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COMMITTEE ON FINANCE

UNITED STATES SENATE

EXECUTIVE SESSION

WASHINGTON, D. C.

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400 Virginia Ave., S.W. Washington, D. C. 20024

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EXECUTIVE SESSION

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Thursday, April 1, 1982

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United States Senate
Committee on Finance
Washington, D.C.

The committee met, pursuant to notice, at 2:10 p.m. in Room 2221, Dirksen Senate Office Building, the Honorable Robert Dole (chairman of the full committee) presiding.

Present: Senators Dole, Chafee, Wallop, Symms, Grassley, Long, Byrd, Bentsen, Matsunaga, Baucus, Boren, Bradley and Mitchell.

Also Present: Robert E. Lighthizer, Chief Counsel; Rodrick DeArment, Deputy Chief Counsel; Rich Belas, Tax Counsel; David Hardee, Minority Tax Counsel; Mark McConaghy, Chief Counsel, Joint Tax Committee; David Brockway, Joint Tax Committee; John Chapoton, Assistant Secretary of Treasury for Tax Policy.

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The Chairman: I apologize to those who traveled long distances yesterday to be here at 2:00. We had a very important matter on the floor that we had to dispose of. We had to of necessity cancel. Many had not eaten yesterday.

So we are back today and I want to suggest that we probably will not get a great deal done today, but we hope to have a discussion first of the minimum tax and then the leasing provisions. First we will have Mr. Belas on the Finance Committee discussing the minimum tax, and then we will have Mr. Chapoton review the Administration's proposal.

Then on the leasing provision we would like to hear from the Joint Committee on how leasing works and review a leasing example, and I am certain there will be questions in these areas because these are two rather significant proposals that will help us raise revenue. There is no doubt in my mind that we are going to have to do a lot of that. We have to bring the deficits down if interest rates are going to come down, and we are going to have a very active mark-up schedule as soon as we return. I will try to have that in the members' hands today because people might have conflicts. We are checking with the members.

We had hoped to be in a position at that time, that the staff be prepared to give us other options in addition to the Administration's proposal, and we will go from these two matters into completed contract, finish the Administration's proposals, and then take a look at some staff options.

Having said that, unless somebody else would like to make a statement, I would call on Mr. Belas.

Senator Wallop: Mr. Chairman, I have a statement that

I would like to have inserted in the record. But in essence, what it says is that I do not really feel like voting for any increases in taxes until I see some sign that we are going to do something about the entitlement programs and the reduction in spending and some kind of indication that Congress is not going to use what it raises in revenue to spend on new programs.

What we do not need is a tax increase and no budget decrease, no consequence for it other than more money drained out of the hands of the taxpayers. And until we see some level of commitment out of here, I just think it is irresponsible to talk about increasing taxes.

Senator Bentsen: Mr. Chairman, I would like to put a statement in the record.

The Chairman: Could I just say, in response to Senator Wallop, I certainly share that view and I have made that view known in meetings that I have had in Senator Baker's office. There is no need for this committee to raise more revenue so that other committees can spend more money.

I believe we ought to achieve or exceed the President's spending reduction goals in this committee, maybe not in the same way, but unless I am mistaken, we will do very well on the spending reduction side. So I share the view expressed by the Senator.

Senator Byrd.

Senator Byrd: What needs to be done is to reduce spending. Spending is what is out of control, totally out of control. Congress is totally undisciplined and has been undisciplined for 20 years. What needs to be done now more than anything else is to control spending. If we control spending, the taxes will take care of themselves.

The Chairman: Mr. Belas.

Mr. Belas: Mr. Chairman, today we have three separate minimum taxes in the Internal Revenue Code. We have an add-on minimum tax applicable to corporations, we have a similar add-on tax applicable to individuals, and we have an alternative tax that also is applicable to individuals. I will briefly go through each of the three minimum taxes.

On corporations, the so-called add-on tax means that in addition to any regular income tax liability a corporation may have, there is a 15 percent tax on a tax base which equals the total amount of so-called preference items, reduced by the greater of $10,000 or the full amount regular tax liability for the year. Basically, that means we have a smaller tax base, and a 15 percent flat rate is applied to that tax base.

The items that are included in that tax base are accelerated depreciation on real property over straight line depreciation, and after a technical correction which is necessary, it will apply to the ACRS system as well. It also applies to percentage depletion to the extent that it exceeds the adjusted basis of property at the end of the year. And it applies to 60-month quick amortization of certain property, such as pollution control facilities, railroad rolling stock, and child care facilities, to the extent that this quick amortization exceeds depreciation. Also it applies to the excess of net long-term capital gains over short-term capital loss.

Finally, with respect to banks, savings and loans and mutual savings banks, financial institutions, it also includes as a preference item the excess of the addition to bad debt reserves over what the bad debt reserve would have been if it had been maintained on an actual loss experience basis. Basically, for the financial institution, they have a method of computing bad debts which may not comport with reality, and the excess over real experience will be included as a tax preference item. Basically that is an add-on tax. It goes into effect no matter what the tax liability of a corporation is.

In addition to that, we have on individuals two minimum taxes. The first one is very similar to the add-on tax for corporations. It is a 15 percent tax on preference items, reduced by the greater of $10,000 or only one-half of the taxpayer's regular tax liability. On corporations, it is the amount over the full tax liability.

They have different preference items for individuals as well. The same accelerated depreciation on real property over straight line depreciation. Also, accelerated depreciation on leased personal property over straight line. A percentage depletion, just as in the corporate tax. And in addition, we have the amortization, just like in the corporate tax, and two new ones: stock options -- qualified or restricted stock options, not the incentive stock options that were enacted last year, the amount by which the fair market value of the shares that were purchased by the option at the time the option was exercised, to the extent it exceeds that option price. The fair market value over the option price is included as a preference item.

Finally, intangible drilling costs. Intangible drilling costs are included to the extent they exceed the taxpayer's net income from oil, gas and geothermal properties for the year.

Finally, there is an alternative tax that does not apply to corporations. It only applies to non-corporate taxpayers. It will apply to a taxpayer if he has a business, as long as he is not operating in corporate form.

The tax is imposed only to the extent that it exceeds the sum of the taxpayer's liability and the taxpayer's add-on minimum tax. The tax is on a base called alternative minimum taxable income. That is gross income minus all your regular deductions, and then you add back certain adjusted itemized deductions and you also add back the capital gains deduction, that 60 percent that is not normally taxed.

The adjusted itemized deductions are all your itemized deductions except for your state, local and foreign taxes, your medical expenses, your casualty losses, and an estate tax deduction for income in respect to the decedent. And it is only to the extent that those itemized deductions exceed 60 percent of your adjusted gross income minus the items that are excluded.

This tax is not at the 15 percent across the board rate. It applies at a graduated rate: 10 percent on the amount of the base, that alternative minimum taxable income base, between $20,000 and $60,000. The first $20,000 is taxfree under the alternative minimum tax. The second $40,000, $20,000 to $60,000, is taxed at a straight 10 percent, and the amounts over $60,000 are taxed at 20 percent.

The Chairman: That is a brief summary of current law?

Mr. Balas: That is current law.

The Chairman: Without any Administration change. Now we will have Mr. Chapoton address how the Administration proposes to change the corporate minimum tax.

Mr. Chapoton: Mr. Chairman, the Administration's proposal would remove altogether the add-on corporate minimum tax and substitute in its place an alternative minimum tax, which would be something like but quite different in scope from the alternative minimum tax that Mr. Belas described on individuals.

Basically, the principal involved here would be that each corporation that has current operating profits or economic income would be required to pay some rate of tax currently. The rate would be 15 percent because that is the current rate of tax. And for that reason, no credit would be allowed against the alternative minimum tax other than the foreign tax credit, in an effort to prevent double taxation of foreign earnings.

Structurally, the tax would be computed by taking the corporation's existing taxable income computed under the normal rules, adding back to existing taxable income the sum of the corporation's preference items within the year, taking that total and subtracting from that total $50,000 to exclude smaller corporations, so that no corporation whose restructured income is less than $50,000 would have any tax under the alternative minimum tax.

