SAVINGS AND RETIREMENT PROPOSALS

HEARING

BEFORE THE

SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

ON

S. 829, S. 1607, S. 1645, S. 1855, and S. 1888

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FRIDAY, DECEMBER 4, 1981

U.S. SENATE,
SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT,
COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:48 a.m., in room 2221, Dirksen Senate Office Building, Hon. John H. Chafee (chairman of the subcommittee) presiding.

Present: Senators Chafee, Symms, Bentsen, Baucus, and Moynihan.

Senator CHAFEE. Good morning, everyone. I apologize for being a little late. As you know, we were here quite late last evening, actually early this morning.

Today the subcommittee is going to have hearings on five bills related to savings, pensions, and investment policy. The agenda today features S. 829, introduced by Senator Baucus, which provides a cost of living increase in annuities for survivors of U.S. Tax Court judges, and S. 1607, introduced by Senator D'Amato, making permanent the $200 to $400 interest and dividend exclusion which is scheduled to expire next year pursuant to the economic recovery bill we passed earlier this year.

[The committee press release announcing this hearing; the bills S. 829, S. 1607, S. 1645, S. 1855, and S. 1888; and the description of these bills by the Joint Committee on Taxation follow:]

Press Release No. 81-178

P R E S S R E L E A S E

FOR IMMEDIATE RELEASE
November 12, 1981

COMMITTEE ON FINANCE
UNITED STATES SENATE
Subcommittee on Savings,
Pensions, and Investment Policy
2227 Dirksen Senate Office Bldg.

FINANCE SUBCOMMITTEE ON SAVING, PENSIONS, AND INVESTMENT POLICY SETS HEARING ON SAVINGS AND RETIREMENT BILLS

The Honorable John H. Chafee (R., Rhode Island), Chairman of the Subcommittee on Savings, Pensions, and Investment Policy of the Senate Committee on Finance, announced today that the Subcommittee will hold a hearing on December 4, 1981, to discuss three tax bills.

The hearing will begin at 9:30 a.m. in Room 2221 of the Dirksen Senate Office Building.

The following proposals will be considered at the hearing:

S. 829-Introduced by Senator Baucus. S. 829 would provide for cost-of-living adjustments in annuities for survivors of Tax Court judges.

S. 1607-Introduced by Senator D'Amato, with Senators Durenberger, Bradley, Mitchell, Heinz, and others. S. 1607 would provide for a minimum interest and dividend exclusion of $200 per individual.

S. 1645-Introduced by Senator Moynihan. S. 1645 would allow funds in individual retirement accounts to be used to purchase collectibles.

Press Release No. 81-178
(revised)

P R E S S   R E L E A S E

FOR IMMEDIATE RELEASE
December 2, 1981

COMMITTEE ON FINANCE
UNITED STATES SENATE
Subcommittee on Savings, Pensions, and Investment Policy
2227 Dirksen Senate Office Bldg.

SENATE FINANCE COMMITTEE SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY INCLUDES ADDITIONAL BILL IN HEARING ON SAVINGS AND RETIREMENT BILLS

The Honorable John H. Chafee, (R., Rhode Island), Chairman of the Subcommittee on Savings, Pensions, and Investment Policy, announced today that an additional bill will be considered at the Subcommittee's hearing on savings and retirement bills scheduled for December 4 at 9:30 a.m.

In addition to bills already scheduled for consideration at the hearing, the following legislative proposal will be considered:

S. 1855--Introduced by Senator Bentsen for himself and Senator Tower. Would make section 457(e)(1) of the Internal Revenue Code of 1954 inapplicable to certain State judicial retirement plans.

DESCRIPTION OF TAX BILLS

(S. 829, S. 1607, S. 1645, S. 1855, and S. 1888)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on December 4, 1981, by the Senate Finance Subcommittee on Savings, Pensions, and Investment Policy.

There are five bills scheduled for the hearing: S. 829 (relating to cost-of-living increases in annuities for survivors of Tax Court judges), S. 1607 (relating to permanent extension of, and increase in, dividend and interest exclusion), S. 1645 (relating to investments in collectibles under certain retirement arrangements), S. 1855 (relating to certain State judicial retirement plans), and S. 1888 (relating to tax treatment of certain variable annuities).

The first part of the pamphlet is a summary of the bills. This is followed by a more detailed description of the bills, including present law, issues, explanation of provisions, effective dates, and estimated revenue effects.

I. SUMMARY

1. S. 829—Senator Baucus

Cost-of-Living Increases in Annuities for Survivors of Tax Court Judges

The bill would provide cost-of-living increases for annuities payable to survivors of judges of the Tax Court by providing that the annuities generally would be increased as the salaries of judges of the Court are increased, but at a lower rate.

Generally, the bill would apply after the date of enactment. However, a catch-up provision is provided for annuities presently in pay status.

2. S. 1607—Senators D'Amato, Hawkins, Durenberger, Specter, Bradley, Mitchell, Cochran, Helms, and Heinz

Permanent Extension of and Increase in Dividend and Interest Exclusion

Individuals may exclude from income up to $200 ($400 on a joint return) of dividends and interest earned from domestic sources in 1981. After 1981, individuals may exclude from income up to $100 ($200 on a joint return) of dividend income. The Economic Recovery Tax Act of 1981 provides for a 15-percent net interest exclusion on up to $3,000 of net interest ($6,000 on a joint return), effective in 1985 and subsequent years. For taxpayers who itemize deductions, interest is eligible for this new exclusion only to the extent that it exceeds the taxpayer's qualified interest expense. In general, qualified interest expense is deductible interest paid or incurred by the taxpayer during the year, other than interest on a home mortgage or interest paid or incurred in the taxpayer's trade or business.

The bill would make the $200/$400 dividend and interest exclusion permanent. In addition, beginning in 1985, the bill would allow taxpayers to exclude (1) $200 ($400 on a joint return) of dividends and interest income, plus (2) the lesser of $250 ($500 on a joint return) or the amount of qualified excess interest. Qualified excess interest would be 15 percent of the excess of interest income, reduced by $200 ($400 on a joint return), over qualified interest expenses for the taxable year.

The provisions making the current dividend and interest exclusion permanent would apply to taxable years beginning after December 31, 1981. The additional exclusion for qualified excess interest would apply to taxable years beginning after December 31, 1984.

3. S. 1645—Senators Moynihan and Symms

Investments in Collectibles Under Certain Retirement Arrangements

Under present law, individuals generally may self-direct investments under individual retirement accounts (IRAs) or under an account in a qualified plan. Under the Economic Recovery Tax Act of 1981, amounts invested in collectibles (antiques, art, gems, stamps, etc.) under an IRA or an individually-directed account in a qualified plan are to be treated as distributions for income tax purposes. The 1981 Act provision will be effective for acquisitions of collectibles after December 31, 1981.

The bill would repeal the 1981 Act provision with respect to the treatment of collectibles, with the same effective date as the 1981 Act.

4. S. 1855—Senators Bentsen and Tower

Certain State Judicial Retirement Plans

Subject to certain limits, compensation deferred by an employee under an eligible State deferred compensation plan is excluded from the employee's income until paid to the employee under the plan. If the plan is not an eligible plan, benefits payable under the plan are included in gross income when there is no substantial risk that the benefits will be forfeited.

The bill provides that participants in a qualified State judicial plan would not be subject to the rule requiring participants in an ineligible plan to include plan benefits in gross income merely because there is no substantial risk that the benefits will be forfeited. The bill would apply to taxable years beginning after December 31, 1978.

5. S. 1888—Senators Symms, Grassley, Durenberger, and Chafee

Tax Treatment of Certain Variable Annuities

Under Revenue Ruling 81-225, earnings on shares of a mutual fund purchased with amounts invested under a wraparound annuity contract generally are taxed currently to the contractholder, if the shares are available for purchase by the general public. The bill generally would codify the result reached in the Revenue Ruling. The bill would preclude the retroactive application of Rev. Rul. 81-225, which was released on September 25, 1981, and generally would apply to amounts invested under a variable annuity contract after that date.

II. DESCRIPTION OF THE BILLS

1. S. 829—Senator Baucus

Cost-of-Living Increases in Annuities for Survivors of Tax Court Judges

Present Law

Present law provides that, at the election of a judge of the United States Tax Court, three percent of the judge's salary is withheld and credited to the "Tax Court judges survivors annuity fund." If a judge electing coverage under the survivors annuity fund dies while a judge and after completing at least five years of service for which salary was withheld for the fund (or for which salary was withheld under the civil service retirement laws), a surviving spouse or surviving dependent child is entitled to an annuity from the fund. If the surviving spouse has not attained age 50 at the date of the judge's death, the annuity commences when the surviving spouse attains age 50. The annuity payable to a surviving spouse terminates upon the spouse's remarriage or death. The annuity payable to a child generally terminates when the child attains age 18.

The annuity payable to a surviving spouse of a judge is equal to a stated percentage (generally 1¼ percent) of the average annual salary (whether judge's salary or compensation for other allowable Federal service) for the five consecutive years for which the judge received the largest average annual salary, multiplied by the sum of the judge's years of judicial or other allowable Federal service. However, the annuity for the surviving spouse cannot exceed 37½ percent of such average annual salary. The amount of the annuity payable to a surviving dependent is based upon the annuity payable to a surviving spouse (subject to certain limits).

The annuity payable to a surviving spouse or surviving dependent is not adjusted for cost-of-living increases.

Issue

The issue is whether the annuity payable to a surviving spouse or a surviving dependent of a Tax Court judge should be adjusted for cost-of-living increases in the future and whether a cost-of-living adjustment should be made retroactively for survivor annuities presently in pay status.

Explanation of the Bill

The bill would adjust an annuity payable to a surviving spouse or a surviving dependent of a Tax Court judge for cost-of-living increases by increasing the amount of the annuity when the salary of judges of the Tax Court is increased.

The bill would affect each annuity payable from the survivors annuity fund which is based in whole or in part upon a deceased judge having rendered some portion of his or her final 18 months of service as a judge of the Tax Court. Under the bill, each such annuity would be increased by three percent for each five percent when the salaries of judges of the Tax Court are increased. If the salary increase is less than five percent, the increase would be disregarded in computing current and future survivor annuities.

The bill includes a catch-up provision for survivor annuities in pay status on the date of enactment. Under this provision, such an annuity would be immediately increased to reflect increases in the salary of judges of the Tax Court after December 31, 1970.

Effective Date

Except as described in the catch-up provision for survivor annuities in pay status, the bill would apply with respect to increases in the salary of judges of the Tax Court taking effect after the date of enactment.

Revenue Effect

It is estimated that the bill would increase fiscal year budget outlays by less than $50,000 annually.

2. S. 1607—Senators D'Amato, Hawkins, Durenberger, Specter, Bradley, Mitchell, Cochran, Helms, and Heinz

Permanent Extension of and Increase in Dividend and Interest Exclusion

Present Law

Present law (section 116, as it applies to taxable years beginning after December 31, 1980, and before January 1, 1982) provides that up to $200 ($400 for joint returns) of dividend and interest income from certain domestic sources is excludible from gross income. The Economic Recovery Tax Act of 1981 (Public Law 97-34) repealed this exclusion, effective for taxable years beginning in 1982. For taxable years beginning after 1981, individuals will be able to exclude from gross income up to $100 of dividend income ($200 on a joint return). Taxpayers who invest in a qualified savings certificate may exclude from income up to $1,000 ($2,000 on a joint return) of interest earned on such savings certificates issued by commercial banks, thrift institutions, or credit unions.[1]

Effective in 1985, taxpayers will be able to exclude 15 percent of up to $3,000 of net interest ($6,000 on a joint return) (new Code sec. 128). Thus, the maximum exclusion will be $450 ($900 on a joint return). Net interest generally is defined as interest received by the taxpayer in excess of interest payments by the taxpayer for which an income tax deduction is allowed. However, mortgage interest and trade or business interest is not taken into account to reduce the amount of interest eligible for the exclusion. Mortgage interest, for this purpose, is interest paid on debt incurred to acquire, construct, reconstruct, or rehabilitate property the taxpayer uses primarily as a dwelling.

Interest eligible for the exclusion includes: (1) interest on deposits received from a bank; (2) interest (whether or not designated as interest) paid in respect to deposits, investment certificates, or withdrawable or repurchasable shares by a mutual savings bank, cooperative bank, domestic building and loan association, industrial loan association or bank, credit union, or other savings or thrift institution chartered and supervised under Federal or State law if the deposits or accounts of the institution are insured under Federal or State law, or protected and guaranteed under State law; (3) interest on bonds, debentures, notes, certificates, or other evidences of indebtedness of a domestic corporation which are in registered form; (4) interest on other evidences of indebtedness issued by a domestic corporation of a type offered by corporations to the public to the extent provided in regulations issued by the Treasury; (5)

[1] Qualified savings certificates are one-year obligations issued between October 1, 1981, and December 31, 1982. The certificates must pay interest at rates equal to 70 percent of the rate on the most recently issued 52-weeks Treasury bills. There are also certain requirements for investment of the proceeds from such savings certificates.

interest on obligations of the United States or a State or local government which is not already excluded from gross income; (6) interest attributable to a participation share in a trust established and maintained by a corporation established pursuant to Federal law (for example, interest attributable to a participation share in a trust established and maintained by the Government National Mortgage Association); and (7) interest paid by an insurance company under an agreement to pay interest on prepaid premiums, life insurance proceeds left on deposit, and, to the extent provided for in Treasury regulations, other amounts left on deposit.

Issue

Two general issues arise in connection with the bill. These are (1) whether the $200/$400 dividend and interest exclusion scheduled for repeal in 1982 should be made permanent and (2) whether the 15-percent net interest exclusion scheduled to take effect in 1985 should apply in addition to the $200/$400 exclusion.

Explanation of the Bill

Under the bill, individuals could exclude from income up to $200 ($400 on a joint return) of dividends and interest earned from domestic sources for taxable years beginning in 1982, 1983, or 1984. For taxable years beginning after December 31, 1984, the interest and dividend exclusion would be the sum of (1) $200 ($400 on a joint return) plus (2) the lesser of $250 ($500 on a joint return) or the qualified excess interest amount. Thus, the maximum interest and dividend exclusion for 1985 and subsequent years would continue to be $450 ($900 on a joint return).

The qualified excess interest would be 15 percent of the excess of interest income, reduced by $200 ($400 on a joint return), over qualified interest expenses for the taxable year. Qualified interest expenses generally would be the excess of total deductible interest over home mortgage interest and trade or business interest.

The operation of this provision can be illustrated by the following example. Assume that, in 1985, an unmarried taxpayer has interest income of $5,200 and deductible interest expenses of $6,000 ($2,000 of which is interest on a home mortgage). For the year, the taxpayer's exclusion would be $350, that is, $200 plus qualified excess interest of $150. Qualified excess interest would be 15 percent of the excess of $5,000 ($5,200 reduced by $200) over $4,000 ($6,000 deductible interest expense reduced by $2,000 home mortgage interest).

Under present law, the exclusion for 1985 would be $180, that is, 15 percent of the excess of $5,200 (interest income) over $4,000 ($6,000 deductible interest expense reduced by $2,000 home mortgage interest).

The bill would repeal the 15-percent net interest exclusion (new Code sec. 128, to be effective for taxable years beginning after December 31, 1984). The definition of interest, for purposes of the bill (both for purposes of the extension of the present law dividend and interest exclusion and the additional exclusion for qualified excess interest), would be the same as the definition of interest for purposes of the 15-percent net interest exclusion added by the Economic Recovery Tax Act of 1981 (see *Present Law* above.)

Effective Dates

The extension of the current dividend and interest exclusion would apply to taxable years beginning after December 31, 1981. The additional exclusion for qualified excess interest would apply to taxable years beginning after December 31, 1984.

Revenue Effect

It is estimated that the bill would reduce fiscal year budget receipts by $600 million in 1982, $2.7 billion in 1983, $2.8 billion in 1984, $2.3 billion in 1985, and $2.1 billion in 1986.

3. S. 1645—Senators Moynihan and Symms

Investments in Collectibles Under Certain Retirement Arrangements

Present Law

In general

Broad discretion generally is allowed with respect to investments by individual retirement accounts (IRAs) and tax-qualified pension, profit-sharing, or stock bonus plans if self-dealing is not involved.[1] Investments by IRAs or by individually directed accounts of employees under qualified plans are not governed by the prudent man and diversification standards of the Employee Retirement Income Security Act of 1974 (ERISA).

An individually directed account is an account in a qualified defined contribution plan. (*e.g.,* a profit-sharing plan) which permits the plan participant to exercise investment control over the assets in the participant's account.

Only a bank, insurance company, or other qualifying financial institution can act as an IRA trustee or custodian. However, the owner of an IRA can self-direct the investment of assets in the account.

1981 Act amendment

The Economic Recovery Tax Act of 1981 (Public Law 97-34) amended the Code generally to discourage IRAs and individually directed accounts in qualified plans from investing in collectibles. Under the Act, an amount in an IRA or in an individually directed account which is used to acquire a collectible is treated as if distributed in the taxable year of the acquisition. The usual income tax rules for distributions from an IRA or from a qualified plan apply, so that the amount considered distributed will generally be included in gross income and may be subject to an additional 10 percent income tax.

A "collectible" is defined as any work of art, rug, antique, metal, gem, stamp, coin, alcoholic beverage, or any other item of tangible personal property specified by Treasury regulations.

The Act applies to acquisitions of collectibles after December 31, 1981.

The adoption of the rule discouraging IRAs and individually directed accounts in qualified plans from investing in collectibles was designed to result in channelling tax-favored retirement savings to investments that contribute to the nation's economic recovery by providing a source of investment capital. There was also concern that the prior law rules, designed to discourage personal

[1] Special rules apply to investments by qualified plans in employer real estate. Also, investments by pension plans in employer securities are subject to a special limitation.

use of collectibles held for investment by an IRA or under an individually directed account, were not effective.

IRA investments and prohibited self-dealing

Under present law and prior law, if an IRA invests in such a way as to provide for the direct and immediate benefit to the IRA beneficiary (for example, if the account is used for a down payment on the house where he lives), then the entire account is deemed distributed.[2] Accordingly, if an IRA trustee transfers a collectible to the IRA beneficiary for the beneficiary's personal use, the entire amount in the IRA, including the fair market value of the collectible, is includible in the beneficiary's gross income for the taxable year.[3]

Investment and prohibited self-dealing under qualified plans

A distribution from a qualified plan is taxable to the distributee to the extent that the amount distributed exceeds the net amount of the employee's nondeductible contributions to the plan. If tangible personal property (including a collectible) is distributed from a qualified plan, the amount of the distribition for income tax purposes is the fair market value of the property, determined as of the date of the distribution.

ERISA generally prohibits a person who is a fiduciary with respect to a qualified plan from transferring plan assets to (or otherwise providing plan assets for the use or benefit of) any "party in interest," including a plan participant who is an employee of an employer maintaining the plan. In addition, under the Code, such a transfer of plan assets to (or providing plan assets for the use or benefit of) certain employees who are plan participants may constitute a "prohibited transaction" resulting in the imposition of an excise tax.[4]

The excise tax is imposed on the "amount involved" with respect to the transaction. Depending upon the facts and circumstances, this amount may be the fair market value of the asset or only the fair market value of the temporary use of the asset.

Issue

The issue is whether the rule adopted under the 1981 Act which discourages IRAs and individually directed accounts of employees under qualified plans from investing in collectibles should be repealed.

Explanation of the Bill

The bill would repeal the 1981 Act provision discouraging IRAs and individually directed acounts from investing in collectibles.

[2] See H. Rept. No. 93-1280. 93d Cong., 2d Sess., p. 339.

[3] Unless the beneficiary has attained age 59½ or is disabled, the penalty for early IRA withdrawals (an additional 10-percent income tax) will also apply to the deemed distribution from the IRA.

[4] The excise tax will apply if the individual benefitting from the transaction is an officer, director, or a shareholder (10 percent or more) of the employer, or is a highly compensated employee.

Effective Date

The repeal would apply to acquisitions of collectibles after December 31, 1981.

Revenue Effect

It is estimated that the repeal would have a negligible effect on budget receipts.

4. S. 1855—Senators Bentsen and Tower Certain State Judicial Retirement Plans

Present Law

Eligible State deferred compensation plan

Under present law (Code sec. 457(a)), employees of a State or local government or a rural electric cooperative are permitted to defer compensation under an eligible State deferred compensation plan if the deferral does not exceed prescribed annual limits (generally the lesser of $7,500 or 33⅓ percent of includible compensation). Amounts of compensation deferred by a participant in an eligible plan, plus any income attributable to the investment of such deferred amounts, are includible in the income of the participant or the participant's beneficiary only when paid or otherwise made available under the plan. An eligible plan is not permitted to make benefits available to a participant before the earlier of (1) the participant's separation from the service of the sponsoring entity, or (2) the occurrence of an unforseeable emergency.

Treatment of participants in an ineligible plan

If a deferred compensation plan fails to meet the requirements of an eligible plan, then all compensation deferred under the plan is includible currently in income by the participants unless the amounts deferred are subject to a substantial risk of forfeiture (sec. 457(e)). If amounts deferred are subject to a substantial risk of forfeiture, then they are includible in the gross income of participants or beneficiaries in the first taxable year in which there is no substantial risk of forfeiture.

This rule for the tax treatment of participants in an ineligible plan does not apply, however, if the tax treatment of a plan participant is governed by tax rules for the plan that are set forth elsewhere in the Internal Revenue Code. For example, the rule does not apply if the ineligible plan is a tax-qualified pension plan (sec. 401(a)), a tax-sheltered annuity program (sec. 403(b)), or includes a trust forming a part of a nonqualified pension plan (sec. 402(b)).

Issue

The issue is whether participants in certain State judicial retirement plans should be excluded from the rule requiring participants in ineligible plans to include plan benefits in gross income when there is no substantial risk that the benefits will be forfeited.

Explanation of the Bill

Under the bill, participants in a qualified State judicial plan would not be subject to the rule requiring participants in an ineligible plan to include plan benefits in gross income merely because there is no substantial risk that the benefits will be forfeited.

A State's retirement plan for the exclusive benefit of its elected judges or their beneficiaries would be a qualified State judicial plan if (1) the plan has been continuously in existence since December 31, 1978, (2) all judges eligible to benefit under the plan are required to participate and to contribute the same fixed percentage of their basic or regular rate of compensation; and (3) a judge's retirement benefit under the plan is a percentage of the compensation of judges of the State holding similar positions.

In addition, the plan could not pay benefits with respect to a participant which exceed the limitations on benefits permitted under tax-qualified plans, and could not provide an option to plan participants as to contributions or benefits the exercise of which would affect the amount of the participant's currently includible compensation. Further, a State's judicial retirement plan would not be a qualified State judicial plan if judges participating in the plan were also eligible to participate, on the basis of their judicial service, in any eligible State deferred compensation plan.

A plan would be considered as benefitting only a State's elected judges or their beneficiaries even though the plan benefits a judge serving under an appointment to complete the unexpired term of an elected judge.

Effective Date

The provisions of the bill would apply to taxable years beginning after December 31, 1978.

Revenue Effect

It is estimated that the bill would have a negligible effect on revenues.

5. S. 1888—Senators Symms, Grassley, Durenberger, and Chafee

Tax Treatment of Certain Variable Annuities

Present Law

In general

Under present law, tax on interest or other current earnings on a policyholder's investment in an annuity contract generally is deferred until amounts characterized as income are withdrawn or annuity payments are received (Code sec. 72(a)). Amounts paid out under a contract before the annuity payments begin, such as policy dividends or payments upon partial surrender of a contract, are first treated as a return of the policyholder's capital and are taxable (as ordinary income) only after all of the policyholder's investment in the contract has been recovered (sec. 72(e)). A portion of each amount paid to a policyholder as an annuity generally is taxed as ordinary income (under an "exclusion ratio" test),[1] as are policy dividends paid after annuity payments begin.

A life insurance company which issues an annuity contract is not taxed on its investment income[2] to the extent that income is required to be added to its policyholder reserves for the annuity contract (secs. 802(b), 804(a), and 809(a)).

Traditional commercial annuities

A commercial annuity contract is a promise by a life insurance company to pay to the beneficiary a given sum for a specified period, which period may terminate at death. Annuity contracts permit the systematic liquidation of an amount consisting of principal (the policyholder's capital) and income. The insurance company may take the risk that such amount will be exhausted before the company's liability under the contract ends but may gain if the liability terminates before that amount is exhausted.

The starting date for annuity payments may be within one year after the initial premium is paid (an immediate annuity) or may be deferred to a later date (a deferred annuity). The period between the time the first premium is paid for an annuity and the time the first annuity payment is due is referred to as the "accumulation period." Annuity payments may be payable for a period which

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[1] Each annuity payment received is generally allocated between ordinary income and excludable return of capital on the basis of the capital investment in the contract at the time annuity payments begin (the exclusion ratio). This allocation between income and capital continues for all of the annuity payments received by the policyholder even after all capital invested in the contract has been recovered tax-free. If the annuity terminates (for example, by reason of death) before capital is exhausted, no loss deduction is allowed. Under rules applicable to annuities under qualified pension plans, an employee's investment in the contract may be recovered first (Code sec. 72(e)).

[2] Capital gains are taxed to the insurance company unless the annuity is issued under a tax-qualified pension, profit-sharing, or stock bonus plan, an individual retirement annuity, or a tax-sheltered annuity, and the assets under such arrangements are held in segregated asset accounts that are not part of the general assets of the insurance company (Code sec. 804(a)).

depends on the date of an individual's death (a life annuity), for a fixed period of time (a period certain annuity), or for the longer of a specified minimum period or life (an annuity for a period certain and life thereafter).

An individual may purchase an annuity by payment of a single premium or by making periodic payments. A deferred annuity contract may, at the election of the individual, be surrendered before annuity payments begin, in exchange for the cash value of the contract. Partial surrenders are similarly permitted under some annuity contracts.

Variable annuities

If either the premium paid for an annuity contract or the annuity benefit under the contract is based on the investment return and the market value of a separate account established by the insurance company, the contract is a "variable annuity contract." Under the rules for taxation of variable annuities (1) income credited to invested assets are not taxed to the insurance company, (2) capital gains on invested assets are taxed to the insurance company unless the contract is held under a tax-qualified retirement arrangement (e.g., a contract under a qualified pension plan), and (3) an investor's tax on earnings on amounts invested under the contract is deferred until amounts are withdrawn or benefits paid. Withdrawals and benefit payments are taxed under the usual rules for annuity contracts.

In a series of three rulings commencing in 1977, the Internal Revenue Service has determined that the tax rules for variable annuity contracts do not apply to certain investment vehicles. The first such ruling, Rev. Rul. 77-85, 1977-1 C.B. 12, applies to "investment" annuities. Rev. Rul. 80-274, 1980-2 C.B. 27, and Rev. Rul. 81-225, 1980-41 I.R.B. 5 apply to so-called "wraparound" annuities. Under the Revenue Rulings, earnings on funds invested under an investment or wraparound annuity contract generally are taxed to the individual taxpayer currently, without deferral of the tax until benefits are paid under the contract.

Investment annuities (Rev. Rul. 77-85)

Under an investment annuity contract, an individual could transfer an asset to an insurance company. (Typically, the transferred asset was a certificate of deposit in a bank or savings and loan association, but investments in mutual funds and certain publicly traded securities were also permitted.) Under the contract, the asset was held in a separate acount by the insurer and invested, or reinvested, pursuant to the individual's control.[3] The annuity benefits were based on the investment return and the market value of the assets in the account. The individual could surrender (or partially surrender) the contract at any time before annuity benefits began and receive cash equal to the amount held in the account (less any applicable charges).

Under a 1965 "private letter" ruling and numerous subsequent rulings, the Internal Revenue Service held that the usual rules for

[3] The contracts typically limited investments to assets which could be readily liquidated, for example, savings deposits, listed securities, or mutual funds. Where appreciated assets are transferred under an investment annuity arrangement, the appreciation is subject to tax in the year of the transfer.

taxation of variable annuities applied to investment annuities. In 1975, the Service suspended the issuance of rulings as to investment annuities and, after public announcement of the suspension, held meetings with affected issuers. In 1977, after these discussions, the Service announced its changed position on the taxation of investment annuities.

Under Rev. Rul. 77-85, earnings on assets first invested under an investment annuity contract after March 9, 1977 (the date the ruling was released) are taxed to the individual taxpayer currently, without deferral of the tax until benefits are paid under the contract. The Service's position was based upon the conclusion that the individual possessed such substantial incidents of ownership in the assets in the separate account that such assets were "owned" by the individual (rather than the insurance company) for income tax purposes.[4]

Wraparound bank deposit annuities (Rev. Rul. 80-274)

The principles of Rev. Rul. 77-85 (earnings taxed currently to the individual) were extended by Rev. Rul. 80-274 to certain wraparound bank deposit annuity contracts.

Under the contract described in Rev. Rul. 80-274, an individual could transfer cash, passbook savings, or a certificate of deposit in a savings and loan association to a life insurance company. Under the contract, the asset (reduced by a fee) was deposited by the insurer in a separate account of the originating savings and loan association, and invested in a certificate of deposit. When the certificate of deposit matured, the insurance company was generally required to reinvest the proceeds in another certificate of deposit. The individual could surrender (or partially surrender) the contract before annuity benefits began and receive cash equal to the amount held in the account (less any applicable charges).

Wraparound mutual fund annuities (Rev. Rul. 81-225)

Rev. Rul. 77-85 and Rev. Rul. 80-274 were amplified recently by Rev. Rul. 81-225, which describes several forms of another type of wraparound annuity contract. Under Rev. Rul. 81-225, an individual could purchase for cash a contract which contained provisions common to many annuity contracts, including (1) the right to surrender the contract in whole or in part for cash, subject to a surrender charge or contingent sales fee that decreased the longer the contract was outstanding, and (2) the right, at future dates of the purchaser's choice, to convert the accumulated values under the contract into a stream of periodic payments under one of several settlement options. Net premiums received by the insurance company under the contracts were allocated solely to accounts, the assets of which were invested either in shares of a single mutual fund registered under the Investment Company Act of 1940, or, through subaccounts, in shares of two or more different

[4] In litigation challenging Rev. Rul. 77-85, the U.S. District Court for the District of Columbia held that the ruling was unreasonable and that the Internal Revenue Service had exceeded its statutory authority in issuing it. On appeal, the order of the District Court was reversed. The appellate court held that the Anti-Injunction Act (Code sec. 7421(a)) barred relief to the plaintiff, marketers of investment annuities, and therefore did not address the merits of the investment annuity issue. *Investment Annuity, Inc.* v. *Blumenthal,* 609 F. 2d 1 (D.C. Cir. 1979), *rev'g* 442 F. Supp. 681 (D.D.C. 1977).

mutual funds identified to the contract purchaser.[5] Typically, the mutual funds were money market funds.

Under Rev. Rul. 81-225, earnings on amounts invested under the contract are taxed to the contract holder currently, without deferral of tax until benefits are paid under the contract, if shares of the mutual fund purchased with amounts invested under the contract are also offered for sale to the general public. The Service's position is based, in part, upon the conclusion that in such a case a contract purchaser's position is substantially identical to what the purchaser's position would have been had the mutual fund shares been purchased directly (in which case, dividends or other distributions made with respect to the shares would be taxed currently to the shareholder). On the other hand, under the Revenue Ruling, earnings are not taxed currently to the contractholder if the mutual fund shares are not offered for sale to the general public, but are available only through the purchase of an annuity contract from the insurance company.

Rev. Rul. 81-225 generally applies to shares of a mutual fund purchased with premiums paid by the contract holder after December 31, 1980. The Revenue Ruling was released on September 25, 1981.

Issues

The issues are (1) whether the results reached in Rev. Rul. 81-225 should be codified by amendment to the Internal Revenue Code, and (2) whether such rules should be applied only to amounts invested under a variable annuity contract after the date the Ruling was released (September 25, 1981).

Explanation of the Bill

The bill generally would codify the result reached in Rev. Rul. 81-225. For tax purposes, an annuity would be defined as including a variable annuity contract with reserves based upon a separate account the assets of which consist of shares of regulated investment companies registered under the Investment Company Act of 1940. However, the bill requires that such shares must not be available for purchase by the general public except through the purchase of a variable annuity contract. If this requirement is met, the shares would be deemed property owned only by the insurance company issuing the annuity contract. Under the income tax rules for variable annuity contracts, dividends and other distributions paid with respect to the shares would not be taxed currently to the contractholder, and tax would be deferred until amounts are withdrawn or benefits are paid under the contract. If, however, the shares are available for purchase by the general public other than through the purchase of a variable annuity contract, under Rev. Rul. 81-225 the shares would be deemed the property of the con-

[5] If premiums were invested in shares of a single mutual fund, an existing shareholder of the mutual fund could exchange his shares for an annuity contract without payment to the insurance company of any fee, sales charge or transfer charge. In addition, the insurance company reserved the right to substitute another mutual fund for the mutual fund first identified to the contract purchaser, if investment in that fund was no longer possible or if the company judged such investment to be inappropriate. If, through subaccounts, net premiums were invested in two or more different mutual funds, the contract purchaser had the right to designate and periodically to reallocate the contract's cash value among the subaccounts.

tractholder, and dividends and other distributions paid with respect to the shares would be taxed to the contractholder currently.

In addition, the bill extends the Revenue Ruling by providing that the investment managers of a regulated investment company, the shares of which are purchased with amounts paid under a variable annuity contract, need not be affiliated with the insurance company issuing the contract. In addition, a variable annuity contract could provide for investment or reinvestment in the shares of more than one regulated investment company (by means of separate accounts or separate subaccounts) at the direction of the contractholder.

The bill also would overturn the retroactive application of Rev. Rul. 81-225. Under the bill, the Revenue Ruling would apply only with respect to earnings on shares purchased with payments made by the contractholder under the contract after September 25, 1981. Earnings on shares purchased with payments made under the contract after December 31, 1980, and before September 25, 1981, would not be taxed currently to the contractholder.

Effective Date

Except as described in that provision of the bill which would overturn the retroactive effect of Rev. Rul. 81-225, the bill generally would apply to contracts entered into or payments made by a contract holder after September 25, 1981.

Revenue Effect

It is estimated that the provision of the bill which would overturn the retroactive effect of Rev. Rul. 81-225 would involve an undetermined, but moderate, revenue loss for fiscal year 1982.

II

97TH CONGRESS
1ST SESSION

S. 829

To amend the Internal Revenue Code of 1954 to provide for cost-of-living adjustments in annuities for survivors of Tax Court judges.

IN THE SENATE OF THE UNITED STATES

MARCH 30 (legislative day, FEBRUARY 16), 1981

Mr. BAUCUS introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to provide for cost-of-living adjustments in annuities for survivors of Tax Court judges.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. ADJUSTMENT OF ANNUITIES FOR SURVIVORS OF TAX COURT JUDGES FOR INCREASES IN COSTS-OF-LIVING.

(a) IN GENERAL.—Section 7448 of the Internal Revenue Code of 1954 (relating to annuities to surviving spouses and dependent children of judges) is amended by redesignating subsection (s) as subsection (t), and by inserting after subsection (r) the following new subsection:

"(s) INCREASES ATTRIBUTABLE TO INCREASED PAY.—Whenever the salary of a judge under section 7443(c) is increased, each annuity payable from the survivors annuity fund which is based, in whole or in part, upon a deceased judge having rendered some portion of his or her final 18 months of service as a judge of the Tax Court, shall also be increased. The amount of the increase in such an annuity shall be determined by multiplying the amount of the annuity, on the date on which the increase in salary becomes effe~~ctive,~~ by 3 percent for each 5 percent by which such salary has been increased. In the event that such salary is increased by less than 5 percent, there shall be no increase in such annuity.".

(b) CATCH-UP FOR SURVIVORS ANNUITIES IN PAY STATUS ON DATE OF ENACTMENT.—If an annuity payable under section 7448(h) of the Internal Revenue Code of 1954 (relating to entitlement to annuity) to the surviving spouse of a judge of the United States Tax Court is being paid on the date of the enactment of this Act, then the amount of that annuity shall be adjusted, as of the first day of the first month beginning more than 30 days after such date, to reflect the amount of the annuity which would have been payable if the amendment made by subsection (a) applied with respect to increases in the salary of a judge under section 7443(c) of such Code taking effect after December 31, 1970.

SEC. 2. EFFECTIVE DATE.

The amendment made by subsection (a) of section 1 shall apply with respect to increases in the salary of judges of the United States Tax Court taking effect after the date of the enactment of this Act.

II

97TH CONGRESS
1ST SESSION

S. 1607

To amend the Internal Revenue Code of 1954 to provide a minimum interest and dividend exclusion of $200 for each individual.

IN THE SENATE OF THE UNITED STATES

SEPTEMBER 10 (legislative day, SEPTEMBER 9), 1981

Mr. D'AMATO (for himself, Mrs. HAWKINS, Mr. DURENBERGER, Mr. SPECTER, Mr. BRADLEY, Mr. MITCHELL, Mr. COCHRAN, Mr. HELMS, and Mr. HEINZ) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to provide a minimum interest and dividend exclusion of $200 for each individual.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. INTEREST EXCLUSION.

(a) PERMANENT EXTENSION OF DIVIDEND AND INTEREST EXCLUSION.—Subsection (c) of section 404 of the Crude Oil Windfall Profit Tax Act of 1980, as amended by the Economic Recovery Tax Act of 1981, is amended by striking out "and before January 1, 1982".

(b) AMOUNT OF EXCLUSION.—

(1) IN GENERAL.—Paragraph (1) of section 116(b) of the Internal Revenue Code of 1954 (relating to maximum dollar amount) is amended to read as follows:

"(1) MAXIMUM DOLLAR AMOUNT.—The aggregate amount excluded under subsection (a) for any taxable year shall not exceed—

"(A) $200 ($400 in the case of a joint return under section 6013) in the case of taxable years beginning in 1982, 1983, or 1984, and

"(B) in the case of taxable years beginning after December 31, 1984, the sum of—

"(i) $200 ($400 in the case of a joint return under section 6013), plus

"(ii) the lesser of—

"(I) $250 ($500 in the case of a joint return under section 6013), or

"(II) the qualified excess interest amount.".

(2) QUALIFIED EXCESS INTEREST AMOUNT DEFINED.—Subsection (c) of section 116 of such Code (relating to definitions and special rules) is amended by adding at the end thereof the following new paragraph:

"(4) QUALIFIED EXCESS INTEREST AMOUNT.—

"(A) In general.—The term 'qualified excess interest amount' means an amount equal to 15 percent of the excess of—

"(i) the amount of interest received by the taxpayer during the taxable year, reduced (but not below zero) by $200 ($400 in the case of a joint return under section 6013), over

"(ii) the qualified interest expenses of the taxpayer for such taxable year.

"(B) Qualified interest expenses.—The term 'qualified interest expense' means an amount equal to the excess of—

"(i) the amount of the deduction allowed the taxpayer under section 163(a) (relating to interest) for the taxable year, over

"(ii) the amount of such deduction allowed with respect to interest paid or accrued on indebtedness incurred in—

"(I) acquiring, constructing, reconstructing, or rehabilitating property which is primarily used by the taxpayer as a dwelling unit (as defined in section 280A(f)(1)), or

"(II) the taxpayer's conduct of a trade or business.".

(c) CONFORMING AMENDMENTS.—

(1) Section 128 of the Internal Revenue Code of 1954 (relating to partial exclusion of interest), as added and amended by the Economic Recovery Tax Act of 1981, is hereby repealed.

(2) Section 302(b) of the Economic Recovery Tax Act of 1981 is amended by striking out paragraph (2).

(3) Paragraph (1) of section 116(c) of such Code (defining interest) is amended to read as follows:

"(1) INTEREST DEFINED.—The term 'interest' means—

"(A) interest on deposits with a bank (as defined in section 581),

"(B) amounts (whether or not designated as interest) paid, in respect of deposits, investment certificates, or withdrawable or repurchasable shares, by—

"(i) an institution which is—

"(I) a mutual savings bank, cooperative bank, domestic building and loan association, or credit union, or

"(II) a savings or thrift institution which is chartered and supervised under Federal or State law,

the deposits or accounts in which are insured under Federal or State law or which are protected and guaranteed under State law, or

"(ii) an industrial loan association or bank chartered and supervised under Federal or State law in a manner similar to a savings and loan institution,

"(C) interest on—

"(i) evidences of indebtedness (including bonds, debentures, notes, and certificates) issued by a domestic corporation in registered form, and

"(ii) to the extent provided in regulations prescribed by the Secretary, other evidences of indebtedness issued by a domestic corporation of a type offered by corporations to the public,

"(D) interest on obligations of the United States, a State, or a political subdivision of a State (not excluded from gross income of the taxpayer under any other provision of law),

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"(E) interest attributable to participation shares in a trust established and maintained by a corporation established pursuant to Federal law, and

"(F) interest paid by an insurance company under an agreement to pay interest on—

"(i) prepaid premiums,

"(ii) life insurance policy proceeds which are left on deposit with such company by a beneficiary, and

"(iii) under regulations prescribed by the Secretary, policyholder dividends left on deposit with such company.".

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to taxable years beginning after December 31, 1981.

(2) CONFORMING AMENDMENTS.—

(A) The amendment made by subsection (c)(1) shall apply to taxable years beginning after December 31, 1984.

(B) The amendment made by subsection (c)(2) shall take effect as if included in the amendments made by the Economic Recovery Tax Act of 1981.

II

97TH CONGRESS
1ST SESSION

S. 1645

To let funds in individual retirement accounts be used to purchase collectibles.

IN THE SENATE OF THE UNITED STATES

SEPTEMBER 18 (legislative day, SEPTEMBER 9), 1981

Mr. MOYNIHAN introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To let funds in individual retirement accounts be used to purchase collectibles.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 408 of the Internal Revenue Code (relating to individual retirement accounts) is amended by striking out subsection (n) and by redesignating subsection (o) as the new subsection (n).

(b) The amendment made by subsection (a) shall apply to property acquired after December 31, 1981, in taxable years ending after such date.

II

97TH CONGRESS
1ST SESSION

S. 1855

To make section 457(e)(1) of the Internal Revenue Code of 1954 inapplicable to certain State judicial plans.

IN THE SENATE OF THE UNITED STATES

NOVEMBER 17 (legislative day, NOVEMBER 2), 1981

Mr. BENTSEN (for himself and Mr. TOWER) introduced the following bill; which was read twice and referred to the Committee on the Judiciary

DECEMBER 2 (legislative day, NOVEMBER 30), 1981

Re-referred to the Committee on Finance, by unanimous consent

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A BILL

To make section 457(e)(1) of the Internal Revenue Code of 1954 inapplicable to certain State judicial plans.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) paragraph (2) of section 457(e) of the Internal Revenue Code of 1954 (relating to tax treatment of participants where plan or arrangement of State is not eligible) is amended by striking out "and" at the end of subparagraph (D), by striking out the period at the end of subparagraph (E) and inserting in lieu thereof ", and", and by adding at the end thereof the following new subparagraph:

"(F) a qualified State judicial plan.".

(b) Paragraph (3) of section 457(e) of such Code is amended by adding at the end thereof the following new subparagraph:

"(C) QUALIFIED STATE JUDICIAL PLAN.—The term 'qualified State judicial plan' means any retirement plan of a State for the exclusive benefit of elected judges or their beneficiaries if—

"(i) such plan has been continuously in existence since December 31, 1978,

"(ii) under such plan, all judges eligible to benefit under the plan—

"(I) are required to participate, and

"(II) are required to contribute the same fixed percentage of their basic or regular rate of compensation as judge,

"(iii) under such plan, no judge has an option as to contributions or benefits the exercise of which would affect the amount of includible compensation,

"(iv) the retirement payments of a judge under the plan are a percentage of the compensation of judges of that State holding similar positions,

"(v) judges participating in the plan are not eligible to participate in any eligible State deferred compensation plan on the basis of judicial service covered by the plan, and

"(vi) the plan during any year does not pay benefits with respect to any participant which exceed the limitations of section 415(b).

For purposes of this subparagraph, the term 'elected judges' includes any judge serving under an appointment to complete a part or all of the unexpired term of an elected judge. Paragraph (1) of subsection (d) shall not apply for purposes of this subparagraph.".

(c) The amendments made by this section shall apply to taxable years beginning after December 31, 1978.

II

97TH CONGRESS
1ST SESSION

S. 1888

To amend the Internal Revenue Code of 1954 to clarify the tax treatment of variable annuity contracts.

IN THE SENATE OF THE UNITED STATES

NOVEMBER 24 (legislative day, NOVEMBER 2), 1981

Mr. SYMMS (for himself, Mr. GRASSLEY, Mr. DURENBERGER, and Mr. CHAFEE) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to clarify the tax treatment of variable annuity contracts.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That

(a) Section 72(o) of the Internal Revenue Code of 1954 is redesignated as section 72(p).

(b) Section 72 of the Internal Revenue Code of 1954 is amended by adding the following new subsection:

"(o) VARIABLE ANNUITY CONTRACTS, ETC.—For purposes of this section, an annuity includes but is not limited to, a variable annuity contract or a contract with reserves based on a segregated asset account (as defined in section 801(g)(1)) and;

"(1) such segregated asset account may be a unit investment trust and may include subaccounts,

"(2) the assets of such accounts or subaccounts funding a variable annuity contract or a contract with reserves based on a segregated asset account may consist of shares of regulated investment companies registered under the Investment Company Act of 1940, provided that such shares are not available for purchase by the general public except through the purchase of a variable annuity contract,

"(3) such contract may allow the contract holder to allocate or reallocate contract amounts attributable to his contract among such subaccounts or other segregated asset accounts, and

"(4) the investment managers of such regulated investment companies need not be members of a controlled group (as defined in section 851(c)(3)) of which the insurance company issuing such contract is a member.

For purposes of this title, assets, including shares of regulated investment companies, acquired to provide funding for such variable annuity contracts or contracts with reserves based on a segregated asset account shall be deemed to be property owned only by the insurance company.".

(c) EFFECTIVE DATES.—

(1) Except as provided in paragraph (2) or (3), the tax treatment of any payment made by a contract holder on or before September 25, 1981, with respect to any annuity described in Revenue Ruling 81–225 shall be determined without regard to such Revenue Ruling 81–225 (and without regard to any other regulation, ruling, or decision reaching the same results, or results similar to the results set forth in such revenue ruling) and with full regard to the rules in effect before such revenue ruling.

(2) With respect to any contract described in section 403(a), 403(b) or 408(b) of the Internal Revenue Code of 1954, the amendments made by subsection (b) shall only apply to a payment made on behalf of an individual included after September 25, 1981, under such contract.

(3) The amendments made by subsection (b) shall apply to contracts entered into or payments made by a contract holder (other than those contracts or payments described in paragraph (2)) after September 25, 1981, with respect to an annuity described in subsection (b).

We will also have hearings on S. 1645, introduced by Senator Moynihan, repealing section 3314(b) of the Economic Recovery Act of 1981, thereby allowing individual retirement accounts to invest in collectibles; S. 1855, introduced by Senator Bentsen, pertaining to State judicial pension plans; and S. 1888, introduced by Senator Symms, with cosponsors, myself, Senators Durenberger, Grassley, Bentsen, and Baucus, clarifying the tax treatment of variable annuity contracts.

Senators Bentsen and Baucus will be here to make statements on behalf of their bills, and, of course, Senator D'Amato is here now. Following their presentations Assistant Secretary Chapoton will offer the Treasury's viewpoint and then we will hear from the witness panel.

So we are delighted to have Senator D'Amato here this morning. If you would proceed, Senator, with your statement, and then I believe we will proceed as I outlined, unless you would prefer to stay here. But I assume you have other matters you have to move on to.

STATEMENT OF HON. ALFONSE D'AMATO, U.S. SENATOR FROM THE STATE OF NEW YORK

Senator D'AMATO. Let me thank the chairman and this subcommittee for its graciousness in giving me the opportunity to be here today to talk on behalf of S. 1607.

Mr. Chairman, on September 10 I introduced S. 1607, a bill to restore and make permanent the $200 exclusion of dividends and interest ($400 in the case of a joint return) from taxable income. This exclusion was repealed as part of the Economic Recovery Tax Act of 1981, although repeal of this provision was not part of the President's program.

The Economic Recovery Tax Act was a remarkable congressional accomplishment; with its omnibus package of tax reductions and investment incentives we took a major step toward restoring America's economic health. In the midst of the Economic Recovery Tax Act, however, is a major, disconcerting irony. I refer, of course, to section 302(b) which repeals the current $200 and $400 exclusion of dividends and interest income from taxable income and replaces it with a partial exclusion of $100, and then applies this to dividend income only.

The new provision, which becomes effective in only 4 more weeks, is a direct contradiction of what the President and Congress sought to accomplish by enacting the Economic Recovery Tax Act. Not only will section 302(b) discourage savings, but it will also result in a tax increase for every single American saver.

In 1982, and thereafter, every single dollar of interest income will be taxed, beginning with the very first dollar. This unwarranted tax increase will fall most heavily upon the elderly living on fixed retirement incomes. It will also have a severe negative impact on lower and middle income working families struggling to make ends meet in spite of inflation. The smallest adverse impact, of course, will be borne by those who can afford to invest sufficient capital in all-savers certificates to receive their $1,000 or $2,000 exclusion in interest income.

In order to receive the full $2,000 exclusion, while receiving interest payments quarterly, you would have to invest $24,718.82 at the current yield of 8.091-percent rate. Unfortunately, not many of my constituents have this much loose cash lying around to invest. Much more typical is the family with $1,500 in a savings account earning less than $90 a year in interest. To me it seems both unfair and cruel that, beginning in less than a month, this meager $90 in interest income will become taxable, while the couple with nearly $25,000 to invest in all-savers certificates will receive $2,000 in tax-free income.

Regardless of the gross inequities involved, the all-savers certificate is not an adequate replacement for the $200/$400 interest and dividend exclusion. When the all-savers certificate—originally projected to cost $3.331 billion over its 15-month life—was adopted, the $200/$400 exclusion was sacrificed in its place.

However, people are not buying the certificates in anywhere near the quantities originally projected. Despite projections made as recently as 2 months ago of $150 billion in sales, as recently as November 10, the most recent figures made available, show that only $17.5 billion of all-savers certificates have been sold, and that at most 25 percent of this money was new money.

The all-savers certificate does not make much economic sense for anyone in the 30 percent tax bracket or lower. The certificates are selling sluggishly and they are not bringing in very much new money to our savings institutions. The $200/$400 exclusion for savers is simply a better mechanism for encouraging savings and providing the capital necessary to revitalize the economy. S. 1607 currently has 24 cosponsors. I ask that we enact without delay S. 1607 and restore the $200/$400 interest and dividend exclusion.

A September 17 C.R.S. report made clear the negative impact that the repeal of the $200/$400 exclusion could have on the average American taxpayer. In that report it was pointed out that much of the cut in the marginal income tax rates, and I am referring to the 5–10–10 cut, will be offset by this repeal. Thus, much of the tax relief granted to the average American taxpayer in the Economic Recovery Tax Act will be unrealized because of this repeal.

The report detailed the proportion of the 1982 tax reduction which would be offset due to repeal of the $200/$400 exclusion. This offset, of course, varied by income levels. While the wealthy will be affected only minimally, many lower and middle income working families may see a large proportion of their tax cut reclaimed by the Federal Treasury because they can no longer exclude interest and dividend income from their taxable income. Couples with $15,000 in income during 1982 could have as much as 46 percent of their tax reduction recaptured because of the increased taxes that they will have to pay due to the repeal of the $200/$400 exclusion. At $20,000 as much as 35 percent could be recaptured. At $25,000 in income up to 27 percent would be recaptured. And when we talk about recaptured, we are saying that the Treasury will lay claim to that money; that is money lost by the families in those brackets. It is interesting to note at $50,000 in income only 14 percent of the tax reduction could be recaptured and lost by the taxpayer.

What this means, of course, is that if we fail to restore the $200/$400 interest and dividend exclusion, the highly-touted tax cut will be little more than a sham for many of those in lower and middle income tax brackets. We cannot get by with just the all-savers program. I'm not attacking all-savers certificates, but their benefits go only to those in marginal tax brackets of greater than 30 percent. I would like to stress to this committee that this represents a very small proportion of total taxpayers. It represents somewhat less than one-third; 66 percent of the taxpayers receive no additional benefits whatsoever from this particular legislation. In 1982 a single person will have to earn more than $21,500 in order to be in a marginal tax bracket of greater than 30 percent. Thus, if they earn less than that, it makes no sense for them to invest in all-savers certificates. Any small savings that they would have would be taxed.

We cannot, by reserving our savings incentives and tax breaks only for the small proportion of American households that exceed these income levels, be meeting our expectations.

Using 1977 statistics, the most recent available, the average American tax return in the $25,000 to $30,000 tax range reported $907 in interest income. For those in the $20,000 to $25,000 income bracket the mean dividend and interest income was $585. The figures were comparatively less for families in lower income brackets and higher for those with more substantial earnings. These middle and lower income families, however, are precisely the taxpayers we should be encouraging to save rather than spend.

Restoration of the $200/$400 interest and dividend exclusion represents equitable tax treatment for all income classes. By repealing the $200/$400 exclusion and replacing it with all-savers certificates, the Congress created a tax exclusion which denies the best incentive for the middle class to save and the economy to prosper. We have denied the little guy the break he also is entitled to receive.

The original reason for enacting the $200/$400 exclusion was to encourage savings. It was put in place for only a short 2-year trial. That trial has been aborted. There are those who argue that the provision does not encourage savings. In rebuttal, I ask: How do they know? At the time that the Senate voted on repeal, the exclusion had been in effect for less than 7 months. Clearly, this was far too short of a trial period. As of yet, no firm statistics have been collected.

At the very least we can be certain that the $200/$400 exclusion does not discourage savings. To those who maintain that all-savers certificates will generate more new savings than the $200/$400 exclusion, despite early evidence to the contrary, I ask: How can such claims be made in the absence of hard data?

Another important reason for restoring the $200/$400 exclusion is that America's economic recovery is dependent upon tax decreases, not increases. Except for the closing of loopholes, we should not be increasing anyone's taxes at this time, especially for the retired and for middle and lower income workers. The United States is an overtaxed society and this Congress has dedicated itself to returning hard-earned income to the people. We should not allow ourselves to stray from this objective by repealing the $200/$400 exclusion.

For all of these reasons I urge enactment of S. 1607. My bill in no way affects the all-savers program. It no way compromises the excellent provisions adopted as part of the Economic Recovery Tax Act to provide a 15 percent exclusion for interest income beginning in 1985. When this percentage exclusion becomes operative, the $200/$400 exclusion will apply as a base exemption. Then, beginning with the 201st dollar, 15 percent of the additional net interest as defined in the Economic Recovery Tax Act will be excludable from taxable income up to a total exclusion of no more than $450 for an individual and $900 in the case of a joint return.

The revenue loss for S. 1607 may sound high—$2.482 billion in 1982 and an average of $2.489 billion a year over the first 5 years—but it's really quite low when you consider that Congress has already decided to forgo this revenue once, in 1979, when the Senate originally enacted this exclusion by a 94 to 4 vote. We have already promised this small amount of tax relief to the American saver, yet now it has been summarily taken away.

I urge this subcommittee to act quickly in reporting S. 1607 to the full Senate Finance Committee and then to the Senate floor. I don't believe that we can delay. We must pass pass S. 1607 if we are going to keep faith with the little guy.

Mr. Chairman, I thank you for giving me this opportunity of sharing these thoughts with you on S. 1607. If I might be permitted, I will just make another observation. Maybe it's something called my own political philosophy, but I've always bridled at those who could take someone else's earnings, under whatever form or philosophy, and think that they know how best to distribute them. I've been upset with those who would take from those who are more affluent, and take their moneys because they have some theory, and distribute it to those who don't earn as much. But I think it's far worse, Mr. Chairman, when we take something from 66 percent of the American public—and I'm talking about those in the lower income groups—and, by the same act that we give additional tax benefits to those who are on substantially higher brackets, wipe out that tax relief for the little guy. That's income distribution that I cannot abide or sit by quietly and watch. I think it's far worse than that which so many have decried; that is, those who seek income leveling by taking from the wealthy and giving to those who are less fortunate. But taking from the little person on the lowest side and, in the same act, giving tax benefits to those who are in a much more substantial position is wrong. I can't see how we can justify it morally, ethically, or legally. We may have the right to do it, but I think it is something that does not inure to the credit of our Congress.

I believe it was an oversight. I believe it was an oversimplification. I believe that, in terms of our rush to accomplish and bring about an opportunity for greater savings, that this was one of the unintended victims and one of those compromises that had to be reached in order to fashion a more comprehensive tax package. I would hope that we could correct what I perceive to be a great deficiency.

Thank you.

REMARKS BY SENATOR ALFONSE D'AMATO BEFORE THE SAVINGS, PENSIONS, AND INVESTMENT POLICY SUBCOMMITTEE

On September 10, I introduced S. 1607, a bill to restore and make permanent the $200 ($400 in the case of a joint return) exclusion of dividends and interest from taxable income. This exclusion was repealed as part of the "Economic Recovery Tax Act of 1981," although repeal of this provision was not part of the President's program.

The "Economic Recovery Tax Act" was a remarkable congressional accomplishment. With this omnibus package of tax reductions and investment incentives we took a major step toward restoring America's economic health.

In the midst of the "Economic Recovery Tax Act," however, is a major disconcerting irony. I refer, of course, to section 302(b) which repeals the current $200/$400 exclusion of dividend and interest income from taxable income and replaces it with a partial exclusion of $100 ($200 in the case of a joint return) and applies this to dividend income only. The provision, which becomes effective in only four more weeks, is a direct contradiction of what the President and Congress sought to accomplish by enacting the "Economic Recovery Tax Act." Not only will section 302(b) discourage savings, but it will also result in a tax increase for every single American saver.

In 1982 and thereafter, every single dollar of interest income will be taxed, beginning with the very first dollar. This unwarranted tax increase will fall most heavily upon the elderly living on fixed retirement incomes. It will also have a severe negative impact on lower and middle income working families struggling to make ends meet in spite of inflation. The smallest adverse impact, of course, will be borne by those who can afford to invest sufficient capital in all savers certificates to receive their $1,000/$2,000 exclusion in interest income.

In order to receive the full $2,000 exclusion, while receiving interest payments quarterly, you would have to invest $24,718.82 at the current 8.091 percent rate. Unfortunately, not many of my constituents have this much loose cash lying around. Much more typical is the family with $1,500 in a savings bank earning less than $90 a year in interest. To me it seems both unfair and cruel that, beginning in less than a month, this meager $90 in interest income will become taxable while the couple with nearly $25,000 lying around in loose cash can invest that money and receive $2,000 in tax-free income.

Regardless of the gross inequities involved, the all savers certificates is not an adequate replacement for the $200/$400 interest and dividend exclusion. When the all savers certificate—originally projected to cost $3.331 billion over its 15 month life—was adopted, the $200/$400 exclusion was sacrificed in its place. However, people are not buying the certificates in anywhere near the quantities originally projected. Despite projections made as recently as two months ago of $150 billion in sales by November 10, the most recent figures available show only $17.5 billion of all savers certificates had been sold and that at most 25 percent of this money was "new" money.

The all savers certificate does not make much economic sense for anyone in the 30 percent tax bracket or lower. The certificates are selling sluggishly and they are not bringing in very much "new" money to our savings institutions. The $200/$400 exclusion for savers is simply a better mechanism for encouraging savings and providing the capital necessary to revitalize the economy. S. 1607 currently has 24 cosponsors. We must, without delay, enact S. 1607 and restore the $200/$400 interest and dividend exclusion.

A September 17 C.R.S. report made clear the negative impact repeal of the $200/$400 exclusion could have on the average American taxpayer. In the report it was pointed out that much of the cut in marginal individual income tax rates (5-10-10) will be offset by the repeal. Thus, much of the tax relief granted to the average American taxpayer in the "Economic Recovery Tax Act" will be unrealized because of this repeal.

The report detailed the proportion of the 1982 tax reduction which could be offset due to repeal of the $200/$400 exclusion. This offset, of course, varied by income levels. While the wealthy will be affected only minimally, many lower and middle income working families may see a large proportion of their tax cut reclaimed by the Federal Treasury because they can no longer exclude interest and dividend income from their taxable income. Couples with $15,000 in income during 1982 could have as much as 46.1 percent of their tax reduction "recaptured" because of the increased taxes that will result due to the repeal of the $200/$400 exclusion. At $20,000 as much as 35.2 percent could be "recaptured," at $25,000 in income up to 27.9 percent could be "recaptured", at $30,000 up to 23.7 percent, at $40,000 up to

19.0 percent, and at $50,000 in income as much as 14.9 percent of the tax reduction could be "recaptured."

What this means, of course, is that if we fail to restore the $200/$400 interest and dividend exclusion, the highly touted tax cut will be little more than a sham for most lower and middle income taxpayers. We can not get by with just the all savers certificate whose benefits go only to those in marginal tax brackets greater than 30 percent. In 1982 a single person will have to earn more than $21,500 in order to be in a marginal tax bracket greater than 30 percent, a couple with two children would need more than $37,500 in income to be in this high bracket. We can not reserve our savings incentives and tax breaks only for that small proportion of American households that exceed these income levels.

Using 1977 statistics, the most recent available, the average American tax return in the $25,000-$30,000 income range reported $907 in dividend and interest income. For those in the $20,000 to $25,000 income bracket the mean dividend and interest income was $585. The figures were comparatively less for families in lower income brackets and higher for those with more substantial earnings. These middle and lower income families, however, are precisely the taxpayers we should be encouraging to save, rather than spend.

Restoration of the $200/$400 interest and dividend exclusion represents equitable tax treatment for all income classes. By repealing $200/$400 and replacing it with all savers, the Congress created a tax exclusion which denies the best opportunity to the middle class to save and the economy to prosper. We have denied the "little guy" the break he so desperately needs and deserves.

The original reason for enacting the $200/$400 exclusion was to encourage savings. Thus, it was put in place for only a short, two year, trail. However, now some argue that the provision does not encourage savings. In rebuttal, I ask: "How do they know?" At the time the Senate voted on repeal the exclusion had been in effect less than seven months. Clearly, this was far too short of a trial period. As of yet, no firm statistics have been collected.

At the very least, we can be certain that the $200/$400 exclusion does not discourage savings. To those who maintain that all savers will generate more "new" savings than $200/$400—despite early evidence to the contrary I again ask: "How can such claims be made in the absence of any hard data?"

Another important reason for restoring the $200/$400 exclusion is that America's economic recovery is dependent upon tax decreases, not tax increases. Except for the closing of loopholes, we should not be increasing anyone's taxes at this time—especially for the retired and middle and lower income working Americans. The U.S. is an overtaxed society and this Congress has dedicated itself to returning hard-earned income to the people. We should not allow ourselves to stray from this objective by repealing the $200/$400 exclusion.

For all of these reasons I urge enactment of S. 1607. My bill in no way affects all savers. It in no way compromises the excellent provision adopted as part of the "Economic Recovery Tax Act" to provide a 15-percent exclusion for interest income beginning in 1985. When this percentage exclusion becomes operative, the $200/$400 exclusion will apply as a base exemption. Then, beginning with the 201st dollar, 15 percent of net interest, as defined in the "Economic Recovery Tax Act," will be excludable from taxable income up to a total exclusion of no more than $450 ($900 in the case of a joint return).

The revenue loss for S. 1607 may sound high—$2.482 billion in 1982 and an average of $2.489 billion a year over the first five years—but it is really quite low when you consider that Congress has already decided to forego this revenue once, in 1979, when the Senate originally enacted this exclusion by 94-4 vote. We have already promised this small amount of tax relief to the American saver, yet now it has been summarily taken away.

I urge you to act quickly in reporting S. 1607 to the full Senate Finance Committee and then to the Senate floor. We can not delay. We must pass S. 1607 and restore the $200/$400 exclusion of dividends and interest from taxable income.

Senator CHAFEE. Thank you very much, Senator, for a very eloquent statement on a problem that those of us sitting here certainly share. As you know, Senator Bentsen was one of the leaders in having passed the original $200-$400 exemption. And everything you say is accurate, including the oversight part when we made these changes and developed the all-savers legislation.

It always struck me as ironic that, while we are here thinking that eventually we want to work toward the elimination of the double taxation on dividends, that we took a step backward in this piece of legislation by cutting the dividend exclusion from $200-$400 to $100-$200. In respect also to the interest part which we wiped out entirely.

So, your points are very valid. What we will be able to accomplish this calendar year, of course, as you recognize the schedule, is extremely doubtful. But what we plan to explore in this subcommittee is the entire issue of individual savings incentives early next year and try to straighten this out.

I know Senator Bentsen is interested in this, Senator.

Senator D'AMATO. Maybe I could get Senator Bentsen to join in this remedial legislation that I have sponsored.

Senator BENTSEN. As the chairman says, I was the principal sponsor of that piece of legislation you are talking about: $200-$400. And I'm not sure I would say it was oversight, but it sure was a lot of frantic pressuring and trading that the last of the tax bills' consideration resulted in. And it's being lost; and I, frankly, don't agree at all with its being wiped out. I think just to leave the stock side of it on dividends at $100 and $200, that's totally inequitable. It ought to be on interest and it ought to be on dividends, both.

I wouldn't put down the all-savers certificates, and I think you may have. When you talk about a figure, that it didn't reach that one, that was some of the smoke that was being blown in support of the all-savers. But it did achieve a substantial amount.

I used to chair the board of a savings and loan, and I have never seen any package sell like this one did; not as much as some of the optimists wanted, but it did a substantial amount and, in addition to that, about 15 to 20 percent of it, I suppose, was new money. I don't agree at all with it being 15 months. I think that gets into the category of hot money. I don't think it accomplishes some of the things we wanted for it in the way of home mortgages. And I sure don't agree with Treasury's position on the idea that you finally convert it to a percentage of the interest earned as tax-free. That just won't sell. And that won't accomplish the objective we are seeking.

So, I am delighted to see you make this presentation. I think we have to take a look at everything we can do to encourage savings in this country. We finally got it up to 5 or 6 percent; it was down to about 4 percent. You know the figures: The Germans and the French saving at about 13 percent, the Japanese at 22 to 25 percent. We have to do things to encourage savings in this country on behalf of low-income and high-income people. So I congratulate the Senator on his presentation.

Senator CHAFEE. Senator Baucus, did you have a statement in connection with this? I know that you have a bill that you wish to make a presentation of.

Senator BAUCUS. I do, Mr. Chairman, but I'm at your pleasure.

Senator CHAFEE. Well, do you have any questions of Senator D'Amato now?

Senator BAUCUS. Not at this point. Thank you.

Senator CHAFEE. All right.

Well, thank you very much, Senator.

Senator D'AMATO. Thank you.

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Senator CHAFEE. And, just so we can keep the procedure straight here, we will take up later the panel that is dealing with Senator D'Amato's bill. But the order of procedure now will be to hear from Senator Bentsen and his legislation, Senator Baucus on his legislation, then Mr. Chapoton, Judge Tannenwald with 829, the panel on 1888, the panel on 1607, and then the panel on 1644.

And so, Senator Bentsen, why don't you proceed?

STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM THE STATE OF TEXAS

Senator BENTSEN. Thank you very much, Mr. Chairman. I appreciate your giving me an opportunity to have a hearing today on S. 1855. This is one of those technical amendments.

