time so that we don't come back with another series of questions almost like a hearing.

Senator Pryor. All right.

The Chairman. Let's take now -- there are two relatively simple sections -- the special accounting rules for magazines, books, and records.

Senator Matsunaga. That is page --

Mr. Brockway. Twenty-nine.

The Chairman. Twenty-nine.

It is a relatively minor section in terms of money, about $100 million. There is a special rule now that allows returns of books and records. The Administration would repeal those special rules; the House would keep them; the Senate would keep them.

Mr. Brockway, do you want to comment?

Mr. Brockway. Yes, Mr. Chairman. Under present law, for magazines and books and records, if you sell them in the case of magazines and it is to be returned within two and a half months at the end of the year, or books within four and a half once after the end of the year, you are not required to include that in income in the year you sell them and then deduct it in the next year; you simply are allowed to not include that in income. You know that you don't have that amount of income. And the Administration would have repealed that rule, would have raised $100 million. Your proposal would retain present law.

The Chairman. And the House proposal would retain it.

Mr. Brockway. Correct.

The Chairman. Questions?

Senator Chafee. Well, Mr. Chairman, yes; I would like to hear from the Administration. Why did you propose it?

Mr. Mentz. I think it is a question really of pure tax theory, Senator Chafee. But the Treasury would not object to the Chairman's proposal on this particular point.

The Chairman. And the last one in this section is the discount coupons. In essence, you buy a can of coffee and in the coffee can is a coupon that says on the next can you get 10 cents off. At the moment the manufacturer can deduct the 10 cents, or I assume deduct a reserve proportion of what he thinks he is going to have to redeem.

The Administration would repeal that, and in essence you would redeem it when the next can of coffee is bought and somebody turns in the coupon.

The Administration repeals it; the House keeps it; and my suggestion was that we agree with the Administration and repeal it.

Comments?

Mr. Brockway?

Mr. Brockway. Well, your description is exactly what the case is. It is a situation where right now taxpayers can set up a reserve, if they get a discount coupon, in the year that you buy the can of coffee with the coupon in it. And what this proposal would say is, if you have the 10 cents off, you get that deduction next year when the customer actually turns in that coupon and buys the coffee for 10 cents less. So, it just allows you the deduction in the year you actually have the reduced price.

The Chairman. Now, Senator Pryor, do you want to go back? Because I think we have no other questions on these sections. Do you want to go back to the section you had a question on? Maybe we can answer them now.

Senator Pryor. Mr. Chairman, that would be on page 27 under the long-term contracts. There are just one or two quick questions I would like to ask.

I would like to know the revenue effect of raising the exemption from the $10-million figure to say $20-25 million. I wonder if we have any of those figures available. If not, I would hope that we could have those figures available.

I am concerned about what we might be doing here to the smaller contractors. This is of some worry to me and possibly to other members of the committee.

Mr. Brockway. Your question, Senator Pryor, was, if you took the $10-million number, the exception in the Chairman's proposal of two years for taxpayers with gross receipts of less than $10 million, and you increase that to a $20-million number -- was that it?

Senator Pryor. Let's say $20 million.

Mr. Brockway. That would be a loss of nine-tenths of a billion.

Senator Pryor. Nine-tenths?

The Chairman. Nine hundred million dollars?

Mr. Brockway. Nine hundred million dollars off the proposal.

Senator Pryor. So, you are really talking about moving that exemption, say, to the $10-million figure? The increments there must be in the figure of $300 million for each $10-million exemption. Would that be correct?

Mr. Brockway. It is hard to do it exactly. I don't think it is necessarily linear. It really turns on how contractors -- how they are stratisphied in terms of size.

Senator Pryor. Now, I know that Chairman Packwood's proposal has a two-year completion date. Now, is this changed from a normal 36-month period? Am I reading this correctly?

Mr. Brockway. That is correct.

Senator Pryor. And do we have any revenue figures there? What is that change bringing in to the Treasury, from the 24 months versus the 36 months under present law?

Mr. Brockway. I don't have numbers that are exactly comparable.

Senator Pryor. Mr. Chairman, if they could just supply those later, I won't hold the committee up any longer.

Mr. Brockway. I think I have numbers, for example, if you did $20 million and three years. That, instead of being a $900-million loss, it would be a $1.4 billion loss. So, if you did both, it would be another $500 million more.

But simply taking the $10-million gross receipt number and then changing the two years to three years, I don't have that specific number. It presumably is less than $500 million, but I don't know yet.

Senator Pryor. I'll bet there is no way to ascertain a figure about how many more contractors would be brought under the tent, so to speak, if you go to the $10 million versus, say, the $20-25 million?