After you take the nontaxable income and the sum of the preferences less $50,000, the resulting item would be your minimum taxable income base. You would multiply 15 percent times that, and compare the resulting minimum tax to ordinary tax liability, and pay the higher of the two. Your ordinary tax liability would be, as computed under present law, ordinary tax less all credits, including foreign tax credit, investment tax credit, energy credits and all other credits; whereas the minimum tax liability would be computed, as I stated, less no credits other than the foreign tax credit.

As I said, the purpose, the attempt is to design a system so that a corporate entity cannot utilize preferences in combination or other provisions in the tax law in combination to reduce its current tax liability to a rate below an effective rate of 15 percent.

The preference items are all of the preferences applicable to corporations under existing law, other than capital gains preference, because mechanically the way this alternative minimum tax works, all of capital gains would be in the base, so it would be taken care of automatically. You would not have to do a special capital gains preference.

So we will take the preferences applicable under existing law to the corporations and we would add the following preferences. We would add intangible drilling costs on successful wells in excess of a ten-year amortization of the IDC costs. That would be an additional preference. The second additional preference would be mining, exploration and development costs, which are expensed in excess of a ten-year amortization of such costs. We would add the lessor's net tax benefits from a safe harbor lease transaction, so that in effect that would say that a lessor or buyer of leases, a buyer of credits and deductions under a leasing transaction, could not use that transaction to reduce his tax liabilities to a lower effective rate than 15 percent.

A fourth additional preference would be interest deductions by financial institutions on debt utilized to carry tax exempt obligations. Under the law applicable to individuals, under Section 265(2) of the code, interest on debt which is used to purchase or carry tax exempt obligations is not deductible, but financial institutions are allowed to deduct such interest. They would be allowed to continue to deduct such interest, but that deduction would be a preference item. So once again, this minimum tax would state that that deduction of interest relative to tax exempt income could not be utilized to drop a financial institution's effective tax liability to lower than 15 percent of its economic income.

The Chairman: If someone could spell out for us on the blackboard so that we can maybe more clearly understand what would happen under the current law, and the same set of circumstances under the Adminstration's proposal. We used to draft Mike Stern all the time. I think maybe he has escaped that.

Would you do it for us, Mike?

[Laughter.]

The Chairman: We can read your writing, Mike.

[Pause.]

The Chairman: Mr. Belas, maybe while Mike is writing that, you could give us -- you have a short example of how it works under current law. Just give us the example you showed me. I think it is short.

Mr. Belas: The important thing to note is that the major difference, the differences between the Administration's proposal and the current tax is that the Administration's proposal is on a much broader base, and it also is an alternative tax, rather than an add-on tax.

To give you an example of how the add-on tax works, say you had a corporation that had an income tax liability of $28,500 for 1980, and it had tax preferences totalling $80,500, more than the corporate tax. So you take the tax preferences, less exemptions of $28,500, which was the amount of the regular tax liability, and you would come out with in excess of $52,000. And that is the amount that is subject to the add-on minimum tax.

You multiply that by 15 percent and you come out with $7,800. That just means that your tax liability is increased by that extra $7,800.

The Chairman: $36,300 rather than $28,500.

Mr. Belas: That is correct. It is a very simple tax, but it is on a very minor base. I would hate to say arbitrary base, but it is on specific items that were considered to be items that were not considered to be the type of thing that you wanted to allow a corporation to escape tax on.

The Chairman: Are these using different figures or the same?

Mr. Belas: These are different figures.

Senator Byrd: Is that an example of a corporation or an individual?

Mr. Chapoton: That is a corporation, Senator Byrd.

The Chairman: Run through that.

Mr. Chapoton: Okay. What that shows is the corporation has regular taxable income of $20,000 and a 46 percent tax rate which we are assuming no surtax exemption. A 46 percent tax rate of $9,200 on that taxable income.

Then the third line down, we begin to compute the minimum tax liability. Taxable income is $20,000 again. We add back to that the preference items, which you have heard described as preference income, but it is the sum of the items I have listed, and you add the two together and you have $80,000 of preference income and $20,000 of taxable income for a total minimum tax base of $100,000, to apply the 15 percent minimum tax rate against that, in order to come up with a minimum tax of $15,000. Compare that with the regular tax liability of $9,200 and you pay the higher, which is $15,000.

So that corporation would have tax liability of $15,000 rather than $9,200.

Let me add right now, because it is an important point, under our proposal, the difference between $9,200 and $15,000, or $5,800, would be a credit against normal tax liability in a later year. It would be a carryover credit, so that a corporation that is subject to the minimum tax for one or a couple of years and then moved back to the regular tax system will have no greater total tax liability over the sum of the years than it would have under the normal tax system. It simply must pay each year at least 15 percent of its normal tax liability. And if it is a corporation that consistently pays lower than a 15 percent effective rate, then it would have obviously a total permanent increase in tax liability.

The Chairman: What do you include in the preference income?

Mr. Chapoton: The preference items would be the ones -- I will run through them very quickly and then we can go over any that you might want to discuss further. Under existing law, a percentage depletion. Five of the preferences are under existing law. The percentage depletion in excess of cost of depletion on minerals; accelerated depreciation on real property in excess of straight line depreciation over a 15-year period; amortization of certified pollution control facilities and amortization of child care facilities, both of which will phase out shortly, so they are retained for a short period of time but are not really important.

The fifth one is reserve for losses on bad debts of financial institutions, the statutory reserve in excess of a reserve allowed, computed on actual experience. That is existing law.

Then you add I believe eight additional preferences: intangible drilling expenses in excess of a ten-year amortization of those intangible drilling expenses in drilling successful oil or gas wells; mining and exploration development costs deducted to the extent they would exceed a ten-year amortization of those costs; the benefits of a lessor under a safe harbor leasing transaction; deduction by financial institutions on debt -- deduction of interest on debt to carry tax exempt securities by financial institutions; the deferred DISC income, which is added to a construction reserve fund or capital construction fund under the Merchant Marine Act. That income is not taxed, or it would be a preference under the minimum tax.

The five-year amortization of motor carrier operating rights would be an additional preference. The original issue discount interest in excess of interest that would be computed on the amount actually borrowed -- in other words, the original issue discount is now being used by a number of corporations to accelerate very dramatically the interest deduction on debt, and the acceleration would be a preference.

And then finally, the deduction on costs in connection with long-term contracts. This is a correlary to our proposal on certain period costs under the completed contract method of accounting. They would be a preference up until the time a contract was subject to the new disallowance or deferral rule under the completed contract proposal that we are making.

The Chairman: What revenue would that raise, if in fact it were adopted as outlined by the Administration?

Mr. Chapoton: It would raise I believe it is $2.3 in fiscal year 83, $4.8 in fiscal 84, $4.5, $3.7 and $3.8 in 87.

Senator Byrd: Could I ask this question? A corporation borrows money to purchase equipment. Is that considered a preference item?

Mr. Chapoton: No, sir.

Senator Byrd: Now this example that you give there, is that under existing law?

Mr. Chapoton: No, that is under the proposal. Perhaps it would be helpful if we showed how that example would apply under existing law.

Under existing law, the corporation would pay its normal tax liability of $9,200, plus it would take its total preferences of $80,000 and subtract $9,200 from that, leaving a minimum tax base of $70,800, and apply 15 percent to that base, which would be approximately $1,200. It would add that to its normal tax liabilty, so this corporation would have higher tax liability under the old minimum tax than under the new minimum tax, which will happen.

The new system, our proposal, would provide that all corporations must pay some minimum rate of tax, but for those corporations that are already paying a significant amount of tax, they would have no add-on tax because they also have some preference items.

Mr. Belas: Mr. Chairman, one thing that I think should be emphasized here is that the preference items are much, much different. So it is kind of oil and water, trying to compare the two.

The Chairman: I understand that.

