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EXECUTIVE MEETING
WEDNESDAY, SEPTEMBER 22, 1982
U.S. Senate
Senate Committee on Finance
Washington, D.C.

The committee met, pursuant to notice, at 10:12 a.m. in room 2221, Dirksen Senate Office Building, Honorable Robert J. Dole (chairman) presiding.

Present: Senators Dole, Packwood, Danforth, Wallop, Durenberger, Armstrong, Symms, Long, Byrd, Bentsen, Matsunaga, Moynihan, Baucus, and Boren.

Also present: Mssrs. Stern, Lighthizer, De Arment, McGonaghy, Hersch, Chapoton, Glickman, Hardee, Stretch, Brockway, Hoyer, and Ms. Burke.

(The press release announcing the meeting follows:)

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1 The Chairman. I am certain there will be other
2 members present. I just wanted to indicate that we would
3 like to take up, first, Subchapter-S, and then Technical
4 Corrections. But before we do anything, I think we have to
5 recognize that we are probably in the last few days of this
6 session.

7 I have heard some members had seven amendments and some
8 had five amendments. I would just say at the start, if we
9 are going to start trying to load up Subchapter-S with
10 amendments or the Technical Corrections bill with amendments,
11 we are just not going to report them out of our committee
12 because we are under time constraints. Unless we can have
13 some agreement I doubt that the leadership on the Senate
14 floor will even let us bring the bills up.

15 I believe the Subchapter-S Legislation is very
16 important. I have asked the staff in the past two days to
17 review some of the questions that have been raised in the
18 hearings. There will be a few staff suggestions.
19 We know there are two or three areas of controversy; we know
20 there are some who would like certain amendments added to
21 Subchapter-S. I have asked the Administration "at the
22 appropriate time" to respond to one or two of those areas;
23 but I would just urge my colleagues that if in fact we
24 want Subchapter-S to pass, and if in fact we want
25 Technical Corrections to pass, that we keep it on that basis:

1 Technical Corrections -- Yes, and Subchapter-S -- Yes.

2 There are other tax bills that the House has now sent
3 to the Senate. We will have a total of 10 of those. Of
4 course, they are all subject to amendments; but I would
5 just stress again the time constraints and the need to make
6 decisions rather quickly.

7 Could we start with Subchapter-S? Mr. Monaghy?

8 Mr. Monaghy. Yes, Mr. Chairman.

9 We have a couple of handouts -- two of them --
10 that briefly describe what is in the bill, H.R. 6055, and
11 one of those has a comparison chart of present law and
12 H.R. 6055.

13 This started as a project some years ago with all
14 staffs assigned to come up with ways to simplify and modify
15 Subchapter-S to make it more workable, to eliminate traps,
16 and to make it operate more akin to the treatment with
17 respect to partnerships.

18 We might spend just a minute going through the
19 principal changes in the bill. Maybe this comparison sheet
20 would be one we could use real quickly.

21 It increases the number of permitted shareholders, for
22 instance, from 25 to 35. It makes some changes with respect
23 to classes of stock, saying that stock may differ in voting
24 rights, that straight debt instruments are never going to
25 cause disqualification.

1 It repeals the passive income limitation that is
2 presently there. Today you can't have passive income in
3 excess of 20 percent of gross receipts. It repeals it for
4 any new Subchapter-S corporation, any corporation that has
5 been a Subchapter-S since its existence, and any "regular"
6 corporation -- we call them "C-corporations" -- that does not
7 have earnings and profits.

8 With respect to a corporation that has earnings and
9 profits and wants to elect Subchapter-S, the passive income
10 limit is retained.

11 It gets rid of a problem with respect to foreign income;
12 it essentially eliminates retroactive terminations and
13 inadvertent terminations; it changes some rules with respect
14 to revocations, so that the majority, for instance, of the
15 shareholders may terminate on election -- not all of them
16 are required.

17 It provides a rule on the choice of taxable years,
18 saying it will be the calendar year unless there is a
19 business purpose.

20 It provides for the straight pass-through treatment
21 of items of income and loss, as exists with respect to
22 partnerships.

23 It makes a better allocation of items of income and
24 loss on a per-share basis.

25 It allows losses to be carried forward. Today you

1 can't use the loss to the extent it exceeds your basis -- it
2 is lost forever -- and this says you can keep it, and if
3 the basis is restored you get the loss in a subsequent year.

4 It simplifies the rules with respect to basis of stock
5 and debt.

6 Also, with respect to fringe benefits it adopts the
7 partnership rules on fringe benefits.

8 With respect to the audit of partnerships or
9 Subchapter-S's, in the Heffer Bill we provided for a
10 partnership audit at the partnership level. This provides
11 a similar treatment which will permit audits at the
12 Subchapter-S level to conform to that.

13 It simplifies the rules with respect to distributions,
14 to treat them like partnership distributions. This generally
15 is effective for taxable years after December 31, 1982.

16 Again, I think this is something that has been worked
17 on by all the staffs. They are all in agreement over a
18 period that really started six or eight years ago.

19 There is another sheet based on the items that have
20 been submitted and looked at. I think all staffs have gone
21 over them -- I know they have -- and suggested technical
22 amendments: The first deals with trusts and permits
23 certain trusts to qualify even though they have multiple
24 beneficiaries. It takes care of a problem with respect
25 to accrued expenses, and it makes clear that rules

1 requiring the matching of inclusion and deductions only
2 apply in the case of cash-basis taxpayers.

3 It makes it clear with respect to windfall profits that
4 an existing Subchapter-S corporation presently is entitled
5 to the exemption for treatment for a thousand barrels. It
6 can continue to have that treatment if it maintains the
7 present Subchapter-S rules.

8 It makes a change with respect to the transfer of
9 stock, saying that we will permit transfers by gift under
10 the grandfather rules.

11 I think it would be our recommendation to all the
12 staffs that these really are in the nature of technical
13 amendments.

14 The Chairman. Is that the view of Treasury on those?

15 Mr. Glickman. Yes, Mr. Chairman.

16 The Chairman. And that has been reviewed by staff of
17 members of the committee? Minority staff?

18 Mr. McGonaghy. Yes.

19 The Chairman. Do you have any objection, Mr. Hardee?

20 Is there any objection to the technical amendments?

21 Senator Bentsen?

22 Senator Bentsen. Mr. Chairman, I will have an
23 amendment to it at the appropriate time.

24 The Chairman. Right. But you have no objection to
25 these?

1 Senator Bentsen. No, I do not.

2 The Chairman. Senator Wallop?

3 Senator Wallop. I have no objections, either.

4 The Chairman. Without objection, then, the additional
5 technical amendments will be agreed to.

6 Mr. Monaghy. There are three other items that
7 have come to the attention of the staffs, that weren't
8 necessarily in the category of "staff technicals."

9 The first one was raised by a number of members --
10 Senator Byrd has raised it with us -- and it deals with
11 whether or not, with respect to the change dealing with
12 fringe benefits, there should be a grandfather provision.

13 The Chairman. This is the amendment that Senator
14 Byrd had an interest in. Is that correct?

15 Mr. Monaghy. That is correct, Mr. Chairman.

16 There is a suggestion, if the committee decided, that
17 would retain the existing treatment for a 5-year period
18 so long as the current passive income limitation is not
19 violated and the majority of stock is not transferred.

20 The Chairman. Is there any objection? Is the Treasury
21 familiar with that provision?

22 Mr. Glickman. Yes. There is no objection, Mr.
23 Chairman.

24 The Chairman. And that has been discussed with
25 Senator Byrd, David?

1 Mr. Hardee. I would prefer waiting until Senator
2 Byrd got here to give his final okay on it. We discussed
3 this last night and I have not had a chance to talk with
4 him about it.

5 The Chairman. Fine. We will just reserve on that,
6 but we don't want the vote to go through without his
7 amendment.

8 Mr. Monaghy. The second of those deals with whether
9 a Subchapter-S can have a disk corporation or a foreign
10 subsidiary. What the bill does presently is state that
11 as to the future the answer to that is No for simplicity
12 purposes, but it would grandfather existing situations. The
13 date on that grandfather is June 23rd.

14 There are at least one or two situations where there
15 has been a disk presumably set up as a subsidiary of
16 Subchapter-S, and the issue there is whether the committee
17 would like to move that date from June 23rd to take care of
18 those one or two cases to some other date such as the date
19 of the committee's markup day.

20 I think the reason as to the future those aren't
21 permitted is really a simplification reason. Some have said
22 that date should be moved to the date of the markup.

23 The third one deals with someone who has broken the
24 Subchapter-S election. Under current law they cannot go
25 back and make the Subchapter-S election for a period of five

1 years. They have asked that they be able to go back and
2 make that Subchapter-S election because of the major
3 revisions here and not have to wait for that five years.

4 The Chairman. Well, I would suggest, unless there is
5 some objection, that we withhold on Senator Byrd's amendment,
6 but that we may approve the other amendments just described
7 by Mr. McGonaghy. Without objection, that will be done.

8 Senator Bentsen?

9 Senator Bentsen. Yes, Mr. Chairman. I have an
10 amendment which I would like to offer, and that is to strike
11 out the passive income test.

12 I really believe that the passive income test does not
13 serve a useful purpose. That is one, of course, where if
14 you have more than 20 percent of a corporation's gross
15 receipts as passive income you lose your Subchapter-S
16 rating.

17 Passive income is things such as royalties, grants,
18 dividends, interest, annuities -- that type of thing. It
19 is a trap that the unwary can fall into.

20 You get into a situation where you have a company
21 that is perhaps in home building. Business gets bad, and
22 you decide to rent your equipment out for a while. All of
23 a sudden you have rental income in. You have been a
24 Subchapter-S, and all of a sudden you are forced into a
25 termination and lose your election. I can cite you a vast

1 number of cases where that type of situation has happened.

2 Now, when we get to looking at what we have had in the
3 testimony, the American Bar Association section of the
4 taxation statement in September of this year correctly
5 points out, I think, when it says, "The passive-income
6 limitation is no longer necessary, causes severe problems
7 in the application of Subchapter-S."

8 In 1980 the Joint Committee Staff recommended
9 elimination of the passive-income test entirely, stating that
10 elimination of this restriction would remove much
11 uncertainty, reduce litigation, and prevent retroactive
12 terminations of Subchapter-S elections.

13 I really don't see the reason for its continuance, and
14 when you get into the question of possible loss of revenue
15 the Joint Committee has estimated that the net effect of
16 all provisions of S. 2350, if you eliminate that, is a
17 revenue loss of less than \$10 million annually.

18 I think removing the last vestige of this passive
19 income trap could not add materially to this negligible
20 revenue loss. I think it would certainly simplify it and
21 save a lot of small companies.

22 You get into a situation questioning earnings and
23 profits and, whether you have an undue accumulation of
24 surplus or earned surplus, some small companies think
25 because they have no earned surplus that they don't have a

1 revenue and profit problem. And yet you have two different
2 ways to figure that -- from a tax standpoint or a revenue
3 and earning category. Some people don't keep two sets of
4 books and are generally not that sophisticated.

5 So I think you simplify the whole thing if you do away
6 with it, at very little cost. I would urge that, and I have
7 the specific provisions of the amendment. It would be page
8 13, strike out line 10 and all that follows through line
9 3 on page 15; and then on page 15, line 4, strike out
10 paragraph 4 and insert paragraph 3.

11 The Chairman. As I understand, the Administration
12 would like to be heard on this amendment. They have a
13 different view.

14 Mr. Glickman?

15 Mr. Glickman. Yes, sir.

16 Senator Bentsen, this is a little background. As you
17 know, as we have gone through this bill, this has really been
18 done in the process of letting everyone work out something
19 that makes sense. We are all concerned with the problems
20 in the Subchapter-S area. As stated, it has been done on
21 a collegial basis.

22 We, too, appreciate the problems with the passive
23 investment income test that have been out there for many,
24 many years. That is why, as a practical matter for new
25 corporations or for old corporations that had no earnings

1 and profits -- Subchapter "C" corporations with no earnings
2 and profits -- we eliminate the passive investment income
3 test.

4 But we do see a severe problem with respect to those
5 corporations that are presently in existence -- Subchapter
6 "C" corporations that are presently in existence -- that have
7 earnings and profits, or future Subchapter "C" corporations
8 that are going to accumulate earnings and profits.

9 If all you do is allow them to move freely from
10 Sub-C to Sub-S when they have substantial stock of earnings
11 and profits, as a practical matter, in our judgment, what
12 you have done is dramatically changed tax planning up
13 not only with the Sub-S area but with the Subchapter-C
14 area.

15 As you know, we have gone towards the direction
16 making Sub-S corporations more like a partnership. In
17 order for a Subchapter-C corporation to go to partnership
18 solution it has to liquidate today, and it will have to
19 pay some tax on that liquidation.

20 Senator Bentsen. Now, wait a minute. You don't
21 go to liquidation to go to Subchapter-S. And that's where
22 you are headed, to a Subchapter-S.

23 Mr. Glickman. As a practical matter now, Senator,
24 after the new bill is finished, we have a pass-through type
25 of entity that is very, very similar to a partnership.

1 Senator Bentsen. No; you are making it one, and that
2 isn't the case. I don't think you have a liquidation. You
3 have not put the assets in the hands of the shareholders,
4 and they will have to pay a tax as those assets are passed
5 to them at some future date. It is not a partnership
6 situation.

7 Mr. Glickman. But as a practical matter, all items of
8 income, all items of deduction will now flow through from
9 the Subchapter-S corporation. There will be a single
10 tax.

11 Senator Bentsen. That's the reason to go. If you
12 are going to get away from a corporate tax, then that's the
13 reason for a Subchapter-S.

14 Mr. Glickman. I agree with that, sir. The point is,
15 the whole purpose here is to make the Subchapter-S
16 provisions very similar to the partnership provisions. That
17 was the stated purpose of this, to make this type of
18 pass-through entity very similar to a partnership
19 pass-through entity. As a practical matter, that is what
20 the bill is going to do.

21 All I was saying was if you went to the partnership
22 entity, in that type of situation, you would have to go
23 through a liquidation.

24 Now what we are saying is that any Sub-C corporation
25 that wants to, from this point forward, can go straight into

1 a Sub-S, have all the benefits of a partnership --

2 Senator Bentsen. How can you say that? I don't have
3 the assets, if I am a stockholder of a Subchapter-S. Those
4 assets have not passed into my hands.

5 Mr. Glickman. But in a partnership they are in the
6 partnership also, Senator. Just like if they are in the
7 corporate solution, they are in the corporation. In other
8 words, if you own 100 percent of the stock of a Subchapter-S
9 corporation, or two people own 50 percent each of stock of a
10 Subchapter-S corporation, or those two people own 50 percent
11 interest in a partnership, in both situations the assets,
12 the ownership of the assets, is in the entity and not in
13 the hands of the shareholders of the partners.

14 Senator Bentsen. Yes; but if they are in the hands
15 of the partnership and the partnership is liquidated,
16 haven't you already paid such taxes as have accrued anyway?

17 Mr. Glickman. If you liquidate a partnership, as a
18 general proposition, there will be no tax on that.

19 Senator Bentsen. That's right. But if you turn around
20 and liquidate a Subchapter-S, finally you have got yourself
21 a tax, haven't you?

22 Mr. Glickman. Well, that's clear. That is clearly
23 correct; but what I am saying is that the benefits that you
24 have obtained by going to Subchapter-S are very similar to
25 the benefits you have obtained in going to a partnership.

1 That is the whole purpose of the bill.

2 Senator Bentsen. Well, once again, if you get a
3 partnership you have ownership of it, and if the partnership
4 is liquidated there is no further tax.