What you have in this situation is that section 457 was never meant to be applicable to mandatory plans on deferred compensation. It was intended to apply to optional plans. You get into a situation with the Texas judges, where the legislature meets every 2 years and does not fund and vest the deferred compensation mandatory plan over a substantial period of time. What they really do is just make an appropriation every 2 years. The effect is it puts these judges in a position that, once their plan vests, then they have to pay the tax on it at that point in time, as I understand it. It is my understanding that Treasury—Treasury is here—says that this was not the intent of 457, and that they have no objections to this correction which would take care of this situation.

Senator CHAFEE. All right, fine.

Senator BENTSEN. I would like to put into the record the detailed explanation.

Senator CHAFEE. Fine.

[The information follows:]

PREPARED STATEMENT OF SENATOR BENTSEN

Mr. Chairman, I want to thank you for granting a hearing today on S. 1855. This legislation addresses a technical, unintended problem caused by section 457 of the Internal Revenue Code. It is in the nature of a technical correction to section 457 since it is fair to say that had Congress perceived this problem when first enacting section 457 in 1978, some effort would have been made to cover the situation this bill should remedy.

Section 457 was adopted to clarify the taxation of benefits under optional salary reduction arrangements sponsored by State and local governments. Congress wrote section 457 to the code to (a) establish structural requirements which deferred compensation salary reduction plans would have to meet to earn favorable tax treatment, and to (b) specify in section 457(e) the tax treatment of salary reduction plan benefits which fail to meet the structural requirements.

If a plan fails to satisfy the requirements of an eligible State deferred compensation plan, then compensation deferred under such plan is includable in a participant's income for the first taxable year in which there is no substantial risk of forfeiture—that is, upon vesting. The Internal Revenue Service recognized at the time it promulgated the proposed section 457 regulation that there are State plans that are the regular retirement plan of the State but which do not qualify as eligible State-deferred compensation plans under the code. Thus, participants in these plans would appear to be subject to the severe tax treatment requiring the inclusion of all such deferred compensation taxable income immediately upon vesting.

Mr. Chairman, this is a very harsh result and in some cases goes well beyond what Congress was attempting to accomplish with section 457. In fact, in the preamble to the proposed regulations, the Internal Revenue Service acknowledged that it is unclear whether this result was intended. The reforms brought about by section 457 were an attempt to prevent situations where employees of State and local government defer recognition of income through optional deferred compensation agreements with their employers. The bill I am introducing today in no way weakens that reform. This legislation is narrowly drawn and provides no loophole for the kind of optional preferred compensation arrangements limited by the 1978 act.

My bill would add to the exceptions to section 457 State judicial plans that are the regular, exclusive, mandatory plan for service as an elected State judge. The bill would not allow additional, optional contribution by judges.

Since I believe that this legislation is essentially a technical correction to the 1978 provision, and is in no way intended to carve out a "safer harbor" for newly adopted plans I have included a limitation in the bill that would apply the exception only, to those plans in existence continuously since December 31, 1978, the point after which section 457 became effective. Further, in light of the technical correction nature of this legislation, the provisions of the bill are generally effective with respect to taxable years beginning after December 31, 1978.

Senator CHAFEE. Now, are you going to be able to stay here? Would you like to question Mr. Chapoton at all on this situation?

Senator BENTSEN. Well, if he's for it, I would like to applaud him; if he's against it, I would like to question him at length.

Senator CHAFEE. Well, Mr. Chapoton, why don't you step up to the desk, and you will undergo trial-by-fire here.

Secretary CHAPOTON. Well, Mr. Chairman, by agreement, because this bill was added to the list late, we are going to submit a statement for the record later on this.

Basically, we are trying to work out this. Certainly, we agree there is a problem that needs to be taken care of, and we are trying to work with Senator Bentsen and Senator Tower and Congressman Pickle to resolve the question. There is clearly a problem.

Senator CHAFEE. You will then be submitting a statement to this subcommittee?

Secretary CHAPOTON. That is correct. Yes, sir.

Senator CHAFEE. Fine.

[The information follows:]

Senator CHAFEE. Thank you. Why don't you just stay there, because you are next up anyway after Senator Baucus.

Is there anything further, Senator Bentsen?

Senator BENTSEN. No. I will just defer any questions of the Secretary until I see what his position is submitted.

Senator CHAFEE. Well, we can certainly do that. If there are problems that arise in the Treasury's submission back, we can certainly have another quick hearing and give the Secretary a chance to come up and you an opportunity to question him.

Senator BENTSEN. Thank you, Mr. Chairman.

Senator CHAFEE. Senator Baucus.

STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM THE STATE OF MONTANA

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Chairman, I am here to speak in behalf of a bill I introduced, S. 829. I have a full statement I would like to have included in the record.

[The prepared statement follows:]

STATEMENT BY SENATOR BAUCUS

Mr. Chairman, I am pleased today to offer this statement in support of S. 1645, introduced by my colleague, Senator Moynihan.

S. 1645 repeals a provision in the Economic Recovery Act of 1981, Sec. 314(b) which prohibits investments in collectibles by individually directed retirement accounts after December 31, 1981. Neither this provision nor the issue of including tangible assets in retirement plans were considered by a Senate committee or the full Senate prior to enactment. It reverses current law which permits IRA's and other qualified retirement plans to invest in collectibles.

I support S. 1645 for the following reasons. When Congress enacted the legislation creating IRA and Keogh plans, it decided that individuals are the best judge of how to run retirement plans. And it turned out that those people investing in gold, silver, gems and other collectibles have made wise investment choices. These investments have significantly outperformed more traditional investments in recent years. I support S. 1645 because I believe that people should continue to have broad flexibility in determining how they wish to invest for their retirement futures.

One reason behind the recent change in the tax law is said to be that investments in collectibles direct retirement savings from the ailing thrift institutions. I disagree. The real cause of the problems in financial markets today is inflation, not investments in collectibles. To direct investments back to these markets, we must put a stop to inflation. Preventing individuals from investing in collectibles for their retirement will do no service to financial markets.

It is also said that investments in collectibles are not "productive" because they do not contribute to capital formation. It seems to me that this misses the point. The objective of Congress when it authorized these IRA and Keogh accounts was to encourage private initiative to establish and fund retirement programs in order to lessen dependence on Social Security and to provide some financial stability upon retirement. Recognizing the success of these programs, the Congress recently expanded the availability of individual retirement accounts.

We cannot permit inroads into the strength and stability of these retirement plans. Sec. 314(b) is such an inroad and for that reason I support Senator Moynihan's efforts to enact legislation effecting a repeal.

Senator BAUCUS. Very briefly, let me summarize.

Since 1961, Tax Court judges have contributed 3 percent of their salary to a pension plan for their surviving spouses. Regrettably, two things have happened since 1961. First, survivor benefit programs for other Americans have increased substantially; and, second, inflation has hit everybody including Tax Court widows. The result is that widows of Tax Court judges have not received any increase in their pension benefits since 1961.

My bill would rectify that. It would give the same cost-of-living increases to Tax Court judge widows as now is available to other Federal judge surviving spouses. The fund can pay for it; this won't cost the taxpayer anything. There is a joint contribution from salaries of judges, along with an appropriation which would not be increased. And the bill, therefore, is designed to take care of inequity at no cost to the taxpayer.

Senator CHAFEE. There is nothing we like better than taking care of an inequity at no cost to the taxpayer.

Mr. Chapoton, would you be good enough to comment? I assume you are not going to be able to stay.

Secretary CHAPOTON. No, sir. I had not planned on staying.

Senator CHAFEE. Well, why don't you go through and state Treasury's position on the various pieces of legislation before us today, starting with 829.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Secretary CHAPOTON. Yes, sir. We, of course, Mr. Chairman, have a statement for the record, and I will just summarize it.

Senator CHAFEE. Fine.

Secretary CHAPOTON. It might take a few minutes, because there are several very important matters before the subcommittee this morning.

Let me mention at the outset, because we are considering, basically, matters of taxation of income from savings and other issues relating to retirement savings. There are three basic objectives we see in incentives for savings.

The first, of course, is to increase savings in the economy and to make these savings available to investment in capital. That benefits not only the saver but the worker whose productivity is increased because of a greater investment in capital, more productive plant and equipment, and eventually the consumer.

The second objective is to insure that our citizens have an adequate income in their later years.

And the third is to reduce or eliminate inherent biases in the Tax Code against savings. Present consumption is clearly favored under our tax laws over future consumption financed by savings. This problem is exacerbated in an inflationary period. We addressed this last summer, as you know, Mr. Chairman, and a number of the items in the Economic Recovery Tax Act were designed to reduce these biases. I would just like to keep those points in mind as we go through these bills.

I might just mention, on Senator Baucus' S. 829, we have no objection, and speaking for the administration we have no objection, to the legislation.

Senator CHAFEE. Mr. Chapoton, in your listing of what you've done to encourage saving, and so forth, and your objectives, you didn't specifically mention the IRA's in any way.

Secretary CHAPOTON. No. I was taking the objectives generically. Certainly, IRA's are a very major portion. But I am just absolutely convinced that this is really going to make tremendous changes in the increase in savings through the IRA's.

Senator CHAFEE. Senator Bentsen, I would be curious of your comments, whether you are as optimistic as I am on the future for the IRA's. I notice all the institutions are now beating the drums for IRA's. To me they show incredible potential for not only increased savings but, of course, achieving the objective of helping people set aside something for their old age.

Senator BENTSEN. Mr. Chairman, anyone who doesn't take advantage of it is just doing some very foolish planning. I think that the sales literature is right, in a sense. I think you are going to see a tremendous response to it with a substantial increase in savings in this country as a result of it. That's going to give us some more in the way of capital formation, and that's just what we need.

Senator CHAFEE. I suspect that we won't see much, although some will be putting money into the IRA's in the first part of the year. Would you agree, Mr. Chapoton, that the real influx of the money might well come a year from now or even prior to April 15, 1983?

Secretary CHAPOTON. Yes, sir. I think because of the advertising, and you are certainly right. All of the institutions are being quite active in this, and as the chairman pointed out when the legislation was being considered, their job is made much easier by the fact that the limits are the same for all without regard to whether the individual is covered by a company-sponsored plan and without regard to whatever status he may be in. In other words, they can just advertise that $2,000 can go in without limit.

But I think you're right. Because the deduction is available people will tend to get to the end of the year and see that the availability of this investment is reducing their tax liability; so we will see a great influx at the end of the year.

Senator CHAFEE. I know this is diverging a bit, but I think one of the encouraging things is that far more institutions are offering them now than previously did. Under existing law prior to the new year, the restrictions on who can get them were very complicated and confusing; coupled with the 15-percent limitation, I think a lot of, say, credit unions were discouraged from offering them.

Secretary CHAPOTON. Also the dollar limitation, too, on the amounts.

Senator CHAFEE. Also the dollar limitation.

Secretary CHAPOTON. Fine.

Senator CHAFEE. Well, go ahead, Mr. Chapoton. I'm sorry to interrupt.

Secretary CHAPOTON. All right.

Commenting first on S. 1607, the interest and dividend exclusion that Senator D'Amato discussed. As you know, this was an amendment. The $200–$400 dividend and interest exclusion was dropped in favor of the all-savers certificate, and beginning in 1985 the partial exclusion, the 15-percent exclusion, of net interest income.

We are opposing reinstatement of the $200–$400 exclusion on a number of grounds. The first ground is simply, Mr. Chairman, the revenue cost in doing so at this time. But we do point out in our statement that we do have some fundamental conceptual problems with a flat-dollar exclusion in that it does not take care of the problem. It does not create a real incentive for saving, certainly no incentive for any people who have more income than the limit, because they simply have the reduction in tax but no incentive to save more.

If the purpose is to increase savings, therefore, we think it falls short on that ground. If the purpose is simply to reduce taxes—and this bill has, of course, the effect of reducing taxes across the board—we think a straight rate reduction is preferable. That's, of course, what was done in the 1981 act. We think in both cases that the $200–$400 exclusion falls short.

Senator CHAFEE. Well, that won't meet with unanimity I presume.

Senator Bentsen?

Senator BENTSEN. Well, you know, I don't totally disagree with his one point; $200 to $400 does not appear to be a very dramatic figure, and that's one of the problems. It doesn't sound like large figures when we talk about the all-savers amounts.

But I think what it points out is that we ought to spend some time in trying to develop an overall approach to really encourage savings more than we have, and I think what has been done on Keogh's and IRA's, those are very progressive steps.

I'm not satisfied. I think we have to look at our all-savers again, and we have to look at this $200–$400, to see if we can't come up with something that is salable and attractive and yet achieves the objectives to encourage savings in this country. So I don't totally disagree with my friend's statement about the $200 and $400, even though I have my name written all over it.

Secretary CHAPOTON. We certainly agree, Senator Bentsen. Whatever is designed, and we all need to work further on designing tax changes to increase savings, but whatever is designed does have to provide incentives for greater savings. And I think that is the main point.

Senator CHAFEE. Yes. I'm not sure that all of your objections to S. 1607 don't apply to the all-savers. What is the difference?

Secretary CHAPOTON. Well, because the annual exclusion amounts are certainly larger than under current law. But a lot of the objections do apply to the all-savers. The amounts are larger, so you reduce the problem. But clearly, when you exceed the dollar limitations there is no further incentive for saving. And indeed, as people have pointed out at length, there is a lot of transfer of savings rather than new savings resulting from all-savers.

Senator CHAFEE. All right. Please proceed, Mr. Chapoton.

Secretary CHAPOTON. S. 1645 relates to investments in collectibles by individual retirement accounts, IRA's, and self-directed accounts. Under the 1981 act, the law specifically provides that a collectible acquired by an IRA or an individually directed retirement account will be treated as a distribution in the year of the acquisition. So, in effect, collectibles are prohibited from being held by IRA's.

A collectible is defined as a work of art, a rug, an antique, metal, gem, stamp, coin, alcoholic beverage or other item of personal property specified in Treasury regulations.

S. 1645 would simply repeal this and would allow collectibles to be acquired by IRA's. We've got reservations about this change in a number of respects. First, as was made clear in the committee report, a principal purpose of making the IRA accounts available to persons already covered by qualified plans was to create an incentive for savings and to increase the pool of investment capital, and thereby hasten the Nation's economic recovery. Congress clearly had in mind savings through banks, thrift institutions, and other traditional investment media, and not through household goods, hobbies, luxury items, or consumables.

As I noted at the outset, the current tax system creates a strong bias toward consumption and toward purchase of goods which can be stored or which yield their income in forms which are not taxed currently, and we feel there is no need to add further incentives now to increase investment in collectibles.

Second, collectibles generally have value not only as investment goods but as consumption goods as well. There is nothing wrong with this. Indeed, their value as an investment is equal to the value of both the present and future flow of consumption services that they yield. But tax incentives for retirement savings were not designed to encourage current consumption but rather to encourage current savings, so there is an undesirable or disincentive effect here.

The third reason for enactment of 408(n), the provision which this bill would repeal, was the inadequate enforcement of the prohibited transaction rules by the IRS. Under the rules applicable to IRA's and to other tax-preferred qualified pension plans, the beneficiary of an IRA is prohibited from using or otherwise obtaining any benefit from his plan investment. For example, if the beneficiary takes property for his personal use, the entire amount including the fair market value of the transferred property is included in his gross income currently, and it is also subject to a 10-percent tax if he is not yet 59½ if the property is used personally, that is, a rug used in his office or a painting hung on his wall. These rules are not widely known, even though the law does require that IRA depositors be given notice of these rules when they set up an IRA account.

But if we set up the law allowing collectibles to be purchased, we will have a tremendous problem of enforcing the self-dealing or the prohibited transaction rules. Taxpayers purchasing collectibles are going to have a strong incentive to use these items, because there is going to be little or no decrease in the value of their retirement funds when they are so used, and the IRS will have a difficult, almost impossible, enforcement task.

Finally, one of the principal benefits of IRA's is that they offer tax deferral on earnings. But if you put in collectibles or other items which don't yield current taxable income, then you lose the benefit of tax deferral that would be available if the investor put dividend or interest income-earning investments in the IRA. Also, the effect of putting collectibles in an individual retirement account is that the appreciation in the collectible, when distributed, will be taxed as ordinary income; whereas, the appreciation, if the investment were held outside of the individual retirement account, would be capital gain. So there will be a tendency for taxpayers to be misled and, indeed, in some circumstances, it would be much preferable for them from their standpoint to make that type of a purchase outside of an individual retirement account.

If there is a feeling that the rule is unduly to restrict diversity of investment by IRA's, we would be happy to work with the committee to try to overcome these rules. But we would need to take into account these problems that I mentioned, both the enforcement problems and the purposes of the individual retirement account, as far as encouraging productive savings in structuring any such rule.

Senator CHAFEE. Thank you, Mr. Chapoton. I must confess I hadn't appreciated that under existing IRA's you weren't permitted collectibles.

Secretary CHAPOTON. No, sir. You are not. Oh, under existing; I'm sorry. Under existing IRA's they are permitted.

Senator CHAFEE. Under the laws that exist today?

Secretary CHAPOTON. Yes, correct.

Senator CHAFEE. You are permitted collectibles. But what you are saying, that if you use one of those collectibles, the rug, for example, in your office, and it's discovered or even if it's not discovered, the IRA is terminated?

Secretary CHAPOTON. In effect, all amounts are deemed distributed. The value is taxed currently, and a 10-percent penalty tax is imposed. Yes, sir.

Senator CHAFEE. So if it's a painting, for example, that has been invested in, the only way to qualify is to keep the painting in a vault, in a third place?

Secretary CHAPOTON. Well, it cannot be converted to personal use, whatever that might be.

Senator CHAFEE. And when we went into the 1982 IRA's, for the future, we repealed that provision.

Secretary CHAPOTON. That's right, prohibited collectibles from being held.

Senator CHAFEE. What about S. 1888?

Secretary CHAPOTON. This relates to variable annuity contracts. It would codify the result reached in a revenue ruling issued in September of this year, 81-225, and it would defer the effective date of the ruling from January 1 of this year, as stated in the ruling, to the date of its issuance, September 25 of this year.

Senator BENTSEN. May I comment on that, Mr. Chairman? Excuse me, Mr. Secretary.

Senator CHAFEE. Yes. Go ahead.

Senator BENTSEN. There is a special order on the floor that I have to address.

Mr. Secretary, I understand your problem in trying to tax these wraparound annuities. My concern, though, and traditionally my concern on this committee, has been any time that you put something in in a retroactive way. And I understand the use of the public-access theory, which I think is somewhat new to the tax law.

But I would urge the Treasury to make the effective date the date of issuance of the regulations. As I understand it, it was made retroactive to the date of January 1.

Secretary CHAPOTON. Yes, sir.

Senator BENTSEN. And I think S. 1888 addresses that particular problem.

Secretary CHAPOTON. That is correct.

Senator BENTSEN. I never mind too much the rules as long as I know what they are, but when they change them and change them retroactively, it's often a very serious problem.

Secretary CHAPOTON. Well, Senator Bentsen, if I might, let me address that question very directly. This point, of course, was considered in depth when the ruling was issued. The facts were these: That a ruling had been issued in 1980, not dealing with this same subject but stating principles that we determined were close enough to it to give fair warning, and public statements were made at the same time, but to give fair warning that the further cases that were eventually covered in the September 1981 ruling might well be questioned. Indeed, the Securities and Exchange Commission required all outstanding offerings of deferred annuities to be stickered; that is, to advise investors that the tax treatment may well be unclear after the 1980 ruling. We felt there was plenty of notice that this was a serious question, at the very least, that the deferral would result.

If we are required to make every announcement of our interpretation of the law prospective, then we will certainly encourage taxpayers, if they have any reason to maintain a position and they think the Service is going to come out with a contrary position, to act as rapidly as possible, knowing that they will be grandfathered. And those who take a more conservative approach will simply not get the benefit that they could have gotten. We think it would be unfair to those who follow the law in a conservative manner, and it would encourage people to do this in the future.

Senator BENTSEN. Well, I wish you wouldn't discourage these optimists who say, "Oh, Treasury really wouldn't do that." But when you go back and change it, even though they know that there has been some risk, I generally try to avoid that.

Secretary CHAPOTON. Well, you will note, Senator Bentsen, that the retroactivity is only until the early part of 1981; so nobody would have to file amended returns. That type of thing was taken into account. It would simply not affect these earnings in 1980 or deposits in these accounts in 1980. But for returns filed for 1981, they would be affected.

Senator CHAFEE. Thank you.

Mr. Chapoton, while you are here, what would you think of requiring a 10-percent penalty for withdrawal of annuity funds before age 59½, like the IRA's? Wouldn't this have the effect of assuring that the annuity contracts that were entered into for retirement purposes indeed entered for that reason rather than some sophisticated investment purpose?

Secretary CHAPOTON. Mr. Chairman, we have been looking at an idea similar to that. As is made clear, I think, in the statement, we think that this committee and the Congress is going to have to deal with this area. We don't have any basic problem if the Congress decides it wants to give this benefit for a tax deferral of savings. If it is going to do so, though, it shouldn't limit its benefit to a case that uses the mechanism of an insurance company and the rules of annuities; indeed, it ought to provide that any financial intermediary can give tax-deferred benefits. But there would have to be some type of restriction such as in the individual retirement accounts, limiting early withdrawal, so that it is not just an investment vehicle for a couple of years and then it comes out with no tax being paid. And, of course, the Congress will have to take into account the cost of permitting significant deferral of all types of investment income.

Senator CHAFEE. I must say I get very, very nervous looking at these that indeed appear to be investment vehicles rather than a true annuity for one's retirement. So we would be anxious to work with you in trying to straighten this out, taking a more general view than this specific problem we are confronted with now.

Secretary CHAPOTON. Yes, sir. That's our feeling entirely, that we need to take a general look at this and that this is a very specific situation. We shouldn't codify this ruling, which is what this legislation would do; we should take a look at the whole area.

Senator CHAFEE. Well, I'm not saying I'm treating the general problem. You know, I'm a cosponsor of this legislation.

I notice Senator Symms is here. Do you want to comment, or do you have any questions for the Secretary?

Senator SYMMS. Well, I want to thank you very much, Senator Chafee, for including S. 1888 in the hearing this morning. I know you had to make some changes to get it done. I do have some remarks. I would just as soon submit them for the record and ask Buck, if I could, a question.

[The prepared statement follows:]

STATEMENT BY SENATOR STEVE SYMMS

Thank you very much, Senator Chafee, for including S. 1888 on this morning's hearing schedule. I know that the arrangements had to be made at the last minute and I appreciate your consideration of this matter and for your co-sponsorship of the bill we recently introduced on mutual fund wrap-around annuities.

The Treasury and the IRS have been on a five-year program to substantially restrict annuities as a base for retirement security. In 1977, the IRS released a revenue ruling that was quickly and decisively overturned by a Federal district court. However, due to a technical device, that decision was overturned.

The Treasury has continued in its attempts to do administratively what they unsuccessfully tried to get Congress to legislate in 1978. On September 25, 1981, the Treasury issued Revenue Ruling 81-225, which changes the tax treatment of variable annuity contracts funded with mutual fund shares.

This most recent Treasury ruling is grounded on a public access policy argument; that is, a person who invests in mutual fund shares through an annuity should not achieve tax deferral if a person who invests directly in the same mutual fund shares is taxed currently. The Treasury ruling is designed to prevent the use of annuities in an asset that could have been purchased directly without the use of an annuity. This latest theory of Treasury's has never been stated anywhere in the more than 50-year history of the rules governing annuity taxation.

As a result, I introduced S. 1888, not because I agree with the ruling but because it is vitally important that Congress act expeditiously and enact certain technical, clarifying changes so that companies and consumers alike will not be unduly harmed.

These rulings on annuities are anti-capital formation, discourage savings and investment for retirement years, and contrary to the policy of this Administration to encourage individual savings and investment. In addition, by the issuance of these revenue rulings, taxes are actually increased at the margin which through the recently passed tax bill, we tried to reduce. However, since it is apparent that Congress and Treasury will be reviewing the taxation of insurance companies in the coming year, I will wait to discuss the merits of these revenue rulings on annuities until that time.

Presently, though, it is essential that the technical, clarifying changes be made.

Senator SYMMS. I just got in, and I apologize. I'm a little bit tardy here this morning, Mr. Chairman.

I notice you oppose the bill. But were there parts of it that you do agree with, and if so, what parts?

Secretary CHAPOTON. We decided that the change, the ruling, should apply as of January 1 of this year for the very considerations that I know that you addressed in deciding that it should apply as of the date of the ruling. And therefore, we would oppose the limitation of the retroactivity portion.

Senator SYMMS. Well, the question I'm asking is: Do the companies and the people, the individuals that are involved in this, actually have the computer capability to physically come up with the information that you would require?

Secretary CHAPOTON. I have heard, in fact I just heard yesterday, that the argument has been made that in some cases it might be difficult for them to come up with that information. That is surprising to me because, as I had explained earlier, the SEC has required every one of these offerings since the 1980 ruling that implied that this may be the result in these cases to sticker the prospectus and to give the taxpayers notice that the tax treatment of these earnings may, indeed, not be deferred. If they had to give the investors notice of that fact, it seems to me that their records should have been maintained where they could indeed furnish the taxpayer that information.

Senator SYMMS. Well, I guess what bothers me is if the taxpayer purchased the annuity under the assumption that you had one set of rules, and then you issue a new rule, it appears to me that you changed the rules in the middle of the game.

Secretary CHAPOTON. Every ruling, Senator Symms, states the law retroactively and prospectively, unless the Commissioner exercises the authority to give it prospective effect only, or the extent to which he exercises the authority to make it prospective only. In this case he exercised that authority to make it prospective only for 1981 and not earlier than 1981.

One of the prime considerations leading to that decision was the fact that after a 1980 ruling we thought taxpayers were indeed on notice of the fact that the Service might maintain that the earnings are currently taxable and the fact that SEC required prospectuses to give notice of that possibility to investors.

So I think an investor was certainly on notice that an aggressive position, that is, no current taxation, might be called into question by the IRS.

Senator SYMMS. Well, what would be the answer, then? If we are going back to the first of 1981, why not go back 2 years?

Secretary CHAPOTON. Well, because we think the 1980 ruling—I think it's very important that fair notice be given at one point, and our feeling was that the ruling issued in 1980 gave that notice. And that clearly was the interpretation. At least the Securities and Exchange Commission thought that there was some notice given in that ruling.

Senator SYMMS. Thank you, Mr. Chairman.

Secretary CHAPOTON. Thank you.

Senator CHAFEE. Thank you very much, Mr. Secretary, for coming.

Secretary CHAPOTON. Thank you, Mr. Chairman.

[The prepared statement of Hon. John E. Chapoton follows:]

For Release Upon Delivery
Expected at 9:30 a.m. EST

STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY
BEFORE THE SUBCOMMITTEE ON SAVINGS, PENSIONS,
AND INVESTMENT POLICY
OF THE SENATE FINANCE COMMITTEE
December 4, 1981

Mr. Chairman and Members of this Subcommittee:

I am pleased to be here today to discuss various bills related to issues of taxation of income from savings and to other issues of retirement savings.

Before proceeding, I would like to outline for you what I believe to be the basic objectives for providing various incentives for savings. The first objective is to increase savings in the economy and to make such savings available for investment in capital. The resulting increase in the capital stock would be of benefit not only to the saver, but also the worker whose productivity and income would increase, and the consumer for whom more and better goods would be made available.

The second objective is to insure that our citizens have an adequate amount of income in their later years. By encouraging taxpayers to save now, we enhance the prospect that they will have a comfortable standard of living in those years. Moreover, their savings will help to build up our capital stock and lessen the extent to which tax collections -- with all their resulting distortions -- will be needed to provide income in old age. For instance, private savings will lessen reliance upon an overburdened social security system as a source of retirement savings.

A final objective is to reduce or eliminate inherent biases in the Tax Code against savings. Present consumption is favored over future consumption financed by savings. Moreover, in an inflationary period, the tax rate on realized capital income may become onerously high, if not confiscatory. Choices are distorted by the interaction of inflation and income taxes: individuals are encouraged to consume rather than invest and to use their savings to purchase or store goods which yield income in a nontaxable form rather than to purchase assets which yield taxable income such as interest and dividends. The Economic Recovery Tax Act of 1981 was designed to reduce many of these biases.

Let us now turn to the bills before you and examine them in light of these various objectives. After setting out a summary and the position of the Treasury Department with respect to each bill, I will discuss each proposal in detail.

Summary

S. 829 would provide periodic cost-of-living increases for annuities payable to survivors of judges of the Tax Court. Treasury does not oppose S. 829.

S. 1607 would extend beyond 1981 the interest and dividend exclusion of $200 per taxpayer or $400 per joint return. For 1985 and later years, an additional $250 per taxpayer ($500 per joint return), or 15 percent of net interest income, whichever is less, would also be excluded. Treasury opposes S. 1607.

S. 1645 would repeal the provision in the Economic Recovery Tax Act of 1981 which provides, effective January 1, 1982, that acquisitions of collectibles (including antiques, art, gems, precious metals, or stamps) by any individual retirement account or self-directed account in a qualified plan will be treated as a distribution for income tax purposes. Treasury opposes S. 1645.

S. 1888 would codify a recent revenue ruling dealing with the tax treatment of variable annuity contracts and would defer the effective date of the revenue ruling to September 25, 1981. In addition, S. 1888 would answer two unresolved aspects of the tax treatment of variable annuity contracts. The Treasury Department opposes S. 1888.

S. 1855 would exempt certain state judicial retirement plans from the requirements generally applicable to state and local government deferred compensation plans. Due to the lateness of our receiving notice that this bill was to be included in today's hearing, Treasury requests additional time to develop our recommendation with respect to S. 1855.

S. 829 -- Cost-of-living Adjustments for Annuities of Survivors of Tax Court Judges

S. 829 would adjust the annuity payable to any surviving spouse or dependent of a Tax Court judge, by applying a 3 percent cost-of-living increase for each 5 percent or greater increase in the salaries of existing Tax Court judges. The bill is generally effective on enactment, but it includes a retroactive catch-up provision for survivors' annuitants on the roles on the date of enactment. Their annuities would be raised by 60 percent of the increase in the salaries of Tax Court judges from 1971 to the present.

The Administration has no objection to the application of COLAs to annuities of survivors of Tax Court judges. We understand that this change would put these annuitants on the same basis as other judges' survivors. The Administration also does not object to the retroactive application of this bill to current survivor annuitants. Nonetheless, the Treasury does not make any recommendation with respect to the general design of this provision because we do not consider this issue to be a matter of tax policy.

S. 1607 -- Interest and Dividend Exclusion

Prior to the Economic Recovery Tax Act of 1981 (ERTA), the interest and dividend exclusion of $200 per taxpayer ($400 per joint return) was available for calendar years 1981 and 1982. For 1983 and thereafter, a dividend exclusion of $100 per taxpayer ($200 per joint return) would be available. ERTA eliminated the $200 interest and dividend exclusion for 1982 and replaced it with an interest exclusion for deposits in All Savers' certificates and, beginning in 1985, an exclusion of 15 percent of up to $3,000 ($6,000 per joint return) of "net interest income." Net interest income generally is defined as the excess of interest income over interest deductions (other than for home mortgages and business). A dividend exclusion of $100 per taxpayer ($200 per joint return) was restored for 1982.

S. 1607 would extend the $200 annual exclusion of interest and dividends. For calendar years 1982, 1983 and 1984, the exclusion would remain essentially the same as it was in 1981.

The 15 percent net interest exclusion in current law for taxable years after 1984 is integrated with S. 1607 by first allowing the $200 per taxpayer exclusion, and then providing an additional exclusion of the lesser of $250 or 15 percent of net interest in excess of the first $200 already excluded. S. 1607 effectively lowers the amount of interest and dividends at which the maximum exclusion is reached.

The revenue cost of S. 1607 is $2.5 billion for fiscal 1983 and $2.6 billion for fiscal 1984. For that reason alone, Treasury must oppose the bill. However, our reasons for opposition are more fundamental. While a flat dollar exclusion does provide tax reduction for many families, it has little savings incentive effect. Over 98 percent of all interest and dividends are received by taxpayers with interest and dividends ~~in~~ excess of a $400 cap. Thus, S. 1607 provides very little savings incentive at the margin for years 1982-84; for years after 1984 it may actually provide a savings disincentive by lowering the amount of interest eligible for some exclusion.

If the purpose of the bill is to reduce or eliminate the bias against savings, then there is no reason to grant an exclusion rate of 100 percent for certain dollars of interest income, and a zero rate on those earnings in excess of a cap. If taxable interest income overstates real interest income because of inflation, or if the tax system is biased against interest income generally because savings is already taxed once when earned as wages, then <u>all</u> of the interest income is deserving of a tax break, not just the first portion. For instance, if a person with $400 of interest income has only $200 of real interest income, it is just as likely that a person with $4,000 of interest income has only $2,000 of real interest income. It would be neither fair nor accurate to grant both individuals an exclusion of $400.

If tax reduction is the objective of this proposal, the appropriate means is simply to reduce tax rates directly. A direct tax rate reduction accomplishes the goal of tax relief in a much simpler fashion than does a flat dollar exclusion of income from some source. Moreover, by reducing marginal rates, tax rate reductions provide genuine incentives.

In summary, an extension of the interest and dividend exclusion beyond 1981, and a cap on the net interest exclusion for years after 1985, simply do not meet the objectives of a savings incentive.

Budget limitations require that Congress judiciously select those proposals most likely to provide actual incentives for savings. This summer, Congress explicitly expressed a preference for the interest exemption provided by the All-Savers' certificate over the exclusion of $200 of interest and dividends per taxpayer. Moreover, there was agreement that for years after 1984 both of these types of provisions should be replaced with a 15 percent net interest exclusion. We believe that it would be a mistake now to increase those revenue reductions in a manner which would provide little incentive to save.

S. 1645 -- Investments in Collectibles by IRAs and Self-Directed Accounts

Section 314(b) of the Economic Recovery Tax Act of 1981 (ERTA) provides that the acquisition of a collectible by an individual retirement account (IRA) or an individually-directed retirement account will be treated as a distribution in the taxable year of the acquisition. A "collectible" is defined as any work of art, rug, antique, metal, gem, stamp, coin, alcoholic beverage, or other item of personal property specified by the Treasury in regulations. If any IRA or self-directed account acquires a collectible after December 31, 1981, the value of the object will be included in the plan beneficiary's gross income. Unless the beneficiary has attained the age of 59 1/2 or is disabled, the value of the collectible will also be subject to a 10% penalty tax. S. 1645 would repeal section 314(b) of ERTA and thus freely permit investment in collectibles by IRAs or self-directed accounts.

As explained in the Committee reports accompanying the Economic Recovery Tax Act, the purpose of making IRA accounts available to persons already covered by qualified plans was to create an incentive for savings, to increase the pool of investment capital, and thereby to hasten the nation's economic recovery. Congress clearly intended to channel the projected increase in IRA savings through banks, thrift institutions, and other traditional investment media, and not directly into household goods (art, antiques); hobbies (coins, stamps); luxury items (gold, silver, jewelry); or consumables (rare wines). Section 314(b) of ERTA therefore prevents persons from enjoying the tax benefits accorded to IRAs and qualified plans if they use their retirement savings to buy such items.

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As I noted at the beginning of this testimony, the current tax system creates a strong bias toward consumption and toward purchase of goods which can be stored or which yield their income in forms which are not taxable currently. The Economic Recovery Tax Act was designed to lessen some of these distortions and to restore the incentive to invest in productive capital. We feel that there is no need to add further incentives now to increase investment in collectibles. The tax system has already created a bias towards their purchase, and inflated their price relative to other goods.

A second reason why investment in collectibles should not take place through retirement accounts is that collectibles generally have value not only as investment goods, but as consumption goods as well. A painting is enjoyable in and of itself, regardless of changes in its value over time. An antique rug is beautiful to look at, regardless of its increasing rarity. Precious minerals and gems are valued by persons who wear jewelry, or use the precious metals in silverware, jewelry, and various forms of artwork. There is nothing inherently wrong with collectibles providing such consumption value; indeed, their value as an investment is equal to the value of both the present and future flows of consumption services that they yield. However, tax incentives for retirement savings were not designed to encourage current consumption, but rather to encourage current savings. To the extent retirement accounts subsidize current consumption, they create inequities among taxpayers and, moreover, distort the demands of consumers to favor the types of goods that are given preferential tax treatment.

It might be argued the prohibited transaction rules are designed or should be designed to require that collectibles be placed in storage so that no one could enjoy the current consumption services that they may yield. However, this type of solution is also inefficient. If goods can provide current consumption value at no additional cost, then storage of such goods may often be inefficient and wasteful.

The third reason for the enactment of Code section 408(n) was Congress's belief that adequate enforcement of the prohibited transaction rules was simply not feasible. These rules bar the beneficiary of an IRA or a self-directed account from using or otherwise obtaining any benefit from plan investments. For instance, if an IRA trustee transfers property to an IRA beneficiary for the beneficiary's personal use, the entire amount of the IRA, including the fair market value of the transferred property, is includible in the beneficiary's gross income, and also is subjected to a 10 percent early withdrawal penalty, if the beneficiary is under age 59 1/2. Similarly, any transfer of plan assets from a qualified plan for the use or benefit of a plan beneficiary will result in the imposition of income tax on the value of the assets transferred and a 5 percent penalty tax on the amount involved in the prohibited transaction.

Unfortunately, these rules prohibiting self-dealing are not widely known, even though all IRA depositors are required to be informed of the rules when they open their IRA accounts. As a result of the elimination of annual reporting requirements for IRAs in 1978, IRA beneficiaries no longer are reminded of the prohibited transaction rules on an annual basis.

Even if the annual reporting requirement were reinstated and these prohibited transaction rules were widely known, it would nevertheless be difficult for the Internal Revenue Service to provide adequate enforcement once a large stock of collectibles is deposited in IRAs and qualified plan accounts. Taxpayers purchasing collectibles will have a strong incentive to use these items because there will be little or no decrease in the value of their retirement funds as a result of that use. The Internal Revenue Service would have to be given adequate resources to check on whether goods are actually being stored or used. I do not think that anyone's interests are served by creating a system that presents these kinds of enforcement problems.

Finally, and as a general observation, it should be noted that one of the principal benefits of IRAs and qualified plans is the tax deferral which they offer on earnings that would otherwise be currently taxable at ordinary income tax rates. By putting coins, stamps and rare wines into IRAs or qualified plans, an individual investor foregoes the tax deferral on dividend and interest income which would have been available, had the plan been invested in stock, bonds, or interest-paying cash. Likewise, because distributions from the IRA or plan are taxed at ordinary income tax rates, the individual investor foregoes the capital gains treatment that would have been available upon the appreciation in these tangible assets, had the assets been held outside the IRA or plan account. Thus, in most cases, individual investors will be better off, after taxes, if they hold rapidly appreciating capital assets outside of an IRA or qualified plan account.

For all of the above reasons, Treasury opposes the elimination of section 408(n). However, we would be willing to work with Congress to insure that IRA and self-directed account provisions allow taxpayers ample opportunity to diversity their portfolios, so long as such investments would not create enforcement problems for the Internal Revenue Service concerning their personal use, or have other deleterious effects.

S. 1888 - Variable Annuity Contracts

S. 1888 would both codify the result reached in Rev. Rul. 81-225 as well as defer the effective date of the ruling to September 25, 1981. In addition, S. 1888 would clarify two currently unresolved aspects of the tax treatment of variable annuity contracts.

Rev. Rul. 81-225 is the third Revenue Ruling issued in recent years that considers the tax treatment of so-called "wraparound" annuities. The arrangements considered in Rev. Rul. 81-225, as well as the arrangements considered in Rev. Rul. 77-85 and Rev. Rul. 80-274, represent attempts to push to an unjustified extreme the special tax treatment accorded deferred annuities under existing law. We believe that these three rulings are proper interpretations of current law. We also believe that this committee should focus on the broader tax policy issues raised by the current treatment of wraparound annuities.

A deferred annuity contract is an agreement pursuant to which a taxpayer deposits funds with a life insurance company. The taxpayer enters into a deferred annuity contract well before periodic annuity payments are to begin. Payments made during this "accumulation period" are invested by the insurance company. The taxpayer is under no obligation to purchase an annuity, or to use the amount in the account for retirement purposes.

Under current law, income from typical portfolio investments such as interest and dividends is normally taxable in the year of actual or constructive receipt by the owner of the securities. Deferred annuities (including deferred variable annuities) are not taxed in this manner. During the period between the purchase of the annuity contract and the time that payments are made (either lump-sum or periodically), taxation of the investment earnings is deferred. Neither the contract holder nor the insurance company pays any current tax on those earnings. Even if the contract holder withdraws cash from his account during the accumulation period, no amount is includible in income until the total withdrawals exceed the total investment in the contract. The net effect of these unique tax provisions is that most holders of deferred annuities are permitted unlimited deferral of income taxes on the investment earnings until the end of the accumulation period.

Rather than considering the provisions contained in S. 1888 that would facilitate the marketing of deferred annuities that are in essence investments in mutual fund shares, the Treasury Department believes that this Committee should focus on the more fundamental and serious tax policy questions raised by the tax treatment of deferred annuities. Traditionally, most annuity contracts purchased by individuals were immediate annuities. These annuities were safe, conservative, but low-yielding investments that both provided income for retirement and insured individuals against the possibility of outliving their assets. Deferred annuities were sold primarily as an investment vehicle that would provide post-retirement income in an annuity form.

In recent years, however, the traditional role of the deferred annuity as a retirement income vehicle has become less significant for two reasons. First, in marketing deferred annuities as tax shelters, brokers and other promoters have emphasized the combined benefits of tax deferral during the accumulation period, the tax-favored treatment of cash withdrawals and the option to withdraw lump-sum amounts. Second, changes in the tax law have made Individual Retirement Accounts, Keogh plans and private pension plans the predominant vehicles for retirement savings. These developments raise at least three serious policy questions.

First, we question whether it make sense to allow extremely favorable tax treatment of deferred annuities which are no longer used primarily for retirement savings, while imposing a current tax on other forms of savings that are made for comparable purposes. Investments in variable deferred annuities that are used to purchase shares in mutual funds or money market funds are not materially different from a direct investment in the applicable fund shares. In both cases, the economic risks and rewards, as well as the ability to liquidate or use the investment as collateral, are equivalent. However, earnings credited to the fund shares are taxed currently, whereas earnings credited to a deferred annuity are not. We do not understand why the tax law favors certain investments only if an insurance company serves as a financial intermediary but not when other financial intermediaries receive the invested funds directly.

Second, to the extent that deferred annuities are used for retirement savings, we question whether, as a matter of policy, the substantial tax benefits should be allowed without applying the restrictions imposed on alternative retirement savings vehicles. To illustrate, Congress has imposed significant limitations on Individual Retirement Accounts: the maximum annual contributions to the accounts are limited; taxpayers generally cannot withdraw funds from the account prior to retirement age without incurring a penalty; and a taxpayer who pledges an account as collateral for a loan is treated as having withdrawn the funds from the account. No comparable restrictions are imposed on deferred annuities. We do not understand why deferred annuities should receive more favorable treatment than Individual Retirement Accounts.

Third, continuation of the present tax treatment of deferred annuities would result in substantial and increasing revenue losses. Eventually, a very substantial portion of the savings by individual taxpayers could be attracted into deferred annuities. Such a development would reduce tax revenues by billions of dollars. These potential revenue losses should not be ignored.1/

Although the special tax treatment of deferred annuities raises these serious tax policy questions, Rev. Rul. 81-225 does not question the basic deferral available to the purchaser of a straight or variable deferred annuity. Rather, Rev. Rul. 81-225 considers whether the tax treatment given deferred variable annuities extends to investments that are, in essence, the direct purchase of investment securities. This revenue ruling holds that a taxpayer will be treated as the owner of mutual fund shares purchased in connection with wraparound annuities unless the issuing insurance company controls the investment in mutual fund shares that are not available to the general public. The Treasury Department examined this question at length. The conclusion reached was based on our analysis of existing law, not on what we believe the law should be. Although we believe that Rev. Rul. 81-225 interprets existing law correctly, we do not believe that the result reached in the

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1/ In addition, this Committee should also consider whether adequate safeguards exist to insure that investors in deferred annuities eventually report the investment income earned during the accumulation period. We understand that certain insurance companies do not maintain adequate records to guarantee that this investment income will be reported by taxpayers.

ruling should be codified. We believe that it would be preferable for Congress to reexamine the overall treatment of deferred annuities rather than codifying a result which is a correct interpretation of current law, but which represents unsound tax policy. If Congress determines that this form of savings should not be taxed currently, investments offered by all financial intermediaries should receive this benefit.

S. 1888 would also clarify two aspects of the treatment of deferred annuities that were not fully analyzed in Rev. Rul. 81-225. First, it would allow a life insurance company issuing these annuities to employ investment managers who are not affiliated with the life insurance company. Second, it would allow contract holders to allocate or transfer their investment in their contracts among various subaccounts of the issuer of the contracts. These questions are currently under administrative consideration at the Internal Revenue Service, and we anticipate that rulings on these issues will be forthcoming in the near future. Whatever the proper interpretation of existing law, we do not believe that legislation should facilitate the sale of these deferred annuities in any manner. For this reason, we oppose the two clarifying amendments to S. 1888.

The final provision of S. 1888 would defer the effective date of Rev. Rul. 81-225. Rev. Rul. 81-225 generally applies only to the mutual fund shares purchased with payments made with respect to mutual fund wraparound annuities after December 31, 1980. S. 1888 would limit the applicability of Rev. Rul. 81-225 to the shares purchased with payments made subsequent to September 25, 1981, the date Rev. Rul. 81-225 was published. The Treasury Department strongly opposes this provision of S. 1888.

The legal reasoning contained in Rev. Rul. 81-225 was not a novel departure from prior published revenue rulings. At a minimum, the publication of Rev. Rul. 80-274 on September 24, 1980 raised serious questions concerning the tax treatment of mutual fund wraparound annuities.2/ Indeed, after the publication of Rev. Rul. 80-274, the Securities and Exchange Commission required companies issuing mutual fund wraparound annuities to "sticker" their prospectuses to discuss the possible tax consequences of investing in their

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2/ Although Rev. Rul. 80-274 considered the use of deferred variable annuity contracts to purchase certificates of deposit issued by a savings and loan association, the legal analysis contained in that ruling is very similar to that contained in Rev. Rul. 81-225.

products in light of that revenue ruling. These stickers not only stated that the issuing life insurance company did not guarantee the tax consequences of investing in the annuities, but also advised any prospective purchaser to seek their own tax counsel.

Any taxpayer who bought or made additional contributions to an annuity after December 31, 1980, thus had more than ample notice of probable adverse tax consequences. In light of this notice, it is singularly inappropriate for Congress to enact legislation that would further defer the effective date of Rev. Rul. 81-225 beyond that announced in the ruling. Rather than constituting an abuse of discretion, the use of the post-December 31, 1980 effective date represents an exceedingly generous exercise of that discretion.

Moreover, deferral of the effective date would not only be unfair to taxpayers who invested according to the probable interpretation of the law; it would also create serious administrative problems. The Internal Revenue Service is constantly faced with questions of interpretation. If the Service's rulings were applied only on a prospective basis, taxpayers could avoid taxes by simply supporting their positions with only the slightest legal authority where it is anticipated that the IRS will correctly interpret the law in a contrary manner. The efficacy of our self-reporting system could be seriously undermined if rulings could only be applied prospectively. It is for this reason that Congress has recognized that revenue rulings are generally to be given full retroactive effect. We have found no special circumstances regarding this ruling that would justify prospective relief.

While we recognize that S. 1888 only would require prospective application of a single ruling, it would establish a dangerous precedent. Rev. Rul. 81-225 was anticipated by many tax advisors. Taxpayers who refrained from purchasing mutual fund wraparound annuities should not be punished for their responsible actions. Nor should taxpayers who acted aggressively, and with knowledge that their position probably would not be sustained, receive an undue windfall.

The Treasury Department is attempting to develop a legislative proposal concerning the tax treatment of deferred annuities. We hope that this proposal will be completed in the near future. It is our hope that we will work with this Committee in formulating appropriate responses to the significant policy questions that have been discussed today.

Senator CHAFEE. Judge Tannenwald, you are in a very favorable position. The Secretary just said he's not opposed to your legislation.

Judge TANNENWALD. Well, I'm very grateful to the Secretary for that. But I would hope that his view would be shared by the members of the committee and the Senate as a whole. I have to admit that the Secretary is not wholly disinterested. After all, the Commissioner of Internal Revenue is a party to every proceeding before us. Indeed, it is exactly for that reason that I made no request to the Treasury for support of this bill.

Senator CHAFEE. Well, you've got it anyway. And while the Secretary's approval of any measures before this committee is not an imprimatur of excellence always; nonetheless, it doesn't do any harm to have the Treasury with you.

Judge TANNENWALD. That's correct, Mr. Chairman.

Senator CHAFEE. So, why don't you proceed, and you don't have to go into too much detail. I understand you have a statement. Why don't you submit that for the record?

Judge TANNENWALD. I have done that.

[The prepared statement follows:]

Statement of Chief Judge Theodore Tannenwald, Jr.,
United States Tax Court,
on S. 829 to Provide for Cost-of-Living Adjustments
in Annuities for Survivors of Tax Court Judges

Before the Subcommittee on Savings, Pensions
and Investment Policy,
Committee on Finance,
United States Senate
December 4, 1981

The United States Tax Court supports, and urges the enactment of, S. 829, introduced by Senator Baucus. This proposed legislation is an important and long-needed reform with respect to annuities paid to the surviving spouses of Tax Court judges.

I. Summary of Principal Points

Our principal points are:

1. The catch-up provision to take into account the huge increase in the cost of living since 1964 is essential to make a fair and equitable adjustment for widows who are presently receiving fixed survivor annuities.

2. The provision for a cost-of-living adjustment to benefits for future survivors of Tax Court judges is also fair and equitable to bring the Tax Court system in line with the provisions respecting survivor benefits of other federal judges.

3. Certain other minimum changes should be made in the present Tax Court survivor benefits system to accord with the provisions applicable to other federal judges, to wit: (a) 18 months instead of 5 years of required judicial service; (b) reducing the base period for computation from 5 to 3 years average annual salary; (c) increasing the ceiling on survivor annuities from 37-1/2% to 40%.

4. The Tax Court system is financially sound and the anticipated annual receipts will be more than sufficient to cover the increased annuities which will be payable if all the suggested changes are made.

II. Discussion of Provisions of S. 829

I will first address the second provision of S. 829, which provides for a catch-up adjustment in the survivor benefits now being received by widows of Tax Court judges. This is a most important and long-overdue provision. Under the existing Tax Court judges' survivors annuity system, the annuity paid a surviving spouse is based on the compensation received by the deceased spouse at the time of death without any adjustment to take into consideration increases in the cost of living. As far as we can determine, our system is the only federal program of its type in which the benefits paid to survivors are not subject to such an adjustment. The most egregious situation is that of Mrs. Lucy B. Opper, and her situation most dramatically demonstrates the need for some cost-of-living feature. Judge Opper, who had served on the Tax Court for 26 years, died in 1964, and Mrs. Opper became eligible for the maximum annuity then payable, $7,647 per annum, and she is continuing to receive that same amount.

Since 1964, the cumulative consumer price index increase has been 184.7%. The benefits of a survivor of a U.S. government employee under the Civil Service system and of a deceased federal judge have been adjusted during this same period to reflect this increase, pursuant to 5 U.S.C. section 8340 and 28 U.S.C. section 376(m), respectively.

At the present time, there are 6 surviving spouses receiving annuities under the Tax Court system. They range in age from 66 to 101 years, and the total cost of their present annuities will be $77,303. Schedule A attached to this statement contains the relevant data for each surviving spouse.

The increase in the annuities paid to the present annuitants that would result from the enactment of the Baucus bill would be $13,062, or a total for all annuities of $90,365. However, we propose that the effective date of the bill be rolled back to December 31, 1963, in order to extend to Mrs. Opper an adjustment comparable to those provided for the other participants. If such change is made, Mrs. Opper's annuity would increase by $3,778 and the increase in cost of all annuities would be $16,840, or total payments of $94,143.

The other provision of S. 829 would permit future cost-of-living adjustments to benefits paid to survivors of Tax Court judges. We think that this is also an important and essential provision. The provision tracks 28 U.S.C. section 376(m), which contains the same formula for adjusting the benefits of survivors of other federal judges.

The Tax Court survivor benefits fund is financially sound and there is sufficient income to cover the entire cost of the Baucus bill, even including the proposed rollback of its effective date. The total face amount of cash and securities the fund as of September 1981 was $846,000.00,[1] and the receipts of the fund for fiscal 1981 were approximately $144,000.00, consisting of contributions by the judges and appropriations of approximately $75,000[2] and income earned by the fund of approximately $69,000. Attached hereto as Schedule B is a historical analysis of the receipts and disbursements of the fund. The total present benefits that would be payable under the Baucus bill, with the rollback, would be $94,143. Thus, the proposed changes could be made without any increased contributions to it.

I recognize that the question of availability of sufficient funds annually to cover annuities which may have to be paid will depend upon several variables. One, of course, is the level of income earned by the fund. The present average rate

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1 The current fair market value of the securities will vary from time to time, depending upon the prevailing interest rate.

2 This figure does not include contributions by Tax Court judges in respect of past government service.

of return is approximately 8.2% on the face value of the United States Government securities held by the fund. We are permitted to invest the funds only in such securities, and it is our practice to hold the securities to maturity. Consequently, fluctuations in the market value of the securities have no real impact. Our judgment is that the 8.2% average rate of return is likely to continue for the foreseeable future, but even if it dropped substantially, we would still have enough current receipts to cover the annuities which might have to be paid.

In this connection, we have no way of knowing, of course, exactly how many annuities will be payable at any one time in the future. But, based upon the ages of the present judges participating in the system and their spouses, our best judgment is that it is probable that we will be paying no more than 7 annuitants at any one time,[3] with an average annuity of $17,500 (based on the present salary level), or total payments of $122,500. Thus, even in this context, if the average rate of return on our investments were to drop from 8.2% to 6%, we would still be able to cover this amount out of annual receipts, which then would approximate $125,000. Another variable, of course, is the impact of future cost-of-living adjustments. However, given the fact that this adjustment is not automatic

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3 The present number of annuitants (6) is the highest since survivor benefits became payable.

but is keyed to increases in the salary of the judges, its impact is almost impossible to determine.

We think that the provisions of S. 829 represent changes in our survivor benefits system that are fair and equitable and represent the minimum that should be done. The Tax Court survivors annuity system was enacted in 1961 and was modeled after the survivor benefits then available under the Civil Service retirement system and under the judicial code. However, since that time many improvements have been made in these systems but no material improvements have been made in the Tax Court system. Mr. Robert J. Myers, who served as consultant to the Tax Court on our survivor benefits system before he assumed his present post as Deputy Commissioner, Social Security Administration, has observed that our system--

> is badly outdated and is not at all comparable in several of its provisions with all other pension plans for federal employees. In particular, the lack of comparability applies especially to (1) the absence of automatic adjustment provisions, (2) the failure to update and make consistent benefit amounts and definitions applicable to child beneficiaries, and also the eligibility conditions for widows and widowers, and (3) the use of a 5-year period for averaging salary instead of the three years that is applicable elsewhere.

The provisions of S. 829 represent a step in the direction of modernizing our system, as would some further amendments which we would like to suggest and to which I would now like to turn my attention.

III. Recommended Further Amendments

All of our suggestions would bring the Tax Court system more in line with other survivor benefit systems, especially that contained in the judicial code (28 U.S.C. section 376). The suggestions are as follows:

1. S. 829 now by implication provides for annuities to be payable after 18 months of service by the deceased judge of the Tax Court. 26 U.S.C. section 7448(b) provides that eligibility for survivor benefits requires 5 years of civilian service by the deceased Tax Court judge. The potential conflict between these two provisions should be clarified. Let me point out that S. 829 is patterned on 28 U.S.C. section 376(h), which is applicable to other federal judges and which has only an 18-months-of-judicial-service requirement. We urge that the suggested clarification be in the direction of conforming the Tax Court provisions to those applicable to other judges. Our judgment is that the potential cost involved in this change would be negligible.

2. Reduce the base period for computing the amount of a survivor's annuity from 5 to 3 years. Such a change would have the effect of bringing Tax Court survivors annuities into line with the provisions now contained in the judicial code (28 U.S.C. section 376(l)(1)) and in the Civil Service retirement system (5 U.S.C. section 8340). This could result in a small increase in future annuities to some surviving spouses, but its impact in terms of available current funds would be

negligible.

3. Increase the ceiling on the annuities payable to a surviving spouse from 37-1/2 percent to 40 percent of the judge's compensation. This change is in line with the judicial code (28 U.S.C. section 376(1(2)) and would provide a lower ceiling than is applicable under the Civil Service retirement system (5 U.S.C. section 8340). It would enable some surviving spouses to receive slightly larger annuities, which are certainly needed in light of today's cost of living. The cost impact would be negligible.

We are confident that the proposed changes can all be made without any changes in the rate of contributions to the fund by the judges or by the government, and we have limited our proposals to those changes which are most urgent and which can be included without requiring additional contributions. However, there are many other features of the Tax Court system which are not in line with the judicial code system or the Civil Service retirement system, and if the Subcommittee should not agree with our evaluation of the impact of the proposed changes and should conclude that a change in the contribution level is necessary, then we strongly urge that all of the benefits and conditions of the system be revised to bring them in line with other systems. We will be delighted to work with the Subcommittee and its staff in developing any additional information which the Subcommittee may desire or in developing any proposed amendments to the present law.

SCHEDULE A

Annuitant	Date of Judge's Death	Present Annual Annuity	Total of Proposed Increases	Proposed Annuity
Mamie C. Black	05-22-75	$14,490	$ 3,761	$18,251
Margaret C. Hoyt	06-21-76	9,944	2,215	12,159
Bernice W. Kern	01-29-71	12,277	3,185	15,462
Sonja K. Mulroney	05-28-79	15,031	1,380	16,411
Lucy B. Opper	06-19-64	7,647	1,984	9,631
Florence B. Pierce	12-14-80	17,914	537	18,451
		$77,303	$13,062	$90,365

SCHEDULE B

PROGRESS OF TAX COURT JUDGES' SURVIVORS ANNUITY FUND, 1962-81
(In Thousands)

Fiscal Year	Government Contribution	Judge's Contributions Regular	Judge's Contributions Deposits	Interest Earnings	Benefit Payments	Fund at End of Year
1962	$20	$ 3	$ 4	$--	$ 3	$ 24
1963	20	6	--	--	4	46
1964	20	6	3	--	4	71
1965	20	7	--	--	11	87
1966	20	8	3	#	11	107
1967	20	8	--	5	11	129
1968	20	10	--	6	12	153
1969	20	12	--	7	12	180
1970	20	18	19	8	12	233
1971	24	21	4	9	13	278
1972	24	20	--	12	20	314
1973	30	21	6	15	18	368
1974	30	22	--	23	22	421
1975	30	23	6	32	21	491
1976	30	24	--	35	34	546
1976 (Transition Quarter)	8	5	--	18	11	566
1977	30	26	--	42	65	599
1978	30	28	--	49	45	661
1979	30	27	--	52	50	720
1980	40	25	--	60	70	775
1981	40	35	4	69	77	846

Less than $500

STATEMENT OF HON. THEODORE TANNENWALD, JR., CHIEF JUDGE, U.S. TAX COURT

Judge TANNENWALD. If I may take just 2 minutes to emphasize to you the problem. And you already know the problem, because you were kind enough to talk to me about it ahead of time.

The Tax Court survivor benefits system came in in 1961. It has not been changed since that date. It is, as far as we can determine, the only system of Government survivor benefits which does not have a cost-of-living adjustment. We have six widows, and my statement shows the six, who have received the same amount of pension since their husbands passed away.

The most critical example is the one of Mrs. Opper, whose husband died in 1964 when the salary of the Tax Court judge was $22,500. She was entitled to the maximum benefit of 37½ percent, and she has received and has been receiving for 17 years the magnificent sum of $7,600 a year, without the slightest adjustment.

Now, we think this is totally unfair. We have hoped that we would have the opportunity, and for one reason or another we haven't in recent years, to get this adjusted. We would urge, Mr. Chairman, that the date of December 31, 1970, which is in Senator Baucus' proposed bill, be moved back to December 31, 1963, in order to take care of Mrs. Opper.

Senator CHAFEE. She is the only one that falls in the interim period?

Judge TANNENWALD. She is the only one that falls within the interim period. As my statement shows, the cost of the changes proposed by Senator Baucus can be borne by the current receipts of the fund. And to my statement is attached a table showing that we have always been able, through the contributions both by the Government, and the judges, and the earnings of the fund, to more than cover the cost. And we can cover this increased cost.

We have, as my statement shows, three additional suggestions of conformity which I will mention very briefly. One is to provide that eligibility for survivor benefits will be available when a judge has served 18 months instead of 5 years, as the present section now provides. And, indeed, there is a gap in Senator Baucus' amendment which creates a conflict as to whether it should be 18 months or 5 years.

Senator CHAFEE. Do you point out this problem in your testimony?

Judge TANNENWALD. That is correct.

And, second, we would like to have a 3-year instead of a 5-year average, which is comparable with both the civil service and the judicial survivor benefit system. And we would like a maximum of 40 percent instead of 37½ percent, which is comparable to the present existing survivor benefit system for other judges.

Our system is outdated; it needs to be modernized. There are other things that could be done. We are asking at this point only for the minimum, and I would urge, Mr. Chairman, that you and your committee and the full Senate and the full Senate Finance Committee give very favorable consideration to this. This is long overdue, particularly the catchup for the present survivors, and I think the adjustment for future survivors, as well.

Senator CHAFEE. I thank you very much, Judge. I would point out just in passing that what you say, of course, is accurate about the others receiving, in effect, indexing of their pensions—survivors of the U.S. Government employees: Military services, other judges, and so forth. But I think it is worthwhile noting in passing that this is probably unique in the pension system in the country. I suspect that nobody in private industry has their pensions indexed.

Judge TANNENWALD. I agree with you, Mr. Chairman.

Senator CHAFEE. My only point is that, when you mentioned the widow of one of the judges that died in 1964 and the benefits being very modest considered in the context of 1981, it's absolutely true. But at the same time I can't help but think of those who are widows or survivors in private industry or, indeed, most State plans. In our State we had all kinds of difficulties and poignant stories of elderly teachers, who received their pension in 1942, or whatever it might be, living on an extremely modest sum that's not being indexed. Somehow, I would be hopeful that those other plans will achieve what the U.S. Government has been able to achieve. I'm in support of your legislation.

Judge TANNENWALD. Mr. Chairman, you are correct; but let me point out one very distinct factor: Judges come to the bench rather late in their professional career. They do not have a very long period of service. And therefore, the pensions which are based upon the number of years of service, which their survivors get, is not as high to begin with as is true in the private sector. And one of the attractions—they come to the bench late in life, relatively speaking, and if they come from the private sector, and I speak from my own experience, they give up a tremendous capacity for earning which would be a source of savings to finance their widows' benefits. They give that up completely.

Now, I hate to tell you what the multiple would be of the earnings that I could make in private practice today, as against what I am making as a judge and what I would have been making over the 16 years that I have been on the bench. I could have well provided for my widow under those circumstances, and I don't think I would have needed a cost-of-living adjustment. But that isn't what happened.

So there is that ameliorating factor for those of the judiciary who come to the bench late in life because we want them with experience. And the attraction of a good survivor-benefit system is important to attract people from the private sector.

Senator CHAFEE. To the bench.

Judge TANNENWALD. To the bench; that's correct.

Senator CHAFEE. Right. Well, thank you very much, Judge. I appreciate your coming.

Judge TANNENWALD. Thank you, Mr. Chairman.

Senator CHAFEE. Now let's move to the panel on S. 1888: Mr. Cohen, ~~Mr. Alexander,~~ Mr. DeShetler, and Mr. Frazer. And, gentlemen, I would ask that you keep your statements brief. We have three panels, two panels after you, and I would like to move right along, if we could.

So why don't we take them in order called. Mr. Cohen, you are familiar here. We are delighted to see you back.

STATEMENT OF MR. EDWIN S. COHEN, ESQ., COVINGTON & BURLING, ON BEHALF OF THE INVESTMENT COMPANY INSTITUTE, WASHINGTON, D.C.

Mr. COHEN. Thank you, Mr. Chairman. My name is Edwin S. Cohen.

Senator CHAFEE. You don't have to qualify as an expert witness. [Laughter.]

Mr. COHEN. Well, I thank you. There may be a challenge to that.

Senator CHAFEE. Mr. Cohen, could you hold 1 minute?

Mr. COHEN. Surely.

Senator CHAFEE. I apparently have an interruption here. We will be in recess for 2 minutes.

[Whereupon, at 10:50 a.m., the hearing was recessed.]

AFTER RECESS

Senator CHAFEE. All right, if we could have it quiet please. Mr. Cohen, why don't you proceed?

Mr. COHEN. Thank you, Mr. Chairman.

My name is Edwin S. Cohen and I appear before the subcommittee today on behalf of the Investment Company Institute. I am a member of the law firm of Covington & Burling, of Washington, D.C.

The Investment Company Institute is the national association of the mutual fund industry. Its membership consists of more than 600 open-end investment companies (known generally as "mutual funds") and their investment advisers and principal underwriters. The institute's mutual fund members have assets of more than $200 billion and have approximately 13 million shareholders.

The pending bill, S. 1888, relates to the Federal income tax treatment of variable annuities in cases in which the funds paid in by contract holders, and the earnings thereon, are invested in shares of regulated investment companies, or mutual funds. The bill is occasioned by Revenue Ruling 81-225 issued by the IRS on September 25 of this year dealing with this subject.

Prior to the issuance of the ruling, I filed with the IRS in October 1980 a memorandum on this subject and, in collaboration with Mr. Alexander and with Mr. William B. Harman, Jr., I filed with the Service and the Treasury more extensive memoranda under date of April and July of 1981. And subsequent to the issuance of the ruling, I filed two memoranda with the Service in October of 1981; the first memorandum requested clarification of matters in the ruling and the other dealt with the effective date of the ruling.

Mr. Chairman, because these memoranda, I believe, will be helpful in an understanding of the issues, I would respectfully request that copies of the memoranda be admitted to the record, and if I may, I offer them for inclusion in the record.

Senator CHAFEE. That would be fine.

Mr. COHEN. Thank you, sir.

[The material follows:]

October 30, 1980

Preliminary Memorandum re Federal Income Tax Status of Individual Holders of Variable Annuity Contracts Involving Insurance Company Segregated Accounts Investing Through Mutual Funds

This preliminary memorandum is submitted to describe and analyze the legal and practical arrangements with respect to various types of variable annuity contracts issued by life insurance companies, including those in which the life insurance company maintains a segregated account in which the funds are invested in one or more mutual funds (known in the Internal Revenue Code as "regulated investment companies").

I

For a century or more life insurance companies have issued both life insurance contracts and annuity contracts. Originally, life insurance contracts and annuity contracts, both of which were based on mortality tables, provided benefits based on fixed dollar amounts. Some thirty years ago there was developed a concept of a variable annuity, in which the funds are invested by the insurance company primarily in common stocks, with the amount of the annuity payment dependent upon the fluctuating value of the investment made by the company. Both the Internal Revenue Code and state insurance company laws were amended to accommodate variable annuities, and the federal income tax treatment to the individual holder was the same whether he held a variable annuity contract or a fixed annuity contract.