Senator Byrd: But under this proposal, or under the existing law too, perhaps, the corporation that has a $20,000 taxable income now pays or would pay under your proposal $15,000.

Mr. Chapoton: That is correct.

Senator Byrd: In other words, a taxable income of $20,000, the company would pay $15,000 in taxes.

Mr. Chapoton: Senator Byrd, that is correct, but the assumption that the proposal and indeed the existing minimum tax proposal proceeds on is that its economic income is somewhat higher than $20,000. So looking at $20,000, we just have to accept the fact that that is not a correct measure of its income for this purpose, and indeed it is reporting more income to its stockholders and creditors.

Senator Long: Could I ask this, Mr. Chapoton. If that preference income you are talking about is an intangible drilling cost, and I understand that would be included, as you well know, Mr. Chapoton, when you are drilling wells, that reduces your tax while you are drilling but at whatever point you stop drilling, then it all catches up to you and you really pay a lot of taxes if you are in that business. You are thoroughly familiar with that, I am sure.

Mr. Chapoton: Yes, sir.

Senator Long: So this is a tax deferral, rather than a tax advantage. Once you stop drilling, the expenses catch up with you and you owe a great deal of taxes.

Now logically it would seem to me that at that point, when you start paying a larger amount of taxes, you would not be paying the minimum. By rights, that fellow would be entitled to the difference between let us say the $9,200 and the $15,000 and have that refunded to him because at that point, he is not getting any tax advantages. He is paying you back for the rapid tax write-off he had up front.

Mr. Chapoton: Yes, Senator Long. That is part of this proposal. When that taxpayer later had taxable income on the normal base, then the difference, the $5,800 difference between $9,200 and $15,000 would be a credit against his normal tax liability.

Senator Long: So at that point, when he is no longer doing the drilling, he would then get a credit against what his ordinary taxes would be?

Mr. Chapoton: That is right. The increase in current tax liability from the application of the minimum tax would be a credit, if he moved back on the regular system.

Senator Long: That would be a credit against his ordinary tax liability?

Mr. Chapoton: A credit against his ordinary tax liability, yes, sir.

Senator Long: That seems fair. I am glad you got that in there.

The Chairman: Senator Bentsen.

Senator Bentsen: Mr. Chairman, my concern with this approach is that we passed a tax bill where we were trying to encourage business to make investments in new plants and new equipment. Of course we have had an interest rate-induced recession that has precluded that from happening thus far. But we went all out to try to accomplish it and we passed a tax bill that was 80 percent for the individual and 20 percent for business.

As I have been told on these numbers that have been provided to me, this particular measure would take back 56 percent of the tax cuts that we gave for business in this last bill, take back 52 percent of them, and that the ratio would turn more to 90 to 10.

We put certain things in there which -- you know, they use the language for political reasons nowadays and call it preference income, but we put it in there for an economic objective that we were trying to achieve. That was a new acceleration of depreciation or whatever other one is listed there, where there might be an excess.

I would rather see us, instead of using a shotgun approach across the board, look at the specifics of the economic objectives that we were seeking. Now one of those that was put into this bill is the so-called safe harbor leasing, which I think is being very much abused and I think destroys confidence in the tax system, the way it is being utilized. I would rather that we took a surgeon's approach to this more than a meatax approach, and that we chose those specific ones that we did not think were working properly, rather than to go back and try to undo some things that I think were necessary in trying to increase the productivity of our country.

Mr. Chapoton: Senator Bentsen, I recognize and we have of course met with numerous groups on this, and those points have been made. I think the thing we have to focus on is that this proposal does not -- well, the add-on minimum tax really does reduce directly the benefit of each incentive deduction or benefit. This only says that they will not be affected adversely at all unless they are used in combination, or as to having the effect of reducing your income -- through the desirable incentive but reducing your income tax liability in a particular year to some point that is considered simply too low, that all entities should pay some normal rate of tax, some minimum rate of tax on economic income.

Senator Bentsen: The trouble with that line of reasoning is we have ourselves a growing industry that we want to see move and we want to see it -- maybe it is high technology -- making a major amount of investment in new equipment, to be more productive and more competitive, and that is what we were trying to urge them to do. And they in effect have deferred their profits, but you slap a tax on them because they have taken too much in the way of purchase of equipment and trying to do some of the very things we were talking about them doing.

So it seems quite counterproductive to me. I would rather take on the specifics of those incentives we put in the system that we do not think are applicable any more, or that are not being properly utilized or are being abused. And I get right back to safe harbor leasing.

Senator Byrd: Can I ask this question? We changed the depreciation schedule in 1981 to 15 percent the first year -- on equipment now -- and then 22 percent and then 21 percent for the next three years. Is any of that depreciation included in the preference income?

Mr. Chapoton: It is not, Senator, except the existing law rule that says accelerated depreciation on real estate is retained, so the effect is that depreciation in excess of straight line over 15 years on structures, on buildings, would be a preference. There could be a slight preference from ACRS on real estate.

Senator Byrd: But not depreciation on equipment?

Mr. Chapoton: Not depreciation on equipment.

Senator Byrd: How about the 10-5-3 on automobiles?

Mr. Chapoton: Three years on automobiles and some R&D equipment, yes.

Senator Byrd: And that is not a preference?

Mr. Chapoton: That is not a preference.

The Chairman: Senator Symms.

Senator Symms: Thank you, Mr. Chairman.

I would like to pursue a little further the questions that Senator Bentsen asked about, and really his general statement about the fact that the business cuts, if we start tampering with this now, what the impact would be on the economy.

What about the illiquidity out there in the corporate world? I was told here that Ford Motor Company, for example, could not roll over their short-term paper a couple of weeks ago and had to do some emergency things. You start tampering, what you are really doing is raising taxes on the corporate part of this economy by this tax; is that not really true?

Mr. Chapoton: Well certainly, there is a tax increase on a part of the corporate community. It is not, and I should have mentioned this earlier, I do not think it is correct to view it as contrasted with the ACRS benefits given last year because most corporations are not affected by the alternative minimum tax at all. But some are and those industries which utilize these special incentives in the tax law, they will have an increase in taxes.

Senator Symms: But is that not going to make, in addition to that, so what we are talking about is raising taxes on an illiquid corporate part of our economy, so they have to go borrow the money then, so we still do not solve the interest rate problem.

Mr. Chapoton: Well, Senator, we always come about in that circle. The question here I think is whether it makes the corporate income tax more fair and a better tax or not. It is going to be a tax increase for those companies that pay more taxes. No doubt about it. They are paying a very low effective rate of taxes before this.

Senator Symms: Do I understand it right that they are going to have to have a double calculation? Does this not make it more complicated?

Mr. Chapoton: Definitely one of the disadvantages of a minimum tax and this minimum tax is the additional computation, yes.

Senator Symms: How much extra will it cost the private sector to do the calculations? Is there any way to estimate that?

Mr. Chapoton: We have not even made an attempt to estimate. Let me be candid. It is not so much computing the tax at the end of the year. It is planning that will be more difficult, and planning is already difficult under the tax laws and under other laws, and this will add a definite element of complexity in tax planning which corporations must do.

Senator Symms: How much more will it cost Treasury?

Mr. Chapoton: The cost to Treasury would not be significant.

Senator Symms: But you have no idea how much it will cost, though, the private sector? Are they going to spend $1 billion to try to raise $3 billion for the IRS?

Mr. Chapoton: I really cannot say but I cannot believe that the cost would be anything like $1 billion.

Let me emphasize that tax planning in larger corporations is already a very sophisticated process, so additional elements, while undesirable, are probably not that expensive.

Senator Symms: Well Mr. Chairman, I just think I would like to say, just so that there will not be any surprise to you as to where I am coming from, but every economist I talk to tells me that if we raise taxes right now on our economy, we are just going to be making the same mistakes that were made in the early 30s when they raised taxes and lengthened out the recession.

