94th Congress } COMMITTEE PRINT
2d Session }

TAX REFORM ACT OF 1976

H.R. 10612

TESTIMONY TO BE RECEIVED WEDNESDAY, JULY 21, 1976

COMMITTEE ON FINANCE

UNITED STATES SENATE

RUSSELL B. LONG, *Chairman*

JULY 1976

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

74-620 O WASHINGTON : 1976

COMMITTEE ON FINANCE

RUSSELL B. LONG, Louisiana, *Chairman*

HERMAN E. TALMADGE, Georgia
VANCE HARTKE, Indiana
ABRAHAM RIBICOFF, Connecticut
HARRY F. BYRD, Jr., Virginia
GAYLORD NELSON, Wisconsin
WALTER F. MONDALE, Minnesota
MIKE GRAVEL, Alaska
LLOYD BENTSEN, Texas
WILLIAM D. HATHAWAY, Maine
FLOYD K. HASKELL, Colorado

CARL T. CURTIS, Nebraska
PAUL J. FANNIN, Arizona
CLIFFORD P. HANSEN, Wyoming
ROBERT DOLE, Kansas
BOB PACKWOOD, Oregon
WILLIAM V. ROTH, Jr., Delaware
BILL BROCK, Tennessee

MICHAEL STERN, *Staff Director*
DONALD V. MOOREHEAD, *Chief Minority Counsel*

CONTENTS

WITNESSES

STATEMENT OF

ROBERT M. BRANDON AND WILLIAM PIETZ

before

THE FINANCE COMMITTEE

of the

UNITED STATES SENATE

Washington, D.C. July 20, 1976

Mr. Chairman and Members of the Committee:

Ordinarily we would welcome an opportunity to appear before this Committee to testify on tax legislation. Today, this is not the case. We are not happy to be here. Our appearance is not an endorsement of these procedures nor should it be construed in any way to rehabilitate or legitimize the numerous ill-considered and secretive special relief provisions which are the subject of these hearings. We are here because we are concerned about the integrity of the tax legislative process, the tax system, and the public's loss of confidence in that system.

Let us say at the outset that these hearings can be a sham unless there is some procedural consequence flowing from them. We would call on the Committee, therefore, to consider in a subsequent mark-up session all the legislation under discussion as well as other legislation not fully considered by the Committee. Without a procedure for the Committee to reconsider after full discussion and full disclosure of all the facts relating to this legislation and other parts of the Committee's tax reform bill, these hearings become a meaningless _ex-post facto_ exercise concerning legislation already approved.

Secondly, even if the Committee re-convenes to consider these and other provisions, these hearings will be of limited use in that process. The burden should not be on public witnesses such as our-selves to evaluate a series of narrow interest amendments where there has been far less than full disclosure of the effects of that legislation or who its beneficiaries are. We should be testifying today not on a list of bill sections but on specific provisions fully disclosed and explained by the staff. Our analysis should be based on public facts about these bills, not on what we can ascertain about them in spite of the lack of public information or obscure references in the bill or its report. Indeed, these hearings are a consequence of some groups digging out information on these provisions that the Committee refused to reveal or chose not to reveal in its Report. It is a dangerous and ludicrous process that produces public laws that the public does not know about;- Tax laws that benefit narrow classes of taxpayers known only to the beneficiaries of these laws, a select group of staff, and indeed, only some members of the Committee and fewer members of the Congress that passes them. In fact, without a public disclosure of all the relevant facts, it is difficult to see how the members of this Committee could evaluate the testimony they are about to receive on the more than eighty (80) technical provisions which are the subject of these hearings.

The fact that we can ultimately decipher the real effect of some of these tax provisions and have an opportunity to comment on them gives us little cause for cheer. It must give less to the other members of the taxpaying public who will also be affected in varying degrees by such legislation. How can a taxpayer or group learn enough about a narrow interest provision from a one sentence description in a Committee press release to formulate a position on it.

It is not enough to say, as the press release announcing these hearings said, that many of these provisions have been the subject of testimony. The hearings on H.R. 10612 drew a great deal of testimony on general tax reform or specific areas dealt with by the House-passed bill. A company or group of taxpayers might testify on a special measure for their own benefit, but it is impossible for members of the public to comment on legislation they do not know exists. Any such narrow interest legislation should be fully disclosed and explained beforehand so that testimony on both sides of the issue can be elicited. The burden should not be on the taxpaying public, but on the proponents of these bills, to fully explain the provision and to show why they should receive special treatment.

We do not oppose this type of legislation simply because it benefits narrow interest groups. We oppose the secretive process by which these provisions were written. In fact, under the full disclosure procedures recently adopted by the House Ways and Means Committee, we opposed only six of thirty bills subject to full public hearings in December. All twenty-four of the "non-objectionable" provisions were approved while four of the six others were rejected by the Committee. Nor do we oppose this type of legislation because it involves revenue loss to the Treasury. We want to ensure only that the lost revenue is money well spent--achieving proper and well thought-out policy goals or achieving equity among taxpayers.

The Chairman of this Committee has taken the somewhat cynical view that tax reform is whatever fifty-one Senators will vote for. We don't agree with that. But more importantly, it cannot continue to be what one lobbyist can convince one member of this Committee to vote for. The process must be changed.

The Process

The major problem with these special relief measures is the lack of an explanation of what the legislation really does, who it benefits, and what its costs are. The public can only conclude from such non-disclosure that the proponents of such a bill have something to hide. Meritorious legislation should be able to withstand scrutiny in the light of day and not depend upon confusion, ignorance or improper influence to pass. Full disclosure would remove the cloud of secrecy from narrow interest legislation as well as guard against unworthy legislation.

Without full disclosure, campaign contributions from the beneficiaries of such special relief cast doubt on the motives of Congressional sponsors. As Appendix B indicates, there is a great deal of overlap between campaign contributions to members of this

Committee and the beneficiaries of the tax legislation this Committee has approved. We are not listing these contributions to necessarily imply any improprieties. The public can judge whether these provisions represent proper constituent services. If campaign finance reform is to mean anything it must require disclosure at both ends so constituents can fully evaluate the performance of their representatives.

The lack of full-disclosure of the purposes and effects of these provisions also often leads to a lack of any real debate or serious deliberation on them. With only the beneficiaries of a bill, a few staff, and one or two members of the Committee fully understanding the effects of legislation being considered, non-meritorious legislation is routinely approved.

Similar problems exist with the deliberations over a number of general interest provisions involving major policy questions. For instance, the Committee adopted after about thirty minutes discussion, a multi-billion dollar tuition tax credit. There were no hearings on this provision; there were no materials prepared by the staff discussing the effects of this provision on post-secondary education; there was no input from HEW, colleges and universities, education groups, or other committees in Congress knowledgeable in the area. In fact, there is no evidence that this multi-billion dollar program will send one more student to college. The only thing that is certain is that it will provide several billion dollars of tax relief for those who happen to send their children to college. Even if this provision were worthwhile, no one could possibly know that based on the deliberations of this Committee. Such processes do little to enhance the image of the Congress.

Similarly, the Committee enacted a billion dollar reduction in capital gains taxes. Senator Bentsen held some hearings on this provision a few years ago and proposed such a change to stimulate a slumping stock market. It is unclear what this provision will accomplish in 1977 when it would become effective.

Other major policy decisions involving hundreds of millions of dollars of new tax subsidy programs were made with little staff analysis, no real input from the public or other interested and knowledgeable groups, and in an atmosphere of confusion that often kept the press, the public and members of the Committee from participating fully. One of the most outrageous examples of this is the refusal of this Committee to make available to Senators or the public the "quasi-bill report" describing the Committee amendments, even though many are supposed to be the subject of comment at this hearing.

The first casualty of such a process is sound tax policy. Equally important is the loss of public confidence in a system that provides special tax relief for a select unnamed few. Finally, a wide range of legitimate tax problems can't be addressed because they become labelled as a part of this defective process.

If sensible procedures were established the Committee could guard against poor tax policy, pass needed reforms, and provide a method for legitimate narrow interest tax problems to be addressed.

Proposed Reforms

Anyone who sat through the Finance Committee's recent mark-up is aware that many general reforms are needed in the process by which the Committee considers tax legislation. It is not our purpose today to focus on these general reforms. Clearly, changes need to be made. These include an agenda with more notice for members on subjects under discussion, staff pamphlets with background information and proposed changes (including changes to be proposed by other members), the position of the Department of Treasury should be solicited and made public, a larger room to provide more access by personal staff to members and more access for the public to the mark-up sessions, a microphone system that allows everyone to know what is being said, voted upon, etc.

Specific Proposals For Considering Narrow Interest Legislation.

Narrow interest legislation falls into several broad categories. First, there are technical changes in the law designed to correct an unintended and unanticipated result on a class of taxpayer. In this case legislation may be a proper remedy but the Congress must guard against technical changes in the law designed to reverse intended changes in the law. It is no accident that one year after reforms were passed in the area of shipping "tax haven" income and the foreign tax credit that a number of "transitional or permanent" provisions have been approved to make those reforms inapplicable to certain taxpayers. This is not a proper function of narrow interest legislation.

A second area involves legislation which reverses current administrative interpretation of the law. The Congress, of course, has the perogative to over-rule the IRS through legislation but must be very careful not to interfere with the fair and proper administration of the tax laws. It is also bad policy to change the rules that all taxpayers live under retroactively for the benefit of specific taxpayers.

A third area of narrow interest legislation might involve broad policy questions that involve narrow classes of taxpayers. The Congress must be very careful in these situations nor to compound the complexities and inequities of the current law by making distinctions for such taxpayers without strong policy reasons after all the facts and circumstances are known.