Mr. Brockway. We will be able to supply that.

Senator Pryor. Thank you. I appreciate that.

I won't hold the committee up, Mr. Chairman.

Senator Bradley. Mr. Chairman?

Senator Chafee. Mr. Chairman?

The Chairman. Senator Bradley, then Senator Chafee.

Senator Bradley. Mr. Chairman, on this long-term contract section, I notice that the House eliminated it and it is a very sizeable revenue number. It raises about $9 billion more in revenue.

I was curious. This is the so-called "completed contract method"? Long-term contracts?

Mr. Brockway. That is correct.

The Chairman. I will tell you what I did on that, Bill. In the drafting of this bill, one of the arguments about the completed contract was the escaping of the defense contractors, very profitable defense contractors, from payment.

What I did is go to the book value on the profits reported to shareholders. And what we pick up on the corporate minimum tax is the difference between the House bill of about $6-7 billion -- this corporate alone -- and $22 billion. So, I simply went at getting them in a different way.

And when you come to the minimum tax figure, you will see a large difference in our figures. And indeed, the General Electrics and the General Dynamics and the others will not be able to escape taxation. But I did it in a different method.

Senator Bradley. Well, could we have an analysis? If you go the minimum tax route, how much more do these companies pay in tax, in the minimum tax, versus how much more they would pay if you simply eliminated completed contracts?

I mean, I think that the issue out there is the fact that, if you get a contract to produce tanks, and you get a five-year contract or a six-year contract, and you complete -- say you get a 50-tank contract -- you complete 10 in the first year, you get paid for that, and you can deduct your expenses, but you don't pay taxes. And in the second year, the same phenomenon. You get paid, but you don't pay taxes until the contract is completed in the fifth year. Is that correct?

Mr. Brockway. Partially, your expenses. The difference between the Chairman's proposal, which is the Administration's proposal, essentially the same proposal here, and the House bill -- the House bill is the percentage-of-completion method. So, if you have completed one quarter of the contract, then you have to include in income one quarter of the income that you expect to earn over the life of the contract in that year.

Under the President's proposal and the Chairman's proposal, you don't include the income until the end of the contract, but you don't get to deduct your expenses attributable to the contract either. Those expenses are required to be capitalized into the contract, and you defer those until the end of the contract.

Under present law, certain expenses are required to; under this proposal, again, these general uniform capitalization rules that apply to inventory and self-constructed assts also apply here.

So, all those direct and indirect costs associated with the contract are not deductible in the earlier year; instead, they are capitalized into the contract. And once the contract is closed out, you know the aggregate amount of income, and that is the year you take it into income.

Senator Bradley. So that, you would receive income in the first year, the second year, the third year, the fourth year, the fifth year, pay no taxes over the whole five-year period, but then in the fifth year you would pay taxes on the whole amount and take the deductions that accrued over the whole five-year period?

Mr. Brockway. That is essentially correct. When you say "income," you mean you receive a cash advance?

Senator Bradley. You would receive payment in each of the years.

Mr. Brockway. You may or may not receive payment, and it may or may not be larger than your expenses that you have incurred.

What happens in the percentage-of-completion, for example, is that you may not have received any payment whatsoever on the contract, but you still have to include your pro-rata portion of the income that you expect to earn over the life of the contract in that year. Neither method really turns on how much cash is paid on the contract; it really just looks at -- one of them tries to allocate the income over the life of the contract, the various years. The other one waits until the end to tally it up and figure it out exactly.

Senator Bradley. So, you don't have any information as to who has actually received payment, received the cash payment?

Mr. Brockway. Essentially, neither system work on when the cash payments are made, the taxpayers on the accrual basis. And taxpayers may in fact not have received as much cash as their expenses as they go along. Other times the person they are doing the contract for may be advancing them money on the contract as the contract goes along. It is just dependent upon the circumstances.

But how much tax you pay and in what year doesn't turn on when you receive the cash payment.

Senator Bradley. If you don't know when they received the payment, how do you determine how much more revenue would flow if you eliminated it?

Mr. Brockway. Because the changes really don't turn on cash payments. Again, they are on-accrual-basis taxpayers. The Administration proposal and the Chairman's proposal raise revenue by virtue of the fact that, under present law if you have a long-term contract, some of your costs have to be capitalized, but not all of your costs have to be capitalized that are attributable to the contract.

And what this proposal would do is say that those costs that are attributable to the contract that are currently deductible, you won't be able to deduct them currently; you will only get it in the year that you close out the contract. So, you raise revenue by deferring the deductions that way.