Variable annuities may be the only type of contract issued by the insurance company. In other instances, the insurance company may issue not only life insurance contracts and fixed annuity contracts but also variable annuity contracts. In either event, the investments made by the insurance company for the benefit of the variable annuity contract holders are maintained in a "segregated account" established by the insurance company as provided by state law, and the value of each variable annuity unit depends solely upon the value from time to time of the segregated account. The insurance company bears the mortality risk and the contract holder bears the investment risk. The investments upon which the value of the variable annuity unit depends are traditionally supervised, under one arrangement or another, by a professional investment manager.

II

Mutual funds were developed more than fifty years ago as a means of permitting the pooling of investment funds to secure diversification of risk and professional investment management. The mutual fund is a so-called "open-end" corporation,*/ which generally is constantly engaged in issuing its shares for cash at net asset value and stands ready to redeem its shares at net asset value upon request of the shareholder. The public

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*/ Some mutual funds are organized as trusts under state law but are regarded as corporations for federal income tax purposes.

issuance of the shares is governed by the Securities Act of 1933, which requires registration of the offering with the S.E.C. and the furnishing of a prospectus to the investor. In addition, the mutual fund itself is governed by the requirements of the Investment Company Act of 1940, also administered by the S.E.C.

At the time of the adoption of the Investment Company Act of 1940, it was recognized that special federal income tax provisions relating to mutual funds were needed. Accordingly, in the Revenue Act of 1942*/ Congress adopted the basic provisions, now found in Subchapter M, Part I, of the Internal Revenue Code (Sections 851-855), that govern the taxation of mutual funds and their shareholders. In broad terms under those provisions regulated investment companies are treated as conduits through which interest, dividends and capital gains, less expenses, flow through for inclusion in the tax returns of their shareholders. Thus regulated investment companies are not allowed the usual corporate deduction for dividends received but are allowed deductions for dividends paid to their shareholders, and the companies regularly distribute their net income to their shareholders. Net long-term capital gains distributed to shareholders as "capital gain dividends" (§852(b)(3)(B), (C) & (D)) are treated as long-term capital gains to shareholders.

*/ Certain special provisions relating to these companies were adopted as early as 1936.

To be treated as a regulated investment company under Subchapter M a corporation must comply with a number of conditions, including the following:

(1) It must be registered with the S.E.C. under the Investment Company Act of 1940, and thus be subject to regulation under that Act. (§851(a)(1)).

(2) At least 90 percent of its gross income must be derived from interest, dividends, payments with respect to securities loans, and gains from the sale or exchange of stocks or securities. (§851(b)(2)).

(3) It must not be a personal holding company as defined in section 542 (§851(a)). Since its income is of a type that necessarily satisfies the income requirements for personal holding status, it can only avoid being a personal holding company, and thus qualify as a regulated investment company, if its stock is beneficially owned by a sufficient number of individuals so that no five individuals beneficially own more than 50 percent of its outstanding stock. (§542(a)(2)). In addition, because under Int. Rev. Code section 851(a)(1) it must be registered with the S.E.C. under the Investment Company Act, its shares must be beneficially owned by more than 100 persons. Inv. Co. Act, §3(c)(1).

(4) Its investments must be diversified (§851(b)(4)). Speaking generally, this requires that at least half of its total assets be represented by cash, government securities, and stocks and securities of any one issuer that (a) do not exceed in value more than 5 percent in

value of the total assets of the investment company and (b) represent no more than 10 percent of the outstanding voting securities of the issuer. Further, no more than 25 percent in value of the assets of the investment company can be invested in the stock or securities of any one issuer.

Typically the mutual fund does not have its own employees manage its investment portfolio. Rather, it enters into a contract with another corporation or partnership which acts as investment manager, and subject to the overall supervision of the board of directors of the mutual fund, the investment management firm selects the investments to be held, purchased or sold by the fund. The Investment Company Act of 1940, Section 15, requires that the management contract be approved initially by a majority vote of the independent directors of the mutual fund (i.e., those not affiliated with the management firm) and by the shareholders of the mutual fund, and that it may not continue for more than two years without being approved annually by a majority vote of the independent directors or by a majority vote of the shareholders.*/

*/ Since the segregated account supporting a variable annuity contract must be registered with the S.E.C. under the Investment Company Act as an investment company, and since the contract holder bears the investment risk inherent in the contract, the S.E.C. requires that the contract holder have voting rights with respect to election of directors and the approval of management contracts, whether the segregated account is a management investment company with its own portfolio of securities or whether the account is a unit investment trust which places its funds in a mutual fund for investment. The contract holder, however, does not have any voting rights with respect to individual securities held in the investment portfolio.

The investment management firm may manage investments for more than one mutual fund, or may also render investment services for individuals, trusts and estates, pension plans, etc.

The prospectuses issued by the mutual funds to potential investors must state the general investment objective of the fund, such as maintenance of current income, capital appreciation, long-term capital growth, or some combination thereof, and this general objective cannot be changed without prior approval by the shareholders. However, the particular portfolio securities to be owned, purchased or sold by the mutual fund are not specified in the prospectus and are determined by the investment managers, not by the individual shareholders of the fund.

III

When variable annuities came upon the scene in the 1950's, a question arose as to whether the exemption for life insurance and annuity contracts in the Securities Act of 1933 and the Investment Company Act of 1940 applied to variable annuities. The S.E.C. took the position that since the variable annuity unit values fluctuate with the value of the securities in the segregated account, registration and prospectuses are required under the Securities Act and the segregated accounts had to be registered as investment companies under the 1940 Act. The S.E.C. position was sustained by the Supreme Court of the United States in S.E.C. v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959).

To comply with the requirement for registration with the S.E.C., the insurance company issuers have adopted two alternative procedures, without substantial practical differences. In some instances the segregated account is registered with the S.E.C. as an investment company known as a "management company" under Section 4(3) of the Investment Company Act, in which event the segregated account itself holds a diversified portfolio of securities. In other instances the segregated account is registered with the S.E.C. as an investment company known as a "unit investment trust" under Section 4(2) */ of the Investment Company Act, in which event the segregated account, upon receiving funds from the variable annuity contract holders, applies them to acquire shares of registered mutual funds, thus placing the funds in mutual funds for investment management. As discussed in Section VI below, the insurance company may maintain two or more segregated accounts (or two or more subaccounts of a segregated account) with different diversified portfolios of securities, or, if the unit investment trust procedure is used, the segregated account may be operated with two or more subaccounts, each of which places its funds in a different mutual fund.

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*/ Section 4(2) of the Investment Company Act defines a "unit investment trust" as follows:

> "(2) 'Unit investment trust' means an investment company which (A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities; but does not include a voting trust."

As a practical matter the insurance company issuers of variable annuity contracts have needed experienced personnel to manage the investment portfolios that support the variable annuities. In some cases the insurance company might use its own employees for this purpose. In others, the investments of a segregated account have been managed under an investment management contract with an investment management firm, which may be affiliated with the insurance company or may be independent of it. Finally, when under the unit investment trust procedure the funds in the segregated account have been placed in a mutual fund, the investment portfolio of the mutual fund has been managed in the traditional fashion of mutual funds by an investment management firm in accordance with an investment management contract between that firm and the mutual fund.

When the assets of the segregated account are placed in a mutual fund, all of the shares of the mutual fund may be owned in the segregated account for the benefit of the variable annuity contract holders, or shares of the mutual fund may also be owned by other persons and continuously offered to the public. In the latter event, a person could acquire and own shares of the mutual fund directly or he could acquire and own a variable annuity contract the unit value of which would depend upon the net asset value of the mutual fund shares. In either event, the investment manager of the mutual fund may be affiliated with the insurance company or may be an independent company.

IV

All of these various procedural methods have developed gradually over the past twenty years or more to meet practical portfolio investment management needs in segregated accounts for variable annuity contracts, and to comply with the requirements of the Securities Act and the Investment Company Act, as interpreted by the Supreme Court and the S.E.C. But whatever procedural method is employed, the discretion over portfolio investment management is exercised by persons other than the individual owner of the variable annuity contract -- either by employees of the insurance company, by investment managers retained by the insurance company to manage the investments of the segregated account, or by investment managers retained to manage the portfolio of the mutual fund in which the funds of the segregated account are placed. The individual is the person beneficially interested in the investment performance, but the selection of particular stocks and securities in the investment portfolio is made by others and the individual has no control over the selection.

V

These circumstances are vitally different from those considered in Rev. Rul. 77-85 and Rev. Rul. 80-274, in which the individual contract holder himself determines the specific underlying investment to be made by the segregated account. That these differences are vital is demonstrated by the fact that if the individual has the right to select the investments, the variable annuity does not have to be registered with the

S.E.C. under the Investment Company Act. If, however, the investments are selected and managed by others, whether through a mutual fund or not, registration with the S.E.C. will be required, and the insurance company and the investment managers will have the duties, responsibilities and potential liabilities provided by that statute.

In the circumstances described in Rev. Ruls. 77-85 and 80-274, the life insurance companies avoided compliance with the Investment Company Act through giving the individual investor the complete control over the selection of investments, and providing no such discretion in the insurance company or an investment manager. Thus, in Rev. Rul. 77-85 the stated facts were that "The amounts in the account are invested by the custodian in accordance with the directions of the policyholder" from a broad approved list, and the policyholder could "direct the custodian in writing at anytime, and from time to time, to sell, purchase, or exchange securities or other assets held in the custodial account."

And in the recent Rev. Rul. 80-274 it is stated that "The amounts deposited [in a specified savings and loan association] are invested in a certificate of deposit for a term designated by the depositor." Upon the expiration of the certificate of deposit the insurance company "is required under the contract to reinvest the proceeds in a certificate of deposit for the same duration unless an investment of the same duration would extend beyond the annuity starting date," in which event a certificate with a shorter maturity would be purchased or the funds would be placed in a passbook savings account. Neither the insurance company nor anyone else had any investment discretion except that the insurance company did "retain the right to withdraw the deposits from a failing savings and loan association or from an association that terminates the plan" and deposit the funds with another such association.

In both these cases the Service ruled that the individual was the owner of the account for federal income tax purposes, for he was the only one who controlled the manner in which the investments were made. No registration with the S.E.C. was involved. By contrast, in the type of variable annuity contract in which investment discretion is vested in persons other than the contract holder, registration with the S.E.C. is required because the contract holder does not have control over the investments. This is true whether the segregated account makes its own investments or whether they are made via a mutual fund through which the funds are invested in stocks and securities. In determining the need for S.E.C. registration as well as determining ownership for federal income tax purposes it is immaterial whether the investment discretion is exercised by employees of the insurance company, by an investment manager which it retains, or by the investment manager of a mutual fund in which the investment funds of the segregated account are placed by the insurance company.

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The governing point is that the individual does not have the investment management discretion or responsibility for the securities portfolio.

VI

In some instances insurance companies permit the variable annuity contract holder to determine in which of two or more segregated accounts (or subaccounts) his premium payments are to be placed. This privilege may be permitted when the segregated accounts (or subaccounts) are registered with the S.E.C. as "management companies" having their own diversified portfolio of securities as well as when the segregated accounts (or subaccounts) are registered as unit investment trusts, each placing its funds in a different mutual fund. In such instances the insurance companies usually permit the contract holder to direct that the funds be withdrawn from one such account (or subaccount) and placed in another such account (or subaccount). The value of his variable annuity units is to be determined by reference to the net asset value of the chosen account (or subaccount). Where the unit investment trust procedure is used, the value of the account (or subaccount) will reflect the net asset value per share of the mutual fund shares held in the account (or subaccount).

As noted earlier, segregated accounts and mutual funds are required by the S.E.C. to state their general investment objective in their prospectuses. Accordingly, this privilege accorded to the variable annuity contract holder to choose between two or more segregated accounts (or subaccounts), whether the segregated account has its own diversified portfolio or holds only shares of a mutual fund, permits him to determine the general investment objective he wishes his variable annuity contract to seek to achieve. But the prospectus does not state the particular stocks or securities or other investments that the segregated account or the mutual fund will make. The selection of particular investments is made by the investment manager, not by the contract holder; that investment manager exercises the discretion to select the investments and bears the responsibilities imposed by the Investment Company Act.

The right of the contract holder to select the broad investment objective to be sought is similar to that which has traditionally existed under various employee benefit plans, in which employees have long been permitted to designate whether they wish funds held for their ultimate benefit to be placed in high income yielding investments, growth stocks or other broad investment categories and from time to time to switch from one category to another. This has been traditionally permitted by TIAA-CREF (Teachers Insurance Annuities Association-College Retirement Equities Fund), by the American Bar Association Retirement Plan and many other programs. The contract holder is not to be deemed the owner of the account where his only right is to determine the broad investment objective and the discretion and responsibility for the selection of specific investments is vested in other persons over whom he has no control.*/

VII

Section 851(f) of the Internal Revenue Code, added by the Tax Reform Act of 1969, provides in general that where a unit investment trust, as defined in the Investment Company Act, issues periodic payment plan certificates, as defined in that Act (sometimes known as "contractual plans"), it "shall not be treated as a person" (§851(f)(1)), and "each owner of an interest in such trust shall, to the extent of such interest, be treated as owning a proportionate share of the assets of such trust" (§851(f)(2)(A)). However, after so providing, section 851(f) states in a final sentence,

> "This subsection shall not apply in the case of a unit investment trust which is a segregated asset account under the insurance laws or regulations of a State."

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*/ It should be noted that Section 1035(a)(3) of the Internal Revenue Code provides that no gain or loss shall be recognized on the exchange of an annuity contract for another annuity contract. This provision applies to variable annuity contracts. Rev. Rul. 68-235, 1968-1 C.B. 360; Rev. Rul. 72-358, 1972-2 C.B. 473. Since different variable annuity contracts can be supported by different segregated accounts (or subaccounts) having different investment objectives, Section 1035 clearly indicates Congressional intent that the right of a variable annuity contract holder to determine the broad investment objective through choosing among several segregated accounts (or subaccounts), or to switch from one to the other, does not make him the owner of the investment assets for federal income tax purposes. Cf. Rev. Rul. 78-204, 1978-1 C.B. 216.

The Senate Finance Committee report accompanying the provision explains:

> "The new provision does not apply in the case of a unit investment trust (or a management-type of investment company) which is a segregated asset account under the insurance laws or regulations of a State. Where these accounts hold assets pursuant to variable annuity contracts, the account is taxed as part of the life insurance company." Rep. No. 91-552, p. 287 (1969).

Accordingly, whether the segregated account maintained with respect to variable annuities has its own diversified portfolio of securities (a management-type of investment company) or uses the unit investment trust procedure to place the premium payments in a mutual fund, Congress has clearly stated that the variable annuity contract holder is not to be considered as owning a proportionate part of the assets of the trust. This provision, however, is clearly inapplicable in the circumstances dealt with in Rev. Rul. 77-85 and Rev. Rul. 80-274, where no management-type of investment company or unit investment trust registered with the S.E.C. under the Investment Company Act is involved.

VIII

For the reasons stated, the holder of a variable annuity contract issued by a life insurance company is not to be deemed the owner for federal income tax purposes where investment discretion over the selection of stocks, securities or other investments is exercised by the insurance company through its own employees, through investment managers of the segregated account or through the investment managers of a mutual fund in which the investment funds in the account are placed.

April 20, 1981

I

The Treasury statement of March 30, 1981 before the Finance Committee, p. 5., states that "the language and the legislative history of the 1959 and 1962 [life insurance company tax] legislation" * * * "indicate that, in Congress' contemplation, a variable annuity involved a commingled fund managed by the life insurance company issuing the annuity." The authority cited for this statement in the accompanying footnote is §801(g)(1)(A), which defines a variable annuity as being based on "the investment experience of the company issuing the contract," and Congressional committee report references to benefits varying with "the insurance company's overall investment experience."

If the quoted language of the Treasury statement is intended to mean that a segregated account of a life insurance company must be managed only by its own employees, or that it cannot be maintained as a unit investment trust holding shares of an open-end regulated investment company, then the authority cited does not support the conclusion. The above quoted excerpts from Section 801(g)(1)(A) and the accompanying committee report language must be read in their full context, which is outlined below:

1. The concept of a variable annuity was developed some thirty years ago by the Teachers Insurance and Annuity Association (TIAA), a nontaxable non-profit organization which provides fixed annuities for professors and teachers. It did so through the

incorporation of an affiliated nontaxable non-profit organization, College Retirement Equities Fund (CREF), which issues only variable annuities to the same group of individuals. Subsequently the Variable Annuity Life Insurance Company (VALIC) was organized in the 1950's as a taxable profit-making stock corporation, and several other such corporations were subsequently organized. In the late 1950's and the early 1960's state insurance laws were amended to permit segregated asset accounts to be established by life insurance companies. These separate accounts provided the mechanism by which life insurance companies engaged in offering life insurance and fixed annuities could also offer variable annuities to the public, with the value of the units, upon which the amount of the variable annuity is calculated, varying with the net asset value of the separate account.

CREF, VALIC and similar early companies issued only variable annuity contracts, and the investment experience upon the basis of which the variable annuity was computed was essentially that of the entire company. But with respect to variable annuity contracts issued out of segregated asset accounts of life insurance companies doing a general life insurance and fixed annuity business, the investment experience upon the basis of which the variable annuity is computed necessarily is that of the segregated asset account, unaffected by the investment experience of the life insurance company in its general account.

The S.E.C. took the position that a variable annuity contract, despite its annuity features, was a "security" subject to the Securities Act of 1933 (33 Act); that VALIC was an "investment company" under the Investment Company Act of 1940 (40 Act); and that the segregated asset account established by a general life insurance company for the issuance of variable annuities is also an "investment company" under the 40 Act, despite the fact that an insurance company is otherwise exempt from the 40 Act. The S.E.C. position with respect to VALIC was sustained by the Supreme Court in S.E.C. v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959), and with respect to general life insurance companies in Prudential Ins. Co. v. S.E.C., 326 F.2d 383 (3rd Cir. 1964), cert. denied, 377 U.S. 953 (1964).

The Supreme Court decision in the VALIC case was handed down shortly before Section 801(g)(1) was added by the Senate Finance Committee in the Life Insurance Company Tax Act of 1959. The language used in 1959 in Section 801(g)(1) (which in 1962 became Section 801(g)(1)(A)) that a variable annuity is "computed on the basis of * * * the investment experience of the company," and the language in the Finance Committee report -- that "benefits payable under the variable annuity vary with the insurance company's overall investment experience" and are based "on the investment experience of the company issuing the contract" -- reflect the fact that in the VALIC case, just decided, these were the only contracts issued by the company. They also reflect the S.E.C.'s position, later sustained in the Prudential case, that when a general life insurance company creates a segregated account for variable annuities the account itself is an "investment company" under the 40 Act."*/

In another sentence in the 1959 Finance Committee report reference is made to "specified units with values which vary with investment experience," without mention of the overall experience of the entire life insurance company. And the 1959 conference committee report, which also uses the phrase "the investment

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*/ The expressions "the investment experience of the company," the "company's investment experience" and the "investment experience of the enterprise" appear in the concurring opinion of Mr. Justice Brennan in the VALIC case when he distinguished between a variable annuity and a fixed annuity. 359 U.S. 77, 78, 79.

experience of the company issuing the contract," specifically makes clear that Section 801(g) was intended to apply "in the case of life insurance companies which issue both variable annuity contracts described in the amendment and other contracts," in which event it is obvious that the amounts payable under the variable annuity contract are to be based upon the investment experience of the segregated account without regard to the experience of the general account of the life insurance company.

2. That the Congressional intention was to refer to the investment experience of the separate account is shown by the language added in 1962 in the next subparagraph 801(g)(1)(B), in which clause (iii) requires that amounts paid in or out "reflect the investment return and the market value of the segregated asset account."

3. The Treasury Regulations under §801(g)(1)(A) make the point abundantly clear, as will be seen from the underscored portion of Regs. §1.801-8(a)(1):

> "§1.801-8 Contracts with reserves based on segregated asset accounts:
>
> "(a) Definitions-(1) Annuity contracts include variable annuity contracts. Section 801(g)(1)(A) provides that for purposes of part I, subchapter L, chapter 1 of the Code, an annuity contract includes a contract which provides for the payment of a variable annuity computed on the basis of recognized mortality tables and the investment experience of the company issuing such a contract. A variable annuity differs

> from the ordinary or fixed dollar annuity in that the annuity benefits payable under a variable annuity contract vary with the insurance company's investment experience with respect to such contracts while the annuity benefits paid under a fixed dollar annuity contract are guaranteed irrespective of the company's actual investment earnings."

This regulation was issued by T.D. 6610, August 27, 1962, before the 1962 legislation was enacted, and thereafter was changed only to reflect the new subparagraph number in the Code. Read together, the two sentences in the regulation make clear that under Section 801(g) the amounts payable under a variable annuity account vary with the investment experience of the segregated account, unless variable annuities are the only contracts issued by the company.

4. Section 801(g)(1) specifically confines its definitions to subchapter L, part I, relating to taxation of life insurance companies, by introducing them with the phrase "For purposes of this part,". The definition by its terms is not applicable in §72, which is in subchapter B, part II. Subchapter L and §72 were enacted at different times and frequently differ in result.

The applicability of §72 to variable annuities was recognized not by statutory provision but by Reg. §1.72-2(b)(3)(i), which was promulgated in 1956 in T.D. 6211 several years before the enactment of

§801(g)(1) in 1959. That regulation deals with contracts in which "the amount of periodic payments may vary in accordance with investment experience (as in certain profit-sharing plans), cost of living indices, or similar fluctuating criteria." There is no suggestion in that regulation that the investment experience is the insurance company's "overall" investment experience, and any such connotation would be contrary to Regulation §1.801-8(a)(1) quoted above and to the essential nature of variable annuities, unless they are the only contracts issued by the life insurance company.

II

There is nothing in Section 801(g) or its legislative history to indicate that the pertinent investment experience can only be derived by investment management provided by common law employees of the life insurance company, or that the life insurance company is prohibited from arranging that the investment management advice for the securities portfolio of the account be provided by investment advisors who are not employees. While the investment management may not be vested in the variable annuity contract holder for the reasons that are set forth in Rev. Ruls. 77-85 and 80-274 and that are discussed further below, it is immaterial whether the investment management is provided by in-house employees of the life insurance company or by independent contractors.

Any such limitation would only have the effect of preferring large insurance companies that can afford a staff of investment advisory employees skilled in the type of investments held in the account over smaller companies that rely on outside investment advisors. Any such limitation would require a host of distinctions as to the extent to which in-house employees could obtain investment advice from outside sources; as to the use of investment advisory personnel of subsidiary or parent or affiliated or partially affiliated companies; or as to the use of persons who are employed part-time by the insurance company and part-time by independent contractors. The source of the management advice that provides the investment experience upon which the variable annuity is computed has no bearing upon the inherent nature of a variable annuity under Sections 801(g) or 72 as long as the contract holder himself does not have the power of management.

Because of the requirements of the 40 Act, the insurance company that establishes and maintains for variable annuity contracts a segregated asset account containing its own portfolio of securities has no inherent or perpetual right to manage the account. A life insurance company that manages such a separate account is treated under the 40 Act in the same manner and subject to the same terms and obligations as any other investment manager, without regard to the status of the managing personnel as employees of the insurance company or as independent contractors, or to the extent of affiliation with the insurance company. Surely if Congress had intended any such distinction under the federal income tax law when it clearly provided none under the Investment Company Act, it would have said so by explicit language.

III

Since a segregated asset account supporting a variable annuity contract can have its investment experience provided by outside investment advisors as well as by in-house employees of the insurance company, it is equally immaterial whether the investment experience is provided for a diversified portfolio of securities held in the account or through the mechanism of having the account constituted as a unit investment trust that invests its funds solely in the shares of an open-end diversified regulated investment company.

As explained further below, the unit investment trust is simply a funnel through which funds are invested in the shares of the regulated investment company. The open-end regulated investment company:

(1) is registered with the S.E.C. under the 40 Act;

(2) has a diversified portfolio of securities as required by Int. Rev. Code Section 851(b)(4);

(3) has only one class of stock outstanding;

(5) derives at least 90 percent of its gross income from interest, dividends and capital gains (Int. Rev. Code §851(b)(2));

(6) in order to eliminate corporate tax under Subchapter M, currently distributes all its net income and capital gains, which are customarily reinvested by the unit investment trust in additional shares of stock of the regulated investment company; and

(7) stands ready to issue its shares daily at their net asset value and to redeem them daily at net asset value upon presentation for redemption by its shareholders.

Thus the investment experience of the open-end regulated investment company, including both its net investment income and realized and unrealized capital gains and losses, is daily reflected in the net asset value of its shares, and when the shares are held in the segregated asset account, constitutes daily the investment experience of the segregated asset account. Such a regulated investment company is totally unlike an ordinary business corporation, such as General Motors, the value of whose shares do not daily and necessarily reflect the value of its underlying assets and operating experience, and which is not engaged in the management of a diversified investment portfolio under the strict requirements of the 40 Act and Subchapter M.

It must be borne in mind that the decisions in the VALIC and Prudential cases -- that a variable annuity issued by a company doing no other business or issued out of a segregated asset account of a general life insurance company constituted an "investment company" under the 40 Act -- produced a number of practical consequences that make a segregated asset account with its own portfolio function essentially like one that is a unit investment trust owning shares in an open-end regulated investment company. Even if the account has its own portfolio of securities, it has to be registered with the S.E.C. under the 40 Act as an investment company subject to all the provisions of the 40 Act and the S.E.C. regulations thereunder, unless the account supports only variable annuities under a qualified pension or profit-sharing plan.

If the segregated account instead of owning its own portfolio of securities, elects to place its assets instead in shares of a regulated investment company, it does so through the mechanism of having the account qualified as a unit investment trust as defined in §4(2) of the 40 Act as follows:

> "(2) 'Unit investment trust' means an investment company which (A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities; but does not include a voting trust."

The unit investment trust, despite the fact that it may own only the shares of a single regulated investment company, nevertheless fulfills all the requirements to be classified as a "regulated investment company" under Int. Rev. Code §851, including the requirement of diversification of assets in Section 851(b)(4).

The unit investment trust has been used as a vehicle for contractual plans under which an investor contracts to purchase periodically shares of an investment company. Int. Rev. Code §851(f), enacted in 1969, provides that such a trust shall not be treated for federal income tax purposes as a person, but each holder of an interest in such trust shall be treated as owning a proportionate share of the assets of the trust. However, it is to be noted that the last sentence of §851(f) says that it "shall not apply in the case of a unit investment trust which is a segregated asset account under the insurance laws or regulations of a State." The Senate Finance Committee report accompanying the provision explains:

> "The new provision does not apply in the case of a unit investment trust (or a management-type of investment company) which is a segregated asset account under the insurance laws or regulations of a State. Where these accounts hold assets pursuant to variable annuity contracts, the account is taxed as part of the life insurance company." Rep. No. 91-552, p. 287 (1969).

It is thus wholly immaterial as a practical and legalistic matter whether the segregated account out of which the variable annuity contract is issued is funded directly through its own diversified investment portfolio of securities or whether it constitutes a unit investment trust that invests solely in shares of an open-end diversified regulated investment company registered under the 40 Act.

As noted earlier, the investment experience of the underlying mutual fund in which the account places its assets necessarily becomes daily the investment experience of the separate account itself, since the net asset value of the shares held in the account reflects daily the net income of the investment company and both its realized and unrealized gains and losses on its portfolio.

IV.

It is respectfully submitted that it is immaterial for purposes of determining the federal income tax status of variable annuity contracts whether the investments made by the separate account are publicly available for direct purchase by the contract holders or are available only for acquisition by the separate account. Investments otherwise proper for the segregated account are not disqualified merely because they can be bought directly. This is true whether the particular investment is the stock or bond of an industrial corporation, a government security, a certificate of deposit or stock of a regulated investment company. CREF, VALIC and other issuers of variable annuities have always invested in publicly available securities, as the Congress well knew. It is not the availability for direct purchase by the individual that is determinative of the qualification of a "variable annuity," as demonstrated later, but rather the question whether the individual controls the selection of the investment or it is managed by others, and whether the investment risks and returns are individually allocated to him or shared with other contract holders.

One practical reason why the availability of the investment asset for direct purchase cannot be the touchstone determining "variable annuity" status, is that innumerable investment opportunities could be made available only to segregated accounts supporting variable annuities. For example, an industrial corporation could issue a type of security available only to a particular variable annuity separate account or available only to separate accounts maintained by one or more insurance companies; a bank or S&L could make available a certificate of deposit with terms and conditions available only to one or more such accounts; or different classes of stock of corporations could be made available only for purchase by one or more such accounts. The elimination of the possibility of direct ownership by individuals surely would not qualify the arrangement as a "variable annuity" if the individual were able to direct and control the investment of the funds in the separate account and the risk and return in that particular investment inured solely to him, as prohibited by Rev. Rul. 77-85 and Rev. Rul. 80-274.

If the segregated account invests solely in the shares of an open-end regulated investment company which are publicly available for direct investment, the contract holder has the same assurance of having a beneficial interest in a diversified investment portfolio managed by experienced investment managers as he would have if the company offered its shares only to the segregated account. He has the same rights to vote for the election of directors of the regulated investment company, the same pooling or sharing of investment risk, the same protection with respect to investment managers, etc., as he would have if the fund issued its shares solely to the segregated account. The only difference would be that there would be other shareholders of the mutual fund, if it were publicly available, who would also have contributed funds to it and would share in the risk and rewards. The mutual fund would simply be larger than without such other shareholders and the investment risk would be more widely shared. The nature of the investment by the segregated account would, however, be precisely the same whether or not the mutual fund offered its shares to the public.

It should be understood that various forms of affiliation between managers of mutual funds and life insurance companies have grown up through the years. No practical distinction can be made that is based upon whether the mutual fund is publicly available for direct purchase by investors or is available only to segregated accounts operating variable annuity contracts, or based upon whether management is provided by the employees of the insurance company or one of its affiliates or of an unaffiliated company. Any such distinctions would as a practical matter produce a variety of discriminatory competitive results without any practical benefit to the public or to the government.

Over the years some companies that manage and offer mutual fund shares have organized or acquired life insurance companies that offer variable annuities. Some life insurance companies offering variable annuities have organized or acquired management companies that offer mutual funds to the public. Some holding companies own life insurance company subsidiaries and management company subsidiaries. If there is a public market for variable annuity contracts, the supply for that market will be furnished by one or more combinations of these various organizations that will simply be forced to conform to the precise form of organization that might be dictated by the IRS and the Treasury.

A number of these combined enterprises already operate variable annuity contracts with separate accounts having their own portfolios, or constituting a unit investment trust investing in a regulated investment company the shares of which are publicly available and in other instances are not publicly available. Some are available only to qualified plans, Keogh plans or IRAs and some are available to other contract holders. There would be no feasible way for the IRS to police sister funds, one of which is publicly available and one of which is not publicly available, to determine whether they have sufficiently disparate investment portfolios. Even if the investment portfolios were invested in different securities, the public would rely primarily upon the reputation of the investment manager or the investment objective of the mutual fund as set forth in the prospectus rather than the precise composition of the particular portfolio at a particular time.

It is submitted that properly analyzed there is not a shred of evidence that the Congress intended that a variable annuity must represent an interest in investments that are not available for direct purchase by the public or that such a requirement would have any material effect upon the market for variable annuities. It might serve to increase the concentration and combination of managers of mutual funds and insurance companies to no public benefit and to introduce the need for hairsplitting decisions by the IRS as to the meaning of "publicly available securities," but it would not provide a practical solution to the issue at hand.

V

The question has been put as to the nature of the legal distinction between the rights of a variable annuity contract holder and the rights of a direct investor in a mutual fund. The following are some important distinctions:

1. The variable annuity contract holder has a guarantee of mortality tables which protects him against longevity and for which he is charged a premium by the insurance company. The direct mutual fund shareholder does not have this protection and is not charged the premium.

2. In the event of death the rights of the variable annuity contract holder pass under state law to the beneficiary named in the contract, and unless death proceeds are payable to the estate of the contract holder the contract is not a part of his estate under state law and not subject to administration by his executor.

Mutual fund shares, however, are assets of the estate controlled by the executor.

3. Under many state laws the variable annuity contract, like fixed annuity contracts, is not subject to attachment or levy by creditors. Mutual fund shares are subject to attachment or levy, as in the case of other property.

4. Variable annuity contracts are subject to regulation by state insurance commissioners and subject to state premium taxes. Mutual funds are not subject to state premium taxes or to regulation by state insurance commissioners, but are subject only to regulation by state securities authorities.

5. Variable annuity contracts vest in someone other than the contract holder the right to substitute a different mutual fund under certain conditions. A direct mutual fund shareholder retains that right in himself.

6. The right of the contract holder to vote his portion of the shares of a mutual fund held in the separate account is derived from the federal 40 Act and is dependent upon that Act and S.E.C. regulations. The voting right of the mutual fund shareholder is derived under the state corporation law of the state in which the mutual fund is incorporated, in addition to the protection given him by the 40 Act.

In addition there are various differences in federal income tax treatment to the holder both during his lifetime and at death. For example, although the value of mutual fund shares and variable annuity contracts are both includible in the gross estate for federal estate tax purposes (unless exempt under section 2039(c), (d) or (e)) the basis of mutual fund shares after death is their market value at the time of death but the basis of a variable annuity contract does not change at death. Rev. Rul. 79-335, 1979-2 C.B. 292. Further, while an exchange of shares in one mutual fund for shares in another gives rise to recognized gain or loss, section 1035 permits a tax-free exchange of one variable annuity contract for another variable annuity contract. Rev. Rul. 68-235, 1968-1 C.B. 360.

Again, the direct holders of shares of a regulated investment company include in their income tax returns in ordinary income the current distributions made to them of net ordinary income and short-term capital gains of the company, and include as long-term capital gains the capital gain dividends currently paid by the company out of its net long-term capital gains, but the regulated investment company incurs no corporate income tax. The holders of variable annuity contracts are subject to tax on distributions made to them to the extent provided in Section 72, including being subject to ordinary income tax on distributions that may represent in part capital gains realized in the segregated account which have been subjected to corporate tax to the insurance company at rates up to 46% if they were short-term and up to 28% if they were long-term.

There are also likely to be in each instance differences with respect to sales or loading charges that may be imposed, either front-end or rear-end; for example, mutual fund shares are often offered on a "no load" basis at net asset value without any charge for acquisition or redemption of shares, whereas variable annuity contracts normally bear a sales load, at least if they are surrendered in the early years of their ownership. There may also be differences in the minimum dollar amounts required to purchase mutual fund shares as contrasted with the minimum dollar amount needed to acquire a variable annuity contract. Again, there may be differences in the right to exchange shares of one mutual fund for shares of another mutual fund under one sponsorship as contrasted to the right to exchange one variable annuity contract for another. These various differences are not inherent in the products but depend upon the specific terms under which they are offered, and the extent of the variation will depend upon the terms set by the sponsoring organization. None of the factors mentioned in this paragraph would seem critical to the distinction between a variable annuity contract and a direct investment in mutual fund shares. The distinctive features are believed to be those enumerated earlier, together with the significant distinction developed in Rev. Ruls. 77-85 and 80-274 further discussed below.

VI

A critical additional hallmark of a variable annuity, developed in Rev. Rul. 77-85 and reinforced in Rev. Rul. 80-274, is that the variable annuity separates the investment risk from the mortality risk by substituting a managed and pooled investment portfolio for a fixed obligation of the insurance company. A fixed annuity imposes upon the life insurance company the risk of mortality as well as the risk of investing funds with which to meet fixed obligations to policyholders. The variable annuity relieves the insurance company from the investment risk, and gives the rewards or detriments of that risk to the contract holders. It does so by offering the holder the opportunity to have his contributions pooled with those of other individuals in an account under experienced investment management in conjunction with other individuals who would share the rewards and detriments of the investment experience. That was the basic concept of CREF and of VALIC and of Prudential which led to the 1956 regulation under §72 and the 1959 and 1962 amendments to §801 and the regulations thereunder and the S.E.C. position under the 40 Act.

There is nothing to indicate that the Congress ever intended that the contract holder would have the right to control the investment of his own contribution and to avoid sharing that investment experience with other contract holders in the same separate account. If the contract holder can name and vary his own investments, the account is no more than a custody arrangement to which is added, for a fee, a mortality guarantee. The essence of insurance is sharing of risk, whether it is fire insurance, accident insurance, life insurance or annuities. If a so-called variable annuity contract permits the individual to name his own investment on which the amount of his annuity will depend, and if he does not share the risk of that investment with other variable annuity contract holders, then for federal income tax purposes he is the owner of the investment.

In the variable annuity there is substituted for the fixed obligation of the insurance company that was present in a fixed annuity the opportunity to participate in a pooled investment portfolio to be managed by an experienced investment manager. It was this feature that caused the Supreme Court to hold that the separate account was an investment company under the 40 Act and, therefore, to accord to the contract holder the various protections of the 40 Act.

In the situations dealt with in Rev. Ruls. 77-85 and 80-274 the investment results accrued solely to the benefit or detriment of the particular contract holder, and no other contract holder shared in his investment experience. No one other than the contract holder was responsible for the investment decision. In Rev. Rul. 80-274, even if one ignores the possibility of default on the principal amount of the certificate of deposit, the interest earnings on the certificate held for the account of the particular contract holder were his alone, unrelated to the interest received on certificates issued at different dates or with different maturities held for other contract holders. The particular contract holder simply made his own separate investment and for a premium charged to his account he acquired mortality risk insurance. By contrast, when there is a sharing of investment risk among various contract holders there is an obligation upon the investment manager to act as a prudent man, including generally an obligation to diversify investments, and to maintain liquidity so as to be able to satisfy surrender requests. It is the necessary assumption of that responsibility by someone other than the contract holder and the sharing of investment risk which are the distinctive features of a variable annuity in contrast to the fixed obligation of the insurance company in a fixed annuity.

That assumption of investment responsibility by the investment manager and the pooling of investment risk represent the essence of a variable annuity and produce for the benefit of a contract holder the protection of the 40 Act. The absence of that management discretion and the separate allocation of each investment to the particular contract holder in Rev. Ruls. 77-85 and 80-274 led to those arrangements being offered without registration under the 40 Act and led the FSLIC to conclude that $100,000 insurance was available separately to each contract holder for whom a specific certificate of deposit was held.

It is believed, therefore, that the two revenue rulings are correct in taking the position that variable annuity status will not be accorded for federal income tax purposes when the contract holder himself controls the investment, when the investment is held for his separate benefit or risk without sharing investment benefits or risks with other contract holders, and when there is no assumption of investment management responsiblity by someone other than the contract holder. On the other hand, if the individual does not control the specific investment of the funds in the account, if the investment risk is shared with other contract holders and if there is an assumption of investment management responsiblity by others, then the contract will be treated as a variable annuity contract for federal income tax purposes so long as the other attributes of such contracts mentioned above are present.

It is submitted that it is immaterial whether the investment management is provided by employees of the separate account, by employees of the life insurance company or of another affiliated or unaffiliated company; that it is immaterial whether the separate account has its own diversified portfolio of investments or is a unit investment trust that owns the shares of an open-end diversified regulated investment company; and that it is immaterial whether that regulated investment company also has other shareholders who are not participants in the separate account. These features relate solely to the means by which the requisite investment characteristics, rights and responsibilities are provided for and do not affect the rights, obligations or risks that are inherent in a variable annuity.

July 23, 1981

Hon. John E. Chapoton
Assistant Secretary of the
Treasury
Washington, D.C. 20220

Dear Mr. Chapoton:

We thank you for the meeting on June 30, 1981 at which we reviewed the federal income tax status of variable annuity contracts based upon segregated asset accounts owning shares of open-end regulated investment companies ("mutual funds").

I.

At the meeting you asked us for information about the relative costs of acquiring mutual fund shares directly and of acquiring a variable annuity contract based upon the mutual fund performance. We enclose a spread sheet, with a brief covering explanation, showing data in columnar form with respect to a number of representative mutual funds and related variable annuity policies. You will note that the annual cost of owning the variable annuity is more than double that of owning mutual fund shares directly. The variable annuity contract, being an insurance product, has two additional inherent costs -- mortality charges*/ and state premium taxes -- as well as greater expense. In addition, because annuities are not intended to serve as liquid investments, withdrawal or surrender charges are imposed.

II.

Also, as noted in our memorandum of April 20, 1981, there are a number of other substantial differences between ownership of mutual fund shares and ownership of variable annuities. Significant tax disadvantages, including double taxation of capital gains, treatment of the entire increment as ordinary income when paid out to the contract holder or beneficiary, and denial of a stepped-up basis at death are inherent in variable annuities, and these tend to offset the tax advantage of deferral.

As discussed in our meeting, section 801(g) is part of the Internal Revenue Code, and we must apply the Code as we find it. The question is not whether section 801 should be changed but how it applies to the pending issues. Congress as recently as 1978 rejected a proposal by the Carter Administration to change the tax treatment of annuity contracts.

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*/ The mortality charges cover guarantee of mortality tables for the life of the contract as well as assurance of recovery in full of the cost of the contract if the holder dies before the annuity commences and the value of the contract is then less than its cost.

Hon. John E. Chapoton
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The memorandum of April 20, 1981 analyzes the issues and the draft form of ruling sets forth the results which, we are convinced, follow from the application of the Code and Regulations to the facts. Also, it discusses the substantial differences between the situations considered in Rev. Rul. 77-85 and Rev. Rul. 80-274 and that now before you. Rev. Rul. 77-85 and Rev. Rul. 80-274 turned on the basic question of control; the taxpayer retained such substantial rights as to be considered the owner of the underlying assets. In both instances, the taxpayer could deal with his assets as he chose. He did not relinquish control nor pool his risk. The devices considered in those rulings were efforts to defer the payment of taxes while retaining all substantial rights and benefits of ownership in income-producing assets.

III.

We submit that the variable annuity contracts here involved constitute annuities within the meaning of section 72 and section 801 of the Code. Without reviewing these provisions in detail, as we did in our earlier memorandum, we note that section 801 specifically provides rules with respect to a "contract with reserves based on a segregated asset account", and section 801(g)(1)(B) defines the term to mean a contract--

> "(i) which provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company,

> (ii) * * * which provides for the payment of annuities, and
>
> (iii) under which the amounts paid in, or the amount paid out, reflect the investment return and the market value of the segregated account."

The contracts here involved fit precisely within this definition because (i) they provide for the allocation of all of the amounts received to a segregated account, (ii) they provide for the payment of annuities and (iii) the amounts paid in or out reflect the investment return and the market value of the segregated asset account. As stated in our previous memorandum, a variable annuity contract meets all the traditional and statutory requirements if, --

> 1. It is issued by a life insurance company out of a segregated asset account and provides for the payment of annuities;
>
> 2. It vests in independent third parties the management control of the investment portfolio upon which the investment return and value of the annuity contract are based; and
>
> 3. The contract holders share the risk of investments made by the investment managers.

IV.

An issue discussed at the June 30 conference was whether a variable annuity contract is to be ignored for federal income tax purposes if the shares of a mutual fund held by the segregated asset account are publicly available for direct purchase by individuals.*/ We submit that public availability of the shares for direct acquisition is immaterial to the present issue -- both as a matter of principle and as a matter of practicality. It is the nature of the open-end regulated investment company and not the availability, or lack of availability, of the mutual fund shares for direct acquisition by individuals that is the reason why the segregated asset account maintained by the life insurance company may invest its funds in them to support the variable annuities.

Open-end regulated investment companies, a mechanism for investment in a diversified portfolio of securities, are subject to regulation by the S.E.C. under the Investment Company Act of 1940 and have been accorded conduit or "flow-through" treatment for federal income tax purposes in

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*/ We would note that the suggested public availability distinction is contrary to the private rulings referred to in Mr. Theodore R. Groom's letter of June 8, 1981, later published as Rev. Rul. 70-525, 1970-2 C.B. 144, Rev. Rul. 76-281, 1976-2 C.B. 206 and Rev. Rul. 78-204, 1978-1 C.B. 216. As he states, in those rulings an insurance company sponsored a regulated investment company whose shares were available to a segregated asset account supporting variable annuities and also to another account (not a variable annuity) that was also treated as a regulated investment company and was offered to the public. Thus the mutual fund shares that supported the variable annuity contract were also offered through another account for acquisition by the public apart from variable annuity contracts.

Subchapter M of the Code. Thus, unlike general business corporations, these regulated investment companies are relieved of corporate tax when they distribute currently all their income, and the character of important types of their income "flows through" to their shareholders.*/ Their shares are not available for purchase and sale in the market but are acquired on original issue from the company and are redeemable for cash at net asset value at the option of the holder. The companies have no senior securities or preferred stocks. Because of the distinctive characteristics of mutual funds, involving undivided interests in a diversified portfolio of securities that is professionally managed, they satisfy the requirements of a segregated asset account for variable annuity contracts. These characteristics do not change if shares of a mutual fund are held by or offered to persons other than segregated asset accounts. They do not change if a mutual fund previously owned only by segregated asset accounts should begin to offer its shares to others, nor if a mutual fund previously offering shares to others should cease to do so.

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*/ Long-term capital gains (§852(b)(3)(B) and (C)); tax-exempt state and local bond interest (§852(b)(5)); dividends from domestic corporations for the $100-$200 dividend exclusion before 1981 and the $200-$400 interest and dividend exclusion in 1981 (§854(b)); and the foreign tax credit (§853).

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A distinction based upon public availability of mutual fund shares would simply cause the maintenance of separate sister or "clone" mutual funds, one of which would offer its shares solely to segregated asset accounts and the other of which would offer its shares to anyone. They would both be managed by the same investment manager and have the same investment objectives.

For example, a sponsor could offer "Progressive Investment Company, Inc." shares to the public generally, and by separate registration statement and prospectus offer to segregated asset accounts supporting variable annuity contracts the shares of "Progressive Investment Company, V.A., Inc." -- identical in all practical respects except for size and a slight difference in name. Such a proposal would exalt form over substance to the advantage of no one, but only with additional expense and inconvenience. It would be unsound and impractical to have the IRS design and police a set of rules prescribing minimum differences between the portfolios of the two companies.

Because the Federal Reserve Board imposed margin requirements of 15 percent on money market mutual funds between March 14, 1980 and July 28, 1980, but exempted an amount equal to the net assets on hand when the margin requirements became effective, 36 sister or "clone" funds were organized and operated during that brief period and promptly thereafter were merged into the original funds. That experience demonstrated that sister or clone funds can be readily created and operated, despite the additional expense and inconvenience.

A requirement of sister or clone funds, with their attendant expense, would be more harmful to smaller organizations in the mutual fund and life insurance company fields than in larger ones. It would also favor those complexes which already operate both mutual funds and life insurance companies, and encourage further combinations of the two under common management. Yet it would serve no goals in the tax policy of the nation.

Thus we believe no logical or practical reason exists for establishing a distinction based upon whether the mutual fund shares supporting the variable annuity are publicly available for purchase and ownership by individuals.

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We shall be pleased to supply any further material you may wish and to discuss the matter further with you and your associates at your convenience.

Respectfully yours,

Donald C. Alexander

Edwin S. Cohen

William B. Harman, Jr.

EXPLANATION OF MUTUAL FUND - VARIABLE ANNUITY CHART

The attached chart compares the costs of (a) the direct purchase of a mutual fund with (b) the purchase of a variable annuity which invests in the same mutual fund. We believe this chart is a representative comparison of the costs involved in purchasing mutual fund shares directly and through a variable annuity contract.

For example, the first column compares the cost of purchasing Massachusetts Cash Management Trust (a mutual fund) with the cost of purchasing a variable annuity from Nationwide Life Insurance Company which invests in the Massachusetts Cash Management Trust.

This particular illustration indicates the general or typical costs involved in the purchase of a mutual fund directly and through a variable annuity as follows:

	Mutual Fund	Variable Annuity
(1) Mutual Fund Expenses (Management fee and other fees). Annual charge = annual percentage of assets	.87%	.87%
(2) Front-end sales load	None	None
(3) Rear-end sales load	None	5%
(4) Mortality/Expense Risk Annual charge - percentage of assets	None	1.3%
(5) Administrative Fee (Annual)	None	$30
(6) Premium Taxes (in states imposing such taxes; either at time the annuity consideration is paid or when applied at the annuity starting date)	None	.5% to 2.5%

The following general conclusions may be drawn based upon the attached chart: the purchase of a variable annuity contract is more costly than the purchase of mutual fund shares because the annuity contract (being an insurance product) has two additional inherent costs - mortality charges and state premium taxes - as well as greater expense. In addition, because annuities are not intended to serve as liquid investments, withdrawal or surrender charges are imposed.

Name of Fund Direct Purchase Expenses*/	Massachusetts Cash Management Trust	Massachusetts Investors Trust	Massachusetts Cash Management Trust	Massachusetts Investors Trust
Front-end sales load	None	7.25% (6)	None	7.25% (6)
Rear-end sales load	None	None	None	None
Management Fee	.5%	.18%	.5%	.18%
All other fees (including custodial and transfer fees, registration fees, reports and prospectus expenses, and other miscellaneous fees).	.37%	.28%	.37%	.28%
Total **/	.87%	.46% plus applicable sales load	.87%	.46% plus applicable sales load

Name of Fund Direct Purchase Expenses*/	Merrill Lynch Ready Assets Trust	Merrill Lynch Basic Value Fund	Putnam Daily Dividend Trust	Putnam Investors Fund, Inc.	Money Market Management, Inc.	Federated High Income Securities, Inc.
Front-end sales load	None	6.5% (6)	None	8.5%(6)	None	6.5%(7)
Rear-end sales load	None	None	None	None	None	None
Management Fee	.375%	.85%	.47%	.39%	.50%	.54%
All other fees (including custodial and transfer fees, registration fees, reports and prospectus expenses, and other miscellaneous fees).	.5%	.3%	.30%	.18%	.52%	.55%
Total **/	.875%	1.15%	.77%	.57% plus applicable sales load	1.02%	1.09% plus applicable sales load

Expenses Incurred through Purchase of Annuity Contract Investing in the Fund

Insurance Company Separate Account	Nationwide NFS Variable Acct.	Nationwide NFS Variable Acct.	Northwestern National NFS/NWNL Account	Northwestern Nat'l NFS/NWNL Account
Mutual Fund expenses***/	.87%	.46%	.87%	.46%
Front-end sales load in contract	None	None	None	None
Rear-end sales load in contract	5%(2)(3)	5%(2)(3)	5%(2)(3)	5%(2)(3)
Mortality/Expense Risk Charge	.8%/.5%	.8%/.5%	.9%/.4%	.9%/.4%
Administrative Fee (Annual)	$30	$30	$30	$30
Premium Taxes (in states imposing such taxes)	.5% to 2.5%	.5% to 2.5%	.5% to 2.5%	.5% to 2.5%

Insurance Company Separate Account	Family Life Variable	Family Life Variable	Investors Life Ins. Co.Putnam Sep.Acct.	Investors Life Ins. Co.Putnam Sep.Acct.	Boston Mutual Variable Acct.A	Boston Mutual Variable Acct.A
Mutual Fund expenses***/	.875%	1.15%	.77%	.57%	1.02%	1.09%
Front-end sales load in contract	None	None	None	None	None	None
Rear-end sales load in contract	5%(8)	5%(8)	6% (4)	6%(4)	5%(2) (5)	5%(2) (5)
Mortality/Expense Risk Charge	.8%/.5%	.8%/.5%	.8%/.15%	.8%/.15%	1.4%/-	1.4%/-
Administrative Fee (Annual)	$30 (1)	$30 (1)	$25	$25	$30	$30
Premium Taxes (in states imposing such taxes)	.5% to 2.5%	.5% to 2.5%	.5% to 2.5%	.5% to 2.5%	.5% to 2.5%	.5% to 7.5%

*/ These percentages are based on the average daily net asset value of the fund.

**/ This amount is deducted from the annual income of the fund before dividends are declared.

***/ Each fund share held in the Separate Account and supporting the contractual benefits and values will be subject to the same expense ratio as a fund share purchased directly.

(1) Also charges up to $4 per year for expenses not covered by Administrative Charge.

(2) Charge is 5% of the lesser of the total of all purchase payments made in the most recent 96 months or the amount withdrawn.

(3) After two years, if cumulative withdrawals do not exceed the current value of purchase payments received more than 96 months before the surrender plus 10% of the purchase payments made in the most recent 96 months, redemption charge is waived.

(4) 6% in first year declining 1% per year. Charge is applicable to amounts which exceed 10% of purchase payments.

(5) After two years, 6% of purchase payments may be withdrawn per year without redemption fee.

(6) Sales load for investments of less than $10,000.

(7) Sales load for investments of less than $15,000.

(8) Same as (2) except that 84 months is substituted for 96 months. No redemption charge applicable to the extent of 10% of annual purchase payments made more than one year prior to such withdrawal.

October 13, 1981

Memorandum re Significant Matters Requiring Clarification Under Rev. Rul. 81-225

This memorandum is submitted on behalf of the Investment Company Institute with respect to significant matters on which it respectfully requests clarification following the issuance of Rev. Rul. 81-225.

The Institute is the national association of the mutual fund industry. Its membership consists of more than 500 mutual funds (known in the Internal Revenue Code as "regulated investment companies"), their investment advisers and principal underwriters. The assets of the member mutual funds represent some 90% of the assets of all mutual funds in the United States.

1. "Portfolio Account" Advisers. In the case of a segregated asset account containing a diversified portfolio of stocks and securities, there being no unit investment trust or an incorporated mutual fund, may the portfolio be managed by a person not affiliated with the insurance company?

Segregated asset accounts that support variable annuity contracts may be operated in either one of two ways: (a) the account itself may own a diversified portfolio of stocks or securities (hereinafter referred to as a "portfolio account"); or (b) the account may be a "unit investment trust" ("UIT") whose sole assets consist of shares of a mutual fund (hereinafter a "UIT account"). In either event, the segregated asset account is an investment company under the Investment Company Act of 1940, required to be registered as such with the S.E.C. In the case of the "portfolio account" the account itself is registered with the S.E.C. as a diversified management investment company; in the case of the "UIT account" the account and the UIT are also registered with the S.E.C. but it is the mutual fund which has the diversified portfolio of securities.

Rev. Rul. 81-225 deals solely with a "UIT account". In situations 1, 2, 3 and 4, where the shares of the mutual fund are available for subscription by the general public, the individual is held to be the owner for federal income tax purposes of the shares of the mutual fund, whether the fund is managed by the insurance company or its affiliate or by an unaffiliated person. In situation 5, where the fund is not available to the general public and is managed by the insurance company or its affiliate, the insurance company rather than the individual is held to be the owner of the shares of the mutual fund.

The ruling does not address the case of a "portfolio account", which is not available to the general public but is available only to purchasers of variable annuity contracts. It is respectfully submitted that in a "portfolio account" it is immaterial whether the portfolio is managed by the insurance company or its affiliate or by a person or firm unaffiliated with the insurance company.

First, in Rev. Rul. 81-225 the conclusion is reached that the individual is "considered the owner of the mutual fund shares for federal income tax purposes", whose position "is substantially identical to what his or her position would have been had the mutual fund shares been purchased directly." The Revenue Ruling focuses on the ownership of the shares of the mutual fund, as distinguished from its underlying portfolio of securities, "because the mutual fund shares themselves are securities, the incidents of ownership of which may be attributed to the policyholder in these situations."

In the "portfolio account" there are no mutual fund shares the ownership of which can be attributed to the individual by reason of their availability for direct purchase by the general public. The "portfolio account" owns a diversified portfolio of securities which are managed and controlled by persons other than the individual contract holder. While each of the many securities held in the diversified account are likely to be available for purchase by the general public, the individual has no knowledge of what those securities will be from time to time; they are purchased, retained or sold from time to time as the investment manager deems advisable without consultation with the individual. We respectfully submit that the premises on which Rev. Rul. 81-225 is based are not applicable to attribute to the individual contract holder ownership of an undivided interest in the securities held in a "portfolio account".

Second, as a practical matter any investment manager of the portfolio must rely to some extent upon advice and factual data obtained from persons who are not employees of the insurance company or its affiliate. For example, the investment adviser would obtain essential information from subscriptions to newspapers, journals, investment data services, lawyers, accountants and other experts who are independent contractors. It would be unrealistic for the IRS to conclude that the individual contract holder is the owner of a portfolio account if the insurance company uses the services of independent contractors who are totally unaffiliated with the contract holder. It would not be feasible as a practical matter to have the decision as to ownership of the underlying portfolio of securities by the insurance company or the contract holder turn upon a determination as to whether the relationship between the insurance company and other parties is that of employer-employee or independent contractor -- a most difficult factual and legal determination which the individual contract holder would be unable to make and on which the National Office of the IRS would not be equipped to rule.

Accordingly, the Institute respectfully submits that in the case of a "portfolio account" it is immaterial for federal income tax purposes whether the account is managed by the insurance company or its affiliate or by an unaffiliated independent contractor or partly by one and partly by another.

2. "UIT Account" Advisers. In the case of a "UIT account" holding only shares of a mutual fund not available to the general public, may the mutual fund be managed by a company not affiliated with the insurance company? May the mutual fund be managed by the insurance company and the insurance company enter into a sub-advisory contract with an unaffiliated company for rendition of management and advisory services for the mutual fund?

In discussing situation 5 (where a UIT account holds only mutual fund shares which are "not sold directly to the general public but are available only through the purchase of an annuity contract"), Rev. Rul. 81-225 concludes that "the sole function" of the mutual fund "is to provide an investment vehicle to allow" the insurance company "to meet its obligations under the annuity contract"; that the situation is "equivalent for federal income tax purposes to the direct purchase" by the insurance company "of the underlying portfolio of assets" of the mutual fund; and that the insurance company "possesses sufficient incidents of ownership to be considered the owner of these underlying assets for federal income tax purposes."

This analysis and conclusion demonstrates that it is immaterial whether the segregated asset account functions as a "UIT account" or a "portfolio account", so long as the mutual fund shares are not offered for puchase by the general public.

The presence or absence of a unit investment trust and a mutual fund, where no member of the general public can acquire any interest in the mutual fund, is immaterial to the federal income tax issue and represents merely a different means of administration and procedure.

Hence, for the reasons noted above with respect to a portfolio account, the Institute submits that it is immaterial to the federal income tax issue in a UIT account whether the insurance company or its affiliate manages and administers the mutual fund through its own employees or arranges that those services are to be performed by employees of an independent contractor.*/ In neither case does the individual contract holder have any power to determine the composition of the underlying portfolio of securities, and in neither case can he acquire an interest in that portfolio save through the variable annuity contract offered by the insurance company.

Moreover, whether the portfolio is managed and administered by the insurance company or its affiliate or by an unaffiliated independent contractor, Section 15 of the Investment Company Act of 1940 requires that the portfolio account, or the mutual fund in the case of a UIT account, enter into a written investment advisory contract with the manager subject to specific rules as to the approval of the contract, its duration and periodic renewal, and the statutory right of the mutual fund to terminate the contract on sixty days notice. Thus the

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*/ See p. 6a for footnote.

*/ Situation 5 assumes facts identical with situation 2 except that the mutual fund shares are not publicly available. Situation 2 differs from situation 1 only in the fact that in situation 2 the mutual fund is managed by the insurance company or its affiliate, and in situation 1 the mutual fund is managed by an investment firm independent of the insurance company. Rev. Rul. 81-225 does not pass upon the results that would occur under the facts of situation 1 if the mutual fund shares were not offered for sale to the general public. In discussing the reasons for its favorable conclusion in situation 5, Rev. Rul. 81-225 makes no mention of the fact that the insurance company or its affiliate is the investment adviser of the mutual fund.

Investment Company Act and the S.E.C. treat both cases alike, requiring the same restrictions and approvals regardless of affiliation or non-affiliation of the investment manager with the insurance company.*/

Again, as in the case of the portfolio account, it would not be feasible as a practical matter in the case of a UIT account to have the decision as to ownership by the insurance company or the contract holder for federal income tax purposes turn upon a determination whether the persons managing the portfolio are employees of the insurance company or its affiliate or have the legal status of independent contractors, a determination that is difficult to make and depends upon a variety of facts and circumstances. Indeed arrangements are possible under which individuals are employed part-time by an insurance company or its affiliate and part-time by an unaffiliated independent contractor. Smaller insurance companies, not affiliated with investment advisory firms and unable to afford extensive investment advisory staffs of employees, would be materially disadvantaged by any distinction based upon affiliation or non-affiliation of the investment adviser and the insurance company.

*/ Because the independent directors of the mutual fund must have the right to change investment advisers for the mutual fund, and substitute a company totally independent of the insurance company, it would seem startling to have that action, which would be taken for the protection of the contract holders, result in the disqualification of the annuity contracts for federal income tax purposes.

Accordingly the Institute submits that the degree of affiliation of the investment adviser and the insurance company, or the status of the relationship as employee or independent contractor, is immaterial to the federal income tax status of the variable annuity contract.

It should be noted that in some instances, for a variety of reasons, a mutual fund enters into a management contract with one company, and that company enters into a submanagement contract with another unaffiliated company. In that type of arrangement both contracts must be approved by the mutual fund under Section 15 of the Investment Company Act and are subject to all of its requirements. The arrangement exists in situations not involving annuity contracts, and could be adapted to annuity contracts if necessary. These contractual arrangements differ in some respects from case to case, depending upon the actual division of duties and responsibilities between the two companies performing the management services for the mutual fund, but in general produce substantially similar results. The Institute submits that the federal income tax status of the variable annuity contracts should not be affected by the division of investment management responsibility between the insurance company or its affiliate and other persons.

3. <u>Resemblance of the Portfolio to Other Portfolios Publicly Available</u>. In determining whether the life insurance company or the annuity contract holder is considered for federal income tax purposes to be the owner of the underlying portfolio, is it material whether the portfolio resembles the portfolio of a mutual fund that is available for purchase by members of the general public?

The Institute submits that the answer should be "No". Despite the fact that this subject, sometimes loosely referred to as "cloning", was discussed in memoranda submitted to the IRS and the Treasury on behalf of the Institute and also discussed orally, Rev. Rul. 81-225 in approving situation 5 does not mention the composition of the "underlying portfolio of assets" of the mutual fund the shares of which are not available to the general public. The governing point in situation 5, in contradistinction to situations 1, 2, 3 and 4, was the availability of the mutual fund shares for purchase by the general public, not the composition of the fund.

As we discussed in our earlier memoranda, it would not be feasible for the IRS to attempt to develop a set of rules regarding the extent of the permissible similarity between two diversified portfolios of securities. Since we are here concerned with managed portfolios, investment decisions must be made daily as to whether to retain, purchase or sell various securities and as to the amount of cash to be retained for future investment opportunities. Hence if resemblance were material it would be essential for the IRS to develop rules that could be publicly announced and adhered to by the investment managers to avoid disqualifying the annuity contracts. Moreover, there would be serious problems in determining which portfolio should give way to the other when investment opportunities arise that would be desirable for both portfolios but where actual purchase for both portfolios might cause disqualification of the annuity contracts.

In earlier submissions we reviewed the experience of the mutual fund industry from March to August 1980 when the Federal Reserve Board imposed 15% reserve requirements on additional amounts invested in money market mutual funds, necessitating the organization of separate "clone" funds to receive investments of the additional amounts. Though the clone funds had the same investment objectives and in general were managed by the same personnel, their investment portfolios were quite different. In part this difference was due to the fact that the new fund was making investments at a different point in time, when different investment opportunities were available. Over a long period of time it might be expected that with the same expressed general objectives and similar investment management personnel the two portfolios would grow increasingly similar, but they would be unlikely ever to be identical. Thus, even if the portfolio supporting a variable annuity account has the same investment objective and all or some of the same investment management personnel, the portfolios in the early stages will necessarily be substantially different but over time would be likely to become increasingly similar. But IRS rules to prevent the gradual growth of similarity, even if they could be designed so as to be followed, would restrict the exercise by the investment managers of their best discretion and merely require the acquisition of different securities of substantially the same kind and quality.

Accordingly, the Institute does not believe that rules limiting the resemblance of the portfolio of the mutual fund, all of whose shares are owned in the UIT account, to the portfolio of another mutual fund available to the general public are feasible or appropriate, nor do they have any significance with respect to the federal income tax status of the variable annuity contract.

4. <u>Contract Holder's Right to Reallocate</u>. In Rev. Rul. 81-225 the variable annuity contract is sustained in situation 5, the facts of which are identical with situation 2 except that the mutual fund shares are not available for purchase by the general public. In situation 3, unlike situation 2, the contract holder "has the right initially to designate and periodically to reallocate the cash value under the contract among" 5 sub-accounts of the segregated

asset account, each of which 5 sub-accounts is "invested solely in the shares of a single, different mutual fund" available to the general public. Would the result in situation 3 be the same as in situation 5 if the shares of each of the 5 mutual funds were not available for purchase by the general public but were owned exclusively by one of the 5 sub-accounts?

As noted earlier, the expressed rationale of the holding in situation 5 is that the case is equivalent to the direct purchase by the insurance company of the underlying portfolio of the assets of the mutual fund, the shares of which are not available for purchase by the general public. The same result would follow with respect to each of the 5 mutual funds, all of whose shares are owned by sub-accounts of the segregated asset account maintained by the life insurance company.

It is to be noted that each of the 5 mutual funds, being a regulated investment company, must have a diversified portfolio of securities, as required by Int. Rev. Code § 851(b)(4). The situation is distinctly different from that in Rev. Rul. 77-85, where the contract holder could designate the particular security he wished to fund his variable annuity contract; here he can know only the general investment objective of the mutual fund and he cannot acquire its shares except through the variable annuity contract.

The result is essentially the same as is achieved if the variable annuity contract entitles the holder only to require his funds to be invested in a single mutual fund, and pursuant to Section 1035 he may exchange his contract for another variable annuity contract based on another segregated account invested in another mutual fund. Similar rights of periodic reallocation of funds between different investment objectives have long existed in various types of qualified plans, Section 403(b) plans, etc., maintained by TIAA-CREF, the American Bar Association, and many employers, all with the approval of the IRS and without any assertion that such rights cause the individual to be the owner of the underlying securities for federal income tax purposes.

5. Closing Mutual Funds to the Public. In some in- instances most of the outstanding shares of a mutual fund are owned by a segregated asset account supporting variable annuity contracts and a relatively small percentage of the outstanding shares are owned by the general public. In lieu of creating a new mutual fund whose shares would be own[illegible] exclusively by the UIT account and would not be offer[illegible] the general public, would it be permissible to clos[illegible] ne existing mutual fund to the general public, offering shares only to the UIT account?

The Institute submits that this procedure should satisfy the requirements of Rev. Rul. 81-225 and believes that in some cases it will accomplish the purposes of the ruling in a much less expensive manner than organization and registration of a new mutual fund. All variable annuity contracts issued after September 25, 1981 would be issued without the individual contract holder (or anyone other than the UIT account) having an opportunity to purchase shares of the mutual fund. While it would theoretically be possible for the individual to find an existing direct owner of shares of the mutual fund and purchase shares from him rather than through an annuity contract, substantially all purchases and sales of mutual fund shares are made on original issue and redemption by the mutual fund, and no other market in the shares exists.