It seems to me like what we need to do before we start raising taxes is to cut spending. I would sure like to see us approach the entitlement programs before we talk about raising taxes. Now it may be that there may be some places that we can do some good and find some accomodation, but I am sure concerned about this, and I hate to have something, particularly this minimum tax which seems so unnecessary and burdensome. To even be talking about it bothers me because

I think it does disrupt the thinking of the investment community so that they begin to wonder if we are going to change the rules every three or four months around here.

I liken it to that movie Rollerball that was quite popular a few years ago where they changed the rules in the middle of the game all the time. If you can keep up with it fast enough, maybe you can have some planning. But I would sure hope that we would just have these sessions and not vote for any tax increases. Like I say, I do not mind the hearings, but I sure hate the mark-ups.

Unless we can talk about cutting entitlement spending, I guess is where I am coming from.

The Chairman: I said earlier that we are going to address the spending cuts in this committee and I think we will achieve or exceed the President's recommendations. So we are just taking up the revenue side first. But every economist I have talked to said if we do not get deficits down, interest rates are not coming down. That is the other side of the coin. If we do not do something on the revenue side to bring down the deficit, as well as the spending side, I am afraid we have more trouble than we can manage.

No one wants to increase taxes, but I would guess that there will be some increases. They may not be unanimous but --

Senator Symms: Mr. Chairman, I would suggest that maybe if we could come to some kind of an agreement, and I think right in this committee we have the area where the deficits are going to have to be narrowed -- social security, Medicare, Medicaid, primarily social security. Without that one, we will never narrow the deficits.

If we could maybe vote a resolution through the committee that we would agree to a five to one ratio or something, that for every $5 we cut in spending we will raise $1 in taxes, then we might have a good ground rule of where to start. I think that would probably signal the thing and bring down interest rates if we would do that. But if we are talking about $1 to $1 --

The Chairman: I think that may be a little on the heavy side.

Senator Symms: Well, I started at five to one and I might settle for four to one.

The Chairman: That is progress. If we get you down to one to one, we might be in business.

Are there other questions on the minimum tax? Senator Matsunaga.

Senator Matsunaga: Mr. Secretary, you quoted figures as to the projected increase by application of minimum tax. I think you said $2.3 billion. What year would that be for?

Mr. Chapoton: The tax would be effective January 31, 1983 and the figure I quote, $2.3 billion, would be for fiscal 83.

Senator Matsunaga: In fiscal 84, $2.8?

Mr. Chapoton: $2.6. I am sorry, Senator, $4.8. I am sorry.

Senator Matsunaga: $4.8 for fiscal 84 and 85?

Mr. Chapoton: $4.5. And in 86, $3.7, and in 87, $3.8.

Senator Matsunaga: All right. Now, this would be as a consequence of minimum tax, only on those smaller corporations?

Mr. Chapoton: No, on all corporations, but smaller corporations there would be a $50,000 exemption, so the smaller corporation would be exempted from the alternative minimum tax by that.

Senator Matsunaga: Does this mean that the larger corporations would be paying an additional 15% over --

Mr. Chapoton: It means that any corporation that is paying an effective rate of tax on this reconstructed income of lower than 15% would be paying 15%.

Senator Matsunaga: I see. And now relative to the preferential income, would each corporation be treated alike, as to the components of such income? Or would it differ from industry to industry?

Mr. Chapoton: The preference items would be listed, as

I have outlined. They are across all corporate entities, but they are certainly heavier in certain industries.

Senator Matsunaga: So as was earlier put to question by Senator Bentsen, you would also include those preferential items which were intended by Congress as an incentive for a particular industry?

Mr. Chapoton: That is correct. Yes, sir. The accelerated cost recovery system, no. But other items are incentive items, as they are under existing minimum tax.

Senator Matsunaga: In other words, items which are included, for example, as incentives for development of alternative energy would also be included?

Mr. Chapoton: No. The energy credits would not be allowed to reduce your minimum tax.

Senator Matsunaga: Under your proposal that would not be allowed at all?

Mr. Chapoton: That would be phased out, and the credits would not be allowed against the minimum tax liability. There is no specific preference item on the alternative energy expenses.

Senator Chafee: Mr. Chairman?

The Chairman: Senator Chafee?

Senator Chafee: Mr. Chapoton, it is said that this minimum tax is heaviest on the capital intensive industries. Why would that be so? And is it so?

Mr. Chapoton: Let me get a specific answer to that. It will hit some capital-intensive industries and not others. But to the extent it does, the main effect is the fact that the investment tax credit and no credits may reduce your minimum tax liability. So you could not use that or any other item to reduce your effective tax rate to below 15%.

Mr. McConaghy: I am not sure, Senator, whether it would just be for capital-intensive industries. Banks, for instance, some would view as not being too capital-intensive, and I think that they would be affected by this. So I am not sure if it is just -- if you can draw the conclusion that it would be just capital-intensive.

The Chairman: They do not have much tax now as an effect of that, right?

Mr. McConaghy: That is right.

Senator Byrd: The investment tax credit, is that a preference item?

Mr. Chapoton: No, it is not a preference item, Senator, but the investment tax credit, or energy tax credits -- no credits would be allowed against a minimum tax liability.

Senator Byrd: Against minimum tax liability?

Mr. Chapoton: That is correct. So these credits could not be used to reduce a corporation's tax liability if it were under the alternative tax. And indeed, the credit is one of the items that could obviously reduce normal tax liability and bring it to a lower than effective 15% rate. And if that happened, minimum tax liability would kick in.

Senator Byrd: Take an example. Suppose a corporation had net taxable income of, say, $100,000, and it had no preference items that you listed, and it had a $100,000 investment tax credit. What would be the situation on that?

Mr. Chapoton: It had $100,000 of income; it would have a $15,000 tax liability and an investment tax credit carryover --

The Chairman: You could sell your tax credits.

Mr. Chapoton: I am sorry. In that case, it would be a $50,000 exemption, but you would up the figure. The result would be the same. There would be a case where the credit would be disallowed. It would be carried over rather than being allowed to reduce taxable income to below 15%.

Senator Byrd: So it would be disallowed but it would not be considered a tax preference.

Mr. Chapoton: It would not be labeled a tax preference; it would be deferred, though.

Senator Byrd: Thank you.

Senator Bradley: Mr. Chapoton, would you say that your new list of what is preference income and what is not could generally be described as base-broadening?

Mr. Chapoton: I suppose it could, Senator. It broadens the base of the existing minimum tax, yes. It is base-broadening, yes.

Senator Bradley: What is the rationale behind that? The general idea of broadening the base?

Mr. Chapoton: Our rationale is an attempt to reconstruct income closer to an economic income base to see that a meaningful effective tax rate is paid currently. Some minimum effective tax rate.

Senator Bradley: And you say that in some cases, that effective tax rate would be lower than normal, ever?

Mr. Chapoton: This would say that it could not be lower than 15%. Without this, it could be lower than that, yes.

Senator Bradley: You have not, in any way, touched ACRS?

Mr. Chapoton: ACRS is not a preference, but as I was describing to Senator Byrd, the investment tax credit, which is not technically a part of ACRS but it could not reduce your tax liability to a lower than 15% rate, so there is an indirect result on the credit, certainly, on the investment tax credit.

Senator Bradley: Would that, as you know it, eliminate the possibility of a negative tax rate for most categories of assets?

Mr. Chapoton: I think that that is a separate question because I think that calculation you are discussing is usually made on an asset-by-asset basis, so this would not affect that directly. It could. It could in a particular case, but in some cases it would not.

Senator Bradley: Thank you, Mr. Chairman.

The Chairman: If there are no other questions on the minimum tax, we would like to move on to the leasing provision. Might say there will be some additional options on the minimum tax which we will discuss at a later meeting.

But we would like to hear the joint committee's reviw of how leasing works and the review of a leasing example at this time. Mr. McConaghy?

Mr. McConaghy: Mr. Chairman, prior to the changes made by ERDA, we had really some different rules that were somewhat complex and uncertain applying to when something was a lease and when it was a conditional sale, or financing arrangments.