5 You liquidate a Subchapter-s, and you have got yourself
6 a tax.

7 Mr. Glickman. I hear what you are saying, sir, but I
8 disagree. I feel that when you go into a Subchapter-S
9 corporation, that is such a pass-through type of entity that
10 it is very similar to being in a partnership.

11 I think that the ownership in a partnership, from a
12 state law standpoint, is very similar to the ownership in
13 a corporation in the sense that the partnership is the
14 entity that owns it. The partnership will borrow the
15 monies; the partnership will have the title in many
16 situations along whose lines.

17 I guess our most severe problem here, Senator Bentsen,
18 is the fact that if we allow this, from this point forward
19 from a planning standpoint, people will go into
20 Subchapter-C, accumulate income at the lower tax rate
21 at the Subchapter-C level, pay that lower corporate tax,
22 then feel no constraints --

23 Senator Bentsen. How much lower a tax rate is that
24 going to be when you have a situation now where you put a
25 top of 50 percent on the investment income? You have

1 equated these much more than you have in the past.

2 Mr. Glickman. Let me just give you a rundown. These
3 numbers are based on 1979 rates, but the rates are not going
4 to vary that much in this situation.

5 If you had taxable income of \$25,000, the corporate
6 liability and individual liability is not very different.
7 If you had taxable income of \$100,000, the corporate
8 liability would be \$26,000 and the individual liability
9 would be \$41,000.

10 If you had taxable income of \$250,000, the corporate
11 liability would be \$95,000 and the individual liability would
12 be \$141,000.

13 What you are playing on here, Senator, is the surtax
14 exemption in the corporation and the fact that that first
15 \$100,000 of income is taxed at a very low effective rate.
16 Thus, what you can do is accumulate that income in the
17 corporation, then move to Subchapter-C, convert that income
18 into passive investment income -- stocks, bonds, C.D.s --

19 Senator Bentsen. But you have paid the corporate
20 rate already, and then you turn around and pay the individual
21 rate, don't you? That is, you pass it out.

22 Mr. Glickman. No.

23 Senator Bentsen. Yes.

24 Am I correctly reading your statement? Didn't you
25 state that a source of inadvertent termination of

1 Subchapter-S elections is a source of worrying litigation?
2 Isn't that your statement before this committee on
3 September 10, 1982?

4 Mr. Glickman. Absolutely. And it is still a big
5 concern, and that's one of the reasons there is a
6 provision in the bill that specifically gives the
7 Commissioner of the Internal Revenue or the Secretary of
8 the Treasury the authority to waive those types of
9 inadvertent terminations because of those types of items.

10 As I understand it, at least on the House side, the
11 committee report language is even much broader than that
12 and gives an example of the type of situation we are
13 talking about. And it specifically refers to the
14 inadvertent termination as a result of the passive violation
15 of the passive investment income case.

16 Senator Bentsen. If it is what you say, then why is
17 it that the Joint Committee estimated the net effect of all
18 of the provisions of S. 2350 as a revenue loss of less than
19 \$10 million annually?

20 Mr. Glickman. Well, I don't think there is going to
21 be any revenue loss because people simply won't go into
22 Subchapter-S corporations. They will maintain their assets
23 in the Subchapter-C corporation, will not make the
24 distributions out, will accumulate their income in that
25 fashion, and with respect to new activity they will form

1 new Subchapter-S corporations with respect to those new
2 activities. Thus, they would be willing to maintain the
3 Subchapter-C status with respect to those earnings involved
4 that are in the Subchapter-C corporation.

5 Mr. McGonaghy. I think, Senator Bentsen, that that
6 estimate on the bill does not take into account the
7 elimination of the passive income limitation with respect
8 to corporations who had some earnings and profits while
9 they were Subchapter-C and want to make that election. The
10 estimate does not include the removal of that limitation as
11 to those corporations.

12 Senator Bentsen. What is staff proposing in this? I
13 want to get away as much as we possibly can from passive
14 income tests. I think it is a trap, and I think all kinds
15 of small companies get caught in that trap. I don't think
16 it serves a useful purpose, frankly.

17 Mr. McGonaghy. We would agree, Senator Bentsen. The
18 staff proposal says, with respect to any new Subchapter-S
19 corporation formed there is no passive income limitation
20 that applies. With respect to any corporation --

21 Senator Bentsen. With respect to any new Subchapter-S
22 that there would be no passive income test?

23 Mr. McGonaghy. Correct.

24 With respect to any Subchapter-S corporation which is
25 existence already and which has always been a Subchapter-S

1 corporation, there would be no passive income limitation
2 applying to them, either.

3 With respect to corporations that are presently
4 Subchapter-C corporations -- regular corporations -- if
5 they did not have earnings and profits and are moving to
6 Subchapter-S, then as to them there would be no passive
7 income limitations.

8 Senator Bentsen. But you really have some problems
9 on your tests there. In effect you have two different sets
10 of accounting that you would have to try to figure out.

11 Mr. McGonaghy. It really highlights the problem, which
12 is: Those corporations which are presently Subchapter-C,
13 or regular corporations, that have accumulated earnings and
14 profits at the corporate and now want to elect Subchapter-S,
15 it is that problem, I think, that we all feel -- and there
16 have been articles written about it after that 1980
17 recommendation -- that we are opening one of the biggest
18 loopholes to allow the bailout of those earnings at capital
19 gains rates.

20 If you would take, for example, a corporation, and
21 assume for the moment for illustration that it has been in
22 existence for 10 years and has had taxable income of a
23 million dollars a year, the difference let's say from 1969
24 to 1979 would be about \$220,000 in tax difference. If it
25 were an individual or a partnership it would pay \$220,000

1 more on that million per year -- on that million dollars of
2 taxable income. If it were a Subchapter-C it would pay on
3 that same income \$220,000 less.

4 Senator Bentsen. Well, what do you do if you have got
5 a Subchapter-S -- and I understood what he said; he said
6 a Subchapter-S that has always been a Subchapter-S -- but
7 what if you have one that has been a Subchapter-C and then
8 in good faith converted to a Subchapter-S? Are you going to
9 turn around and hit them with a passive income test?

10 Mr. McGonaghy. Only if they have old earnings and
11 profits that are carried over from their Subchapter-C status.

12 Senator Bentsen. But it does not necessarily mean an
13 accumulated surplus, does it?

14 Mr. McGonaghy. If there were not accumulated earnings
15 and profits --

16 Senator Bentsen. That isn't what I said to you. I
17 said if you did not have an accumulated surplus, you could
18 still have earnings and profits category, couldn't you?

19 Mr. McGonaghy. Well, we are just talking about those
20 corporations which have earnings and profits.

21 Senator Bentsen. That is right.

22 Mr. McGonaghy. Right. And as to those, if those
23 earnings and profits were attributable, in other words are
24 from their Subchapter-C status where they got some benefits
25 from being in that corporate form, then as to those they

1 would have to -- as they do under existing law -- continue
2 to have that passive income limitation apply to them.

3 We agree that we would like to come up with a solution
4 that addresses it and gets rid of it as to those as well.
5 There have been two or three suggestions: One is to exact
6 a toll charge for them, going out of Subchapter-C status
7 into Subchapter-S, the same way that a corporation may
8 liquidate today to get out of corporate status and go into
9 partnership form. That essentially would impose a tax at
10 the shareholder level, either under normal liquidation
11 where there would be capital gains on appreciation, or under
12 the rules for 333 which would have ordinary income on
13 the earnings and profits. That has not been accepted by very
14 many people.

15 There has been another suggestion that we should exact
16 some kind of toll charge for doing that, because they did
17 have an advantage and they can bail out those earnings, but
18 let's have a softer kind of a toll charge for doing it, but
19 only where they had the earnings and profits.

20 One solution has been suggested that is very
21 complicated. We do feel that we should look at it and try
22 to solve it so that we can get rid of that problem.

23 Certainly, on the other hand, most people will admit
24 that it is a problem, that it does potentially provide for
25 the bailout of earnings and profits at capital gains rates

1 that is not permitted if I want to go and liquidate and
2 essentially go into partnership form. We should address
3 that issue.

4 I think the ABA, which has indicated it has a problem
5 and recognizes that that problem exists, would like to work
6 with us. I think there are other groups out there that
7 also recognize it is a problem and feel we should try to
8 attempt some solution.

9 But we decided we don't have an adequate solution and,
10 rather than address it in some complicated fashion, we
11 should go forward with those that are new Subchapter-S's,
12 those that have always been Subchapter-S's, and those
13 Subchapter-C corporations which do not have earnings and
14 profits, and put the new rules in place, get rid of the
15 passive income limitations to them, and keep the existing
16 rule until we can figure out how to handle the problem of
17 a "C" that essentially has earnings and profits and try to
18 come back to you with a recommendation as to that.

19 Senator Bentsen. When do you incorporate that?

20 Senator Armstrong. Would you yield to me for a
21 question and perhaps for an observation?

22 Senator Bentsen. Sure.

23 Senator Armstrong. I arrived after you began your
24 discussion of this issue, and my question is this: Do you
25 have an amendment pending to just abolish the whole

1 passive earnings test?

2 Senator Bentsen. Yes, I do.

3 Senator Armstrong. May I be added as a cosponsor to
4 that?

5 Senator Bentsen. Sure.

6 Senator Armstrong. I am aware of the points that are
7 being made by Mr. McConaghy, and I think they have some
8 validity; but in the final analysis, those previous earnings
9 and profits that are locked up in Sub-C corporations, one of
10 two things is going to happen: Either the value of those
11 assets will be consumed -- that is, used by their owners
12 in some consumptive way, in which case there will have to
13 be a liquidation because there is no way they can invest
14 those in consumption items, that is, food, clothing or
15 shelter, unless it gets into their hands personally, and
16 that requires a liquidation to occur or a dividend, in which,
17 in either case they are taxed -- or they are going to use
18 them in an investment mode, in which case tax will be paid
19 on the personal rate schedule under Sub-S.

20 I do see and understand the argument, but I'm
21 persuaded that Senator Bentsen is completely right, and the
22 straightforward way to do it is just exactly what we set out
23 to do in 1980, and that is to abolish the whole thing.

24 The Chairman. I am not as familiar with the details
25 of this as either Senator Armstrong or Senator Bentsen; but,

1 as I understand, the Treasury feels so strongly about this
2 provision; unless we can accommodate it you would just as
3 soon not have the bill at all. Is that correct?

4 Mr. Chapoton. Mr. Chairman, that is correct.

5 As Mr. Glickman said, we are all concerned about the
6 inadvertent terminations, and the staffs have worked very
7 hard dealing with that problem.

8 We are also very concerned that we not, in this very
9 worthwhile Subchapter-S project, open up a new planning
10 device for every corporate liquidation that comes along
11 where you can simply avoid the second tier of tax on which
12 would otherwise be a liquidation. And if we do that, we
13 will turn this worthwhile Subchapter-S project into something
14 that is a gimmick; there will be articles written about it,
15 and everybody will have to consider it in every liquidation
16 of a Chapter-C corporation. You will have to consider the
17 use of a Subchapter-S corporation. You will have to put
18 the pencil to it; and indeed in most cases it will come
19 out better not to liquidate but to kick into a
20 Subchapter-C corporation, reinvest the assets, and take
21 out what you need to consume. That's true -- what you
22 are going to spend on your home or personal consumption
23 you will have to pay the double tax; but what you are going
24 to reinvest -- there will be no reason to liquidate; you
25 will simply avoid the tax and will have had the best of

1 both worlds.

2 It would give us such concern that we would much prefer
3 to see the Subchapter-S put over rather than to use this
4 device to open up a --

5 Senator Armstrong. But, Mr. Chairman, the Secretary's
6 explanation doesn't respond to the threshold question of why
7 that isn't okay.

8 Senator Bentsen. That's right.

9 Senator Armstrong. These corporations and these
10 investors do not exist in order primarily to produce taxes
11 for the Treasury. If they had elected in the first place to
12 be taxed as a partnership or as individuals they wouldn't
13 have incurred this.

14 I think that the first showing that has got to be made
15 is why this was a good idea in the first place. I have never
16 been convinced that it was. Why was the passive income
17 test a good idea in the first place?

18 Mr. Chapoton. Simply because of the concern that they
19 used the corporation to pay a lower tax in the interim, and
20 they have had the benefit of the lower tax.

21 Senator Armstrong. So what? What is wrong with that?
22 The whole point of this legislation is to say that people
23 who elect a corporate form of organization should not be at
24 a tax disadvantage vis-a-vis people who elect to be taxed
25 as a proprietorship or as a partnership.

1 You are just saying that is all right for the future,
2 but with respect to people who have previously been taxed
3 as Sub-C corporations that they shouldn't get that benefit.

4 My point is this: To the extent that they actually
5 consumed what they have liquidated, they do have to either
6 liquidate or declare a dividend, and that's a taxable
7 event. But if all they are going to do is invest it, even
8 in a passive investment, they are going to be taxed in
9 exactly the same way as any other partnership.

10 Why they should pay what Mr. Glickman has termed a
11 "toll charge" is simply not plain to me. I can sure listen
12 to it, but it seems to me pretty clear-cut.

13 Senator Bentsen. I must say, too, I don't understand
14 why the connotation is bad on passive income. I don't
15 understand why it should be.

16 Senator Symms. Would the Senator from Texas yield for
17 a question? You may want to answer his question first.

18 Mr. Glickman. Well, Senator Armstrong, let me see if
19 I can respond to your question.

20 Obviously, when Subchapter-S first came into the law
21 in 1958, the spread between the individual rights and the
22 corporate rights was dramatic. At that same time we had
23 the personal holding company rules in, and there was a real
24 feeling then that you shouldn't be putting passive
25 investment types of income into corporations.

1 Senator Armstrong. Why?

2 Mr. Glickman. Because we do have a double tax system
3 here. Whether we like it or not, we were in a double tax
4 system, and this was one of the methods of accumulating
5 that type of income --

6 Senator Armstrong. Why was that just, or why was it
7 good tax policy? Why should somebody who invests, say, in
8 bulldozers be taxed differently than somebody who invests
9 in the stock of a bulldozer company?

10 Mr. Glickman. I think the answer to that, sir, is:
11 Why should you have the ability to go into a corporation and
12 get a lower tax than if you did the same thing as an
13 individual? In other words, what you are doing is putting
14 a premium on the entity you use, that you choose to do your
15 business in, and as a practical matter it seems to me that
16 we ought to be moving away from that type of preference of
17 one type of entity or another.

18 Following through, we now agree that we ought to
19 eliminate the passive investment income test. The rates
20 have become closer together -- the maximum rate is at
21 50 percent at the individual level, as you know. So
22 we are recommending the elimination of the passive
23 investment income test in the future with respect to these
24 types of situations.

25 The problem that we have here, though -- and I think

1 you have put your finger on it -- is that what you really
2 are doing to some degree is integrating the tax system.
3 What you will have is people going to the Sub-C's,
4 accumulating at this lower rate of tax for a number of
5 years, switching into a Sub-S, never paying any tax on that
6 accumulation, yet distributing out income which is on that
7 accumulation.

8 Now, perhaps the integration of the tax system might
9 be wise, but I don't think we ought to do it through the
10 Sub-chapter-S mode.

11 Senator Armstrong. Well, Mr. Glickman, I believe you
12 inadvertently stated something that is not exactly right;
13 and that is, you said the accumulation would not be taxed.
14 It would be taxed at the corporate rates during the period
15 that they were in a Sub-C tax mode.