In the case of holders of non-grandfathered variable annuity contracts issued when the mutual fund shares were publicly available, who continue to hold the contracts after the mutual fund is closed to the public, their contracts would not meet the requirements of Rev. Rul: 81-225 since the mutual fund shares were available for direct purchase when the contracts were issued. Grandfathered contracts would continue to be treated as annuity contracts after the fund is closed to the public. Individuals purchasing contracts after the mutual fund was not available to the general public would not have had the opportunity to purchase the mutual fund shares, and thus would satisfy the requirements of Rev. Rul, 81-225. The fact that the mutual fund would have among its shareholders some individuals who bought their shares when the mutual fund shares were offered to the public should not affect the annuity contracts purchased when the shares are not available to the public.

6. New Sub-Accounts. If a UIT account now has one or more sub-accounts, each of which owns only shares of a publicly available mutual fund, may a new sub-account supporting a variable annuity contract be created which owns only shares of a new mutual fund, all of whose shares are owned in the sub-account and none of which are available for purchase by the general public?

It is submitted that it is immaterial whether all the shares of the new mutual fund are owned in a sub-account of an existing segregated asset account or are owned in a new segregated asset account. Sub-accounts can be administered in the same manner as if they were separate segregated asset accounts, and as a practical matter the rights of the variable annuity contract holder are the same. Accordingly, it is submitted that the federal income tax results should be the same.

The reason why it may be desired to use a new sub-account of an existing segregated asset account rather than create a new segregated asset account is that a new segregated asset account would have to be newly registered with the S.E.C. and a new form of variable annuity contract would have to be filed in each of the states in which the variable annuity contracts are offered, with significant expense and delay. If new sub-accounts of an already registered segregated asset account could be employed, the existing registration statement with the S.E.C. could be amended and the existing contract modified to limit the right of the contract holder so as to permit his funds to be allocated only to shares of a mutual fund not available to the general public. Such a procedure would be much less expensive and time-consuming.

We note that under Rev. Rul. 81-225 the presence of post-1980 contracts not complying with the requirements of the ruling does not taint the pre-1981 contracts that are grandfathered (or future contributions under 403(a) and (b) or 408(b) contracts entered into before September 25, 1981). We know of no reason why there should be any taint to affect new contracts that meet the requirements of Rev. Rul. 81-225 issued out of new sub-accounts of an existing segregated asset account, and that procedure would be significantly less expensive and time-consuming to employ.

October 27, 1981

Supplemental Memorandum on Behalf of the
Investment Company Institute re Significant
Matters Requiring Clarification Under
Rev. Rul. 81-225

This memorandum is submitted on behalf of the Investment Company Institute with respect to significant matters on which it respectfully requests clarification following the issuance of Rev. Rul. 81-225. This memorandum relates to additional matters concerning the effective date of the ruling, which were not discussed in the previous memorandum submitted on behalf of the Institute on October 13, 1981.

These problems regarding the effective date of the ruling present special difficulties which would be obviated if the December 31, 1980 effective date in the ruling were changed to September 25, 1981, the date of issuance of the ruling. The Institute respectfully urges that the effective date be so changed as a matter of fairness and as a means of eliminating the complexities discussed below.

1. Serious Difficulties in the Preparation, Filing and Furnishing of Forms 1087. Rev. Rul. 81-225, in concluding that in situations 1, 2, 3 and 4 the insurance company is a nominee of the contract holder with respect to gross dividends and other contributions on stock received on

account of mutual fund shares purchased with payments made by the contract holder after December 31, 1980 states:

> "IC [Insurance Company] must file Forms 1096 and 1087 with the Internal Revenue Service to report the dividends received from XY [Mutual Fund] as a nominee of A [Contract Holder] and furnish A a statement showing those amounts."

The Institute is informed that there will be extreme difficulty in complying with this requirement, and especially in doing so before the due date of these forms on February 28, 1982. It is estimated that there are in the neighborhood of 100,000 variable annuity contracts outstanding of the type referred to in situations 1, 2, 3 and 4, and to date no method has been found to produce the required Forms 1087 from the present records of the mutual fund or the insurance company without detailed clerical work on each of the accounts or the development of new computer programs.

The basic reason for this is that insurance company records have generally been maintained in the traditional fashion applicable to variable annuity contracts. Insurance companies maintaining variable annuity segregated asset accounts are not required to report dividend information for contract holders on Form 1087. This information has not heretofore been material to the operation of the accounts, and in many cases the present records of the companies do not provide the information.

The accounts are operated, both for each individual contract holder and for the account as a whole, by reference to the total number of units outstanding in the account or sub-account, the daily value per unit, and the number of units held for each contract holder. Dividends received from the mutual fund by the account or sub-account are automatically reinvested in additional shares of the mutual fund; hence the receipt of a dividend and its immediate reinvestment by the account does not affect the unit value nor the amount of units outstanding. The number of units do change, however, whenever amounts are paid in or withdrawn by a contract holder.

For federal income tax purposes the only information heretofore needed has been the aggregate amount of dividends received by the account or sub-account, a figure which must be included in the federal income tax return of the insurance company. Thus the conclusion in Rev. Rul. 81-225 that the contracts are not variable annuity contracts with respect to amounts paid in after 1980 (although they are annuity contracts for amounts paid in prior to 1981) leaves many of the companies with no ready means of providing the requested information on Form 1087.

The current records of the separate account or sub-account would show in the aggregate for the entire account or sub-account the aggregate amount of each dividend received by the account or sub-account from the mutual fund. The number of dividends received in 1981 would vary from account to account depending upon the dividend payment practice of the mutual fund whose shares are held in the account or sub-account. For example, money market mutual funds normally declare dividends daily, and thus there would be 365 different dividends from each of such funds during the year 1981. Some mutual funds declare ordinary dividends monthly and some will declare a capital gain dividend once a year (a total of 13 dividend payments). Other funds may declare ordinary dividends quarterly and an annual capital gain dividend (a total of 5 dividend payments).

The insurance company or its affiliate, the mutual fund or its investment adviser, or a third party (such as a bank) will maintain a record for each contract holder that will show:

(a) For 1981 the aggregate amounts, if any, paid in by the individual prior to January 1, 1981 and the total number of units (to several decimal points) in the account or sub-account standing to the credit of the individual as of January 1, 1981. The number of units standing to the credit of the contract holder will have depended upon the dollar amount that the individual paid in and the unit value of the account or sub-account on each day on which he made a payment.

(b) The dollar amount contributed by the contract holder on each date in 1981 and the number of units (to several decimal points) so acquired by him.

(c) The dollar amounts of any withdrawals made by the contract holder in 1981 and the reduction in the number of units resulting from the withdrawal, determined by the unit value on the date of the withdrawal.

The serious difficulty in producing the Forms 1087 stems from the fact that generally the records have not been kept in a fashion that would allocate to each contract holder the amount of the dividends received by the account or sub-account from the mutual fund. Because the total number of units outstanding in the account or sub-account may vary daily during the year 1981, and there may be changes in the number of units held by the particular contract holder, it is not possible to make a single calculation for the year 1981 of the amount of dividends received that are allocable to that contract holder. To obtain this information it would be necessary to make the following multiple calculations:

(1) For each dividend payment date, divide the aggregate dividend received in the account or

sub-account by the total number of units outstanding on that date, thereby obtaining the amount of dividends received on that date per unit outstanding.

(2) For each dividend payment date, multiply the amount of dividends received per unit by the number of units in the account or sub-account which were owned by the individual contract holder on that date and which were acquired by him after December 31, 1980. The calculations would have to be made separately for each date (in the case of money market funds, 365 dates). However, for the period during which there was no change in the number of units held by the particular contract holder, it would be possible to aggregate the dividends received per unit during that period and multiply that aggregate by the number of units held by the individual throughout the period.

(3) Obtain the total for the year 1981 of the amounts aggregated under the preceding subparagraph (2) for each contract holder.

(4) The calculations would have to be made separately for ordinary dividends and capital gains dividends. With respect to ordinary income dividends, in the case of some mutual funds a distinction would have to be made between those dividends eligible for

the $200-$400 exclusion (presumably this could be accomplished by applying a percentage to the amounts calculated for each contract holder under the preceding subparagraph. (2)). Thus four dollar amounts would have to be obtained for each contract holder for the Form 1087: (a) the aggregate dividends, (b) the ordinary income dividends available for the exclusion, (c) the ordinary income dividends not available for the exclusion and (d) the capital gain dividends, if any.

(5) With respect to contracts which permitted the holder to transfer funds from investment in one mutual fund to investment in another mutual fund, any such transfer necessarily is recorded as a withdrawal from one account or sub-account and a payment into another account or sub-account with a different number of units and a different unit value, necessitating a separate calculation thereafter of dividends allocable to the contract holder. A significant number of contract holders have designated part of their funds to be invested in one mutual fund and part in another mutual fund (or several mutual funds), necessitating separate calculations and Forms 1087 with respect to each mutual fund.

(6) Some provision may have to be made to reflect the surrender charge that may have been imposed with

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respect to withdrawals in 1981, since those amounts would seem to be deductible by the contract holder under Int. Rev. Code §212.

(7) Because the dividend calculations would have to be made separately for each contract holder, it might be necessary to have the calculations made independently by two different persons in order to detect and correct errors in the calculations.

(8) After the four amounts to be reported on Form 1087 for each contract holder has been determined, it would be necessary to transcribe the information on three copies of the Form 1087 (one for the Internal Revenue Service, one for the individual and one for the company). Either this would have to be transcribed manually or a new computer program would have to be designed to feed the information into the computer in which the names, addresses and taxpayer account number of each contract holder is maintained.

To accomplish this task for the year 1981, it would be necessary in many cases to prepare entirely new computer programs or to secure and train a group of people, none of whom have attempted this type of calculation previously. While the group could be assembled and trained for the task prior to January 1, 1982, the actual work of making the calculations could not be begun before January 1 for several reasons: (1) the need for assembling and training the personnel; (2) the information could change by reason of dividend payments received until December 31, 1981; and (3) withdrawals on or before that date by contract holders that would affect the number of units held by them. The time constraints on producing the information are severe because the calculations would have to be completed in time for them to be transcribed either manually or electronically on Form 1087 and mailed to the Internal Revenue Service and contract holders by February 28, 1982.

The personnel assembled and trained for this task would never be needed again because it is unlikely that the types of contracts described in situations 1, 2, 3 and 4 would continue to exist after the close of 1981, and even to the extent that they would exist, programs could be developed to maintain the necessary data currently as to dividends received on or after January 1, 1982.

It is obvious from the above description that Rev. Rul. 81-225, issued when the year 1981 was three-quarters ended, creates for the insurance companies a most serious -- and perhaps for some an impossible -- task in preparing the Forms 1087.

2. Additional Payments in and Withdrawals in 1981 Under Pre-1981 Contracts: If an individual acquired a contract before 1981, paid in additional amounts in 1981 and made a partial withdrawal later in 1981, should the amounts withdrawn be treated as reducing the pre-1981 payments or as reducing the amounts paid in 1981?

In the section relating to "Prosepctive Application," Rev. Rul. 81-225 states that payments made into separate accounts on or before December 31, 1980 will be treated as though they are paid into a segregated asset account, but payments made thereafter will be treated as payments to the mutual fund for shares of the mutual fund.

So-called "flexible premium" contracts permit the contract holder to make payments to the insurance company from time to time. An individual may have purchased a contract described in situations 1, 2, 3 and 4 on or before December 31, 1980, and subsequently paid in additional amounts in 1981. If later in 1981 he withdrew part, but not all, of the surrender value of his contract, should the withdrawn amount be deemed to have come from the pre-1981 grandfathered amounts or from the post-1980 amounts that are not grandfathered?

The question has significance because under Rev. Rul. 81-225 the mutual fund dividends allocable to the pre-1981 amounts represent income to the insurance company, while those allocable to the post-1980 amounts would be income to the contract holder and required to be reported on Form 1087.

A corresponding question would exist if withdrawals were made by the individual in 1981 and he thereafter paid in additional amounts.

The Institute suggests that the simplest and fairest solution would be to assume that all dividends received in 1981 allocable to units held by a contract holder be treated as received in respect of units acquired on or before December 31, 1980, except to the extent allocable to units acquired by him through net additional payments in made by him after that date (i.e., on any date in 1981 the excess of units held for him on that date over the units held for him on December 31, 1980). The calculations in these cases would involve some complications in any event, but they would be minimized if, as suggested, they were confined to cases in which the number of units held for the contract holder on any date in 1981 exceed the number of units held for him on December 31, 1980.

3. Annuity Received as a Distribution in Lieu of a Lump Sum Retirement Payment: Does Rev. Rul. 81-225 apply to a deferred variable annuity of a type described in situations 1, 2, 3 or 4 received by an individual between December 31, 1980 and September 25, 1981 as a distribution in lieu of a lump sum retirement payment pursuant to Section 402(a) or Section 72(h)?

Rev. Rul. 81-225 states that it will apply only prospectively to Section 403(a) or (b) or Section 408(b) because Rev. Rul. 80-274 did not address those sections. Rev. Rul. 80-274 also did not address Section 402(a) or Section 72(h). The Institute submits that Rev. Rul. 81-225 should similarly apply only prospectively to the latter sections, and that a deferred variable annuity contract of a type described in situations 1, 2, 3 and 4 received on or before September 25, 1981, as a distribution in lieu of a lump sum retirement payment should be excluded from gross income pursuant to Sections 402(a) and 72(h).

4. Dividend Reinvestment: Under a deferred variable annuity contract acquired on or before December 31, 1980 (all payments in having been made on or before that date), if the insurance company, pursuant to the terms of the contract, invests dividends received from mutual fund shares held in a separate acount in additional shares of the mutual fund, will all the mutual fund shares allocable to the contract be regarded as owned by the insurance company and not by the contract holder?

The Institute submits that such reinvestment by the insurance company is not an additional payment made into the separate account subsequent to December 31, 1980. Rev. Rul. 81-225 states "payments made into separate accounts, . . . on or before December 31, 1980, will be treated as though they are paid into a segregated asset account within the meaning of Section 801(g)(1)." In the described situation, the policyholder's payment was made on or before December 31, 1980. The receipt of dividends by the separate account and their reinvestment by the insurance company do not increase the number of units in the account or sub-account held for the contract holder. Under Rev. Rul. 81-225, the assets held in the separate account, including dividend distributions on mutual fund shares, are owned by the insurance company. Therefore, the reinvestment of these dividends is not to be treated as an additional payment by the policyholder.

5. Would the grandfathered status of a pre-1981 contract be affected if the contract holder in 1981 exercised a right to reallocate among the sub-accounts in the segregated account?

A question somewhat similar to question 4 above exists in cases in which, as in situation 3, the contract holder "has the right initially to designate and periodically to reallocate the cash value under the contract among the 5 sub-accounts." In the case of amounts paid in on or before December 31, 1980, would the amounts that are grandfathered be affected if in 1981 the individual exercised the right to reallocate among the sub-accounts? The Institute submits that any such reallocation should have no effect upon the grandfathered status of the account, because there are no further "payments made into separate accounts" after December 31, 1980 and the individual is not the owner of mutual fund shares purchased with payments made by him on or before that date.

6. <u>Exchange of Grandfathered Annuity for Non-Grandfathered Annuity</u>: Will the holder of a deferred variable annuity contract obtained in 1981 in exchange for a similar contract purchased on or before December 31, 1980, be accorded nonrecognition treatment on the exchange pursuant to Section 1035(a) when both annuity contracts are of a type described in situations 1, 2, 3 and 4? Will the new contract be regarded as an annuity to the same extent as the pre-1981 contract?

If the policyholder had continued to hold the original deferred variable annuity contract it would be treated as a qualifying annuity under Rev. Rul. 81-225 because it was purchased on or before December 31, 1980. Similarly, if the policyholder had obtained the deferred variable annuity contract he presently holds on or before December 31, 1980, it would be treated as a qualifying annuity under Rev. Rul. 81-225. However, literal application of Rev. Rul. 81-225 might result in the 1981 exchange being taxable because the 1981 deferred variable annuity contract obtained would not be treated as an annuity contract even though the similar pre-1981 contract was treated as an annuity contract.

The Institute submits that this treatment would be inappropriate. The contracts being similar, it would be unreasonable to conclude that the transaction must be reconstructed as a taxable surrender of an annuity contract, with gain taxable as ordinary income, followed by the purchase of mutual fund shares. In actuality there was merely an exchange of one annuity contract for another similar contract, one of which was issued on or before December 31, 1980 and the other issued thereafter. The individual owner could not possibly have foretold that Rev. Rul. 81-225 would select December 31, 1980 as a the cut-off date for treatment of such contracts as variable annuities. Nor could the contract holder have contemplated that income accumulated in the account prior to 1981 would represent 1981 income merely because he made a 1981 exchange of similar contracts; he would have assumed either that there was a tax-free exchange of one annuity contract for another under Section 1035 or conceivably that neither contract was an annuity contract. In the latter event pre-1981 dividends would have been income in 1980 or earlier years, but not in 1981.

The Institute submits that, at least with respect to exchanges of one such contract issued before 1981 for another such contract issued in 1981 on or before September 25, the exchange should be regarded as covered by section 1035(a), and the new contract should be treated as an annuity contract acquired on or before December 31, 1980. Thus, the insurance company, not the policyholder, would be the owner of any mutual fund shares held in the separate account with respect to such contracts.

Substantially all of the problems of effective date discussed above would be eliminated if Rev. Rul. 81-225 were modified to grandfather amounts paid in on or before September 25, 1981 rather December 31, 1980. The Institute respectfully submits that the effective date should be so changed.

Mr. COHEN. Mr. Chairman, the institute supports the provisions of S. 1888 that the assets of the segregated asset account maintained by life insurance companies for the variable annuity contract may consist of shares of the mutual funds. And it supports the further provisions of the bill that it is immaterial whether the investment adviser of the mutual fund is or is not affiliated with the life insurance company issuing the contract.

The institute believes that it should be understood that the investment adviser should be able to exercise its full discretion in managing the investment portfolio of the mutual funds. It should be made clear that there are no restrictions that would make it necessary for the mutual fund to maintain an investment portfolio different from the portfolio of other mutual funds or that would make it necessary that the mutual funds have different investment advisers.

The institute agrees with the provision of the bill that it is immaterial whether or not the contract holder can directly invest amounts of his contract to a mutual fund having different investment objectives.

And we also support, Mr. Chairman, the provisions of the bill that would change the January 1, 1981 effective date of the Revenue Ruling to September 25, 1981, the date of its issuance.

I might add that Mr. Chapoton, in his statement before the committee a little while ago, noted that a ruling of a related nature involving savings and loan associations had been issued in September 1980, and that the Treasury thought that that ruling gave fair notice to the investors and the insurance companies that the ruling of September 1981 would be issued. The difficulty is that it took a year for the Service to make up its mind as to precisely what the ruling would be. No one knew in advance what, if any, cutoff date, with respect to the ruling, would be. And without going into the details, I don't think it would be possible for the insurance companies to keep the records that are necessary under the ruling without knowing in advance what the effective date would be that would be selected by the Service. And that wasn't known until September 25, 1981.

I would like to explain that to Mr. Chapoton because I don't believe he is aware of that.

For the reasons stated in our written statement and expanded in the memorandum that I have submitted for the record, the institute believes that these conclusions in the bill can and should be reached by administrative action under the present law. But in the event that rulings to that effect are not forthcoming, the institute believes that the relief provided by the bill is appropriate and desirable and that it should be enacted.

Mr. Chairman, we understand that further rulings may be issued by the Service on this subject. And because we think there may be some modifications of the language of the bill that may be appropriate, we respectfully request the opportunity to submit a further statement for the record before it is closed.

Senator CHAFEE. That would be fine. Now, obviously, you are going to have an opportunity or you will avail yourself of an opportunity to inform Mr. Chapoton or his assistants of the problems that you raised with his suggestion that you had fair warning under the prior ruling.

[The prepared statement follows:]

SUMMARY OF PRINCIPAL POINTS IN
STATEMENT OF EDWIN S. COHEN
ON BEHALF OF THE
INVESTMENT COMPANY INSTITUTE
BEFORE THE
SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON SAVINGS, PENSIONS
AND INVESTMENT POLICY
REGARDING S. 1888, RELATING TO VARIABLE ANNUITIES
DECEMBER 4, 1981

The Investment Company Institute, the national association of the mutual fund industry, supports the provisions of S. 1888 that the assets of a segregated asset account funding a variable annuity contract may consist of shares of a regulated investment company, or mutual fund, whether or not the investment advisor of the mutual fund is affiliated with the insurance company issuing the contract, and whether or not the contract holder can direct reinvestment of amounts attributable to his contract in a mutual fund having a different investment objective.

The Institute also supports the provisions of the bill that would change the January 1, 1981 effective date of Revenue Ruling 81-225 to September 25, 1981, the date of its issuance.

The Institute believes that these conclusions can and should be reached by administrative action under existing law; but in the event that rulings to that effect are not forthcoming, it believes that the relief provided by the bill is appropriate and desirable and that S. 1888 should be enacted.

STATEMENT OF EDWIN S. COHEN
ON BEHALF OF THE
INVESTMENT COMPANY INSTITUTE
BEFORE THE
SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON SAVINGS, PENSIONS
AND INVESTMENT POLICY
REGARDING S. 1888, RELATING TO VARIABLE ANNUITIES
DECEMBER 4, 1981

My name is Edwin S. Cohen and I appear before the Subcommittee today on behalf of the Investment Company Institute. I am a member of the law firm of Covington & Burling, of Washington, D.C.

The Investment Company Institute is the national association of the mutual fund industry. Its membership consists of more than 600 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. The Institute's mutual fund members have assets of more than $200 billion and have approximately 13 million shareholders.

S. 1888 relates to the federal income tax treatment of variable annuities in cases in which the funds paid in by contract holders, and the earnings thereon, are invested in shares of regulated investment companies, or mutual funds. The bill is occasioned by the issuance by the Internal Revenue Service on September 25, 1981 of Revenue Ruling 81-225 dealing with this subject.

Prior to the issuance of the ruling I filed with the Internal Revenue Service on behalf of the Institute a memorandum dated October 30, 1980 on this subject and, in collaboration with Donald C. Alexander and William B. Harman, Jr., filed with the Service and the Treasury more extensive memoranda under date of April 21, 1981 and July 23, 1981. Subsequent to the issuance of the ruling I filed with the Service on behalf of the Institute further memoranda dated October 13, 1981 and October 27, 1981; the first memorandum requested clarification of matters not specifically dealt with in the ruling, and the second related to its effective date. The latter memorandum included a description of the grave difficulties faced by insurance companies in endeavoring to comply with the requirements of the ruling to notify the Service and the contract holders of the amounts of income which, according to the ruling, are to be reported by the contract holders in their 1981 returns.

Because I believe these five memoranda will be helpful in an understanding of the issues, I respectfully request that copies of them be admitted to the record of these proceedings.

Revenue Ruling 81-225 took the position that where an insurance company issuing a variable annuity contract invests the funds paid in by the investor in the shares of a mutual fund that are publicly available for direct investment, the contract holder is deemed to be the owner of the mutual fund shares for federal income tax purposes. The ruling also held that the insurance company, and not the contract holder, is the owner of the mutual fund shares if they are not publicly available for direct investment by the individual. This conclusion was reached on an assumed set of facts in which the investment advisor of the mutual fund was "affiliated" with the insurance company and the contract holder did not have a right to direct that the amounts standing to the credit of his variable annuity contract be switched to another mutual fund having a different investment objective. The ruling did not specifically deal with the situation in which the investment advisor to the mutual fund is not "affiliated" with the insurance company or the contract holder has the right to have the amounts invested in a different mutual fund.

In our memorandum to the Service dated October 13, 1981 we respectfully requested the Service to make clear that it is immaterial whether or not the investment advisor is affiliated with the insurance company, and that it is likewise immaterial whether the contract holder can direct reinvestment of the amounts in a mutual fund having a different investment objective. S. 1888 would require these conclusions and the Institute accordingly supports the bill. We trust that the Service will come to the same conclusions under existing law, for the reasons stated in our memorandum of October 13, 1981.

Essentially, the Institute believes that the tax consequences of the variable annuity contract cannot under present law -- nor should they as a matter of policy -- depend upon the identity of the investment advisor, nor upon whether the advisor or advisors are full-time or part-time employees of the insurance company or independent contractors. Nor should the right of switching investment objectives be material, since Internal Revenue Code section 1035 has for many years permitted a tax-free exchange of one annuity contract for another; moreover, the right to change broad investment objectives has been a common provision in retirement plans for many years without objection from the Service.

Mutual funds provide a mechanism by which persons may pool their investment resources with those of others in order to obtain diversification of risk and experienced investment management. Mutual funds-

-are regulated by the Securities and Exchange Commission under the Investment Company Act of 1940;

-have only one class of stock outstanding and no debt securities;

-are required to have a diversified portfolio of securities;

-are required to have an investment objective described in the prospectus that must be furnished to investors; and

-currently distribute to their shareholders all their net investment income and capital gains.

In recognition of these circumstances, Subchapter M of the Internal Revenue Code for many years has treated these regulated investment companies essentially as conduits, or "flow-through" entities, for federal income tax purposes, imposing no tax on the companies themselves but imposing income tax to the shareholders on the current distributions of net investment income and capital gains. Long-term capital gains, dividends and certain other items received by the companies retain their character as such in the hands of the shareholders to whom they are distributed.

Variable annuities have traditionally involved investments in a diversified portfolio of securities. Mutual funds have traditionally provided a mechanism for diversified investments and are ideally suited for the purpose. For the reasons stated in our memoranda filed before the issuance of Revenue Ruling 81-225, it is the Institute's position that it is immaterial whether the funds in the segregated asset accounts of insurance companies are pooled with those of other investors in mutual funds whose shares are available to other investors. The Institute believes that Revenue Ruling 81-225 in requiring that where amounts in the segregated asset accounts are invested in the shares of mutual funds those mutual fund shares must not be available for direct acquisition by individuals, will merely increase the cost of investment management through multiplying the number of mutual funds. It will not increase the revenues nor serve any other public purpose.

S. 1888 would confirm this requirement of separate mutual funds. While the Institute believes that the requirement merely increases investment expense without accompanying public benefit, the rule can be complied with and the Institute will not actively oppose it. At the same time, the Institute believes, for the reasons stated in our memorandum of

October 13, 1981, it should be understood that the investment advisor of the two mutual funds can exercise its full discretion in managing the two investment portfolios. It should be clear that there ~~are no~~ restrictions that would make it necessary for the two mutual funds to maintain dissimilar investment portfolios.

The Institute supports the provisions of S. 1888 that would change the January 1, 1981 effective date of Revenue Ruling 81-225 to September 25, 1981. In our memorandum of October 27,1981, we described the extreme difficulties the insurance companies would face in complying with the requirement of furnishing to contract holders and the Service information as to the amount of income that under the ruling should be reported by the contract holders in their 1981 returns. Without the furnishing of that information, contract holders cannot comply with the ruling in filing their 1981 returns. We would add that some eleven months elapsed from the time of the filing of our first memorandum before the issuance of the ruling on September 25, 1981. We well understand that with the change in administration in January and preoccupation with the Economic Recovery Tax Act of 1981 in August, there was a necessary delay in the issuance of the ruling. But it was not possible to foretell the position that would be taken in the ruling or the contracts to which it would be made applicable. Even now there are matters requiring further clarification, as our two memoranda of October 13 and 27 note. We trust that the Service and the Treasury on their own initiative will conclude in the light of our memoranda and data furnished by others that they should change the January 1, 1981 effective date of the ruling to September 25, 1981, the date of its issuance; if not, the Institute submits the date should be so changed by statute.

To summarize our position: we believe that the relief which S. 1888 would provide can and should be provided by administrative action; if that is not forthcoming, the Institute supports S. 1888, since for the reasons we have stated we believe that the relief provided by the bill is appropriate and desirable.

STATEMENT OF DONALD ALEXANDER, ESQ., MORGAN, LEWIS, & BOCKIUS, WASHINGTON, D.C., ON BEHALF OF MERRILL LYNCH LIFE AGENCY, INC. AND FAMILY LIFE INSURANCE CO.

Mr. ALEXANDER. Mr. Chairman, my name is Donald Alexander, and I am a partner in the Washington law firm of Morgan, Lewis, & Bockius. I am representing here today Merrill Lynch Life Agency and Family Life Insurance Co. And I am deeply concerned about some of the matters that Mr. Chapoton set forth in his statement, one in particular going to tax administration that he discussed before you.

I would like to file a written statement, with your permission, at a later date, sir.

Senator CHAFEE. Fine.

Mr. ALEXANDER. In my judgment, the problem with the bill to correct part of Revenue Ruling 81-225——

Senator CHAFEE. Would you bring that mike a little closer to you, Mr. Alexander?

Mr. ALEXANDER. Yes, sir. I think that this bill, Senator Symms, doesn't go far enough. I think these are very worthy objectives, but I find Revenue Ruling 81-225 to be—just to pick up part of the Treasury statement with which I agree—unsound tax policy. That's at the top of page 11 of the Treasury statement.

This ruling purports——

Senator CHAFEE. Now that's the statement of Mr. Chapoton today?

Mr. ALEXANDER. That is correct. At the top of page 11 of the written statement, there is a discussion of the ruling (81-225) and the result of the ruling that would be codified by S. 1888. And it suggests that the ruling is a correct interpretation of current law, and I don't agree with that. But it said the ruling represents unsound tax policy. I do agree with that proposition. I think it is unsound tax policy. I don't believe it correctly reflects current law, nor do I agree that anyone reading the two prior rulings in this trilogy, Rev. Rul. 77-85, dealing with investment annuities, and 80-274, the savers, annuity ruling issued in 1980, which Mr. Cohen described, would find that those rulings afford any grounds for the sweeping ruling dealing with true variable annuities that we found this September in the issuance of 81-225.

The first two rulings turned on the question of retained rights of ownership by the policyholder. In the savers' annuity ruling, the policyholder was treated as a separate entity having ownership rights for the purpose of $100,000 in FSLIC insurance. It's awfully hard for someone to contend before one Government agency that he or she is the owner of the underlying asset in a so-called wraparound annuity, and contend before another that there are not sufficient rights of ownership to permit taxation of the income.

We don't have that situation at all in the true variable annuity, and that's the issue before you today. Now Mr. Chapoton said that one of his objectives was to provide adequate income in later years. Another was to provide increased savings. Adequate income in later years is what this is all about. And also what this is all about is whether section 801(g)(1) of the Internal Revenue Code, dealing with variable annuities, may be partially repealed by administrative edict, so I question whether the bill that we are discussing this morning goes far enough. It would be preferable, if it were feasible to eliminate this interpretation completely. At a minimum, it would be preferable to eliminate this interpretation insofar as it applies to annuities purchased by qualified retirement plans, by individual retirement accounts, or by schoolteachers and governmental accounts, because there you don't have the problem that Mr. Chapoton described, the failure to impose a current tax.

Finally, a point on the administration of the tax laws. Mr. Cohen has discussed the sticker argument for retroactivity. And Mr. Chapoton said that rulings should be retroactive unless otherwise provided.

I believe to the contrary. Rulings should be prospective, as indeed the first investment annuity ruling in 1977 was, as indeed the 1980 ruling has been applied, unless it is otherwise necessary to the integrity of the tax law.

Senator CHAFEE. Well, Mr. Chapoton certainly gave the impression that having retroactive rulings is nothing unusual.

Mr. ALEXANDER. It is unusual, I believe, sir. And I think I can speak with perhaps some background on that subject having been responsible for the process for 4 years. I think the contrary is true. When the 1977 ruling was issued dealing with investment annuities, it was not made retroactive. It was not made retroactive despite the fact that it presented a far more difficult problem for the protection of the revenues than what we are talking about today.

Senator CHAFEE. Your testimony is somewhat different from Mr. Cohen's. Mr. Cohen, if I am quoting his testimony correctly, would prefer that whatever is done here is done by administrative action. But Mr. Cohen was satisfied with Senator Symms' bill. Am I quoting you correctly?

Mr. COHEN. Mr. Chairman, in the interest of holding my oral statement in the limit of 5 minutes, I did not cover a point that is in our written statement and which would clarify our position. I don't think I differ with Mr. Alexander in that we both disagree with the conclusion in the September 1981 revenue ruling that it is necessary to have two mutual funds. We both feel that is not necessary or desirable.

All that we have said in the written statement is that we can live with the requirement of two separate mutual funds if that is what is wanted by the IRS. We feel there is no public benefit in it. And it would simply require additional expense to investors and others. But we can live with it.

I agree with Mr. Alexander that there is no point in insisting upon two different mutual funds.

Mr. ALEXANDER. I think it is not only undesirable and unnecessary in the administration of tax laws, but it's against the public interest.

Senator CHAFEE. All right. Mr. DeShetler.

[The written statement of Mr. Alexander follows:]

SUBMISSION OF DONALD C. ALEXANDER

ON BEHALF OF

MERRILL LYNCH LIFE AGENCY

AND

FAMILY LIFE INSURANCE COMPANY

BEFORE THE

SENATE COMMITTEE ON FINANCE

SUBCOMMITTEE ON SAVINGS, PENSIONS

AND INVESTMENT POLICY

REGARDING S. 1888, RELATING TO VARIABLE ANNUITIES

DECEMBER 4, 1981

This submission supplements the oral statement of Donald C. Alexander given at the Subcommittee's December 4 hearing.

Summary

Merrill Lynch Life Agency, Inc. and Family Life Insurance Company ("the Companies") support the provisions of S. 1888 which permit a regulated open-end investment company (mutual fund) supporting a variable annuity contract to have an investment advisor not affiliated with the insurance company issuing the contract, and which allow the contract holder to have the right to direct the investment and reinvestment of funds held under the contract among various mutual funds. The Companies also support the

provisions of the bill which eliminate the retroactive features of Rev. Rul. 81-225.

However, the Companies feel that Rev. Rul. 81-225 was not justified under current law or as a matter of public policy, and that the bill does not go far enough in overruling it. In addition, the Companies believe that certain changes should be made in the bill to ensure that it fulfills its objectives.

Problems with Rev. Rul. 81-225

Rev. Rul. 81-225 purported to distinguish between accounts in which the policyholders "possessed sufficient incidents of ownership in the underlying investments or certificates so that the interest, dividends, or other income therefrom was ... includible in gross income of the [policyholders] under section 61(a) of the [Internal Revenue] Code" and true segregated asset accounts for the purposes of section 801(g) of the Code, under which the policyholders did not possess such incidents of ownership in the underlying assets. We believe that the tests it set up did not adequately distinguish between the two situations.

The primary test enunciated by Rev. Rul. 81-225 was whether "the mutual fund shares [in which the account invests] are available for purchase not only by the prospective purchaser of the deferred variable annuity, but also by other members of the general public ...." If so, the

Service contends that "the mutual fund [sic] themselves are securities the incidents of ownership of which may be attributed to the policyholder." If the mutual fund shares are not available for purchase by the general public, incidents of ownership will not be attributed to the policyholder.

Neither in Rev. Rul. 81-225 nor in testimony before your Subcommittee has the Service or Treasury explained why, as a matter of either current law or public policy, publicly-available mutual funds are different in this respect from mutual funds used solely to fund variable annuity contracts. To the extent there is a difference between the policyholder's ownership and control over a publicly-held mutual fund and one used only to fund variable annuities, his or her control over the latter is greater, not less. The policyholders' voting rights with respect to a publicly-held mutual fund are diluted by the votes of the public shareholders, while in the case of non-publicly-held annuities, this is not the case.

The distinction also flies in the face of legislative intent. Variable annuities have always provided the policyholder with choices over the types of investments which would be the basis for the growth in the annuity and over the company, with its expertise, from which to buy the annuity. Such choices, which were present in the vari le annuities Congress was faced with when it decided to recognize variable annuities as annuities for tax purposes, are the same as those made by a policyholder who decides to have funds under a contract invested in a particular mutual fund, whether or not it is publicly-available. Such choices are quite different from a right to direct specific investment decisions of the underlying fund, a right which was present in both earlier rulings in which the Service held that policyholders would be taxed currently on the income of the account supporting an "annuity."

Service and Treasury officials appear to be considering several further issues under Rev. Rul. 81-225. One is whether a non-publicly-available fund might be treated as publicly-available if it resembled a publicly-available fund. For example, a fund might possibly be considered publicly-available if it were managed by an investment adviser which itself managed a publicly-available fund or which was affiliated with an investment adviser to such a fund. Similarities in investments held or in investment objectives might possibly cause a publicly-available fund and a non-publicly-available fund to be treated as parts of the same fund. Other issues under Rev. Rul. 81-225 now under consideration include the questions whether a life insurance company should be prohibited from employing an unrelated investment adviser, and whether contract holders should be prohibited from allocating or transferring their investment in their contracts among various subaccounts of the issuer of the contracts.

All of these distinctions are highly questionable. It should make no difference whether a non-publicly-available fund resembles a publicly-available fund. A resemblance test, whether expressed in terms of investments held, investment objectives, or investment adviser, would be hard to comply with and hard to police, and would discriminate against firms which were in any way associated with a public fund. If avoidance of policyholder control over investments is the test for annuity treatment, an annuity in which such control is lacking should qualify for treatment as such whether the control is held by the insurance company, an affiliate thereof, or a non-affiliate. Since Congress, in enacting section 1035 of the Code, has enabled a policyholder to switch from an annuity investing in one type of asset to an annuity investing in a different type of asset without incurring taxation, the ability to make the same switch within the confines of a single annuity contract should not give rise to unfavorable tax consequences.

Rev. Rul. 81-225 applies to all payments received under annuity contracts (except section 403(a), 403(b), and 408(b) annuities) after December 31, 1980. This causes hardships to policyholders who are subject to current taxation on income they believed to be tax-deferred, and to insurance companies, which are obliged to report the income of the underlying mutual fund to policyholders even though they had no advance notice of the need to keep the types of records necessary to divide the income of the fund among policyholders and between pre-1981 and post-1980 contributions.

Treasury has argued that this retroactivity is justified. It contends that Rev. Rul. 80-274, issued a year before Rev. Rul. 81-225, put companies and policyholders on notice that annuities based on mutual funds were bad. It points to the "stickering" of mutual fund annuities required by the SEC as evidence for this contention.

The Companies do not agree. The SEC-mandated "stickering" was designed to alert policyholders to any conceivable problem, and did not represent an SEC judgment that Rev. Rul. 80-274 applied to mutual fund annuities. An action taken to protect policyholders should not now be used against them. In fact, many responsible tax practitioners (the very persons the SEC "sticker" advised policyholders to consult) felt that sufficiently distinguishing features of the savers' annuities discussed in Rev. Rul. 80-274 were (a) the availability of FSLIC coverage, indicating that policyholders were obtaining ownership rights before one federal agency while denying ownership responsibilities before another, (b) the absence of a pooled fund constituting a segregated asset account under state law, and (c) the absence of investment discretion by any person other than the policyholders. None of these features was present in the mutual fund annuities.

Treasury's contention that Rev. Rul. 80-274 applied to mutual funds is also weakened by its own long delay in issuing Rev. Rul. 81-225. Within a few weeks after issuance of Rev. Rul. 80-274, several taxpayers (including the Companies) had requested rulings concerning mutual fund annuities. In a conference in January, 1981, Service officials told the Companies that they were not sure how the Service would rule on such annuities. Rev. Rul. 81-225 was not issued for more than nine months after that conference, and a full year after Rev. Rul. 80-274. If the Service took so long to make up its mind on the subject of mutual fund annuities, it is unfair to expect companies and policyholders to have guessed its decision in advance.

Responses to Rev. Rul. 81-225

The Companies believe that the best response to Rev. Rul. 81-225 would be to overrule it entirely, rather than to confirm its central tenet. Failing that, the Companies believe that it should be limited to annuities other than section 403(a), 403(b), and 408(b) annuities. The "evil," if there is one, in mutual fund annuities does not exist in the case of annuities purchased under employer plans or individual retirement arrangements. In the case of a section 403(a), 403(b), or 408(b) annuity, the amounts which may be contributed and the restrictions on withdrawal are the same as those imposed in the case of a trust or custodial account under sections 401(a), 403(b)(7), and 408(a), respectively, over which the individual is permitted to have investment control. In such cases, exemption or deferral of taxation is governed not by general section 72 principles, but by a specific statutory judgment that such exemption or deferral is warranted.

S. 1888 is, however, a long step in the right direction toward curing some of the defects in Rev. Rul. 81-225. The Companies have certain technical suggestions with respect to the language of the bill, and think it should be broadened to resolve the important open issues mentioned above.

STATEMENT OF KENNETH DeSHETLER, VICE PRESIDENT, CORPORATE RELATIONS, NATIONWIDE LIFE INSURANCE CO., COLUMBUS, OHIO

Mr. DESHETLER. My name is Kenneth DeShetler. I am vice president of Nationwide Insurance Companies.

Over 50 percent of the policies directly affected by the retroactive application of this revenue ruling were settled through Nationwide. We strongly support the expeditious enactment of S. 1888.

Variable annuities funded by mutual fund shares have proven to be an extremely effective way for middle income Americans to provide for their retirement security while expanding at the same time, the capital formation base of our country.

I do not believe that anyone here today disagrees with the notion that private retirement savings programs to augment social security must be strongly encouraged. Congress clearly provided in the tax laws that the earnings of these variable annuities is not taxed until paid to the taxpayer. Further, the Treasury's own regulations indicate that section 72 tax deferral applies to contracts which are considered to be annuity contracts in accordance with the customary practices of life insurance companies.

In Revenue Ruling 81-225 they have recently overruled Congress and are taxing our policyholders currently on nonqualified variable annuity earnings.

What particularly concerns us, Mr. Chairman, is the inequitable retroactive application of that ruling. Without warning or rationale, that ruling imposes a 1981 tax liability on 21,000 policyholders of Nationwide who in good faith and often on the advice of independent tax advisers purchased these annuities with after tax dollars with the understanding that the earnings would be deferred pursuant to the law in effect for over 50 years.

The retroactive application of that ruling cannot be condoned and should be reversed. We are beginning to hear cases, Senator, in which considerable hardship is done where familes, at the end of their retirement period, have taken a lump sum pension plan and rolled it over into this program only to find then that it's, in fact, the—that it is taxable in the year 1981.

Senator CHAFEE. Mr. DeShetler, why don't you pause 1 minute. We have a very distinguished native of your State, and a representative, of course, in the U.S. Senate, Senator Glenn. And, Senator, if you have a statement, we would be delighted to receive it at this time.

[The prepared statement follows:]

STATEMENT OF KENNETH DESHETLER, NATIONWIDE LIFE INSURANCE CO.

Thank you, Mr. Chairman. My name is Kenneth DeShetler. I am Vice President - Corporate Relations of Nationwide Life Insurance Company of Columbus, Ohio.

Nationwide Life Insurance Company is a subsidiary of Nationwide Corporation, a holding company primarily engaged through its subsidiaries in the business of life and health insurance and financial services. Such subsidiaries include, in addition to Nationwide Life, Gulf Atlantic Life Insurance Company, Michigan Life Insurance Company, National Casualty Company, Pacific Life Insurance Company, West Coast Life Insurance Company, National Services, Inc., Heritage Securities, Inc., Gates McDonald and Company, Western Credit Union Corporation and Nationwide Real Estate Services, Inc.

Nationwide Life Insurance Company along with Nationwide Mutual Insurance Company, Nationwide Mutual Fire Insurance Company, Nationwide General Insurance Company and Nationwide Premium Accounts, Inc., compose the Nationwide Group.

To provide some benchmark of the extent of Nationwide Life's activity in the variable annuity market, the following statistics are useful:

> Based on figures compiled by the Life Insurance Marketing Research Association, for the first six months of 1981, Nationwide Life ranked first and accounted for 55 percent of all non-qualified, variable annuity sales -- \$120,544,000 of \$218,010,000. With respect to qualified variable annuity sales, Nationwide Life ranked first, accounting for 29 percent

of sales -- $70,640,000 of $244,883,000. For policies sold prior to 1981, both percentages would be higher.

Currently Nationwide Life has approximately 41,000 policyholders of variable annuity contracts, approximately 21,000 of which would be detrimentally affected specifically by the retroactive application of Rev. Rul. 81-225.

Let me begin by briefly explaining my company's position. On behalf of our affected policyholders, we strongly support the immediate enactment of S. 1888 sponsored by Senators Symms, Grassley, Durenberger and Chafee. That legislation adopts the "public access" theory of Rev. Rul 81-225 and embodies an evenhanded treatment of annuity policyholders attempting to save for their eventual retirement. Importantly, the legislation reverses the unfair retroactive application of Rev. Rul. 81-225.

We additionally urge its enactment because it would serve to encourage (rather than dissuade as the IRS has chosen to do) Americans to pursue alternate vehicles for their future financial planning. Certainly at a time when many are looking to private industry to provide viable retirement-saving options for the consumer, S. 1888 is highly consistent with that need.

With those general thoughts in mind, let me discuss the specific problems inherent in Rev. Rul. 81-225 which the remedial legislation addresses.

Tax Code Treatment

Section 72 of the Internal Revenue Code (IRC) provides for the tax treatment of annuities but does not define the term annuity. The regulations at § 1.72-2(a)(1) provide the following guidance:

> The contracts under which amounts paid will be subject to the provisions of Section 72 include those contracts which are considered to be life insurance, endowment and annuity contracts in accordance with the customary practice of life insurance companies.

What is a Variable Annuity?

Generally, an annuity is a contract for a payment of a sum of money periodically either for the life of the policyholder and/or his spouse or for a term of years. An annuity contract is purchased from an insurance company with "after tax" dollars, unless purchased in conjunction with a "qualified" plan under I.R.C. § 403 or § 408. An annuity generates earnings between the date of purchase and when the amounts are paid to the policyholder. These earnings are tax-deferred under § 72; they are not taxed currently to the policyholder.

When paid, generally at retirement, the periodic payments consist of a return of capital investment in the contract, and a payment of earnings on such investment. Under IRS § 72, annuity proceeds are excluded from the policyholder's current income to the extent they represent a return of the initial contract investment. The excess is taxed as ordinary income when paid under § 72.

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A very simple, generalized example will illustrate the concept. Mr. A purchases an annuity from Company X for $10 in 1981. By 2001, the contract has generated $90 of income. This income is not taxed to Mr. A during this 20-year period. In 2001, Mr. A decides to retire and be paid his annuity annually over a ten-year period. Each annual payment of $10 will be treated as a return of $1 of capital. Nine dollars will be taxed as ordinary income under § 72.

Under a fixed annuity contract the insurer guarantees a specified rate of interest to be paid to the policyholder on the amount of his investment (or premium). The guaranteed amount is payable either in a lump sum at the maturity of the contract or in the form of monthly installments. The insurance company bears the risk that the investment return it earned on the premiums paid will supply sufficient funds to meet payments guaranteed to the contract. The premiums paid by the policyholder become part of the general assets of the insurer.

A variable annuity provides that the value of the policyholder contract varies in accordance with the investment results of a segregated asset account in which the policyholder's net premium is invested. Thus, the policyholder assumes the investment risk under the contract, rather than the insurance company as under a fixed annuity. Variable annuity contracts are funded through "segregated asset accounts" which, pursuant to state law, are separate from the general assets of the insurer and are described in I.R.C. § 801(g)(1)(B).

Nationwide Product Description

The Spectrum variable annuity sponsored by Nationwide Life Insurance Company is typical of variable annuity products currently being offered; pursuant to state law and I.R.C. § 801(g), Nationwide has established a segregated asset account. Premium payments for its variable annuity contracts are paid into the separate account and are used to purchase shares of mutual funds advised by Massachusetts Financial Services Company. These shares are held in the separate account. Increases and/or decreases in their value are reflected within the account and the value of a policyholder's undivided interest in that account.

During the years prior to the time the policyholder begins to receive annuity payments, an interest in the account will increase or decrease depending on the investment performance of the account. After the policyholder has begun to receive annuity payments, the amount of such payments will likewise vary according to the investment performance of the underlying assets. It is important to understand that a policyholder's premium for a Spectrum variable annuity purchases an undivided interest in a Nationwide separate account or sub-account and not an interest in specific mutual fund shares.

To restate, according to the Treasury's own regulations, § 72 applies to those contracts which are considered to be annuity contracts in accordance with the customary practice of life insurance companies. Since the early 1900's, the Federal income taxation of annuities under § 72 has been basically consistent. Earnings on assets held by the issuing company to fund the annuities are not taxed to the policyholder until paid to him, at which time they are taxed as ordinary income.

Related Revenue Rulings

In 1977, the IRS issued Rev. Rul. 77-85 taxing the policyholder rather than insurance company on amounts credited to his account under an annuity policy. The ruling was based on the fact that the policyholder could change investment selections and was held to have sufficient incidents of ownership in the assets to make him, not the insurance company the owner of the assets. Hence, the earnings on such assets were taxed to him. This ruling was applied on a prospective basis only. It was overturned by a Federal district court. The court held (1) the contract assets were in fact owned by the company and not the policyholder, and therefore, not currently taxable to the policyholder and (2) the ruling was unreasonable and beyond the IRS's lawful authority. However, due to the prohibitions of the Anti Injunction Act, the district court opinion was reversed on appeal.

Despite this consistent history and the district court opinion with respect to Rev. Rul. 77-85, in October of 1980, the IRS again legislated by issuing Rev. Rul. 80-274. It denies the historic tax treatment to an annuity that was funded with certificates of deposit issued by savings and loan associations. The rationale of 80-274 was the same as 77-85. Again, this ruling was applied on a prospective basis only. In response to the 80-274 ruling, several bills were introduced in this Congress and are awaiting action that would overturn the 1977 and 1980 rulings.

Again, ignoring the historical treatment of annuity taxation, the IRS has recently legislated by announcing Rev. Rul. 81-225. This ruling basically taxes the annuity holder on mutual fund shares held by the insurance company as the investment vehicle for variable annuity policies when the mutual fund shares are available for purchase by the general public. Unlike Rev. Rul. 77-85 and Rev. Rul. 80-274, this ruling was made retroactive to January 1, 1981.

Rulings are Contrary to Law

All three of these rulings, to the extent that they deny the Congressionally mandated and historic tax treatment of annuities to variable annuity products are contrary to law. Rev. Rul. 81-225's retroactive application is unjustifiable, inequitable and ignores the manner in which payments into segregated asset accounts used to fund variable annuities are made and accounted for.

S. 1888 solves the problems raised by Rev. Rul. 81-225. While we do not agree completely with the ruling, we urge the expeditious enactment of this legislation adopting the "public access" theory of the ruling. It is critical that Congress provide certainty to consumers and companies alike trying to make informed, thoughtful, financial decisions.

Supplemental Retirement-Savings Plans Needed

I do not intend to make this hearing a forum on the social security system and individual retirement. Suffice it to say that no one seriously contends, nor was it ever intended, that individuals rely solely on their social security for retirement income. Consequently, individuals must save and invest for their retirement security.

The variable annuities targeted in Rev. Rul. 81-225 are generally purchased with "after-tax" dollars and any earnings on such accounts are taxed as ordinary income when paid. Annuities clearly have been, and will hopefully continue to be, an excellent means for middle-income Americans to provide retirement savings. Annuities remain a viable retirement vehicle because taxation is deferred on the income earned on these invested amounts until eventually paid out to the annuitant.

Additionally, in about one-half of the states, premium taxes are paid on premiums received for the annuities. It should be clear that these taxes are indirectly paid by the variable annuity holders. Commensurate with the benefit to the individual from retirement savings, is the benefit to our country from the expanding capital formation base. I don't think anyone here today disagrees with the notion that private retirement savings must be strongly encouraged in order to add to that foundation.

Other Provisions of S. 1888

Let me briefly address the other aspects of S. 1888. First, the legislation reverses the abuse of administrative discretion concerning the retroactive application of the ruling. Without warning or rationale, that ruling imposes a 1981 tax liability on persons who in good faith and often on the advice of independent tax advisers, purchased these annuities with the understanding that earnings from them would be deferred according to tax law that has been in effect for over 50 years.

The public access rationale could not have been foreseen and is contrary to at least three recently published rulings (Rev. Rul. 70-525, Rev. Rul. 76-281, and Rev. Rul. 78-204) that sanctioned variable annuities where mutual fund shares supporting the variable annuity were also offered through another account to the general public. Further, as will be discussed in detail by another witness today, it will be almost impossible for any insurance company to compute and report the earnings on the annuity as required by the retroactive application of the ruling.

In short, the retroactive application of this revenue ruling, based on agency whim rather than clear statutory guidance, is inherently inequitable.

Second, although not addressed in the ruling, S. 1888 clarifies that an independent investment manager is permissible. Under Federal securities law, variable annuity contract holders have the right to remove an investment manager. Of course, S. 1888 does not allow the contract holder himself to be the investment manager.

Finally, § 1035 of the tax law has for years recognized that an exchange of one annuity contract for another is not taxable. Also not addressed in Rev. Rul. 81-225, S. 1888 clarifies that the annuity holder may allocate or reallocate funds credited to his contract among subaccounts of a single segregated asset contract. Contract holders wishing to alter investment orientation to reflect our ever-changing economic conditions should be able to accomplish this goal without formally going through the cumbersome and expensive administrative aspects of a more formal exchange.

Conclusion

In summary, S. 1888 provides critical statutory guidance concerning the proper tax treatment of variable annuities funded by mutual fund shares. By concurring with the approach already taken by the Treasury, the Congress is establishing as a policy matter through legislation, that the earnings on these annuities will be tax deferred when the mutual fund shares are not otherwise available to the public. Yet the most important accomplishment of the bill is to eliminate the retroactive application of the ruling.

On behalf of our 41,000 policyholders, we urge the immediate enactment of S. 1888.

Thank you, Mr. Chairman.

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NEWS FROM
NATIONWIDE
INSURANCE

FOR IMMEDIATE RELEASE

NATIONWIDE INSURANCE CALLS ON SENATE TO ENACT BILL
TO OVERTURN "UNREASONABLE" FEATURES OF IRS RULING

WASHINGTON, D.C., Dec. 4, 1981 -- A Nationwide Insurance executive urged Senate members here today to provide immediate financial relief to tens of thousands of consumers by enacting legislation to overturn the "unreasonable" retroactive application of an Internal Revenue Service ruling against variable annuities.

"The retroactive feature of IRS Revenue Ruling 81-225 has placed an inequitable and unlawful tax liability on our policyholders and a virtually impossible administrative burden on my company," Kenneth DeShetler, vice president-corporate relations, Nationwide Insurance Companies, Columbus, Ohio, told members of the Senate Finance's Subcommittee on Savings, Pensions and Investment Policy. "S 1888 removes that injustice and should be enacted."

The bill, introduced by Sen. Symms (R-Idaho) and co-sponsored by Sen. Chafee (R-R.I.), would also clarify two other areas in question: that unaffiliated investment managers be permitted, and that a contract holder be able to allocate or reassign contract amounts among separate asset accounts or subaccounts of one account. DeShetler said Nationwide endorses those provisions.

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During the hearing, he also submitted a statement on behalf of nine insurance companies, including Nationwide. The companies strongly urged "elimination of the inequitable retroactive application of the ruling," and emphasized the need to bring a greater degree of soundness and clarity to the treatment of annuity products. The companies involved include: Life Insurance Company of North America; Hartford Variable Annuity Life Insurance Company; American General Life Insurance Company; Family Life Insurance Company; National Benefit Life Insurance Company; Northwestern National Life Insurance Company; and Pacific Fidelity Life Insurance Company.

An annuity is a contract for a payment of a sum of money periodically either for the life of the policyholder and/or his spouse or for a certain number of years.

The IRS decision, issued on September 25, removed the tax-deferral on investment income of "wraparound" annuities (investment return wrapped around mutual funds) when the mutual fund shares are available to the public for investment other than through the variable annuity. IRS surprised even experts by making the ruling applicable retroactively to the first of the year.

"Variable annuities funded by mutual shares have proven to be a very effective way for middle income Americans to provide for their retirement security," DeShetler said. "And it should not be forgotten," he added, "that during these strained economic times, many are looking to the private sector for viable alternate retirement-savings vehicles to supplement Social

Security."

DeShetler said the retroactive application particularly concerns Nationwide because "without warning or rationale, it imposes a 1981 tax liability on thousands of our policyholders who in good faith, and often on the advice of independent tax advisers, purchased these annuities, with 'after tax' dollars understanding that the earnings would be tax-deferred."

Nationwide Life Insurance Company, one of the Nationwide Group of Companies, ranks first in the industry in variable annuity sales.

S 1888 does concur with the IRS "public access" theory by establishing that the earnings on these annuities will be tax deferred when the mutual fund shares are not otherwise available to the public. DeShetler said that while Nationwide believes the IRS ruling is incorrect, his company is supporting the legislative adoption of the theory in order for Congress to provide "expeditious certainty to consumers and companies alike trying to make informed, thoughtful, financial decisions."

The Senate bill's companion in the House of Representatives is HR 5004. It was introduced by Congressman Richard Gephardt (D-MO) and has a growing list of co-sponsors.

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STATEMENT OF HON. JOHN GLENN, U.S. SENATOR FROM THE STATE OF OHIO

Senator GLENN. Mr. Chairman, I don't have any real statement here, but I was going to be here to introduce Mr. DeShetler to members of the committee. I am pleased to introduce you to him. He is a good friend, personal friend. I have known him for many years. And he is a man who knows a great deal about the insurance business. He is vice president for corporate relations of Nationwide Insurance, one of our major companies in this country, which is headquartered in Columbus. He's had extensive experience in the insurance field and law, having served as Ohio's insurance commissioner for the whole State.

Prior to that, he was a municipal court judge in Toledo for 8 years. And served as presiding judge of that court the last 2 years. He served as the acting U.S. Commissioner for the western division of the northern district of Ohio. And before going on the bench, he was a chief prosecuting attorney for the city of Toledo.

Ken will be addressing us, of course, on S. 1888, which is a very important piece of legislation to the insurance industry and to the members of the public who have purchased the annuities that are the subject of this bill. One of the major features of this legislation, of course, is elimination of the retroactive effect of an Internal Revenue Service ruling issued last September.

I am concerned about the potential inequities that could result if these transactions in mutual fund annuities, entered into in good faith, are modified after the fact in ways not anticipated by any of the parties. I will be looking closely at this bill myself, and I urge members of the subcommittee to do the same. I am confident that Ken's testimony will be very helpful to you all.

I apologize that we were over in a meeting with some of the Governors and I was late getting here. But it is a pleasure to see you again. And I know your advice to the committee will be expert and well received.

Thank you.

Senator CHAFEE. Thank you very much, Senator Glenn, for taking the trouble to come by.

STATEMENT OF SENATOR JOHN GLENN INTRODUCING KENNETH E. DESHETLER TO THE SAVINGS, PENSION, AND INVESTMENT POLICY SUBCOMMITTEE

Mr. Chairman and members of the Committee, I am pleased to introduce to you today a constituent, a good friend, and a man who knows a great deal about the insurance business.

Ken DeShetler is the Vice President for Corporate Relations of Nationwide Insurance Company, headquartered in Columbus, Ohio. He has had extensive experience in the insurance field and the law, having served for four years as Insurance Commissioner for the State of Ohio. Prior to that, Ken was a Municipal Court Judge in Toledo, Ohio, for eight years, the last two of which he served as Presiding Judge of that Court. He has also served as the Acting United States Commissioner for the Western Division of the Northern District of Ohio. Before going on the bench, Ken was the Chief Prosecuting Attorney for the city of Toledo.

Ken will be addressing you this morning on S. 1888, which is a very important piece of legislation to the insurance industry and to the members of the public who have purchased the annuities that are the subject of this bill. One of the major features of this legislation is its elimination of the retroactive effect of an Internal Revenue Service ruling issued last September.

I am concerned about the potential inequities that could result if these transactions in mutual fund annuities, entered into in good faith, are modified after the fact in ways not anticipated by any of the parties. I will be looking closely at this bill myself, I urge members of the Subcommittee to do the same, and I am confident Ken's testimony will be helpful to us all.

Senator CHAFEE. I must say I learned something. I never knew that the whole Nationwide group is headquartered in Columbus.

Mr. DESHETLER. It is, indeed.

Senator CHAFEE. Well, that must be a very, very major industry. How many people do you have?

Mr. DESHETLER. We have about 11,000 employees and some 6,000 or so agents.

Senator CHAFEE. All 11,000 people in Columbus?

Mr. DESHETLER. Not all of them are there.

Senator CHAFEE. Oh, they are around the country.

Mr. DESHETLER. About 6,500 in Columbus.

Senator GLENN. When you are in downtown Columbus, the big building will attest to the success of Nationwide.

Senator CHAFEE. Well, it certainly is. Thank you very much, Senator, for coming here. And, Mr. DeShetler, why don't you proceed.

Mr. DESHETLER. Senator, I was trying to draw your attention to the fact that we are starting to see cases of considerable hardship. I know of one case in particular where there is a widow with five children who put, to her, what was a considerable sum of money into this only to find out that it may be, in fact, taxed in the year 1981.

Immediate action is necessary. The retroactive application of the ruling has placed an inequitable and unlawful tax liability on our policyholders. And it would be virtually impossible, administratively, on the company.

S. 1888 removes that injustice and I would suggest to you that it should be enacted.

Senator, I had an opportunity to review the Treasury statement this morning and would direct your attention to page 10 in which they talk about the potential tax consequences. And I will read it quickly, if I might. It says: "Continuation of the present tax treatment to defer would merely result in a substantial increasing of revenue losses. Eventually, a very substantial portion of the savings by individual taxpayers could be attracted into deferred annuity. Such development would reduce tax revenue by billions of dollars. These potential revenue losses should not be ignored."

I suggest to you that that, in a sense, might be superfluous—it does not relate to this bill. The retroactive application of this bill, if altered, would have a tax consequence or a deduction to the Treasury in the neighborhood of $10 million at the most. So I would hope that the committee would not be misled in respect to that.

I believe that what the Treasury is trying to do today administratively, is what they were unsuccessful in doing in 1978 legislatively.

That concludes my statement today on behalf of Nationwide. However, I am pleased to announce that I have been authorized by the following companies to convey to this committee their strong support for elimination of the inequitable retroactive application of this rule and the need to bring a degree of clarity to the area of annuity products. Those companies are: Life Insurance Co. of North America, Hartford Variable Annuity Life Co., American

General Life Insurance, Family Life Insurance, National Benefit Life Insurance, and Northwestern National Life Insurance Co.

Thank you, Mr. Chairman.

Senator CHAFEE. Mr. DeShetler, when Nationwide sold these annuities, did you give any suggestion or what you might consider a warning to your purchasers that this might be taxable?

Mr. DESHETLER. Well, Senator, as a matter of fact as I understand, the IRS, in somewhat of a cynical vein, I think maybe they were doing this to prestage their ultimate judgment—they asked the SEC to require the sticker. The sticker was, in fact, put on. There was a suggestion that the tax consequences would be in question. But I would suggest to you, Senator, that the American public, when they are alerted to a situation like this, that there is essentially a feeling that retroactive application of such rules is essentially unfair. I think most Americans feel that retroactivity is not fair so the average buyer would not, even though he saw the sticker, contemplate that under any circumstances the Government would act against his interest to the extent of making a retroactive application, maybe saying prospectively you can't use this device as a tax deferral system. But under no circumstances can I imagine that many of our buyers contemplated a retroactive application.

Senator CHAFEE. Yes, but I think that you would have a greater obligation than just putting a sticker on it. After all, you are selling Nationwide's reputation. And you are selling an investment, as it were. Indeed, an annuity. And I would hope that you didn't feel that you had met your obligations by just putting a sticker on a policy.

Mr. DESHETLER. Well, we did, of course, suggest that they shouldn't, you know, acting in their own interest, seek or consult with independent advisers. And I think at that time there was no one who knew what the Treasury was going to do; particularly, in respect to the retroactive application.

Senator CHAFEE. You were here before when I had the discussion with Mr. Chapoton about talking or discussing a 10-percent withdrawal penalty if anybody takes money out of these annuities before age 59½. What do you think of that?

Mr. DESHETLER. Well, I would say generally the notion of creating some restrictions is one in which I think the industry would be prepared to work with this committee or the Treasury in establishing significant differential limitations. That's not to say the 10 percent isn't inappropriate.

Senator CHAFEE. No. I'll confess that I am not an expert in this area. And it is very complicated. But it does make me a little nervous that we are embarking into an area here where it seems that people are able to handle a sophisticated investment through these mechanisms. And that it could well be a dodge. I am not saying the annuities, the amounts judged, but——

Mr. DESHETLER. There are some penalties already imposed under some of the contracts, Senator, to discourage that kind of movement.

Senator CHAFEE. Fine, Mr. DeShetler. Thank you very much.

Mr. Fraser from Massachusetts?

Mr. COHEN. Mr. Chairman?

Senator CHAFEE. Mr. Cohen.

Mr. COHEN. May I just note that a proposal for imposing a penalty on withdrawals from annuity contracts was considered by the Ways and Means Committee in 1978, when the Treasury asked for legislation, and was rejected by the committee. There are difficulties with it. I don't want to take up your time this morning in going into all of the difficulties, but it is not an easy solution to the problem.

I don't think that is a simple solution that is desirable.

Senator CHAFEE. As you know, Mr. Cohen, if we got into anything like that, we would have extensive hearings. And those affected would have a chance to make their views known.

Mr. COHEN. Yes.

Senator CHAFEE. All right. Mr. Fraser.

STATEMENT OF DUNCAN FRASER, SENIOR VICE PRESIDENT AND TREASURER, MASSACHUSETTS FINANCIAL SERVICES, BOSTON, MASS.

Mr. FRASER. Good morning. By way of introduction, I am Duncan Fraser. And have served for the last 9 years as treasurer of Massachusetts Financial Services Co.

I have submitted testimony in which I strongly object to one aspect of Revenue Ruling 81-225, which would be corrected by the timely enactment of S. 1888.

Specifically, my concern this morning is the retroactive application of Revenue Ruling 81-225, which deems as taxable to the contract holders, income dividends and capital gains distributions received by Nationwide in respect to 1981 purchase payments. And which affects not only contract holders who have made purchase payments after December 31, 1980, but because of the pricing mechanisms employed, also has the potential for effecting investment values of purchase payments made prior to January 1981.

Our involvement with S. 1888 is twofold. MFS acts as investment adviser to mutual funds whose shares are sold to Nationwide as a result of Nationwide's issuance of variable annuity contracts.

Additionally, we have an obligation to provide administrative recordkeeping services for the owners or purchasers of Nationwide variable annuities. The requirement of Revenue Ruling 81-225 that Nationwide provide to all effective contract holders information pertaining to the receipt of taxable income in 1981, is, from the variable annuity records we maintain, not possible.

Apparent in the words and applied in the theory of Revenue Ruling 81-225 is a presumption that variable annuity contract holder recordkeeping and mutual fund shareholder recordkeeping are identical. This is erroneous.

The annuity processing system has not been designed to attribute mutual fund income dividends and capital gains distributions to individual contract holders. The data for such attribution does not exist in the variable annuity processing system. The daily calculation of the accumulation unit values, the pricing statement for variable annuities roughly equivalent to net asset value statements for mutual funds, is accomplished by a proportional or ratio formula which updates the previous calculation for current investment results of underlying mutual fund shares. The workings of this formula does not provide for an increase in accumulation unit value in respect of any mutual fund activity other than an increase in net asset value.