Generally in the tax laws, depreciation and the investment tax credit follow ownership of the property. If a transaction in substance is characterized as a lease, then the lessor, who would be treated as the owner, gets the depreciation and the investment tax credit. If it is treated as a conditional sale or a financing technique, then, of course, that lessee/user would be the person who gets the investment tax credit and depreciation.

So prior to any change, there were a number of factors that were looked at. The law, I think, was somewhat unclear from the cases. The Service took a position in its private rulings that you look at certain guidelines or factors, and those factors included things like was there an economic profit absent the tax benefits; did the lessor have a 20% minimum at risk; did the lessee have the right to purchase the property at the end of the term at less than fair market value; the lessee must not have been able to have an investment in the lease and must not lend any of the purchase costs to the owner; and the use of the property at the end of the term of the lease by a person other than that lessor must be commercially feasible.

I think most people would view those as factors that were at least designed to try to determine what the substance of the transaction was.

In ERDA, we adopted or changed those rules. We really overrode those rules and provided a safe harbor that would really guarantee when a transaction would be treated as a lease rather than a financing arrangement or a conditional sale, even though it did not comply with the old IRS guidelines or some of the criteria that the courts imposed.

Essentially, those criteria were somewhat simple. The parties to the agreement must elect to treat it as a lease.

We allowed it only where the nominal lessor -- that is a person who is not the user but was a corporation -- we did not let individuals, in effect, buy or transfer and get the benefit of transferring those tax benefits. We dropped the minimum at-risk investment and said that the lessor must have a minimum at-risk investment of at least 10%. The old rule was 20%.

We put some rules in on how long that lease term could be, and we applied it to what we call qualified lease property, which is really new Section 38 property; that being tangible property that is eligible for depreciation or the investment tax credit.

That really permitted two or three things. One, it made it easier essentially to transfer the benefits from depreciation and the benefits from the investment tax credit prior to what we did in ERDA. It was clear that those benefits still could be transferred. However, negative benefits, in effect, or benefits more generous than expensing could not have been transferred, and it provided some certainty. But essentially, I think it was designed to take some of the benefits that could not be used by what we did in depreciation in the ITC, and permit them to be transferred to someone else.

Now, we have an example which I think is fairly typical. It is an example which should be passed out that explains what we see as the typical transaction after looking at many of the lease transactions that have occurred.

We and the Treasury are analyzing those returns. There are some 20,000 returns and we are not finished doing that. We hope to be able to have something out when you come back from the Easter recess, but we find that this is fairly typical of what we see.

Essentially, it starts out with two corporations. One is a corporation that really is what we will commonly refer to, I guess, from now on as a loss company or a company that is really not paying income tax liability. Another company which is a profitable company, and it expects to have and does have taxable income and is paying, let us say, the maximum 46% rate.

So the company which is the loss company -- and we will say that is X in this example -- essentially needs equipment, needs to purchase it. It cannot use the tax benefits from the purchase of that equipment because it has no tax liability. So in the typical kind of agreement, that company, X, would purchase equipment, and we are going to use five year recovery class equipment, for $1 million. That same loss company, X, of course, cannot use the same tax benefits that would flow from depreciation or the investment tax credit. Under safe harbor leasing, it would first sell the asset to the profit company and here it would sell it for a million dollars.

That profit company -- and this is what the market shows -- would pay for those tax benefits. Essentially, a down payment of $214,000 in cash, and it would give a note for the balance. In this case, the note would be the difference between a million and $214,000, which is $786,000. So the loss company sells the asset to the profit company, and the profit company is willing to pay $214,000 in cash, and it would give, to pay for the rest of the asset, a non-recourse note for the balance which is $786,000.

Let us assume today in this market that notice for nine years, the longest term possible, 17% annual interest and it is paid in equal installments of $176,600. Under the statute it does require that there be a level payment schedule for that loan.

The next step to accomplish the transfer essentially of those benefits would be that Y -- and Y is the profit company -- it turns around and leases the equipment back to X. After all, X is the one that really wants to use the equipment. It leases it back to the loss company for the exact term, nine years, and it charges rental for that, exactly equivalent to its installment payments under its note, so it would charge rental of $176,676, and that would exactly offset the debt service that it has to pay under the note. And so those two would wash. That is what you really end up with. The only money that really has changed hands between X, again the loss company, and Y is $214,000, and that has been paid to that loss company.

Now, at the end of the lease term, the arrangement we see at least is that the profit company -- in this case, Y -- would sell that equipment to the loss company for a dollar. Essentially, that is put in the lease agreement before the enter into it. Let us assume that in this case, there are third party fees, meaning there are fees paid to people other than the lessor and the lessee; that those fees are $4800 and that they are split evenly so that the profit company pays $2400 and the loss company pays $2400. Essentially, those are fees to consummate the deal.

The result really is that the loss company has purchased the $1 million asset and its net cost really is $788,400. The profit company essentially has purchased for $216,400 tax savings worth $277,500. That is essentially the discounted value of the depreciation and the investment tax credit. Now, the profit company obviously will enter into this because it has paid essentially $214,000 essentially to get tax deductions that are worth $277,500.

The second page of this, which we can just kind of glance at, kind of gives the substance of this transaction and that is, this is the buyer of the tax benefits, this is a profitable company, would he buy essentially those tax benefits? In the case we see, of course, they do. They will have depreciation deductions in the first five years, such as Senator Byrd indicated, under the five-year schedule of 15%, 21% and so forth.

They will end up paying interest on the note they give back to the lessee. There are some amortized fees. If they do receive rental income, then the sum and substance of the transaction is that the buyer of the benefits ends up with tax deductions. In the last column, in the first five years, it has some positive change in tax. In the next five years -- and if you add up the present value of those tax changes, it has resulted in a reduction of $277,500 for the buyer of the tax benefits. That is assuming, of course, a 12% discount rate.

So this we see as essentially the typical kind of a transaction. So far, of that revenue loss of $277,500, the way it would break out in this example is that the seller of the tax benefits -- which is the non-profitable company -- would gain $211,600 or about 76% of that revenue. The buyer would gain $61,000 or 22% and third parties would gain $4800 or about 1.7%. That is our average of the transactions that we have, based on the tapes that we have so far which illustrate that there will be a total of 20,000 forms that we will have received.

The Chairman: Senator Byrd just established the revenue loss of this program. Are those figures still the same, Mr. Chapoton, the revenue loss figures, what the Treasury now indicates that the revenue loss is?

Mr. Chapoton: The revenue loss figures we are estimating would be $3.2 billion in 1982, below $50 million in 1981, $3.2 in 82, $3.8 in 83, $5.4 in 84.

The Chairman: Are these in line with the original estimates?

Mr. Chapoton: Yes, they are the original estimates. On the data we have received so far, the only thing we have been able to tell is that the total volume is consistent with our revenue estimates, but we are analyzing further the particular lease transactions and will be able to determine with more certainty how close our revenue estimates are. But of this total volume of safe harbor leasing, the original estimates were quite close.

The Chairman: Senatory Byrd?

Senator Byrd: On this, you say X purchases equipment for a million dollars. Who puts up the million dollars?

Mr. McConaghy: Well, X does, Senator Byrd, and then it turns around and sells immediately. It, X, is a non-profitable company that needs that equipment and its business will be the user. But essentially, it cannot use the tax benefit, so it will put up that money, essentially turn right around and sell it to a profitable company for cash, plus a non-recourse loan for the rest of the payment.

Senator Byrd: Is it correct that they pay a million dollars in cash. Now, they get back --

Mr. McConaghy: No, not in cash. To the seller of the equipment, that is right.

Senator Byrd: X is the corporation that does not expect to make a profit?

Mr. McConaghy: That is right.

Senator Byrd: It pays a million dollars for the piece of equipment; then it sells that million dollar piece of equipment and gets $214,000 for it.

Mr. McConaghy: That is correct.

Senator Byrd: And a note for the rest.

Mr. McConaghy: That is correct.

Senator Byrd: So they would then recoup that $700,000 and some over a period of nine years. They would not get it back immediately; they would get it back over a period of nine years.