The House bill, percentage-of-completion method, again doesn't turn on when your payments are. I mean, obviously, in the end, all of it, your aggregate profit on the contract, ultimately is going to turn on how much costs you have and how much income payments you make at some point in the future. But the way that the method works is your reasonable estimate of how much income you are going to earn on this contract over its entire life -- five years or ten years, whatever it might be -- and then you have to assign, based on, essentially, the cost depth. If you do 10 percent of the costs, incur those in the first year, then you have to include in income that first year 10 percent of your expected profits, whether or not you receive a cash payment. You may receive more, you may receive less. But that isn't how you compute your income.

Senator Bradley. My interest is to, if you could, get the information. This is kind of one of those choices: do you eliminate the tax preference? If so, you get $14 billion. Or do you put a minimum tax on it? If so, how much do you get with the minimum tax instead of the completed contract?

I think that basically what we are after is the same issue, which is to make sure that companies pay the tax.

The Chairman. Can I ask -- Senator Chafee wanted to be recognized first.

Senator Chafee. You go ahead.

The Chairman. I want to ask Mr. Brockway a question.

Isn't it true that under the House bill there is still a distinct possibility that major corporations that make profits may still pay no taxes in 1986 and '87 and '88?

Mr. Brockway. That is correct, Mr. Chairman. The way the House bill works in a number of areas on the minimum tax, it grandfathers existing contracts. So, until you have a full cycle that is turned over, you may have a number of corporations that don't pay tax, even though --

The Chairman. And as opposed to that, under the minimum tax proposal that I have submitted, it would be almost impossible for those corporations to escape paying some tax.

Mr. Brockway. That is correct. In your proposal you look at the book profits --

The Chairman. Now.

Mr. Brockway -- now, in measuring how much the minimum tax liability is.

The Chairman. Senator Danforth, and then Secretary Mentz.

Senator Danforth. Mr. Chairman, let me explain the situation as I understand it. There is no doubt that in the past large defense contractors did not pay their fair share of federal income taxes. The reason for that was that they utilized the completed-contract method of accounting as it existed prior to the effect taking place of the changes we made in TEFRA.

The reason that defense contractors didn't pay their fair share of taxes -- there are really two reasons. The first reason was that under the old law they were able to put off indefinitely the end of the contract, by keeping the contract alive in very modest ways, but keeping it alive, so that the contract just wouldn't end. There would be five years into the future, 10 years in the future, delivery of parts. And that would keep the contract from coming to an end.

The second reason why they were able to escape their fair share of taxes was that the date on which deductions were taken and the date on which income was realized were two different dates. And they were able to deduct costs early on in the contract period and put off the realization of income to late.

What we did in 1982 when TEFRA was passed was to significantly reform the completed-contract method of accounting in both ways: to prevent the interminable delays in closing out the contract and also to make, to create, a more equitable matching of the deductions and the realization of income.

Now, what has been proposed by the Administration is a further reform of the completed-contract method, a further reform so that, as I understand it, under the Administration's proposal and the Chairman's proposal there would really be an exact matching of the deduction and the realization of income.

Now, the upshot of all of this is that under the old system, the pre-reformed system, between 1981 and 1984, over those four years, the average tax rate paid by the top nine defense contractors in this country was 6.9 percent.

Now, TEFRA was phased in over three years, and now that TEFRA is fully phased in, the projected tax rate, if we were to do nothing, for the nine largest defense contractors has gone from 6.9 percent to 29.1 percent.

If the President's proposal and the Chairman's proposal are adopted, the effective tax rate for the top nine contractors wouldn't be 29.1 percent, it would go up to 34.7 percent. Now, that is my understanding of the facts, over the next five years.

The problem with repealing the completed-contract method and moving to the percentage-completion method is that these same contractors and other contractors as well -- it is not just defense -- would be taxed on money that they have not received. And the reason for that is that, in a lot of these contracts, in fact the contractors are incurring costs in the early stages of the contracts and are not receiving any revenue during that period of time.

Typically, they incur costs early in the contract period which are very high in relationship to what they receive. And then at the end of the contract they are receiving more than they are paying out.

The problem with the percentage-of-completion method is that it makes the contractor estimate what his profit is going to be at the end, and then spread that estimated profit over the term of the contract, even though the money hasn't come in yet. So, you are taxing in advance.

So the effect of this -- and I am trying to get the numbers on this -- is that on these contractors, instead of an effective tax rate going from 6.9 percent, which is obviously too low, to 34.7 percent, which it would be under the Chairman's proposal, it would go significantly over 34.7 percent. And I don't think that that is what we want to do.