And with respect to mutual fund shares which the insurance company has owned for over 1 year, new funds and net asset value are diminished by 28 percent, an amount representing a reserve for long-term capital gains taxes.

Because the calculation of accumulation unit values is progressive and done by a proportional formula and based on previous value, any alteration in the formula would render each and every day's stated accumulated value incorrect. The amount of any adjustment would apply, therefore, not only to 1981 purchase payments, but also to the account values in respect of payments received by Nationwide during 1977, 1978, 1979, and 1980.

Furthermore, amounts confirmed to annuitants during the year would similarly have been misstated.

I have prepared a written explanation of the pricing formula together with an example of its application, and I——

Senator CHAFEE. I get the drift. I couldn't repeat back to you what you said, but the point is you can't figure it out. Is that correct?

Mr. FRASER. That's it, sir.

Senator CHAFEE. All right.

[The prepared statement follows:]

STATEMENT OF DUNCAN FRASER, MASSACHUSETTS FINANCIAL SERVICES CO.

Thank you, Mr. Chairman. My name is Duncan Fraser. I am Senior Vice President and Treasurer of Massachusetts Financial Services Company of Boston, Massachusetts. I am here today to strongly support the immediate enactment of S. 1888 and to discuss one particularly disturbing aspect of Revenue Ruling 81-225, the egregious retroactive application of that ruling.

Under the ruling, policyholders are taxed on the earnings of purchase payments made after December 31, 1980. Further, under the ruling, the insurance companies must file Forms 1096 and 1087 with the I.R.S. to report the dividends received from the mutual fund and furnish the policyholder a statement showing these amounts.

The income reporting required under Revenue Ruling 81-225 presumes a level of administrator's knowledge concerning income attribution which does not exist and which renders the application of 81-225 a full re-processing of all financial transactions, resulting in a direct impact on pre-1981 contract holders. It is clear that the Treasury erroneously perceived greater similarities between mutual fund processing and variable annuity processing than exist.

In mutual fund processing, transaction records are kept at the shareholder level, including detailed recording of all principal (share) transactions and all distributions (income payments and capital gains distributions). Our processing systems have been developed anticipating the requirement to provide shareholders annually with Form 1099 information and upon request to provide cost and proceeds information for determining capital gains tax status. Each shareholder transaction is recorded in detail on the transfer agent's records and in summary in the records maintained by the mutual fund custodian. The custodian calculates a net asset value, daily, at which price transactions recorded on that day are effected. The calculation of such net asset value is accomplished by separately valuing the mutual fund assets and liabilities in a process which is begun afresh each business day and is applicable for but one business day.

Variable annuity processing is entirely different and presents the following notable differences. The mutual fund transfer agent maintains but two accounts in the name of the insurance company which issues the variable annuity contracts. The two accounts represent aggregations of all contract holder activities separated between purchases of tax-qualified products on one hand and purchasers of non-qualified products on the other. In the case of Nationwide Life Insurance Company, these two accounts represent the sum of investments under its MPS Variable Account and include activities from investments during 1978, 1979, 1980 and 1981. The insurance company provides for a contract holder processing system which records individual investor data and which has not been designed to attribute mutual fund income dividends and capital gains distributions to individual contract holders. The data for such attributions does not exist in the variable annuity processing system. The daily calculation of accumulation unit values is accomplished via a proportional, or ratio formula which updates the previous calculation for current investment results of underlying mutual fund shares. This formula does not provide for an increase in accumulation unit value in respect of any mutual fund activity other than an increasing net asset value and, with respect to mutual fund shares which the insurance company has owned for over one year, the net asset value movements are diminished by 30% (currently 28%), which amount represents a reserve for long-term capital gains taxes. Because the calculation of accumulation unit values is progressive or iterative, by a proportional calculation based upon a previous value, any alteration in the formula such as the removal of the capital gains reserve would render each and every day's stated accumulation unit value incorrect. The amount of any adjustment would apply, therefore, not only to 1981 purchase payments but also to the account values in respect of payments received by Nationwide Life Insurance Company during 1978, 1979 and 1980. Furthermore, valuations performed for calculating amounts withdrawable upon surrender or upon the exercise of exchange provisions would similarly have been quantified indirectly to the end that data supplied all contract holders who have surrendered a portion or the entirety of their contract or to contract holders who have exchanged, were erroneous, including pre-1981 investors.

For the reasons described above, the Nationwide Life Insurance Company annuity processing system is incapable of developing the type data required by Revenue Ruling 81-225. The mechanics of this processing system did not anticipate the requirements of "pass through" income to the investor. The accumulation unit values at which all variable annuity business has been transacted and confirmed include formula elements which, if changed, affect all investors, not merely 1981 investors.

Consequently, apart from the obvious equity involved, we strongly urge the immediate enactment of S. 1888 that reverses the retroactive application of the ruling.

Thank you Mr. Chairman.

The formula for non-qualified variable annuity pricing suggested by Nationwide is as follows:

$$NIF_t = \frac{.7*NAV_t + .3*AC_{t-1} + .7*LTCG_t + STCG_t + INC_t}{.7*NAV_{t-1} + .3*AC_{t-1}} - .0000275*\Delta D \quad \text{(Note 1)}$$

where:

NAV_t = The x dividend or capital gain Net Asset Value of the fund priced at the end of day t.
AC_t = Average cost per mutual fund share at the end of day t after <u>all</u> transactions.
$LTCG_t$ = Per share Long Term Capital Gain Distribution 'x' on day t.
$STCG_t$ = Per share Short Term Capital Gain Distribution 'x' on day t.
$SHRS_t$ = Shares of the fund owned by Nationwide on day t after all purchases or redemptions of shares on day t.
CS_t = The average per share cost of the shares purchased or redeemed on day t, defined as the difference in aggregate cumulative cost divided by the change in shares.
$\Delta SHRS$ = $SHRS_t - SHRS_{t-1}$ or new shares purchased or redeemed on day t at NAV_t for new unit value purchases or redemptions and reinvestment of dividends and capital gains distribution.
NOTE: It is assumed that Nationwide purchases new shares on the ex-date of a distribution. The income or capital gain is not distributed to Nationwide until the payable date.
UV_t = Unit Value of the variable annuity on day t.
t = Today.
t-1 = The most recent previous pricing day.
ΔD = The difference in calendar days, t - (t-1). All distributions that take place between day (t-1) and t are assumed to go x on day t and to be reinvested at NAV_t.
INC_t = Per share income dividend 'x' on day t.
Cash Flow = Net $ value of purchase or redemption of units by unit value holder net of acquisition charges.

This form of the expression of the Net Investment Factor has the following desirable features:

1) All the information is available at the close of the business day after the pricing of the fund.
2) All shares are redeemed or purchased by Nationwide at today's closing net asset value (NAV_t).
3) Units are issued or redeemed at the end of the day based on that day's unit value.

Note 1: Note that the formula currently employed has been altered to reflect changes in long-term capital gains tax rates which differ from those used in the memorandum.

4) The tax liability of the fund at any time is covered by the reserve account.
5) It is algebraically and numerically equivalent to the formula derived by MFS* if the following assumptions are made:

A) $AC_t = (AC_{t-1}*SHRS_{t-1} + CS_t*\Delta SHRS_t)/SHRS_t$

B) CASH FLOW = $.7*NAV_t*\Delta SHRS_t + .3*CS_t*\Delta SHRS_t - (.7*CG_t + INC_t + STCG_t)*SHRS_{t-1}$

From the marketing point of view, the Nationwide NIF expression has the following drawbacks:

1) The expression does not necessarily guarantee that the unit value holder will retain 70% of the change in NAV or 30% of the change in average cost.

2) This formula does not address the problem of the retention, by Nationwide, of 30% of the undistributed gain - whether that gain is income or capital gain.

The unit value for each day, t, is found by multiplying the unit value of the previous period (t-1) by the NIF_t. Thus $UV_t = UV_{t-1}*NIF_t$.

Two cases are attached as examples of the assumptions that are made about the accounting of the Nationwide Annuity account and about the calculation of the Net Investment Factor. The order of processing of transactions is as follows:

1) The (NAV_t) net asset value of the fund is determined x any income and capital gains.
2) On the x-date, Nationwide purchases new shares at NAV_t in order to reinvest for the x dividend and capital gain. (The actual income distribution is not made to Nationwide until the payable date weeks later.)
3) UV_t is calculated FOR EACH FUND.
4) Redemptions or purchases (in units or in dollars) of the variable annuity units are made at price UV_t. ($Value = Cash Flow)
5) Additional shares are sold or purchased by UIT at NAV_t. ($Value = Cash Flow)
6) To compensate for the tax effect of a realized loss or gain resulting from a UIT redemption of underlying shares, the UIT sells or purchases additional shares.

For simplicity's sake, neither case includes the ΔD*.0000275 portion of the NIF expression. Two assumptions that are made about cash flow and average cost can be illustrated in the case #1 on day 4-18.

A) $AC_t = (AC_{t-1}*SHRS_{t-1} + CS_t*\Delta SHRS_t) / SHRS_t$

$$\text{i.e. } 7.56399568 = \frac{(7.55975975*30{,}080.321 + \frac{4211.242}{539.903} * 539.903)}{30{,}620.224}$$

$$= \frac{(227{,}400 + 4211.242)}{30{,}620.224}$$

$$= \frac{231{,}611.242}{30{,}620.224} = 7.56399568$$

$$* \quad NIF = \frac{(.7*NAV_t + .3*AC_t) * SHRS_t - \text{Cash flow}}{(.7*NAV_{t-1} + .3*AC_{t-1})\ SHRS_{t-1}}$$

B) Cash Flow = $.7NAV_t * SHRS_t + .3*CS_t*\Delta SHRS_t - (.7*CG_t + INC_t + STCG_t)*SHRS_{t-1}$

i.e. (.7)(7.80)(539.903) + (.3)(4211.242/539.903)*539.903 - (.7*.2)*(30,080.321)

= 2947.87 + 1263.37 - 4211.24

= 0

One of the drawbacks mentioned can be verified by any one of several examples in the cases. The unit value holder does not necessarily receive .7 times the change in NAV_t. On day 4 of case #2 the NAV drops from $8.00 to $7.00; the average cost does not change. A 70¢ ($1.00*.7) drop from an $8 NAV_3 would yield a .9125 NIF; yet the NIF_4 for that day is .9166. A shareholder has no idea of the cost basis of the fund. If a shareholder were told to expect that he would accrue 70% of the loss or gain of the fund, he would be frustrated trying to verify this with mutual fund prices in the newspaper. Likewise, he would be pleasantly surprised to see that on day 5, NAV_5 is $6.00 and a unit is worth about 71.7¢, but on day 7, NAV_7 is $6.00 and a unit is worth 72.3¢. That same shareholder might note with displeasure a change in the other direction. The annuity products "cushion" the unit value holder on the up and downside. The magnitude of that cushion cannot be explicitly stated for marketing purposes.

The second drawback, the retention of the reserve for undistributed gains in NAV including income, can be better illustrated by another example. Suppose MFS had a mutual fund whose cost basis and NAV at the beginning of the quarter was $10.00. Assume that over a period of a quarter this fund accrued a 20¢ income dividend and no capital gain. If it is further assumed that no transactions take place during the quarter and that the fund is priced at the beginning of the quarter and the day before the x-dividend date at the end of the quarter, the pre x-date NIF is 1.014.[1] The unit value is 1.014 times the unit value at the beginning of the quarter. The NIF on the x-date is about 1.0059.[2] The unit value holder receives the full benefit of the accrued income on the x date. (1.0140*1.0059 = 1.020). Under such a scenario, the maximum disadvantage is 6¢ on a $10.00 NAV or 60 basis points.

I tested the Nationwide NIF formula against our case examples and found that it resulted in identical NIF's to those calculated by MFS' expression when the average cost figure is expressed to the same precision as the NIF and unit value. I have worked with Charlie Weaver from Nationwide on this problem, and both of us are convinced of the mathematical appropriateness of the formula. Previous differences in Nationwide's and MFS' numbers were a direct result of using only three decimal precision in the average cost figure, while NIF's were calculated with eight decimal precision. If the advantages, disadvantages and assumptions are acceptable, the NIF calculation suggested by Nationwide should be implemented.

1. $\dfrac{.7*(10.20) + .3*(10.00)}{.7*(10.00) + .3*(10.00)}$

2. $\dfrac{.7*(10.00) + .3*(10.00) + .20}{.7*(10.20) + .3*(10.00)}$

CASE #1

Date	NAV_t	$COST: Purch(Red) CS_t*$SHRS_t$	$COST: Cum $Cost AC_t*$SHRS_t$	SHARES: Purch(Red) $\Delta SHRS_t$	SHARES: Cum $SHRS_t$	Avg. Cost AC_t	NIF	Unit Value	Units Purch	Cum-Units
4-13	7.47	150,000	150,000	20,080.321	20,080.321	7.47000000	1.00000000	1.00000000	150,000.000	150,000.000
4-14	7.60	-	150,000	-	20,080.321	7.47000000	1.01218206	1.01218206	-	150,000.000
4-17	7.74									
10,000 Shrs. Purch		77,400	227,400	10,000.000	30,080.321	7.55975975	1.01296125	1.02530120	75,490.012	225,490.012
4-18	7.80	-	227,400	-	30,080.321	-				
Cap Gain $.20		4,211.24	231,611.24	539.903	30,620.224	7.56399568	1.02367964	1.04957996		
4-19	7.00									
$200,000 Purch		200,000	431,611.24	28,571.429	59,191.653	7.29175852	.92754747	.97353524	204,436.837	430,926.849
4-20	6.00									
$100,000 Red		(124,499.99)	307,111.25	(16,666.666)	42,524.987					
Real Loss		7,350.00	314,461.25	1,225.000	43,749.987	7.18768785	.901234952	.87738399	(113,975.183)	316,951.666
4-21	8.00									
$100,000 Red		(95,828.31)	218,632.94	12,500.000	31,249.987					
Real Gain		(1,251.51)	217,381.43	(156,439)	31,093.548	6.99120766	1.22025370	1.07063106	(93,402.857)	223,548.809

DATE	Value of NW Shares	Tax (liab) Or Gain	Total Value	Value of Units	Diff.
4-14	$152,610.44	(783.13)	151,827.31	151,827.31	-
4-17	232,821.69	(1,626.51)	231,195.17	231,195.18	.01
4-18	238,837.75	(2,167.95)	236,669.80	236,669.80	-
4-19	414,341.57	5,180.90	419,522.47	419,522.47	-
4-20	262,499.92	15,588.40	278,088.30	278,088.32	.02
4-21	248,748.38	(9,410.09)	239,338.29	239,338.30	.01

CASE #2

Scenario - Falling NAV & Large redemptions

Date	NAV_t	\$COST Purch(Red)	Cum\$Cost	SHARES Purch (Red)	Cum	Avg.Cost	NIF-Net Investment Factor	Unit Value	Units Purch (Red)	Cum Units
1	10.00	100,000	100,000	10,000	10,000	10.00000000	1.00000000	1.00000000	100,000.000	100,000.000
2	9.00	-	100,000	-	10,000	10.00000000	.93000000	.93000000	-	100,000.000
3	8.00									
\$40,000 purch		40,000	140,000	5,000	15,000	9.33333333	.92473118	.86000000	46,511.628	146,511.628
4	7.00	-	140,000	-	15,000	9.33333333	.91666667	.78833333	-	146,511.628
5	6.00									
\$30,000	Red	(50,000)	90,000	-5,000	10,000					
\$20,000	Real loss	6,000	96,000	1,000	11,000	8.72727273	.90909091	.71666667	-41,860.466	104,651.162
6	5.00									
\$25,000	Red	(50,000)	46,000	-5,000	6,000					
\$25,000	Real loss	+7,500	53,500	+1,500	7,500	7.13333333	.89733333	.64308888	-38,874.875	65,776.287
7	6.00	-	53,500	-	7,500	7.13333333	1.12411347	.72290487	-	65,776.287

Date	Value of NW Shares	Tax (Liab) or Gain	Total Value	Value of Units	Diff.
2	\$90,000	\$3,000	93,000	93,000.00	-
3	120,000	6,000	126,000	126,000.00	-
4	105,000	10,500	115,500	115,500.00	-
5	66,000	9,000	75,000	75,000.00	-
6	37,500	4,800	42,300	42,300.00	-
7	45,000	2,550	47,550	47,550.00	-

Senator SYMMS. Mr. Chairman, on that point, I asked Mr. Chapoton if the people involved in this had the ability to do it. And are you telling us that you don't have the ability to do it?

Mr. FRASER. I am specifically telling you that the processing system for the variable annuity recordkeeping contains no data that can be attributed to individual investors. Yes, sir.

Senator SYMMS. So then what you are saying is in direct conflict with what the Secretary said.

Mr. FRASER. Absolutely, with due respect.

Senator SYMMS. We always assume that. [Laughter.]

I guess, Mr. Chairman, my problem is I can't understand why Treasury wants to implement some ruling with which it is impossible to comply. I don't know how you expect people to comply with a law that is impossible.

Senator CHAFEE. I don't expect you will get any argument from this panel.

Mr. FRASER. Such application would require the creation of totally new systems.

Mr. COHEN. Senator, I would just like to emphasize one other thing that I don't think Mr. Chapoton took into account today. He said that the insurance companies had knowledge from the date of the issuance, which would be September 1980, that this might happen. But you couldn't have kept the records unless you knew what effective date the Treasury and the IRS were going to select. When they selected the date of January 1, 1981, that was a date that couldn't have been foretold. And so you would have to distinguish between amounts paid in before that date, and amounts paid in after that date in preparing the information. Not until they selected the date would you have been able to build up a system to make the information available.

Senator CHAFEE. Anything else, Senator Symms?

Senator SYMMS. Just one question, Mr. Chairman. I know that the morning is moving on, but in my opening remarks which I submitted for the record, I made the statement that the Treasury ruling was grounded on public access to policy arguments. That is, a person who invests in mutual fund shares through an annuity should not achieve tax deferral. If a person who invests directly in the same mutual fund shares is taxed currently, the Treasury is designed to prevent the use of annuities in an asset that could have been purchased directly without the use of the annuity.

Now the latest theory of Treasury has never been stated anywhere in more than a 50-year history of the rules governing annuity taxation.

Mr. Alexander, do you think that's a correct statement in your experience?

Mr. ALEXANDER. That's two statements. The first is your expression of the rationale of this ruling. That is completely correct. And that has nothing to do with the two rulings that preceded it.

Second, your characterization of this rationale as being entirely novel in the 50 years of annuity taxation—I learned some years ago not to be absolutely sure of myself because it is possible that somebody may have dreamed up some crazy idea 30 years ago. Subject only to that qualification, I would agree entirely with the second as well as the first proposition.

Senator CHAFEE. This committee will not be doing anything on these measures until next year, I expect, and Congress may well be out of here by a week from tomorrow. What are the timing problems that you are confronted with assuming that we agreed with you?

Mr. FRASER. The notice requirements from Nationwide are due to contract holders within the first 31 days of the year. And notice to the IRS, 28 days later.

Mr. ALEXANDER. Right. This demands the forms 1087 and 1096. The production of the form 1087 produces the problems you have just heard about. It produces a very, very expensive undertaking to try to cope as nearly as possible as one can with the difficulties that have been described.

The problem we have, if no action is taken, is that the time will have passed for effective action in this particular regard.

Senator CHAFEE. But aren't we talking about taxable years, and taxpayers filing their taxes——

Mr. ALEXANDER. These are calendar year taxpayers. And under this revenue ruling, the insurance company has an obligation to deliver form 1087, treating itself as having been a nominee for the period January 1, 1981 through September 25, 1981, with respect to new policies and new amounts deposited under old policies.

Mr. DESHETLER. The retroactivity aspect of it creates enormous time pressures. The rest of it, of course, could be done at a more leisurely basis. But that problem is there.

Mr. COHEN. Mr. Chairman, the taxpayers, the contract holders, who put their money in after January 1, 1981, will not be able to file a tax return on April 15 to reflect this income as required, because they don't know the amounts of such income, unless the insurance companies can have the time to tell them and the IRS by January 31 and February 28 what those amounts are. The problem is that no one has that information per individual. They have all the global information, but it has not been maintained per individual. Even if it had been maintained, we wouldn't have known when to cut it off—to cut off the information with respect solely to the amounts paid in after January 1, 1981. No way to predict that date in advance.

Senator CHAFEE. Are you saying that if we are going to do something about this, it has to be done this calendar year?

Mr. COHEN. It has to be done before the tax filing season.

Senator SYMMS. Mr. Chairman, Mr. Cohen, you said you thought that they could do this administratively.

Mr. COHEN. Yes.

Senator SYMMS. I tend to agree with you. I also thought—when we introduced this bill, the reason for it was to try to keep these taxpayers from being unduly damaged. Mr. Alexander, do you think that this with what he said that it could be done administratively?

Mr. ALEXANDER. Oh, it could be done administratively. They could solve some of the remaining glitches, two of which are addressed in the bill and others that I hope will be addressed as well. And they could also turn back on the retroactivity requirement. However, it surely appears from the Treasury position this morning that they have no intention of the latter, assuming they have any intention whatever as to the former. So, therefore, action would be necessary, and necessary quickly.

Mr. DeShetler. We would urge your consideration before you go home, Senator.

Senator Chafee. Thank you very much, gentlemen.

The next panel. Mr. Dwyer, Mr. Hacking, and Mr. Hoyle, we would ask you to summarize your statements since we have your full statements.

Mr. Donovan, are you substituting for——

Mr. Donovan. No; I'm accompanying Mr. Dwyer.

Senator Chafee. All right. Mr. Dwyer, why don't you proceed? And as I say, we do have time restrictions, so if you have a lengthy statement, just submit it and you can summarize. I think we are pretty familiar with these issues on this one. Why don't you go ahead?

STATEMENT OF VERNON J. DWYER, MANAGER, PENTAGON FEDERAL CREDIT UNION, AND SECRETARY, NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS (NAFCU), ON BEHALF OF NAFCU, ARLINGTON, VA.

Mr. Dwyer. Mr. Chairman and members of the subcommittee, I am Vernon J. Dwyer, secretary of the National Association of Federal Credit Unions and manager of the Pentagon Federal Credit Union. I also serve as the credit union representative on the Federal Reserve Board's Thrift Advisory Council. The National Association of Federal Credit Unions is, as you perhaps know, the only national trade association exclusively representing the interests of our Nation's federally chartered credit unions. There are 12,233 of these. And have 26.8 million members who hold more than $36.4 billion in savings.

And I appreciate the opportunity to appear here to consider Senator D'Amato's bill and to reenact the $200 and $400 for joint returns exclusion for interest and/or dividends.

Mr. Chairman and members of the committee, the policy that you are considering strikes at the core of this Nation's economic health. As a Nation, we are dependent upon one another for our financial success. Increased employment and productivity rely upon capital investment. We must reexamine the core of individual savings to restore the missing element of a healthy, productive economy. And we are here today to urge this subcommittee to endorse the restoration of the single saving incentive applied to all savers.

As you are well aware, the Crude Oil Windfall Profits Tax Act of 1980 contained a provision (section 404) which allowed an exclusion from taxable income of the first $200 ($400 in the case of a joint return) of interest and/or dividends earned on savings or investments in domestic corporations during the calendar years 1981 and 1982. This legislation expanded the existing $100/$200 exclusion for stock dividends only. NAFCU endorsed this expansion as an encouraging first step in providing savers with an incentive to increase their savings.

In the process of the formulation of the Economic Recovery Tax Act of 1981, long before any credible information could be gathered as to the effectiveness of the $200/$400 exclusion, the legislature repealed the second year of this provision. However, the $100/$200 stock dividend exclusion remains intact. This exemplifies the provision that could have greatly aided the small saver but was modified to reward only those wealthy and sophisticated enough to invest in the stock market.

Now the single substitute for this savings incentive is the all-savers certificate which provides an exclusion of up to $1,000 ($2,000 for joint returns) for interest and/or dividends earned on certain 1-year certificates at a specified rate. Economists determined that those taxpayers in less than 30 percent brackets were not likely to benefit from the purchase of an all-savers certificate. Therefore, this substitute removed any savings incentives for most taxpayers in brackets under 30 percent.

In addition to denying tax benefits to many potential savers, the decision to repeal the $200/$400 interest/dividend exclusion for 1982 was inequitable to those taxpayers who acted prudently and relied upon this exclusion in their savings plan.

Senator CHAFEE. I would urge everyone with a lengthy statement to summarize, and stress the points that you particularly want to drive home. I will give you 1 more minute, Mr. Dwyer, and then we will have to move on.

Mr. DWYER. Very well, sir. We would like to reemphasize the severity of our concern as representatives of a credit union and the credit union movement wherein the small saver has been, if you will, discriminated against willy-nilly by the removal of this provision that we have referred to before.

We suggest the serious need for reversal in the savings pattern of American consumers. This restoration of this interest/dividend exclusion will, we believe, correct the imbalance that now exists. Therefore, we endorse the prompt action by Congress to reenact and make permanent the tax exclusion for interest and/or dividends, and to increase this exclusion in the years ahead, sir.

Senator CHAFEE. All right, fine.

[The prepared statement follows:]

Statement of Vernon J. Dwyer on Behalf of the National Association of Federal Credit Unions

Mr. Chairman and members of the subcommittee, I am Vernon J. Dwyer, secretary of the National Association of Federal Credit Unions and manager of Pentagon Federal Credit Union. I also serve as the credit union representative on the Federal Reserve Board's Thrift Advisory Council. The National Association of Federal Credit Unions (NAFCU) is the only national trade association exclusively representing the interests of our nation's federally chartered credit unions. There are 12,233 Federal credit unions throughout the country whose 26.8 million members hold more than 36.4 billion dollars in savings.

I appreciate the opportunity to appear before you today as you consider Senator D'Amato's bill (S. 1607) to reenact the $200 ($400 for joint returns) exclusion for interest and/or dividends. At the outset, let me say that NAFCU strongly encourages positive committee action on this legislation.

Mr. Chairman and members of the subcommittee, the policy that you are considering strikes at the core of this nation's economic health. As a nation, we are dependent upon one another for our financial success. Increased employment and productivity rely upon capital investment. The source of investment is both personal and business savings. We must reexamine the core of individual savings to restore the missing element of a healthy, productive economy. We are here today to urge this subcommittee to endorse the restoration of the single saving incentive that applied to all savers.

The personal savings rate in this country has been declining steadily since 1973. For the third quarter of 1981, the personal savings rate is 4.9% of disposable income. At the same time, consumer prices rose at an annual rate of 4.4% last month. The underlying level of inflation is still at a rate of 8-9% per year, according to the Commerce Department. We believe that steps must be taken to encourage savings in this country.

Credit unions are one segment of an economic structure which reflects the saving habits of Americans. As consumer-owned institutions, credit unions are very close to the heart of middle-income savers. In fact, the median size account at Federal credit unions is $1,180.

As you are well aware, the "Crude Oil Windfall Profits Tax Act of 1980" contained a provision (Section 404) which allowed an exclusion from taxable income of the first $200 ($400 in the case of a joint return) of interest and/or dividends earned on savings or investments in domestic corporations during the calendar years 1981 and 1982. This legislation expanded the existing $100/$200 exclusion for stock dividends only. NAFCU endorsed this expansion as an encouraging first step in providing savers with an incentive to increase their savings.

In the process of the formulation of the Economic Recovery Tax Act of 1981, long before any credible information could be gathered as to the effectiveness of the $200/$400 exclusion, the legislature repealed the second year of this provision. However, the $100/$200 stock dividend exclusion remains intact. This exemplifies a provision that could have greatly aided the small saver but was modified to reward only those wealthy and sophisticated enough to invest in the stock market.

ALL SAVERS - NO SUBSTITUTE

The single substitute for this savings incentive is the "All Savers" certificate which provides an exclusion of up to $1,000 ($2,000 for joint returns) for interest and/or dividends earned on certain one-year certificates at a specified rate. Economists determined that those taxpayers in less than 30% brackets were not likely to benefit from the purchase of an "All Savers" certificate. Therefore, this substitute removed any savings incentives for most taxpayers in brackets under 30%.

In addition to denying tax benefits to many potential savers, the decision to repeal the $200/$400 interest/dividend exclusion for 1982 was inequitable to those taxpayers who acted prudently and relied upon this exclusion in their savings planning. Taxpayers who invested funds in long-term certificates in 1981 with the legitimate expectation that up to $200 per year per person would be excludable in 1981 and 1982 will lose out. In fact, these same individuals were often denied the opportunity to shift these funds from existing certificates into "All Savers" certificates in order to reap the benefits of tax-deductible interest or dividends. Taxpayers who do their best to save but are unable to lock up funds for an entire year are deprived of the opportunity to earn tax-free interest and/or dividends.

The $200/$400 interest/dividend exclusion was truly for all savers; the "All Savers" certificate program although it is a viable savings incentive, falls short of benefitting all savers.

The $200/$400 exclusion provides the saver with several options for his/her investment. The taxpayer may choose the best vehicle that best meets his/her needs. This approach is much more appropriate than forcing the taxpayer into a single, rigid certificate program that may not meet his/her needs.

S. 1607

S, 1607, introduced by Senator D'Amato, which now has 24 co-sponsors in the Senate, including Senators Bradley, Durenberger, Heinz, Mitchell, and Moynihan, distinguished members of the full Finance Committee, would amend the Internal Revenue Code of 1954 to provide an exclusion for interest and dividends earned of up to $200 for each individual. This legislation further provides for an increase in this exclusion for years beginning after December 31, 1984.

The National Association of Federal Credit Unions strongly endorses the proposal of Senator D'Amato and its numerous co-sponsors. The restoration of the interest/dividend exclusion for 1982 and the continuation and expansion of this exclusion is an important step toward encouraging savings.

TREND TOWARD SAVING

The National Association of Federal Credit Unions recognizes the serious need for a reversal in the saving patterns of American consumers. We must move away from subsidizing the borrower and toward rewarding the saver. According to a staff working paper of the Congressional Budget Office, almost 50% of all households in the United States do not earn the maximum of $200 ($400) on their savings. Some have questioned whether this savings incentive only rewards those who are already saving and does not prompt new saving. Since almost one-half of the potential savers in this country have not reached the maximum $200/$400 exclusion level, this argument does not hold.

NAFCU believes that the best way to stimulate new savings would be to remove all tax on savings income; however, we recognize that this approach must be gradual in order to provide time for the Treasury Department to adjust to a lower return from taxes. Senator D'Amato's bill recognizes this and provides for an increase in the exclusion in years to come. S. 1607 increases the excludable amount of interest/dividend income for years beginning after December 31, 1984, by the lesser of $250 or a qualified excess interest amount. This provision is contained in the Economic Recovery Tax Act of 1981, passed by this Congress last summer. A built-in incentive for increased savings is contained in the bill. NAFCU supports this concept as it rewards increased savings in the years ahead.

Congress must make a basic policy decision in its consideration of S. 1706: Is the objective of Congress to stimulate the most investment in the short run--and thus the tax breaks should be geared to the wealthy--or is it to change the trend of the average taxpayer from borrowing to saving? The "All Savers" certificates are directed toward those taxpayers in the over-30% bracket who can afford to lock away funds for 12 months. Although these two savings incentives should not be viewed as mutually exclusive, the $200/$400 interest/dividend exclusion rewards all saving taxpayers. The All Savers Certificates are a one-time shot-in-the-arm for

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financial institutions and savers; the $200/$400 exclusion is a policy of rewarding those who save on a regular basis.

OTHER PROPOSALS

Mr. Chairman, several other proposals designed to encourage greater consumer savings have been introduced. The National Association of Federal Credit Unions firmly supports the concept that the best way to encourage savings is to remove the disincentive that taxes have become. Senator Heinz and Senator D'Amato introduced the "Small Savers Incentive Act" which would increase the excludable amount of interest and/or dividends in years after December 31, 1982, up to a maximum of $450. This legislation provides a stimulus for new savings because the exclusion is based upon a percentage of interest and/or dividends earned. NAFCU endorses this bill as well as the many proposals that would provide incentives for average working people to save.

S. 1645

This subcommittee is also addressing the issue of Individual Retirement Account investments in collectibles. As a credit union representative, I must encourage this subcommittee to oppose allowing investments in collectibles. It is in the best interest of the country to encourage saving rather than spending. By permitting IRA investments to be made in collectibles, the Congress would be encouraging more consumer spending. Furthermore, Individual Retirement Accounts are meant to be a stable investment which will serve as a source of future retirement funds. Collectibles are often quite speculative in nature and thus do not serve as a stable source of investment. In addition, one of the benefits of exanding IRA eligibility and contribution limits is the promise of an increase in savings at our financial institutions which would lead to the rebirth of consumer loans and reasonable mortgages. I urge this subcommittee to reject the proposal to open IRA investments to the purchasing of collectibles. While on the issue of IRAs, I would like to urge this committee to consider further expansion of this excellent savings incentive. The creation of a "Homemaker IRA" is one very important area that I believe deserves consideration. It is time that we recognized the fact that not only employed people but also those who are unemployed and raising our families must be supported in old age. The "Homemaker IRA" would be a much more adequate source of retirement funds for those who work in the home. While drawing attention to this particular aspect of IRA expansion, I encourage the members of this subcommittee to continue efforts to broaden the IRA as a savings vehicle for retirement.

SUMMARY

The National Association of Federal Credit Unions recognizes the serious need for a reversal in the saving patterns of American consumers. The $200/$400 interest/dividend exclusion provides a savings incentive for Americans at all income levels. S. 1607 simply restores the $200/$400 interest/dividend exclusion for 1982, 1983, and 1984. We, therefore, endorse prompt action by Congress to reenact and make permanent the tax exclusion for interest and/or dividends and to increase this exclusion in the years ahead.

Senator CHAFEE. Gentlemen, Mr. Hacking and Mr. Hoyle, it would be helpful to me if you could address possibly—and it may not be within your statements—address the points that Mr. Chapoton raised which are really three. Namely, the Congress is giving a substantial tax cut and, thus, people can use their money the way they wish. Their income taxes are being reduced.

Second, he says that, frankly, this doesn't produce additional savings of any substantial quantity. What you are doing is you are giving a tax break to somebody who is already saving. It's not a saving incentive, it's a tax reduction.

And the third point he made concerns an exclusion rate for certain dollars of interest—namely $200/$400. And zero for anything above it. If you are going to encourage savings, then you should go to a percentage of savings, even way in excess of $400. That's the way to encourage savings.

Why don't you gentlemen proceed? Mr. Hacking.

STATEMENT OF JAMES M. HACKING, ASSISTANT LEGISLATIVE COUNSEL, NATIONAL RETIRED TEACHERS ASSOCIATION AND AMERICAN ASSOCIATION OF RETIRED PERSONS, WASHINGTON, D.C.

Mr. HACKING. Thank you, Senator. I am here to present the views of the National Retired Teachers Association and the American Association of Retired Persons on Senator D'Amato's bill, S. 1607. I will submit the associations' statement for the record and proceed to summarize.

The associations strongly support Senator D'Amato's bill which would maintain the $200/$400 interest and dividend exclusion that this year's Economic Recovery Tax Act has scheduled for extinction.

It seems to us that if it were going to reverse declining——

Senator CHAFEE. Could you pull the mike a little closer, Mr. Hacking?

Mr. HACKING. If we are going to reverse this country's declining productivity and declining rates of saving and investment to begin to bring our economic house back into some semblance of order, it makes sense to provide people with strong incentives to save and invest. Although this year's tax bill contained important new retirement savings incentives—which, incidentally, the associations strongly supported—the other savings provisions of the bill were not helpful to most savers, especially small savers who are elderly.

In our view, one of the most unfortunate features of this year's tax bill was the provision relating to the so-called "all-savers certificate." The associations opposed the all savers provision and are now opposed to its extension beyond the scheduled end-of-1982 expiration date. The all-savers certificate is valueless to moderate and lower income savers who are taxpayers and who are in marginal tax brackets of under 30 percent. Because their income is less than that of the general population and because their major income source, namely social security, is tax free, most elderly savers are not in a position to benefit from the all-savers certificate. In addition to the fact that many savers receive no benefit at all from the all-savers provision, the associations feel that this provision will not attract significant amounts of new savings. Therefore, it won't do much to help the country's economy. And it probably won't do much to help the financial depository institutions with their problems.

What is worse, however, is that having created the all-savers provision, the Congress scheduled the current $200 and $400 interest and dividend exclusion for elimination at the end of this year. That was done to offset the revenue loss from the preferential tax treatment given to all-saver certificate interest income. The old dividend only $100 exclusion is to be put back into place.

At this junction, the associations urge that the all-savers certificate provision be allowed to expire at the end of 1982 as is currently planned. At the same time, we think meaningful incentives and rewards for all people who save and invest—regardless of how—be added to the tax code. S. 1607 provides a positive step in that direction. We suggest it be incorporated into legislation that would begin to restore the personal tax base so the people understand that the Congress is serious about bringing the Federal budget into balance, serious about encouraging people to save and invest, and serious about getting the inflation rate down to tolerable levels and keeping it there.

That concludes my statement, Senator.

Senator CHAFEE. All right.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL RETIRED TEACHERS ASSOCIATION AND THE AMERICAN ASSOCIATION OF RETIRED PERSONS

INTRODUCTION

The National Retired Teachers Association and the American Association of Retired Persons are pleased to appear today in support of S. 1607, a bill which would provide for a minimum interest and dividend exclusion of $200 ($400 for joint returns). We believe that this bill is needed to reverse the discrimination against the small saver that resulted from passage of the Economic Recovery Tax Act (ERTA).

The Associations have appeared previously before this Subcommittee and elsewhere to express the view that tax policy should actively encourage people to save and invest. We were pleased to see that the ERTA contained important new retirement savings incentives. Once in place, in 1982, the expansion of Individual Retirement Account eligibility and the allowance of deductible employee contributions to private pension plans should greatly increase people's desire to save for retirement. This feature of the tax bill creates sound retirement planning policy and is a proper response to the present economic needs.

While the retirement savings provisions were positive features of the tax bill, the other savings provisions were not helpful at all for most savers. This is particularly true for people who are already retired and unable to take advantage of the IRA expansion. Many older savers will actually suffer a loss because of the tax legislation passed this year.

Savings "Incentives" Passed in the Economic Recovery Tax Act

Instead of passing legislation which would actively encourage new savings and investment, Congress adopted the "all-savers" provision as a part of its final bill. This provision provides a $1,000 ($2,000 for joint returns) exemption for the interest paid on special certificates. These certificates will pay 70 percent of the one-year Treasury bill rate.

The Associations were strongly opposed to the passage of the "all-savers" bill, and we are equally opposed to its extension beyond the scheduled end of 1982 expiration date. The "all-savers" certificate is worthless to moderate and lower-income savers who are in less than the 30 percent marginal tax bracket. These people fare better by paying taxes on the income from investments providing a market rate of return. Because their income is less than that of the general population, and because a major income source, social security, is tax-free, most elderly savers are not in a position to benefit from the "all-savers" certificate.

In addition to the fact that many savers receive no benefit from the "all-savers" provision, the Associations feel that this provision will also not provide assistance to the economy. We are doubtful that the "all-savers" certificate will encourage people to save additional sums, because it merely provides a federal subsidy to savings paying less than the market rate of interest. Existing savings will be shifted because of the certificate, but little additional savings will be generated.

To make matters worse, Congress eliminated for 1982 the $200 ($400 for joint returns) interest and dividend exclusion to offset the revenue loss from the "all-savers" certificate. Instead, a more limited $100 ($200 for joint returns) dividend-only exemption was put into place. For savers who can take advantage of neither the "all-savers" device nor the expanded IRA, the repeal of the $200/$400 exemption causes an increase in their taxes paid on investment income.

The Remedy: Limit the "All-Savers" Certificate and Restore and Expand the $200/$400 Interest and Dividend Exemption

The Associations believe that the problems created by ERTA can be remedied by restricting the "all-savers" certificate's life to the end of 1982, as is currently provided by law. At the same time, meaningful incentives and rewards for all who save and invest should be added to the tax code. S. 1607 provides the first step in this direction.

A $200/$400 interest and dividend exemption will also compensate elderly savers for the destruction inflation has caused to their savings. Statistics indicate that the elderly are savers. Ninety-three percent of all people over age 65

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with tax liability received interest income, according to the latest available Internal Revenue Service statistics (for tax year 1978). Most of these people, however, have relatively small accounts. A study issued by the President's Commission on Pension Policy indicates that, in 1977, 90 percent of the people age 65 and over who received property income, which includes interest income, received less than $6,000 from this source.

While the amount of interest income received by the elderly is relatively small, it is an important factor in their efforts to make ends meet. Tax policy should also support these efforts. S. 1670 should be passed by Congress and then expanded as soon as possible so that people receive the message that it makes economic sense to save and invest.

Senator CHAFEE. Do you want to comment on what Mr. Chapoton said?

Mr. HACKING. Well, Senator, I think people tend to respond more readily to more simplistic provisions in the tax code. I think having an exclusion defined in a fixed dollar amount is more readily understood by taxpayers as they proceed to act in response to tax preferences.

On the other hand, when you have complicated provisions that use percentages or complicated formulas, people do not readily perceive them as advantageous. And, therefore, those types of incentives are likely to be missed and fail to have the effect that was intended.

Senator CHAFEE. Are you suggesting in your statement that despite the tax cut, that many of your people may actually have a tax increase due to the elimination of the deductibility—the taxability now of interest income?

Mr. HACKING. We think that's a possibility. It depends on the individual's income mix and the amounts.

Senator CHAFEE. I see. All right, Mr. Hoyle.

STATEMENT OF KARL HOYLE, VICE PRESIDENT FOR GOVERNMENT AFFAIRS, CREDIT UNION NATIONAL ASSOCIATION, INC., WASHINGTON, D.C.

Mr. HOYLE. Senator, if you promise not to tell Brooke that I didn't read her statement, I won't read it.

Senator CHAFEE. All right, fine.

Mr. HOYLE. I'm here today on behalf of the Credit Union National Association and I would like to make a few brief points, Senator, realizing, as you indicated earlier, that much of what is being talked about here today will be discussed next year.

Senator, there are three points we would like to make regarding these hearings:

First. The all-savers certificate has served its purpose. And it should not be continued next year. We would like to see the $200/$400 savings incentive put back in place next year. And CUNA would like to suggest increasing the limit on the incentive hiked to $1,000/$2,000.

Second. We suggest the committee explore some of the savings incentives utilized in other nations. The high cost of housing means families of the future will have to save longer for a home. Canada and Europe provide savings incentives for such socially desirable goals as housing. Such a plan here could not only benefit financial institutions by providing them a base of longterm funds but would also aid the Nation build its capital base.

Third. Last year in testimony before this committee we indicated that one of the major reasons that not many financial institutions or people took advantage of the $200/$400 was this incentive program was not publicized. We believe the reason for this was the knowledge that the program might be, as it ultimatly was, terminated. This year we have launched a marketing program in support of the IRA to make sure the maximum number of people know about and utilize the program.

Senator, allow me to extend the thanks of the credit union movement to you and all the other members of this committee that helped bring about the expansion of the IRA program.

Senator CHAFEE. You are submitting a copy of your booklet today, aren't you?

Mr. HOYLE. Yes, Senator, we are.

Senator CHAFEE. I would like to have a copy of that myself, if I might. Is this the one for the record or do you have another?

Mr. HOYLE. I don't happen to have another one with me right now, Senator, but I will certainly get it up here today.

Senator CHAFEE. All right. We will put this into the record.

Mr. HOYLE. I will get some up to your office, sir.

Senator CHAFEE. All right. Thank you.

Mr. HOYLE. Furthermore, we would like to encourage, with regard to the all-savers certificate, something along the lines of S. 243—a one-time rollover. A nondeductible contribution in IRA's, say, in the amount of $8,000 and possibly from the ASC's.

Senator, we have got some papers on how thrifts in other nations are utilizing various instruments, tax deferred instruments, to provide funds for savings. We would like to give those to the committee.

And we look forward to working with you next year on exploring some of these means of encouraging additional savings through different types of IRAs and specialized accounts.

[The prepared statement follows:]

TESTIMONY OF KARL T. HOYLE, VICE PRESIDENT AND DEPUTY DIRECTOR, GOVERNMENTAL AFFAIRS DIVISION, CREDIT UNION NATIONAL ASSOCIATION, INC. (CUNA)

Mr. Chairman and members of the Subcommittee, my name is Karl Hoyle. I am vice president and deputy director of the Credit Union National Association's (CUNA) Governmental Affairs Division. I appreciate the opportunity to appear before you today on the continuing important matter of savings tax incentives.

This is CUNA's first opportunity to testify on savings incentives since the passage of Public Law 97-34, which established the tax-exempt All Savers Certificates and greatly expanded and improved Individual Retirement Accounts (IRAs). Mr. Chairman, CUNA wishes to thank you personally, and other members of the Subcommittee, for the leadership you provided in that battle. Without your help, consumers would not be able to enjoy the benefits of liberalized IRAs beginning next month.

In our testimony today, we shall limit our comments to S.1607, providing a minimum interest and dividend exclusion of $200 per individual. I shall also propose several new features which CUNA believes would greatly enhance savings flows and practices in this country.

The $200/$400 Tax Exclusion

As we all know, the temporary $200/$400 tax exclusion for interest and dividend income expires this year. Efforts to make it permanent fell victim earlier this year to other savings tax incentive measures -- principally the All Savers Certificates -- which Congress felt were of more immediate importance to the economic health of the nation. CUNA urges that the $200/$400 exclusion now be reinstated and made permanent.

All of the reasons we cited in support of the $200/$400 tax exclusion for interest and dividend income, when it was enacted as part of the Windfall Profits tax bill, are still with us. The need to provide small savers with some form of relief from the twin ravages of inflation and taxes is as important today as it was in April 1980 when the tax exclusion was enacted. The need for capital formation through increased savings continues unabated.

Unless the $200/$400 exclusion is made a permanent part of the tax laws, earnings on savings will be added to all other types of ordinary income for federal income tax purposes. This means that savings will again be subject to the highest marginal tax rate of the saver.

While we believe a much larger exclusion is justified, perhaps $1000/$2000, especially considering the higher rates even on passbook savings which institutions are authorized to pay, restoration of the exclusion is the minimum action which must be taken. It is far better than nothing.

<u>The Exclusion Must Be Permanent</u>

In our testimony last year, Senator Durenberger asked why the $200/$400 exclusion had not, at that point, generated a significant inflow of funds. Our answer was that, frankly, financial institutions had done little to promote the benefit to their customers.

A major reason for this was because of uncertainty that this feature would be continued. Remember, the exclusion was originally enacted for only two years. The fact that it was ended bolstered the decision of most institutions not to invest in marketing programs.

In order for the exclusion truly to be a tax incentive for savers, savers must be able to know of and depend on it as a permanent exclusion. CUNA strongly urges Congress not to make the same mistake this time in reinstating the $200/$400 exclusion, by making it temporary. A permanent exclusion is necessary and will provide an incentive to financial institutions to fully publicize the law and its benefits.

For example, CUNA has embarked on an ambitious promotion and marketing program for the liberalized and expanded IRA program which Congress enacted earlier this year. One example of the types of publications we are making available to the public, as well as to credit union members, to encourage their participation, is a plain-language booklet called "Facts About IRAs". We submit a copy of the booklet along with our testimony to be included in the record of these hearings.

All Savers Should Expire

Another important reason for reinstating the $200/$400 exclusion is that the day of the All Savers Certificate is over. All Savers was a great experiment but all the benefits that the thrift industry was supposed to receive from the tax-free certificate were realized during the first few months that the certificates were offered, say thrift industry representatives.

In October, the first month that the All Saver Certificates were offered, banks, credit unions and thrifts sold nearly $38 billion ASCs. If sales continue at this level, the certificates will have attracted almost $115 billion after only three months. This figure almost equals the $120 billion target that experts forecast the program would draw throughout its one-year life. This influx of funds ended an 8-month period during which thrifts suffered a consistent net outflow of savings.

Since its usefulness is ended, the Credit Union National Association does not recommend that the All Savers program be continued next year. It was a stop-gap measure that has done whatever good it is going to do and should be phased out and replaced with a permanent exclusion for interest and dividend income.

Specialized Savings Account

If Congress is unwilling or unable at this point to substantially increase the $200/$400 tax exclusion, it should give consideration to other forms of tax-deferred savings accounts for special purposes such as housing and education. Targeted tax incentives for these purposes are every bit as important as savings for retirement. To illustrate the point, let me give a personal example.

My daughter Shannon is 12 years old. In five years, when she is ready to attend college, her tuition bill at a four-year private institution will total a whopping $38,359. This assumes that education costs will rise only a modest 5 percent a year.

According to Robin Oegerle, President of Financial Strategies, Inc., a Washington financial planning firm, in order for Shannon to meet that bill, she -- or I -- will have to put aside $4,736 a year in a credit union share account that pays 8% a year. Even on my inflated salary, I can't afford to put that kind of money into savings unless I get some sort of tax break. I don't think Shannon can afford it either on the allowance I give her.

In addition to wanting a college education, Shannon would like to own her own house one day. In fact, she already has picked out her "dream home." The house is worth about $70,000 in today's market. By the time Shannon is 30 years old, the same house will cost nearly $400,000 if home prices rise 10 percent a year.

In order for Shannon to accumulate enough money just for a downpayment, she must put $2,713 a year into a passbook account, or about $2,000 a year, in an 8% credit union share account. I doubt she will be able to save that amount either unless she gets some help in the form of a tax exclusion or tax deferral.

There is plenty of precedent for savings incentives of this sort. Many foreign governments assist homebuyers through special savings plans to buy a house. There's no reason why the same principle can't be applied to finance the ever-rising cost of a higher education.

We encourage this Committee to examine the experiences of other countries and to explore these ideas further in future hearings.

Summary and Conclusion

CUNA believes the decision made earlier this year, providing a one-time, one-year All Savers Certificate and liberalizing Individual Retirement Accounts, was correct. The IRA accounts represent a good start toward developing a lo g-term savings base for this country. The All Savers Certificates reversed the year-long outflow of savings from thrift institutions while paying a bonus to savers.

We recognize, however, from a public policy standpoint both instruments are discriminatory since they allow tax benefits only to those who can afford to put aside the required savings. Part of this problem will disappear if Congress permits the All Savers program to expire as we have recommended.

For reasons of equity, as well as to attract the broadest base of savings possible, CUNA also recommends that the $200/$400 tax exclusion for interest and dividend income be reinstated. This will truly provide a tax break to "all savers." We urge that it be made permanent so it will be a true incentive. We also believe the exclusion should be increased to $1,000/$2,000 to reflect the higher rates which are required in today's financial marketplace. If this is not possible at the present time, then we urge that consideration be given to providing more targeted tax incentives for special savings purposes.

CUNA and I thank you for your time. I will be happy to answer any questions you may have.

Senator CHAFEE. Thank you very much for that testimony, Mr. Hoyle. I think there are illustrations here of what the cost of one's youngsters education is. It's frightening.

Mr. HOYLE. I'm frightened.

Senator CHAFEE. Well, be of good cheer. [Laughter.]

The suggestion of the Treasury constantly is that while we are trying to encourage savings this legislation doesn't. That the people are going to save regardless and the very modest exemption of $100/$200 or $200/$400 isn't going to make the difference between whether one has a savings account or doesn't have a savings account.

Why don't you address that, Mr. Hacking.

Mr. HACKING. Senator, most older people tend to be small savers. And they also tend to keep significant amounts of money in passbook savings accounts. Now as you know, those accounts pay 5¼ or 5½ percent interest depending on whether the account is with a commerical bank or a savings and loan institution.

What has been happening to these people over the past decade is that, having savings tied up in an account like that while at the same time you have a rate of inflation running well in excess of those interest rate ceilings—the underlying value of the asset, the savings account itself, has been eroded away. Moreover, the purchasing power of the income stream coming from that asset doesn't buy too much anymore. These people continue to write to us and indeed have been writing to us for years urging us to try to get for them some kind of compensation for the inflation losses that they are suffering with respect to their savings. They want some kind of significant tax breaks enacted—tax breaks with respect to interest and dividend income.

That's one reason why I am here today. In the larger context of the economy, the idea of encouraging saving and investment is a good one because such action should help bring our economic house back into order.

We think these gross income exclusions for interest and dividend income are the kinds of bases on which to build if we are going to go in the right direction in terms of tax policy. Those are the reasons for my being here. The associations obviously think that we ought to try to encourage people to save and invest more than they do and reward them for doing so.

Senator CHAFEE. Of course, the IRA's aren't very attractive to your people.

Mr. HACKING. Not at their age.

Senator CHAFEE. Mr. Hoyle, a good deal of your testimony dealt with the IRA's and the expansion of them. Is your association putting a vigorous effort into the IRA's?

Mr. HOYLE. Yes, they are, Senator. We have a service corporation called ICU Services Corp. They have a marketing package that is currently in the process of being put out. In an article in Better Homes & Gardens, we encouraged on IRA's, the availability of booklets like this explaining what the IRA program is about are publicized.

In regard to Mr. Chapoton's statement, Senator, I think the low savings rate in this country versus the saving rates in other countries where there are incentives testifies to the fact that this money will be put away. And I would disagree with Mr. Chapoton that $200/$400 isn't enough or rather agree with him that it should be more like $1,000/$2,000.

Senator CHAFEE. I think Mr. Rostenkowski has suggested the tax-free rollover into the IRA's. I suppose that would have great appeal.

Mr. HOYLE. Yes. We have discussed that at a recent leadership meeting. And would support such a movement for a one-time rollover. We feel the certain amount of those funds for those people in the age group, in their early fifties, might go into that. Some of the other money is obviously hot money and wouldn't find its way into IRA's.

Senator CHAFEE. Thank you very much, gentlemen.

Let's take all seven of the panel at once. And I will take them in order here. So that would be in the following order: Mr. Blair, Mr. Welker, Mr. Perkins, Mr. Perschke, Mr. Shull, Mr. Bravin, and Mr. Blumert.

Let's start with Mr. Blair.

STATEMENT OF NEAL B. BLAIR, PRESIDENT, FREE THE EAGLE, OREM, UTAH

Mr. BLAIR. By way of introduction, my name is Neal Blair. And I am the president of Free the Eagle. Free the Eagle is the citizen's lobby that was formed in 1980 by the investment adviser, Howard J. Ruff.

Senator CHAFEE. It's not a wildlife organization?

Mr. BLAIR. No, sir.

Senator CHAFEE. Go to it.

Mr. BLAIR. We have approximately 650 community forum groups dispersed throughout the 50 States. One of our objectives is to help create pockets of stability by encouraging a political climate for individuals of low- and moderate-income means to keep up with inflation. A vital part of our program is to oppose legislation and administrative decisions that we feel create and perpetuate the weakening of our economy by encouraging inflation and taking away an individual's freedom of choice in the consumer investment marketplace.

After that introduction, in summary of my prepared statement, I want to express our support for Senate bill 1645, which would have the net effect of repealing 314(b) of Public Law 87-34.

Senator, we feel that 314(b) neatly handcuffed those prudent people who have had pension strategy, that up to a point, employed the philosophy of putting some percentage of their assets in IRA's and Keoghs in inflation hedging items.

Senator CHAFEE. Now, gentlemen, again let me say that most of us know the arguments for these matters. All of you were here when Mr. Chapoton spoke. You heard his reasons the Treasury objects. As you know, Treasury has considerable influence with this committee. If Treasury has a point, we listen to it. We don't always follow it, but we listen to it. So the best way to advance your cause is to present the arguments rebutting Mr. Chapoton's presentation.

Go ahead, Mr. Blair.

Mr. BLAIR. Then specifically addressing some of Treasury's arguments, we feel that they are basically without merit. And we can't find any basis, in fact, for any of the points that have been proposed by Treasury. And we would be pleased to address any questions in that regard.

For instance, Treasury has indicated that they felt that these investments worked at cross-purposes with the philosophy behind IRA's and Keoghs. We find no cross-purposes whatsoever. We feel that an excellent case can be made that money that goes into hard assets or real assets does not come out of the banking stream or traditional institutional streams in this country.

We feel that a good case can be made for a tremendous productivity and contribution to the economy whether we are talking about mining copper or silver or if we are talking about the stamp or coin industry.

Senator CHAFEE. As you know, the purpose of savings and the reason we want to encourage savings in this country is to make a pool of capital available. And when people take cash and put it in the bank, then capital is available. When somebody goes and buys a picture or a Krugerrand or whatever it is and puts it in the bank, is that making capital available?

Mr. BLAIR. Yes, sir.

Senator CHAFEE. I'm not arguing a point, I want your view.

Mr. BLAIR. Yes, it is making capital. Those that would purport that it isn't seem to be assuming that the seller of this item takes the money and puts it in his mattress or it goes into thin air somewhere. This just isn't the case. It may have one brief stop and then it goes back into the banking stream, the monetary stream.

We feel that responses also have been giving the small investor pretty cavalier treatment, when they feel the Government should be an investment adviser and, say, well—the investor is really better off by not putting hard assets——

Senator SYMMS. If the chairman would yield to me, I would like to ask you a question.

Now you are here as president of Free the Eagle, but you are really talking about free the people, aren't you?

Mr. BLAIR. Yes, sir.

Senator SYMMS. From what I have heard Ronald Reagan say for the past 15 years is that he wants to allow a mood investment. In other words, let the market decide. Let the investments flow where they might. The present law is a denial of freedom of choice of the American people to invest their money in whatever they choose. Is that correct?

Mr. BLAIR. Yes, sir.

Senator SYMMS. The Treasury is taking an antifree choice position in the position they have taken. It's a denial of America's ability to invest in whatever they want.

Mr. BLAIR. That's right.

Senator SYMMS. That's why I sponsored Senator Moynihan's bill. I'm glad to see he is here.

Senator CHAFEE. I'm afraid your time is up, Mr. Blair. We will have a summary part at the end.

Mr. BLAIR. Right.

Senator CHAFEE. Senator Moynihan is here. Senator, did you want to make a statement in connection with your legislation?

Senator MOYNIHAN. No, sir. I would rather hear this panel.

Senator CHAFEE. All right. Go ahead, Mr. Blair. I can give you one-half minute.

Mr. BLAIR. In very brief summary, we feel that this is a denial of the freedom of choice to potentially 40 million Americans to protect themselves against the ravages of inflation. Our data show that prior to hard assets being allowed in IRA's and Keoghs, they traditionally experienced an 11- to 12-percent decline in purchasing power annually. And we feel that it's a travesty that Americans should be denied their freedom to invest in real assets if they so choose. Thank you.

Senator CHAFEE. Fine. Thank you very much, Mr. Blair. Mr. Welker, from the American Institute for Economic Research.

[The prepared statement follows:]

HOWARD J. RUFF CHAIRMAN

Free the Eagle

Testimony Before the
Senate Finance Committee
Subcommittee on Savings, Pensions, and Investments

by Neal B. Blair
President of Free the Eagle
Citizen's Lobby

December 4, 1981

SUMMARY: OPPOSITION TO SECTION 314(b) OF THE ECONOMIC RECOVERY ACT.

The rushed passage of Provision 314(b), as part of the Economic Recovery Act of 1981 was a setback for all Americans. The surprise language was passed without an opportunity for public or full Congressional discussion, just as Congress was preparing for summer recess in mid-August.

The net effect of this amendment is the prohibition of real assets in pension plans such as IRA's and Keogh's. This is particularly disturbing since IRA's and Keogh's will be available to all working Americans under age 59½ starting January 1, 1982. It neatly handcuffed those prudent earners whose pension strategies have, up to this point, employed the philosophy of maintaining some percentage of real assets in their pension account as a shield against the ravages of inflation.

As of January 1, 1982, no Americans will be able to

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claim a tax deduction on monies placed in IRAs, Keoghs, or possibly other self-directed accounts under corporate plans if they choose to use the funds in these accounts to purchase such real assets as diamonds, gold, silver, gems, rare coins, art, antiques, stamps, rare wines, rare rugs, or anything designated by the Secretary of the Treasury as a "collectible."

Though the Economic Recovery Act of 1981, as a whole, greatly improves the stature of self-directed pension investing, Provision 314(b) is a blatant restriction on the freedom to choose the content of their pension for the more than 40 million potential American earners. Even more important, this language limits the latitude of thoughtful prudent Americans who choose balanced, safe, and profitable portfolio strategies to weather the economic storms throughout the lifespan of their pension income.

As a veteran of 18 years on the Washington scene, I have seen my share of disappointments in the form of mounting regulation, deficit spending, price controls, and general exploitation of the able and productive through taxation and inflation. This particular clause, however, placed amidst perhaps the most prolific piece of tax <u>freedom</u> legislation in modern times, comes as a particularly bitter blow -- especially after the hard work our citizen's lobby group, "Free the Eagle," and others put into supportive lobbying on behalf of the tax package. (It is apparently the only part of the bill that took away a tax advantage rather than granting one.)

Through research conducted after Provision 314(b)'s dubious passage, the crowning blow came when we interviewed members of the Senate Finance Committee and the House Ways and Means Committee and learned that the language became law almost covertly and went unnoticed by most of them.

As President of our citizen's lobby, "Free the Eagle," I welcome the opportunity to present our views. But first, I would like to explore this provision's impact on those in the work force that are eligible for IRA's or Keogh's.

BACKGROUND

In 1974, President Gerald Ford signed into law the Employee Retirement Income Security Act (ERISA), giving birth to the Individual Retirement Account (IRA) pension program for individuals not covered by an employer's pension plan. Though tax sheltered and deductible from the gross earnings on the wage-earner's federal tax return, annual contributions were originally limited to a maximum 15% of the individual's earned income, with the total not to exceed $1,500. (Contributions could be expanded only by including a spouse in the plan.) IRA holders, per the law, cannot withdraw tax-free money from the account until age 59½. At that point, when in theory the individual's tax rate will be lower, the distributions are taxed as ordinary income.

The Keogh pension program, intended for the self-employed, is older than the IRA, though expanded in 1974 by ERISA. The Keogh plan contribution ceiling was raised by that law to $7,500 or 15% of one's annual earnings, whichever was less. The ERISA provisions, thus, represented a large step forward in the savings potential for the unpensioned wage-earner.

In the period of heavy currency depreciation that followed, however, most IRAs and Keoghs became, as our Free the Eagle founder and chairman, Howard Ruff says, "guaranteed instruments of inflationary purchasing power confiscation." With consumer prices high and rates of interest in a moderate range, those plans placed with banks, savings and loans, and insurance companies on a fixed rate of return were -- and continue to be -- subjected to inflation erosion. From December 1977 to December 1980, the principal in this type of account lost almost 35% in purchasing power, when measured against the consumer price index in that time frame. And with the threat of inflation escalating us into higher tax brackets -- tax cuts or no tax cuts -- there is not assurance to the pension investor that he will be in a lower tax bracket at age 59½.

IRAs and Keoghs, as a result of inflationary expectations, then experienced the transfer of account-holder monies into real assets under relaxed interpretation of the prudent man rule. Plans could be set up to allow investment in stocks, bonds, mutual funds, money market funds, Treasury bills, as well as real assets such as gold, silver, diamonds, colored gemstones, numismatic coins, or stamps, allowing investors to buy and sell assets to fit the current economic scenario, while still maintaining the original tax advantages established by ERISA.

So closely did the hard money pension philosophy adhere to the adage "money is simply an idea backed by confidence," that when word of the proposed Social Security benefit cuts came out of the Office of Management and Budget early this year, hard money pension investors began an almost immediate step-up in their collectibles portfolios, according to Charles Satterlee, head of the hard asset pension division at Investment Rarities, Inc., in Minneapolis.

Just as the murmurs were about to turn to rumbles, the various retirement savings incentives were wisely introduced into the Economic Recovery Act of 1981 tax cut program.

Except for 314(b), a handsome pension incentive package came as a result of the Act. Briefly, here are some of the expanded tax benefits included in the final tax cut bill:

1.) Former ERISA-established limitations of 15%-of-earnings on annual IRA contributions were waved, permitting contributions up to $2,000 each year ($2,250 for married couples where one spouse is unemployed).

2.) Keogh ceilings were doubled to $15,000 annually, though holding to the 15%-of-earnings restriction for those self-employed investors who make less than $100,000 a year.

3.) Participants in present company retirement plans can now open an additional IRA tax-free account, thus increasing annual tax-deferred savings.

THE CATCH

Now, the pernicious provision that narrows all American's freedom of choice over what goes into these newly-expanded accounts. Provision 314-b reads like this:

. . .Investments in collectibles treated as distributions.

1.) In general, the acquisition by an individual retirement account, or by an individually-directed account under a plan described in Section 401(a) of any collectible shall be treated (for purposes of this section and section 402) as a distribution from such account in an an amount equal to the cost to such account of such collectible.

2.) Collectible defined -- for purposes of this subsection, the term 'collectible' means:

(A) "Any work of art,
(B) Any rug or antique,
(C) Any metal or gem,
(D) Any stamp or coin,
(E) Any alcoholic beverage, or
(F) Any other tangible personal property specified by the Secretary for purposes of this subsection. . ."

. . .Effective date -- The amendment made by paragraph (1) shall apply to property acquired after December 31, 1981, in taxable years ending after such date.

The affluent (those who maintain sizeable investable funds allowing them to take advantage of paper IRAs/Keoghs, plus separate hard money investments as capital protection with long-term capital gains tax treatment) will have opportunities to cash in on.

On the other hand, we have the medium and small investor, who will suffer the greatest injustice from this clause, since he does not have the highly capitalized posture of his affluent counterpart. He is not in a position to be helped through inflationary times <u>at all</u> by the new high-yielding, tax-free interest accounts afforded to the 40% and 50% tax bracket group. Sure, he could move into a money market fund, if he meets the minimum requirements, and collect 17%; he could just take the 15+% offered by the new small savers certificate; he could try a 14% to 15% insurance annuity; but, should the U.S. be subjected to another round of accelerating inflation, he could only helplessly stand by, without alternatives (thanks to 314(b)), and watch the complete devastation of his nest egg until age 59½.

We have seen many letters generated by Treasury and certain Congressional offices since the bill was signed into law that have defended 314(b). We find the rationale in these letters to be without merit and can find no basis, in fact, to support their conclusions.

In brief, they state that the nation's best interests are served by encouraging economic growth through tax incentives which foster individual savings and channel those savings into financial institutions where they can foster economic growth. For example, to quote from one of the letters:

> "Congress included this provision because these investments work at cross purposes with the objectives of the Act. While it may be true that collectibles have provided investors with a safe hedge against inflation, Congress decided that persons should not enjoy the tax benefits accorded to IRA, plans to buy luxuries or items related to hobbies or personal tastes. These investments do not tend to generate the increased capital formation we need for improving our economy. By channeling increased retirement savings toward financial institutions, more funds will be available for housing construction, mortgages, and additional plants and equipment for private industry. Investments in collectibles provide no such economic benefits."

These assumptions are not valid. First, Congress made no such informed decision. The language of 314(b) was inserted into the act without the knowledge of most members of either the Senate Finance or House Ways and Means Committees and only a limited number of persons at Treasury. There were no hearings. These letters defending 314(b) appear to simply be trying to put the best face on a bad situation.

This after the fact rationale seems to assume that the money would disappear into thin air or be stuffed in a mattress somewhere. If somebody buys a "real asset" from somebody else, the money doesn't disappear into thin air. The person who sold the asset puts the money in the bank. It just makes a brief stop on the way there. There is no more or less money in financial institutions because of the investments in real assets.