Mr. McConaghy: That is right. They, however, would have to pay rent for using that piece of equipment.

Senator Byrd: That is how they get it back?

Mr. McConaghy: Yes, and that would cancel out exactly the payments on the note from the profitable company to the non-profitable company.

Senator Byrd: What I am trying to get clear is, do they have to actually put out a million dollars?

Mr. McConaghy: No.

Senator Byrd: If they go out on the open market and buy a piece of equipment for a million dollars, someone has to pay for it.

Mr. McConaghy: To a person who constructs the equipment, that person is going to end up probably getting cash of a million dollars. The non-profitable company will go out and finance the purchase of that equipment. It will pay whatever down payment it has and finance the balance of it, and it will turn around and sell that to the profitable company, receive a down payment from it of cash, plus take back a non-recourse note.

It, then, the user has to pay rent for using the equipment, but the buyer, the profitable company, will have to pay level payments for the balance of the note.

Mr. Chapoton: Senator, the net result to the user, the lessee, is for a million dollar piece of equipment you pay $788,000, and the lease transaction gives him up front a portion of the tax benefits that would be earned over the useful life of that property, in this case of $277,000. So that is the cost.

Senator Byrd: Thank you.

Mr. McConaghy: On the transfer of that, meaning when the loss company sells the equipment to the profitable company and then the profitable company leases it back under the safe harbor rules, essentially that is somewhat of a paper transaction and the ownership itself can and does end up with a non-profitable lessee.

Senator Byrd: But what is not a paper transaction, as I visualize it, is someone has to pay a million dollars for the equipment to get it in the first place, is that not correct?

Mr. McConaghy: That is correct.

Senator Byrd: And that would be the unprofitable company that assumes that obligation.

Mr. McConaghy: That is correct.

The Chairman: Have you found any cases that are not turning out the way you anticipated, as you review the 20,000? I mean, is it working like the Treasury thought it would?

Mr. Chapoton: We are still looking at it, but basically I think it is correct to say it is working like we thought it would. That is, the transactions are certainly being done, the equipment is being purchased, and the costs, a portion of the present value of the future tax benefits, are being realized by the users of equipment, the lessees. And those tax benefits would not be available to them outside of leasing.

That is the basic structure.

The Chairman: I read today that Mr. Weidenbaum is indicating strong support for leasing. I assume that is the Administration's position?

Mr. Chapoton: Mr. Chairman, we want to look very closely at this data. It requires a lot of analysis. The Joint Committee staff is doing it and we are doing it. So I think at this time let us look at that. We still have been supportive and there is no reason to back up on our support yet, but we do want to look at the data thoroughly.

Senator Long: Let me ask one or two questions. In 1982 how mucch do you think the investment tax credit plus the ACRS is costing the Treasury in terms of revenue? In other words, assuming that you did not have those, how much additional revenue would you have flowing into the Treasury other than this leasing?

I see it is $3.2 billion on leasing. The investment tax credit and the ACRS, how much are they accounting for in those years, '82, '83 and '84?

Mr. McConaghy: Senator Long, the investment credit itself presently is about $20 billion.

Mr. Chapoton: Senator, I can give you the figure readily on what the changes in '81 cost, but I do not have available what the credit cost by itself.

Mr. McConaghy: We have the increased estimates on the capital cost recovery provisions, Senator Long. But if you want the total figures on what essentially the revenue is from all of the ITC and the depreciation, it would take a couple of minutes to get that for 1982.

Senator Long: I would not think it would take long for you to give us an educated guess as to what the accelerated depreciation and the -- I guess for my purposes it is really worth thinking about all depreciation. What does that cost?

Basically we are talking about being able to sell depreciation. We are talking about being able to sell depreciation, plus sell the investment tax credit. That is what we are talking about. We are talking about a situation where some get it and some do not.

Now, it is worth thinking in terms of how much will that cost the treasury? The $20 billion for investment tax credit -- take just the accelerated depreciation. How much did that cost the treasury? Add all of it, all of the accelerated depreciation, what we had before plus what we have added on now.

Mr. McConaghy: We will have that for you in a minute.

We are just adding up the pieces.

The Chairman: While they are adding that up, could I ask, Mr. Chapoton, were the results in the GE transaction, those could have been anticipated? That is no problem for Treasury?

Mr. Chapoton: Well, Senator, all we know about that transaction, all I know about it specifically is what I read in the newspapers. I guess it should not surprise one if you have this in the law, because it was a case where GE paid, I think the estimates were, $300 or $400 million for these benefits. So it got a return on that $300 or $400 million investment.

I understand, and I understand this from just discussions, not from seeing any figures, that net cash in last year that GE was behind, that is it certainly paid more in dollars than it got in tax benefits in that year. So the benefit to GE will come in tax benefits in later years, which presumably, if things go as planned, would result in $300 or $400 million, resulting in a return on its investment.

Senator Long: You can give me the rest of it when you can get it. But here is the point I am getting to. When one talks about reducing the tax liability, let us say, for General Electric and IBM, as a practical matter the tax liabilities have not been reduced any more than it would reduce their tax liability if they took some of their money and bought a tax anticipation certificate, and then when their tax came due they just handed you the tax anticipation certificate as part of the consideration that they were using, along with cash, to pay for their taxes.

Because if they owe $345 million in taxes and they buy -- if they buy someone else's credits, it really works out about the same as it would if they were buying a tax anticipation certificate. Then they are buying something that they could use to help pay taxes with, but it does not reduce their tax liability.

Mr. Chapoton: Technically, it reduces the amount they would write as a check to the U.S. Government. Instead, they write a part of that check to someone else, that is correct. I would agree, it is exactly comparable to some sort of tax anticipation certificate.

Senator Long: And so now, it seems to me that to a considerable degree the merits of this proposition were prejudiced by the fact that in putting it into effect this thing was calculated as though GE had reduced their tax liability from $345 million, let us say, down to $45 million, something like that, by buying these certificates.

As a practical matter, it seems to me that, talking about it more in advance, we should have written this so that the tax liability, the $345 million, that is the taxes they pay, and then below that they can write how they paid it, whether it was all in cash or buying tax credits from other people or what.

But insofar as they are buying these tax credits from others, they are paying money for that, that they are out of pocket for that. And when you look at what GE or IBM make out of it, I think people are overlooking what they could have made with the same money if they had just bought a bond, any bond, corporate bond, federal bond, bought a bond or bought money market certificates.

That has not apparently been taken into account when you hear those figures as to what the profit company is making out of this compared to the losing company, because if you take that into account the profit company is not making much, nothing like 17 percent, for example, over and above the interest on the money.

Mr. Chapoton: That is correct. I think that is a correct analysis, and that is what we are trying to examine in a lot more detail. The profit company is making a return on its investment or it would not otherwise make the investment.

There is a lot of discussion on whether the return is unreasonably high for one reason or another. It would be hard to believe that it is unreasonably high if the marketplace is working correctly.

Senator Long: Well, Dr. Morton Feldstein has been a very competent and able witness before this Committee. He just pointed out to me in an informal conversation that it is made to look as though the profit companies are making a lot more out of this than is the case by the fact that you are not looking at the interest that their money would have earned if, instead of buying someone's investment tax credit, they had just bought a piece a piece of commercial paper out there on the market and collected their interest on that money as part of the overall transaction.

The Chairman: Are they not getting a better return on their money?

Mr. Chapoton: That is what we are trying to see. Not necessarily. I have heard it suggested that some of them are getting a smaller return than they would obtain from other comparable investments.

The Chairman: Does the Joint Committee agree with that?

Mr. McConaghy: We are also doing some work on that, Senator Dole. But in the example, for instance, we have assumed the 12 percent return, and of course the buyer gets that additional amount on top of the 12 percent return. There are some other things that have to be cranked in, but certainly we will try to provide that return.

Senator Byrd: Just for clarification, I thought that your sheet showed that it was a 22 percent return, Mark.

Mr. McConaghy: No, Senator Byrd. What I was saying was that of that revenue essentially, the revenue loss from that transaction, 22 percent of the revenue loss --

Senator Byrd: 22 percent of the revenue loss came from the profitable company?