Many of these provisions, whatever form they take, are private relief bills. They should be treated as other private relief bills with the names of the beneficiaries disclosed. But there is a broader question involving these bills that the Committee should address.

In many respects, when this Committee considers legislation of this type it is really functioning in a judicial capacity; sitting as a court of tax equity. The Committee may want to think in the longer run about legislation to establish some sort of taxpayers' court of equity. Presently, only certain taxpayers with meritorious claims have the where withal, the connections or the influence to come to this Committee and have their claims considered. The merits of their claims have been less important than the financial resources to hire tax attorneys or lobbyists with Washington connections or the access to Committee members. We would suggest that Congress think about some kind of legislation that will allow all taxpayers, whether they have the financial resources to get to Washington or not, to have an opportunity to have the equities of their case adjudicated.

Specifically, we would recommend the following procedural reforms in considering narrow interest legislation:

1.) Establishment of a subcommittee to screen narrow interest legislation brought to the Committee's attention. This first step would be designed to weed out obviously non-meritorious provisions or general policy issues properly the subject of general tax legislation.

2.) The Treasury Department, the IRS and any other affected agency should prepare bill reports to accompany these provisions.

3.) Staff pamphlets providing full disclosure of all relevant facts about each provision including beneficiaries and lobbyists, rationale for the provision, staff analysis, Treasury and IRS positions, and revenue effect.

4.) Full public hearings conducted after the dissemination of the descriptive pamphlets and after sufficient time to evaluate the provisions. If the proponents of a provision are unwilling to testify on behalf of that provision at these hearings, the provision should be automatically dropped. 11

5.) These bills should not be reported out as part of omnibus tax legislation, but rather should be reported separately as miscellaneous bills accompanied by full Committee reports.

Conclusion

In light of the foregoing, we would ask the Committee to split off from H.R. 10612 all those miscellaneous provisions and Committee amendments that by the Committee's own admission have received inadequate deliberation. Ironically, the only provisions listed in the notice of hearings are those which have already been uncovered and publicly criticized by parties other than the Committee. Yet we know there are several other narrow interest provisions in the bill.

Other provisions in the bill have had equally insufficient treatment. The Committee should not force the full Senate to vote on provisions that have not been fully considered. We would suggest instead that the Senate proceed on the major elements of H.R. 10612 and set aside those other provisions for consideration in this session under procedures consistent with our proposals.

Comments on Some Specific Provisions.

The following comments are on some specific provisions mentioned in the Committee's press release. These comments and, therefore, our position are based on the sometimes limited information available on each provision.

SOME OBJECTIONABLE SECTIONS AND BRIEF ANALYSIS

Section of bill

802 and 803 --Refundability and extension of Investment Tax Credits.

Half of all utilities are already off the tax roles. The committee has not considered whether refund will be subtracted from the "hypothetical taxes paid" used in the utility rate base which would further compound the problem of customer overcharging. Encourages over-investment by airlines. Negative income tax for corporations.

806 --Investment Tax Credit on ships. Also eligible for tax free construction funds-- See Appendix A.

1021 --Investments in U.S. Property--two separate retroactive changes to excuse any tax now owing. Benefits Superior Oil which invested in U.S. continental shelf drilling rigs and Pyramid Ventures which invested in U.S. stock market. Each claims not to have known this was a repatriation. Unfairly discriminates against others--who knew the law and paid the tax.

1024 --Narrowing definition of shipping ("tax haven") income to exclude, for several companies, the carrying of supplies from a country (Nigeria) to a drilling rig on its continental shelf. This might have been defensible had there been added the requirement that the carrier pay taxes in that country. But it is (in fact purposely broad) enough to cover companies chartered in Panama, Liberia or other tax haven countries.

1024 --Narrowing definition of shipping ("tax haven") income to exclude a Panamanian shipping company which charters ships to a related scrap dealer, Southern Scrap Co., of Louisiana, on other than a long term charter basis. There is no reason why such a shipping company should escape taxes even though

74-820 O - 76 -- 2

Section
of bill

they claim to have foreign competition. Ironically, the amendment was drawn so narrowly (to disqualify all other taxpayers) that it inadvertently disqualifies the intended beneficiary.

1025 --Exclusion of agricultural products grown and sold outside the U.S. from U.S. taxation. May perhaps give such goods a competitive advantage over goods grown in the U.S. and exported Some tax experts are concerned that this will serve as a precedent for extending tax free treatment to sales of every other imaginable category of goods--any of which may presently be subject to the tax haven rules (as "foreign base company sales income.") This could significantly undermine present tax haven rules.

1031 --Three year exclusion for mining and Puerto Rican operations from repeal of per country foreign tax credit methods for Freeport Minerals and Pittsburg Plate Glass Co.. Such exclusions have no valid rationale and reduce the erstwhile revenue impact of repeal ($50 million) so that it will be only $25 to $40 million.

1031 --Special Carryback of denied excess 1978 foreign tax credits of oil companies. An unjustified partial repeal of the 1975 reform (for Natomas Corp.) which will deny credits in excess of 50% of income. Designed narrowly to benefit a few companies who won't have large credits prior to 1978.

1032 --Sun Oil Exclusion from Recapture of Foreign Losses. The recapture rules enacted in 1975 are fair rules designed to prevent "having one's cake and eating it too." See attached write-up. Sun Oil found it economically desirable to contract to drill in the North Sea and it seems unlikely that this decision was made in reliance on the continuation of an overly generous tax law with respect to foreign losses.

1035 --Expansion of "Oil Related Income" definition to include interest

Section of bill

income. See attached write-up. Gives multinational oil companies additional ways to use the extra 2 percentage points above 48% which the Hartke-Nelson et. al. amendment would abolish.

1035 --Narrowing of "Oil Related Income" definition to suit T.U. International. See attached write-up. Seems to take income (income from transportation or distribution of gas by a utility) which would naturally be oil related income and classify it (perhaps illogically) as non-oil related income. This opportunistic definition contrasts with the preceding amendment and the Tenneco amendment which follows below.

1035 --Expansion (Clarification) of "Oil Related Income" definition to include sale of stock. This provision may be technically defensible as a mere clarification of existing law which expressly includes sale of assets. But contrasts with preceding amendment. It could apparently cover expropriations and this might have unexpectedly large revenue cost.

1035 --Mobil-Iranian amendments--This provision unjustifiably makes the 1975 reform (so recently agreed to by Congress) applicable only to newcomers having no economic interest on March 29, 1975 at estimated cost of $40 million yearly for at least 10 years. This estimate may prove very low if other countries expropriate properties thus depriving more companies of an "economic interest". Will make possible the labeling of royalties as taxes.

1035 --Indonesian-Production sharing unjustifiably overrules April 1976 IRS ruling. See attached write-up. The IRS ruling was believed to have been well-founded by many tax specialists. This amendment could have enormous revenue cost if it discourages the IRS from making similar rulings in other countries.

1041 --Non-taxation of interest earned by foreigners on bonds and bank accounts. On the House floor the non-taxation of bond interest

Section
of bill

and dividends was defeated. The Finance Committee also declined to make dividends tax free. See Appendix A.

1042 --H.H. Robertson-- This provision reverses an IRS position upheld by the courts. It is strongly opposed by the Treasury staff, who were not consulted during mark-up. See Appendix A.

1052 --Hanna Mining Co.--Under present law a company computing its foreign tax credit on the overall method can't consolidate a Western Hemisphere Trade Corporation subsidiary with other subsidiaries. WHTC's are taxed at only 34% instead of 48%--which rate advantage is phased out by 1980 under the bill. (Companies using the per country method can consolidate but the committee bill repeals this method.) The existing non-consolidation rule was designed to prevent tax avoidance that will result from mixing income tax at 34% with income taxes at 48% when computing the credit. (If a foreign country levies a tax at $45 on WHTC income of $100 and the U.S. taxes it at 34% there will be excess credits of $11 available to shelter other income.) In any case the amendment is discriminatory in its narrow tailoring.

1305 --Expensing of Pre-Publication Costs-- Overrules an apparently logical IRS ruling requiring the capitalization of large research and development costs incurred in publishing encyclopedias and text books over the life of that particular edition. The staff has estimated no revenue loss for this provision on the theory that the IRS ruling has not been enforced to date and its overruling produces no change. In fact, this provision will cost the Treasury several hundred million dollars, largely to Encyclopedia Britanica, otherwise collectable under the legal ruling.

1307 --IDS Face Amount Certificates. See Appendix A.

1308 Alabama Coca-Cola Franchise-- See Appendix A. Personal holding company rules apply a 70% penalty tax to closely held corporations (which are taxable at 48%) which earn passive types of income and pay no dividends to shareholders (who might be taxable at 70%). Royalties are regarded as "more passive" than rents. This amendment alters a logical 1971 IRS ruling that payments for a license to a secret process are royalties rather than rents. The amendment calls them rents. Lobbyists argued that the corporation only held the license (and thus received the royalties) to protect the perpetual life of the license and not for tax avoidance. But if this were so it can avoid the holding company tax by paying out its profits as dividends.

1311 --Texas Optical Co.--See Appendix A. The 1969 Reform Act which repealed favorable capital gains treatment contained no exceptions for later sales under contracts binding in 1969. Such an exception may have been warranted and perhaps even a retroactive enactment of one six years later is defensible. But the draftsmen have seemingly bent over backwards to help one party by providing that the contract in existence in 1969 need not have been "binding: and that the rule (intended to cover a professional practice) also cover transfer of a related business. The rule narrowly excludes other taxpayers, who may have paid their tax without petitioning Congress.