We feel that the small investor is given cavalier treatment in other letters from Congressmen when they most unhelpfully point out that perhaps you would be better off if your collectibles were outside of an IRA account anyway, because when an IRA is liquidated, it's taxed as regular income, not capital gains. That my sound wonderful, except for the little person whose TOTAL investment program consists of his IRA and/or Keogh plan. This person should have a choice.

The repeal of 314(b) is not simply a battle over collectibles in pension accounts. Provision 314(b) is an outright tourniquet to an artery needed to sustain the life of an inflation hedged retirement income. If this artery can be shut off without a proper hearing in Congress, which other arteries will come next?

I thank the Committee for this opportunity to express my support of S-1645 repealing section 314(b) of the Economic Recovery Act of 1981.

STATEMENT OF ERNEST WELKER, DIRECTOR OF RESEARCH, AMERICAN INSTITUTE FOR ECONOMIC RESEARCH, WASHINGTON, D.C.

Senator CHAFEE. The American Institute for Economic Research of which my father subscribes. I see your literature in my father's house.

Mr. WELKER. He is probably one of the younger members.

Senator CHAFEE. He's an avid supporter. What's the name of the man who founded this?

Mr. WELKER. E. C. Harwood; Col. E. C. Harwood.

Senator CHAFEE. Col. E. C. Harwood is somewhat of a hero. My father thinks so.

Mr. WELKER. Rightly so. [Laughter.]

Senator CHAFEE. Why don't you proceed.

Mr. WELKER. Thank you, Mr. Chairman. For those who aren't familiar with the American Institute for Economic Research, we are an independent educational nonprofit research organization operating since 1933, primarily specializing in the study of money and banking but other aspects of the economy as well.

We appear here very seldom, and I appreciate the opportunity to speak to this issue in support of Senate bill 1645.

I will agree with the remarks of those that preceded me, Mr. Blair, that a key issue here is a matter of freedom of savers to invest. In that sense, I disagree somewhat with the characterization of Mr. Chapoton that the aim of the Economic Recovery Tax Act of 1981 was to increase savings per se. The aim is to increase the rate of economic growth in this country through proper and appropriate investments. I think part of the Reagan administration view and a view widely held in this country now is to give people more power over their assets to invest them as they see fit. And to consume as they see fit as well.

I won't dwell on that. I will allow my prepared statement to address that issue.

Here, I would like to talk to the matter of gold—especially gold coins and bullion-type gold coins—and to gold bullion as a luxury item. I think it is far from a luxury item. If you will recall——

Senator CHAFEE. Now, gentlemen. Bonds, that's one. Gold coins, perhaps. And I am not asking you to carry the banner for rug deals or Christie's or the great auction houses for fortune paintings. But where do we draw the line? Are you saying there should be no line drawn? Or are you just saying gold is all right?

Mr. WELKER. I think there should be no lines drawn for the reason of freedom. People should have freedom of choice insofar as the product of their labor goes.

Senator CHAFEE. There are limitations on freedom in this country.

Mr. WELKER. I understand.

Senator CHAFEE. Should one person be allowed to put $10,000 into a savings account? I put $10,000 into a gorgeous persian rug which I then proceed to lay down in my living room. Now you wouldn't think that was all right. Or do you?

Mr. WELKER. I think there are problems with that that are more difficult to handle than with gold. I would like to speak to the gold issue in particular.

Senator CHAFEE. All right. But it seems to me that if your argument is for everything, that you have got to touch on these other points. If you are arguing solely for gold, then argue solely for gold.

Mr. WELKER. Well, I would like here in my oral testimony to argue solely for gold. In my prepared statement, I have argued for all.

Senator CHAFEE. All right.

Mr. WELKER. And particularly, I would like to call to the committee members' attention that the dollar, in fact, until 1933 was a given weight of gold for domestic conversion and until 1971 for redemption by foreign central banks. So what we are talking about is that whenever anybody held a bond that was denominated in dollars, up until 1971 and certainly until 1933, they were, in fact, investing in gold. Now that has been taken away from them. The demand for gold that formerly could be reflected in a dollar-denominated bond now must be directed to gold itself, bullion-type coins or bullion proper. And that demand, we think, is far from a luxury demand. It's a demand to protect the purchasing power of one's most basic savings that people will have to survive on in their retirement years.

We further would add that insofar as gold being a sterile asset or nonproductive is concerned, it is highly questionable that investment in dollar-denominated corporate or U.S. Government bonds—which in our calculation have lost $800 billion in purchasing power from 1940—can somehow have been considered advantageous to the economy. We think that the savings, the real purchasing power, that is for a time reposed in gold, will be available in future years for more appropriate—if not in the view of the Congress—investment in productive assets at that time.

If it's a view of the saver-investor today that certain investments do not represent productive assets, we think it is appropriate that the saver-investor has the opportunity to hold his purchasing power until later.

Senator CHAFEE. Thank you. Your time is up unfortunately, Mr. Welker.

[The prepared statement follows:]

December 4, 1981

BEFORE THE
SUBCOMMITTEE ON SAVINGS, PENSIONS,
AND INVESTMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE

STATEMENT OF ERNEST P. WELKER, DIRECTOR OF RESEARCH, AMERICAN INSTITUTE FOR ECONOMIC RESEARCH, IN SUPPORT OF S. 1645

My name is Ernest P. Welker. I appear today in behalf of the American Institute for Economic Research (AIER), which I serve as Director of Research. I appear in connection with your consideration of S.1645, and to support its enactment.

While possessing no direct interest in the regulation by Congress of pension fund investments, AIER considers it unwise and unfair for Congress to identify certain kinds of investments as being forbidden to pension fund accounts that are individually managed. We support enactment of S.1645 because it would repeal the provision of the Economic Recovery Tax Act of 1981 that places unreasonable limitations on pension fund investments. Before stating our reasons for this view, it may be useful briefly to describe AIER itself.

Founded in 1933, AIER is an independent tax exempt scientific and educational organization located in Great Barrington, Massachusetts, in the heart of the Berkshire Hills. Its purposes are to conduct scientific research in economics and to disseminate the results of such research in order to educate individual students and the general public so that there may be widespread understanding of the fundamental economic relationships affecting the citizens of the United States, with the ultimate objective of preserving the best of the Nation's heritage and advancing the welfare of the American people. Over 10,000 persons currently subscribe to AIER's present periodicals, and each year about 150,000 people receive at least one of our publications. Since the 1930's, several millions of copies of our various educational bulletins have been distributed to the general public and college students.

From its beginning, AIER has specialized in monetary economics. Early in its history, AIER concluded that gold and sound commercial banking were necessary elements of a sound monetary system. For the duration of our operations to date, we have continually warned of the harmful consequences that eventually would become apparent as the ties between currency units, sound commerical banking, and gold were severed step by step between 1933 (when President Roosevelt declared it illegal for U.S. citizens to hold gold) and 1971 (when President Nixon unilaterally declared the dollar a fiat currency). These unsound actions were extended into the international monetary framework when the cornerstone of the Bretton Woods plan of the IMF was the dollar, which itself was being undermined. Now, for the first time since economies became highly industrialized and specialized, the world is without a monetary unit of the most reliable, lasting exchange value -- gold. All currencies are mere promises to pay more promises.

When after World War II most economists were propounding the idea that business cycles could be tamed and high employment guaranteed through wise monetary and fiscal control, we warned of developing deep difficulties. For purposes here, we simply mention that beginning in the late 1950's, AIER predicted severely worsening economic conditions because of prolonged inflating, which was evident to us even then. We could foresee that business firms would find it increasingly difficult to prosper, that the dollar would lose purchasing power, and that the "price" of gold would rise markedly, unless U.S. policies were changed. The investment implications were that, irrespective of the direction of short-term fluctuations, U.S. common stocks as a whole would not continue to advance in price, dollar-denominated bonds would be the equivalent of certificates of guaranteed confiscation (as the purchasing power of principal would fall), and gold-related investments were needed as a purchasing-power insurance against the high risks of a distorted economy and money. Because fundamental economic policies and conditions did not change, that view was maintained throughout the 1960's, 1970's, and to this day.

We doubt that chronic inflating in the United States will continue indefinitely. If there is a return to sound monetary policies, a substantial shift in investments from gold-related investments to U.S. stocks, dollar-denominated bonds, or even savings accounts may be appropriate. But the mere promises by officials that they will stop inflating are not adequate evidence for acting on those promises. Such promises have been made repeatedly since at least the mid-1960's, and investors who acted on the promises suffered greatly because of it. After enduring repeated instances of broken promises and the related losses, many Americans simply reduced their saving rate. While one can regret the adverse consequences the lower savings have had for the rate of U.S. productivity, one cannot legitimately blame individuals for acting in their self interests. True, the time may come when U.S. monetary and fiscal policies again become sound and warrant a return to earlier saving and investment patterns. If such policies are implemented, individuals -- again acting in their self-interests -- will voluntarily adjust their behavior appropriately. They will not -- and should not -- do so beforehand, regardless of what tax impediments or inducements Congress creates. As one observes the Budget spectacle now going on, there is justification for deep doubt that the U.S. Government truly has turned away from the past destructive economic policies.

In our view, the economic evidence available to the careful investor at the present time, and in the recent past, warrants the placing of a substantial portion of his assets held for long-term investment -- and not for current needs or market trading -- in forms most likely to withstand purchasing power losses from inflating. Gold and gold-related assets (which include official gold coins, public and private-mintage gold medallions, gold certificates, and stocks issued by gold mining companies and related enterprises) are among those that have proven to be a reliable "hedge" against inflating compared to almost all the conventional long-term investment alternatives available to individuals. Many U.S. investors, probably millions, have now made this discovery and hold, or have recently held, some portion of their investment funds in the form of gold or gold-related assets. Among these, we understand, are pension funds of some states and municipalities.

For many individuals, pension plan funds represent a major portion of savings they will need to live on in their later years. Section 314(b) of the Economic Recovery Tax Act of 1981, just enacted by Congress this summer, will as of 1982 effectively prohibit all individuals who control their own pension investments from causing any portion of those funds to be invested in either gold or gold coins. The effective prohibition also extends to other precious metals and other property loosely and pejoratively referred to as "collectibles."

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Insofar as gold-related assets are affected, we think this effort by Congress to deny an important and proven investment avenue to those who might believe that such investments offer a substantial opportunity to avoid being among the worse victims of prolonged inflating cannot be justified on any economic ground. We especially believe that the grounds stated in the legislative history of Section 314(b) provide no reasonable justification for its enactment. We note that the Congress has never considered the terms and implications of Section 314(b) as a matter separate from the much broader collection of issues embodied in the 1981 tax legislation. Consequently, the public has never had an opportunity to advise the Congress of the compelling reasons why gold and gold-related assets, among others, are essential elements in any careful investor's long-term program for ensuring financial security and independence in his or her retirement years. Because S.1645 would repeal Section 314(b), we urge its enactment.

The House Committee Report on Section 314(b) of the 1981 Act offers only this single, unadorned argument in support of this change in the law (H. Rep. No. 97-201, p. 143-144):

> "The Committee is concerned that collectibles divert retirement savings from thrift institutions and other traditional investment media and that investments in collectibles do not contribute to productive capital formation."

In our view "thrift institutions" and "traditional investment media" have no entitlement to the investment funds of individuals saving for retirement. If legal restrictions and the consequences of chronic inflating have disabled such institutions from making investments in the form desired by significant numbers of people, then the remedy should lie in eliminating the inflating and restrictions. In regard to thrift institutions particularly, Congress and the pertinent regulatory agencies have already begun to initiate appropriate changes. Surely, persons attempting to ensure their financial security in their older years cannot rightfully be made to bear the costs of relieving thrift institutions of their plight.

We do not know precisely what is meant by the term "traditional investment media," but the historical fact is that gold and gold-related assets have served as a mechanism for saving and wealth preservation literally for thousands of years, and in most of the cultures known to man. If savings and investments are corollaries, and we believe they should be so viewed, there is no more traditional form of investment and savings than the holding of gold. The United States Treasury itself holds a reported 264 million ounces of gold in its own reserve -- more than any other government in the world. The U.S. Treasury has sound reason for holding so much gold: come what may, gold has always been able to buy things. In other words, it always has purchasing power. We find it sadly ironic that at so late a stage in our nation's monetary plight -- while a U.S. Gold Commission is again studying the potentially useful role of gold -- and well after government restrictions on individual ownership of gold have been abandoned, the Congress should now prohibit this investment to pension and IRA accounts. Moreover, the Congress does this while the United States itself remains the world's single largest investor in gold.

The House Committee's observation that "collectibles do not contribute to productive capital formation" is accurate in the narrow sense that the implicated property will not be presently devoted to the production of additional things. But it does not logically follow that capital formation will never be enhanced by such forms of investment. When, in the judgement of the saver-investor, economic conditions again warrant investment in processing equipment and enterprises, those individuals who retain the purchasing power value of their savings will be in a position to finance the productive activities of the time. Looking from another perspective at the issue of economic consequences from saving in various ways, we can find no productive benefit having been provided to the U.S. economy from the $800 billion purchasing power losses (in 1981 dollars) absorbed since 1940 by U.S. investors who have held government and corporate bonds.

In all events, a paternalism and "father knows best" policy is wholly inappropriate in a political system where the citizen is sovereign and economic activities are not centrally directed. In our present investment market place, investors have the opportunity to become well informed and thus to understand the consequences of their own investment decisions. And in view of the sorry record of experience of common stock and bond investments during the past 15 years and more, the well informed understandably are searching for a better alternative. We think it indefensible in this context that Congress should say to individuals that they shall not invest retirement funds in a particular form, or that they must bear the penalty of higher taxes if they choose one form over other, less desirable, forms in their judgement.

The House Committee's formulation recognizes there is a competition among investment alternatives, and it expressly chooses sides. Our view, which we believe is well supported by economic experience, is that the political system is less efficient than the market itself in allocating resources among possible productive uses. One who invests part of a retirement fund in gold today rather than in corporate stocks or bonds makes a judgement that when the retirement fund is distributed in the future he will get a greater amount of buying power than if the latter investments are made. Such an investor could be wrong, as could investors in other things. But if the gold investor is right, he will be in a position to invest or spend more in the future, and productive capital formation will have been better served by the investment in gold than by the now politically favored investments.

Perhaps it will be useful to remind this Committee that when Congress enacted ERISA in 1974, it specifically authorized the creation and protection of individually directed pension accounts. Section 404(c) of ERISA provides that where the conditions of ERISA are met, plan trustees and other fiduciaries may not be held responsible for the investment decisions made by the individual. At that time Congress expressed the view that for an account to be considered individually controlled, "a broad range of investments must be available to the individual participants and beneficiaries." H. Rep. 93-1280, pp. 305-306 (Conference Committee Report on ERISA). In our view that was sound policy. Surely, retirement funds that have held gold-related investments have benefitted therefrom since ERISA was implemented. It is contradictory for Congress now to seek to limit the breadth of investments available to individually directed pension accounts.

Myriad voices participate in the ongoing economic debate as to the best course for this nation to follow in conducting its fiscal and monetary policy. Individuals participate in and determine the outcome of that debate in part by the investment choices they make. For most of this Nation's history -- and when this Nation's economy grew to be the envy of the world -- economic freedom allowed to investors was thought to foster long run economic efficiency and productivity. Does Congress now think it can ordain efficient and productive investments by edict or fiat? Everywhere one looks, command economies are failing. We believe that economic progress is advanced only through the free and informed choice of private citizens and firms to spend and invest as their best judgement dictates. We have no doubt that government policies significantly influence the extent to which resources are efficiently and productively allocated, but the means is for government to seek to provide a fair field with no favor, not to determine the outcome of the economic game. Government prohibitions and limitations respecting particular forms of investment have no useful role to play in the enhancement of productivity.

We think it important for Congress to perceive that gold has a special economic role. In addition, gold bullion and gold coins are as liquid, as fungible, as available, and as widely traded in organized markets as is any form of investment which the Congress might otherwise consider appropriate and conducive to productivity.

Thus, we urge the repeal of Section 314(b). If the Congress is concerned that "collectibles" represent possibilities of current consumption or other abuses inconsistent with tax-favored savings for retirement security, it could enact legislation to correct those specific abuses. Short of that, we consider it harmful to the economy and unfair to savers concerned about preserving the buying power of their retirement fund for the Congress to command those who control their own retirement fund to invest in specified ways. Nobody, we submit, knows enough about the needs of individual savers and the future of our complex economy to be at all confident that the result of such command investing will be favorable either to the saver or the Nation.

Thank you for affording AIER and myself this opportunity to be heard.

Senator CHAFEE. I have to go. Senators Symms and Moynihan will be here, for which I would like to express my appreciation. I would also like to mention that Senator Helms is extremely interested in what you are propounding, gentlemen. And he is going to submit a statement in the record in support of Senator Moynihan's bill.

Let me just ask you one quick question before I go. You have had this in existence under the current IRA statute. How has it worked out? Have people used it?

Mr. WELKER. Yes, sir.

Senator CHAFEE. I know the situation was quite different with the 15-percent limitation and the $1,500 and so forth, but have people used it?

Mr. WELKER. Yes, sir. Very much so.

Mr. PERKINS. Yes, sir.

Mr. BRAVIN. Insofar as the diamond industry is concerned, it has been a shot in the arm to our industry. We sell, for investment purposes, investment grade diamonds. This is a Cadillac of the industry. And there is publicity that Elizabeth Taylor has a 15-carat diamond. Many other people in these United States go out and buy diamonds. You are taking away the optimum. You are taking away the Cadillac of our industry, with due respect.

Senator CHAFEE. Yes. But under this proposal, I wouldn't expect that a person would be permitted to wear their diamonds.

Mr. BRAVIN. We are not suggesting that they wear them.

Senator CHAFEE. In other words, in all fairness, the only thing they should be permitted to do is buy that diamond and put it in the safe deposit. Is that right?

Mr. PERKINS. Yes. We agree with that 100 percent.

Mr. BRAVIN. We go along with that.

Senator CHAFEE. But Elizabeth Taylor wears her diamonds.

Mr. BRAVIN. But Congress does not understand the diamond business. I brought with me today a little package to show that these investment grade diamonds should be sealed. I have many here which you can examine, and I will leave more if you need it. [Laughter.]

Senator CHAFEE. But I don't understand your illustration of Elizabeth Taylor. She wears her diamonds.

Mr. BRAVIN. She's supposed to have them insured when she wears them. That's why people don't carry diamonds around because they are afraid that something may happen.

Mr. SHULL. Mr. Chairman, we will be happy to work with you on this abuse question.

Senator CHAFEE. All right, fine.

STATEMENT OF ROBERT J. PERKINS, CHAIRMAN, CONGRESSIONAL COORDINATING COMMITTEE, INTERNATIONAL INVESTMENT GEMSTONE COUNCIL, THOUSAND OAKS, CALIF.

Senator SYMMS. Mr. Perkins.

Mr. PERKINS. Thank you, Senator Symms. I represent the International Investment Gemstone Council which is concerned with increasing and improving the environment for investment. We are very grateful and gracious to Senator Moynihan. He is here today and we thank him for introducing a bill that you and others have cosponsored.

My prepared statement covers all of the points Mr. Chapoton raised.

Senator SYMMS. All of your prepared remarks will be submitted and included in our record.

Mr. PERKINS. Yes. I would like to take on the point that Buck raised that in some sense tangible assets were not really savings but they had a consumption component.

Classically, the definition of savings—investment comes from savings. Savings is foregoing current consumption. And when someone—to take the chairman's example—buys a $10,000 persian rug and does not put it on his floor, which is prohibited by law, but puts it in safekeeping for possible appreciation, he or she is making an investment. That money is recycled through the economy.

Being a small businessman myself, it should be obvious that most stocks and bonds purchased on the New York Stock Exchange do not end up in the purchase of additional planner equipment. Unless it is a new issue, which is very unusual in the New York Stock Exchange, that money goes to other investors, just as the money that is used to purchase a persian rug goes to other investors.

So it seems to me that if the concept of what we want to do is not permit—what we want to do is encourage savings, encourage people to forgo current consumption so there is a greater pool of capital available for our country. As Senator Moynihan so aptly pointed out when he introduced this bill, to deny the people the opportunity to use tangible assets in their IRA and Keogh accounts removes an incentive to save. And that is contrary to the public policy at this time, and seems to us that it should be changed.

Thank you.

[The prepared statement follows:]

Testimony of Robert J. Perkins

Executive Vice President
Polygon Diamond Trading Network, Inc.

and

Chairman, Congressional Coordinating Committee
International Investment Gemstone Council

Good morning. I am here today as the representative of the International Investment Gemstone Council.

The International Investment Gemstone Council emerged from three days of intense discussion in June, 1981, concerning the present and future challenges faced by the investment gem industry. The Council provides a form for communication, a source of reliable information and a network through which all members can assist each other and the industry as a whole. It is a non-profit organization, designed to unify, promote and raise the standards of the investment gem industry.

Bernard Cirlin, editor and publisher of Precioustones Newsletter, is serving as Chairman of the Council. Internationally recognised economist Dr. James Calderwood and noted educator and former university administrator, Dr. Harry Murphy, have been named as administrators for the Council. While it is a young organization, the International Investment Gemstone Council has already received support from an impressive list of names. Included are, T.G. Punchiappuhamy, Chairman of the State Gem Corporation of Sri Lanka; William Hurwitz, President of Colonial Jewelers; Moise Rahmani of Tache & Cie in Antwerp; Joel Arem, Ph.D, renowned colored stone expert; Barry Shore of University Gems Corporation; Sarabeth Koethe of the United States Gemological Services, Inc., Laboratory; Robert Perlman of the International Gemological Institute; and Jack Abraham of Precious Gem Resources, Inc.

With over 300 members throughout the world, the International Investment Gemstone Council is the largest representative body of people involved in the buying and selling of diamonds and other precious gemstones for investment purposes.

I am the volunteer Chairman of the Congressional Coordinating Committee. Because of my previous experience working in Washington, D.C., both as a staff assistant to a United States Senator and within the political parties, it was hoped that I might be able to convey to the Finance Committee the extreme unhappiness and concern caused by the prohibition against the utilization of tangible assets in IRA and Keogh accounts.

Parenthetically, a few words might be appropriate about my existing position within the diamond community. I serve as Executive Vice President of Polygon Diamond Trading Network, Inc., a joint service of my firm and the AutEx Systems Division of the Xerox Corporation. Working together, Polygon DTN and Xerox are creating and establishing a computerized, inter-dealer trading network for certificated diamonds. The Polygon Network will link firms that buy and sell certificated diamonds: diamond cutting firms, diamond investment companies, financial planners, jewelry wholesalers and retailers, and brokerage firms and other members of the securities industry.

Despite the long-held belief that diamonds must be "seen" in order to be traded, the rapid increase in the acceptance of grading certificates issued by independent laboratories makes the electronic trading of diamonds possible. According to an estimate carried in the Washington Post, the current trading in certificate diamonds is $600,000,000 a year. Obviously, we feel this market is ready for a more efficient method of trading.

During the course of the market research conducted by Xerox and my firm on the Polygon Network, I came in contact with a great many people from all aspects of the diamond community. I can report to you first hand of the extreme sense of frustration and betrayal they felt when Congress recently prohibited the utilization of diamonds, gold, silver and other tangible assets in IRA and Keogh plans.

Their frustration comes from an obvious source: the fact that Congress held no hearings on the passage of this legislation. There was little or no discussion on the merits of the case prior to the passage of the language by the House, and no discussion whatsoever within the Conference Committee itself. As Senator Helms remarked to you, Senator Chaffee, this was certainly a surprise to all of us.

The source of betrayal stems from the belief, which I shall discuss in some detail, that the legislation passed is contrary to the policy generally exhibited in the Economic Tax Recovery Act of 1981: the encouragement of investment through the encouragement of savings.

I believe there are four major reasons why it is inappropriate for Congress to distinguish between tangible assets such as gold, diamonds and the like, and other investment opportunities for retirement plans. These reasons are:

1) From a macro-economic perspective, there is no difference to the economy between an individual investing in tangible assets versus investing in most typical investments. From a micro-economic perspective, tangible assets have, over time, often performed as well as, and in some cases better than, stocks and bonds.

2) Congressional intent in the Tax Bill is clearly to encourage savings. In order to encourage savings, public policy should make more investment options available, not fewer.

3) As a guide to public policy, government should not penalize one industry or segment of an industry unless a public purpose can be clearly demonstrated.

4) Unless there is overriding cause, Government should not presuppose it has better investment sense than individuals. This is particularly true in IRA and Keogh plans, in which indivduals are given the obligation to determine the best investment strategy for their own personal retirement.

I would like to review each of these four reasons in more detail.

First, from a macro-economic perspective, there is no difference to the economy between an individual investing in tangible assets versus investing in most typical investments. A major reason given for the exclusion of gold, silver, diamonds and the like from IRA or Keogh plans was that such assets are "non- productive." This argument is not sound.

While the term "productive asset" can have a number of meanings, the term is usually applied to plant and equipment. Stocks, bonds, government securities, and the like do not qualify as productive assets under this definition. In fact, in most cases the proceeds of the sale of stocks and bonds do not directly go toward the purchase of productive assets. Unless a stock or bond is a new issue, the money flows not to the company but to another investor. Congress has not chosen to limit investments suitable for IRA or Keogh to original issues of stocks or bonds.

This is, of course, exactly identical to the situation with tangible assets. The purchase of a tangible asset gives money to either the original asset producer or to an intermediary purchaser. From a micro-economic perspective, tangible assets have, over time, often performed as well as, and in some cases better than, stocks and bonds.

Individuals invest funds in IRA or Keogh plans in order to have money available for retirement. Thus, one criterion of "productive" assets might be that they increase in value faster than increases in the cost of living.

Diamonds, gold and silver obviously qualify as "productive" under this definition. Between 1967 and 1980, the GNP deflator (probably the best measure of inflation) increased from 80 to 177.4[1] This represents an increase of 220 percent.

During this same period, the Dow Jones Industrial average of 30 stocks increased 20 percent, the Standard and Poors composite of 500 stocks increased 70 percent, the median price of a single family home increased 245 percent, the price of gold and silver increased about 1400 percent and the price of diamonds increased from 1000 to 4000 percent, depending on the quality of the diamond.

I am sure this Committee has more knowledge than I on the devastating impact of inflation on pensions and retirement plans. Prudent indivduals, planning now for a retirement ten, twenty, or even forty years away, clearly need a wide variety of options available to them to be confident that their retirement dollars will keep pace with inflation. Diamonds, gold, silver and other tangible investments have a key role to play: gold, silver and diamonds represent legitimate long-range investment options.

Discussing Congressional intent before a Committee of Congress may be presumptious. However, my second point is that as an outsider viewing the legislative process, it appears that Congressional intent in the Economic Recovery Tax Act was clearly to encourage savings. In order to encourage savings, public policy should make more investment options available, not fewer.

The key to investment is savings. People must be induced to forgo current consumption in order to make assets available for investment. The key word is "induced." Under classical economic theory, the interest rate would increase to provide additional incentives to save in times when more funds were required.

However, as Keynes dramatically demonstrated, in a complex society savings do not necessarily respond directly to changes in the interest rate. At some low interest rates, people will save despite the low rate. And, at the other extreme, in some cases people will refuse to save even with high rates of interest.

Thus, additional incentives to save are critical. This is particularly true during periods of high inflation when interest rate increases do not attract a corresponding increase in savings. When introducing legislation permitting investment in tangible assets for IRA and Keogh accounts, Senator Daniel Patrick Moynihan discussed this fact:

> "But the ban on collectibles will reduce saving by people who feel holding collectibles is the only way to protect a retirement fund from inflation. And there are many such people. So, one should ask: Does Congress want to encourage everyone to save for retirement, or just people who are satisfied with stocks, bonds, savings accounts and other traditional investments. That is the issue."[2]

Additionally, the ban on investment in tangible assets runs contra the increasing emphasis on deregulation. The prohibition increases government interference and intervention.

My third point is that as a guide to public policy, government should not penalize one industry or segment of an industry unless a public purpose can be clearly demonstrated.

In his book The Economic Prerequisites of Democracy, Daniel Usher argues that people within a democracy must understand the rationale for redistribution of wealth. Government can, does and must tax, reward, and subsidize certain activities for the public good.

However, within the framework of government it is essential that economic discrimination, which is a form of punishment, be rational and explainable. The prohibition against the use of tangible assets in IRA or Keogh accounts fits neither of these two requirements.

The prohibition is certainly not rational. There is no evidence that previous IRA or Keogh investments in tangible assets have caused harm to the economy. In fact, most industry experts have agreed that purchases of tangible assets for Keogh and IRA accounts represent only a small percentage of the total demand for these assets.

The only argument advanced is that IRA or Keogh plans could be abused by the purchase of some tangible assets for personal use. For example, antique furniture could be used by the IRA or Keogh plan holder. However, laws currently exist prohibiting such use of IRA or Keogh assets. If a person takes possession, even temporarily, of a tangible IRA or Keogh asset, the asset will not qualify for the special tax treatment. In fact, the trustee of an IRA or Keogh account cannot even name the investor custodian to care for the asset. As one article summarized it, "You cannot possess them in any sense."[3]

Also, there has been no evidence presented to demonstrate that a sudden upsurge in fraud or deception requires the extreme measure of prohibiting investment in all hard assets, even those which clearly cannot be "consumed" currently.

Finally, there is no economic rationale for the argument that investments in tangible assets are harmful to the long-term goals of the individual investor. As discussed earlier, to date such investments have actually done quite well.

Nor is the prohibition explainable. The legislative history of the bill, a less than stunning example of the legislative process, is alone enough to incite criticism. Many members of the both the House Ways and Means Committee and the Senate Finance Committee admitted they were not even aware of the amendment. For some reason the amendment was classified as "technical," and thus did not receive Senate or House hearings, debate on either the floor or in the Conference Committee, or any public input. Many people have echoed Howard Ruff's assertion that the bill was "blatantly unfair."

While tangible assets do not comprise a substantial percentage of their business, those firms and individuals that deal in such assets are being singled out to suffer for no benefit to the economy as a whole. Not only are producers injured (gold miners, diamond cutters, and the like) but also those people who sell hard assets to their clients.

The damage goes beyond the reduction in sales and production resulting directly from the ban on tangible assets in IRA and Keogh accounts. Non-IRA or Keogh investors are also disturbed over this new policy and now question the wisdom of investing in tangible assets at all. While this is clearly not the intent of the act, it is an unfortunate outcome of it.

My fourth point is simple: unless there is overriding cause, Government should not presuppose it has better investment sense than individuals. This is particularly true in IRA and Keogh plans, in which individuals are given the obligation to determine the best investment strategy for their own personal retirement.

As Senator Jessie Helms said during debate on the Conference Report on H.R. 4242 (hardly an appropriate moment to request a change),

> "But, the action of the Congress to adopt this section does exactly what Congress should not do and said it would not do when it adopted the basic law applicable to IRA and Keogh plans. That rule is that individuals are the best judge of how their retirement plans should be run...We show arrogance by pretending to have more knowledge than the individuals personally involved in these plans."[4]

Some have attempted to rebute this approach by arguing that tangible investments are somehow inappropriate for IRA or Keogh plans. An IRA or Keogh plan has two advantages. First, income taxes can be deferred until a later date, ideally when the individual is in a lower tax bracket. And, second, interest or dividend income can accrue tax-free until withdrawn.

Obviously, tangible assets do not pay dividends. Also, because the total increase in value is accorded capital gains treatment, some claim it is not appropriate to use tangible assets in Keogh or IRA accounts.

Of course, this argument applies equally well to a broad class of stocks. As one writer pointed out, "to penalize investment in real assets is similar to saying that we can invest in IBM, which pays quarterly dividends, but not in the XYZ Corporation, which might grow into the IBM of tomorrow but might not pay dividends for ten years or more."[5]

Hundreds of thousands of investors are in hundreds of thousands of different situations. Each person's financial strategy is unique, and the appropriate use of IRA or Keogh plans varies. Congress wisely gave individuals broad flexibility over the use of IRA and Keogh plans, flexibility that should not be withdrawn.

From another perspective, it might be argued that Congress is moving into a totally new field. If this Committee determines that tangible assets are not "desirable" for Keogh and IRA accounts, what about other types of investment that may be considered by some as "undersirable."

For example, real estate might be considered a non-productive investment. And the purchase of stocks or bonds issued by foreign companies might be considered unpatriotic. Of course, certain Senators might wish to prevent investment in companies with above average occurances of pollution violations, or those firms that make products not "essential" to the national survival like tobacco companies. The list could be extended indefinitely.

The answer is obvious: Congress ought to not prohibit the utilization of tangible assets in Keogh and IRA accounts.

In summary, there are no economic or social arguments that require the drastic action of prohibiting investment in tangible assets for IRA and Keogh accounts. Congress currently has the opportunity to permit such actions and should do so.

FOOTNOTES

1. Assumes 1972 = 100. Source is the Economic Report of the President, 1980.

2. Congressional Record, Volume 127, No. 130, S10040-81 (September 18, 1981)

3. "Tangible Investments in Retirement Accounts, " Michael Thomsett, The Collector-Investor, September, 1981, page 30.

4. Congressional Record, Volume 127, No. 120, S9188-81 (August 3, 1981)

5. The IMI bulletin, Institute on Money and Inflation, Vol. 3, No. 5, July-August, 1981, Howard Segermark, Editor.

Senator SYMMS. Let's see. Walter Perschke, president of the National Association of Numismatic Professionals.

STATEMENT OF WALTER PERSCHKE, PRESIDENT, NATIONAL ASSOCIATION OF NUMISMATIC PROFESSIONALS, WASHINGTON, D.C.

Mr. PERSCHKE. Mr. Chairman, my name is Walter Perschke. I am the president of the Numisco, Inc., in Chicago. I appear on behalf of the National Association of Numismatic Professionals in support of S. 1645.

One argument that has been made by Treasury for prohibiting IRA investment in collectibles is that retirement savings should be funneled into productive assets. One definition of a "productive asset" and one I think that would be accepted by many of those 40 million Americans with these small accounts is that a productive asset is one that increases in value at a rate faster than the cost of living.

The track record of rare coin appreciation is impressive, and consistent over time. And I would like to give you two quick examples.

Comparing rare coins with the consumer price index over two time periods is enlightening. From January 1971, the CPI has risen 234 percent. Several years ago, I constructed two indices with which to monitor the prices and price changes of high quality gold and silver numismatic coins. A detailed explanation of these indices has been submitted for the record.

Using that same January 1971 base, these two indices for gold and silver, respectively, show an absolute increase of 4,279 percent and 5,052 percent. Those were compound rates of 40.7 and 42.8, respectively.

Mr. MOYNIHAN. Alexandrian Tetratrachm. Would the same increase have occurred?

Mr. PERSCHKE. You are getting into an area of very specific expertise. No. This does not reflect the gold value. This reflects the collector or numismatic value of the coins. These are the coins that have increased the most.

The comparison with the CPI is, obviously, very favorable for rare coins, but even more favorable are those percentage comparisons with stocks at 5.8 percent and bonds at 3.8 percent compounded annual rates for this same time period.

The second timeframe is even more appropriate to retirement investment. A gentleman named Harold Bareford began collecting coins in the forties. His collection was kept intact until after his death, and auctioned in 1978 and 1981. Mr. Bareford was an attorney. And his meticulous recordkeeping has provided us with a rich legacy of information on the long-term rates of return in numismatics.

Giving you the highlights of that, he purchased 242 gold coins at a cost of $13,800 and 31 years later, they brought $1.2 million at public auction, 87 times his cost, compared to a CPI increase of 4 times in the same period.

The silver coins did a little better than the gold coins. There, his purchase price was $12,000 and the price realized was $1,227,000, again at public auction, 99 times his cost.

Senator SYMMS. He bought them in 1940?

Mr. PERSCHKE. In 1948 and 1949.

Senator SYMMS. He sold them when?

Mr. PERSCHKE. In 1978 and 1981. So I am using comparison figures with the same——

Senator SYMMS. Thank you very much. Did you summarize your statement then? We are very pressed on time and I would like to hear from everyone.

Mr. PERSCHKE. I would just basically touch on the question of the individual choice. I think individuals who are utilizing their own savings to prepare for their own retirement should have the widest possible latitude in preparing and choosing those investments. In 1974, when Congress introduced IRA's to encourage wage earners to invest their own savings to provide for retirement, it wisely allowed wide flexibility in their choice of investments. That individual freedom that they had the wisdom to preserve then should not be abrogated now. Considering the impressive and documented track record of rare coin investment, the lack of evidence to preclude numismatics from retirement accounts and the imperative of individual choice, I urge the repeal of 314(b).

[The prepared statement follows:]

PREPARED STATEMENT OF WALTER PERSCHKE

Mr. Chairman, my name is Walter Perschke, President of Numisco, Inc. in Chicago, Illinois. I appear on behalf of the National Association of Numismatic Professionals in support of S. 1645, a bill to repeal section 314(b) of the Economic Recovery Tax Act of 1981.

This provision of the 1981 Act prohibits Individual Retirement Accounts (IRAs) and other self-directed retirement plans from investing in "collectibles" such as coins, stamps, metals, gems and other tangible assets.

No hearings on this proposal were held in either the House or the Senate. This clause was included in the bill reported out of Ways and Means (H.R. 4242) and in the Hance-Conable substitute (H.R. 4260), approved by the House on July 29, and was virtually unnoticed and ignored during House debate on the overall bill. It was not included in the Senate tax bill.

We welcome this opportunity to be heard on section 314(b) which we feel is an uncalled-for restriction on people saving for their retirement.

One argument for prohibiting IRA investments in collectibles is that retirement savings should be funneled into "productive assets." One definition of a productive asset is that it increases in value at a faster rate than the cost of living. The track record of rare coin appreciation is impressive and consistent over time. Comparing rare coins with the consumer price index over two time periods is enlightening.

From January, 1971 to date, the CPI has risen from 119.2 to 279.3 for a total increase of 234 percent. Several years ago, my firm constructed two indices with which to monitor the prices of high quality gold and silver numismatic coins. A detailed explanation of how they were constructed and a listing of the representative coins chosen is submitted and I ask that it be included with my statement in the printed hearing record.

Suffice it to say, the index coins were chosen to represent the average appreciation of their universe (gold or silver) over the previous 30 years and because they were and still are readily available and actively traded in the marketplace.

Using January, 1971 as a base equals 1, these two indices stand at 42.79 amd 50.52 today for gold and silver respectively—an absolute increase of 4279 percent and 5052 percent and compound rates of return of 40.70 percent and 42.84 percent. The comparison with the CPI is obviously favorable, but even more favorable is the comparison with stocks at 5.8 percent and bonds at 3.8 percent compound annual rates of return for the same period. I can supply whatever additional detail is necessary in support of these figures.

The second time frame is perhaps more appropriate to retirement investing. A gentleman named Harold Bareford began collecting coins in the 1940's. His collections of gold and silver coins were auctioned, after his death, in 1978 and 1981. Mr. Bareford was an attorney and his meticulous record keeping has provided us with a rich legacy of information on long-term rates of return in numismatics. The average time between purchase and sale was a little more than 30 years. His own personal documentation can and has been corroborated by auction records at which he acquired most of his collection. The collection was diversified as is representative of the coin market.

The Bareford's total cost for the 242 gold coins in the collection was $13,832 and a little less than 31 years later they realized $1,207,215 at public auction. That is an absolute increase of 87.3 times his purchase price or a percentage gain of 8730 percent. The compound annual rate of return was 15.66 percent compared to a CPI increase of 3.52 percent annualized, or 417 percent in total.

The silver coins on the whole did somewhat better. One individual rarity which equalled nearly half the initial cost of the 420 U.S. silver coins has been segregated for clarity. The purchase price of $12,371.38 yielded a return of $1,227,050.00 in 1981 again at public auction. That represents 99 times the initial cost and an annualized return of 16.56 plus.

The CPI by comparison for the average 32 year holding period ending in October, 1981 rose from 71.4 to 279.3, an overall increase of 3.91 times and an annualized rate of 4.35 percent. At 3.91 versus 99 times and 4.35 percent versus 16.56 percent, this numismatic collection outdistanced, not merely outpaced, the cost of living. Remember, this is a real case history. I request that documentation of the Bareford Collection, which we have prepared, be included in the printed hearing record.

The broader question being addressed in this issue is freedom of choice. Who is the best person to determine the investment strategy for the retirement fund of an individual when the contributor and ultimate recipient are one in the same? Whose decision should this be? Clearly, the decision resides with the beneficiary.

Individuals who are utilizing their own savings to prepare for their own retirement should have the widest possible latitude in the type of investments they care to make.

The government should not assume that it has better investment judgment than individuals. Especially when you are focusing on IRA and Keogh plans. To do so implies a wisdom that will have to be demonstrated, if not proven, and also a support for the individual in their retirement if that "better investment judgment" does not prevail over both alternatives and inflation.

In addition, those who have specialized knowledge in numismatics should not be prevented from using it to their own benefit and forced to invest their own retirement funds in other areas about which they have limited or no knowledge. They will also be deprived of the income derived from using their expertise to advise and supply others with numismatic investments.

If savings are a desirable goal of national policy, then the corollary question becomes, "Are some savings more equal than others?" The answer to that question is certainly no, and if it were yes, does government propose to judge which savings are "more equal" than savings invested in tangibles?

If savings are defined as deferred expenditures, foregoing consumption today for consumption in retirement, then the residence or "parking place" for those savings should be determined by the person who saves today. The government should not penalize one industry for the benefit of another. Nor should it discriminate among investments unless there is a clearly defined national purpose.

There is not proof that Keogh and IRA accounts invested in tangibles have in any way been detrimental to our economy. Quite the contrary. There is evidence that the growth in demand for rare coins by investors has created jobs in the industry. There are 7,000 individuals and firms dealing in rare coins today versus 4,000 in 1976. I would estimate that increase represents 15,000 jobs that did not exist in 1976. Speaking for my own firm, Numisco, Inc., we employed eight people in 1976 versus 28 today.

In 1974 when Congress provided for IRAs to encourage wage earners to invest their own savings to provide for retirement, it wisely allowed wide flexibility in their choice of investments.

One additional point. Because of the relatively small amount in each retirement account, the individual is restricted in the scope of investment choices. Numismatics requires only a small amount of capital and is ideally suited for such modest investment.

Considering the impressive, documented track record, the imperative of individual choice and the lack of evidence to preclude numismatics from retirement accounts, I urge the repeal of section 314(b).

Mr. PERSCHKE. Mr. Chairman, I would like to submit the following materials relating to the long-term rate of return of various tangible assets and request that they be included with my statement in the printed hearing record.

One, "The Value of Smart Long-Term Investments," the New York Times, October 18, 1981.

Two, "The Bareford Auction Results: A Unique History of Numismatic Prices," The Numisco Letter, April 1979 and October 30, 1981.

Three, "Gold and Silver Coin Indexes," The Numisco Letter, June 1981.

[These materials, No. 2 and No. 3, were made part of the official committee files:]

[From the New York Times, Oct. 18, 1981]

THE VALUE OF SMART LONG-TERM INVESTMENTS

When New York lawyer Harold S. Bareford started buying coins four decades ago prices were laughably low by current standards. Of course, Mr. Bareford didn't have the benefit of this hindsight, but he did have the foresight to buy exceptional coins and his vision paid off handsomely for him and his heirs.

In 1978, shortly after his death, Mr. Bareford's collection of United States gold coins was sold at public auction for $1.2 million—more than 87 times the sum he had paid for its contents, a relatively paltry $13,832. This week, Stack's of New York will conduct a similar sale of his U.S. silver coins and English coins, and similar gains seem likely.

The two Bareford sales offer powerful evidence of the investment potential of rare coins. They also should serve as a lesson to would-be investors in today's more turbulent market, according to Harvey G. Stack, whose firm conducted the earlier sale as well.

"Rare coins must be viewed as a long-term investment," Mr. Stack declares. "You can't expect instant profits, as many people seem to be doing today; you shouldn't expect a return for a minimum of five to ten years. But those who do adopt a long-term approach, as Mr. Bareford did, have found coins to be a very secure investment."

Harold Bareford bought his first coins in the period just before World War II. However, he made the bulk of his purchases during the decade following the war, attending almost all the major auction sales in the late 1940's and early 1950's and patronizing most of the major dealers.

He summed up his philosophy in 1947 in a note to one of those dealers. "I collect only the finest specimens," he wrote, "and am not interested in any coin which is not perfect." Those are standards widely held today, but few of his fellow buyers were nearly as demanding at the time.

Mr. Bareford was equally meticulous concerning the records he kept, making it easy to track the performance of his coins. Here, too, he stood out from the crowd, for few of his contemporaries made a similar effort to log their transactions in detail. His records show, for instance, that in 1947 he paid just $310 for a 1933 $10 gold piece. At the Stack's sale three years ago, it went for an astonishing $92,500—nearly 300 times what he had paid. And the coin market hadn't yet peaked at the time of that sale in Dec. 1978.

Present-day investors might very well question whether similar profits will ever be possible again. Gold, after all, costs more than 10 times as much now, so the base price of any gold coin is correspondingly higher. In those days it was priced at $35 an ounce and that modest rate was fixed by law.

There's yet another lesson in the Bareford story, though—a lesson on historical perspective. Harold Bareford all but discontinued and further purchases of U.S. coins in 1955 because, in his opinion, they had gotten too expensive. Needless to say, they were still enormous bargains when judged by the standards of 1981. It was then that he turned to English coins, assembling a collection that was comparable in quality to his U.S. gold and silver.

Though his purchases proved to be exceptionally profitable, Mr. Bareford never considered himself an investor. He thought of himself first and foremost as a collector. He demonstrated that not only in the way he assembled his coins, but also in the way he immersed himself in organized numismatics.

He was a member of the American Numismatic Association and the British Numismatic Society, a fellow of the American Numismatic Society and the Royal Numismatic Society and a long-time officer of the Metropolitan New York Numismatic Convention. He also served as president of the New York Numismatic Club from 1959 to 1961, and the presidential medal bearing his portrait appears on the covers of the catalogs of both Bareford Sales.

The star of this week's sale is the Dexter specimen of the 1804 silver dollar. Mr. Bareford acquired this famous piece in 1950 from well-known dealer Abe Kosoff in a private transaction. The $10,000 purchase price was the highest amount he ever spent on any single coin, a fact which underscores the importance he attached to the acquisition. The catalog describes the coin as "a specimen striking in superb condition"—one which therefore met Mr. Bareford's exacting criteria. It figures to bring a strong six-figure price.

Other important offerings include a choice uncirculated 1787 Immunis Columbia piece, said to be "probably the finest known"; exceptional sets of early U.S. dimes and half dimes; a brilliant uncirculated 1804 quarter; and a "gem" 1795 draped bust silver dollar.

Among the outstanding items in the English collection are a "virtually mint state" gold rose ryal of James I; an extremely fine example of the gold triple unite of 1643; an about uncirculated specimen of the 1644 OX silver pound; and a "virtually uncirculated" 1658 pattern crown of Lord Protector Oliver Cromwell.

The two-session sale will take place Thursday and Friday at the New York Sheraton Hotel, Seventh Avenue at 56th Street, with bidding to begin at 7 P.M. each night. The 1804 dollar and the English coins both will be offered on the second night. For a copy of the catalog and a post-sale list of prices realized, send $7.50 to Stack's, 123 West 57th Street, New York, N.Y. 10019.

Senator SYMMS. How long will it be before people in the numismatic coin collection business will set up corporations? If you just buy stock in that corporation, you own shares of numismatic coins. I would think a good lawyer would already be doing that.

Mr. PERSCHKE. I think they are.

Mr. PERKINS. Thompson McKenna, Senator, already has a diamond mutual fund. You don't buy the diamond, you buy into the company.

Senator SYMMS. Thompson McKenna?

Mr. PERKINS. Yes; New York City.

Senator SYMMS. In other words, what Treasury is doing is denying the small man on the street from the opportunity to do this and leaving it for those individuals that are up there that know how to hire the lawyers and wheel and deal; they can still do it. Persian rugs in this corporation, artifacts, gold coins, silver coins, diamonds, whatever.

Mr. PERSCHKE. Another argument that Treasury made was the comparison between $2,000 invested individually and $2,000 in an IRA for the tax implications. To the individual, the difficulty with that is that that is not really the choice. That is a correct argument, but it is irrelevant to the purpose of this legislation.

What is relevant is after you have put the money in the IRA account, what do you then do with it? And you should look to the maximum return. And clearly collectibles have provided that.

Senator SYMMS. Thank you very much.

STATEMENT OF LOUIS F. SHULL, PRESIDENT AMERICAN STAMP DEALERS ASSOCIATION, LAKE SUCCESS, N.Y.

Senator SYMMS. Mr. Shull.

Mr. SHULL. Yes, Mr. Chairman. I respectfully ask that my statement be submitted for the record and I will quickly summarize my comments.

The American Stamp Dealers Association, of which I am president, is a member of the Legislative Alliance of Philatelists and Hard Asset Dealers and Collectors. I appear today on behalf of both organizations to offer testimony in support of S. 1645, a bill introduced by Senator Moynihan to repeal sections 314(b) of the Economic Recovery Tax Act of 1981.

The Legislative Alliance was formed recently. It represents over 5,000 dealers and over 150,000 stamp collectors around the country. Accompanying me is Mr. Joe Krois, president of the Legislative Alliance. Joe is sitting in the back, here, I think.

Section 314(b) of the Economy Recovery Tax Act represents a departure from the longstanding Government policy in favor of a novel, unexamined theory of questionable validity. Section 314(b), in the name of economic recovery, makes a substantive intrusion into fundamental principles of pension and retirement policy. This provision was adopted even though it will constrain the strength of many retirement accounts, and even though individual direction with broad discretion is widely accepted as the best means to achieve maximum growth and return in retirement accounts.

The most frequently mentioned justification for section 314(b) is that it will somehow bolster faltering saving institutions. Second, to channel investments into so-called productive assets. And, third, to eliminate the personal use of assets being set aside for retirement purposes.

In actuality, none of these objectives are aided by this provision. Section 314's sole achievement is to deprive these retirement accounts of the advantages of a fully diversified portfolio.

We argue that collectibles are productive assets. They support thousands of small businesses which trade in coins, stamps, gems, antiques, art, precious metals, and other items of tangible personal property. Investment in certain hard assets encourages mining and world trade. For example, the purchase of precious metals or investment grade diamonds often subsidizes the exploration and development of less glamorous metals as well as industry grade diamonds which serve vital industry uses.

In actuality, the whole concept of productive assets is misleading, and secondary to the policies underlying the authorization of tax incentives for individual retirement accounts.

The purpose of these programs is to stimulate individuals to take responsibility for their own retirement needs. And their success minimizes dependence on an overburdened social security system.

I am skipping over several pages here, Mr. Chairman, because I know we are pressed for time.

In conclusion, section 314(b) violates the established Government policy that individuals ought to have the flexibility to make whatever investments they deem to be in the best interest of their retirement accounts. In so doing, it achieves no sound public policy objective. Section 314(b) weakens the ability of persons to plan for their own retirement future through private initiative, leading to increased dependence, as I stated, on an already overburdened social security system.

I strongly recommend that the committee and the Congress act this session to repeal 314(b) as to avoid this January 1, 1982, effective date.

I wish to add for the record a statement by the American Society of Appraisers in support of S. 1645.

[The document follows:]

PREPARED STATEMENT BY PETER J. RECLITE, INTERNATIONAL PRESIDENT OF AMERICAN SOCIETY OF APPRAISERS

This statement is made on behalf of the American Society of Appraisers. Our Society appreciates the opportunity to participate in these hearings.

A brief introductory statement may be helpful in explaining why an appraisal society is concerned about that portion of the Economic Recovery Tax Act of 1981--Section 314(b)(1)--which is the subject of Senate Bill 1645.

The American Society of Appraisers is an education/research-oriented professional appraisal society, international in scope, structure and membership. It is composed of approximately 5000 valuation counsellors who are related to communities and cities by virtue of public service in the disciplines of appraising. Similar to the other major nationwide testing/certifying societies in its Code of Ethics structure, educational programs, examinations, certification procedures and monitored professional comportment criteria, ASA is especially recognized in two respects: (1) it is the only nationwide multi-discipline testing/designating appraisal group in the U.S., (2) it is the only valuation group in the United States which tests and issues professional designations for valuation practitioners who are expert in the Personal Property Discipline, which specially includes the subcategory of "Collectibles".

* * * * * *

It is the issue of collectibles and the value implications of such collectibles as related to taxation, that is the subject of this Hearing, and which causes your Committee's attention to be focused upon S. 1645 (Moynihan).

S. 1645 is designed to amend Section 408 of the Internal Revenue Code by deleting subsection (n). Subsection (n) was added by Section 314(b)(1) of the Economic Recovery Tax Act of 1981.

Section 314(b)(1) now mandates that investments in collectibles for retirement purposes will be taxed as ordinary income after December 31, 1981. The term "collectibles" includes artwork, antiques, gems, stamps, coins and any other tangible property so specified by the government. Thus, this new law restricts the use of certain assets in IRA and Keogh retirement plans.

We have been informed that a major reason Section 314(b)(1) was adopted was because of a concern that "collectibles divert retirement savings from thrift institutions and other traditional investment media and that investments in collectibles do not contribute to productive capital formation" (Congressional Record; August 3, 1981; Vol. 127, No. 120, p.1).

*   *   *   *   *   *

The American Society of Appraisers has a generic responsibility for all appraisal disciplines; 69% of its designated membership practices in the field of Real Estate Valuation. However, ASA has a special and unique responsibility for the other disciplines, such as Business Enterprise Valuation and Personal Property Valuation.

It is this special and unique responsibility in Personal Property Valuation which impels ASA to adopt, and urge your Committee's consideration of, the following position statement:

(a) the concern above-expressed that collectibles "divert retirement savings" and "do not contribute to productive capital formation" should not be "solved" in a fashion that will prohibit the citizens of this country from making their own investment decisions;

(b) those citizens who wish to invest in collectibles and include them in IRA and Keogh Retirement plans, should have that right;

(c) government, in its tax collection efforts, should not have a mandate such as 314(b)(1) to prohibit individuals from making their own decisions as to how their retirement plans can best be handled;

(d) IRA and Keogh plans should not be treated and regulated by government as depositories for luxury or hobby items; these plans are constituted for retirement purposes, and citizens should have the unimpeded right to invest in the marketplace in whatever manner will permit them to best care and provide for their retirement;

(e) Section 314(b)(1) is discriminatory in its specific interdiction against investments in collectibles; the government is discouraging retirement plans from including investments in collectibles which have long been considered an effective reservoir of value, especially in times of inflation;

(f) the investment discretion of citizens and managers of retirement savings accounts is inequitably and unfairly restricted by legislation such as 314(b)(1). In a current environment which is dominated by an inflationary economy, uncertain Social Security fund provisions and low interest rates on traditional savings alternatives, it is imperative that citizens not be restricted in their efforts to provide for personal retirement;

(g) the contention that collectibles investments placed in retirement plans present technical difficulties in that they cannot be valued with any degree of certainty (and therefore should not be permitted the same tax benefits as properties representing "traditional investment media") is neither factual nor accurate. Collectibles are regularly subject to specific value determination by professional appraisers who are expert, experienced, tested and designated in valuing collectibles.

(h) Section 314(b)(1) establishes a dangerous precedent whereby the tax laws are used to discriminate among classes of assets and selection of investment options.

CONCLUSION; RECOMMENDATION

It is the considered opinion of the American Society of Appraisers that funds in individual retirement accounts should be permitted to be used to purchase collectibles; it is recommended that subsection (n) of Section 408 of the Internal Revenue Code of 1954, as added by Section 314(b)(1) of the Economic Recovery Tax Act of 1981, be repealed.

Mr. SHULL. I could also give examples as my friend Walter Perschke has of the money that can be made in stamps. In this city in 1923, a man bought a sheet of stamps for $24. That sheet of stamps today is worth well over $10 million.

Senator SYMMS. Thank you very much. I appreciate it. I think Senator Moynihan and I both would say that as members of this committee, faced with the responsibility for the social security of the country, that anything that lessens the demand on the use of that fund is helpful. And I think your point is well taken.

Mr. SHULL. I did skip over the Post Office in my oral statement. In my prepared statement, I covered that. The post office's philatelic windows, which caters to collectors, last year sold over $100 million worth of stamps. Now a lot of these sheets of stamps go in the attic or they go in the bank vault and no one touches them. No mailman walks one foot for those $100 million worth of stamps. And they have these movie stars that are on TV cuts telling you to go into stamp collecting. Now are they going to turn around the other side and say you can't put these stamps in your IRA account? To me, it's completely inconsistent. Completely ambiguous.

Senator SYMMS. Thank you very much.

[The prepared statement follows:]

Before the Savings, Pensions & Investment Policy
Subcommittee of the Senate Finance Committee

Statement of

Lewis Shull

for the
American Stamp Dealer Association
and the
Legislative Alliance of Philatelists
and Hard Asset Dealers and Collectors

Mr. Chairman and Members of the Subcommittee:

The American Stamp Dealers Association, of which I am president, is a member of the Legislative Alliance of Philatelists and Hard Asset Dealers and Collectors. I appear today on behalf of both organizations to offer testimony in support of S.1645, a bill introduced by Senator Moynihan to repeal section 314(b) of the Economic Recovery Tax Act of 1981. This provision, effective January 1, 1982, restricts investments in hard assets and collectibles by individually directed retirement accounts.

The Legislative Alliance was formed recently, largely in response to enactment of sec. 314(b). Participating members include representatives of over 5,000 stamp dealers and over 150,000 stamp collectors from around the country. Accompanying me is Mr. Joseph Krois, Jr., president of the Legislative Alliance.

Sec. 314(b) of the Economy Recovery Tax Act represents a departure from a longstanding government policy, in favor of a novel, unexamined theory of questionable validity. Section 314(b), in the name of economic recovery, makes a substantive intrusion into fundamental principles of pension and retirement policy. This provision was adopted even though it will constrain the strength of many retirement accounts, and even though individual direction with broad discretion is widely accepted as the best means to achieve maximum growth and return in retirement accounts. This provision totally ignores the consequences of inflation which is the number one enemy of retirement accounts.

As the committee knows, no hearing was held nor record developed on this issue prior to its inclusion in the Economic Recovery Tax Act. Thus, the underlying policy reasons for the provision are left mostly to conjecture. The most frequently mentioned justifications are: first, to somehow bolster faltering savings institutions; second, to channel investments into so called productive assets; and third, to eliminate the personal use of assets being set aside for retirement purposes. In actuality none of these objectives are aided by this provision. Sec. 314's sole achievement is to deprive these retirement accounts of the advantages of a fully diversified portfolio.

The suggestion that investments in hard assets are to be discouraged because they are somehow "non-productive" has no basis in any accepted economic theory. Productive assets are said by some to mean those assets which tend to generate increased capital formation. It is argued that by channeling retirement savings away from collectibles, increased funds for capital investment are made available. This reasoning ignores economic reality. Prohibiting investments in hard assets still leaves the investor or the retirement account with numerous investment opportunities which fail to increase funds at financial institutions or contribute to capital formation. Furthermore, even if placed directly in a financial institution, the funds may well be used to finance a venture unrelated to capital investment, such as the major corporate takeovers which we are now witnessing.

We argue that collectibles are productive assets. They support thousands of small businesses which trade in coins, stamps, gems, antiques, art, precious metals and other items of tangible personal property. Investment in certain hard assets encourages mining and world trade. For example, the purchase of precious metals or investment grade diamonds often subsidizes the exploration and development of less glamorous strategic metals as well as industrial grade diamonds which serve vital industry uses.

In actuality, the whole concept of productive assets is misleading and secondary to the policies underlying the authorization of tax incentives for individual retirement accounts. The purpose of these programs is to stimulate individuals to take responsibility for their own retirement needs, and their success minimizes dependence on an overburdened Social Security System. These retirement account programs are not designed primarily to stimulate various sectors of the economy or to build capital formation, and sec. 314(b), by attempting to put a priority on other objectives, deviates dangerously from the real purpose of these policies.

In passing sec. 314(b), Congress was apparently also concerned about the perceived problem of current enjoyment of investments made by the retirement account. I use the term "perceived" because there was no evidence before the Congress nor is there any evidence that I know of indicating that any abuse problem exists beyond what the Congress may have anticipated when enacting statutes authorizing IRA and Keogh plans. As the committee knows, all such accounts must be established as a domestic trust or as a custody account, and any abuses under these legal relationships would suffer liabilities and penalties under both ERISA and the tax code. The Treasury Department may find these statutes difficult to enforce, if so, then the committee may want to consider amendments strengthening these provisions. It is a drastic and patently unfair measure, however, to prevent retirement accounts from investing in collectibles altogether on account of some unsubstantiated "perceived abuse."

Recent setbacks of financial institutions are unrelated to investments in collectibles. These failings have been attributed to government regulation, poor management, Federal Reserve policy, and inflation, but in no way are they related to retirement account investments in hard assets or collectibles. Moreover, individuals who invest in collectibles have already made a deliberate decision that at least some portion of their accounts needs protection from inflation. For this reason they are not likely to invest those funds in a typical interest bearing account.

The new government policy of prohibiting investment in collectibles runs in diametric opposition to settled retirement and pension policy which is that retirement plans ought to be encouraged to maximize their growth and return. Congress sought to allow IRA and Keogh plans to achieve this objective by permitting individuals a freedom of choice in directing accounts. This freedom reflects the widely accepted view that a prudent investor should seek diversification in his portfolio. With diversification, the investor is protected against the consequences of poor performance by any particular sector of the economy or type of investment and, most importantly, against inflation. Among the investment opportunities, collectibles are the most effective in protecting portfolios against the ravages of inflation. A recent study by Solomon Brothers shows that over the last ten years, hard assets have outperformed other traditional investments. The attractiveness of collectibles over the next ten years is, as with most investments, uncertain and some may argue that collectibles are not ideally suited for retirement accounts. However, this is no reason for Congress to proscribe individually directed retirement accounts from investing in hard assets and collectibles.

It is indeed curious that the federal government which stabilizes its currency through billions of dollars of gold reserves should deny this right to others. In addition, the U.S. Post Office promotes and sells over $100 million dollars a year in stamps to collectors, and the Treasury Department sells approximately $6 million worth of coins to collectors, and yet the federal government, while it markets these collectibles, is at the same time willing to tell an individual planning for his retirement future that he may not invest in those very items that the government sells and holds out as sound investments.

The implications of this policy reach not only the retiree, but U.S. Treasury as well. Disbursements are taxable and to the extent that the retirement accounts are denied attractive investment opportunities, the eventual payments to the Treasury upon retirement will be less.

It is useful for this committee to understand how this provision became law. It was suggested by Congressman Shannon of Massachusetts and included in H.R. 4242, the omnibus tax bill reported by the Ways and Means Committee. There were no hearings held on this subject and no bills or specific language before the Ways and Means Committee when it was agreed to in principle at a committee mark up session. Although not included in the Administration specifics which were originally presented to the Congress, the provision was picked up by drafters of the Administration supported substitute which passed the House. It was not considered at all by the Senate, but was adopted by the House-Senate conference without change. The conference report provides little explanation or justification of the provision.

The failure to include any public imput or to develop any record leaves many unanswered questions, the most immediate of which is the scope of the provision. The term "individually - directed account" lacks any certain meaning. It is not defined in sec. 314(b) or any other pertinent statute. This leaves open the question as to whether or not every plan described in sec. 401(a) of the tax code is reached by this provision. Potentially, sec. 314(b) applies to all Keogh plans, all defined contribution plans, and all defined benefit plans. This ambiquity underscores the point that the Congress lacked any careful guidance when it adopted this provision, and that a reexamination is in order.

Conclusion

Sec. 314(b) violates the established government policy that individuals ought to have the flexibility to make whatever investments they deem to be in the best interest of their retirement accounts. In so doing, it achieves no sound public policy objective. Sec. 314(b) weakens the ability of persons to plan for their own retirement future through private initiative, leading to increased dependence on an already overburdened Social Security System. I strongly recommend that the Committee and the Congress act this session to repeal section 314(b) so as to avoid its January 1, 1982, effective date.

Thank you for the opportunity to testify this morning.

STATEMENT OF HYMAN BRAVIN, ESQ., GENERAL COUNSEL, DIAMOND DEALERS CLUB, NEW YORK, N.Y.

Senator SYMMS. Mr. Hyman Bravin, Esq., Diamond Dealers.

Mr. BRAVIN. Thank you very much, Chairman Symms. Senator Moynihan and members of the panel, I am going to say very few words about my clients and then I am going to address myself to a remark made by Secretary John E. Chapoton. I am very sorry that Senator Chafee is not here because he urged us to address ourselves to remarks made by the Secretary.

First, it came as a great surprise to those of us in the diamond industry that we are referred as hard asset people. And that we are included under the term "collectibles."

My clients number in excess of 2,000 members. Some of them are dealers, some are brokers, and some are manufacturers. We have been in business as an organization for 50 years. And in the 50 years that we have been in existence, we have seen our great country become the diamond center of the entire world.

We never had any problems with the Federal Government; we never asked for a handout. We've asked for the elimination of tariffs. We believe in playing fair. And suddenly out of the blue we are included, referred to, characterized as hard asset people and collectibles.

We have people who work—they work hard. Our organization in the State of New York, alone, is supportive of over 50,000 families. I urge all of you, in your visits to the city of New York to take a walk down 47th Street between Fifth Avenue and Sixth Avenue. People are employed. Real people.

I want to address myself very quickly to the point made by the Secretary. And that is he verbalized the concern this morning that the Senate may regard section 314(b) as an undue restriction of diversity of investments. Of course, he was concerned because he knows darn well that what the Government is doing today is interfering with our ability to choose what we want to invest our money in.

Investment grade diamonds are a legitimate investment. They are marketable throughout the entire world. And investors have a right to determine what investments, whether they be stock, bonds, real estate, gold, silver, paintings, old coins, stamps, or diamonds, are best suited for them. It is not a question of whether you or I, Mr. Chairman and Senator Moynihan, prefer diamonds as an investment or how we may regard their future worth.

I'll be finished in 30 seconds.

But individuals do have a legitimate right to make that choice themselves. They have the right of constitutional dimension to make a free choice.

Now I don't want to hold you up because if I hold you up, I am going to miss my sabbath in New York City.

This bill, 314(b) the subsection thereof, is a violation of the very spirit of the Economic Recovery Tax Act.

Senator SYMMS. I thank you very much, Mr. Bravin. I couldn't agree with you more. And I might just say on defense of this committee that we did not agree with this. This was accepted at a late night conference session at 3 or 4 in the morning. And I wasn't on the conference. That is how it became law. I am certain that this committee supports this position. I hope we can get some action on this bill. I would have to say I am very disappointed in Treasury's attitude about it because it seems totally repugnant to the belief of our President.

Mr. MOYNIHAN. What do the beliefs of the President have to do with the position of the Treasury? [Laughter.]

Senator SYMMS. Senator Moynihan, I am beginning to wonder. [Laughter.]

Senator SYMMS. I think that is what concerns us all. I think it's the water they serve down at Treasury that makes them want to tax everybody. After they have been there about 3 months, they all get the same way.

Mr. MOYNIHAN. They want you to take these pieces of paper and believe in them. And if most of us don't, we are in a lot of trouble.