Mr. McConaghy: Went to the profitable company, 76 percent to the non-profitable company, and 2 percent to outside parties.

Senator Long, we do have those figures.

Senator Long: To properly analyze that, you have to reduce that 22 percent by what they could have made if they had taken their money over the period that this transaction is taking place and simply put it in commercial paper.

Mr. McConaghy: That is correct, and that is what we are in the process of doing, Senator Long. And we will publish that data. We will try to tell you exactly what that rate of return is and --

Senator Long: Up until recently you could get 16 or 17 percent in the money market, for example.

Mr. McConaghy: Using -- this is using the 12 percent after-tax discount, and there would certainly be a higher return to the buyer than the 16 or 17 percent, Senator Long. We will try to provide that.

Senator Long: So the 22 percent comes down by more than 50 percent.

Mr. Chapoton: I think the 22 -- we are not talking about the same thing.

Senator Long: If you are talking about what General Electric is making out of it or what IBM is making out of it, my impression is that it is more like 5 percent than it is 22 when you look at what the interest on the money would be and that type of thing, the interest on the money during the payoff period and considerations of that sort. It is nothing like the gross figure that you can come up with.

Mr. McConaghy: Senator Long, what really would be happening here is that the buyer would be getting a 12 percent after-tax return plus $60,000. Now, if it were in a 46 percent tax bracket, that 12 percent after-tax return is obviously somewhere around 22 to 23 percent pre-tax, plus $60,000.

But to be able to crank all the things in, which we shall do, we will have it for you.

Senator Long: Do you have the figure that you started to give, the cost of the accelerated depreciation?

Mr. McConaghy: Yes. For 1983 we show about $15 billion for accelerated depreciation, about $20 billion in investment tax credit. And then we have safe harbor leasing, which we have another $2.2 billion in accelerated depreciation and about $1.4 billion of investment tax credits.

And the investment tax credit would be $31.4 billion and accelerated depreciation $17.2 billion, taking into account the ITC and accelerated depreciation and safe harbor.

Senator Long: The point that gets me to is this. What you have here with safe harbor leasing is to permit all the companies that earn an investment tax credit by making the investment and the companies that earn the right to accelerate depreciation by buying the equipment, all of which we are trying to encourage to make the economy expand, all those companies that participate in that being permitted to sell their tax credits and their accelerated depreciation, in many instances that is the difference between making it and not making it.

Now, those are the people who need it. Now, on the other hand you are coming up with -- here is an item that costs about ten percent of what the investment tax credit and the accelerated depreciation is costing, and to deny that to these companies involved is a matter of putting a tax subsidy on a basis that those who need it the most do not get it and those who need it the least do get it, and that is totally contrary to any theory I have ever seen in my life.

A subsidy is supposed to help the guy that needs it the worst first, and the people that need it the least are supposed to get it the last. And to repeal this would do just exactly the opposite, and to me that is totally unfair.

Furthermore, when you talk about the saving, I am told -- and the more I think about it, I believe this is correct -- that you do not have $3.8 billion you are going to pick up, for a reason. These companies are going to merge. They are going to sell out. They are going to do whatever they can to survive or to sell what they have left, including those tax credits, to someone, even if they have to sell them the whole company in order to take advantage of whatever assets they have.

And those tax credits are assets and those deductions are assets if they move timely. So to a large extent I am told that these people are going to find ways to use these tax credits and deductions, except it is going to happen in a less desirable way -- mergers, which tend to reduce competition, and matters of that sort.

Now, that is bad for the economy, Mr. Chapoton. Are you not interested in continuing as much competition out there in the free marketplace as you can?

Mr. Chapoton: Yes, Senator, that is a very real concern, and it is indeed the principal concern that gave rise to our proposing the safe harbor leasing. That is, that these benefits will not be allowed to lie on the table or disappear. They will be utilized either through mergers or through the old law leasing rules, which are less efficient.

So some system we felt needed to be designed to allow some slippage, some passage of those benefits in the system in the most efficient way possible. That is the purpose of safe harbor leasing, and those problems will indeed be brought back to the table if safe harbor leasing is repealed.

Senator Long: That is why it seems to me that if you are thinking in terms of tax uniformity, which I think is a crucial principle to taxation, tax uniformity, tax fairness, tax equity, all of that dictates just what you have been supporting up until now, Mr. Chapoton, with regard to the safe harbor leasing.

Now, there are a lot of people that might not understand that. I see Mr. Herblock with his cartoons saying -- looking as though it is a joke, that poor people go up to the Treasury and they want to sell their deductions and cannot do it.

We started out giving them a better deal than this with the earned income credit. They got a refundable tax credit for 100 cents on the dollar to the extent that we provided for them, and we are rather proud of doing that. I had something to do with it. I am rather proud of that.

That is the same principle. We did not start out applying that principle to the benefit of the rich; we started out using it for the benefit of the poor.

And just in terms of what you are trying to achieve, I think that the leasing makes all the sense in the world. I have said many times, I prefer to do it the same way we do it for the poor, do it as a refundable tax credit. But I am told that there were other problems, that it would be difficult to administer, it would be more difficult to keep up with the small companies and all.

At least the leasing provision seems to be a self-policing kind of thing, because the profit company has the burden of watching the non-profitable company to see that they really earn their credits. So that has an advantage in that respect.

Mr. Chapoton: That is correct.

Senator Byrd: But to me, I think it would be a mistake, and in my judgment even an injustice, to take the leasing away from the companies that need it. What is Eastern Airlines going to do, for example, if we do this to them? They would have to merge with someone or they are going to be in a very serious circumstance trying to fly their airplanes. Is that correct or not?

Mr. Chapoton: I believe they have stated that, and I repeat, those situations will have to be examined very closely if there is any serious cutback on safe harbor leasing.

Senator Long: I was one of those that voted to save the Chrysler Corporation. We put taxpayers' money right into it. And it seems to me between keeping Chrysler afloat and helping Chrysler to move ahead, it is better to let them sell their tax credits than to have to put more federal funds directly into it.

And with regard to these other companies, as between forcing the company to merge in order to use something that is rightfully theirs and letting them sell their tax credits, I think it would be better to let them sell the credit. So it seems to me that this is a good proposal compared to the alternative. If the alternative is to deny it to those who need it the most, I think it is a good proposal.

Mr. Chapoton: That is the purpose, to equalize the cost of equipment to all companies. That is the purpose of safe harbor leasing.

The Chairman: Senator Chafee, I am going to have to leave, and maybe you could close the meeting. I will say as I leave that we will be looking at some modifications of this proposal. I guess there are several options, one being repeal, another being refundability, another one being a number of modifications in the effective date.

Some suggest January, some have suggested February 19th, at least one person I know of. And as far as I know that date has not been changed. I have had a lot of phone calls saying -- I was going to have a press conference with Don Regan and announce a new date. He has not called me.

But I think Senator Long makes some good points. There are ways we can take care of mergers, that we can discourage those without keeping this program in full force. But it is a problem we are going to have to deal with.

We hope that today we have outlined some areas that will keep members busy during the recess, so that we can make some decisions as soon as we come back. Having said that, Senator Chafee and then Senator Matsunaga.

Senator Chafee: Thank you, Mr. Chairman.

Mr. Chapoton, it seems to me the problem here is that not the lessee in which Eastern is going to buy the Boeing aircraft -- and that is splendid, that does exactly what we are trying to do under the accelerated cost reduction system and under the safe harbor leasing -- but the problem comes with the perception of the lessor.

And so what are some suggestions which you might have as regards that perception? Somehow to have a company purchase -- if someone is going to sell them, you have to have someone there to buy them, obviously -- however, to have someone buy them and then end up with no taxes obviously has an adverse public perception to it.

Now what do you propose? What might we do? Not permit such purchases to bring a corporation's tax liability down to zero? Would that be covered by your minimum tax?