16 Now, somebody thinks those tax rates are too low.
17 Somebody thinks we ought to have corporate tax rates at
18 60 percent or 70 percent. I don't think that. I think
19 this whole scheme we have built is sort of an
20 anti-investment, anti-productivity scheme.

21 So, in general, my desire is to lower both corporate
22 and personal taxes and to do those things which encourage
23 people to take the socially desirable course which is to
24 amass capital and employ it productively.

25 It seems to me that the amendment which

1 Senator Bentsen suggests serves that end. It is not only
2 just to the taxpayers but it has some broader connotations
3 in terms of what it means to the economy.

4 Senator Symms. Let me ask a question on that point.
5 If you don't have the Bentsen Amendment, how are you going
6 to treat the construction company that, say in the last
7 10-year period, operated as a Subchapter-S corporation,
8 had most of their income from construction work, and in
9 the process built some buildings so they have rental income,
10 and now they are slowed down in the construction. Are they
11 going to wake up one morning and find out, without his
12 amendment, that they have failed the passive income test?
13 How is Treasury going to treat that? That just doesn't
14 seem equitable to me, when all of a sudden they find out
15 a year later that they are no longer a Subchapter-S
16 corporation.

17 Mr. Glickman. Senator Symms, in that case, if they
18 have been a Subchapter-S corporation since their inception
19 they probably will not have earnings and profits which they
20 have accumulated. They could, but --

21 Senator Armstrong. Well, they could have. What if
22 they built a building out here?

23 Mr. Glickman. No, but the Subchapter-S corporation,
24 as a general proposition, if they have been Subchapter-S
25 from their inception they can't have earnings and profits.

1 And Treasury would not have any problem with saying, with
2 respect to the earnings and profits which have been
3 accumulated during the period of time that they were
4 Subchapter-S, not to take those into consideration in making
5 the passive investment income test.

6 So, in the situation that you just now gave, that
7 corporation would not be subject to the passive investment
8 income test, because it wouldn't have earnings and profits
9 that would be taken into account.

10 Senator Armstrong. Well, I think it could have. What
11 if they lost all their income from construction jobs because
12 there is a slowdown in construction, so the only income they
13 have back is passive? And then next year they find out
14 when they file their tax returns that they are in a different
15 status?

16 Mr. Glickman. What I meant to say was that if they
17 have been Subchapter-S from their inception, with respect
18 to that type of situation, the passive investment income
19 test would not apply to them because either they wouldn't
20 have any earnings or profits accumulated or, if they did,
21 like I said, we could ignore that type of earnings and
22 profits so that the passive investment income tests do not
23 apply.

24 Senator Armstrong. Okay; but what about a Subchapter-C
25 that wanted to move into Subchapter-S? How would you treat

1 that, then?

2 Mr. Glickman. Well, if it is a Subchapter-C corporation
3 that has accumulated earnings and profits and has moved into
4 a Subchapter-S corporation, that is the precise problem
5 that we are concerned about.

6 Now, if they inadvertently violate passive investment
7 income tests, the Commissioner has the ability to waive that
8 type of violation. And we specifically built that into the
9 provision to avoid the unintended termination problem.

10 Senator Bentsen. If the Senator would yield a moment,
11 I think what you are really getting to, and I think the crux
12 of this, is that you fellows are getting back to a
13 step-forward basis again. There is the question of the
14 carried-forward basis, and the fellow finally dies, and
15 the state has a stepped-up basis. We fought that fight
16 before. We settled that one last time. Senator Byrd and
17 Senator Wallop were leaders in that fight. It looks to
18 me like that is one of the things that is concerning you
19 here.

20 Mr. Chapoton. That could be an additional
21 consideration, I suppose, in the tax-planning device; but
22 that is not a major factor in our thinking.

23 I think we have two questions. One is we are worried
24 about the inadvertent termination. We certainly are
25 worried about that and want to go as far as we can in

1 avoiding an inadvertent penalty.

2 Then, I think Senator Armstrong meets the question
3 head-on when he says we should just avoid the double
4 taxation whenever we can. I think we might agree with that
5 on a policy ground if we had that policy question before us;
6 but what we are clearly doing by putting in an unlimited
7 passive income test is we are giving taxpayers the
8 opportunity to plan to avoid the double tax in particular
9 situations. We just hate to see a good amendment, a
10 sound amendment to Subchapter-S, being used for that planning
11 device. Obviously if it is available people would use it.

12 The Chairman. I wonder, before we dispose the final
13 disposition of this amendment, if we might go back and
14 approve the amendment of Senator Byrd, as I understand on
15 fringe benefits? If that is acceptable to you.

16 Senator Byrd. It is not what I would prefer, but it
17 is acceptable.

18 The Chairman. So, without objection, that amendment
19 will be approved. We were waiting for Senator Byrd's
20 arrival.

21 Again, I don't have any strong feelings. I don't
22 understand this amendment as well as some who have a direct
23 interest in it; but I do understand, as I think I heard
24 Treasury say, that if this amendment is adopted you would
25 just as soon not have the bill. So I think we have to make

1 that judgment.

2 Now, is there any middle ground? Is there any way
3 we can satisfy some of the concerns expressed by Senator
4 Armstrong and Senator Bentsen and others. Still, if the
5 Administration doesn't support the bill we are not going to
6 have a bill.

7 There are a number of good provisions in it. What can
8 we do to get out of this dilemma?

9 Senator Baucus. Mr. Chairman, on that very point, I
10 personally believe the passive income tests are just too
11 strict as it is in the bill. Twenty percent is just too
12 low. However, I do understand some of the concerns that
13 Treasury has, as the Chairman has even alluded to.

14 I am wondering if 50 percent might make more sense to
15 some of the members of the committee here. I understand
16 that there is a 50-percent gross receipts tax used to
17 prevent abuse when they classify in losses on small business
18 stock. I am wondering if that 50-percent level that makes
19 sense there might also make sense in the test here?

20 Senator Bentsen. If I might interrupt, Senator, you
21 run into some of the same problems, I think. It is just a
22 question of degree.

23 I am quite willing to see if we can explore with
24 Treasury and find some middle ground. There are a lot of
25 good things in this piece of legislation, and I would like

1 to see it prevail.

2 I strongly disagree with the passive income test. I
3 don't see what is wrong with passive income, frankly. I
4 don't see the bad connotation there. But if we find an
5 area of agreement, to try to be constructive, Mr. Chairman,
6 I would try -- I am not sure that we can.

7 Mr. Chapoton. Senator Bentsen, we have been kicking
8 this around. One thought we have had, and I am not sure we
9 thought it through thoroughly, is to the extent that you
10 exceed the 20-percent test it would be a tax on the passive
11 income at the corporate level. There would be no inadvertent
12 termination of the Subchapter-S, but you simply could not
13 use the Subchapter-S corporation for the purpose that we
14 were concerned about beyond the 20-percent limit. And it
15 would clearly prevent the inadvertent termination of the
16 Subchapter-S status.

17 Senator Bentsen. For that particular year you would
18 have a corporate tax on the excess?

19 Mr. Chapoton. On the passive income in excess of
20 20 percent.

21 Senator Bentsen. On the excess?

22 Mr. Chapoton. You see, there is precedent for that.
23 That is what is done in certain situations for capital
24 gains realized by Subchapter-S corporations.

25 Senator Bentsen. And you would not violate

1 Subchapter-S classification?

2 Mr. Chapoton. That is correct; you would not lose your
3 Subchapter-S status.

4 The Chairman. Well, I wonder if we might agree that
5 we can maybe almost immediately start to see if we can
6 work out some agreement.

7 Senator Bentsen. I am willing to explore that.

8 The Chairman. Is that all right, Senator Armstrong?
9 Senator Wallop?

10 Senator Armstrong. Well, Mr. Chairman, of course I am
11 always eager to reach an accommodation with the Treasury,
12 but I must say I am dumbfounded to think that the Secretary
13 is really telling us that were an amendment such as
14 Senator Bentsen has suggested adopted that he would really
15 rather not have the bill at all.

16 Is the Secretary telling us that literally he would
17 recommend to the President of the United States that the
18 bill be vetoed? And is he also saying he thinks the
19 President under those circumstances would veto such a bill?

20 Mr. Chapoton. I have learned not to speculate on
21 veto, Senator Armstrong. What I said was that we would
22 rather see it put over so we could work on this problem
23 more.

24 What we are concerned about -- and, as I said earlier,
25 I think you meet the point head-on -- is it would be a

1 method of avoiding the double tax. We would then have
2 changed a bill which does a lot of good things into a bill
3 which is a great planning technique on every corporate
4 liquidation.

5 Senator Armstrong. I am skeptical of that.

6 I must say that my interest in this issue arose in the
7 first place when we had a measure on regulated investment
8 companies before this committee, and I said: Why is it fair
9 that companies that have a hundred stockholders or more get
10 one kind of treatment, whereas the smaller companies that
11 have less than a hundred stockholders can't qualify for
12 this treatment?

13 What I was told was, "Don't worry about it. We are
14 going to fix it up when the Subchapter-S bill comes." Well,
15 this is the Subchapter-S bill, and the expectation that
16 I had, and I think other members of the committee had, was
17 that we were going to do away with the passive income test.

18 Now we find out that the Treasury isn't willing to
19 do that. I understand the points. I think it is a
20 reasonable argument; but I am not persuaded by it. And I
21 am a little distressed, Mr. Chairman. Indeed, I am a little
22 offended by the notion that, from the Treasury's standpoint,
23 if we don't want to do it the way they want to do it this
24 year, as opposed to the way they wanted to do it last year,
25 that they are going to take their marbles and go home.

1 Maybe some of the rest of us will do the same thing. You
2 know, at this stage of the game anybody can kill a bill;
3 that's nothing big.

4 But I would really appeal to the Treasury not to be
5 so adamant and so hard-nosed about it. We will try to work
6 something out; but, you know, this is a good bill whether
7 this provision is in or out.

8 Mr. Chapoton. Senator Armstrong, first of all, I think
9 we have taken care of the pass-through for the future. The
10 small corporations can now have complete pass-through of
11 passive income. We are dealing with one particular
12 situation; but we want to emphasize how major it is to us.
13 Really, we have spent an awful lot of time on it, talked to
14 outsiders and staff here. It is a major concern,
15 obviously.

16 The Chairman. Well, unless there are other questions
17 on this, I know we have a cloture vote at noon, and I would
18 hope we might address any other amendments or questions with
19 reference to Subchapter-S, and if in fact we can resolve
20 any other questions leave this one question open. Then
21 perhaps by tomorrow morning we will have been able to --

22 Senator Bentsen. Will we be back on this tomorrow
23 morning, Mr. Chairman?

24 The Chairman. Well, I don't see how we can finish it
25 this morning.

1 Senator Bentsen. Well, with that understanding, that
2 we will have a chance to bring it up in the morning --

3 The Chairman. Oh, yes. We are not going to move on it
4 until there is, hopefully, some agreement.

5 Senator Bentsen. I am trying to be constructive. I
6 would like to work something out here. I am obviously
7 disagreeing with Treasury on this issue.

8 Senator Byrd. I would like to ask a question of the
9 Treasury.

10 Mr. Chapoton, Senator Bentsen brought up the question of
11 carry-over basis. Before you came to the Department that
12 portion of the Tax Law was repealed. In the vote to repeal
13 that, those who were opposed to repeal got 14 votes in the
14 Senate -- or it might have been 8, but there were very few
15 votes. But I still hear that word brought up by Treasury
16 officials.

17 What is the current attitude or view of the
18 Department of the Treasury and your division of the
19 Department of the Treasury in regard to carry-over basis?

20 Mr. Chapoton. Senator, we are against carry-over
21 basis. As I pointed out in response to Senator Bentsen's
22 question, the question of a step-up of this stock and this
23 situation might enter into a planning device as the effects
24 of death on tax planning always are questioned. But we are
25 not getting into and do not want to get into the

1 carry-over basis question. We are opposed to carry-over
2 basis.

3 Senator Byrd. You are opposed to carry-over basis, not
4 just in regard to Subchapter-S, or this bill, or any other
5 bill -- you are just opposed to the principle of carry-over
6 basis, is that correct?

7 Mr. Chapoton. That is correct. I have seen those
8 problems; the Congress attempted to deal with that; and I
9 think the safest conclusion is to say they are insoluble
10 and we shouldn't revisit that.

11 Senator Byrd. That is a good, clear-cut answer, and
12 I am very glad to get that.

13 The Chairman. I think we can reassure you, Mr.
14 Chapoton, they are insoluble.

15 (Laughter)

16 Senator Moynihan. Mr. Chairman, I have an amendment
17 on Subchapter-S; but if we are not going to be able to
18 resolve the passive income question, then apparently we
19 won't be able to move forward on the legislation. So might
20 I reserve to bring it up afterwards, if it seems like it
21 would be productive?

22 The Chairman. Right.

23 Senator Wallop, do you have questions on this?

24 Senator Wallop. No; my questions were resolved in the
25 technical amendments. I have an amendment which we are

1 trying to work on now, and I believe we may well have it
2 worked out very shortly.

3 I would just like to say, with regard to Senator
4 Bentsen's amendment, that I really hope we can work something
5 out, because there are a lot of things that are very
6 important to small business in this piece of legislation
7 which I would hate to see us lose.

8 Senator Long. Mr. Chairman, I would just like to
9 make this point, somewhat parallel to the Treasury's
10 position.

11 We have here a bill, as I understand it, where the
12 purpose is to simplify and streamline the Subchapter-S. Is
13 that correct, Mr. Chapoton? It is not a bill to expand
14 Subchapter-S necessarily, or to enlarge upon it, but a bill
15 to streamline and simplify. It does expand it somewhat,
16 does it not? It affects more people, being a
17 Subchapter-S corporation, for example.

18 Mr. Chapoton. It definitely does, and we are
19 encouraging that -- the number of shareholders -- and
20 indeed doing away with the passive income test in the
21 future. It will expand it and simplify it dramatically.

22 Senator Long. So, insofar as it goes, it is a good
23 bill. I sometimes have said that is about all you can say
24 of any bill, that it is a good bill insofar as it goes.

25 So everybody will have to agree that it is a good bill;

1 it ought to become law. And there is not really much to
2 argue about in what is in the bill.

3 But now, when we go beyond that and try to broaden it
4 to do a lot more things for different people, it then
5 becomes controversial and will not pass -- it won't become
6 law.

7 I would hope that the Senators would be willing to
8 withhold amendments that are going to have the effect of
9 killing a good piece of legislation.

10 Doesn't this have a lot to do with simplification, so
11 people can properly administer the laws that we have?

12 Mr. Chapoton. Yes, sir, it certainly does.

13 Senator Long. So, it seems to me as though we are
14 here with a good bill that would simplify it, make the
15 law more easy to administer; it would expand Subchapter-S
16 somewhat to make it more useful in more situations. So,
17 generally speaking, the taxpayers would all be better off.

18 Now, someone comes along and he wants to expand in
19 the areas of which some particular group has an interest.
20 Well, when they do that we wind up with no bill. I think
21 that would be a very sad travesty.

22 In these closing days you can't pass anything
23 controversial this late. Just one good solid man with a
24 good constitution and good lungs and a good digestive
25 tract can just stand there and keep the bill from passing.

1 We know that to be the case, and everybody knows it -- a
2 single Senator can kill this bill. That being the case
3 this late in the session, I would just pray, Senators, let
4 us just try to pass what we can pass and forego what we
5 can't pass.

6 I will take my chances on the same basis. If it is
7 something where the Administration says, "Well, we are going
8 to have to be against the bill if you do that," at that
9 point I think we know it is not going to become law. We
10 ought to just to try to pass it.