Senator SYMMS. They don't like to have that test out there. I might say that my State is the biggest silver producer in the world. We produce over half of America's silver. Several of the companies have been engaged in producing silver medallions or silver 5- and 1-ounce coins—sunshine money now on the market. Treasury's policy denies the people the opportunity to invest in real tangible assets. As my father always told me, if you have a little bit of silver, you can always bribe the guards. [Laughter.]

Thank you.

[The prepared statement follows:]

December 3, 1981

Position Paper
of the
Diamond Dealers Club of New York
on the Economic Recovery Tax Act
of 1981, Section 314(b).

The Diamond Dealers Club, the world's largest diamond dealers association, with a membership in excess of 2,000, seeks the repeal of Section 314(b) and supports the bill introduced by Senator Moynihan (S. 1645) which if enacted into law would result in the outright repeal of Section 314(b).

Section 314(b) of The Economic Recovery Tax Act of 1981 ("1981 Act"), which becomes effective after December 31, 1981, contains a provision therein which has and will continue to seriously effect the diamond industry and its customers. Under the new tax bill people who have previously been placing investment-grade stamps, coins, diamonds, art works and other collectibles in their Individual Retirement Accounts (IRA) and Keogh plans will no longer be able to do so.

In the past years, the public evinced a growing interest in using investment-grade diamonds for IRA and Keogh plans. This new source of income for our country's diamond industry was not only supportive of the Diamond Dealers Club membership composed of dealers, manufacturers and brokers but more than 100,000 families who play a supportive role in our industry also benefited from this new source of income.

When our industry first learned of Section 314(b) of the 1981 Act it was too late to act meaningfully. The diamond industry learned with surprise that they were a "hard asset" and that their industry was included under the term "collectibles" in Section 314(b).

We, in the diamond industry are sophisticated enough to understand that when a bill is hammered out in the legislative halls,that in the final moments of debate certain new laws are introduced without full discussion and consideration. We are not critical of "how" the bill was passed but we feel that we are entitled to know "why" the bill was enacted into law. Our research indicates that there is no legislative history to Section 314(b). Chairman Dan Rostenkowski, Chairman of the House Committee on Ways and Means in a letter dated September 18, 1981 to New York Congressman Mario Biaggi advanced two reasons why Section 314(b) was passed by his committee:

> "These provisions were included in the Act because both the Administration and the Congress were concerned that in some cases these retirement arrangements were being used as a tax deductible means of acquiring personal property, more for personal enjoyment and use than for investment purposes. Moreover, there is concern that collectibles divert retirement savings from thrift institutions and other traditional investment media and that investments in collectibles do not contribute to productive capital formation."

It is the position of the Diamond Dealers Club that the "intent" of some people when they made retirement arrangements under Individual Retirement Accounts and Keogh plans is not the concern of the Administration and the Congress as long as the integrity of the diamond or any other collectible is safeguarded and so regulated to avoid any abuse of the law governing Individual Retirement Accounts and Keogh plans. In this regard it is to be noted that diamond dealers, manufacturers and gemmological institutions have taken measures to prevent substitution of diamonds and other ruses. Upon request, they will seal the diamond in a heavy plastic case with a rating of its weight, clarity and color, and microfilm copy of the certificate, which is accepted internationally as validation of the diamond's identity and grade. The identity of the stone is assured since substitution would necessitate a breaking of the sealed plastic.

The Congress in recent sessions has enacted sufficient safeguards to bar the abuse of assets in retirement accounts under Internal Revenue Code Section 4975(c)(1)(D). This Section sets forth prohibited transactions and a penalty for a single abuse resulting in disqualification of the entire account and is enough deterrent to discourage anyone from contemplating an abuse of the basic retirement funding laws. Further, the Administration has been aggressive in making maximum use of its Code of Federal Regulations to protect the integrity of retirement funds.

I am authorized to represent to this Committee that the Diamond Dealers Club is prepared to fully cooperate with the Internal Revenue Service or any other administrative agency charged with the responsibility to monitor retirement funds.

Congressman Rostenkowski's second point "collectibles divert retirement savings from thrift institutions. . . and that investments in collectibles do not contribute to productive capital formation" is simply incorrect when referring to gems.

Discovery, mining, cutting, polishing and retailing these gems is a labor intensive industry. The ultimate aim of the "productive capital formation" is the building of industries and the creation of jobs. For every gem put into an IRA or Keogh plan a new gem must be found and prepared to take its place. Far from being a detriment to the goal of increased employment and trade, encouraging the collecting of gems is an efficient use of the tax system to accomplish these goals.

Congressman Rostenkowski implies that the use of the tax bill is to help the ". . . thrift institutions and other traditional investment media". If this is to be done at the expense of a great many other industries, we can find no congressional articulation of such policy.

We are certain that the Congress had no desire to inflict a blow against our industry, expecially in view of the present economic situation. Acting in fact with insufficient information Congress used a classification of "collectibles" that upon reflection should be seen as arbitrary. We urge you to now find that the term "collectibles" has no fair or substantial relationship to the object of the legislation. We hope you will support Senator's Moynihan's Bill #1645 and repeal this unfair and inequitable section of the 1981 tax law.

STATEMENT OF BURTON S. BLUMERT, EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION OF COIN AND PRECIOUS METALS DEALERS, NEW YORK, N.Y.

Senator SYMMS. Now, Mr. Blumert, we would like to hear from you.

Mr. BLUMERT. Thank you, Senator Symms, Senator Moynihan. I am here today as executive director of the National Association of Coin and Precious Metals Dealers. Our organization numbers approximately 350 of America's fine precious metal and numismatic dealers.

In my testimony, which I submit to the committee, I go into some details along the lines that my colleagues have so eloquently stated. I would like to, just for a moment, talk about Secretary Chapoton's total disregard of the whole point of retirement concept. Why the people think about retirement? Clearly, they are concerned about their future. They are concerned about those years in which they are not able to produce sufficiently.

Our society has been ravaged by inflation. The last two decades have seen the savings of our middle class and our retired people decimated. Senator Moynihan suggests that Treasury is suggesting that we accept these pieces of paper. But in dealing with the future, retired people and those who are so concerned recognize that the conventional ways are no longer applicable. So it is not because of some gimmick that people turn to items of substance to protect their savings. And it's not a question of whether something increases 8 or 12 percent or one asset is productive or nonproductive. What is at issue here is what am I going to have in 20 years? What will I have to show? Can I pass anything on to my heirs? These are critical questions, I believe. And I hear Treasury not even considering any of these things.

Not only is it incumbent, I believe, to dismantle 314(b) and to pass Senator Moynihan's bill, S. 1645, it is absolutely essential for people to understand that inflation is the enemy and that this, in one important significant fashion, indicatcs and points up the problem that inflation had best be dealt with, and people can deal with it best in their own lives by planning for the future with items of substance.

The people on this panel represents items of substance.

Thank you, Mr. Chairman.

[The prepared statement follows:]

PREPARED STATEMENT OF BURTON S. BLUMERT, EXECUTIVE DIRECTOR OF THE NATIONAL ASSOCIATION OF COIN & PRECIOUS METALS DEALERS, ACCOMPANIED BY DAVID L. GANZ, GENERAL COUNSEL, BEFORE THE SUBCOMMITTEE ON SAVINGS PENSIONS & INVESTMENT POLICY OF THE SENATE COMMITTEE ON FINANCE, AT WASHINGTON, D.C., DECEMBER 4, 1981.

Chairman Chafee, and distinguished members of the Subcommittee on Savings, Pensions and Investment Policy, my name is Burton S. Blumert, and I am the Executive Director of the National Association of Coin & Precious Metals Dealers. I am delighted to be here with you this morning to testify in favor of the repeal of Section 314(b) of the Economic Recovery Act of 1981. Accompanying me this morning is our organization's general counsel, David L. Ganz, who is a practicing attorney familiar with both coinage and tax law.

Let me tell you a little bit about the organization that I represent, Mr. Chairman. The National Association of Coin & Precious Metals Dealers was born in the spring of 1981 as a trade association designed to function on both a local, and national level to keep members of the numismatic and precious metals industry abreast of proposed rules and regulations of various federal and state departments, and agencies, and frankly, to function as a clearinghouse and information center for the bevy of information affecting the industry which has emerged over the course of the past year.

Initially, our organization banded together because of so-called holding laws, and to establish ethics and standards of the industry that we felt would benefit the public at large, as well as our prospective membership. The reason for the holding laws had to do with the large increase in value associated with gold and silver, as well as rare coins, and a desire on the part of municipal authorities to regulate their sale in the name of crime prevention.

This constituted a serious threat to the manner in which coin dealers, as well as precious metals dealers, earn their livelihood, so it was natural that our group would band together. Initially, membership in our group centered around a teletype network that had been established in the 1960's to service the fast-paced action of the coin dealing community. Since that time, membership has expanded to include a variety of other individuals and corporations.

From the original 22 members who met in Indianapolis at the organizational meeting in April, 1981, the National Association of Coin and Precious Metals Dealers has grown to more than 350 members in 42 states of the union.

Many of our members have been involved in the coin business, and with precious metals, for many years. My own company, Camino Coin Co., was founded in 1959. Many others are in existence for comparable periods of time. While we can offer no firm figures as to the annualizaed inventory of our members, or their sales, I think it is fair to estimate that our membership has a combined inventory in excess of $300-million, and combined annual sales of both coins and precious metal (bullion) in excess of $10-billion.

This sum involves more than mere dollars, Mr. Chairman. Thousands of individuals are employed in the coin and precious metals industries and allied fields. And, it is apparent that tens of thousands of Americans -- millions of people -- have acquired both coins and precious metals through the years as a form of investment. These rare coins and precious metals of gold, silver, and platinum have been used by countless Americans as a form of planning for their retirement.

It is my belief, Mr. Chairman, and I believe that it is shared by many of our countrymen, that the Economic Recovery Act of 1981, as a generalized concept, is something that was desperately needed for our national economic survival. Based on extensive legislative history of which I am sure the chair is aware, many portions were given over to extensive consideration, while others were patched together literally as the midnight oils burned.

The aim, of course, was to provide an economic stimulus to many sections of the nation's economy. While significant portions of the Economic Recovery Act of 1981 are laudable, it is my belief, and that of the industry that my group represents, that one particular provision is regrettable. This is Section 314(b) -- a provision which effectively denies millions of Americans the right to utilize rare coins, as well as precious metals, a part of their retirement planning.

Our national association strongly believes in the right of the individual to make an intelligent choice as to how their retirement ought to be provided for. The essence of individual retirement accounts (IRAs), and H.R. 10 plans or Keogh accounts, is that individuals ought to be afforded a vehicle with which to build a financial cushion upon which they can have financial security in their later years.

Retirement assets can take many forms: real estate can be purchased, stocks can be acquired, monies can be left in certificates of deposit, or money market funds, or at least until the advent of Section 314(b), it could be placed in a variety of hard assets.

Before I attempt to define a hard asset, I think a definition of inflation is in order. Inflation is an increase in the money supply which has a dramatic impact on consumer prices. This chronic situation over the past two decades has decimated the savings of our citizens, particularly those on fixed incomes and in retirement. The conventional methods of keeping assets such as savings accounts, bonds, and other equity investments have proven disastrous. The lesson of history in this regard is clear, so it is natural that people will seek the alternative of hard assets.

What, then, is a hard asset?

Basically, Mr. Chairman, a hard asset is any item of tangible personal property which tends to maintain, or at least increase its value or purchasing power in these inflation-ridden times. Quite clearly, as the accompanying chart shows* the purchasing power of the dollar has substantially declined in the past decade. Today's dollar ~~is~~ worth half of what it could have purchased in 1970. And yet, with this decline in purchasing power for currency, there are some items which have more than kept pace with this decline -- and made substantial advances in the process.

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*See accompanying charts on the Decline of the Dollar's Purchasing Power, prepared by The Conference Board (April, 1981).

If it had been legal for Americans to own gold bullion just a dozen years ago, they would have been able to maintain the value of their savings due to the dramatic price increments that took place in the 1970's. Of course, bullion could not be purchased -- it was illegal until you changed the law in 1974 -- but despite that, those who acquired bullion in 1975, and have held it since, have benefitted substantially from its upward fluctuations. Even those who purchased in mid-1979 (before the dramatic gains of early 1980, which have since receded) are ahead of the game. Those who have acquired rare coins have likewise protected their savings. The charts attached to this, and other exhibits, illustrate this.*

None of this is to say, Mr. Chairman, that gold is not going down as well as up, nor is it to allege that coins only go up in value. We know that this is not the case. Just as stocks and bonds fluctuate in value, and real estate varies depending upon such vagaries as interest rates, and buyer interest, bullion and rare coins have likewise fluctuated. But the statistical record bears out that each has substantially outpaced inflation, whether taken individually, or in the aggregate.

Rather than getting embroiled in the numerical clutter in this presentation to the committee, I have asked our general counsel to prepare charts and tables, which are appended to this formal statement, indicating for the record the performance rate of

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*See chart on gold prices for 1979-1980 from Journal of Investment Finance in appendix. Coin gains compared to the consumer price index is found in a graph in the appendix as well.

gold, silver, platinum, and rare coins over a protracted period of time. The purpose is to show this committee, in capsule form, the type of track record that these media enjoy. For example, on January 16, 1970, the price of gold was just under $35.00 an ounce. On November 19, 1981, the price of gold was $401.00 an ounce. This is the equivalent of 1,045 percent gain over a period of a dozen years, which means a compounded annual yield of more than 22 percent.

The track record with rare coins can readily be measured with individual coins, but a basket approach does not really exist. A study by Salomon Brothers, the investment banking house, however, discloses that according to their survey, coins outpaced stocks, bonds, and a variety of other media during the period 1968 to 1978; historically, since that point, the upward trend has basically continued.

There are a number of interesting stories which I could relate to you showing how, precisely, coins have protected savings through the years. One of the better examples, I think can be seen from the collection of Harold S. Bareford, a New York attorney who died in 1978. Mr. Bareford collected coins, mostly American issues, from about 1947 to 1954. He kept meticulous records, detailing the acquisition costs, and since in many cases the coins were purchased at public auction sales, we have further evidence of the history, pedigree, and worth of these pieces. Mr. Bareford's collection of gold coins was sold a year or so ago, and his silver coins just the other month. The results are somewhat startling.

In 1950, Mr. Bareford acquired an 1804 silver dollar at a cost of $10,000. On resale at auction in 1981, the identical coin brought $280,000. Not every piece, obviously, can record such a spectacular dollar gain, but some of the other coins, equally, showed substantial increments in value. The trend is evident on inexpensive and expensive pieces, alike.* Quite clearly, not everyone has the ability, or the means, to buy coins in this price range. But, coins whose prices are within the limits of Keogh accounts, or IRAs, are very much involved. Bareford's coin collection showed that a consistent savings did better than keep pace with the higher cost of living -- it quite simply outran inflation entirely.

Bareford's example is not an isolated one; just about every person who has collected coins for any period of time is aware of the income and growth potential. It is no accident, then, that in planning for retirement, rare coins, bullion, stamps and many other assets have been utilized. The reason is obvious: the historical record suggests that despite the compounding and growth associated with equity investments, the net effect after inflation, is fewer real dollars.

Planning a rare coin and precious metals retirement has spawned a growth industry in which the members of our National Association are active participants, employing thousands of people in 42 of our 50 states. We believe that is in inequitable to remove from the people the

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*The appendix contains an article appraising Bareford's collection, and its sale, including acquisition costs for a number of coins, the 1981 prices realized, and the percentages of gain.

right to designate how some, or all, of their retirement assets are invested. And we believe that it is essential for the preservation of our industry that Section 314(b) is repealed.

As you know, Mr. Chairman, the provisions of Section 314(b) of the Economic Recovery Act of 1981 amends Section 408 of the Internal Revenue Code of 1954 to effectively prohibit the investment of any self-directed retirement fund into hard assets like stamps, coins, and even works of art. The definition contained in the law is all-encompassing: "Any work of art, any rug or antique, any metal or gem, any stamp or coin, any alcoholic beverage," is covered, together with "any other tangible personal properties specified" by the Secretary of the Treasury.

We are aware, Mr. Chairman, that tangible personal property is definitely not real estate, but can include just about anything else except money. (Coins, by their specific inclusion, are thus given a definition by the government to mean tangible personal property, which under the Uniform Commercial Code, they are generally not considered to be.)

Clearly, a close reading of the law states that it does not make an outright prohibition against investment in rare coins, bullion, or other tangibles, nor does it prevent a person from placing these items into an individual retirement account or a Keogh account. What it does do, however, is require that any acquisition after December 31, 1981 count as an income distribution, thus making it taxable as current income, and further assessing the penalties associated with a premature distribution. The practical effect of this, as the drafters no doubt intended, is to bar investments into collectibles because of the tremendous economic penalty.

It is clear from the legislative history of this provision that it was adopted without prior notice to the public and without any hearings. We do not question the right of Congress to do this, but clearly, the National Association of Coin and Precious Metals Dealers questions its wisdom. In making an effective prohibition against use of collectibles, and in particular coins and bullion in retirement plans, Congress has mandated that the public cannot invest in an asset which has substantially outperformed the more traditional investments in recent years.

It is obvious that extremely broad powers, sweepingly, have been added that could potentially, through regulation, restrict investments in other hard assets not even contemplated by the framers: even the extent of the present prohibition is unclear. It is not known whether it includes jointly-owned property, tangibles owned in a joint venture or a general partnership, or rare coins that are owned through a limited partnership. Coins or bullion that are owned by a trust, like-wise, may be affected - or they may not. We simply do not know.

We are delighted that this subcommittee is holding these hearings on this new provision of law and we urge that this committee promptly take action which will repeal this ill-conceived legislative dictum which inhibits Americans from making an intelligent investment choice in hard assets.

In this regard, the National Association of Coin and Precious Metals Dealers enthusiastically endorses the legislation introduced by Senator Moynihan of New York (S. 1645) which would, in effect, repeal Section 314(b), and we think that this is commendable and deserves the support of this subcommittee.

Mr. Chairman, I want to also note that while I cannot possible be expected to be speaking for the eight to ten million coin collectors in the United States, many of whom have utilized rare coins or bullion as part of their retirement planning, I think that it is fair to state that there is outrage from this community--just as there is within the membership of our National Association--that such a major change was foisted upon us without consideration of the negative, adverse, and potentially devastating consequences.

There have been a number of articles which have appeared in the trade press which ably discuss many of the issues, and with the Chair's permission, I would like to attach some of them to part of my testimony and make them part of the record.* So that the subcommittee fully understands how even a modest contribution to an individual retirement account or Keogh account utilizing rare coins can pyramid into a substantial retirement fund, I am also attaching an article by our general counsel which appeared in the 35th edition

*Articles from Coin World and COINage Magazine are appended.

of A Guide Book of United States Coins, in which the concept of planning your rare coin retirement is extensively discussed. I believe that it is of interest for the Chair to note that the Guide Book, known widely by the color of its cover, or the "Red Book," was first published in 1947, and, in 35 editions since then has sold over ten million copies. Clearly, the article included in the 35th edition, by Mr. Ganz, comes from a highly recommended source that is regarded as authoritative in the coin industry.

It seems to me that it is critical that Section 314(b) be repealed, andthat if it is not legislatively possible to do so before December 31st, that any repeal be made retroactive to that date--so that Americans who have used this medium can continue to do so, and that those who wish to do so in the future have the opportunity.

No matter what rationale is utilized, Mr. Chairman, in order to support the elimination of collectibles, and in particular coins and bullion from pension planning, it is clear that it will not withstand either economic or substantive analysis. If the purpose was to assist the savings and thrift industry by putting capital back into them, be assured that the hemorrhage created by the low interest rates that these institutions offer--effectively giving the depositor less than a hedge against inflation, and diminished dollars in value--will continue unabated. From every survey and study that we are aware of, more than 80 percent of the funds utilized for the purchases of rare coins for Keogh and individual retirement accounts came from money-market funds.

If there is something that the law is successful in, it is in denying freedom of choice in making effective retirement planning--which, after all, is the common-sense goal of millions of Americans.

It seems to me, Mr. Chairman, as well as to the members of the National Association of Coin & Precious Metals Dealers, that the government already regulates far too many facets of our life. We have all read in the daily newspapers of the difficulties many Americans have in planning for their retirement because of fears of inadequacy in our Social Security System. That's something that is frightening. It is our belief that most intelligent adults--whether senior citizens or at the start of their working careers--do want to do something about planning for their retirement years. Increasingly, we have found that they seek to do so with a firm, hard asset which they believe will afford them with a more comfortable retirement.

If Section 314(b) remains unchanged, it would effectively prevent those who have currently invested in hard assets from rolling them over and diversifying their investment portfolios. We believe this is inequitable as well as a denial of the fundamental right to peace of mind and financial security during the golden years. One of the key inequities is that if these individuals purchased coins and precious metals outside of a self-directed individual retirement plan, thev would be able to make such a tax-free exchange under Section 1031 of the Internal Revenue Code. The purpose of portfolio diversification in this manner is to permit greater growth potential, and to spread the risk. And, of course, re-investments made in this manner (as in any other "like-kind" exchange) are exempt from taxation (until ultimate sale) under the Internal Revenue Code.

Retirement planning involves substantially more than investment and reinvestment of funds, or assets such as coins and precious metals. It involves psychological and philosophical choices which must be considered as significant as the dollars invested. And, clearlv, because retirement plans involve expenditures of current income, it means that a choice must be made by each participant as to how their income will be spent.

There are obvious benefits to planning your hard asset retirement. As the accompanying data in the exhibits attached to my testimony show, the track record of rare coins--and bullion--has significantly outpaced inflation for long-term growth. We believe it is an intelligent choice and trust that when you have reviewed the facts, you will feel this way too.

A person examining this data ought to conclude that there is a reasonable expectation of substantial gain when hard assets are held for a period of many years. If the asset does not give as substantial a return as the investor desires, a "roll over" into another asset is permitted under the tax law.

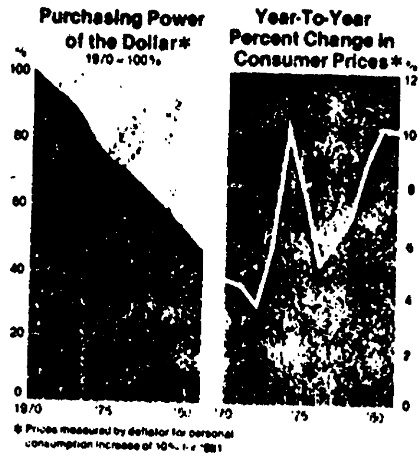
Essentially, each of these are free choices, and that, after all, is what our economic system is all about. It smacks of paternalism, and a lack of understanding of the economic realities of our time, to tell millions of Americans that, first, the government knows best and that coins and stamps are not a solid means of retirement planning, and second, that the money is better off in a thrift institution which, as late as last year, was still offering long-term IRA and Keogh investments at an unattractive 8-1/2 percent rate. It surely cannot be that the intent of the framers of Section 314(b) was to eliminate risk from retirement planning; indeed, stock portfolio investments--as well as real estate purchases for self-directed plans--are entirely unaffected. Instead, just one area of concentration--hard assets--has been singled out and, in our opinion, unfairly discriminated against.

Frankly, the rationale of Section 314(b) is not readily apparent. Any reasons advanced for its creation--and now retention--simply do not pass muster. We believe that it is essential that this committee take prompt action and report out S.1645, and obliterate the ill-conceived plan that passed as part of an otherwise worthy tax package.

I thank the Chair and members of this Committee for their kind attention, and would be delighted to answer any questions that you may have.

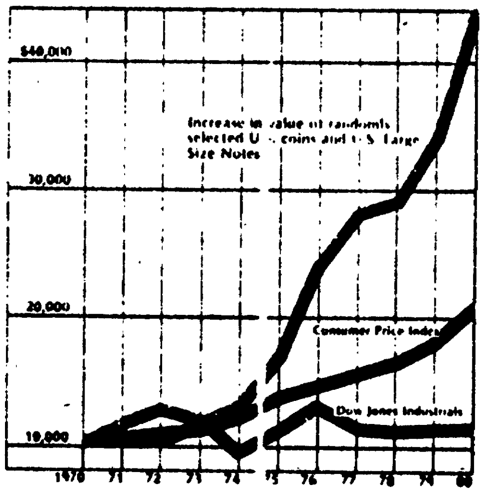
[Appendix follows]

DECLINE IN THE DOLLAR'S PURCHASING POWER
(1970 - 1981)



Source: The Conference Board, Economic Road Maps Nos. 1900-1901 ["The Two-Way Squeeze, 1981"] April, 1981.

RANDOMLY SELECTED PORTFOLIO OF RARE U.S. COINS AND PAPER CURRENCY (1970-1980)



Source: Kagin's Numismatic Investment Corp., utilizing "A Guide Book of United States Coins" (1970-80 eds.), "U.S. Large Size Paper Money 1861 to 1923."

SILVER PRICE AVERAGES 1874-1979 (With High/Low)

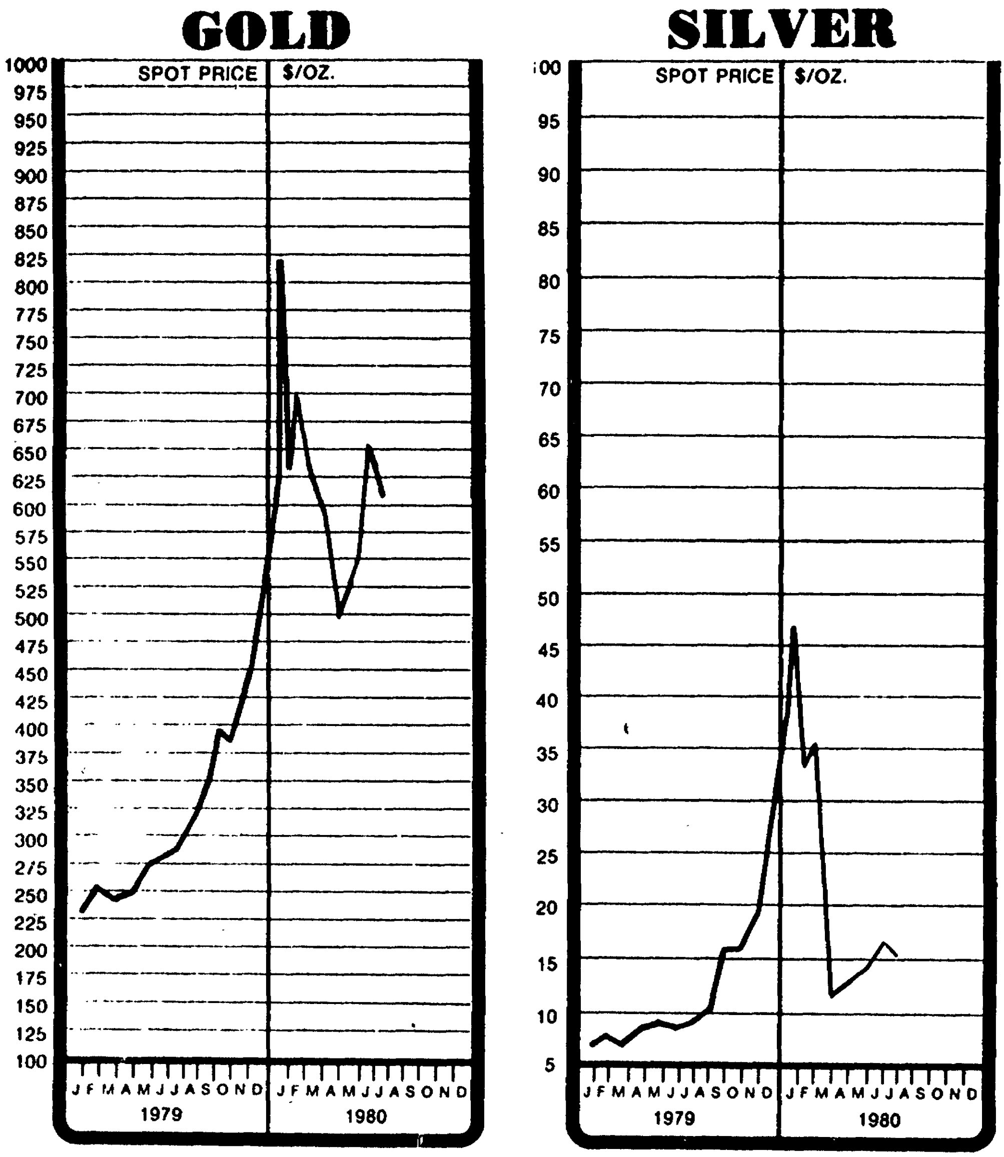
Price of silver per troy ounce in New York, 1874-1979[1]

Calendar year	High	Low	Average	Calendar year	High	Low	Average
1874	$1.29375	$1.25500	$1.27195	1927	$0.60312	$0.54187	$0.56680
1875	1.26125	1.21000	1.23883	1928	.63937	.56812	.58488
1876	1.20000	1.03500	1.14950	1929	.57812	.46812	.53306
1877	1.26000	1.16000	1.19408	1930	.46875	.30750	.38154
1878	1.20750	1.08500	1.15429	1931	.37500	.25750	.28701
1879	1.16750	1.06500	1.12088	1932	.31000	.24250	.27892
1880	1.15000	1.11250	1.13931	1933	.45000	.24500	.34727
1881	1.14500	1.11000	1.12823	1934	.55750	.41750	.47973
1882	1.15000	1.09000	1.13855	1935	.81000	.49750	.64273
1883	1.11750	1.09500	1.10874	1936	.49750	.44750	.45087
1884	1.13250	1.08000	1.11161	1937	.46750	.44750	.44883
1885	1.09500	1.02750	1.06428	1938	.44750	.42750	.43225
1886	1.03500	.92500	.99880	1939	.42750	.34750	.39082
1887	1.03500	.95000	.97899	1940	.35625	.34750	.34773
1888	.97750	.92000	.94300	1941	.35125	.34750	.34783
1889	.97250	.92500	.93634	1942	.44750	.35125	.38333
1890	1.20500	.95750	1.05329	1943	.44750	.44750	.44750
1891	1.07500	.94750	.99033	1944	.44750	.44750	.44750
1892	.95250	.83000	.87552	1945	.70750	.44750	.51928
1893	.85000	.65000	.78219	1946	.90125	.70750	.80151
1894	.70000	.59500	.64043	1947	.86250	.59750	.71820
1895	.69000	.60000	.66268	1948	.77500	.70000	.74361
1896	.70250	.65625	.68195	1949	.73250	.70000	.71930
1897	.66125	.52750	.60774	1950	.80000	.71750	.74169
1898	.62250	.55125	.59064	1951	.90160	.80000	.89368
1899	.64750	.58625	.60507	1952	.88000	.82750	.84941
1900	.65750	.59750	.62065	1953	.85250	.83250	.85188
1901	.64500	.54750	.59703	1954	.85250	.85250	.85250
1902	.56875	.47375	.52815	1955	.92000	.85250	.89099
1903	.62375	.47500	.54208	1956	.91625	.90000	.90826
1904	.62500	.53175	.57843	1957	.91375	.89625	.90820
1905	.66500	.55625	.61008	1958	.90375	.88625	.89044
1906	.72375	.63125	.67379	1959	.91625	.89875	.91202
1907	.71000	.52750	.65979	1960	.91375	.91375	.91375
1908	.58875	.48250	.53496	1961	1.04750	.91375	.92449
1909	.54500	.50750	.52163	1962	1.22000	1.01250	1.08521
1910	.57625	.50750	.54245	1963[2]	1.29300	1.21000	1.27912
1911	.57500	.52125	.54002	1964[2]	1.29300	1.29300	1.29300
1912	.65625	.55250	.62006	1965[2]	1.29300	1.29300	1.29300
1913	.65125	.59000	.61241	1966[2]	1.29300	1.29300	1.29300
1914	.60875	.49000	.56331	1967[2]	2.17000	1.29300	1.54967
1915	.58000	.47750	.51062	1968	2.56500	1.81000	2.14460
1916	.79125	.57250	.67151	1969	2.02500	1.54000	1.79067
1917	1.16500	.73125	.84000	1970	1.93000	1.57200	1.77082
1918	1.01937	.88937	.98445	1971	1.75200	1.28800	1.54564
1919	1.38250	1.01375	1.12067	1972	2.04800	1.38700	1.68455
1920	1.37875	.60375	1.01940	1973	3.28000	1.96200	2.55756
1921	.73813	.53188	.63096	1974	6.70000	3.27000	4.70798
1922	.74188	.62875	.67934	1975	5.22500	3.91000	4.41852
1923	.69000	.62875	.65239	1976	5.10000	3.81500	4.35346
1924	.72375	.63000	.67111	1977	4.96000	4.30000	4.62302
1925	.73187	.66812	.69406	1978	6.29600	4.82900	5.40089
1926	.68937	.51812	.62428	1979	28.00000	5.96100	11.09378

[1] Prices are as follows:
1874-1917. Asked price per fine ounce (unrefined)
1918-29. Mean of bid and asked prices per fine ounce (unrefined)
1930-61. Official quotations per ounce 999/1000 fine (unrefined)
1962-66. Official quotations per ounce 999/1000 fine (refined). Quotations for refined silver are one-fourth cent above prices for unrefined silver
1968-79. Handy & Harman, New York, N.Y.
[2] The price of $1.293 per ounce was effective continuously from Sept. 9, 1963 through May 18, 1967

Source: Treas. Doc. 3280, Annual Report of the Director of the Mint for the fiscal year ended September 30, 1979 at p. 93.

Gold and Silver Price Trends - 1979-1980
[Showing Depth and Height of Market]



Source: Journal of Investment Finance, Gold & Silver Letter, vol. 10, No. 9 (Aug. 8, 1980), p. 5.

54 COIN WORLD, Wednesday, November 11, 1981

Bareford collection auction sets records

By David L. Ganz
Special Correspondent

Stack's sold the Harold S. Bareford collection of United States subsidiary coinage and silver dollars, as well as his holdings of English coins at public auction sale Oct. 22-23.

The $1.8 *million* prices realized set records throughout the coin market.

Highlighting the sale was an 1804 silver dollar, *originally* the *Dexter specimen,* which brought a $280,000 *bid from* Chicago coin dealer Edward Milas.

But the real story of the sale was Bareford, a New York attorney who collected coins from 1947 to 1964, proved that he was just as astute a collector of American silver coins and early English pieces as he was with the gold coins that he owned which were sold about eight months after his death in 1978.

In December 1978 Stack's sold the Harold S. Bareford gold collection, an offering of slightly more than 100 coins which were purchased over a seven-year period for $13,832. The total prices realized from that sale was $1,207,215.

Some three years later, U.S. coins costing $33,039 (of which one coin, the 1804 dollar, cost $10,000) brought $1.5 *million,* and English coins costing Bareford $6,973 sold for $357,010, smashing price barriers in the process.

Nearly every coin in the collection had a pedigree, meaning it either came from another auction sale, or from a major dealer who had earlier acquired it from a recognized major collection, and as a result, the collecting habits of Bareford, who at one time was general counsel to Warner Brothers Studios, *have formed* a basis for major study of price trends in the coin market over a period of 30 years.

Clearly, the major single piece in the collection (and the coin which realized the highest price) was the *Dexter* specimen *(Class I) of the* 1804 silver dollar, which Bareford acquired by purchase through the late Sol Kaplan and veteran professional Abe Kosoff in 1950, for $10,000.

That was a record price for the coin at the time, and the cost was higher than any other item in Bareford's extensive collection of gold and silver coins which contained many other rarities.

Gain on the coin was substantial, $270,000 over cost, and on the average, over a 30-year time frame the coin had a compounded annual growth rate of nearly 12 percent per year — phenomenal at a time when savings institutions were *paying four* or five percent, and even respectable today.

Without considering the 1804 dollar in the holdings of American issues, acquisition cost would be $23,039, with a gross price realized of $1.2 million, or more than 52 times what was paid for each coin, on the average.

Quality was a watchword in Bareford's collecting habits, and as a result, many finest-known specimens were included in the *offering. The* condition was such that, *in* many cases, a *numerical* grading guide would have been superfluous.

Choice pedigree pieces which, opened at nominal prices sold on the floor at staggering levels. If the opening bids seemed to be representative of a certain dullness in the market, the final hammer price showed tremendous vitality, and elasticity of demand for top conditioned pieces.

Representative of some of the prices achieved was the bidding on the 1827 Proof dime, acquired by Bareford for $20 in June 1947 from Ohio dealer James Kelly. The 1981 resale price was $29,000, which Chicago dealer Edward Milas termed a [illegible]

adding ' that's at least double what it would have brought in 1979," and proof positive that "good coins bring good money."

Bareford's collection started with some Colonial pieces that were eclectic in scope, but highly representative of America's first coinage. Typical was an extremely Fine 1652 Oak Tree shilling, which he had purchased in 1950 from New Netherlands Coin Company for $30. The 1981 resale price of the Noe 4 (Crosby 3-D variety) was $6,2[illegible].

Probably the finest known Immunis Columbia, dated 1787 and still Uncirculated, went for $4,[illegible]. Bareford had acquired i from New Netherlands in 1952 for $20; earlier, it was in the 1918 Jackman sale where it sold for $18.

Bareford's half dime collection was one of the finest in terms of condition, and appearance. His 1794 first year of issue in BU, acquired for about $100 in 1947, brought $6,500. The 1795 (Valentine 2a variety) was bought in the Will W. Neil collection, sold by B. Max Mehl in 1947 for $31.50, and had a 1981 resale price of $7,500. The net gain on the coin: 23,700 percent.

Most startling is the near-shifting of zeros and decimal points which occurred with three 179[illegible] half dimes, V-1 in A.U., and V-2 and V-4 in BU condition. The V-1 cost Bareford $92.5[illegible] at the Neil sale in 1947, and brought $7,250 in 1981. The others each cost $72.50 and brought $7,750 and $8,000 respectively.

Another extraordinary Bareford piece was the 1840 Proof half dime acquired from the Curtis collection, sold by B. Max Mehl in 1942 for $15.75. The 1981 resale price at the auction: $1[illegible],000.

Another major coin with an impressive pedigree was the 1846 *half dime, Proof,* from the Allenburger collection sold by B. Max Mehl in 1948 for $55. The 1981 resale price was $7,750.

But the real story was not that there were such dramatic price gains of four and five items. What was of keen import was that even the common items gained substantially. An 1852-O half dime in BU shows how, precisely.

Acquired at the Anderson Dupont sale in 1954 for $22, the coin was auctioned in 1981 for $800. The gain on this affordable coin: 35.3 times acquisition cost, or 3,530 percent, just around 14 percent annual, compounded return.

In acquiring coins, Bareford stressed quality, and, significantly, he also was interested in price. Hardly a single coin in the collection, with the possible exception of the 1804 silver dollar, was overpaid for.

In other series acquired by him, the prices realized reflect (as they do with the half dimes) this dedication. For example, the 1796 dime, AU with prooflike surfaces, cost Bare-

★ Please turn to page 66

ford just $23 from the Col. Green collection sold by Wayte Raymond, and resold in 1981 for $8,000.

Another, the 1798 from the collection of Adolphe Menjou (sold by Numismatic Gallery for $100 in 1950) brought $20,000, and another Menjou piece, the 1800 in BU, cost the same $100 and brought $15,000.

Other early date dimes fitting this pattern include the rare Proof 1824/22 dime, also a Menjou coin at $46 which realized $16,000, and an 1827 Proof dime (acquired from James Kelly at $20) which resold 34 years *later* for $29,000.

There were, as Harvey G. Stack termed them, "valleys" in the sale. These included coins which, in today's market, are not in vogue, and whose prices realized reflected the lack of general interest. Barber dimes appeared to be included.

Yet, even here, Bareford did not do badly. A cleaned 1912-D Barber dime, BU, which cost $3, was sold for $100.

In an eclectic offering of type quarters, an 1804 Browning-1 variety, BU, acquired from the Michael Higgy collection in 1943 (and later sold to Bareford for $200 in 1958) brought a whopping $21,500, while an 1806, Browning-2, in BU went for $11,000, having come from Hollinbeck-Kagin's sale in 1951 at $57.50.

Another early Bust quarter, the 1807 (Browning R-1a) in BU, sold by Hans M.F. Schulman in 1951 for $52.50, jumped to the $6,500 mark, while 1818 Browning-3 in BU, ex-Jerome Kern collection sold by B. Max Mehl in 1950, for $12.50, went for $8,000.

To the collector in 1981, many of the names, and the prices, may seem foreign. But to the numismatist of the 1940's and the 1950's, it is clear that Bareford bid in every major auction sale, and more often than not, did manage to snag a few prize specimens.

Some of the dealers (as well as the collections from which the coins were initially acquired) have long since passed from the numismatic scene. But mention a name — Farouk, Mehl, Numismatic Gallery, Jerome Kern, Adolphe Menjou, Wayte Raymond, Henry Chapman, New Netherlands, Virgil Brand, and of course Stack's, and they are amply represented — with other leading sellers of ...

Bareford's collection was phenomenal in many respects, the most significant of which is that he systematically acquired pieces of high quality condition in a true collection, as opposed to the accumulation that many numismatists find themselves with after years.

Equally so, he did so without attempting to form an investment of any significance. Impressively, the investment panned out anyway. Each of the coins rose impressively, at percentage rates that would boggle the mind.

If Bareford had invested his funds (in identical quantity) in virtually any other medium, including real estate, art, antiques or even the stock and bond market, there is little doubt that the same track record could be created.

Bareford's distinctive accomplishment was in creating an investment out of a collection by merely the act of intelligently pursuing a hobby, out of both enjoyment and pleasure. For the purist, when both his gold and silver holdings are considered, over a period of seven years, or so, he invested $53,894, and, as the auction records show, he reached a result of over $3 million.

Clearly, as Harvey Stack declares, "not every investment is a collection, but," as Bareford showed, dramatically, "every collection is an investment."

From: A Guide Book of United States Coins, 35th ed. 1982, pp. 252 et seq.

INVESTING IN COINS: PLANNING YOUR RARE COIN RETIREMENT

by David L. Ganz

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Coin collecting is more than a hobby today, it is a growth industry involving millions of people and billions of dollars. Not only are collectors acquiring coins, but more and more investors are entering the field. Long-time collectors know from experience that when it comes time to cash in their hobby, they have been richly rewarded by a collection that has, almost by itself, grown into an investment. So it is with considerable accuracy that coin collecting has been currently promoted as one way that a person interested in making systematic and regular investments can plan a successful retirement. In addition, it clearly is also a means by which any collector can find a sound economic base upon which to build and grow.

Examination of the 34 prior editions of this Guide Book clearly reveals the extent to which coins have risen in value over the course of the last three dozen years. Gains made are nothing short of spectacular. Although the United States has had no less than six recessions since 1946, the track record of coins has proven conclusively that investors seeking both regulated growth and unprecedented possibilities for future expansion ought not to neglect examining this medium. Increasingly, they have chosen numismatics, moving into the realm of coins as a sound alternative to stocks, bonds, bullion, and even real estate.

Lockluster performance in other media, and an inability to maintain value in an era of double-digit inflation is certainly one of the contributing causes to the rise of coin collecting as an investment. Each day brings a new economic shiver and an added reason as to why coins ought to be acquired in lieu of other fixed assets or investments. The grim economic statistics of the nation, as prepared by the Federal Reserve Bank of St. Louis in its "International Economic Conditions" publication, show that from 1967 to 1980, consumer prices have risen on the average of 11% per year; short term interest rates, which averaged 5% in 1976, and 7% in 1978, were well into double digits for most of 1980; the prime rate in early 1981 topped 20-½% interest, and even Treasury Bills, the government's own commercial paper, rose to record rates of over 16% annual interest for six months.

What does all this point to, and of what relevance is it to a collector?

It should be clear that every collector ultimately is an investor. By the very nature of making systematic acquisitions, an investment is formulated at the same time that a collection is being born. It is equally clear that while every collection is an investment, not every investment is a collection. This is apparent because the mere acquisition of coins in a haphazard manner forms nothing upon which value can be based other than the potential intrinsic rarity of each individual piece. Both domestic and international economics, and tax laws, affect this directly.

How, though, have coins increased through the years?

An impartial study conducted by Salomon Brothers, Stock Research Department in July, 1978, is revealing. Reprinted in the *New England Economic Review*, published by the Federal Reserve Bank of Boston, the study shows that with the exception of gold (which is subject to wild fluctuation), Chinese ceramics (largely unavailable until recently), postage stamps, and old masters, nothing has outpaced coins in an average annual growth on investment in the 10-year period 1968 through 1978.

TABLE
Average Annual Growth on Investment
(1968-1978)

Chinese Ceramics	19.2%
Gold	16.3%
Stamps	15.4%
Old Masters	13.0%
Coins	13.0%
Diamonds	12.6%
Oil	11.5%
Farmland	10.6%
Housing	9.2%
Silver	9.1%
Foreign Exchange	6.2%
Consumer Price Index	6.1%
Bonds	6.1%
Stocks	2.8%

SOURCE: Salomon Brothers, Stock Research Department, July, 1978, reprinted in Richard Kopcke, "Are Stocks A Bargain", *New England Economic Review* (May/June 1979) page 7.

The mere systematic collecting of coins does not, of course, offer any type of a guarantee that an investment of solid magnitude is being created. Moreover, given the scope of current tax laws and regulations, it seems clear that understanding the complicated means by which gains and losses are not only made but also recognized by the Internal Revenue Service (IRS) is essential if a collector is to maximize his collection and investment.

Increasingly, many are turning to other ways by which collections can constitute not only an investment, but also an important tax savings. If the collection is constituted as part of an investor's retirement program, financial rewards can be reaped while simultaneously enjoying coin collecting. This may be done either in the form of a pension plan, or as an individual retirement account (IRA) or a Keogh (self-employed individual retirement) plan.

A variety of offering plans have been constituted, some utilizing a single person, others a principal of limited partnership. Most are tailored to the individual collector and his needs. To understand how rare coin retirement planning works, you first must examine the government's ground rules.

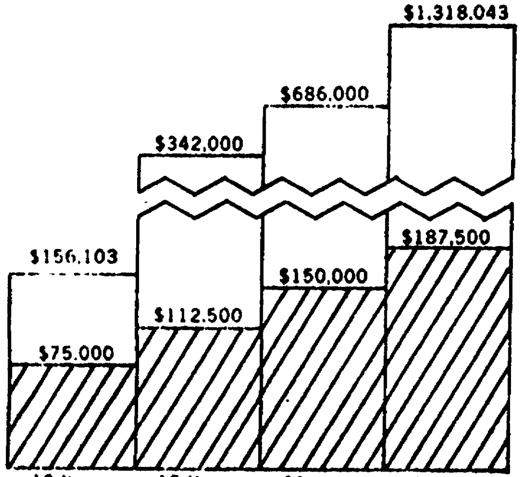
For IRA's, an individual is permitted to set aside an amount equal to 15% or less of annual income up to $1500 per year per person or $1,750 where a non-working spouse is involved in a joint effort. This sum set aside is directly reduced from the gross income on which income tax is otherwise paid.

For a married person (with non-working spouse) earning a salary of $20,000 per year, the tax saving is dramatic. In that case, on a joint return using standard deductions, a tax of $2,751 would be due. The IRA maximum contribution of $1,750 is an adjustment to income and immediately reduces gross income to $18,250, on which a tax of $2,319 is paid, effectively reducing taxes by 15.7%.

In the case of a Keogh account, a self-employed individual who does not have any other pension plan may set aside 15% of gross income (up to a $7,500 per year maximum) which, again, is reduced directly from his gross income before income tax is paid. On the first $50,000 in gross income, his tax savings may be employed. Again, as an illustration, the tax for a married couple with a gross income of $40,000 (with non-working spouse) would be $9,355 without benefit of Keogh, $6,987 with it employed. The cost of setting aside $6,000 is compensated by the government reducing its tax bite 25.3%, making Uncle Sam a "partner" to the extent of a $2,368 tax reduction.

Once money is set aside under either of these programs, it may be invested in coins, stocks, or even just kept in the bank earning interest. A trustee must control the plan and its assets, but you can select that entity (a bank, a limited partnership investing in rare coins, or anything or anyone else approved by the Internal Revenue Service). By law, the retirement account must be set aside until the holder either reaches the age of 59-½ or retires between then and age 70. (There are certain exceptions to this. You should consult with your tax advisor for details.) As the proceeds are paid out, income tax is paid on the appreciated value (either of the coins as they are sold, or, if money alone is utilized, on the principal sum plus interest accrued).

The beauty of such a medium when it comes to coins is obvious. The accompanying chart clearly shows the following examples: Assuming the rate of return specified in the *New England Economic Review* article of 13% annually a $7,500 investment accumulated over a period of ten years gives a pay-in of $75,000 and yields at least $156,103, using the most basic compounding formula. For an individual utilizing the maximum contribution for a 15-year



Note. Sums invested ($7,500 per year)

Projected profits based on $7,500 annual contribution (13% annual return compounded) period a pay-in of $112,500 would yield approximately $342,000. For a 40-year old making the maximum contribution until the age 60, a total of $150,000 would be used for purchases for a potential yield of $686,000 while for a 35-year old making 25 annual contributions of $7,500 (a pay-in of $187,500), the potential reward (assuming that the projected rates continue) would be $1,318,043.

If the entire collection were then liquidated, or placed into an investment giving a return of even 7% per year, the recipient would have $92,263.01 in *interest* available without even dealing with the principal.

But, there are a host of other means by which the investment can be maximized. It stands to reason that the lower value a coin has, the more it stands to appreciate. For example, when Indian Head cents were commonly selling in uncirculated condition for $7, a 100% profit was gained when they rose to the $14 level. An uncirculated Indian Head cent in the 34th edition of the Guide Book shows a common date selling for $32.50 as MS-60. For that coin to gain the same 100% requires a new price range of $65. Moreover, the higher that a coin goes in value, the greater the increm ent is required to go after the percentage gain — that being the goal of eve y investor.

In the case of an 1804 silver dollar, listed at $ 400,000, in the 31st Edition from the Garrett Sale by Bowers and Ruddy, the coin would have to rise to the $800,000 level in order to gain 100%. Put ano her way, for that coin to return to its owner the same rate as other coins avera e according to the New England study within 4 years from the date of sale, the price of over $650,000 would be required.

Most collectors, obviously, are not dealing ith such high ticket items. But who can forget that proof Barber dimes, once common, and listing in the 9th Edition Guide Book at $7.50 and $8 each, wou l regularly be selling for $2,000 and beyond. And once the coin has reached t at $2,000 level or beyond, it is tracked in with other expensive pieces which equire dramatic dollar gains in order to catch up to the percentage figure tha is desirable for a growth rate.

What a collector can do in this instance is to set up a tax-free exchange. This device can be best explained by way of an ex: nple. Collectors or investors in gold coins are aware that since the dramatic in rease in the price of gold, many gold coins have a high value. The percentage g me works there too. A Mexican 50-peso piece or Centenario contains 1.2 ounce of gold (and arbitrarily valued at $700 per coin) and must increase at the ra e of 12% on the principal sum in order to obtain a maximum return. By th same token, an Austrian 100 corona piece has less gold in it (.98 troy ounc s).

Thus, the approximate equivalent in value is such that 100 of the centenarios is of approximate equal value to 123 Austria 100 corona pieces.

Ordinarily, if an individual wished to obtai more leverage (in the form of 23 additional coins, all containing gold, but wit a likelihood of each individual piece obtaining a higher value) a sale and re-pu chase would have to take place. That would be a taxable transaction on any g in or loss. But, if an exchange or trade can be worked out, the swap would qualify as a tax-free exchange under §1031(a) of the Internal Revenue Code.

The reason for this is that §1031 of the Inter al Revenue Code provides that no gain or loss shall be recognized if property h ld for investment is exchanged solely for property of a like kind also to be h d for investment. Income Tax Regulation §1.1031(a)-1(b) provides that the ords "like kind" refer to the nature or character of the property, *not* its rade or quality. The Internal Revenue Service has held that the difference b ween gold coins minted by one country, and gold coins minted by another c untry (when such coins are not used as a circulating medium of exchange) ar primarily of size, shape, and the amount of content. But the nature of the go coin remains the same, and it thus is a "like kind" property capable of a t x-free exchange (Revenue Rule 76-214).

Plainly, there is a difference between a nu ismatic coin and a bullion coin and in another ruling, Revenue Rule 79-14: the Internal Revenue Service opined that any tax-free exchange was not pe missible for a U.S. double eagle with a South Africa Krugerrand. The ratio ale is that although the coins appear to be similar because they both cont: n gold, they actually represent totally different types of underlying investm t—one in bullion, the other in a "numismatic" item.

The Internal Revenue Service thus holds that they are not of the same nature or character. The result of these two ru ngs do suggest that numismatic property may be similarly exchanged; thus, a proof Barber dime might be exchanged for 10 proof Indian Head cents, or 1795 F-12 half dollar could be exchanged for an 1883 proof Liberty nickel, nd an 1864 small motto 2-cent piece in MS-60.

Where does all this leave the collector who ddenly realizes that after years of acquiring coins, a solid investment has bee built? And, what is the person to do who wishes to invest in, but not really ecome, a true collector of coins.

There really is a happy medium—a marri e, or amalgam—which is available to the collector, the investor, as well as the collecting investor. There are also a variety of outside entities which ar offer assistance, guidance, and advice to the neophyte as well as the more perienced individual.

Individual retirement accounts and self-employment (Keogh) plans can be utilized in tandem with limited partnerships that invest in rare coins. A combination plan which keeps some assets in a high-interest savings account may be blended with rare coins, real estate, stocks, bonds or other investment medium.

Or, you can just collect coins for the fun of it, and, when the time eventually comes for your collection to be sold or broken up, the odds are strong that you will be surprised by the dramatic gains that your coins have made. Not just the gold issues which fluctuate with bullion's swirling prices, but also those old, circulated coppers. Remember, even the Indian head cents that were selling in very good and fine condition at 15 cents each in the 1960's are now worth more than a dollar, an increase of six-fold in less than two decades.

What is clear is that, increasingly, whether you collect coins for fun, profit, or a combination of those reasons, it is a means by which you can personally guarantee your own financial security in later years. You can begin planning your rare coin retirement today, building a million dollar investment in pleasure, enjoyment, education and fun, in that wonderful world of coin collecting.

DAVID L. GANZ, a New York attorney who has collected coins since the 14th edition of this Guide Book was printed, is legislative counsel to the American Numismatic Association. He has written extensively over the last 15 years, publishing over 3,000 articles in a variety of periodicals and legal journals, and written two books on the economic and legal implications of collecting and investing in coins. He is a member of the bar of New York and the District of Columbia, and is admitted to practice before the U.S. Tax Court and the Supreme Court of the United States.

Coin World - Sept. 2, 1981
(Page 1, col. 1)

Dealers offer support for group opposing Reagan tax provision

Professional numismatists, meeting in Chicago Aug. 13, agreed unanimously to support the efforts and principles of a group representing the coin, stamp, art, diamond and hard asset industries which met two days earlier in New York, to oppose Section 143b of the Economic Recovery Act of 1981.

The section provides that collectibles acquired through self-directed IRA or Keogh retirement plans would be taxed into oblivion, preventing for all practical purposes their use in retirement planning.

Attending a meeting held in the offices of NUMISCO Inc., which was chaired by Lee. J. Belasario, vice president of New England Rare Coin Galleries, were Don Kagin of Kagin's, Des Moines, Iowa; Mike Haynes of Steve Ivy Rare Coins, Dallas; Edward Milas of [redacted], Chicago; Robert Harwell [redacted] & Harwell, Atlanta; William Hawfield of Bowers & Ruddy Galleries in Los Angeles; Walter Perschke, NUMISCO, Chicago; and Gary Sturtridge of the House of Stuart, [redacted] of the Professional Numismatists Guild.

Those assembled heard Rafael Guber, director of financial services at New England Rare Coin Galleries, report on the Aug. 11 meeting in New York of the Committee for Financial Freedom - Coalition of Concerned Investors, Dealers and Tangible Asset Collectors.

Held at the offices of Hassenfeld & Stein, major diamond wholesalers, the earlier meeting represented a loose coalition of various people in the tangible assets-collectibles-hard assets fields, Guber said, who were gathered to assess their common interests, and to develop a plan basically to present their views to the people of the United States through their representatives in Washington, who were not given an opportunity to understand an opposing point of view when the legislation was passed.

Following their unanimous endorsement of the Committee for Financial Freedom, the group named Walter Perschke to represent them at the committee's next meeting.

Guber told Coin World that not enough opportunity had been given to people in the collectibles business, as well as collectors and investors, to present their opposing viewpoints. "We believe that the logic and fairness of the cause speaks for itself," he said. "We basically want a forum to make our presentations to the people."

He called the argument that people should be encouraged to invest only in "productive assets"—conventional pe[redacted] one. "What happens to the money people spend for rare coins? Does it get burned?" he asked.

"A company like New England Rare Coins, for example, employs 175 people, all of whom have salaries and bank accounts; and the company itself, which preaches diversified assets to its clients, puts a portion of its own assets into small business loans and other diversified areas."

The second argument advanced by proponents of the offending Section

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143b of the legislation, to become effective Jan. 1, 1982, that it will help the ailing Savings and Loan Association industry, is "really ridiculous," Guber said, insofar as it ignores the real problem.

"The Savings and Loan industry is not able to do battle with the money market funds, which is their real enemy, so it has to go out and pick on the little kid on the block," he pointed out as an analogy.

Guber estimated that four percent at the most—or, more likely, half that amount—of all funds tied up in IRAs or Keoghs might be in collectibles.

"That amount is not going to have any material impact on the Savings and Loans in the first place, and, in the second, my impression is that most money that gets put into collectibles is taken out of money market funds. Most people keep money in a money market fund as a holding action, and the money (that is not spent on collectibles) is going to go right back into those same money market funds."

Rather than helping the Savings and Loan Association industry, Guber termed Section 143b "a cruel joke" on those it was supposedly helping.

From COINage Magazine (Nov. 1981)

THE FIGHT GOES ON

BEHIND THE S CENES STRUGGLES OVER COINS AND IRA, KEOGH

by DAVID L. GANZ

Investment in rare coins was given a kick in the shins this year when the Administration's tax bill turned up a surprise provision that virtually eliminates the use of rare coins in individual retirement accounts and other self-directed pension plans.

From a practical standpoint, the impact on the coin industry, as a whole, is so substantial that in the absence of a change in the law, or a new interpretation of its provisions, the use of coins as a significant tax-shelter and investment vehicle will all but cease on an individual level.

Not only the coin industry, but also stamps, antiques, Persian rug collectors, and even those who collect rare wines and whiskey have been directly affected by the Economic Recovery Act of 1981, signed into law by President Reagan on August 13. While the legislation, initially, was designed to provide economic stimulus to sec ons of the economy which badly need d it, the surprise attack on numismatic ivestments caught the industry off guar l in both its scope and intent.

Basically, Se . 314(b) of the law amends a por ion of the Internal Revenue Code of 1954 by altering a prior determination th t coins placed in an individual retireme it account were not taxable until distrib ited. Under that determination, one-h f the cost of every coin placed into an i dividual retirement account or Keogh (sometimes known as H.R. 10) was ictually borne by the government in t e form of a retirement contribution.

Under the ne v rules, the initial and most obvious e ect is to force any individual seeking o use a collectible as an investment vehic e to pay their own way.

Strangely en igh, the law defines a collectible to me n "any work of art, any rug, or antique, any metal or gem, any stamp or coin (and) any alcoholic beverage," whic apparently means that the government is in mortal fear that a bottle of Thunderbird wine is being used for retirement plans.

Equally sinister, however, is a provision which adds that in addition to this list, "any other tangible personal property specified" by the Secretary of the Treasury may also be added.

To the neophyte, tangible personal property does not include real estate, but it *can* include just about anything else except money. Because of this, coins had to be specifically included in the definition of the new law if they were to be excluded from use in Keogh and individual retirement account plans.

The effective date of the new law is December 31, 1981, though not if a group of coin dealers, stamp dealers and gemologists have anything to say about it.

In a series of meetings held from coast to coast, leaders of the coin, stamp and gem industry, who have been hit hard by this, have agreed to take a concerted plan of action. *Continued on page 118*

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Part of this plan of action involves that the lobbying of Congress, always a difficult task at best, with the basic idea or game plan being to find a means of accommodation with the government's goal of making some alteration in individual retirement plan that are self-directed.

While leaders were tight-lipped about the exact nature of their plans, this much has been learned; one of two approaches is being considered. Either the technical amendments legislation that is designed to correct flaws in the tax bill will be utilized, or a separate legislative approach will be considered. In either event, the aim, plainly, is to alter the law before the effective date at the start of the next year.

Michael R. Haynes, President of Ivy Financial Corporation, was initially one of the spear-head leaders of the group, and took his denunciation of the "insidious legislation" to Washington where he personally lobbied the halls of Congress to first try and ascertain the reason for the alteration of existing policy, and secondly to try and find a satisfactory alternative.

From that Washington trip, Haynes deduced that the legislation which passed was enacted without hearings, or any formalized consideration. Rather, it was simply placed as part of Congressman James M. Shannon (D-Mass.) proposal for an alternative tax measure.

Apparently introduced at the behest of the thrift industry, which has been decimated by money market funds that pay substantially higher returns than their own savings account plans, even the backers of the proposal probably thought it stood little chance in the ordinary course of things. However, the climate under which the tax bill was passed significantly altered this, with one effect being that a number of political rules were simply thrown out the window.

In the waning hours of Congress before it went out for summer recess, not to return until Labor Day, the Tax Act was passed. It was a must-pass bill, having been wrangled over with Speaker Tip O'Neil (with whom Shannon is close) and a number of other partisan leaders. The problem focused in on the oil windfall profits tax and other highly controversial measures.

By the time the vote came, on Sunday in Senate during a rare weekend session, the legislators were simply too tired to fully analyze what was before them. In the House, which voted two days later, the furor which had arisen did cause some bewilderment, but not sufficient to entice the Congressmen not to pass the measure, but instead send it back to the Committee process.

That, in fact, was impossibly, something the sponsors knew in advance. Thus, even though a small amount of advance warning was had about the impending disastrous change, nothing could be done to stop the steam-roller effect that inevitably resulted

Interestingly, in the aftermath, a number of so-called tax experts argued that the impact on the savings and thrift

[illegible] in any event, it was foolish for a collector or an investor to utilize coins in a rare coin retirement plan because it did not acually maximize revenue.

"It's dumb," was what one accountant was quoted on the front page of a *Wall Street Journal* article analyzing the situation, when referring to people placing rare coins and stamps in Keogh and retirement accounts. His argument is that it was better to place the money into a certificate yielding a fixed sum identifiable over the period of time. He cited an example that at a 20% fixed yield, assuming the same appreciation for coins and stamps, the loss of a capital gain treatment within pension plan creates a substantial disparity.

What this ignores, however, is that coins over the course of the last 20 years have increased in value at a substantially higher rate than 20% per annum, in some cases approaching rates of 50% or more Thus, even if capital gains treatment is denied, and ordinary income is taxed, the clear beneficiary is the collector and the user.

But those who offer opposition to this, and this includes people such as Senator Jesse Helms, (R-North Carolina), Steve Syms (R-Idaho), and others, argue that the government is simply intruding into a freedom of choice issue—how a person can plan for their retirement

Increasingly, as it becomes clear that Social Security will not be able to effectively assist a person in their retirement plans because of the ravages of inflation, and diminishing reserves, other attractive alternatives must be looked at.

Increasingly, rare coins have acted as such an alternative.

Interestingly enough, the 1982 edition of the *Guidebook of United States Coins* (commonly known as the Redbook) analyzes the use of Keogh and individual retirement accounts with rare coins. Assuming that a $7,500 contribution was made over a period of 25 years, the average individual would have put $187,500 into a collection. If coins increased at a rate of just 13% compounded, at the end of that 25-year period of time, (which a 35-year-old person could start and conclude by his 60th birthday), over 1.3 million dollars would be realized. This could then be withdrawn over a period of 10 years or more in addition to any interest that could be earned on the proceeds for a very comfortable retirement plan.

In the coming weeks, it seems obvious and likely that an attack will be directly mounted on Congess in order to alter the December 31 effective date. One possibility is that the date may be postponed so that actual hearings can be held; they have been promised by Senator Chafee, of Rhode Island, who heads up the Pension Sub-Committee in the Senate.

But another possibility, perhaps more exciting, is that the thrift industries will become victims of their own tactic—with a rider placed onto a must-pass bill that totally repeals the insidious provision.

Like all machinations on Capitol Hill, this one will largely be fought in private, though afterwards the commentators will analyze it and remark in wonderment about how strange our American political system actually is.

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Coin dealers join hands in battle against Reagan tax law provision

By David L. Ganz
Special Correspondent

Representatives from the coin, stamp, art, diamond and hard-asset industries, each of which is affected by the Economic Recovery Act of 1981 signed into law by President Reagan Aug. 13, are meeting across the nation in an attempt to formulate a concerted plan of action.

Under the terms of the law, effective Jan.1, 1982, coins and other collectibles acquired by self-directed pension plans known as individual retirement accounts (IRAs) and Keoghs would be taxed into oblivion, preventing for all practical purposes their use in retirement planning.

[illegible] in New York City on Aug. [illegible] for the purpose of trying to chart a course of action that will unite all of the interest toward a common goal of effectively dealing with what could be a crippling blow to coins in particular and the collectibles field in general.

Under the aegis of divergent interests from many different collectible fields, a group of industry leaders and interested representatives met at the offices of Alexander Hassenfield in New York City and formed an entity bearing the name of Committee for Financial Freedom, whose purpose is to permit individuals to invest their retirement assets in the manner that they, and not the government or any savings bank, deem prudent.

Invitations went out to a variety of industries, and representatives from a cross-section attended. The coin, [illegible] field were in attendance. No list of those in attendance was released for publication.

Later that same day, Aug. 11, a group exclusively of stamp dealers and investors met at the offices of Scott & Co. in the Harmer-Rooke building in New York City. Neil S. B[illegible] of the Howard Ruff organization and Howard Segermark, legislative assistant to Sen. Jesse Helms, b[illegible] of whom attended the earlier meeting, were among the speakers.

They revealed at this meeting, which the press had been invited to attend, that two different types of lobbying efforts on behalf of the elimination or repeal or [illegible]

Each is regulated by law, they explained.

Segermark noted that the original language was added almost "as a coup" but predicted that another offensive provision which would eliminate the capital gains treatment of coins and other collectibles, was "probably dead in the water" for the time being.

Also revealed by Blair was that the Treasury Department apparently backs the proposal, arguing that "productive assets" for society as a whole were being denied by purchases of collectibles.

[illegible] coin dealer in attendance, explaining the obvious multiplier effect that comes from coin purchases. The monies or proceeds are utilized by the buyer in the community, and by the seller as well, he argued.

Meanwhile, on Aug. 13, a meeting of coin dealers took place in Chicago for the purposes of trying to unite the industry behind a single front. Professional Numismatic Guild President Gary Sturtridge flew from Kansas to the meeting, joining Ed Milas, PNG vice president, in Chicago.

The scope of the problem has cut a broad swarth throughout the industry, as Michael Haynes of the Ivy organization, and Lee Bellasario of New England Rare Coins, together with the Professional Numismatists Guild, and other individuals and firms, have joined forces to try and offer a united voice for change.

What will occur in the coming weeks remains [illegible] but with Congress expected back in session at Sept. 9, it can be anticipated that shortly [illegible] an offensive will be mounted. The stakes are high but the collectible industry as a whole remains optimistic.