I know Mr. Mentz wanted to be recognized, and I would like to hear from the Treasury also.

(Continued on next page)

The Chariman. Mr. Secretary?

Mr. Mentz. Thank you, Mr. Chairman.

I would just like to say that the Administration supports the chairman's proposal here and agrees with Senator Danforth.

I think you may hear kind of popular jargon that while we ought to repeal that completed contract method, that is just a boondoggle for the defense contractors.

I think your proposal is a well-balanced one that really handles the problem just about the right way. The problem with percentage of completion in the House bill is that a profit has to be estimated, and then that profit is taken into account in accordance with the percentage of costs that are incurred in the completion of the contract.

Now, it could be that the contractor will estimate the profit at X dollars and start taking it in, based on a portion of costs as he goes along; and somewhere in the middle or the end of the contract, it turns out that some disaster comes upon him, and there is no profit. There is a loss.

If there is a loss, he has already paid those taxes; and he is not going to get them back until the contract is over and, in effect, there is a carry-back.

But the result of that is you are taxing an imputed profit before you know what the profit is on a kind of an almost notional basis.

Your proposal doesn't seek to do that but does, as Senator Danforth articulated, provide a full capitalization rule so you have the correct match of the income with the expenses, which is where we started this morning, where we are trying to get from a standpoint of tax accounting theory.

And your proposal, by treating completed contract in the minimum tax as a preference, eliminates the perception problem of the contractor who zeroes out because he has got everything deferred.

A contractor such as the one that Senator Danforth was referring to, who is in the process of having a number of contracts and he is picking up income as contracts are completed, he is going to be paying regular tax.

He is not going to be in the minimum tax; and in my judgment, that is the correct result. But for the case where--at least from the standpoint of perception--the more abusive case where there is no income reported on the regular tax system, your proposal catches it. The House proposal does not because of the phase-in.

So, I really just want to lend the Administration's support to your position and the position advocated by Senator Danforth.

The Chairman. Further comments?

Senator Chafee. Mr. Chairman?

The Chairman. Senator Chafee?

Senator Chafee. I would like to ask Treasury why, in the--and this applies to the chairman's proposal as well--you must meet the two requirements? The contract must be for not more than two years and the taxpayers' average annual gross receipts must be $10 million or less.

Instead of, it seems to me, ratcheting upward the $10 million as suggested here, or $20, or whatever it is, why not just have it not apply to contracts that are two years or less?

As I understand these situations, you have got a contractor who is not being paid or being paid a portion of what his costs are, and then it all comes in at the end and works its way out. It seems to me two years is a fairly brief time.

Mr. Mentz. Well, I think it ultimately becomes a revenue issue. This exception is for real property construction contracts for the period of less than two years and a taxpayer who has got annual gross receipts of $10 million or less.

You can have some pretty substantial contracts that are under two years, and we would favor the full capitalization rules for those contracts.

In other words, we wouldn't let them out just because they are under two years, unless they were real estate contracts and less than $10 million.

It is a sort of a targetted exception, Senator.

Senator Chafee. I am not objecting to the real property part, but I just don't understand why it is different for somebody whose annual gross receipts run under $10 million.

Mr. Mentz. It is just a small business-- That condition is targetted to small businesses. I guess the point you are raising is: Should it be so limited?

Senator Chafee. That is really the question. Yes.

Mr. Mentz. Yes.

Senator Chafee. If somebody is installing sewer lines or whatever it might be, a $10 million business is pretty small; and I just wondered why even have the limitation on the annual gross.

Would that cost you a lot of revenue if you had the restriction solely apply to the two years instead of the --

Mr. Brockway. It could, in fact, be a fairly substantial amount of revenue, eliminating that exception--I mean, eliminating the cap on the exception. Just simply applying it to small business of $10 million or less and say on all contracts, no matter how large the contractor is --

Senator Chafee. No, no. Vice versa. The two years would apply.

Mr. Brockway. But if you simply said the rule does not apply if the contract is less than two years regardless of size --

Senator Chafee. Yes.

Mr. Brockway. Well, then that could be a fairly substantial amount of revenue because you would have very large contractors doing a lot of business; and essentially, you have a situation where you have a contract that overlaps over the year and they may, in fact, have been paid under the contract.

You may be paid or may not. You may have borrowed against the contract. Essentially, you have earned the income--part of the income in the first year and part of the income in the second year--but it allows you to defer the income to the subsequent year.

And I think the exception is in there, simply because again it is one of these issues of whether the additional accounting problems are worth it for imposing those on the smaller businesses less able to comply and whether the smaller businesses might not have the same ability to get credit as a larger contractor might be able to get to ensure that they did not have a liquidity problem on one of these contracts.