11 Senator Bentsen. Mr. Chairman, if I may just respond
12 to that.

13 Mr. Chairman, I have never been a part of a filibuster
14 since I have been in the United States Senate. I have tried
15 to work to try to be constructive in these things, and I
16 think this is a constructive amendment that I have proposed,
17 and it is a simplification amendment. I think it has
18 substantial merit.

19 That doesn't mean that we can't improve on a piece of
20 legislation that does have constructive things in it, and
21 that is what I am attempting to do.

22 I further stated that I would stand aside and try to
23 work something out with Treasury, and that has been my
24 posture I think ever since I have been on this committee.

25 The Chairman. And I would say, Senator Moynihan, does

1 yours involve casualty companies?

2 Senator Moynihan. Yes.

3 The Chairman. That is another one that is hotly
4 disputed.

5 Senator Moynihan. And if Senator Bentsen's can be
6 resolved and the bill is going forward, I will offer it.
7 If in five minutes it can't be resolved, I will accept the
8 fact that it can't.

9 The Chairman. Again, I have discussed that with
10 Treasury, and there may be some way to accommodate it.

11 Senator Moynihan. Perhaps I could talk to Mr.
12 Glickman, who seems to know a lot more about it than I do.

13 The Chairman. I was going to say, if there are
14 amendments, maybe we can speed up the process if in the
15 interim here we can have a staff discussion, and if we can
16 work it out we would like to work it out. In fact, if we
17 could work it out between now -- or even we could come back
18 again at 1:30, if we could work it out; because, as
19 Senator Long pointed out, we are in the last stage of this
20 session before the election. There may be a post-election
21 session, but this is a pretty good piece of legislation.
22 But I think generally we can work things out here, and
23 hopefully we can accommodate Senator Armstrong and
24 Senator Bentsen and others.

25 Senator Byrd?

1 Senator Byrd. Yes. I would like to ask a question.

2 On this fact sheet that has been distributed,
3 under "Distributions of Appreciated Property," it says
4 "Under the present law generally no gain recognized on
5 distribution." Now, under this proposal it says, "Gain
6 recognized on distribution of appreciated property." Now,
7 would you explain what that means?

8 Mr. Glickman. Senator Byrd, if there is appreciated
9 property in the Subchapter-S corporation, and that
10 appreciated property is distributed out, the new provision
11 would provide, in essence, the gain would be recognized,
12 as it reads here, on that appreciation; whereas, under the
13 prior law there would be a carry-over basis, and thus there
14 would be no gain recognized.

15 The purpose for this, as I understand it, was to
16 prevent the bailing out of earnings and profits, again --
17 distributions by corporations with appreciated property
18 and without any recognition of the gain at the corporate
19 level.

20 Mark, you might go into this further.

21 Mr. McGonaghy. Senator Byrd, suppose that the
22 Subchapter-S has a piece of property with a \$100 basis, and
23 it is worth \$1000. If that is distributed out to a
24 shareholder, and the issue is what if the shareholder then
25 turns around and sells it, what should be his gain?

1 Obviously, if a corporation sold it there would be
2 \$900 worth of gain. In a partnership, when that same piece
3 of property comes out to a partner he steps into the
4 shoes of the partnership, and if he sells it the next day
5 he would have \$900 of gain.

6 Senator Byrd. Capital gain?

7 Mr. McGonaghy. Yes, capital gain.

8 This adopts that same rule that I just described for
9 partnerships for Subchapter-S corporations, so that if that
10 Subchapter-S corporation had that asset of \$100 and it was
11 worth \$1000, distributed it out to a shareholder and the
12 shareholder sold it the next day, the shareholder would have
13 a basis of \$100, recognized \$900 worth of capital gains.
14 If he didn't have that rule, and on the distribution the
15 shareholder got a \$1000 basis without any tax being paid,
16 if the corporation sold it the next day that would never
17 be taxed.

18 Senator Byrd. That's the way it is under the present
19 law?

20 Mr. McConaghy. Under partnership rules -- that is
21 correct.

22 Senator Byrd. Under the present Subchapter-S rules?

23 Mr. McConaghy. Not under the present Subchapter-S
24 rules.

25 Senator Byrd. Well, I am looking at this sheet. It

1 says "present law." I assumed that you are speaking about
2 Subchapter-S.

3 Mr. McConaghy. That's right. Presently you can make
4 that distribution out of an existing Subchapter-S, and that
5 is treated as a dividend today. And, as treated as a
6 dividend, there essentially would be ordinary income tax on
7 it.

8 Senator Byrd. Yes.

9 Now, suppose the individual dies and it is received by
10 his estate rather than by him individually -- how is it
11 handled?

12 Mr. McConaghy. There would be a step-up, just as the
13 normal step-up rules with respect to his stock. It would
14 step-up the fair market value at death.

15 Senator Byrd. There would be no tax on that
16 appreciated value?

17 Mr. McConaghy. If he sold his stock which has that
18 step-up in basis, there would be no tax on it. That is
19 absolutely right.

20 Senator Byrd. Do you mean if the estate sold the stock?

21 Mr. McConaghy. That is correct.

22 Senator Byrd. Yes. So it doesn't change the estate
23 tax law?

24 Mr. McConaghy. Oh, no. It is not intended to nor
25 should it.

1 Senator Byrd. Thank you.

2 Senator Matsunaga. Mr. President -- I'm sorry; I was
3 thinking of 1984 -- Mr. Chairman.

4 (Laughter)

5 Senator Matsunaga. Mr. Chairman, I was prepared to
6 offer an amendment relative to the grandfathering of
7 corporations with disk subsidiaries. As I understand it,
8 the staff, intelligent as they are, already recommended this
9 and the committee has approved it. Am I correct?

10 The Chairman. Right. Yes. And we apologize. We
11 knew it was your initiative, but we thought while there was
12 a movement to approve the amendment that we should do that.

13 Senator Matsunaga. Right. I appreciate it very much.
14 Thank you very much.

15 The Chairman. Are there any other amendments or
16 questions on Subchapter-S?

17 (No response)

18 The Chairman. As I understand, I really believe if
19 there is staff available right now maybe we can move on to
20 Technical Corrections. We might be able to resolve both
21 Senator Moynihan's concern and the other Senators'. So
22 let's move to Technical Corrections, and maybe we can get a
23 staff meeting in the back room.

24

25

1 The Chairman. We are now on the technical
2 corrections. And Dave or whoever might want to explain that.
3 These are, as I understand, technical corrections that have
4 been in the process for a number of months based on
5 corrections of the 1981 passed last year, plus a couple
6 of necessary corrections we'd like to have made; maybe more
7 that I am not aware of in the bill just passed about a month
8 ago.

9 Mr. Brockway. That's correct, Senator. There are
10 some changes also in the Installment Sales Act that passed
11 in 1980 and also the Bankruptcy Act. There are two or
12 three where the act just passed. There are two or three
13 that have been suggested that are strictly technical and
14 it will be a real problem if they aren't adopted this year
15 rather than next year when you will consider the full
16 technical corrections on this year's act.

17 But, otherwise, they basically are on last year's
18 Economic Recovery Act. This House bill -- 56 -- has a
19 number of them. I think there is a general concensus
20 that those are all strictly technical. And as far as I
21 know, there is no controversy on the provisions of that bill.

22 Since the House bill was passed, there has been a
23 number of submissions made to the Committee. And the staff
24 has gone over it -- both Minority and Majority, Joint
25 Committee staff and Treasury. We have a list that we would

1 suggest to the Committee that are strictly technical in
2 nature in our view. And are appropriate amendments to the
3 Act.

4 The Chairman. Could I just say to the members,
5 because I don't want to deprive anyone of the opportunity
6 of offering amendments -- what I thought we might do,
7 based on precedence, is to suggest to members that if, in
8 fact, they have amendments which they may feel are almost
9 technical, if they would submit those amendments to Mr.
10 Lighthizer. Then we would have the minority-majority staff,
11 Joint Committee and Treasury representatives go over the
12 amendments.

13 And if there is approval or agreement that the
14 amendments are technical in nature or amendments that should
15 be adopted, then we could add those amendments. Hopefully,
16 as soon as tomorrow. Because this is another bill -- if
17 we are going to act on it, we must move rather quickly.

18 It has passed the House. And we would like to make
19 these technical changes as quickly as we can.

20 Senator Long?

21 Senator Long. Well, I do want to offer or discuss
22 at least one amendment that I would like to offer. It
23 doesn't cost the Treasury a penny. If there is a Treasury
24 objection to it, I would like to have an open discussion.

25 The Chairman. Oh, yes. We are not going to

1 deprive anyone.

2 Senator Baucus. Mr. Chairman, do I understand you
3 to suggest that we discuss at this moment some amendments
4 we may have.

5 The Chairman. That we submit those amendments now.

6 Senator Baucus. Only submit them?

7 The Chairman. Right. It might save some time.

8 We certainly can discuss them now, but I thought first we
9 might have Mr. Brockway discuss the amendments that the staff
10 has already looked at, which were submitted by a number of
11 members. And if we have no objection to those, we will
12 adopt those.

13 Mr. Brockway. Senator, I gather that it has been
14 distributed with the hand-out. The summary.

15 The Chairman. Do we have those?

16 Mr. Brockway. It's entitled, "Suggested Technical
17 Amendments."

18 The first set of technicals deal with the ACRS
19 anti-churning rules. And the Economic Recovery Act under
20 the ACRS rules. There were anti-churning rules to prevent
21 related parties from selling property that they had in
22 service before the effective date to a related party, and
23 therefore qualifying under the new, more accelerated
24 deductions provided under last year's act.

25 In certain circumstances, it appears that those

1 anti-churning rules do go too far and deal with situations
2 that were clearly not motivated to receive the more
3 accelerated deductions provided under the ACRS system.

4 One situation is where a taxpayer inherits
5 property. Obviously, that is not a situation even though
6 you have acquired it. If you have acquired inherited
7 property from a relative, it is obviously not one where there
8 is a churning transaction designed to get an increased
9 write-off.

10 Another situation is where taxpayers sell their
11 interest in a partnership. And under the anti-churning
12 rules, it provides that where a partnership has more than
13 10 percent common ownership with another partnership and sells
14 property to that other partnership is a transaction covered
15 by the anti-churning rules. It is not clear that one can
16 have that 10 percent out where you sell partnership
17 interests. If you sell the partnership interest rather
18 than the underlying property -- this would provide that if
19 there is a sale of the partnership interest and there is
20 less than 10 percent common ownership of the partnership
21 before and after the sale, the partnership interest -- the
22 anti-churning rules do not apply.

23 Finally, there is a situation dealing with
24 transfer of real estate where there is incidental personal
25 property included. Under the anti-churning rules, that

1 personal property, in order to qualify for the new ACRS
2 deductions -- the property has to have both a new user and a
3 new owner. For real property, you only need a new owner.
4 There is no need to have a new user because that might force
5 evictions.

6 This says that where the property is incidental under
7 regulations, there will not be the anti-churning rules.

8 The Chairman. As I understand, that amendment has
9 been -- has Treasury addressed this amendment?

10 Mr. Chapoton. Yes, sir. We are in agreement.

11 The Chairman. You concur that it's technical in
12 nature? It's been reviewed by members of staff on both
13 sides? Is that correct, Mike, David?

14 Mr. Stern. As far as I know.

15 The Chairman. I am advised that it has been. So
16 if there is no objection --

17 Mr. Brockway. The next amendment dealing with the
18 rehabilitation really just corrects a possible reading of
19 the Act resulting from erroneous cross-reference. To
20 qualify as a substantial rehabilitation, the property has
21 to have rehabilitation expenditures at least equal to the
22 basis of the property during the 24 month period before the
23 rehab property is put in service.

24 Arguably, this can be read in situations where a
25 taxpayer acquires an old building, rehabs it and then puts

1 it in service where the acquisition date was less than 24
2 months before it was put in service. Arguably, this can
3 be read to not allow the credits to apply. And this allows
4 it to apply.

5 The Chairman. I don't want to shut any debate
6 off in any of these provisions, but if, in fact, they are
7 technical, and if they have been reviewed by Treasury,
8 and the staff on both sides has reviewed it and members have
9 been, therefore, alerted, I think we identify them as
10 strictly technical. We might speed up the process.

11 Now has the Treasury --

12 Mr. Chapoton. Yes, sir. We have reviewed this
13 and agree with it.

14 The Chairman. Without objection, that will be
15 adopted.

16 Mr. Brockway. The next one deals with foreign
17 currency contracts under the straddle rules. The mart to
18 market rules apply where contracts are created in a regulated
19 market where there is a mart to market system for regulated
20 futures contracts. In the foreign currency area, a number
21 of large transactions are created on the inner bank market
22 which does not meet all the specifications although the
23 securities are substantially identical, if not identical,
24 with those created on the mart to markets.

25 This creates a problem for taxpayers who deal in

1 both markets. The House bill provides that transactions
2 on the inner bank market where they are substantially to
3 those traded on the regulated futures exchange are covered
4 by the mart to market rules.

5 That, in the House bill, was only on the
6 prospective basis. In order to resolve problems with
7 taxpayers, this allows it also to, by an elective basis,
8 retroactively to the effective date of the mart to market
9 rule.

10 The Chairman. Again, does Treasury have any
11 objections?

12 Mr. Chapoton. We agree with the amendment. We
13 reviewed it very closely.

14 The Chairman. Has Treasury reviewed all these
15 amendments?

16 Mr. Chapoton. Yes, sir. All these on this list
17 we have reviewed.

18 The Chairman. Have they been reviewed by staff?

19 Mr. Brockway. Both the majority and the minority
20 have gone over them.

21 The Chairman. Any objections interposed by
22 members to any of these amendments?

23 Senator Wallop. Mr. Chairman, I have some
24 questions to ask of staff on the tenth item.

25 The Chairman. We are going to go ahead one at a

1 time, but I thought we could speed it up unless there was
2 some reason not to.

3 Mr. Brockway. The next item deals with designation of
4 securities as being ordinary income assets or investment
5 assets. Last year's bill provided that a dealer has to
6 designate it as capital gains from the day of buying.
7 Apparently, there is some possibility of avoiding this
8 rule by buying an option. If the option goes up in value,
9 you take delivery and redesignate and avoid the rule. This
10 provides that where you take delivery of securities,
11 pursuant to an option, that you have to designate the
12 option itself to be an investment asset.

13 There's another one dealing with the straddle rules.
14 Last year's bill required capitalization of interest
15 incurred to carry a personal property that was part of a
16 straddle.

17 Evidently, if you have certain short sell expenses
18 that are equivalent of interest that may not be covered by
19 this rule. And this would say that where they are equivalent
20 of interest that they would be treated as interest for
21 purpose of that capitalization of carrying charge rule.

22 The final one dealing with straddles deals with
23 cash settlement contracts. In order to qualify for
24 mart to market treatment -- under the bill passed last year,
25 the property had to be a contract for delivery of personal

1 property. This left out certain cash settlement contracts
2 where on a future stock index where you cannot deliver or
3 there is not delivery of the underlying property. The
4 House bill eliminates the requirement that there be a
5 requirement of delivery of the underlying property.

6 The suggestion here is to cut that back somewhat just
7 to deal with the transactions that have come to light.
8 Saying that the settlement price has to be with reference
9 to a stock index or other personal property.

10 The Chairman. I'm going to suggest that we put the
11 entire explanation in the record. That was which number
12 that we just discussed?

13 Mr. Brockway. That was up through number 6.

14 The Chairman. Are there any questions of any members
15 on number seven, number eight or number nine? I mean they
16 are explained in the hand-out and it would save time.