"It may be a long hard fight," said one representative, "but we're willing to go to the wall on this one. It's an important issue that goes beyond coins, stamps or other items. It's a livelihood, and the right for [illegible]

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ple to determine how they can save for their retirement," perhaps the broadest philosophical base of all.

The Reagan tax law alters the current tax law significantly, for under present requirements, an individual has the right to determine the manner and type of investment made for retirement planning. The main limitation at present is dollar amount — basically 15 percent of income, to a cap of $1,500 for IRAs, and $7,500 per year for Keoghs. These limits also will change under the new law.

Until Dec. 31 (when the old law expires, and the new law replaces it), each time that an IRA or Keogh plan acquires a collectible, the owner is entitled to take a tax deduction for the full value of the acquisition, up to the income limits provided for.

The practical effect of this is to reduce the amount of tax that a person has to pay to the government, and also to defer until retirement the gains that the asset makes. Distribution of the plans at any time after age 59½ is permitted, and gains are taxed as ordinary income.

What the new law does is to change this significantly. Instead of prohibiting investment of retirement funds in collectibles, which some legal scholars believe would be unconstitutional, and discriminatory, they have elevated them to a new level of taxation.

Acquisition of collectibles (defined in the law as any work of art, rug, antique, metal or gem, stamp or coin, alcoholic beverage or other item specified by the Treasury Secretary) is not prohibited by the IRA or Keogh.

Instead, the acquisition is merely taxed into oblivion, for the purchase from Keogh or IRA funds is treated as a distribution. That means that the purchase price is not deducted from current income. Instead, it is taxed at current levels.

Also significantly, a penalty is attached for a premature distribution, which the law prohibits in plans before the applicant attains the age of 59½. At present time, the penalty is 10 percent, and itself is not a tax deduction.

The idea of utilizing taxation to achieve a governmental goal is not new to the numismatic field. The reason that National Bank notes no longer are printed is that the government imposed a tax on their issuance, while no tax was imposed for Federal Reserve or United States notes.

In recent years, a number of coin collectors, as well as collectors of other hard assets, have utilized their expertise to assist in their retirement planning. The means has been acquisition of collectibles — coins, stamps, art, diamonds, antiques, and other items — placed into a long-term pension plan.

For the collectors, this was an almost ideal world. The government subsidized the acquisition in the form of a tax deduction, and by using the "upgrading" or "swapping" provisions of Internal Revenue Code, Section 1031, a constant "rollover" was possible.

Competing with collectibles, of course, are stocks and bonds, and also savings banks and money market funds — which pay a fixed rate of interest for a predetermined period of time.

According to data collected by knowledgeable people in the coin industry, most of the funds which have gone into Keogh and IRAs utilizing rare coins have previously come from the money market funds, which have yields of 15 percent and higher.

Interestingly, however, it appears that the savings banks and savings and loan associations were behind the push to eliminate collectibles from Keoghs and IRAs. The same force is believed to have spent $3 million to successfully lobby Congress to pass an "all savers" certificate, offering a tax-free yield to compete with other rates in the marketplace.

If industries affected by the change were slow to mobilize initially, they have since moved with alacrity. Telephone lines have buzzed, and lights burned late, in trying to formulate a plan of action that various affected groups could rally around.

Two strategies appear to be emerging, each of them obviously from the legislative history under which the Economic Recovery Act of 1981 was enacted, and the provision termed "obnoxious" by several industry leaders born.

The first strategy can be gleamed from the *Congressional Record* colloquoy between Senators Jesse Helms, R-N.C. and John Chafee, R-R.I., on Aug. 3, just prior to passage of the tax bill.

Helms inquired of Chafee whether the full Senate, or the Subcommittee on Savings, Pensions and Investment policy had ever considered the elimination of collectibles in Keoghs and IRAs. Chafee, of course, replied in the negative.

Chafee then promised to promptly hold hearings on the issue if Helms were to introduce legislation designed to permit the continuance of coins and other collectibles in IRAs and Keogh accounts.

Even before the hearing issue is dealt with, there remains another possibility. In its haste to pass a tax law, Congress did make a number of other mistakes, errors, and even typographical embarrassments. Here, many believe members of Congress were not even aware of the provision or its effect.

This is common in a situation where expeditious passage is the goal. The time frame was so tight for initial passage that when Michael Haynes of Ivy [illegible] and Donald Kagin of Kagin's tried initially to obtain copies of the text language prior to passage, Senate Finance committee staffers were unable to offer more than hand-lettered summaries, not the actual text.

The resolution of these errors historically has come in the form of a technical corrections act, which will likely be enacted before the actual tax bill becomes law Dec. 31.

If the past offers any lesson, the technical corrections legislation for the Tax Reform Act of 1976, and others, often went to substantive change — usually as a result of lobbying groups' efforts. So that affords another option now being explored.

The controversial provision of the Economic Recovery Tax Act has stirred up a hornet's nest of opposition from many individuals and political and financial factions. Criticism of Section 314(b) appears to be cutting across ideological boundaries as spokespersons for various groups attack the new law.

Rep. Larry P. McDonald, D-Ga., attacked the plan on the floor of the House of Representatives before votes were taken, stating that the provision "will drastically alter the basic concept of Individual Retirement Accounts and other types of individual retirement plans."

Continuing, Rep. McDonald said "Section 314(b) will

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impose a prohibitive penalty on those individuals who seek a hedge against rampaging inflation by investing in tangible assests. By this provision, we are in essence establishing a national economic policy with regard to retirement plans whereby only intangible assets (paper) are to be considered as a proper form of investment by those who are working and who are making investments and attempting to plan for their retirement."

McDonald wondered aloud whether this was the intention of Congress, because "regardless of our intent, this will be the effect of our actions. In a fluctuating economy, can we say with certainty that one form of investment, tangible or intangible, is acceptable while the other is not?

"Section 314(b) is contrary to the basic principle under which Congress enacted legislation creating IRAs and other types of individual retirement plans. Is it now our intention to renounce that principle and declare that the individual is incompetent to invest the money that he or she has earned and that Congress will direct such investments? What is to become of the concept of freedom of choice and its basic tenet that the individual is the best judge of his own personal affairs?" he asked.

"In no uncertain terms," Rep. McDonald added, "Section 314(b) deprives our citizens of that basic freedom of choice, to self direct their investment dollars."

McDonald had a ray of hope for investors upset at having that freedom of choice taken from them.

"In the near future," he noted, "legislation will be introduced to correct the unfortunate provision that we are voting on today."

Reaction to the provision by the various investment factions has been mixed, according to *Washington Post* staff writer Nancy L. Ross. According to Ross, not all investment counselors are unhappy with the new law. Steven Lash of Christie's, New York City auction house, said "We have never felt that art as an investment was a very good idea."

However, few others in the investments field have taken the side of the congressmen who voted approval of the tax provision. Ross quotes Michael Freedman, president of G[illegible]stone Trading Corp., a New York diamond brokerage, as calling the move "outrageous." Ross writes that Freedman "and other dealers plan a 'vigorous resistance' against what they see as 'a blatant grab by the banking industry to prevent investors from determining where they'd like to put their funds. It's a negative approach to (the industry's) inadequacies.'"

Howard Ruff, a nationally known investments writer, told Ross "This administration and Congress have violated a free-market principle that has nothing to do with tax-cutting."

Members of the South Carolina Libertarian party have joined the fight against the new regulation, adding their voices to the quickly growing groundswell of angry non-supporters of the bill.

"No man's life, liberty or property are safe while the legislature is in session," writes Tom Waldenfels, chairman of the South Carolina political party, "but it is unusual for Congress to attack all three in one act, as they have in forbidding hard asset retirement investments."

Waldenfels said that the provision in the tax reform act just passed would "deprive most American citizens of the right to provide for their old age by investing their money in assets that would have some protection for them against the inflation that the government is causing."

The South Carolina politician plans to go to Washington with the National Committee for Monetary Reform "to petition for redress of grievance."

An investment counselor, Waldenfels said "Either Congress does not know what it is doing or it is trying to reduce older Americans to a state of complete dependency on government handouts by confiscating their savings through high taxes and inflation, as it has been doing for almost 50 years."

Rafael G. Guber, director of investor educational services for New England Rare Coin Galleries, a Bos-

Continued from page 14

ton-based numismatic firm, said recently that "If savings and loans believe that this legislation will have a material effect on their current financial straits, then they have been subjected to a cruel hoax."

Guber notes that "The beauty of a collectible investment is precisely that government influence over its value is limited. The government may stop a merger or control the money supply, but it cannot set a value for an 1804 silver dollar or a flawless one karat diamond. Collectibles are one of the truly free markets left, and the investor should not be penalized for protecting himself by participating in it."

Senator SYMMS. Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, I just want to thank these gentlemen. I know everyone wants to be off.

Mr. BRAVIN. Thank you, Senator.

Senator MOYNIHAN. I would like to make two points, if I can. The first is that the IRA tax provisions were created to provide for retirement. They were not created in order to increase the liquidity of mutual savings institutions or the volume of the American Stock Exchange or anything external to the retirement purposes of individuals for individual retirement.

And it misuses those purposes when Treasury comes down and says you can always do this other thing that has socially redeemable value.

The other point is to say that with respect to savings, the collections that these gentlemen represent are part of retirement. At time of death, they are almost always liquidated. And finally the Treasury gets theirs.

To my mind, I have to note that I am not afraid of Government. But there are things people are entitled to do for themselves, which is among others, to arrange for their retirement as they see fit.

Mr. BLUMERT. Hear-hear.

Senator SYMMS. Thank you very much, Senator Moynihan. I want to thank all of you.

And I might just say I don't have too much confidence in Government. I might just note for the record that the right hand of the Government is trying to sell silver out of the national stockpile, and the left hand of the Government is telling an individual American that you can't buy it and put it in your retirement account. In the meantime, in my State in Idaho, we've had a loss of over 3,000 jobs in the past 6 months. Unemployment will rapidly increase when Bunker Hill is finally closed and shut down. It will mean that 25 percent of the lead, zinc, and silver smelting industry in this country will be closing. And yet, we have a Government policy that is antifair market value for the price of silver which is instrumental in whether or not my State survives.

In addition to it being against the individual American, it also has a repercussion that affects the lives of men and women who live and work in the United States because there is a policy coming out of Washington that seems to be against a certain segment of production in this country. In this case, the production of silver. When we should be encouraging the production of it, we are discouraging it.

Mr. MOYNIHAN. I had a lot of suspicions about this administration and you are confirming. [Laughter.]

Senator SYMMS. Well, I would have to say, Senator, this is inconsistent with the past administrations too. [Laughter.]

Thank you very much.

[Whereupon, at 12:32 p.m., the hearing was adjourned.]

[By the direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT OF

U.S. SENATOR WILLIAM V. ROTH, JR.

BEFORE THE SUBCOMMITTEE ON INTERNATIONAL TRADE

SENATE COMMITTEE ON FINANCE

I wish to thank the Chairman, Senator Danforth, for convening this most important hearing on the operation of the Trade Adjustment Assistance (TAA) program.

The TAA plan was created by Congress in the Trade Expansion Act of 1962, in recognition that a liberal national trade policy -- while providing important benefits to the country as a whole -- also imposes disproportionate burdens on workers, firms and communities confronted by increased import competition. The program was originally targeted to provide financial and technical assistance enabling those adversely affected to adjust to such increased import competition. In this way, Congress reasoned, the country as a whole would benefit from more productive employment, greater overall job stability and more competitive businesses.

The reasons for Congress' original support for Trade Adjustment are still valid today. Past experience has shown us that much of labor's support for the trade-liberalizing acts of government has been based on the availability of a program that will give them a back-up when markets for their goods are temporarily or permanently taken over by increasing imports.

For example, we could not have achieved widespread domestic acceptance of the tariff and nontariff barrier-reducing agreements reached by U.S. officials in the 1975-1979 Multilateral Trade Negotiations had it not been for the existence of TAA. We will need that support throughout future trade discussions and negotiations, as well.

Trade-related unemployment problems do not promise to disappear over the near term. Our automotive industry, for example, is facing 30 percent domestic market penetration by Japanese producers this year, and further worker layoffs are projected due to necessary production cutbacks. Many of these workers will rely on Trade Readjustment Allowances to tide them over.

Last spring, during Senate consideration of President Reagan's recommended revisions in the TAA program, I argued strongly that the eligibility criteria included in those revisions were especially restrictive and would only serve to cut back substantially payment to those workers who rightly deserve compensation. Moreover, workers who are deemed ineligible to receive TAA payments would also be denied the retraining opportunities for which many of us have fought long and hard during recent Senate deliberations on the Continuing Resolution.

Due to my efforts and those of many of my colleagues on the Finance Committee, Congress agreed to a six-month delay in enactment of changes in the eligibility criterion from the present "contribute importantly" to the Administration-proposed "substantial cause". I believe now is the time to cast in stone the concept that, in cases where increasing imports contribute importantly to total or partial separation from employment, displaced workers should be eligible to receive Trade Readjustment Allowances and any training money available.

For this reason, I was happy to support legislation introduced by the Chairman of this Subcommittee to allow eligibility standards included in the 1974 Trade Act to remain in effect for the duration of the present TAA program.

I hope today's hearing will help build a record of support for this legislation (S. 1865) and will reinforce in everyone's mind the importance of maintaining a viable, usable and forward-looking adjustment assistance program.

One Liberty Plaza 165 Broadway New York New York 10080 212 637-5654

Merrill Lynch
Pierce
Fenner & Smith Inc.

Daniel P. Tully
Executive Vice President
Director

December 21, 1981

Committee on Finance
U.S. Senate
Subcommittee on Savings, Pensions
and Investment Policy
2227 Dirksen Senate Office Building
Washington, D. C. 20510

Gentlemen:

We would appreciate having the following statement included in the record of the December 4th hearings on savings and retirement bills.

Merrill Lynch supports an amendment to the Economic Recovery Tax Act of 1981 which would permit the purchase of gold and silver in an Individual Retirement Account or a Keogh Account. We believe that this is desirable for the following reasons.

1) Gold and silver are bona fide investments which can provide useful diversification in a balanced portfolio for long-term investment and can also be a hedge against inflation. These are important objectives for retirement accounts.

2) Gold and silver can be distinguished from other forms of collectibles by the ready availability of prices on recognized exchanges, liquid secondary markets, recognized custodians and precise bookkeeping records which lend themselves to disclosure and identification for tax purposes.

3) No convincing reason has been advanced why gold and silver should be excluded from the range of investment products available to persons seeking to accumlate capital for their retirement years.

I Gold and Silver as a Legitimate Investment

John A. Chapoton, the Assistant Secretary of the Treasury, in his testimony before this Subcommittee on December 4th, identified gold and silver as luxury items. This may be true when they are fashioned into jewelry, but it most emphatically is not true of gold, gold bullion coins and silver bullion which are purchased and sold by banks, brokers and other financial institutions for investment purposes. The price of gold is established daily both at the London Gold Fixing and in transactions in futures on registered commodity exchanges and published in financial publications and other communications media. Gold and silver trade in worldwide over-the-counter markets that operate virtually 24 hours a day. Investors can hold their metal with various reputable custodians. At Merrill Lynch, for example, a position in precious metals is shown on a customer statement in generally the same manner as a position in stocks, bonds, options or any other investment purchase through our Company. We are attaching as Exhibit A typical monthly statements which show how a position would be recorded and priced.

It should point out that the Department of Labor, the regulatory body that governs ERISA plans, stated in July 23, 1979 release regulations (44 Fed. Reg. 37221) that is was not appropriate for it to establish a list of permitted investments for ERISA covered plans. This position thus places on the Fiduciary the burden of determining whether or not an investment vehicle was appropriate for an ERISA covered plan. The DOL specifically refused to adopt rules that would specify appropriate investments that might be permissible under the Prudence Rule. It stated that "No such list could be complete; moreover the Department does not intend to create or suggest a legal list of investment for plan fiduciaries." We believe that the DOL's position was consistent with Congressional intent and good public policy. Accordingly, we suggest that the recent imposition of a "legal list" of investment vehicles for an IRA or Keogh account is inappropriate.

The Committee undoubtedly is aware that the State of Alaska, for one, has included gold as one of its investments in its pension fund for public employees.

II Controls for Tax Purposes

Secretary Chapoton in his testimony discussed the serious enforcement problems which would be faced by the IRS if retirement accounts are permitted to invest in so-called collectibles or even consumable items. These problems do not exist for purchases of gold and silver bullion. Custody of the bullion is maintained by fully insured third party banks. The amount, purchase date and value of the metal upon purchase, sale or withdrawal are recorded on statements and a Form 1099 is provided to the IRS by the Custodian at year end and upon withdrawal. The enforcement problems for the IRS are no different than they are for securities in an IRA or Keogh account. The liquid secondary market and daily pricing are matter of public record and will assure proper evaluation when taxes are due.

III No Reason Shown to Exclude Gold or Silver

First, it should be noted that one of the purposes of establishing an IRA was to permit a citizen to establish a fund for his retirement and manage it in anyway he saw fit. We do not believe it is the proper function of Government to dictate to an individual the form his investment should take. We can appreciate that some forms of investment may be difficult, if not impossible, for the IRS to police to be sure that they are genuine investments and not simply tax avoidance schemes. As we indicated above, however, that problem does not exist when the purchase of gold and silver bullion is concerned. Second, Secretary Chapoton indicated that because withdrawals from retirement accounts are subject to ordinary income tax rates, an individual with a large capital gain might be better off purchasing that asset outside of the retirement account. A self directed retirement account provides an individual with maximum flexibility in choosing his investments and in choosing the proper time to switch his investments from one vehicle to another. Economic conditions will surely differ at different times during the years that a retirement account may be in effect. It may be prudent for an investor to have his holdings in high yielding bonds or money market funds during one period, growth stocks during another period, or in gold and silver during a period when inflation appears to be accelerating.

An individual may choose to diversify his portfolio by having a combination of the above alternatives simultaneouly or he may choose to switch frequently as the economic winds blow. The objective would be to maximize the amount available to him at retirement and whether that amount is made up of dividends, interest, capital appreciation or a combination of the three is certainly a secondary consideration.

A rigorous 60-month test (ending June 1980) of gold for volatility and performance was conducted by economist Eugene J. Sherman of The International Gold Corporation Ltd. and published in October, 1980. A copy of his report is attached. Mr. Sherman concluded that "gold provides an escape from the U.S. financial environment -- short-term rates, stock," that "the price of gold is less volatile than are the prices for stocks and bonds," and that "it gives somewhat greater rewards for good market timing." In other words, gold has tended since it began trading freely to move independently of the price of financial assets. This evidence, confirmed by other independent research, suggests that it serves as an important "portfolio hedge." This underscores that fact that gold can be instrumental in diversifying a portfolio that is primarily constituted of equity and fixed income paper assets.

For all of these reasons, we believe that it is in the interest of the investing public to have the opportunity to purchase gold and silver in retirement accounts and we urge this Subcommittee to support legislation to accomplish that purpose.

Very truly yours,

DPT:jb

Attachments

Merrill Lynch Pierce Fenner & Smith Inc.
Member Securities Investor Protection Corporation SIPC

Statement of Security Account

ACCOUNT #	A/E #	PAGE #	SS OR ID	TELEPHONE #
		1		212-637-1212

OFFICE SERVING YOUR ACCOUNT	ACCOUNT EXECUTIVE
PO BOX 618 WALL ST STA NEW YORK NY 10005	

PERIOD STARTING	PERIOD ENDING	TYPE	BUYING POWER
AUG 29 1981	SEP 25 1981	CASH	

OPENING BALANCE	CLOSING BALANCE	MARKET VALUE
$5000.00CR	$.00	$5823

A

11372

DATE	TRANSACTION	DESCRIPTION	PRICE	AMOUNT
08 28	OPENING BALANCE			$5000.00CR
		*****PURCHASES, SALES AND OTHER TRANSACTIONS*****		
08 31	FUND DELIVERY	5000 ML READY ASSET TRUST		
08 31	BOUGHT	5000 ML READY ASSET TRUST	1	$5000.00
09 17	BOUGHT	11 CDN MAPLELEAF 1980 $12.98 HNDLNG FEE ADDED	472	$5282.86
09 18	RECEIVED	4283 ML READY ASSET TRUST		
09 18	SOLD	4283 ML READY ASSET TRUST	1	$4283.00CR
		SUB-TOTAL		$5999.86
		*****FUNDS RECEIVED, WITHDRAWALS AND CHARGES*****		
09 15	FUNDS RECEIVED	FUNDS RECEIVED		$1000.00CR
09 18	JOURNAL ENTRY	TRF FRM REG 17395117		$4282.86CR
09 21	JOURNAL ENTRY	TRF TO REG 17395117		$4283.00
		SUB-TOTAL		$999.86CR
09 25	CLOSING BALANCE			$.00

SECURITY POSITIONS IN YOUR ACCOUNT		PRICE OF 09 25	MARKET VALUE	ANL % YIELD	EST. INCOME
11	CDN MAPLELEAF 1980	460.000	$5060		
763	READY ASSET TRUST	1.000	$763		
TOTAL MARKET VALUE OF PRICED SECURITIES			$5823		

FOR AN EXPLANATION OF SYMBOLS PLEASE SEE REVERSE SIDE
PLEASE ADVISE YOUR ACCOUNT EXECUTIVE IMMEDIATELY OF ANY DISCREPANCIES ON YOUR STATEMENT OR IF YOU CONTEMPLATE CHANGING YOUR ADDRESS
WHEN MAKING INQUIRIES PLEASE MENTION YOUR ACCOUNT NUMBER AND ADDRESS ALL CORRESPONDENCE TO THE OFFICE SERVICING YOUR ACCOUNT
WE URGE YOU TO PRESERVE THIS STATEMENT FOR USE IN PREPARING INCOME TAX RETURNS

09 25 1981 173 95117

S P E C I M E N

Merrill Lynch
Pierce Fenner & Smith Inc.
Member Securities Investor Protection Corporation SIPC

Statement of Security Account

ACCOUNT #	A/E #	PAGE #	SS OR ID	TELEPHONE #
	6702	1		212-637-1212

OFFICE SERVING YOUR ACCOUNT	ACCOUNT EXECUTIVE
PO BOX 618 WALL ST STA NEW YORK NY 10005	

PERIOD STARTING	PERIOD ENDING	TYPE	BUYING POWER
MAY 30 1981	JUN 26 1981	CASH	

OPENING BALANCE	CLOSING BALANCE	MARKET VALUE
$.00	$.00	$10000

A

07387

SECURITY POSITIONS IN YOUR ACCOUNT	PRICE OF 06 26	MARKET VALUE	ANL % YIELD	EST. INCOME
1 SILVER 1000 OZ 999	10.680	$10000		
TOTAL MARKET VALUE OF PRICED SECURITIES		$10000		

YOUR STATEMENT ENCLOSURE CONTAINS AN IMPORTANT NOTICE REGARDING CUSTODIAL SERVICE FEES AND A RETURNABLE POST CARD IF WE DON'T HAVE YOUR CORRECT ADDRESS.

S P E C I M E N

91-209 O—82——23

STATEMENT

OF THE

AMERICAN BANKERS ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

COMMITTEE ON FINANCE

UNITED STATES SENATE

ON S. 1733

December 4, 1981

The American Bankers Association (ABA) is a trade association composed of more than 14,500 banks, over 90 percent of the nation's full service banks. Approximately 4,000 of these institutions are authorized to serve their customers as trustees and executors. The Association has a long involvement in the federal estate and gift tax area because of our member's experience in the planning and administration of customer's estates. We appreciate the opportunity to present our views on S. 1733, to provide for the use of declaratory judgments by the Tax Court on issues relating to the installment payments of estate tax, under Section 6166 of the Code.

Section 6166 provides for an extension of time for payment of estate taxes where the estate consists largely of an interest in a closely held business. Under current law any dispute which arises under Section 6166 cannot be resolved in a judicial forum because the Tax Court lacks jurisdictional basis to review the Internal Revenue Service's interpretation of Section 6166. As a result, the Service is the sole arbiter of Section 6166 disputes. The ABA believes this result is undesirable and supports S. 1733 providing for a declaratory judgment procedure for resolving Section 6166 controversies.

Under present law, except in a few instances, judicial review of tax issues generally is available to taxpayers only where there is a dispute over the correctness of a tax assessment. Because the decision of the Internal Revenue Service to deny an election under Section 6166 or a decision to accelerate the remaining tax involves a dispute as to the timing of estate tax payments rather than the amount of tax, no deficiency is involved and, therefore, the decision is not subject to judicial review.

Over the past several years, Congress has demonstrated a willingness to provide the Tax Court with the power to issue declaratory judgments where the traditional remedies found in deficiency and refund proceedings were inadequate to protect taxpayers from erroneous Service action. This fact is evidenced by the Tax Court's current use of this power in the areas of employment retirement plans, tax exempt organizations, and the transfer of property from the United States under Section 367.

It is our belief that this power should be extended to include conflicts arising out of the applicability of Section 6166. Otherwise, taxpayers will not be afforded a fair and adequate remedy in the Tax Court from erroneous or arbitrary Service action.

Lastly, we note a similar provision was included in H.R. 4242 (the Economic Recovery Tax Act of 1981), as it passed the House of Representatives. Unfortunately the House-passed provision was deleted in conference from the bill that was finally enacted into law. This oversight should be corrected promptly.

We thank the Subcommittee for the opportunity to comment on this proposal.

BLANCHARD
James U. Blanchard & Co., Inc.

To: Senate Finance Committee

Enclosed within is testimony supporting the repeal of Section 314(b) of The Economic Recovery Act. This testimony was prepared by James U. Blanchard, III, Chairman of the National Committee for Monetary Reform and President of James U. Blanchard Company, Inc. (Biography Below)

James U. Blanchard, III

James Blanchard founded the National Committee for Monetary Reform in 1971 after he became convinced from his studies of free market economics that the United States was headed toward the inevitable destruction of the dollar. Recognizing that the primary means of protection against state-organized monetary destruction has always been gold, he organized the Committee to Legalize Gold-with its first aim the repeal of legislation which banned private ownership of gold in the U.S.A. Through a series of letters, the publication of the GOLD Newsletter and an ongoing "grass roots" organizational effort, the Committee to Legalize was successful in encouraging a national movement that led to gold legalizaiton in 1975.

Having achieved the first goal, NCMR has continued to strive for the establishment of a gold standard. NCMR actively supports such legislation as the successful legalization of gold-clause contracts.

The NCMR sponsored its first pro-free market economic conference in New Orleans in January of 1974. That conference attracted over 700 concerned investors, and has since grown to become internationally recognized as the largest and most important annual conference on free market economics and investment strategies in the world.

P.O. Box 314, Route 2 • Darby Bridge Road • Taylors, South Carolina 29687 • (800) 845-3970 • (803) 895-1300

Section 314(b) is an attack on one of our most important personal freedoms, the right to make our own investment decisions. The provision passed by Congress, without debate or hearings, requires that any investment by a self-directed retirement plan in collectibles be treated by the IRS as a distribution and taxable to the individual in the year purchased. This effectively prohibits the investment in collectibles by self-directed IRA, Keogh (HR-10), and corporate retirement plans.

This legislation is a gross injustice against the small investor who is trying to protect his assets against currency depreciation. The chart shown below clearly indicates that collectibles have far outperformed more traditional investments such as stocks and bonds over the past 5 and 10 years.

The Wall Street journal, Friday, June 19, 1981
PERFORMANCE OF TANGIBLE AND FINANCIAL INVESTMENTS
By Salomon Brothers

	10 yrs.	5 yrs.	1 yr.
Oil	30.8%	20.9%	14.3%
Gold	28	30.7	-13.9
U.S. Coins	27.1	29.7	- 8
U.S. Stamps	23.5	32.9	18
Silver	21.5	20.1	-26.6
Old Masters	15.4	16.8	22.9
Diamonds	14.5	16.9	0
Housing	10.3	11.6	8.1
Consumer Price Index	8.3	9.7	10
Stocks	5.8	9.8	25.3
Bonds	3.8	1.1	- 9.6

I believe that the working American with a retirement plan should be able to place some of his assets in a field which has established such a remarkable investment record.

Certain "special interest" groups have supported 314(b) because they have mistakenly concluded that collectibles represent major competition for available assets. The amount of retirment funds in collectibles is inconsequential as compared to money invested in money market funds, certificates of deposit, insurance products and other conventional types of investments.

The primary justification for 314(b) is the idea that money invested in collectibles does not benefit our nation's economy, .This is a gross distortion of economics. All collectibles are already owned by someone and a switch in ownership from one person to another or from an individual to a retirement plan does not reduce the net amount of productive capital available. Money received by firms dealing in collectibles flows through all levels of our local, state, and national economy. These firms buy services from all segments of the economy and pay out millions in salaries to employees. This is used to buy personal goods and services, invest in conventional and collectible investments, etc. The collectibles industry creates not only jobs. We are major customers for several service industries including advertising, telephone and direct mail services.

Another argument advanced in favor of 314(b) is the criticism that many retirement plan sponsors receive some special enjoyment or present use from IRA and Keogh collectible investments. This accusation is not supported by the facts.

Currently there are over 45 trust institutions which allow collectible investments in retirement plans. To my knowledge, all of these institutions require the storage of all collectible Keogh and IRA investments by the trust institution. Plan sponsors and individual plan participants do not have access to the collectible investments and no present use or enjoyment may take place.

I believe the confusion on this issue arises from the practice of one trust company in Massachusetts, home of Representative James Shannon, sponsor of 314(b). This trust institution received "special permission" from the Treasury Department to allow individual IRA and Keogh sponsors to maintain custody of of all investments both conventional and collectible. The institution received a charter directly from the Department of the Treasury and is not regulated by National Bank or state regulatory agencies like other trust institutions. This practice of allowing plan sponsors to hold collectibles is not practiced by other institutions and the Treasury must take responsibility for these actions because the IRS originally approved their plan documents and program.

The vast majority of retirement plans, sponsors, and trust institutions should not be punished due to an oversight of the Treasury Department. The abuses mentioned simply have not occurred on the scale implied by the proponents of 314(b) because normal trust practices prohibit those actions.

I see no justification for allowing section 314(b) to stand as law. This ill conceived provision was apparently written in haste by individuals with no working knowledge or understanding of retirement plans and included in the tax bill in the final few days before passage. No time was ever afforded for deliberation. In fact, based on our inquiries, very few in Congress even knew the provision was in the bill. I feel sure that if representatives of the collectibles industry, such as myself, had been given the opportunity to present the facts in this matter, 314(b) would have been withdrawn from the bill.

Thousands of people affected by this provision have felt cheated and outraged by the capriciousness of their government's action toward their life savings. Still, real hardship can be avoided by quick passage of remedial legislation. I commend Senator Chafee and the others on this committee for addressing this issue in these hearings. I am confident that you will decide in favor of overturning 314(b) and will recommend action towards that end.

The Municipal Court
SAN DIEGO JUDICIAL DISTRICT
COUNTY COURTHOUSE
220 W. BROADWAY
SAN DIEGO, CA 92101

CHAMBERS OF
MANUEL L. KUGLER
JUDGE

December 24, 1981

S. 1855 (Bentsen)
State Judicial Retirement Plans
[Internal Revenue Code §457(e)(1)

Legislation introduced by Senator Bentsen is aimed at correcting an inequity in present tax structure affecting judicial retirement compensation. I urge your committee to support this legislation in the U. S. Senate, and to give serious consideration to this statement which I am submitting as the California state representative of the National Conference of Special Court Judges Circuit Council.

Respectfully,

Manuel L. Kugler

MANUEL L. KUGLER
Judge

MLK:co

NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS

NEW YORK, N.Y. 10166

Cable Address
Savings, New York

WASHINGTON OFFICE
LOUIS H. NEVINS
Senior Vice President and Director
SUITE 200
1709 NEW YORK AVENUE, N.W.
WASHINGTON, D.C. 20006
TEL. 202: 785-8144

December 17, 1981

The Honorable John H. Chafee
Chairman
Subcommittee on Savings, Pensions
and Investment Policy
Committee on Finance
U. S. Senate
Washington, D.C. 20510

Re: Hearings on S. 1645 - December 4, 1981

Dear Mr. Chairman:

The National Association of Mutual Savings Banks takes this opportunity to comment on S. 1645, a bill which would allow funds in individual retirement accounts and other self-directed retirement savings plans to be used to purchase collectibles such as art, coins, antiques, and rare wines. We respectfully request that our comments be included in the record of the subcommittee's December 4, 1981 hearing on S. 1645.

NAMSB is the trade association for the nation's 450 mutual savings banks. Located in 17 states, savings banks are community-oriented mutual institutions without stockholders. In the areas where they are most heavily concentrated, savings banks are the dominant mortgage lenders as well as the largest holders of consumer savings among the various types of depository institutions. Total assets of mutual savings banks exceed $170 billion, two-thirds of which is represented by mortgage investments.

The savings bank industry was among the earliest supporters of legislation to extend the existing Individual Retirement Account (IRA) program into a broadly-based, tax-deferred provision which would encourage individuals to undertake additional long-term savings for retirement. We recognized that legislation to provide tax incentives for savings was vitally needed on many grounds: to correct the anti-saver bias of the tax code; to stimulate the nation's perilously low personal savings rate; and to strengthen battered, long-term capital markets. We believed then, and believe now, that the expanded retirement savings provided in the Economic Recovery Tax Act of 1981 will encourage increased investment and productivity growth in the economy and thereby contribute to the battle against inflation.

In this vein, we were supportive of Section 314(b) of the tax act. The effect of Section 314(b) is to prohibit the investment of any self-directed retirement fund into tangible assets such as coins, antiques, rugs, gems, and rare wines. S. 1645 would repeal this prohibition. The National Association is opposed to S. 1645. We believe the sounder public policy is to prohibit IRA investment in these so-called "collectibles." More specifically, we believe that S. 1645 should not be enacted for a number of reasons.

First, a major purpose in expanding the IRA program was to create an incentive for savings to increase the pool of investment capital and thereby hasten the nation's economic recovery. Such a goal can be best achieved through channelling the projected increase in IRA savings through banks, thrift institutions and other traditional media. A key component in the economic recovery plan is an increase in productivity. In many cases, increased productivity will require long-term investment in capital investments such as plants, equipment and new technology.

IRA-type savings are long term and are thus ideally suited for financing the long-term capital investment so necessary to reindustrialize our nation. Retirement savings are also suited for mortgage lending and thus IRA expansion will likely assist the beleaguered housing industry. In contrast, we would question the public policy implications of providing tax incentives to encourage Americans to place their long-term retirement savings in such non-productive investments as rare wines, oriental rugs and diamonds.

Another reason for barring investment in collectibles is the difficulty of enforcing prohibitions against current consumption. Although rules in existence at the time Section 314(b) was enacted barred the beneficiary of an IRA from obtaining any benefit from plan investments, such rules were not widely known. As a result, many taxpayers unknowingly violated the law. Moreover, the IRS found the rules extremely difficult to enforce. A prime example of the potential abuse is the taxpayer who uses his retirement account to buy paintings for his living room walls. Such cases are very difficult to uncover.

In addition, dealers and traders in tangible assets are generally not regulated. Thrift institutions, banks, securities firms, and insurance companies are all well-regulated and the value of investments made through such firms can be readily measured on a day-to-day basis. The same cannot be said for investments in collectibles. As detailed in a recent column in Newsweek (copy enclosed), the marketplace for collectibles is replete with exaggerations with respect to quality and price. In many cases, the prices quoted are derived from dealers' transaction prices and do not reflect the price that an investor would pay upon purchasing a collectible, or receive upon the sale of a collectible. Adding to the problem is the fact that collectibles are relatively illiquid and the market for resales may be very thin. Further marring the attractiveness of collectibles as a long-term savings vehicle is the presence of fakes and alterations. While we do not suggest that protection of those individuals who take advantage of the tax incentives provided by the IRA program is the priority governmental concern, we believe the safety and soundness of their investments is at least of some concern.

Given the very real difficulties in policing the marketplace and recognizing the substantial tax incentives associated with the IRA program, we believe that it is sound public policy to prohibit certain investments from qualifying under an IRA plan. Virtually every tax incentive seeks to influence spending decisions to some degree. Not all donations qualify for the charitable deduction. Not all business investments qualify for the investment tax credit. Government has a legitimate interest in restricting the types of investments which qualify for favorable tax treatment, and one very important interest is to assure that funds saved under the program are channelled into productive, job-creating, capital investments.

Finally, we question whether the investment of IRA funds in collectibles is even sensible tax planning in view of the fact that it deprives the taxpayer of capital gains treatment on any appreciation that might occur. In most cases, a taxpayer is far better off if tangible assets like collectibles are held outside of an IRA or other qualified account.

In conclusion, the National Association of Mutual Savings Banks believes that Section 314(b) was sound legislation and that S. 1645 should not be enacted.

Sincerely,

Louis H. Nevins
Senior Vice President and Director

Enclosure

The Sinking Rock Market

JANE BRYANT QUINN

Tangible investments are as tough to write about as they are to buy intelligently. A good number of people in the business exaggerate, with respect to quality and price. Stamps that have not traded recently are entered into a "stamp-price index" at the price someone thinks they *ought* to bring, without regard to current market conditions. A diamond salesman might flourish an index showing that diamond prices have never dropped—omitting the fact that those are the prices for uncut diamonds, set by the De Beers monopoly. High-grade polished stones have apparently dropped more than 50 percent from last year's highs.

The price quotes you normally see (including the quotes in this column) derive from dealers' transaction prices—sometimes called "wholesale" prices without actually being so. They may bear only a nodding acquaintance with the price that investors have to pay. If you wanted to buy a diamond, a stamp or a coin, you might be charged quite a bit more. If you wanted to sell, you might be offered less.

And then there's the fact that tangibles are unique. One stamp, one diamond, one rare coin may cost more, or less, than its look-alike fellows because of minute differences in physical condition. If your stamp has a hinge mark on the back, for example, it may not necessarily sell at the price quoted for an unhinged specimen.

"Perfect," of course, is a matter of judgment. When demand for rare coins was running high, dealers' vaults disgorged a lot of coins classified mint-state 65 (normally, the best available). But a coin dealer's eyesight improves as the market weakens. That same coin today might be classed as mint-state 63, and priced down.

Fortunes have been made in tangibles, by people who bought carefully, knew what they were doing, bided their time and got lucky. Over the past year and a half, however, their luck ran out. Prices for most tangible investments peaked in early 1980 and have been flat to awful ever since. Items favored by investors, rather than hobbyists and collectors, appear to have suffered the worst declines. A report from the war zones:

- **Diamonds:** Last January dealers started wondering whether 1-carat, D-flawless diamonds would drop below the "psychologically important" $50,000 barrier. They did. By March the dealer price was down to $44,000 and falling. By May the De Beers monopoly started holding top-grade rough diamonds off the market in a major effort to stabilize prices.

But even monopolies can't always have their way. De Beers may have helped the market to a weak rally (although dealers disagree on that point). But it soon fell back again, into steep decline. Dealers now quote D-flawless diamonds at $25,000 to $30,000 wholesale (which Bernard Cirlin, editor of PreciouStones Newsletter, translates into $36,000 to $37,000 for individual investors). It is hard, however, to buy at the low end of that range. Many dealers would rather hold on to their best stones, in hopes of another run-up in price.

> ***Fortunes have been made in stones and stamps by people who got lucky. Recently, their luck ran out.***

If you tried to sell an investment diamond during the recent embarrassment, you probably found no takers at anywhere near the published prices. On the downside, diamonds are notoriously illiquid.

In a miracle of bad timing, Thomson McKinnon Securities, Inc., raised $13 million last March for a trust invested in diamonds. Getting current information on this trust from Thomson McKinnon is like pulling teeth, and no wonder: from an opening value of $994.10, shares stood at $565.32 at the end of October, and that's an *estimated* value. Shares are sold like over-the-counter stock, for whatever price you can get.

Diamond prices, incidentally, belie the conventional wisdom that the best stones make the best investments. Top-grade diamonds gained tremendously in recent years, but also dropped tremendously in price. Some cheaper stones apparently suffered smaller declines. The fancies—like pink diamonds—still sell steadily to wealthy collectors and are holding up reasonably we

- **Colored Gems:** It's even harder to puz out a fair price for colored stones than it for diamonds. In January, wholesale pric for a 1-carat, color-4 ruby ranged fro $3,500 to $6,700, according to the Colle tor-Investor—the spread reflecting wh each dealer thinks of his particular ston and the extent of ruby fever in his selli area. But by any measure, says Sarabe Koethe, executive director of the Unit States Gemological Services, Inc., rubi emeralds and other colored gems are shar ly down in price.

Buying interest recently shifted to sen precious stones (now called "collecto stones" to make them sound better). Pric are up a bit for tsavorite, spinel and bl zoisite. But be warned that the colore stones market is shot through with frau An irradiated topaz or red tourmaline m shine like a star on the day you buy, but fa to colorlessness as the years go by.

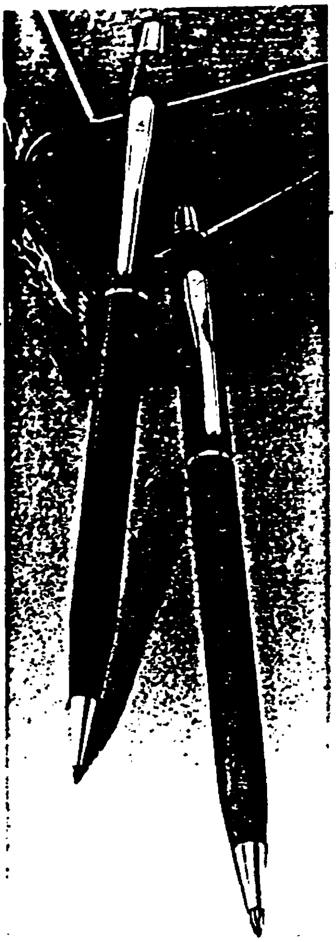
- **Stamps:** Gem people are money peopl but stamp people tend to be collecto Pleased as they are to see the value of the fine stamps rise, stamp collectors cann help but resent the many moneyed specul tors whose feverish buying, in recent yea made it so hard for hobbyists to assemb the key stamps they needed.

The investor is now having his com uppance and the hobbyist, his day.

Some of the stamps especially popul with investors have been plunging in valu As a good example, take the red-hot, thre stamp Graf Zeppelin set, which has broug as much as $12,000. Last February fine se went for around $5,000. Now they're dow to $2,100, and much less if you're trying sell instead of buy. Prices are also down f proof sets, foreign stamps and some oth interesting issues in sufficient supply to a tract avid traders.

(Scott's U.S. StampIndex, incidentall which is widely relied on by collectors, co tinues to show the Zepps at $5,500. "O editors didn't see fit to change the price f this stamp," said T. M. Kerrigan, an assis ant editor at Scott's Stamp Market Updat "The editors decided to hold to a fair pri and they see that as $5,500." You can s from this why it's often so hard to get a goo handle on tangibles' prices.)

But while investors are thinking of usi



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JANE BRYANT QUINN

their Zepps to mail a letter, serious collectors are bidding some nineteenth-century American classics to new highs. Many investors have become collectors, and as they reform, they put new price pressure on the dwindling number of truly fine stamps available in the world. Middle-range stamps are down in price—but so far, steady demand from hobbyists seems to be keeping them from falling too far.

Collectors make minute distinctions among stamps that baffle the casual investor. A perfect classic stamp today might bring twice the expected price, while one with a thin spot or a damaged perforation could drop to half its catalog value. Even the classic stamps, however, are likely to suffer in really hard times. In the 1975 recession, prices dropped on some top stamps that collectors thought would go up forever.

Investors trying to sell their collections are probably finding a lot of doctored stamps, even outright fakes. The supply-side theory of stamp investing says that when there aren't enough good stamps to go around, someone will supply them.

■ **Rare Coins:** Silver and gold coins followed the metals markets down. Rarities still bring excellent prices, but most coins now sell well below their 1979-80 peaks.

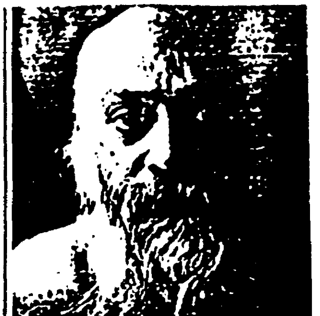
Past experience says that gem, stamp and rare-coin prices will rise again. Investors (especially those who bought at the top of the market) are practically cheering for another outburst of inflation, in hopes of being bailed out of their mistakes. But if interest rates stay relatively high and the economy low, the next upswing in tangibles could be a long time coming.

The 1981 Tax Act effectively throws new tangible investments out of Keogh plans and Individual Retirement Accounts. Starting Jan. 1, you may not use Keogh or IRA money to buy stamps, coins, gems, metals, rugs, antiques, works of art, alcoholic beverages or other tangibles that the IRS prohibits without landing in tax trouble. Such purchases will be treated as money withdrawn from the plan. You'll owe income taxes and, if you're under 59½, a 10 percent penalty for early withdrawal.

You may still buy tangibles for your IRA or Keogh before the end of the year. But if you subsequently sold those stamps or coins, you would not be able to use the proceeds to buy more tangibles. The new IRA and Keogh rules would limit you to more conventional investments.

Dealers in tangibles hope to undo the law. But even if they succeed, stamps, coins and gems may not belong in an IRA or Keogh. Money withdrawn from such a plan is generally taxed as ordinary income, including the profits on tangible investments. When those same tangibles are held personally, profits are taxed as capital gains.

Associate VIRGINIA WILSON



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TO: Senate Finance Committee

Enclosed within is testimony supporting the repeal of Section 314(b) of The Economic Recovery Act. This testimony was prepared by Ronald O. Holland, President of Retirement Consultants, Inc. (Biography Below)

Ron Holland

President of Retirement Consultants, Inc., a National Retirement Consulting firm providing flexible retirement planning services that utilize a wide range of alternative and conventional investments. Also serves as Director of James U. Blanchard & Co., Inc./Retirement Division.

Formerly a Bank Vice President and Trust Officer in charge of a Greenville, S.C., trust department. Ron established one of the first hard asset retirement programs in the United States.

Ron has written articles discussing hard assets and retirement planning for Precious Stones Newsletter, GOLD Newsletter, and Market Alert. He has been a speaker or conducted workshops at the National Committee for Monetary Reform Annual Convention in New Orleans. He has been quoted in Wall Street Journal, Business Week, Newsweek, Trusts & Estates, Money Magazine, Fortune, etc.

I am very much concerned about the implications of Section 314(b) of The Economic Recovery Act, should it remain in effect. The most serious consequence of this legislation is the sacrifice of the freedom to choose how personal retirement funds are to be invested. 314(b) will have the effect of limiting retirement plan investments only to those products which have failed to even keep up with the rate of inflation during recent years.

I was a Vice President/Trust Officer and trust department manager for First Citizens Bank in South Carolina for seven years. I became very discouraged by the investment performance of the retirement plans we administered and invested. Therefore, I began one of the first self-directed collectibles retirement programs and saw first-hand how clients in 1979, investing only a small portion of their retirement funds in collectibles, far outperformed both the bank's and other conventional retirement plan investments. For 1979, our clients, who had invested in collectibles, averaged on an annualized basis in excess of a 90% return. Of course, this is not to be expected every year but the long term appreciation history of collectibles is clear and well documented.

Conventional retirement plans have not kept up with inflation, not preserved purchasing power, and have failed to produce real retirement security. This is in contrast to retirement plans that have diversified a portion of plan investments into collectibles. These plans have, by and large, earned a rate of return far in excess of inflation. Real retirement security has been the end result, not paper profits and real losses.

If you compare the return earned by investors in savings accounts, stocks, bonds, and insurance products since IRA's were established and Keogh's were liberalized by the Employee Retirement Income Security Act of 1974, (ERISA), you will discover that most of those participating in conventional investments would have been better off if they had never opened a retirement plan. If plan return and investment performance were adjusted for inflation, almost every plan would show real losses in purchasing power.

This attempt to suspend the right to make our own investment choices was made without hearings and debate on the pretext of stimulating savings in order to promote capital formation and so called "productive" investments. I believe Senator Bradley from New Jersey put it best in his letter to me dated November 12, 1981, when he said the reason for the act was to, "...Boost capital formation and productive investment. Facilitating retirement savings was only a secondary goal of the legislation."

Capital formation is important. I understand the problem disintermediation poses to the banking and savings industry. I agree that there is a serious need to encourage capital formation in this country. Preserving the financial integrity of our financial institutions and stimulating capital formation must be a top priority of government policy during the 1980's, but this will not be accomplished by prohibiting the purchase of collectibles.

The passage of a law discriminating against collectibles is nothing but another bandaid response to a symptom of inflation. It ignores the root cause. Only a tiny fraction of retirement plan funds are invested in hard assets, not enough to make any real difference in the ability of financial institutions to raise capital. A better and much more equitable solution would be for the government to get its house in order by controlling spending and the creation of dollars, thereby attacking the real culprit, inflation. Government financed inflation is the real cause of a lack of capital formation in this country. How can businesses and potential consumers afford to borrow, when they have been crowded out of the credit markets by the massive debt requirements of government?

In addition, I believe it is wrong to classify collectibles as nonproductive assets. The money invested in collectibles does not somehow magically disappear. It continues to flow throughout the economy. The dealer or company that sells the collectible investment to the retirement plan in turn invests the money received in advertising, equipment, offices, salaries, etc. The funds paid out to clerical staff, salesman, management, etc. is used to buy homes, invest in savings accounts, the stock market, and even government securities, another investment which could be termed "nonproductive", as those funds are drained from the pool of available capital.

In summary, I've seen no real evidence that collectibles fail to contribute to the economy of this nation. In fact, collectibles and other alternative investments are a growing part of the investment market and they, together with conventional investments, help to provide the investment diversification so necessary in our economy today. The only real difference between collectibles and conventional investments is collectibles have a proven track record of outperforming inflation while conventional investments have not.

The only real reason to ever participate in a retirement plan is to preserve one's purchasing power until retirement years, so that at that time the individual can be financially secure and live the enjoyable and well-deserved lifestyle he or she has looked forward to. This is not the time to take away the right of the individual to invest in collectibles when working Americans are faced with high inflation rates, growing taxation, and the deterioration of our once solid social security system. Next year, every working American will have the right to contribute to a retirement plan. Is it in the best interest of the people of this country to give them the right to save for their retirement years but to take away their right to choose how their funds are to be invested? I ask you to please continue to give the American citizens the right to choose retirement investments which will preserve their purchasing power.

The American people have much more at stake here than just the issue of collectibles in retirement plans. The issue is whether or not we will continue to have the right to make our own investment decisions without the government making arbitrary decisions as to whether or not they are in the "public interest". History has shown that individuals always make better decisions for themselves than the government can on a collective basis. I urge the the committee to return to working Americans the right to a financially secure retirement by continuing to allow them to choose the investments which best meet their personal objectives.

Jewelers of America, Inc.

December 23, 1981

Dec. 4 hrg.

The Honorable Robert Dole
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Chairman Dole:

The Jewelers of America, Inc. (JA), a national trade association representing over 12,000 retail jewelers, appreciates this opportunity to comment on S. 1645, a bill currently under consideration by the Senate Finance Committee. This legislation would repeal section 314(b) of the Economic Recovery Tax Act of 1981 (ERTA) which states that the acquisition of collectible items through an IRA or Keogh retirement plan be treated as a taxable item after December 31, 1981. JA opposes S. 1645 and believes the ban on tax-free purchases of collectibles was both proper and timely.

One of the collectibles purchased through various retirement plans has been the investment diamond. For the most part, these particular gemstones have been offered by diamond investment firms. The sales practices of many diamond investment establishments have often been blatantly misleading to diamond investors who end up purchasing overpriced merchandise under the impression that resale will be quick, easy, and profitable. Sadly, that is too frequently not the case. Instead, a new fee is paid to the investment firm (for resale), and the diamond investment is sold for considerably less than the original cost. In effect, investors have been influenced by sales literature and promises that were spurious at best and fraudulent at worst.

Recently, the Federal Trade Commission found the conduct of the American Diamond Company of California deceitful enough to take action against the firm. A consent agreement has been signed between the FTC and the California company over alleged violations of federal law prohibiting unfair acts and practices and unfair methods of competition. (See, FTC v. Baker, Inc. et al, 46 Federal Register at page 60211.) The consent order stems from charges that the American Diamond Company, through promotion of advertising and oral presentations, made several false and misleading representations to customers and failed to disclose material facts regarding gemstones purchased for investment purposes.

The American Diamond Company representatives sold diamonds ranging in size from .04 to .60 carats but neglected to disclose relevant information concerning difficulties investors may experience in resale. The sales representatives often failed to mention the resale fee the firm charged its customers as well as the limitations of the certificates grading the gems. The valuation certificate served only an identification purpose and did not carry an independent valuation of the gem. The FTC concluded that diamond prices were often arbitrary and dramatically inflated. While this consent order does not constitute an admission of guilt, the company's acquiescence to the consent speaks for itself.

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The Honorable Robert Dole
December 23, 1981
Page 2

The International Diamond Corporation, a diamond investment operation in the state of Missouri, has been the object of a continuing investigation. The State of Missouri has filed suit accusing the company of misrepresenting the sale price of diamonds, buy-back agreements, guarantees, and the marketability of the gems for investment purposes. This case is significant because the International Diamond Corporation operates in all 50 states and employs 5,000 sales people. In Missouri alone, the company has sold more than $1 million of investment diamonds in the past three years. (See, New York Times, December 21, 1981 at page B19.)

The July 1981 issue of Gem Market Reporter listed a few price comparisons between International Diamond Corporation's price and those suggested in the May edition of Precious Stones Newsletter.

Carat	Quality	IDC Selling Price	PSN Price
1.06	VVS2 F	$25,980	$14,000
1.08	VS1 E	$26,460	$14,000
1.07	VVS2 E	$34,430	$18,400
1.08	VS1 F	$18,210	$10,933

In the case of the International Diamond Corporation, the valuation of a particular gem is an in-house judgment and not that of a recognized independent appraiser. (A useful article on this scam is contained in the November 23, 1981 Forbes at page 226.)

The investment sales practices described above have created excessive fluctuation in diamond prices and have had a damaging impact on diamond merchandising generally. JA believes that the sound value of the diamond is an important aspect of its mystique, but wearing the jewelry should remain the primary reason for purchase. That is why the JA membership has serious reservations about promoting investment diamonds for retirement plans.

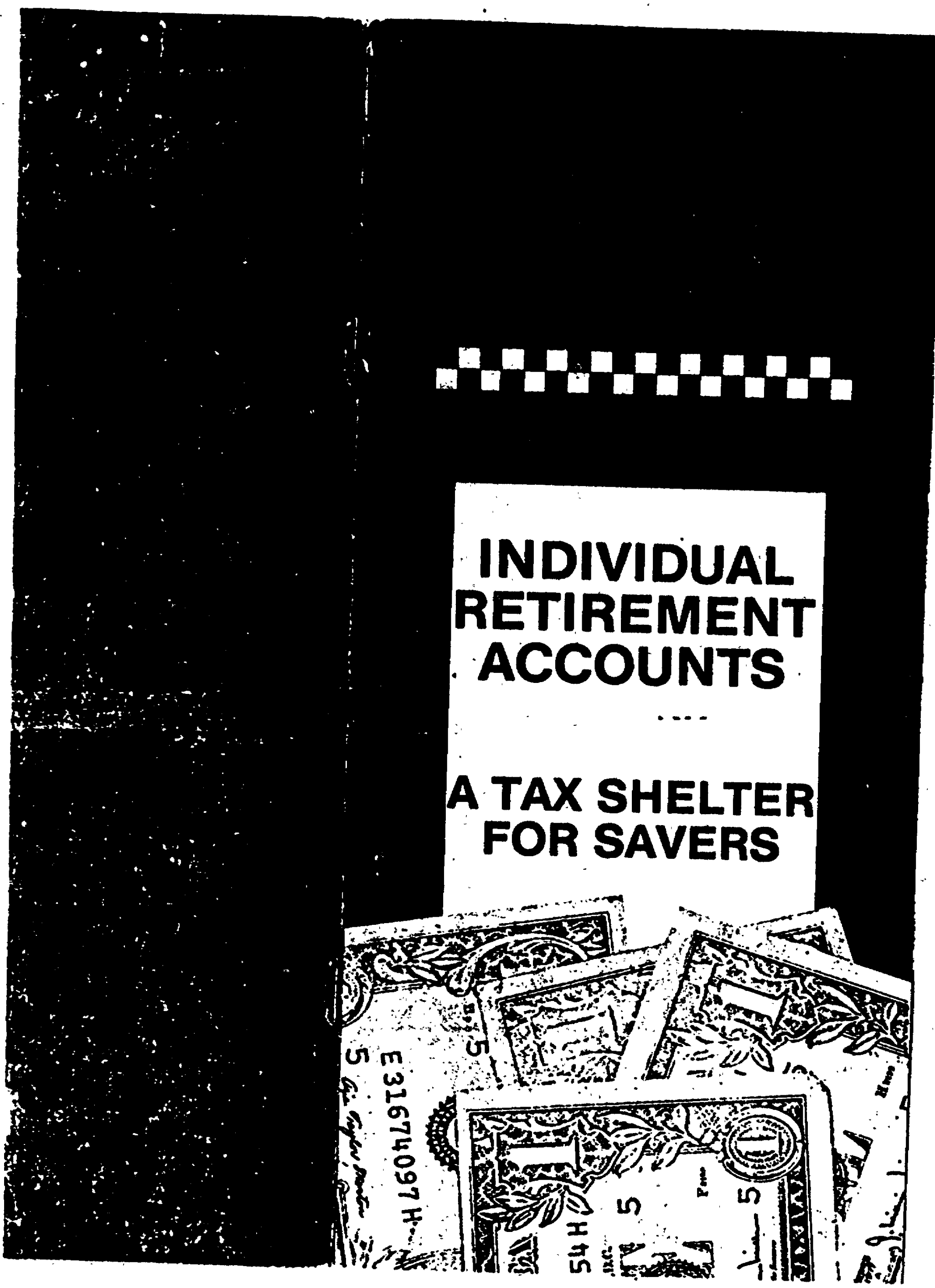
In conclusion, JA remains a firm supporter of the Economic Recovery Tax Act which is directed at generating savings and investment. The tax-free purchase of collectibles through retirement plans circumvents the intention of the Act and does nothing to aid the country's investment in new, productive assets. We urge the Congress to ignore the pleading of special interest groups that would again allow collectibles as an investment vehicle for retirement funds. Our nation cannot possibly realize long-term benefits from such an inappropriate practice, and Congress should take no action to aid and abet fraudulent practices which make a mockery of our tax code.

The membership of Jewelers of America stands unalterably opposed to S. 1645 which would repeal the ban on tax-free purchase of collectibles through qualified retirement plans.

Sincerely,

Michael D. Roman

Michael D. Roman
Chairman of the Board


INDIVIDUAL RETIREMENT ACCOUNTS
A TAX SHELTER FOR SAVERS

A TAX SHELTER FOR SAVERS

Now you can deduct up to $2,000 from your income—and pay no taxes on the earnings of that $2,000 until you retire.

The opportunity is yours with an IRA.

Before January of 1982, only people not covered by a company pension plan could set up an Individual Retirement Account, or IRA. Now anyone with earned income is eligible—even if already covered by a company retirement plan.

Aside from the tax advantages, IRAs are a great way to save. Let's say you and your spouse are 39 and both working. If each of you contributes $2,000 a year to an IRA, you'll accumulate $481,650 by age 65—assuming an annual interest rate of 10 percent.

If that sounds good, read on.

WHAT IS AN IRA?

It's a tax-sheltered retirement plan that allows you to set aside up to $2,000 a year from your wages or salary. You don't pay taxes on the account until you retire. However, you cannot withdraw any money before you reach age 59-½ without paying additional taxes (unless you become disabled), and you cannot use the money as collateral for a loan.

WHAT IS MY TAX BREAK?

Each year you can deduct from taxable income the amount you put into an IRA that year. For example, say you have a taxable income of about $25,000 a year and are in the 35% tax bracket. If you put $2,000 a year into an IRA, you will save $700 in taxes; if you're in the 50% bracket, you will save $1,000 in taxes.

Remember, too, you pay no taxes on your IRA savings until you withdraw your money. If you're retired, then your income will probably be less, putting you in a lower tax bracket.

WHO CAN OPEN AN IRA?

Anyone who is younger than 70-½ years old and who works at a paying job is eligible. You also can set up an IRA on behalf of a husband or wife who is not employed.

WHAT KIND OF IRAs ARE AVAILABLE?

There are many. They range from passbook savings to annuities, from mutual funds to retirement bonds. To narrow your choices, ask yourself: "Do I want an IRA that pays a higher rate of return but which may involve some risk of losing part or all of my investment? Or do I want to set up an IRA which pays a lower rate of return but involves little or no risk?" Only you can decide which IRA plan is best for you.

WHERE CAN I OPEN AN IRA?

You can open an IRA at your credit union or at any commercial bank, mutual savings bank, savings and loan association, insurance company, or brokerage firm which offers IRAs. Simply tell your credit union manager, banker or broker that you are interested in setting up an IRA account.

CAN I SET UP AN IRA THROUGH MY COMPANY?

That depends on your company. Some firms will probably allow you to make tax-deductible contributions to their thrift or profit-sharing plans. Others may offer new IRA programs through an intermediary like a credit union, bank or mutual fund.

HOW MUCH CAN I INVEST?

You may contribute up to $2,000 a year to your own IRA. If you are married and your spouse is not working, you may set up an IRA for your spouse and contribute up to $2,250 a year between the two accounts. If both you and your spouse are employed, you each may contribute up to $2,000 a year for a total of $4,000.

WHEN MUST I MAKE MY CONTRIBUTIONS?

You may make your IRA contributions throughout the year—for example, through regular payroll deductions at your credit union—or you may make a single lump-sum payment. Normally, you may contribute money up to your tax filing date, April 15, and still take the deduction for the prior tax year.

MUST I CONTRIBUTE EACH YEAR?

No, you don't have to put money into your IRA each year, neither are you required to put in the maximum amount. However, contributing the maximum generally will result in a larger retirement fund and you'll get a tax break for every dollar paid in as long as you don't exceed the maximum.

WHAT IF I CONTRIBUTE TOO MUCH?

If you put more money into your IRA than the law allows, you will have to pay taxes on it plus a 6% penalty. The penalty is non-deductible and is charged each year that the "excess contribution" stays in your account. You may avoid the penalty by withdrawing the excess, plus any interest, before your federal income tax return is due.

ARE THERE SERVICE CHARGES OR FEES?

Credit unions and other financial institutions generally are not expected to charge fees for managing IRA accounts. Mutual funds and insurance companies normally do charge administrative fees. The fees are usually subtracted from your account at least once a year.

CAN I SWITCH IRAs?

Yes. Once you select an IRA, your decision needn't be final. You can move your money from one IRA investment to another once a year without tax penalty. However, depending on your IRA, you may lose some of your interest earnings and you may not be able to get back the administrative fees that you paid.

CAN I HAVE MORE THAN ONE IRA?

Yes. You can have as many IRAs as you want as long as your total contributions do not exceed the amount allowed each year. For example, you might consider splitting your IRA funds among different types of investments. Remember, you may not invest more than the permissible limit without incurring tax penalties.

WHEN WILL I RECEIVE MY IRA INCOME?

The earliest age you can receive income without tax penalty is 59-½, unless you become disabled. You must begin receiving IRA income no later than age 70-½. Otherwise, you pay a 50 percent penalty tax on the amount that should have been withdrawn.

WHAT IF I NEED MY MONEY SOONER?

You can withdraw all or part of your money whenever you choose, *but* you will incur substantial tax penalties, and possibly interest penalties, if you take the money out before age 59-½. Also, you may not borrow on your IRA or use it as collateral for a loan since for tax purposes this is considered the same as a withdrawal.

In the event of early withdrawal, the amount distributed is subject to income tax for the year in which it is withdrawn, and also is subject to an additional 10% tax.

HOW WILL MY IRA INCOME BE PAID?

At the time you decide to begin receiving the income from your IRA, you may choose from the following options:

- *Lump Sum*—You receive the entire account balance in one payment.
- *Period Certain*—You receive your entire amount during a number of months.
- *Life Annuity*—Monthly payments are made to you for the rest of your life with no payments to anyone after your death.
- *Joint & Survivor Annuity*—You receive smaller monthly payments during your lifetime, and your spouse continues to receive payments after your death.

HOW WILL MY IRA INCOME BE TAXED?

Once you start receiving money from your IRA, you pay income tax on the amount you withdraw each year. If you receive your IRA in a lump sum, you pay taxes on the entire amount you withdraw in the year. If you receive your money in installments, your tax payments are spread out.

If you're retired, your tax bracket probably is lower, so you pay less. Also, you may be able to take advantage of five-year income averaging. However, IRAs are not eligible for capital gains treatment or the special 10-year averaging that applies to lump sum payments made from other retirement plans.

WHAT ABOUT ESTATE AND GIFT TAXES?

Any amount remaining in your IRA after your death is not subject to federal estate taxes *if* paid to your beneficiary in installments over a period of at least three years. A lump sum payment to your beneficiary is taxed as part of your estate. Also, a distribution payable to a beneficiary at your death will not be subject to federal gift taxes.

WHAT MUST I BE TOLD?

When you open your IRA, your credit union or other institution must provide you with a written statement explaining in plain language how your IRA works. Among other things, this explanation must disclose:

- An estimate of how an IRA investment will grow in five years and what your account will be worth when you reach age 60, 65 and 70. The estimate will assume you contribute a certain amount each year and that your contributions earn interest at a certain rate. If the interest rate is not guaranteed, an assumed rate will be used and an explanation given.
- Sales commissions or administrative fees. In the case of a life insurance company endowment contract, you will be told what portion of your contribution will apply to the cost of life insurance and, therefore, is not deductible.

WHAT IF I CHANGE MY MIND?

If you change your mind about starting an IRA, you can cancel your investment within seven days after you receive your written explanation. All your money will be returned without penalty.

ADVANTAGES OF IRAs!

Under many company retirement plans, it takes a number of years before you earn the right to receive even a portion of your pension benefits. Also, you usually have to work 10 to 30 years to receive full benefits. Since many people change jobs more often than this, they never qualify for benefits. In other words, they never "vest" in a company plan.

Others find that, even if they are fully vested, their benefits are not enough to live on throughout retirement.

In contrast, your IRA contributions and earnings belong to you from the day you open the account. The money is yours no matter where you worked, how long you worked or when you retire. You can count on your IRA to help you finance your retirement—and *to save taxes* while doing it.

SOME QUESTIONS TO ASK

The decision to set up an IRA is easy. Figuring out where to put your IRA funds is more difficult. To help you choose from the array of IRA investment opportunities, we have listed key questions that you'll want to ask to compare one IRA with another. The answers should make your IRA shopping easier.

- How much interest or dividend income will I be paid on my IRA investment?
- How is the interest calculated?
- How long will this rate remain in effect?
- Is there a minimum amount that I must invest to receive this rate?
- Can I contribute to my IRA by having money automatically deducted from my payroll check?
- When can I change my IRA investment without incurring any tax penalty or early withdrawal penalty?
- Do I risk losing all or part of my money if the institution closes or is mismanaged?
- How much are the administrative fees, commissions or other service charges?