1312 --Reporting of Tip Income-- See Appendix A. Employers have always been required to report to the IRS the amounts of tips reported to them by the employee. It is not at all clear why employees cannot keep a running total of their charge account tips and report them to the employer just as they do on other tips. Failure to report tips is a frequent abuse which is hard to police.

1322 --<u>Contributions to Capital of Water Utilities</u>. The illogic of not treating these non-refundable payments by customers as income is revealed by the fact that the committee decided not to apply this same treatment to gas and phone utilities because it would then cost $100 million per year.

1508 --<u>Consolidation of casualty insurance losses against income from life or health insurance</u>. Such consolidation has never been permitted because (roughly speaking) only one half of life insurance income is subject to tax. (This is a special preference enjoyed because--arguably--taxable income may be overstated due to underestimation of future claims.) The amendment partially deals with this by allowing offset of only one half of the casualty losses but they can continually be carried over to future years.

Prudential, Metropolitan, and perhaps other large insurers have recently entered the casualty business and the Treasury will in effect subsidize their start-up losses and perhaps enable them to undercut smaller companies who have no other business against which to use casualty losses. Numerous casualty companies, e.g. Kemper, thus oppose this. Since it doesn't take effect until 1978 it is not urgent and should be preceded by a comprehensive study of insurance taxation.

1701 and --Railroad tax preferences--Very few railroads pay any income taxes.
1702 Additional preferences will be used by some conglomerate holding companies to shelter income from other businesses. At a minimum, any new preferences would not be deductible against nonrailroad income--even if the committee believes that railroads need a subsidy and should therefore be allowed to depart from normal accounting rules in writing off rail and ties etc. The amortization of grading and tunnel bores undercuts the compromise worked out in the 1969 Reform Act. Until 1969 such costs were not deductible at all. It was then decided to allow

such write-offs on post-1969 investments as an incentive. Now allowing write-offs on all pre-1969 investments is a giveaway which can have no incentive effect.

* * * *

PARTIALLY INCLUSIVE LIST OF SOME SECTIONS WHICH MIGHT BE UNOBJECTIONABLE
(Judged solely upon inadequate information available to date.)

Section
of bill

1013 p.215--Effective date on foreign trusts advanced a week

1023 p.229--American International Group, Inc. Bermuda insurance earnings

1024 p.230--Hall Corporation Shipping Ltd.

1032 p.240--Boise Cascade

1032 p.240--Robert Hall

1035 p.250--Section 907 limit on individuals

1036 p.257--American International Group, Inc. --Reclassifying certain insurance income as foreign income.

1043 p.271--Contiguous Country Branches

1044 p.276--Royal Bank of Canada

1304 p.401--Political debts

1317 p.424--Depletion amendments

1320 p.431--Simultaneous liquidations

1321 p.433--Local Taxation of Barges Prohibited

1509 p.457--BMA--inadvertent distribution

APPENDIX A

The following pages contain a description of the amendments referred to in the preceding analysis together with names of beneficiaries where known.

<u>Refundable Investment credit (see 802 ;pg 177 of report)</u>
Primarily for airlines, such as United Airlines and utilities. Starting in 1984 companies will receive a check from the treasury in the amount of any post 1975 investment credits which go unused because future taxable income is too low. Cost in 1984: $300-500 million

(Refunds don't start until 1984 because taxpayers must exhaust their existing right to carry forward unused credits for 7 years to offset taxable income in those years.) Overinvestment in aircraft has yielded excess accelerated depreciation and investment credits.

<u>2 Year Extension of Existing Carryover Periods for Expiring Investment Credit and Foreign Tax Credits - (sec 803; p.178 of report)</u> sought by airlines, such as United Airlines and Chrysler. Airlines sought to extend their ability to keep alive old (pre 1976) unused investment credits which can already be carried forward at least 7 years and often 10 years. They have been seeking to make these old credits refundable (just as post 1975 credits will be) and this gives them two more years in which to lobby. The committee later applied this to <u>foreign</u> tax credits apparently to benefit Chrysler. Cost: $14 million in FY 1977 and $30 million in FY 1978.

Allowing the Investment Tax Credit on Maritime Capital Construction Funds (sec. 806, p.196 of report)

Explanation of the Amendment

A Finance Committee Amendment to the House Tax Reform Bill allows shipbuilders to take the 10% investment tax credit for money spent to build ships in the United States, even though the construction is financed with previously untaxed profits deposited in so-called "capital construction funds" (CCFs).

These CCFs are special accounts created by the Merchant Marine Act of 1970 to provide tax benefits to shipbuilders. Shipping earnings may be deposited tax free in these accounts and used to build additional vessels. The interest and dividends earned on fund deposits and all additional vessel earnings may also be redeposited, tax free, in these funds. This money is untaxed until it is withdrawn for non-shipping purposes.

The Finance Committee Report explains that "when these funds are used to finance ship construction, there is no tax cost, or basis" in order "to prevent a double allowance for these tax-deferred amounts". Because there is no tax cost, or "basis", sums expended out of those privileged accounts have not resulted in an investment tax credit or depreciation allowances. Not surprisingly, the shipping industry and its supporters have argued that the investment credit should be applied to these expenditures, but the IRS has resisted their efforts.

Analysis

The Treasury Department strongly opposed this change in testimony before the Ways and Means Committee and under the present bill for four reasons-- 1) it is a dangerous attack on basic tax principles; 2) CCFs already provide a major tax break; 3) the extension of the direct subsidy program would be more efficient; and 4) there is no need for the subsidy and the revenue loss could be significant. Other testimony showed that the subsidy is wasteful and its chief beneficiaries may be oil companies, banks and steel companies.

The Provision Does Violence to Basic Tax Principles

Basis. The Treasury Department was particularly concerned with the implications of "breaking the connection between 'basis' and other provisions of the law". As Assistant Treasury Secretary Walker explained: "The concept of 'basis' is central to the code. Once a taxpayer has freely disposable money or property which becomes freely disposable because he has paid the appropriate taxes in acquiring it, he gets a tax cost basis in any property he acquires with it."

Property acquired with money from already tax-free profits has no basis. The investment credit and depreciation allowances are predicated on the existence of a tax basis. Granting tax-free profits and then an investment credit for expenditures out of those untaxed profits provides an enormous double dip for one selective industry. If investors in shipbuilding are granted an investment tax credit in the absence of a legitimate tax basis, there is no persuasive argument against giving them depreciation without basis, or extending this benefit to other subsidized industries. The revenue implications would be phenomenal.

Income. This amendment violates the basic principle that a receipt is not to be recognized for tax purposes until it has first been taken into income. Persons and corporations who pay no tax should not get the benefits accorded to those who do.

Auditing. The existence of two different tax bases--one for depreciation purposes and the other for investment credit purposes--will significantly complicate an already difficult audit job for the IRS.

CCPs Already Provide a Major Tax Break

Treasury testimony showed that the net tax benefit already provided by CCPs is equal to an investment tax credit of 17 percent.

The Wrong Corporations Will Benefit

Oil Companies. Seventeen oil companies have CCFs. They receive a tax break for building ships to transport Alaskan oil. However, this shipping is subject to the cabotage laws, so there is no foreign competition and the United States gets no benefit from this tax gift.

Banks. By building ships and leasing them to commercial shippers, banks are able to use these CCFs to shelter income completely unrelated to shipping.

Steel Companies. Ten steel companies have CCFs. They save tax dollars while building ships for the movement of ore on the Great Lakes. As with Alaskan oil, this ship construction is free from foreign competition by law, so the tax subsidy does not result in additional U.S. shipbuilding.

The Subsidy Should Be Direct

The best method of arriving at the proper level of subsidy and controlling who receives it is through the appropriation process, rather than the back-door technique of a "tax expenditure". Over half-a-billion dollars is already provided to the shipping industry this way under the Merchant Marine Act.

There will Be a Serious Revenue Loss

The Senate Finance Committee estimates that in fiscal 1977 the amendment will cost $21 million and that by 1981 the annual cost will be $45 million. The projections of the Shipbuilders Council of America suggest an annual revenue loss of $75 million. Some analysts project that the incentive effects of the change could lead to revenue losses in excess of $100 million annually.

Shipbuilding Does Not Need an Additional Subsidy

In addition to CCFs, shipbuilders are given $600 million in operating-differential and construction-differential subsidies under the Merchant Marine Act. They also receive loan guarantees of over $4 billion.

Private shipyard employment has increased every year since 1971 and as of the beginning of 1975 there was a $4.2 billion backlog of commercial ship construction contracts with U.S. yards.

Piggybacking the investment credit on CCFs gives shipbuilding an effective tax credit of 27%. There is no good reason to add this large subsidy.

A One Week Change in the Effective Date of the New Grantor Trust Rule (sec. 1013, p. 215 of the report)

People presently put their investments in foreign trusts because such trusts do not pay any United States income taxes. The bill would remedy this by taxing the grantor on the income of the trust. The effective date of the House bill is May 21, 1974, in order to catch eleventh hour tax avoiders who rushed to set up such trusts once they heard that the House Ways and Means

Committee was considering this provision. The Senate Committee changed the effective date to May 29, 1974, purportedly because the wire services delayed reporting the House action for a week. It is not clear who is trying to beat the effective date with this amendment but apparently it is a client of John Hall, a California tax attorney.

Investments in U.S. Property (Sec. 1021; p. 225 of Report)

Under present law when a U.S. corporation reinvests the earnings of a foreign subsidiary in property located in the U.S. this is considered a repatriation of foreign earnings and triggers the U.S. corporate income tax. The bill redefines what will be considered investment in U.S. property to eliminate some hardships.