17 (No response)

18 The Chairman. If there are no questions, then without
19 objection. They are technical in nature. When you get to
20 number 10, I think Senator Wallop had a question on that one.

21 Senator Wallop?

22 Senator Wallop. Mr. Chairman, with regards to the
23 second item under number 10, I have four questions which I
24 wish to raise.

25 And the first one is that the House version of the

1 Technical Corrections Act, as it applies to the windfall
2 profits tax, adds the following language to the definition
3 of crude oil. And I will quote it:

4 "In the case of crude oil, which is condensate
5 recovered off the premises by mechanical separation, such
6 crude oil shall be treated as removed from the premises on
7 the date on which it is so removed."

8 Generally speaking, there is no particular problem with
9 that statutory language. However, there is a problem with
10 the House Committee report language interpreting the change.
11 It is my understanding that various staffs interested in
12 this provision have been working on alternative language
13 which will clarify the intent of the statutory change.

14 And my present understanding of the proposed Finance
15 Committee report language -- I quote -- "A bright line
16 test will be provided to the effect that if the gas well
17 production passes through, an operational standard and
18 mechanical field separator, that the condensate recovered
19 from that separation process will be subject to the so-called
20 windfall profits tax. But that any further condensate
21 collected beyond that point, unless there is compensation
22 to the producer, will not be subject to that tax."

23 Am I correct in that understanding?

24 Mr. Stretch. Senator, that is correct. Obviously,
25 if there is not compensation for the condensate, there would

1 be a zero removal price, and there would not be a windfall
2 profit in that.

3 Senator Wallop. Is it also clear, then, that no
4 windfall tax liability to a producer will be based on
5 compensation actually received for the condensate?

6 Mr. Chapoton. You mean not received?

7 Senator Wallop. Right.

8 Mr. Chapoton. That is correct.

9 Senator Wallop. And the third question is that some
10 concern has been expressed by the pipeline companies that
11 the statutory language and the report language is going to
12 make them liable for the windfall profits tax rather than
13 just being responsible for withholding as the first
14 purchaser.

15 Will the Committee report make it clear that no
16 windfall profits tax liability is being created for the
17 pipeline companies except to the expense that that company
18 is also a producer?

19 Mr. Chapoton. That is our understanding. Yes, sir.

20 Senator Wallop. Because the point that I'm trying to
21 make here is the fact that a pipeline may collect condensate
22 in its pipeline and does not make the pipeline a producer
23 for the purposes of the windfall profits tax.

24 Mr. Chapoton. That's correct.

25 Senator Wallop. And the last question is that am I also

1 correct in my understanding that the only time a windfall
2 profits tax liability will accrue with respect to gas well
3 condensate will be between the wellhead and the gas processing
4 plant? And that products from the outlet side of the
5 processing plant will not be subject to the windfall profits
6 tax?

7 Mr. Chapoton. Senator, that is correct. Under the
8 DOE regulation, only condensate recovered at or before the
9 inlet side of the processing plant were treated as crude
10 oil. And, therefore, those are the only things subject to
11 tax under the act.

12 Senator Wallop. I would ask that the Committee report
13 reflect that understanding.

14 Mr. DeArment. It will, Senator.

15 Senator Wallop. Thank you very much.

16 Senator Bentsen. I congratulate the Senator on the
17 clarification, which was certainly needed in that regard.

18 Senator Wallop. Thank you.

19 Senator Bentsen. Are there other comments on the list
20 of amendments.

21 Senator Matsunaga. Mr. Chairman, I was prepared to offer
22 an amendment on the all-savers certificate, but I note that
23 on page 2, item 8 covers it. And I want to congratulate the
24 staff and Treasury for having gone ahead on it.

25 Senator Packwood. Pat Moynihan.

1 Senator Moynihan. Mr. Chairman, there is a technical
2 correction, which I believe the Treasury is well prepared to
3 accept, in our 1982 bill. We provided that the closely
4 held corporations could purchase tax losses under safe
5 harbor.

6 But by what I believe to be -- and I am told by Mr.
7 Wessler of the Joint Committee -- was a simple drafting
8 error, this did not apply to leases with public transit
9 authority.

10 Mr. Brockway. Senator, at least that point is
11 ambiguous. It is not on the list of the other three or
12 four technicals that we prepared on technicals for this
13 year's bill because we weren't aware that time was of the
14 essence on it. But, evidently, there is some timing concern
15 on it. And that was a drafting error that arguably
16 closely held corporations cannot be safe harbor lessors
17 when you are dealing with mass transit properties, simply
18 because mass transit had a separate effect.

19 Senator Moynihan. Right. I wonder if the Treasury
20 could accept that technical change.

21 Mr. Chapoton. We are familiar with that. We have
22 no objection to it. It is, of course, the 1982 act and not
23 the 1981 act. We had no objections to it. And it is, we
24 think, technical.

25 Senator Moynihan. If that is agreeable, Mr. Chairman,

1 I would propose it. And express my appreciate.

2 Senator Packwood. Thank you. Any objections?

3 (No response)

4 Senator Packwood. Senator Boren next and then Harry.

5 Senator Boren. Mr. Chairman, on item 15, the alcohol
6 fuel amendment, I notice that we have cured the problem
7 of effective date here with this amendment, but there is
8 an additional problem that I have been contacted about.

9 And that is that the 90/10 percent index -- 10 percent
10 alcohol content -- there is great difficulty in getting an
11 exact 10 percent. So the retailers of this product are
12 really caught in a Catch 22. If they exceed the 10 percent,
13 they are in trouble with the EPA. If they fall even a
14 fraction below the 10 percent, they are in trouble in terms
15 of the tax exemption. And so they have to have exactly the
16 right content in terms of what is being enforced now. At
17 least this is being enforced this way in Oklahoma. They
18 are running in and running these spot tests. And if it is
19 just a fraction off, they are denying the tax exemption.

20 And in heating the product in producing, I am told
21 that technically it is a virtual impossibility of achieving
22 an exact 10 percent content with each and every batch. And
23 I realize you can't just open the door and have no strength.

24 I would be willing to consider either approach. Either
25 that we would adopt report language saying that the IRS

1 should be instructed to enforce the 90/10 test in a reasonable
2 manner, which recognizes the commercial and operational
3 practicalities that are involved, or perhaps that we might
4 amend the current language to say that there should be at
5 least 10 percent, and say 10 percent or more or something
6 else.

7 Mr. Chapoton. Senator Boren, we are aware of the
8 problem. I think the concern is legitimate. The
9 interpretation has been much too strict. We think -- and I
10 was just confirming that we have authority to take care of
11 the problem. We certainly are going to take care of the
12 problem. But if you want to have Committee report language,
13 that would be fine also.

14 Senator Boren. Well, Mr. Chairman, I would like to
15 propose that we put report language in then that
16 says it is enforced in a reasonable manner which gives
17 consideration to the practicing problems that the
18 operators and sellers have.

19 The Chairman. That seems reasonable to me. If
20 Treasury has no objection --

21 Mr. Chapoton. None at all.

22 Senator Boren. Thank you.

23 The Chairman. Senator Byrd.

24 Senator Byrd. Under the last tax bill, the partial
25 liquidation provisions were repealed. A transitional rule

1 was provided under which corporations which acquired
2 direct control of another corporation before July 23, 1982
3 and adopted a plan of partial liquidation of the acquired
4 corporation by October 1, 1982 would not be subject to the
5 new rules.

6 Now my question is would there be any objection to
7 saying "acquired direct control," which the law now says,
8 or "indirect control"? Either direct or indirect control.

9 Mr. Chapoton. Senator Byrd, I need to look at that.
10 I am not familiar with it personally.

11 Senator Byrd. If you don't mind, please take a look
12 at it and see what you think about it. Does Committee
13 staff have a view?

14 Mr. Stretch. At the staff level, we are aware of it.
15 I guess there is some question as to whether it would come
16 within the nature of being a technical change. But we were
17 made aware of it in the last day or two. And it would be
18 helpful if we could have some time to look at it.

19 The Chairman. Then if we could submit that amendment.
20 Is that all right, Senator Byrd?

21 Senator Byrd. Fine.

22 The Chairman. Present it for staff review.

23 Senator Byrd. Sure.

24 The Chairman. Are there any other questions on the
25 technical changes?

17

1 Mr. Stretch. I understand that there is no objection
2 to any of the ones from the two lists.

3 The Chairman. So we can accept the technical changes
4 then with the report language suggested by Senator Boren.

5 Senator Wallop, your questions have been answered?

6 Senator Wallop. My questions were answered.

7 Senator Boren. Mr. Chairman, on the technical
8 amendments, I am curious what the revenue effect is, if
9 any.

10 The Chairman. Are there any revenue implications, Mr.
11 Brockway, in the package?

12 Mr. Stretch. Evidently, there is one provision -- item
13 13 -- where there is revenue impact of possibly \$50 million
14 a year.

15 Senator Wallop. How much?

16 Mr. Stretch. Fifty.

17 Senator Baucus. And there are no other revenue effects
18 from the others?

19 Mr. Stretch. Otherwise, the revenue impact is negligible
20 of the other amendments. And this is one simply the trusts,
21 because of the mechanical rules, weren't eligible for the
22 exemption.

23 Senator Baucus. I'm just curious. What is your best
24 estimate of the total revenue effect of the items listed?
25 These 15 different technical amendments. The total is

1 about \$50 million annually. Is that correct?

2 Mr. Stretch. That's correct. \$50 million.

3 Senator Baucus. Thank you.

4 The Chairman. Does this include -- there are members
5 that want to discuss their amendments. Are there other
6 staff suggestions or recommendations that the Committee
7 might want to consider? Do you have other staff
8 recommendations or suggestions on the Technical Corrections
9 Act?

10 Mr. Chapoton. Let me get a clarification, if I might,
11 of one thing. It has just come to our attention. It's on
12 the second list, the number two item -- for-stock refund
13 on the cigarette tax. Are we on that list?

14 The Chairman. No.

15 Mr. Stretch. I believe that was gone through.
16 The rules on the suggested tacking of amendments to this
17 year's act. Also, three or four were also part of the list
18 that was gone over.

19 The Chairman. Are they in this list?

20 Mr. Stretch. There's a separate piece of paper on
21 that. One is dealing with safe harbor leasing for
22 turbines and boilers for rural electric coops. A for-stock
23 rule and then a rule dealing with the merger provisions
24 where you elect to have a retroactive --

25 The Chairman. Well, in one of these that I read -- I

1 believe it was the Wall Street Journal -- we had made a
2 mistake. Is that it?

3 Mr. Stretch. That's correct. That's the one dealing
4 in the merger bill where there's a special. In the
5 Committee amendment there was provided that cashpayers
6 could qualify for new merger rules under certain situations.
7 There were beneficial tax rates. They could qualify by
8 electing on a retroactive basis.

9 Technically, this could be read to put the liability
10 in the selling group. This would resolve that problem.

11 The Chairman. Wrong group?

12 Mr. Stretch. Correct.

13 The Chairman. Are there any objections, then, to the
14 second list?

15 (No response)

16 The Chairman. Does Treasury want to be heard on any?

17 Mr. Chapoton. Mr. Chairman, we agree with the items
18 on the second list. The one point, though, that has been
19 raised on the cigarette tax -- it is an extension authorized
20 in that. The way it's drafted, it's by hardship. I think
21 we would prefer if a showing could be made that the
22 extension is needed.

23 This problem was created because simply the date
24 specified in the statute was too early. Had the knowledgeable
25 parties been there we would not have had that date. We just

1 would prefer that it just be 30 days across the board
2 without any extension on a hardship.

3 The Chairman. Well, without objection, we will make
4 that change. And those amendments will be agreed to..

5 Now are there any other staff recommendations or
6 suggestions on the Technical Corrections Act?

7 Mr. Stretch. Not at the moment, Senator, although I
8 gather that certain Senators may have other things.

9 The Chairman. All right. Now we can proceed and
10 discuss what they perceive to be technical amendments. And
11 I would again suggest that if there is any dispute that
12 maybe we could go through the process of Joint Committee,
13 minority-majority, Finance Committee and Treasury looking
14 over all the amendments or we aren't going to be able to
15 finish this today.

16 Before we hear from Senator Long on his amendment, I
17 wonder if we can't take care of Senator Moynihan's amendment, to
18 jump back to Subchapter S for a minute.

19 Senator Moynihan. Mr. Chairman, would you give us just
20 a few more moments?

21 The Chairman. All right.

22 Senator Moynihan. If we have agreement, it is a two
23 minute discussion. If not, we won't bring it up.

24 The Chairman. Senator Long.

25 Senator Long. Here is a problem. We have an increase

1 to major oil companies differently from the way we increase
2 the independents for purposes of depletion allowance and
3 for purposes of windfall profits tax. And I was around to
4 help write the bill and to help get the exception for
5 independents and to maintain it.

6 Now here is Crystal Oil over at Longview, Texas seeking
7 to sell jet fuel at Barksdale Air Force Base. Now Crystal
8 Oil is an independent producer. Now the statute doesn't
9 say that a sale to the United States Government is a retail
10 sale or is not a retail sale.

11 Just to give you an example of whether it is or not,
12 this jet fuel is --

13 Mr. Chapoton. Senator Long, may I interrupt just a
14 minute? I was not for Crystal Oil but for other taxpayers.
15 I was personally involved in this very question in the
16 legislation and in the subsequent development of the
17 regulations on the other side of the issue. So I
18 personally have to disqualify on this issue. And perhaps --
19 I guess Mr. Glickman is still involved with the Subchapter
20 S discussion. I will have to bow out. Maybe we should wait
21 until he returns for you to discuss this issue.

22 Senator Long. Well, where is he?

23 Mr. Chapoton. I guess they are still involved in
24 the Subchapter S subcommittee.

25 Senator Long. Well, I'm sorry you can't help us in

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1 this because I thought you might be about the only fellow
2 in the Treasury who really would know what the dickens I
3 am talking about.

4 Mr. Chapoton. I am very familiar with what you are
5 talking about. I argued the issue at some length.

6 The Chairman. I think we could go ahead and discuss
7 it and the Joint Committee could respond. The record will
8 show that Mr. Chapoton has removed himself from the
9 discussion.

10 Senator Long. Well, let me just explain this from
11 my point of view. Now this jet fuel is not sold except to
12 the military. But the nearest comparable price that I know
13 to find would be just the price they charge for aviation
14 gasoline out here at National Airport.

15 \$1.80 a gallon. That's what you pay at National Air-
16 port to buy some jet fuel. All right. The Barksdale
17 Strategic Air Command wants their jet fuel tailored more
18 to their precise requirements, which they call "JP-40."
19 This man is selling it for \$.93-1/2, approximately one-half
20 the price you pay if you bring your jet airplane up for
21 retail sale at National Airport, Shreveport Airport,
22 Morris or anywhere else.

23 Now if that is not a wholesale sale, I would like to
24 know what it is. You are selling it at half the price
25 because you are making a big sale. Someone in Treasury --

1 I don't know who. And it's just an honest difference of
 2 opinion -- would say, well, they would regard a sale to the
 3 United States Government as being a retail sale. Well, that
 4 means that the man can't sell.

5 So the result is that the government does not pick up
 6 one penny. This man is not going to lose his independent
 7 exemption in order to sell this fuel to the government. He
 8 is not going to give up his independent exemption. He just
 9 won't make the sale. And so the government pays a higher
 10 price than it would have to pay otherwise to deny this person
 11 the opportunity to sell the gas.