Mr. Chapoton: That is what I was going to say. That is covered by our minimum tax. So if the minimum tax we propose were in place, it would require that a corporation that engages in safe harbor leasing from the lessor's standpoint have some tax liability. It could not use this benefit, the benefits acquired through the lease, to reduce its effective rate to lower than 15 percent. So it would put a floor on the tax liability.

Senator Chafee: Therefore, they would not buy any tax credits?

Mr. Chapoton: They would stop sooner.

Senator Chafee: We had testimony here that there are plenty of buyers out there, so it would really are not affect the situation dramatically.

Mr. Chapoton: That is important, too. It is important that for this to work efficiently, there has to be an ample supply of buyers out there, yes.

Senator Chafee: Well, do you have any legislation, your way of treating it would be through the minimum tax rather than any specific legislation saying that you could not buy any more than to bring your tax down below a certain amount?

Mr. Chapoton: That would really be the same effect.

Senator Chafee: All right. Thank you.

Senator Matsunaga: Mr. Chapoton, the Treasury is not proposing a repeal of the safe harbor lease-back provision, is it?

Mr. Chapoton: Absolutely not. No, sir.

Senator Matsunaga: Now, the question, I suppose, as to whether there should be repeal or modification could be based on abuse of the safe harbor leasing provisions. Now, from the point of view of the Treasury, have you seen any abuse of that provision?

Mr. Chapoton: Senator, I would like to avoid answering that too specifically, because we want to review the exact facts. We read in the newspapers a lot of alleged abuses. We now have good information.

I think it is sometimes perceived as an abuse if the lessee is in a different rate of tax, paying a different rate of tax than a lessor. It is sometimes suggested that there might be an abuse where the taxpayer has current profitability but no tax liability.

Senator Matsunaga: Let me put it this way. If that were an abuse, that makes it a little difficult. Is the safe harbor leasing provision working as you had anticipated, or is it working as though you have lost control over it?

Mr. Chapoton: Clearly, it is not out of control, which was suggested earlier on. That we know by the total volume that we have picked up in our survey or in the Internal Revenue forms that have come in as compared to our estimate of the total volume of safe harbor leasing.

But we need to study the figures a lot more to see if it is working exactly as we planned. Certainly, it is working. Certainly, there is a high degree of efficiency in some of the transactions, a low degree of efficiency in some others. We need to see why that is. We just need to do a lot more analysis. It is very complicated.

Senator Matsunaga: I suppose the bottom-line question would be, have you lost by way of revenues more than you had anticipated or just about what you had expected?

Mr. Chapoton: All indications so far are just about what we had expected, but we will know more about that.

Senator Matsunaga: When will you know?

Mr. Chapoton: Within the next 2 weeks. We have more information now, and we are running through the tapes. We will have more information in the next couple of weeks.

Senator Byrd: Could I ask just one question?

Mr. McConaghy, does the staff have any recommendations? I understand you have been working on this. Do you have any recommendations as to how this might be modified?

Mr. McConaghy: We do not yet, Senator Byrd. But perhaps we will be able to make those recommendations after the Easter recess.

Senator Byrd: Thank you.

Senator Grassley: I have a point I would like to bring up that does not deal with just the selling of the credits, but it does deal with some changes we made in the last law. And I am not really addressing these to the administration, since you are not suggeting any changes in the law. But I would like to have you be aware of it just in case it does come up for discussion with regard to any changes we do make in the law.

That deals with the subject of our retaining the fixed purchase price when a lease is signed as opposed to the old law where there had to be a fair market value determination if there was going to be a purchase of that piece of equipment.

Now, these changes had been made, and it is working well. And there are people now beginning to make use of these changes in the leasing law. And to the extent to which we are talking about repealing safe harbor leasing, these could be lost in the shuffle when actually there is not any abuse of this program.

So I would like to know how you might look at that in the case that you might consent later on to some change in the leasing law and whether or not you would see anything wrong if we would single this out and not change the changes that were made in the last law. Either one of you.

Mr. Chapoton: Senator, if safe harbor leasing were repealed tomorrow, that would be a principal problem we would have, because you would then fall back, without safe harbor leasing we are under the old leasing rules. One of the rules was there had to be a fair market value; the purchase could not be any greater benefit to the lessee than a fair market value purchase option at the end of the term of the lease. That caused a lot of problems.

That resulted in the airlines purchasing back their airplanes at the end of a 15-year lease at the increased value that the quipment had at that time. That was a real problem.

On the other hand, that was also the factor of the old rules which gave economic substance, if you will, to the lease transaction.

All I can say is that if safe harbor leasing is dramatically cut back, that will be a principal problem which this committee will have to address.

Mr. McGonaghy: I think, Senator Grassley, as Mr. Chapoton says, if it were repealed, I think that would be a problem. I think certainly your suggestion of saying that if you determine fair market value at the time you went into the transaction, then that would satisfy essentially the requirement that was contained in the old rules. Something like that certainly could be looked at.

Senator Grassley: Okay. Well, at this point, since August, when the law went into effect, we have not noted any abuse of these provisions. And I know the term "abuse" is a questionable term to use because it depends upon whom we are looking at and what good we attempted to accomplish.

But at least we have not seen people reduce their taxes down to practically nothing as a result of this provision in the law. So there has not been abuse in that fashion; right?

Mr. McGonaghy: Well, we are still looking at that, Senator Grassley, and it is difficult to answer. We do see transactions which are essentially between the parent and subsidiary, they are filing consolidated returns.

We are analyzing those to see if it is a question of the net income limitation on depletion or essentially foreign tax credit or why they are entering into a lease between the parent and sub. And I do not think we are prepared to really give you an answer to that yet.

Senator Grassley: Thank you. The meeting is adjourned.

[Whereupon, at 3:55 p.m., the Committee was adjourned.]

STATEMENT BY SENATOR MALCOLM WALLOP

BEFORE THE SENATE COMMITTEE ON FINANCE

APRIL 1, 1982

As we begin this mark-up this afternoon, I feel compelled to make a few comments to bring into perspective my conviction on how I feel we should proceed as we begin to consider Committee selected portions of the Administation's budget proposals and some of our own as well.

As a preliminary matter, I am absolutely amazed by the attention this Congress seems to pay to the budget deficit projections. Trying to decide which numbers we should be using, is sort of like deciding whether, given the choice, I would rather have Hong Kong Flu ~~measles~~ or the Bitter flu. I don't want either one, but in either ~~both~~ ~~cases~~ case there is no doubt I'm sick. This budget deficit projections game we seem to have a preoccupation with is ridiculous - Regardless of ~~it makes no difference~~ whose figure we adopt ~~-~~ it will be wrong. The pure fact of the matter is that any deficit is too high, and our efforts must be focused on how we are going to reduce it.

What distresses me even more about the exercise we have been going through the last couple of months are the indications I am seeing that the Congress has really not changed all that much from just a few short years ago. If there is a way to reduce expenditures or raise revenues in one place, someone else has two ideas of where we can spend it in another. It is something I will have no part of. If we are really serious about making budget cuts and about looking at entitlement spending, as I think we have to be - we must do so with the thought in mind that the money saved will reduce the deficit and not pay for another program somewhere else in the budget. Be assured that I will vote for no tax increase until we commit to expenditure cuts. And just as certainly, I will not vote to raise new revenue, new taxes, to give this Congress more money to spend with its accustomed blank check attitude, as if there were no tomorrow.

We took a ~~the~~ first step last year. We did reduce the rate of growth in government spending. Now, we have got to have the courage to take the next step, and take it soon. If we don't, the numbers which are really important - the unemployed, the housing starts, the growth in GNP, and business failures, can do nothing but get worse. Worse not because we have a $100 billion dollar deficit, but because our businesses - our people will not have the confidence that this Congress is serious about bringing government spending under control. It is the cloud of uncertainty which is strangling this country, and it is time we did something about it.

We can talk of raising revenues until we take it all and parcel out our idea of largesse from one end of the country to the other, - and guess what - we would still deficit spend unless we stop buying our reelection with promises of universal Valhalla.