However, the bill contains a special retroactive exception for Superior Oil Co. Superior accidentally invested foreign earnings in a drilling rig on the U.S. continental shelf without being aware that in 1969 congress defined U.S. investment as including the continental shelf.

There is another special exception to the definition designate to exclude Pyramid Ventures Corp. of Louisiana.

It is known that Pyramid Ventures Corp. invested in the U.S. stock market in 1975 without realizing that this triggered a tax. They still have not paid the tax. The bill's new definition of repatriation would result in such an investment (in stock of a party not related to the U.S. parent) not being considered a repatriation. The new definition has been made retroactive to 1975 to help this corporation.

<u>Excluding certain insurance earnings from the rules which subject tax-haven earnings of foreign operations to U.S. tax (Sec. 1023; p. 229 of Report)</u>

The American International Group Inc., a U.S. insurance corporation sought this exclusion for its Bermuda operation.
Cost: $11 million in FY 1977; $10 million yearly thereafter.

The excluded earnings are those which must be set aside and reinvested to meet capital and legal reserve requirements <u>as if</u> (hypothetically) the more stringent U.S. requirements applied in the foreign country.

<u>Four exclusions of certain shipping profits from rules which subject tax haven earnings of foreign operations to U.S. tax (Sec. 1024; p. 230)</u>

Consists of technical amendments narrowing only slightly the definition of shipping income. (Shipping income is ineligible for deferral of tax on foreign earnings-unless promptly reinvested in shipping operations-because shipping income can be easily manipulated into tax haven countries.)

The first exception to the tax haven rules for foreign subsidiaries would be provided for income from shipping between two or more points within the country in which a foreign shipping subsidiary is incorporated (and in which the ship is registered). In addition, if a company has virtually all of its assets in foreign shipping operations, repayments of unsecured loans would be treated as reinvestment in shipping operations for purposes of the tax haven rules in the same manner as is treated the repayment of secured loans. (Fourth exception listed in the Report.) Both of these rules are for Hall Corporation Shipping Ltd. owned by Frank A. Augsbury Jr. and family.

Three Year Transitional Exclusion of Certain Mining Companies and Puerto Rican Operations From This Bill's Repeal of the Per Country Method of Computing the Foreign Tax Credit (Sec. 1031 (c)(2); p. 238 of Report).

Benefits among others, the Freeport Sulphur Co., and would cost the Treasury between $10 million and $25 million of the anticipated $50 million a year expected to come from the repeal. Would permit use of the per country limitation for three more years provided that: 80% of a company's foreign operations involved mining of hard minerals; there is a commitment to expand these operations; and the activities are carried out through a seperate corporation which has been in existence for at least five years and has been operated at a loss for at least two years.

A similar three-year postponement was accorded Puerto Rican operations, apparently at the request of PPG Industries, Inc. (Pittsburgh Plate Glass).

Exception to Foreign Loss Recapture Rules of the Senate Bill For Some of Boise Cascade Corporation's Chilean Losses (Sec. 1032 (c)(2) p. 240 of Report).

After 1975 the bill will curb the advantages of deducting foreign start-up losses against U.S. income and then paying no U.S. tax on subsequent profitable foreign operations (due to the foreign tax credit). But it doesn't apply to losses from the future disposition of securities which were received before 1975 if they were received as compensation for an expropriation of property.

"The second exception" on p. 240 is designed for the Robert Hall Co. (the apparel retailer), and allows escape from recapture where the loss (although incurred after this bill's effective date) is from stock, indebtedness, or guarantees of a corporation in which the taxpayer owned at least 10% of the voting stock, if it has had losses in three of the last five years.

<u>Special Carryback of Excess Foreign Tax Credits of Oil Companies (Sec. 1035 (a); p. 246 of Report)</u>.

Amounts not allowed as foreign tax credits on foreign oil extraction income in 1978 and later years (because of the Tax Reduction Act of 1975) could be carried back (to taxable years ending in 1975 to 1977 only). The 1975 Act generally provides that oil company credits in excess of 50% of taxable income are not usable. A floor amendment proposed by Nelson, Hartke et. al. would reduce this 50% limit to 48%.

Designed to benefit Natomas Corp. Cost: $8 million in FY 1977; $10 million in FY 1978.

<u>Special Transitional Exclusion From the Recapture of Foreign Oil Related Losses (Sec. 1035 b ; p. 247 of Report)</u>.

Existing law (enacted in 1975) curbs the practice of using foreign drilling losses to reduce U.S. taxable income and then paying no U.S. taxes when operations become profitable (due to the foreign tax credit). Such losses are later "recaptured" by reducing the amount of foreign taxes allowed to offset U.S. tax on subsequent profits.

The committee approved a transition rule on foreign losses to aid the Sun Oil Co., presumably in it's North Sea operations. The provision applies to losses incurred before July 1, 1979, under binding contracts entered into prior to July 1, 1974. The amount of the loss which could be recaptured in any year would be limited to 15% of the loss in each of the first four years in which oil-related income is earned. The remaining loss would be recaptured in the fifth year. Cost: $21 million in FY 1977; $6 million in FY 1978. Recouped in later years.

Expansion of the Definition of Oil Related Income (Against Which Foreign Tax Credits From Oil Extraction Operations Can Be Offset) By Including Certain Interest Income (Sec. 1035 (c); p. 248 of Report).

Benefits most of the major oil companies. Most majors have branches which are organized as U.S. corporations but earned all of their income abroad. These branches are capitalized with both debt and equity; thus they pay dividends and interest to their parent company. The amendment provides that interest received from a domestic corporation which earned less than 20% of its income in the U.S. will qualify as "Oil Related Income". Foreign tax credits from extraction operations can only be offset against oil related income under present law (Tax Reduction Act of 1975).

Dividends already are included, as are both interest and dividends from foreign chartered corporations. There is no strong logic that dictates either exclusion or inclusion but inclusion will cost the Treasury $40 million in FY 1977 and $90 million yearly after that.

Moreover, inclusion simply gives oil companies another way to use their credits for foreign "taxes" in excess of 48% of extraction income, many of which "taxes" are actually royalties.

74-620 O - 76 -- 3

Special Definition of Oil Related Income to Exclude Income from Transportation or Distribution of Natural Gas by a Regulated Public Utility Which Meets Certain Narrow Requirements (Sec.1035(c)(5); p.250 of Report).

Amendment benefits I.U. International Corporation, a Philadelphia based conglomerate. Under the 1975 Tax Reduction Act oil related income cannot be consolidated with non-oil income. I.U. International evidently desires to consolidate certain gas utility income with its non-oil income to use some foreign tax credits on such income. Cost: $5 million.

Clarification of Definition of Oil Related Income (Against Which Oil Extraction Foreign Tax Credits Can be Offset) to Include Gain On Sale of Common Stock of A Foreign Corporation (Sec 1035(C)(2)(B) p.250 of Report)

Amendment is designed to benefit Tenneco on its liquidation of a Canadian subsidiary. The law already allows this favorable treatment on the sale of assets. Cost: less than $5 million annually.

Partial Repeal of 1975 Tax Reduction Act To Allow Mobil and Other Oil Companies In Iran To Claim Foreign Tax Credits Even Though They Have No "Economic Interest" in Properties After Expropriation (Sec. 1035 (E) ; p. 251 of Report).

Amendment was sought by Mobil Oil Corporation. The 1975 Tax Reduction Act denies foreign tax credits when oil companies no longer own an "economic interest" in the wells (i.e. they own no mineral rights after expropriation) and they buy their crude oil from the host country at other than market prices. This prevents the disguising of part of the purchase price as a foreign tax.

Mobil hopes to quietly repeal the 1975 Act wherever a company had owned an interest on March 29, 1975. The 1975 Act thus would only apply to newcomers. Cost: $40 million yearly for at least 10 years.

Overruling of Recent (April, 1976) IRS Ruling Which Had Denied Foreign Tax Credits On Production Sharing Contracts In Indonesia (Sec. 1035 (f); p. 253 of Report).

Amendment sought by Natomas Corporation and others who operate in two Indonesian consortiums. (Natomas also received another special interest amendment allowing Carryback of Excess Credits disallowed by the 1975 Tax Reduction Act.)

It is increasingly common for a corporation wholly owned by the host country to own all oil reserves, while the U.S. oil company acts as a service contractor and receives a share of the oil production as its compensation. The government-owned corporation pays over some of the oil revenues to the government and this is arbitrarily labelled an indirect payment of income taxes on behalf of the U.S. owned oil company.

The IRS denied the foreign tax credit in part because the foreign country already owns all the oil and thus there is really no payment by the contractor to the government and in any event, any such payment would be a royalty.

Amendment will overrule the IRS ruling for 5 years as to contracts entered into by April 8, 1976. To restrict benefits to small companies the benefits will be unavailable to the extent a company has excess credits available from other countries. Cost: $25 million yearly for five years.

Exclusion From Taxation Of Interest Earned By Foreigners On U.S. Bank Accounts And Bonds (Sec. 1041; p. 258 of Report).

Amendment sought by Laredo National Bank (Texas), which holds large Mexican deposits, and many other banks.

The only U.S. tax that foreigners now pay on dividends or interest they make from investments in this country is a 30% withholding tax. (This is lowered by bilateral treaty with some countries.) H.R. 10612 would repeal this 30% tax supposedly to encourage more investment in U.S. corporations, bonds, and bank deposits.

Foreign investors who pay taxes on such interest in their country of residence receive a credit against their domestic tax to avoid double taxation. They would either pay the U.S. tax or the tax in their own country. Repeal of the U.S. tax thus amounts to "revenue sharing" with foreign treasuries. Therefore, the major benefactor of this provision will be foreign governments and foreigners who pay little or no tax to their home country and who will now pay no tax to the U.S. either.