12 I have got an amendment that would just say that the
 13 sale of this petroleum to the United States Government is
 14 not a retail sale. Now this saves the government money.
 15 There is no way the government can lose anything on it
 16 because the person is just not going to make the sale
 17 otherwise.

18 Now if it ever occurred to me that anybody was going
 19 to construe the Act in that fashion, I would have taken care
 20 of that when we were passing these laws. I would have
 21 passed every one of them.

22 But I just think it ought to be amended to say that
 23 for this purpose, a sale to the United States Government is
 24 not regarded as a retail sale.. When you are selling it
 25 at half the price that you sell for commerical products, and

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1 you are selling it in competition with people who are
2 making bulk sales, it ought to be regarded as something
3 other than a retail sale.

4 Mr. DeArment. So the amendment would provide that
5 these sales would be regarded as bulk sales for purposes of
6 both the independent exemption and --

7 Senator Long. Yes. That's right. You just amend the
8 law. You define "retailer" to make it clear that you
9 are not regarded as a major oil company because you make a
10 sale to the United States Government.

11 Mr. Glickman. Senator Long, I'm sorry I didn't hear
12 all of what you have said, but we have talked to the people
13 involved several times. We talked to them first when the
14 regs were in question as to whether we could do something in
15 our regulations. In our judgment, at that point in time,
16 there just wasn't anything that we could even get close to
17 hang our hat on.

18 It seemed to us that when you are talking about this
19 type of exemption what this Committee intended or what the
20 Congress intended -- I don't know. It could have clearly
21 exempted these people if you had wanted to at the time. I
22 don't think there was any inadvertence in where the
23 parathetical sprays in bulk sale was placed.

24 But our problem, just from the standpoint here -- it
25 started out with just sales to the Department of Defense. I

1 heard you say, I believe, sales to the Federal Government.

2 Senator Long. Department of Defense, yes.

3 Mr. Glickman. You were just limiting it to the
4 Department of Defense?

5 Senator Long. Department of Defense.

6 Mr. Glickman. Obviously, we sat around trying to think
7 who else are we going to hear from. And other agencies of
8 the government also buy fuel oil, a number of type of things,
9 in bulk. So I would expect that we would start getting
10 pressure there. And then the state governments perhaps
11 would get into the picture.

12 And the question really was is how broad you were going
13 to ultimately make it. Obviously, you could keep it as
14 narrow as you want. But it just was a question of how do
15 you stop that once it starts. That was the problem that
16 the Administration had with coming out and saying we
17 support it unequivocally.

18 Senator Long. Well, now as far as I am concerned, this
19 would have been no problem at all if Treasury had seen fit
20 to construe the law and merely say, look here, you are selling
21 this stuff on negotiated sale for \$.93; a retail sale at
22 there at National Airport brings you \$1.80 -- twice the
23 price. So, obviously, when you are making a large sale, a
24 very large sale, and you are selling for half the unit
25 price, if you simply regarded that as being a wholesale sale

1 or a sale by anybody other than the retailer -- that's it.

2 Now, I ask the question: Well, why couldn't this
3 fellow just sell to somebody that owns a string of filling
4 stations or just sell to the fellow who delivers gas
5 aboard the commercial planes out at Shreveport Airport and
6 let them sell it to Barksdale? Why couldn't he solve his
7 problem that way?

8 Well, the answer is: Well, they have thought about
9 that. But under the Department of Defense regulations, if
10 he did that, he would still be construed under the Department
11 of Defense law as being the seller. They would still
12 construe him as being the seller even though he sold it
13 to somebody who was, in fact, a retailer. And so there being
14 no other way to do it, the only way I thought of to do it
15 was to do it legislatively, but I can say here to this
16 Committee that this is the kind of thing that happens
17 because a little fellow is not represented up here. Any
18 major oil company would have a representative and say, look,
19 you know this could create a problem for us. We would like
20 you to make clear that that's not regarded as a retail sale.
21 We are selling at half the price. It ought to be regarded
22 as a wholesale sale. Anything other than a retail sale.

23 We would have taken care of it. But here's a little
24 fellow down there in Shreveport, Louisiana. He's got a
25 refinery over there in Texas. So he is not represented by

1 a lobbyist up here to raise the point. And somebody
2 construes the law adversely to his interest. And he just
3 gets the worst of it so it takes an act of Congress to get
4 him straightened back out.

5 But I would think that in fairness, the Treasury ought
6 to go along with this because it won't cost the Treasury
7 one red copper cent for the simple reason the man is not
8 going to make the sale if he is going to lose his independent
9 status. It will save the government money because he is
10 not going to get any sale at all unless he sells it cheaper
11 than the people that are buying it now.

12 This fellow has even laid a pipeline to take the jet
13 fuel into the airbase to take it from the Texas Eastern
14 Pipeline, across over to Shreveport, and on from the pipeline
15 into the base. They can't use the pipeline because of this
16 construction of the law.

17 And to me, it is very simple just to say, well, this
18 type of sale is not a retail sale.

19 The Chairman. Do you agree with that, Mr. Glickman?

20 Mr. Glickman. Well, the revenue impact, Senator Long,
21 is difficult. There could be some other taxpayers --

22 Senator Long. How can there be any revenue impact?
23 He is not making the sales and he is not going to make the
24 sales.

25 The Chairman. Does the Joint Committee have anything?

1 Mr. Stretch. Evidently there may be some loss because
2 if there is at least one other taxpayer in this situation
3 that is making the sale and may be treated as a integrated
4 producer --

5 Senator Long. You understand that you can sell up to
6 \$5 million worth without losing your independent exemption?

7 Mr. Stretch. Yes.

8 Senator Long. Okay. So that the other person selling
9 might be selling less than the \$5 million, just like this
10 guy can sell less than \$5 million. But he can't use that
11 pipeline when he's selling amounts less than \$5 million.

12 Mr. Stretch. My understanding is that this other
13 taxpayer is treated as integrated now because of this. But
14 in any event, the revenue would not be substantial as far as
15 we are aware if you consider the windfall profits tax. It
16 would still be less than \$10 million. We are working on
17 that number.

18 Mr. Glickman. Senator Long, I think from Treasury's
19 standpoint, if you are going to do this -- if this
20 Committee wants to do it -- I think it should be done
21 legislatively. I think that we have struggled --

22 Senator Long. That's what I recommended.

23 Mr. Glickman. I understand. We have struggled with
24 this and we cannot do it through our regulations.

25 The Chairman. You don't have any quarrel with doing it

1 legislatively?

2 Mr. Glickman. Well, except for the problem of how
3 much you are going to open up, Mr. Chairman, I guess not.

4 Senator Long. I am told that there is only one other
5 refiner in the United States who would like to deliver some
6 gas -- who might at some future point -- sell some gas where
7 this problem would exist -- jet fuel. At the present time,
8 he doesn't intend to do so. But there is some base out in
9 Texas or somewhere where some person might want to make a
10 sale, and the same problem would apply.

11 Mr. Glickman. I guess I was concerned with when
12 somebody comes in and is selling to the Department of
13 Agriculture or to one of the other departments some other
14 type of item, how do we say --

15 Senator Long. Tell them to go see Congress.

16 The Chairman. Does the Joint Committee have any
17 revenue estimates? Are you concerned about this?

18 Mr. Stretch. We are working on this. As I responded
19 to Senator Long, there may well be some revenue, but it is
20 pretty clear that it is not substantial.

21 Senator Long. You understand that there can't be any
22 revenue loss as far as this taxpayer is concerned?

23 Mr. Stretch. That's right.

24 Senator Long. Because this taxpayer is just not going
25 to make the sale.

1 Mr. Stretch. Given the representation that he does
2 not make the sale to --

3 The Chairman. Well, is there objection to the
4 amendment?

5 Mr. Stretch. I think, Senator, the question comes down
6 to -- on the windfall, it is clear it is a technical
7 question to that Act. On the depletion point, that's
8 obviously the 1975 Act, not the one under --

9 Senator Long. Well, let me get to that. We amended
10 the law. It was the Cranston amendment. I supported it.
11 Bob Dole did too. It was back when we knocked out the
12 percentage depletion for major companies. We defined
13 what "independent" was back at that time.

14 Then when Lloyd Bentsen came along with his amendments
15 to the windfall law he used some of that same language
16 and incorporated it by reference into the windfall law.
17 So when Treasury construes the law, as they have -- and I'm
18 not quarrelling with them about the way they construe it.
19 They can construe it in good conscience the best way the
20 good Lord can show them how to do it. God knows, I don't
21 envy you your job. Now Treasury construes the law different
22 from the way some of us would construe it so we want to
23 correct an error that we made.

24 We have made it twice. We saw it get the worst of it
25 under the initial decision with the Cranston amendment. And

1 then it gets the worst of it again when we write the
2 windfall law. That compounds the burden on him of an
3 unintended provision in the law. It certainly wouldn't
4 have been there if I had known about it -- that this was
5 going to be a problem.

6 Now when we correct that, we are correcting a provision
7 in the law which was incorporated by reference in the
8 windfall act. In other words, you write a law and you start
9 by taking all these definitions over here and you incorporate
10 that into your act. And the problem applies both with
11 regard to windfall law and with regard to the law that went
12 before that.

13 So to correct it, you can draft your language how you
14 want to do it. As far as I am concerned, we would have done
15 it when we had the windfall law before us, just like we
16 could have done it when they had the previous piece of
17 legislation before us.

18 But the problem is there, and it is compounded by the
19 windfall law.

20 Mr. Stretch. Senator, let me say that I think staff
21 level -- we think it makes sense to coordinate the two.
22 Assuming that the change would be made in windfall, you
23 ought to coordinate the two provisions so that they are
24 treated the same way.

25 The Chairman. I wonder if you might do this. We are

1 not going to be able to complete this technical correction.
2 You might draft some language. Would that be satisfactory,
3 Senator Long?

4 Senator Long. I've got some language that might do it.
5 I suggest you look at the language that I have got. I've
6 got some language here that we think would take care of it.

7 But if I can solve the problem, you can write the
8 language any way your heart desires.

9 (Laughter)

10 The Chairman. Right.

11 Senator Long. If you get me out of the trap, write it
12 any way you want to.

13 The Chairman. That's fine. And we will do that. We
14 will solve the problem, and you write the language.

15 Senator Packwood. Mr. Chairman?

16 The Chairman. I think Senator Packwood has something.

17 Senator Packwood. I've got one that I think is
18 non-controversial that both the Joint Committee and Treasury
19 are familiar with. And that is that normalization will
20 apply to safe harbor leases. And it apparently does not
21 now under the way that we passed the law. Buck, am I
22 correct?

23 Mr. Chapoton. I think it may well apply now, but we
24 would welcome clarification that it does.

25 Senator Packwood. And you will write the regulations

1 on it?

2 Mr. Chapton. We would have to do it by regulations.

3 Senator Packwood. But you do need a technical
4 amendment to say that it does apply. We intended it to
5 apply. I don't think we meant that it shouldn't.

6 Mr. Chapoton. I think we could probably do it anyway.

7 The Chairman. It might be helpful. Without objection,
8 the amendment is agreed to.

9 Senator Moynihan. Mr. Chairman.

10 Mr. Chairman. Go ahead, Senator Moynihan.

11 Senator Moynihan. Mr. Chairman, I would simply like to
12 ask if the Committee would consider as a technical amendment
13 a situation in Rochester, New York where for a quarter of
14 a century there has been a hospice program before they were
15 known as such. However, it provides its services
16 indirectly. It sees that patients get the care through
17 this arrangement and that arrangement rather than directly
18 in the same institution. It has the exact purpose as a
19 hospice, but it is not eligible under the legislation -- our
20 1982 legislation -- because of the question of the direct
21 as against the indirect provision of services.

22 And since the object is the same -- I do not assert that
23 this is technical, but I think it might be. And I think it
24 is good legislation because there are several ways to
25 achieve the purpose that we made eligible for Medicare

1 reimbursement. And I believe the Committee --

2 The Chairman. We have on the agenda a Medicare
3 technical corrections provision. Would this be -- I'm not
4 familiar with the amendment. Sheila, do you have any
5 comment on it?

6 Ms. Burke. The amendment is, as Senator Moynihan
7 indicated, not a technical amendment in the purest form.
8 It is the inclusion of a hospice that would not otherwise
9 be covered under the statute as we passed it. Basically
10 a hospice that coordinates services rather than delivers
11 them. Therefore, because we require you to deliver things
12 directly, it would not qualify.

13 The amendment could be considered in the context of
14 the Medicare/Medicaid provision which would go back to
15 Ways and Means because it is, indeed, a Ways and Means
16 issue.

17 Senator Moynihan. Well, when that time comes, I would
18 like to offer it. Thank you very much. It's a good
19 amendment, but if it is not technical, it's not technical.

20 The Chairman. Well, I would be very willing to add that
21 to our technical. It may be an amendment that the Ways and
22 Means Committee would want.

23 Senator Moynihan. I think they would.

24 The Chairman. But if they did not, we --

25 Senator Moynihan. Could we do it on that basis, Mr.

1 Chairman?

2 The Chairman. Yes.

3 Senator Moynihan. I appreciate that very much. And
4 so would the people in Rochester.

5 The Chairman. There is a vote just started. We might
6 be able to conclude Subchapter S. I understand, Senator
7 Moynihan, that your amendment --

8 Senator Moynihan. We will let that pass.

9 The Chairman. You will not bring up your amendment
10 so that leaves one amendment of Senator Bentsen.

11 Senator Boren. On the Medicare/Medicaid is it in
12 order to offer technical amendments on that?

13 The Chairman. I promised Senator Bentsen he may be
14 recognized for a couple of technical amendments on the
15 Technical Corrections Act.

16 Senator Bentsen. Thank you very much, Mr. Chairman.
17 The first one is on Cal Farley's Boys' Ranch. This is a
18 boys' ranch in Texas that was started back in 1939. It now
19 has some 400 boys that they take care of. And that's boys
20 from broken homes, destitute parents; that type of a
21 situation.

22 But on the windfall profits tax, they were exempted on
23 their properties of the ranch itself, but they had separated
24 out back in about 1960 into a foundation their investment
25 properties. Now we are only talking about approximately

1 \$30,000.00 a year in the way of taxes that would be lost by
2 it.

3 But the two charities operate for the same purpose.
4 The one for the properties of the ranch itself, and their
5 investment properties dedicated to the same purpose. And,
6 frankly, I should have taken care of that one when we passed
7 the piece of legislation, but I had not anticipated that.
8 And it's a disparate treatment that is taking place on those
9 two charities. And I would like to see that corrected. And
10 I have an amendment for that purpose.

11 The Chairman. Does Treasury have --

12 Mr. Chapoton. Senator, the question I'm not clear on --
13 we have no problem whatsoever if the organization holding
14 the property was a title holding company and what is
15 referred to as a 501(c)(2) title holding company. We had
16 concern extending the across the board exemption to a
17 private foundation which qualifies as a public charity
18 under 509(a)(3) because it is controlled by a public
19 charity. Now I don't know whether the latter situation is
20 required in your case. If it's just a title holding
21 arrangement, we have absolutely no difficulty. I understand
22 there is a problem with title holding companies not
23 qualifying.

24 Senator Bentsen. Frankly, I don't know the exact
25 situation on that as to the title owning. Just a minute.

1 Let me talk to staff and see if we have it.

2 Mr. Chapoton. If it is the latter, maybe we could --
3 Senator Bentsen. It is the latter.

4 Mr. Chapoton. It is the latter?

5 Senator Bentsen. Yes.

6 Mr. Chapoton. Let us look at it a bit further. I
7 think we would have reluctance to just open up the exemption
8 to an organization which is -- all 509(8)(3) organizations
9 are in many, many respects like private foundations.