But it could be a fairly substantial amount of money if you simply said no cap whatsoever.

Senator Chafee. All right. Thank you.

Senator Bradley. Mr. Chairman, could I just do one last point? Mr. Mentz said that the problem--and also Senator Danforth--was that these companies have this terrible burden of being able to estimate their profits.

I mean, it is not like the person paying them is likely to be bankrupt next year. It is the United States Government. I mean, they have a pretty good idea that they are going to get paid.

And in fact, in many cases, they have had cost overruns. And it also seems to me that they have had a pretty good relationship over the years between the Pentagon and the defense contractor.

So, my question is: Is this really a terrible burden to make changes in the accounting procedure on the basis that they won't be able to estimate their profit? If they have a problem, they just come to the Pentagon and say, gee, this is going to cost more.

It seems to me that has happened frequently.

Mr. Mentz. I certainly wasn't suggesting that it was a credit problem that they were worried about, at least not with Uncle Whiskers.

But my point was completion of a contract normally will depend upon satisfaction of the terms of the contract; and sometimes those terms aren't satisfied, which results in a loss, either nonpayment or not full payment, and therefore no profit; or not all contracts are cost plus, so that sometimes you can have no profit, even though you originally estimated there was a profit.

That is what makes horse races. So, it seems to me that--or I should say the point that I was trying to make on behalf of the Administration was that the chairman's approach I think is a more balanced one by not requiring the taxation based on that estimate, which may or may not be on the mark, as long as it is backed up with a pretty tough minimum tax, which I think is a fair characterization of the chairman's minimum tax.

Senator Danforth. Mr. Chairman, if under the percentage completion method the contractor guesses wrong, and if he underpays his taxes, then at the end of the period when he looks back, he has to pay interest on the underpaid taxes. Correct?

Mr. Mentz. That is right, under the House bill.

Senator Danforth. And if he overpays, Uncle Sam pays him interest. Right?

Mr. Mentz. Right.

Senator Danforth. I don't understand why we would want to tax a business more--if it is going to be tax 34 point something percent and the maximum tax rate under the bill is 35 percent, I just don't understand why we would want to single out certain businesses to pay more than that by making them pay on estimates that may be inaccurate, when it is the custom of the industry to front end-load the costs and to receive most of their revenue at the end of the contract.

Senator Bradley. If their effective tax rate is going to be 34 percent, then basically they won't be subject to the minimum tax, is what you are saying.

Senator Danforth. That is correct. I mean, the minimum tax is designed to catch people who don't pay taxes at all; and I think what we are going to see here is companies that are going to be paying well in excess of the minimum tax.

The minimum tax is just a floor. The minimum tax is just a net to catch those who otherwise would slip through, but they are going to be caught.

Let me ask you this, Mr. Mentz: Am I correct in believing that the combination of TEFRA and the proposal that the Administration has made, that that combination does take care of the abuses that were found in earlier laws, the abuses of indefinitely putting off to the termination of a contract and the abuse of deducting costs early which don't match up to the revenues received?

Mr. Mentz. Yes, I think they go a long way in that direction; and indeed, we haven't really even seen yet the full effect of even TEFRA because regulations under the extended period long-term contracts have only recently been finalized.

So, I think TEFRA by itself is having an impact as we go along. I think these capitalization rules in the chairman's proposal are an extension of that and a logical extension of that.

And I think that Treasury position would be that on an ongoing income tax basis--forget minimum tax for the moment--an ongoing tax basis, that is probably the correct way to measure income.

Senator Danforth. And under this proposal, interest is capitalized. Correct?

Mr. Mentz. That is right.

Senator Danforth. And also, earlier we talked about the problem of corporate executives salaries being capitalized rather than expensed. Under this proposal, salaries also would be capitalized, wouldn't they?

Mr. Mentz. Yes. Some salaries would be, I suppose. I was asked whether the President's or the CEO's salary would be capitalized. I think that may not be; but in general, the answer is yes.

The Chairman. Any other questions?

(No response)

The Chairman. If not, we are in adjournment until two weeks from Tuesday.

(Whereupon, at 12:22 p.m., the meeting was adjourned.)

CERTIFICATE

This is to certify that the foregoing proceedings of an Executive Session of the Committee on Finance, held on March 26, 1986, in re: Tax Reform, were held as appears herein and that this is the original transcript thereof.

William J. Moffitt

WILLIAM J. MOFFITT
Official Court Reporter

My Commission expires April 14, 1989.