Repealing the tax would create an unwarranted windfall for such investors, as well as treating them more generously than U.S. citizens who make the same investments, but who are required to pay regular U.S. taxes. Moreover, the U.S. has long encouraged other nations to maintain the integrity of their revenue base and has criticized nations which create tax havens to attract capital.

This tax holiday provision is costly because it will apply to all investors who already invest in the U.S. for non-tax reasons.

It is questionable how much new investment will be created or whether huge investment by foreigners in U.S. industry is in the national interest. Many countries (particularly the newly-enriched OPEC nations), have strict limits on the amount of capital they allow to be invested in other countries (fear of expropriation, outflows of capital, etc.). Because of OPEC hesitancy it appears that any capital inflows will come mostly from Western Europe. Of course, the banks and investment firms can only profit from whatever increase does result, but the Treasury will foot the bill. Even if bank profits are increased, the Treasury won't benefit much since banks pay taxes at an extremely low effective rate.

Technical Clarification of Rules For Determining the Source Of Insurance Underwriting Income (Sec. 1036 : p.257 of Report).

Amendment is one of two special amendments sought by American International Group. At present insurance contracts negotiated in the U.S. covering overseas risks may be subject to foreign taxation, but classified as U.S. income under U.S. tax laws and therefore ineligible for the foreign tax credit. This amendment would classify such income as foreign income to prevent double taxation. Cost: less than $5 million annually.

Overruling Of Tax Court Decision (Affirmed by Court of Appeals) Which Had Required H.H. Robertson To Pay A Tax On A Liquidating Dividend (Sec. 1042 : p. 270 of Report).

H.K. Robertson Co. liquidated a foreign subsidiary and as required by present law (Sec. 367) obtained an IRS ruling that it would pay ordinary income tax on its accumulated earnings and profits. Robertson miscalculated the tax owed because it had reduced its accumulated earnings by the fair market value of certain property it had earlier paid out as a dividend instead of by its cost basis. The courts held that its computation was clearly contrary to law.

The bill modifies the general requirement that an IRS ruling be obtained before a foreign liquidation. But it also includes a retroactive "special rule in the case of certain past liquidations: not withstanding that a refund would be barred by any court case." Cost: $2 million.

Contiguous Country Branches of Domestic Insurance Companies (sec. 1043, p.271 of the report.)

Under present law a domestic mutual life insurance company pays taxes on its worldwide taxable income, receiving a credit for foreign taxes paid. Because taxes imposed by the United States exceed those of Canada, the insurance industry has tried to get a special exception for their Canadian branches.

This amendment frees profits of Canadian branches from United States taxes, as long as the profits are not repatriated to the United States. It takes effect December 31, 1975.

Mutual insurance companies use the separate branch accounting system whereby premiums and policyholder dividend rates are based upon the separate mortality and earnings experience of the Canadian branch. Therefore, these specially treated profits benefit only Canadian policyholders and may not be used to provide benefits for U.S. policyholders.

C.

The major insurance companies requested this tax preference. The revenue loss will be $4 million in 1977 and $8 million annually thereafter.

Permitting Foreign Banks To Treat Gains On Debt Instruments After July 11, 1969 as Capital Gains to the Extent They Have Capital Losses Incurred Prior to July 11, 1969 (Sec. 1044; p. 276 of Report).

Amendment sought by Royal Bank of Canada. The 1969 Tax Reform Act changed the character of certain income from capital gains to ordinary income. This would accidentally prevent using capital loss carryforwards to reduce taxes on such income. Cost: Less than $5 million.

Permitting Consolidation of Canadian Mining Subsidiaries (Sec. 1052 (b) ; p. 284 of Report).

Amendment tailored to a Canadian iron ore subsidiary of Hanna Mining Co. The bill repeals favorable treatment for Western Hemisphere Trade Cos. (WHTCs) and repeals the per-country method of computing foreign tax credits. The new foreign tax credit rules prohibit consolidation of WHTC's with non-WHTC's. The amendment would allow such consolidation if over 95% of gross is derived from mining in a country contiguous to the U.S.

Tax Treatment of Certain Debts Owed By Political Parties (Sec. 1304, p. 401 of the Report).

The present law does not allow a tax deduction for bad debts of political parties. This law is an effort to avoid favorable tax treatment to individuals or corporations who would "donate" their services to political campaigns knowing they will not actually be paid for them. However, recently more and more professional services are provided to political campaigns by professionals who anticipate payment for those services (polling, direct mailing, media campaigns, etc.) Some of these people have been stuck with large debts after recent campaigns and while making good faith efforts to collect the debts, have been unable to. They are also denied a tax deduction. The amendment would grant a tax deduction to such bona fide bad debts.

Specifically, Charles Guggenheim has been seeking this change in the law because of bad debts incurred during past Democratic campaigns.

Ironically, the Senate Finance Committee has worded the prospective change in such a way that it could only be of help to a major Republican campaign professional, Henry Deirdorf, but could be of no help to Mr. Guggenheim.

__Amendment Overruling the IRS On The Question of Expensing Pre-Publication Costs (Sec. 1305, p. 403 of the Report).__

__Explanation:__

This amendment would allow past expensing (writing off in one year) of prepublication costs, overruling the IRS position relating to encyclopedia publishers and other technical and textbook publishers.

The IRS has published a revenue ruling (Rev. Rule 73-395), that would require publishers to capitalize over the life of a book, expenses relating to research. Publishers have been expensing (writing off in one year) such costs. This primarily covers a situation such as the Britannica III where most of the cost of production is in research. The IRS has ruled that such expenses should properly be deducted over the commercial life of the publication and not written off in the first year and has applied this ruling retroactively. The bill would make this ruling prospective only.

Revenue Effect:

This amendment could mean reductions in tax liabilites of several hundred million dollars for a narrow class of taxpayers, (mainly Encyclopedia Britannica) who have taken these fast write-offs in the past.

Amendment Overruling IRS Regulations On The Tax Treatment Of Face-Amount Certificates (Bill 1307, p. 407 of the Report).

This amendment relates to the tax treatment of face amount certificates--an installment investment certificate promising a lump sum interest yield after 22 years. These certificates are sold almost exclusively (95%) by Investors Syndicate of America, a subsidiary of the Minneapolis-based mutual fund, Investor Diversified Services. The IRS has recently ruled that investors in these certificates must include in income a ratable portion of the interest payments deferrred until maturity. (This treatment is the same as that applied to other deposit arrangements that provide for interest to be paid in a lump sum at maturity--i.e. certificates of deposit).

In 1975, ISA filed suit to enjoin the IRS from enforcing its regulations. The U.S. Court of Appeals in the District of Columbia ruled against ISA

The amendment would overturn the IRS regulations, giving interest on face amount certificates the favorable tax treatment accorded such investments before Congress cracked down on them in 1969.

The House Ways & Means Committee after hearings and several hours of debate defeated similar legislation earlier this year.

These certificates are notoriously bad investments yielding only 3% over the 22 year period. Furthermore, the investor will lose up to 20% of his money if he bows out of the deal within the first 8 years. (According to Forbes, at least half of the investors do drop out early with an actual out of pocket loss.) After 10 years the average yield is 1.1%, after 15 years it is only 2.9%.

Tens of thousands of people buy these certificates ($320 million worth in 1974). Forbes notes "a person would be far better off putting his money in a bank or U.S. Savings Bonds,...or in whole life insurance," and asks; "Is it wrong to persuade people to invest their hard earned savings in so unprofitable a way?" As a practical matter--Congress ought not to lift a finger to grant ISA the legislation which it says it needs to continue marketing these unconscionable instruments to consumers (whose average annual income is between $12,000 and $14,000)

Amendment to Exempt From Personal Holding Company Income Rent From The Lease of Intangible Property (Sec. 1308; p. 409 of the Report).

This retroactive amendment would apparently exempt income received by a Coca-Cola Franchise (we believe in Alabama) from being treated as personal holding company income (taxed at 70% instead of the 48% corporate rate) .

Presently, a corporation or partnership set up to collect primarily passive types of investment income for its shareholders or partners is treated as a personal holding company and taxed at the regular 70% individual tax rates. Exceptions are made for income where the corporation leases its tangible property to a 25% shareholder. The exception does not apply to intangible property such as trademarks or licenses. The amendment would change this rule to include certain intangible property within the exception.

In this case, apparently, a Coca-Cola bottling franchise owned by a corporation or partnership leases its license to one of its own shareholders or partners who operates the franchise in his own right. Without this section, the corporation or partnership, which is merely operating as a "corporate pocketbook" to shelter ordinary investment income, would be taxed as a personal holding company at 70%.

The amendment is retroactive for twelve years to 1964. Apparently, the individuals involved would qualify for cash refunds from the Treasury.

Reporting Tip Income--(sec 1312; p.416 of report).

This amendment was added at the behest of the Marriott Corporation and the restaurant workers unions. Under the amendment, an employer would not have to include any tip income on an employee's W-2 Form which was not reported to him by the employee pursuant to sec. 6053 of the

Internal Revenue Code. The effect of the amendment is to free employers from the responsibility of reporting tip income from charge account receipts. Thus, if an employee fails to report charge account tip income to his employer, the employer is not required to report those tips to the IRS.

The amendment will result in tax savings for restaurant workers of less than $5 million.

Rules Relative to Limitations on Oil & Gas Percentage Depletion (Sec. 1317; p. 424 of the Report).

This section contains a series of amendments to help narrow classes of o . and gas operators.

The 1975 Tax Reduction Act repealed the oil and gas depletion allowance for integrated oil producers who own retail outlets. One part of this section restores the depletion allowance for all integrated companies with $5 million of sales or less. There are several large oil and gas companies who will benefit from this proposal (among the top 70 oil companies in the country).