10 Senator Bentsen. Obviously, you have got disparate
11 treatment for the two charities operating for exactly the
12 same objective, and that's just not equitable. And I would
13 like to see it addressed and corrected. You might put that
14 kind of a limitation on it.

15 Mr. Chapoton. Okay. We could probably take care of
16 my concerns if we just had drafting authority to handle that.

17 Senator Bentsen. That's fine. I'd be glad to work
18 with you.

19 Mr. DeArment. Senator Bentsen, this new category of
20 eligible foundations would still have the same kind of
21 rules that applied to other charities in that the royalties
22 had to be in the organizations hands on a particular date
23 in 1980. I forget what it was.

24 Senator Bentsen. All right. It sounds all right to me.

25 Mr. DeArment. I think that's the way this works.

1 Senator Bentsen. I am quite willing to have the
2 drafting authority there as long as we understand the
3 objective and try to achieve it.

4 I would like to touch one more then. Another one is
5 on the REIT, reinstated invest trust, disqualification under
6 the ACRS rules. We've got a situation there where you
7 have a 35 year life on a dividends paid deduction. And on
8 the other hand, your ACRS on is about 15 years. You end
9 up with a contradiction there. And I have an amendment in
10 to try to correct that. And I believe that has been taken
11 up with staff.

12 Mr. Brockway. Senator, the staff is looking at it.
13 They do think this is a technical question. But we just
14 received it this morning. I gather that Treasury is not
15 fully familiar with this so if we could have some time to
16 look at it and go over it.

17 Senator Bentsen. All right.

18 Mr. Brockway. But it does appear to be something that
19 is technical.

20 Senator Bentsen. All right, Mr. Chairman.

21 The Chairman. I am going to recognize Senator Symms.
22 We still have a few minutes. If we might come back at
23 1:30 maybe we'd have an opportunity to wrap up the
24 Subchapter S. Would that be all right, Senator Bentsen?

25 Senator Bentsen. That's fine.

1 The Chairman. Tomorrow morning we need to go into
2 conference on H.R. 4717, which has some provisions that
3 Senator Durenberger and other Senators are interested in.
4 And if we can't resolve that in conference, then it might
5 mean that he would want to offer amendments at the
6 appropriate time.

7 Senator Packwood. Will we have more amendments to this
8 bill tomorrow or the day after?

9 The Chairman. What I would suggest -- anybody who has
10 amendments, they will submit them to staff, and then we
11 will have sort of a Committee review to see if they
12 are technical in nature. If there are any objections, if
13 we know we are going to have some problems in the House,
14 we probably better be very careful about whether or not we
15 accept them. We are down to the point, as Jake Garnes
16 said, a chimp can delay this for a week. And there's no
17 reference to anyone here.

18 (Laughter)

19 Senator Boren. Are we going to do the Medicare/Medicaid
20 tomorrow or the next?

21 The Chairman. We can do it interchangeably here.

22 Senator Symms. Mr. Chairman, it may be that you would
23 rather do it if it is a technical amendment. I'm not
24 certain how the Chair is going to view this amendment --
25 whether it is technical or not.

1 Senator Boren. I have one. It'll take 15 seconds.

2 The Chairman. All right. Fine.

3 Senator Boren. And this is offered on behalf of
4 Senator Packwood and myself. It's a situation that just
5 affects the states of Oklahoma, Georgia, Kansas, Mississippi,
6 South Carolina and Oregon.

7 In the error rate calculations, when we used the
8 109 percent charges figure, we did not realize at that
9 time that there is some states with a declining match. And
10 this federal match -- we have already taken care of problems
11 like New York who have an increasing match, but we have
12 inadvertently penalized those states with the declining match.

13 Staff has the exact wording of the amendment, but all it
14 would do is stay harmless to those states that have a
15 declining federal match.

16 The Chairman. That's correct. In fact, the Senator
17 called it to my attention and I have discussed it with
18 staff. And I think the amendment should be adopted.

19 Senator Boren. I would move the adoption.

20 The Chairman. And it is technical in nature.

21 Senator Symms. I'm for the amendment too.

22 The Chairman. Right. Senator Symms, do you want to
23 raise yours now?

24 Senator Symms. I'd just like to raise it before
25 Senator Bentsen and Senator Long leave the room. And the

4
1 Chairman may have a different bill he wants to put it on.
2 We do have a problem. I view it as a technical amendment.
3 And if you recall in the last summer's tax bill, Senator
4 Bentsen offered the amendment dealing with loan loss
5 reserves for banks at 1 percent.

6 On January of 1983, they are automatically going to be
7 reduced to a six-tenths of one percent loan loss reserve
8 levels. And in my opinion, if we want to ask our banks to
9 be undercapitalized, that's the fastest way to do it. We
10 ought to fix that right now. I view it as technical. I
11 understand Treasury is in support of it. I just want to see
12 that we get it done on a bill that is going to pass between
13 now and the end of the session.

14 The Chairman. I don't think Treasury supports it as
15 technical.

16 Senator Symms. It's not technical, but it's in the
17 present tax law and --

18 The Chairman. It's not technical but they support it.

19 Mr. Chapoton. We are supporting the 1 percent bad
20 debt reserve.

21 Senator Long. Are you supporting it on this bill?

22 Mr. Chapoton. Well, I think that's a judgment for the
23 Committee. It's clearly not technical.

24 The Chairman. If the Senator would permit me, let me
25 check around and see how that might operate.

1 Senator Symms. I just think it's very important. I
2 will just say that. I won't offer it this morning and we
3 can maybe do it tomorrow.

4 The Chairman. There was a discussion, to be very
5 candid about it, during the consideration of the tax bill.
6 And we had inquiries from a number of bankers across the
7 country who are concerned about this. And we made the same
8 kind of inquiries to them about withholding.

9 (Laughter)

10 Senator Symms. Mr. Chairman, I think we all have to
11 admit we made a mistake. We didn't put it in the same
12 amendment with the withholding because some of the bankers
13 did, in fact, back off on some of their opposition.

14 The Chairman. Do we apply it just to those who
15 supported withholding?

16 (Laughter)

17 The Chairman. Well, we will come back at 1:30.

18 (Whereupon, at 12:12 p.m., the hearing was recessed.)
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AFTERNOON SESSION

(1:50 p.m.)

1
2
3 The Chairman. I know Senator Armstrong, Senator
4 Bentsen and the Treasury representatives, as well as well as
5 some members of the staff, are meeting with reference to
6 Subchapter S, and we will know in a few moments whether or not
7 that can be resolved. If not now, maybe later today or
8 tomorrow.

9 But are there technical corrections in the Medicare area
10 that we might look at? There are not too many members present
11 right now.

12 (Laughter)

13 The Chairman. It might be a chance to really make some
14 changes in the tax law.

15 (Laughter)

16 The Chairman. But there are some strictly technical
17 areas that I think have been agreed upon by a majority of the
18 Minority staff, cleared with the appropriate departments.

19 Shiela, do you want to comment on those?

20 Ms. Burke. Yes, sir. The technical amendments are, in
21 fact, literally that. They are corrections in titles and
22 cross-references. They have been cleared by the Administra-
23 tion--by the Democrats--and they have been seen by all sides.
24 They should cause no problem.

25 The Chairman. Is that correct, Bob?

1 Mr. Hoyer. Yes, sir.

2 The Chairman. Now as I understand, Senator Baucus had a
3 technical amendment. Is that included in the ones that you
4 have included here?

5 Ms. Burke. It is not, Senator. It is an amendment that
6 is not technical in nature. It has to do with the
7 Administration's review of the existing PSROs.

8 The intention, as I understand it, of the Baucus
9 provision would be for the Administration to redo the
10 evaluations done earlier this year because of discrepancies
11 found in those reviews by the GAO. It is not technical in
12 nature. It is a direction to be included to the Secretary to
13 redo those reviews in proceeding with the statute as we
14 changed it this year. We have no objection.

15 The Chairman. It is not technical in probably the
16 technical sense, but it is desirable. Correct?

17 Ms. Burke. Yes, sir.

18 The Chairman. I know of no objection to the amendment.
19 I cannot obviously approve it. But are there other
20 technical amendments that other members have called our
21 attention to? We have taken care of Senator Boren's.

22 Ms. Burke. Yes, sir

23 The Chairman. And Senator Packwood's.

24 Ms. Burke. Mr. Moynihan's position.

25 The Chairman. Senator Moynihan's Rochester hospice

1 amendment. That is not technical. And if there is any
2 question about that, it will be properly taken care of.

3 Ms. Burke. There are no others that we have been made
4 aware of.

5 The Chairman. It is my hope that we might then add the
6 technical Medicare amendments to the Technical Corrections
7 Act.

8 Now have we checked with the Ways and Means Committee to
9 see if that meets with their approval?

10 Ms. Burke. Yes, sir, I believe so. And the technical
11 amendments have indeed been cleared by the House committees
12 involved also. So they are aware of them. And they have
13 cleared them with the exception of the two we added this
14 morning which we will talk with them about.

15 The Chairman. All right. Well, let's proceed on the
16 basis that if any member has any objection to any of the
17 technical amendments or have any additions--technical
18 additions--obviously they can still be considered. But I
19 don't see any problem, as long as there is complete
20 agreement, that we can't on a temporary basis adopt those
21 technical amendments. They will be made a part of the
22 Technical Corrections Act.

23 And is there anything else?

24 Ms. Burke. No, sir.

25 The Chairman. The Chair is informed that they are still

1 discussing, and negotiating, or whatever, the one remaining
2 question of Subchapter S, and that appears to be a matter
3 that will take some time. So I think we will recess. I
4 hope to meet tomorrow afternoon.

5 We have a conference tomorrow morning on H.R. 4717, and
6 it has been a rather slow conference.

7 (Laughter)

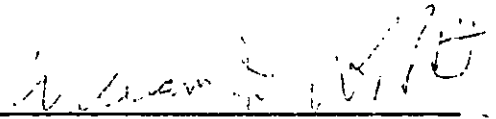
8 The Chairman. We started last November, and many people
9 have forgotten what is in it, but some haven't. So we are
10 going to meet again tomorrow.

11 But I would hope that we could have some resolution
12 because Treasury, not that they will make a final determina-
13 tion, but if their view is that we should not report
14 Subchapter S, if in fact the amendment offered by Senator
15 Bentsen and Senator Armstrong is adopted, then we will not
16 report Subchapter S. But we will go on with the technical
17 corrections matter tomorrow afternoon. If we work out the
18 other, we will go on to that.

19 (Whereupon, at 2:00 p.m., the meeting was adjourned.)
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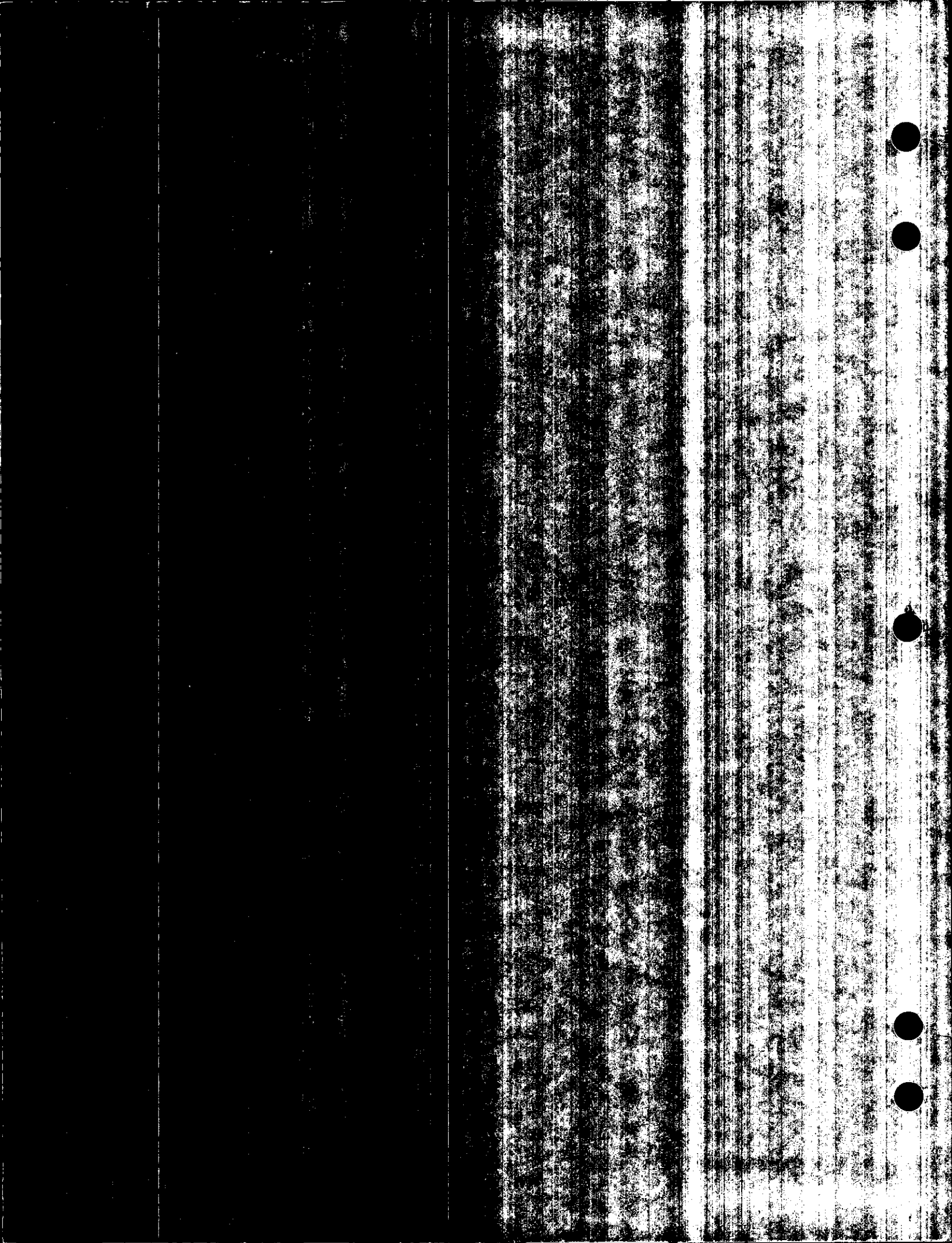
C E R T I F I C A T E

1
2 This is to certify that the foregoing proceedings
3 before the United States Senate Finance Committee, in re: an
4 executive meeting, were held as herein appears, on Wednesday,
5 September 22, 1982, and that this is the original copy
6 thereof.

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10 
11 WILLIAM J. MOFFITT
12 Official Reporter

13 My Commission expires April 14, 1984
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United States Senate

COMMITTEE ON FINANCE
WASHINGTON, D.C. 20510

ROBERT E. LIGHTHIZER, CHIEF COUNSEL
MICHAEL STERN, MINORITY STAFF DIRECTOR

September 20, 1982

M E M O R A N D U M

TO: ALL MEMBERS OF THE FINANCE COMMITTEE

FROM: BOB DOLE

SUBJECT: FINANCE COMMITTEE MARKUP OF THE SUBCHAPTER S
REVISION ACT AND TECHNICAL CORRECTIONS

The Committee on Finance will consider H.R. 6055 (the Subchapter S Revision Act of 1982), H.R. 6056 (The Technical Corrections Act of 1982), and certain technical corrections of the Medicare and Medicaid provisions of the Tax Equity and Fiscal Responsibility Act of 1982 at an executive session on Wednesday, September 22, 1982 at 10 a.m.