Also a special provision restores depletion allowance for one independent oil producer who happens to own six gas stations in Israel but does not sell his U.S. production through those stations. (Belco Petroleum Corporation was inadvertently hit by the integrated company rule.)

Two sections modify the depletion repeal exception rules to benefit unnamed trusts that own oil properties and receive depletion.

Revenue Loss: This section loses $18 million in FY 1977, $10 million in FY 1981.

Technical Rules Relating to Simultaneous Liquidation of Parent and Subsidiary Corporations (Sec. 1320; p. 431 of the report).

Under present law a corporation which has adopted a plan of complete liquidation and sells or exchanges some or all of its assets within 12 months does not recognize a gain or loss from the sale or exchange. This is because the shareholders will be taxed on the proceeds after liquidation is completed. This rule does not apply to corporations which are 80% controlled by other corporations because the parent corporation (which is the shareholder in this instance) will not be taxed at the time of liquidation. Therefore, the subsidiary is taxed on the sale or exchange. When both the parent and subsidiary are liquidated this rule might result in inequity, (because the shareholders of the parent will be taxed) so the Internal Revenue Service has held that so long as the subsidiary is liquidated before the parent, the assets can then be sold or exchanged as part of a general liquidation plan and neither the parent nor the subsidiary must recognize a gain or loss. (Upon liquidation the shareholders of the parent would recognize the gain or loss).

This amendment liberalizes the rules for sales of property by subsidiaries. Under the terms of the amendment the sale or exchange of the subsidiary's assets as part of a general liquidation plan does not result in the recognition of gain or loss regardless of whether the subsidiary or the parent is liquidated first.

This provision was supported by the American Bar Association. But it s also backed by an unidentified N.Y. city attorney on behalf of an identified client. It is effective January 1. 1976.

Prohibition of State-Local Taxation of Vessels Using Interstate Waterways (sec. 1321; p.433 of the report)

At the request of Senator Eastland, Chairman Long included this limitation on the taxing powers of the states. The amendment would prohibit the taxation by a state of vessels of another state using the navigable waters of the United States in interstate commerce. Apparently this was passed because a political subdivision of Louisiana has levied a tax on barges. Brent Towing of Greenville, Miss. requested it. It overrules a court case upholding the right to tax.

Contributions to Capital of Regulated Public Utilities in Aid of Construction (sec. 1322; p.434 of the report)

This provision allows regulated water and sewage disposal utilities to exclude from income amounts received as "contributions in aid of construction".

Utilities typically make a hookup charge for customers and the money is placed in escrow and is returned to the customer when service is stopped, usually because of a move to another locale by the customer. The funds placed in escrow are not required to be counted in gross income. In the case of some customers, however, usually businesses, the cost to the utility of initiating service is so high that the utility requires a special contribution, either in cash or material, before it will hook up the customer. The contribution is not refundable.

The IRS ruled that such a transaction resulted in income to the utility. This amendment by making such payments "contributions to capital" of the utility, would reverse this result.

This provision will be effective for "contributions" made on or after February 1, 1976. It will save the utilities $13 million in fiscal year 1977 and $11 million annually thereafter.

If this treatment were to be extended to gas and telephone companies it would cost $100 million a year.

Amendment to Allow Certain Franchise Transfers To Receive Capital Gains Treatment (Sec. 1411, p. 414 of the Report).

The first part of this section simply extends the 1969 Tax Reform Act general rule, denying capital gains treatment to the transfer of a franchise, to partnership situations.

But the retroactive transitional rule is a special rule to allow capital gains treatment to the transfer of a professional practice if a contract was in existence prior to January 1, 1970, and the transferor is an employee or partner of the transferee.

Such franchise transfers are typically franchise optical companies. The amendment was offered on behalf of the Texas State Optical Company.

Permitting Insurance Companies To Consolidate Their Life Insurance Operations With Casualty Insurance Operations (Sec. 1508; p. 454 of Report).

Amendment sought by a dozen major insurers. At present non-insurance companies (such as ITT) can file a consolidated return and thus offset casualty insurance losses against other business income. The amendment is a logical extension of this rule. Cost: $0 in FY 1977; $25 million in FY 1978; $50 million yearly thereafter.

Special Treatment of Certain Inadvertent Distributions Of A Life Insurance Company (Sec. 1509; p. 457 of Report).

Amendment will apply only to Businessmen's Assurance Co. of America. It miscalculated the tax effect of a dividend which was inadvertently paid from a (taxable) surplus account. It discovered the error and had the dividend paid back before the end of the year. Amendment is retroactive to 1959 and applies only to dividends paid back before the end of the year.

This provision was enacted as the vehicle for September 1, 1976 tax-out extension.

Special Treatment of Concrete Railroad Ties Replacing Wood Ties (sec. 1702, p.482 of report).

This amendment was introduced for the benefit of Florida East Coast R.R. and Kansas City Southern R.R., the only privately-owned railroads using concrete ties. Contrary to principles of accounting and past tax rules, it allows the immediate deduction of the costs of installing concrete railroad ties, but not to exceed the replacement cost of wood ties. Because wood ties have become extremely expensive, this amendment allows these companies to deduct much of the installation cost immediately. Under normal business practice the cost of these ties would be capitalized over their useful life..

The bill grants this favored treatment for any expenses since December 31, 1975 and for the future. It will cost less than $5 million a year, but all benefits will go to these two companies.

Special Interest Energy Amendment (Sec. 2001 et. seq.; p. 549 of Report).

The homeowner insulation credit, which will generally benefit Johns-Manville, Certain-Teed Products, etc., has appended to it a credit for automotive clock-timers (the so-called "Honeywell amendment") and a credit for heat pumps, pushed by GE and Westinghouse. The geothermal drilling and depletion deductions will probably primarily benefit Union Oil or Pacific Gas And Electric in their joint California Geyser operation. The "exemption from the retailer excise tax on special motor fuels (propane) for certain non-highway use" will simply equalize the treatment of propane and diesel fuel. It will benefit Eaton Corp. a maker of lift trucks.

Income from Fairs, Expositions and Trade Shows (sec.2107; p.601 of report).

This amendment provides that tax-exempt organizations will not be subject to an unrelated-business income tax on rental income from trade shows even though the exhibitors sell their products at the trade show. It also exempts income from entertainment activities at public fairs. Two IRS rulings had held that income from parimutuel betting on horse racing at a county fair and income received by an exempt business league from renting display space at a trade show. where selling was permitted are taxable as unrelated business income.

This provision was urged by the American Society of Association Executives and is retroactive to December 31, 1962 for public fairs and to December 31, 1969 for conventions and trade shows.

APPENDIX B: Campaign Contributions

The following is a partial list of companies who appear to benefit from specific provisions in the Tax Reform Bill. Included is a separate compilation of contributions made by officers of those companies to the campaigns of members of the Senate Finance Committee. The information is necessarily incomplete because of difficulties both in identifying the beneficiaries of particular provisions in the bill, and ascertaining the corporate affiliations of many campaign contributors. In light of these difficulties, time has not permitted a check of all campaign finance records.

We suggest no impropriety with regard to the various campaign contributions. We feel, nevertheless, that it is important that this information be made available to the public.

1021, p. 225	Pyramid Ventures	Donald Scafidi, Pres. $800 To Long
	Superior Oil Co.	$1000 to Long 500 to Bentsen (pres.)
1024, p.230	Jackson Marine Corp. Aransas Pass, Tex.	$1000 to Bentsen (pres.) 500 to Bentsen (sen.)
	Arthur Levy Boat Services Morgan City, La.	2300 to Long
	Deutsch, Kerrigan and Stiles, lawyers for Arthur Levy, Inc.	1000 to Long
1025e, p.232	Grain companies, Cook Industries, Memphis	$4750 to Bentsen (pres.) 880 to Brock 200 to Packwood
1031c, p.238	Freeport Minerals	$1700 to Long 400 to Bentsen (sen.)
1032, p.240	Boise Cascade Corp. (officers are residents of Idaho)	$250 to Long
1035a, p.246	Natomas Corp.	$500 to Bentsen (pres.)
1035b, p.247	Sun Oil Co. (officers & Pew Family)	$2200 to Hansen 2000 to Dole 1000 to Curtis
	Pepper, Hamilton & Scheetz, lobbyists	$ 200 to Packwodd
1035c(2),p.250	Tenneco, Inc.	$5000 to Bentsen (sen.) $800 to Long

1035c(2),p.250	I.U. International	$550 to Bentsen (sen.) $500 to Bentsen (pres.) $100 to Long $100 to Dole
	Williams and Jensen, lobbyists	$2700 to Dole $2100 to Long $1000 to Bentsen (sen.) 250 to Packwood 200 to Hartke

1035c,p.248 All major oil companies

1035e,p.251 Contributions by those identifying themselves as officers of the major oil companies:

Gravel:	Atlantic-Richfield	$2,500
	Hess Oil.	2,000
	Std. Oil of Ohio	700
	Continental Oil	700
Dole:	Union Oil Calif.	1,000
	Atlantic Richfield	500
	Citgo	1,000
Long:	Continental Oil	1,300
	Citgo	1,000
	Exxon	1,000
	Shell	900
Bentsen:	Moncrief Oil, Ft. Worth	$7,100
	Continental	2,000
	Std. Of Ohio	800
	Mobil	600
	Gulf	400
	Shell	350

Ragan and Mason, lobbyists for Gulf Oil:	Gravel	$1,000
	Bentsen	550
	Hartke	500
	Dole	500
	Haskell	200
Patton, Boggs and Blow, lobbyists for Atlantic-Rickfield, Exxon and Sohio:	Gravel	2,050
	Bentsen	1,680
	Haskell	200
	Packwood	100
Dawson, Riddell, etc., lobbyists for Standard Oil of Ohio:	Hartke	1,100
	Bentsen	750

1035f, p. 253	Natomas Corp.	(see above)
1041, p. 258	Laredo National Bank	J.C. Martin, Mayor of Laredo, and Radcliffe Killam, Directors of the bank, and Mr. Martin's wife gave $1000 each to Bentsen's senate campaign and $1000 each to Bentsen's pres. campaign

1043, p. 262 — All major insurance companies

Long:	Mutual of Omaha	$2,500
	Pan American Life	2,000
	New York Life	1,250
	Continental Life	200
Bentsen:	Prudential Life	2,000 (sen.)
	Equitable Life	500

Ribicoff : $5,400 from Connecticut insurance agents

Dole: Over $10,000 from various insurance agents whose company affiliations could not be identified

---

1317, p.424 — Belco Petroleum Co. — Arthur Belfer, Pres. contributed:

$2,000 to Ribicoff
1,000 to Gravel
500 to Hansen

Registered Lobbyists:

Vinson, Elkins, Searls, Connally and Smith of Houston, through John Chapoton

The firm contributed $6,500 to Bentsen's senate campaign, $550 to his presidential campaign

Maurice Rosenblatt, National Counsel Associates $100 to Bentsen (pres.)

1411, p.414 — Texas State Optical Co. Rogers Brothers Investments — Rogers Bros. makes optical equipment. Two of the four brothers are optometrists, and own a TSO franchise in Beaumont

The four brothers gave
$2200 to Bentsen (sen.)
$1000 to Bentsen (pres.)

1321, p. 433	Brent Towing, Greenville, Miss. Jesse Brent Amendment proposed on behalf of Senator Eastland by Senator Long. (American Waterways Operators of Virginia, which donated $1,000 to Eastland, may also benefit.)	$1,500 to Eastland (1972)

[*Source: Tax Analysts and Advocates]

1508, p. 454	All casualty companies affiliated with life insurance companies.	(see above)
1509, p. 457	BMA Corp.	$2,050 to Bentsen (pres.) $1,000 to Dole
Committee amendment on use of IDB's for private hospital construction	FEDPAC, the political action committee of the Federation of American Hospitals and beneficiary of one of the Committee amendments, gave:	$1,000 to Bentsen $1,000 to Dole $2,100 to Packwood

environmental action
Suite 731 1346 Connecticut Ave. NW Washington, DC 20036 (202) 833-1845

TESTIMONY OF A. BLAKEMAN EARLY

OF ENVIRONMENTAL ACTION

BEFORE THE

SENAT FINANCE COMMITTEE

ON H.R. 16012

THE TAX REFORM ACT OF 1976

JULY 20, 1976

Good morning. My name is A. Blakeman Early, I am with Environmental Action, a national citizen's environmental lobbying organization. Environmental Action has been particularly active in promoting resource recovery legislation before the Congress. I am here to discuss section 2006 of H.R. 10612, the Tax Reform Act of 1976, the Recycling Tax Credit.

Tax Equity

As the Committee knows, many recycling tax credit proposals have been considered over the past several years and with each succeeding proposal the complexity of this subject area has become more apparent. While this proposal is distinguishable from others primarily by the addition of the base period which is designed to prevent windfall benefits, it still attempts to deal with a complex problem in the same fashion. It seeks to eliminate the effects of tax benefits to virgin materials users by creating a countervailing tax benefit to recyclable materials users across the board without regard to whether the benefits will achieve greater recycling of a given material. The benefits are extended without regard to whether the use of the recyclable material is even in competition with virgin materials which generate the original tax credits to be offset. Indeed, the benefits are extended without regard to whether there is any additional recyclable material which can be recycled. As the Aluminum Recycling Association has pointed out in its statement in opposition to this proposal, recycled aluminum alloy and primary aluminum alloy are used in wholly different products and so are not in competition. In addition, primary alloy manufacturers rely on foreign sources for their raw material, bauxite, and therefore can not use the percentage depletion allowance to a great extent. Materials such as textiles and plastics qualify for the tax credit when no data has been developed indicating to what extent virgin material counterparts have achieved an unfair tax advantage. Clearly then, if tax equity is the goal, the equity achieved by the subject proposal is a rough one, indeed. The only effective means of achieving tax equity, if that is the Committee's goal is to remove the benefits which accrue to virgin materials users, not to enact a countervailing benefit to recyclers which can not even be shown to approximate the virgin materials benefits.

Increased Recycling

The testimony and data provided to the Finance Committee in support of this proposal and past proposals is replete with the environmental, energy, materials, and balance of payment benefits which will accrue from the increased recycling promoted by the proposal. But will any appreciable increase in recycling result from the enactment of the subject provision? Proponents of this measure have presented no data to demonstrate its effectiveness in increasing the use of recyclable materials. Again, this is due in part to the failure of the measure to treat each material category on an individual basis. The lack of greater recycling of these materials is caused by a bewildering combination of technical, economic, and institutional barriers which vary depending upon which material is considered. Although it is difficult to generalize, many problems surround the impurities found in most recyclable materials which either require more processing than virgin materials need in order to remove them, or which simply are not removable using existing technology. (Attachment 1) The Committee can not expect that a tax credit of the size proposed will be sufficient to overcome technological barriers requiring extensive research and development in each materials area, for the needs are different for each material. Section 2006 does not take into account that for some materials the technological barriers are too great. Therefore the use of that recyclable material should not qualify for the credit since no additional recycling will result and the only result would be that existing levels of recycling will receive windfall benefits.

The evidence we have examined indicates that the recycling tax credit proposal will also be ineffective in overcoming the economic factors which inhibit greater recycling. This data indicates that the factors limiting the use of secondary materials are not fundamentally altered by the minor adjustment in price enabled by this proposal. Attachment 2, taken from a study done for the U.S. Environmental Protection Agency, which compares subsidies to the product charge in the paper industry, illustrates that even when excessively large subsidies are introduced, demand for secondary material increases only slightly. This is because the subsidy would not be passed forward in the form of lower prices and stimulate demand. The subsidy would be kept as "economic rent", or excess profit. Attachment 3 demonstrates that the cumulative tax subsidies available to virgin materials extraction industries, and to users of such materials because of the high degree of vertical integration, represent a small percentage of the total price of such materials. These findings indicate that the removal of these tax advantages would provide only a marginal increase to the cost of virgin materials in the form of higher prices. Consequently, the incentive to substitute post-consumer scrap would also be very low. A corresponding tax credit for secondary material suppliers would also represent a small percentage of post-consumer scrap price, since such prices are equal to or higher than competing virgin material prices. If the impact of such a tax credit on post-consumer scrap prices is small, then the corresponding incentive to suppliers to increase supply will also be small. Moreover, such a small reduction in post-consumer scraps prices would be unlikely to cause manufacturers to substitute such material for virgin materials.

Another study of the paper and steel industries found that demand and supply are inelastic and not responsive to price. The study found that subsidies of supply would have a reduced impact on the users since often half the cost of scrap materials is in transportation which would not be affected by a subsidy. (See Attachment 4).

Therefore, the reduction of recyclable materials cost to the user through the proposed tax credit is unlikely to increase demand for such material significantly because the credit will lower the cost of such materials only slightly. To the extent that demand is marginally increased, suppliers will respond, in part, by raising prices and shifting more recyclable materials from the export market to the domestic market -- not by obtaining more recyclables from the waste stream. This is why the proposal is opposed by the Association of Brass and Bronze Ingot Manufacturers and the Aluminum Recyclers Association as well as the Garden State Paper Company which provided much of the testimony in favor of the original proposal considered by the Finance Committee last summer. Indeed, we feel that the principal reason the measure is supported by recycled materials suppliers, who do not qualify for the credit, is that such suppliers will be able to increase the price of recyclable materials they sell users receiving the credit.

Finally, a major defect in the formulation of the provision is that the calculation of the credit is based on the price of the recycled material, which bears no relationship to the weight of the material -- a more accurate measure of the burden such material places on the disposal system -- and which also is no measure of the quantity of the materials available in the waste stream for recycling. Consequently, nonferrous metals such as aluminum would receive a disproportionately high part of the tax credit relative to the low tonnage of non ferrous which is presently recycled and relative to the additional tonnage which is available for recycling. In addition, basing the credit on the price will have a tendency to exacerbate the boom and bust pricing experienced in the recyclable materials markets. This is because when demand for recyclable material is low, prices are down too, and the tax benefit is at its lowest, since it is based on price. This is the time when the incentive is most needed. Conversely, when prices are high, due to high demand, the tax benefit is at its greatest during a period when it is least needed.

<u>The Windfall Problem</u>

The tax credit proposal will provide substantial "windfall" profits despite complex but ineffective provisions to prevent them. Manufacturers will receive a "windfall" by qualifying for the credit by recycling materials which they would have recycled without the tax credit. The provisions, by limiting accrual of the credit until purchases of recyclable material by the manufacturer exceed 75 percent of base period purchases, subsidize the manufacturer for increases in total production over previous levels even if he has not increased the actual percentage of recycled material in his product. Thus, manufacturers will be subsidized for using recycled material which they would have used simply to meet increases in production. Proponents of the recycling tax credit proposal claim that tax loss will be minimal because for each ton of recyclable material used, there will be a corresponding decrease in use of virgin material which would qualify for a tax credit. This assumes that there will be an increase in recycling, which we question. The assertion fails to account for the tax loss I have just described. The revenue loss would be much greater under Senator Gravel's amendment which I will discuss later.