An agenda and short description of the items to be considered is attached.

ROBERT J. DOLE, KANS., CHAIRMAN

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United States Senate

COMMITTEE ON FINANCE

WASHINGTON, D.C. 20510

ROBERT E. LIGHTHIZER, CHIEF COUNSEL
MICHAEL STERN, MINORITY STAFF DIRECTOR

AGENDA

Executive Session
Wednesday, September 22, 1982

10 a.m.

1. H.R. 6055, The Subchapter S Revision Act of 1982.
2. H.R. 6056, the Technical Corrections Act of 1982.
3. Technical corrections of Medicare and Medicaid provisions of the Tax Equity and Fiscal Responsibility Act of 1982.

I. H.R. 6055

In general, H.R. 6055 is intended to simplify and modify the tax rules relating to eligibility for subchapter S status and the operation of subchapter S corporations. This is accomplished by removing eligibility restrictions that appear unnecessary and by revising the rules relating to income, distributions, etc., that tend to create traps for the unwary. The principal changes from present law made by the bill are summarized below.

Eligibility

With respect to initial and continued eligibility of a corporation for subchapter S treatment, the bill makes the following changes:

- (1) The number of permitted shareholders will be increased from 25 to 35;
- (2) Differences in voting rights in common stock will not violate the one-class-of-stock requirement;
- (3) The present law rule which results in the termination of an election if the corporation derives more than 80 percent of its gross receipts from sources outside the United States will be repealed;
- (4) The present law rule which automatically terminates a corporation's subchapter S election if more than 20 percent of a corporation's gross receipts for any taxable year is passive investment income will be eliminated for corporations which do not have accumulated earnings and profits from regular corporate years at the close of the taxable year, and will be modified for corporations with accumulated earnings and profits; and
- (5) A person who becomes a shareholder of a subchapter S corporation after the initial election of subchapter S status will not have the power to terminate the election by affirmatively refusing to consent to the election. Accordingly, the new shareholder will be bound by the initial election until the election is otherwise terminated.

Elections, revocations and terminations

The bill liberalizes the rules relating to (1) the effect of an election of subchapter S status, (2) the effect of an event which causes a corporation to become ineligible for subchapter S treatment, and (3) the manner of revoking a subchapter S election.

Passthrough of income, etc.

The bill provides that the character of items of income, deduction, loss, and credits of the corporation will pass through

to the shareholders in the same general manner as the character of such items of a partnership passes through to partners.

Selection of taxable year

Under the bill, rules generally similar to those applicable to partnerships will apply to the selection of a taxable year for a subchapter S corporation. The taxable year of a corporation which makes a subchapter S election will be required to be either the calendar year, or any other accounting period for which the corporation establishes a business purpose to the satisfaction of the Treasury Department.

Carryforward of loss

Under the bill, a subchapter S shareholder will be entitled to carry forward a loss to the extent that the amount of the loss passed through for the year exceeds the aggregate amount of the basis in his or her subchapter S stock and loans to the corporation. The loss carried forward can be deducted only by that shareholder if and when the basis in his or her stock of, or loans to, the corporation is restored.

Distributions

The rules relating to distributions from subchapter S corporations are extensively revised to make the rules more analogous to those applicable to partnerships.

Fringe benefits

Under the bill, rules similar to the partnership tax rules will apply to employee fringe benefits.

Treatment of transactions between corporation and related parties

Under the bill, amounts accruing to any cash-basis shareholder owning 2 percent or more of the corporation's stock will be deductible only when paid.

Administration

The bill provides that the items of subchapter S income, deductions, and credits will be determined in audit and judicial proceedings at the corporate level rather than separately with each shareholder. Shareholders would be given notice of, and the opportunity to participate in, Internal Revenue Service proceedings with the corporation.

This provision conforms subchapter S corporations to the "entity audit" approach enacted for partnerships as part of the Tax Equity and Fiscal Responsibility Act of 1982.

Effective date

The bill generally will be effective for taxable years beginning after December 31, 1982.

II. H.R. 6056

H.R. 6056 contains technical, conforming, and clarifying amendments to provisions of the Economic Recovery Tax Act of 1981, the Crude Oil Windfall Profit Tax Act of 1980, the Installment Sales Revision Act of 1980, the Bankruptcy Tax Act of 1980, and certain other 1980 tax legislation. The provisions are meant to carry out the intent of Congress in enacting the original legislation.

III. Medicaid and Medicare Provisions

The committee will also consider certain technical amendments to the medicaid and medicare provisions of the Tax Equity and Fiscal Responsibility Act of 1982.

Suggested Technical Amendments

Subchapter S Amendments

Trusts

The present qualified subchapter S trusts rules would be amended so that a trust would not be disqualified simply because, after the death of the income beneficiary, the trust could have multiple beneficiaries. A 60-day grace period would be allowed for a trust to dispose of stock after the death of the current income beneficiary. Successor beneficiaries would be deemed to elect qualified trusts treatment unless an affirmative refusal is made.

Accrued expenses

The bill would be clarified so that the new rules (sec. 267(f)) matching the deductions of subchapter S corporations with inclusions of income by shareholders would only apply to such corporations accruing expenses to case basis taxpayers.

Windfall profits

An existing subchapter S corporation whose shareholder's present quantity of oil production, together with his or her pro rata share of the corporation's production, would exceed 1,000 barrels could elect to not have the provisions of the bill apply.

Taxable year

The transfer of stock to a family member (within the meaning of sec. 704(e)(3)) would not be treated as a transfer for purposes of applying the taxable year grandfather rules.

Other Suggested Amendments

Fringe benefits

Existing subchapter S corporations could retain existing fringe benefits for five years so long as the current passive income test is not violated and the majority of stock is not transferred.

DISC and foreign subsidiaries

The provision in the House bill grandfathering DISC and foreign subsidiaries would apply as of September 22, 1982.

Suggested Technical Amendments

Safe Harbor Leasing Transitional Rules for Turbines and Boilers

The bill would amend the safe harbor leasing transitional rules under the new tax act for turbines and boilers of cooperatives (sec. 208(d)(3)(E)). Under the amendment, the transitional rule for boilers and turbines is clarified to apply only to a cooperative organization engaged in furnishing electric energy to persons in rural areas.

Floor Stocks - Cigarette Tax

The bill would provide that no interest would be charged during the period (up to 30 days) that Treasury extends the term for paying the tax on cigarette floor stocks.

Section 338

The new tax bill provided an election to treat the purchase of stock of a corporation as the purchase of assets. The provision was made retroactive for purchases after August 31, 1980 and before September 1, 1982. Where the target corporation was a member of an affiliated group on the acquisition date, concern has been raised that the selling corporation may incur additional tax liability. An amendment would be provided that the seller of a target corporation during this retroactive period could not be liable for any additional tax by reason of the purchaser's election.

Clerical errors

Certain typographical and similar clerical errors in the new Act would be corrected.

SUGGESTED TECHNICAL AMENDMENTS

1. ACRS - Anti-churning

ERTA provided recovery benefits for both new and used property placed in service after 1980. Anti-churning rules apply to prevent turn over of pre-ERTA property. The bill would clarify that the anti-churning rules of ACRS would not apply in the case of the death of a taxpayer, or in the case where more than 90 percent of partnership interests are acquired by parties unrelated to the selling partners.

Also, the Treasury Department could prescribe regulations to provide that the same anti-churning rules would be provided for section 1245 property transferred incidental to the transfer of section 1250 property as applies to the section 1250 property itself. This would allow certain property to qualify for ACRS where the user has not changed.

2. Rehabilitation Credit

ERTA added provisions allowing 15, 20, and 25 percent investment credits for the rehabilitation of certain buildings where the rehabilitation was substantial. In order to qualify as a substantial rehabilitation, generally expenditures equal to the adjusted basis of the property must be made during a 24-month period, not to begin before the holding period begins. The bill would clarify that the beginning of the holding period for this purpose would be determined when the property is acquired, rather than when placed in service.

3. Foreign Currency Contracts

The House bill provided that foreign currency contracts will be marked-to-market beginning with contracts entered into after May 11, 1982. The amendment would provide that these provisions can be elected, within 90 days of enactment of the Technical Corrections bill, to apply as if the provision had originally been included in ERTA. The 5-year income spread-forward allowed by ERTA for pre-ERTA gain would not apply.

4. Designation of Securities by Securities Dealers

The bill would be amended to provide that the requirement that the dealers in securities can elect, on the date the security was acquired, to have the security treated as an investment asset would apply to securities acquired pursuant to the exercise of an option only where the option had been properly designated as held for investment. This rule would apply to securities acquired after September 22, 1982.

5. Capitalization of Carrying Charges

ERTA added a provision requiring the capitalization of interest to carry personal property as part of a straddle. The Act would be amended to provide that certain short sale expenses which are the equivalent of interest would be treated in the same manner as interest for this purpose.

6. Cash Settlement Contracts

The Technical Corrections bill, as passed by the House, treats "cash settlement" contracts as regulated futures contracts which are market-to-market, notwithstanding that personal property is not delivered as required by ERTA. This provision would be clarified to insure that the amendment applies only to cash settlement contracts, i.e., contracts where cash settlement is provided by reference to the price of personal property, including indices based on the price of personal property.

7. Targeted Jobs Credit

The bill would provide that the certification that an individual is an eligible employee based on his or her income would be determined for the six-month period ending on the earlier of the hiring date or determination date. This would be effective with respect to individuals who begin work after May 11, 1982, with regard to certifications issued after the date of enactment of the Technical Corrections Act.

8. All Saver's Certificate

The bill would be amended to provide that certain certificates issued by U.S. military banking facilities abroad could qualify as an All Saver's certificate, notwithstanding that the deposits are not insured.

9. Bankruptcy Tax Act

The Bankruptcy Tax Act provided tax-free reorganization treatment for certain asset transfers in bankruptcy cases. The bill would provide that a tax-free reorganization could include transfers to a bankrupt corporation as well as from a bankrupt corporation, under the same conditions generally made applicable by the Bankruptcy Act. That Act also provided for ordinary income treatment on certain stock disposed of by former creditors who received the stock in exchange for their claims. The bill would clarify that income would not be recognized to the extent that stock received by a creditor was disposed of in a later tax-free reorganization.

10. Definition of Crude Oil

Under the Windfall Profit Tax Act, crude oil subject to the tax is defined to include condensate covered at or before the inlet side of the gas processing plant by mechanical separation. The technical corrections bill passed by the House provided for two changes in the Windfall Profit Tax Act to remove arguments against the taxability of condensate.

Two modifications of the actions taken by the House are recommended

1. The statute should specifically provide that no withholding will be required retroactively as a result of the technical amendments (although the producer's liability for the tax will remain).

2. The committee report would be modified to indicate that the Finance Committee does not believe it would be appropriate to impose a windfall profit tax on incidental liquids recovered in pipeline operations (unless such liquids are allocated back to the producer by contract) if (1) the producer of the gas applied standard separation technology before delivery of the gas to the pipeline, and (2) the producer was not compensated for the incidental liquids.

11. Independent Stripper Oil Transfer Rule

The technical corrections bill passed by the House provides that the anti-transfer rules in the independent stripper oil exemption will not apply unless there is, in fact, a transfer of property.

The committee could provide that the transfer rule is to apply only in the case of transfers of proven oil and gas properties. The committee report would clarify that a farm-out for development is not a transfer for purposes of this rule. There is no revenue estimate as yet.

12. Net Profits Interest Arrangements

The bill passed by the House provides special rules for the allocation of crude oil and exploration, development, and production costs for windfall profit tax purposes in the case of net profits interest arrangements entered into after March 31, 1982.

1. The committee could provide that these rules are not to apply, under regulations, to oil produced prior to the first time the property subject to the agreement reaches payout. Allocation rules would be provided to govern the allocation of oil from different tiers and price categories.

13. Royalty Oil Exemption for Trust Beneficiaries

Trusts are not entitled to the qualified royalty exemption under the windfall profit tax.

Beneficiaries of trusts would be permitted to claim the royalty owners exemption with respect to their respective share of the trust's production. The exemption would be claimed through refund claims at year end. No exemption would be allowed with respect to production allocated to the trust. Anti-transfer and allocation rules would be provided. The amendment would apply to production in 1982 and subsequent years.

14. Incorporation of Oil as Gas Property

Under present law, the 1,000-barrel percentage depletion amount is not available if a proven property is transferred. An exception to this rule occurs in the case of the incorporation of oil or gas property.

The House bill clarifies that, in the case of any well, qualifying transfers include equipment essential to the efficient and effective production of oil or gas. The committee could clarify this amendment by indicating that the qualifying equipment need not relate to any particular well as long as it is related to the efficient production from the property.

15. Alcohol Fuel Denaturant Amendment

To be eligible for the gaschol exemption from the motor fuel excise tax, the fuel mixture must contain at least 10 percent alcohol. The Windfall Profit Tax Act authorized the use of gasoline as an alcohol denaturant and when so used the gasoline would become part of alcohol volume. This and all of the other alcohol fuel provisions in the Windfall Profit Tax Act became effective on October 1, 1980.

The amendment would permit the use of gasoline as an denaturant as of the effective date of the Windfall Profit Tax Act.

Summary of Principal Changes Made by H.R. 6055, as passed by the House

<u>Subject</u>	<u>Present Law</u>	<u>H.R. 6055</u>
Maximum number of share- holders	25	35
Classes of stock	One	One, but stock may differ in voting rights. Straight-debt may never cause disqualification.
Passive Income test	Passive income may not exceed 20% of gross receipts	Repealed for new corporations and corporations without subchapter C accumulated earnings and profits. Retained for corporations with accumulated earnings and profits; modified to exclude certain interest income.
Foreign Income	Foreign income may not exceed 80% of gross receipts	Foreign income test repealed.
Terminations	Generally, effective for entire taxable year.	Generally, effective only prospectively; 2 short taxable years result.
Inadvertent termination	No relief provision.	Allows Secretary to waive inadvertent terminations.
Revocations	All shareholders must agree; new shareholders may terminate election.	Only shareholders together holding more than 50% of stock may terminate election.
Choice of taxable year	No restrictions.	Only calendar year permitted unless corporation can show business purpose for other accounting period. Existing corporations "grandfathered" unless more than 50% change of ownership occurs.

Subject

Present Law

H. R. 6055

Pass-through of items

Character of items (other than net long-term capital gain) not passed through.

Character of every item of income, deduction, gain, or loss passed through to shareholders, generally like a partnership.

Allocation method

Undistributed taxable income allocated only to shareholders as of end of taxable year; net operating loss allocated on per-share, per-day basis.

All items allocated on per-share, per-day basis.

Loss limitation

Deductible losses cannot exceed shareholder basis in stock and debt. Excess is lost.

Generally the same except that excess losses may be carried forward.

Basis of stock and debt.

Basis of stock increased by undistributed taxable income and decreased by losses and distributions of undistributed taxable income and previously taxed income.

Basis of stock increased by items of income; decreased by deductions and distributions.

Fringe benefits

No provision.

Basis of debt decreased by losses after basis of stock reduced to zero, no restoration.

Basis of debt decreased by losses after basis of stock reduced to zero; may be restored by subsequent income.

Partnership rules apply; 2% or more shareholder treated as partner.

Audit

Determination made at shareholder level.

Items determined at corporate level.

Distributions

Distributions from current earnings taxed as a dividend: Provision allows cash distribution of previously taxed income tax-free.

For corporations without accumulated earnings, distributions are tax-free to extent of basis in stock; corporation with accumulated earnings may distribute subchapter S income tax-free before distributions of accumulated earnings.