In addition, we note with dismay that provisions in previous recycling tax credit proposals designed to limit possible windfall have been eliminated in this proposal. The provisions make no attempt, as found in prior versions, to limit the credit to purchasers of post-consumer material and exclude purchases of industrial converting wastes, 90 percent of which are currently being recycled. Gone is the requirement that the tax credit can only be applied against new investment in recycling equipment. (Identified by EPA as the best means of assuring that long term substitution of recyclable material will take place.) Except for scrap paper, gone also is the ceiling provision which terminates the credit should the price of the recyclable material rise high enough to provide its own incentive to increase supply and to prevent excessive revenue loss. Finally, the requirement that the credit be terminated at such time as tax benefits for virgin materials users are removed by the Congress has also been eliminated.

A great deal of controversy surrounds the level of tax loss and windfall benefit which will result from the proposal. Although the Report on H.R. 10612 states that the tax loss in 1977 will be $9 million, the Association of Brass and Ingot Manufacturers calculates that the scrap copper processors it represents would be entitled to $6,913,012 in credits. Since copper represents less than 5 percent of the material recycled each year, the Committee's calculations may be in error. More importantly, the Committee calculation of the revenue loss when the proposal is in full effect in 1981 is $345 million. Attachment 5 provides the U.S. Treasury calculation of the cost-per-ton of additional recycling created by the proposal when in full effect. It shows that the Federal government will in effect be paying from 2.60 to 20.10 times the market price in the form of lost revenue for every ton of additional material recycled. We submit that these moneys would be far more effectively spent if used to ensure that the recently passed Solid Waste Utilization Act (S. 2150) were fully funded. This bill provides technical assistance, planning, grants, and loan guarantees to stimulate the supply and use of recyclable materials and the safe disposal of non-recoverable waste. We are far more optimistic about the prospect of success for such an approach.

Finally, I would like to address the amendments to section 2006 recently proposed by Senators Mike Gravel and John Tunney. In our view, both proposals would amplify the current problems with the measure which I have outlined.

Amendment number 2016, introduced by Senator Gravel would essentially eliminate the base period as established in H.R. 10612 over a three year period. Recyclers would therefore receive a credit for 100 percent of the base year plus 100 percent of any incremental increase in recyclables used. Therefore, barring any major economic decline the revenue loss in 1981 should be about four times the Committee's original estimate, or $1.380 billion. A staggering tax loss, yet the data we presented indicates that as a percentage of recyclable materials cost to the user, it will be small and thus have little effect.

Amendment number 2017 introduced by Senator Gravel and Senator Tunney is a clear example of the inappropriateness of trying to apply the recycling tax credit approach across the board without regard to the technological and economic realities of the materials involved. The major effect of the amendment is to extend the 5 percent recycling tax credit already provided to purchasers of recyclable glass and plastic to purchasers of energy and other products produced from garbage residues, after all recyclable materials have been removed.

First, the amendment can not be supported by a tax equity argument since the production of steam is not directly subsidized through tax benefits resembling the depletion allowance and such allowance has been largely removed for oil production. This is not to imply that other subsidies for fossil fuels producers do not exist. More important, is the fact that the overwhelming impediment to the purchase of energy products from these resource recovery facilities is caused by the newness and questionable reliability of the technology involved and the technological modifications users must make in order to accomodate these products. These technological risks could not be remotely affected by such a modest tax benefit. Although we support the concept of encouraging the development of energy recovery facilities, we believe that such facilities must operate on a free market basis without depending on subsidies for support. Where financial encouragement is necessary, it is far more effective if provided directly to the energy developer, rather than indirectly through the energy user, which simultaneously has the effect of encouraging increased energy use caused by lower energy costs.

Alternative Proposals

Although we recognize that current tax policy encourages the excessive use of virgin materials and energy, there are several approaches to correcting such inequities and providing an incentive for increased recycling: 1) tax credits for users of recyclable material, 2) tax credits for suppliers of recyclable material, 3) severance taxes on virgin materials extractors, 4) disposal charges on producers of consumer products which do not contain recycled material, and 5) the removal of existing tax benefits available to virgin materials users. The best manner for Congress to rationally alter tax policy in this area so as to create an effective incentive for recycling which will minimize tax revenue loss is to consider such proposals concurrently, rather than consecutively. In this way, if the Congress chose to pass more than one proposal, the passage of one would not jeopardize valuable support for the other. The Senate passed the Solid Waste Utilization Act on June 30 which contains a comprehensive study provision requiring an examination of all the available proposals for creating an effective incentive to encourage greater recycling. We urge the Senate to defer passage of the recycling tax credit until the completion of such a study to enable an effective analysis of the options to be conducted. Given the importance and complexity of improving our national materials policy to increase recycling and the importance of reducing revenue loss to a minimum to achieve the budget ceiling established by the congressional budgeting process, a delay to ensure that such information is considered before legislation in this area is passed is a necessity. Make no mistake about it, we view this provision as a special interest tax loophole -- not as a provision to save energy and improve the environment.

My testimony presented today has the support of the following organizations besides Environmental Action:

Environmental Policy Center

Friends of the Earth

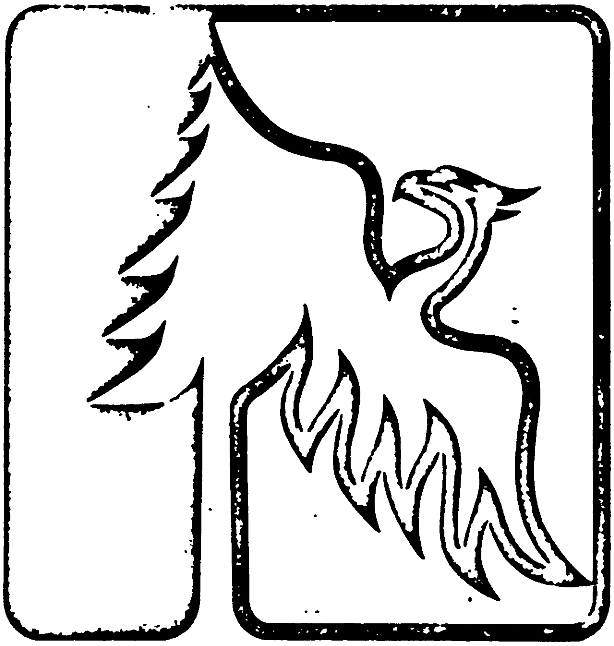
Taxation with Representation

Public Interest Economic Center

Public Citizen - Tax Research Group

Attachment 1

PAPER RECYCLING



the impacts of contaminants

1973-1985

A Report by the
Midwest Research Institute
and
Franklin Associates
for the Solid Waste Council
of the Paper Industry

74-020 O - 76 -- 5

Attachment 1-2

as well. In total, however, wood pulp continued to increase as a percent of total paper making fibers until 1973.

From 1973 to 1985, the use of waste paper is forecast to grow from 22.3 percent in 1973 to 24.4 percent in 1985. In tonnage, this is a significant turnaround, and in fact, the actual waste paper fiber use will increase substantially as its use outpaces growth in total paper demand.

The trends in fiber sources are summarized in Table 2-1. Total waste paper use will increase from 14.3 million tons in 1973 to 23.0 million tons in 1985, or from 22.3 percent of total fiber to 24.8 percent of total fiber.

Thus waste paper will become a more important fiber source in the future. This means it will be used in more grades of paper and in higher percentages. As it becomes more important, the type of contaminants associated with paper recovered for recycling will be of interest to the companies that recycle post-consumer grades.

Some uncertainties occur today because the concentration of contaminants is rising and the types of substances encountered cannot be fully removed or dispersed in the paper mills. If this situation prevails, then recycling costs and recycled products could become noncompetitive with virgin fiber and recycling will not expand as rapidly as it would otherwise. In either case, the effect of rapidly increasing contaminants could be unfavorable to the industry as it shifts its raw materials base toward waste paper.

TABLE 2-1
Fibrous Raw Materials Used in Paper Manufacture, 1950 to 1985
(In thousand tons and percent)

	Roundwood		Wood Residues		Total Wood Pulp		Waste Paper		Other Fibers		
Year	Tons	Percent	Tons	Percent	Tons	Percent	Tons	Percent	Tons	Percent	Total
1950	15,518	59.9	991	3.8	16,509	63.7	7,456	30.7	1,439	5.6	25,404
1955	19,737	62.0	1,716	5.4	21,453	67.4	9,041	28.4	1,340	4.2	31,845
1960	21,331	59.8	4,369	12.2	25,700	72.0	9,032	25.3	971	2.7	35,703
1965	25,369	56.2	8,638	19.2	34,007	75.4	10,231	22.9	879	2.0	45,117
1970	30,710	54.8	12,482	22.3	43,192	77.1	12,021	21.5	828	1.5	56,041
1973	30,490	47.6	18,372	28.6	48,862	76.2	14,319	22.3	964	1.5	64,145
1980	34,010	44.2	24,130	31.3	58,140	75.5	17,860	23.2	1,000	1.3	77,000
1985	39,510	42.6	29,210	31.5	68,720	74.1	22,990	24.8	1,000	1.1	92,710

Source: American Pulpwood Association, American Paper Institute, Midwest Research Institute.

Attachment 2

RESEARCH TRIANGLE INSTITUTE

Contract No. 68-01-3267
RTI Project No. 41U-1079-1

January 1976

The statements, findings, and conclusions presented in this draft report are tentative and are not necessarily those that will be found in the final report. Therefore, please do not cite or quote this document.

Draft Final Report

THE CASE FOR VIRGIN MATERIAL CHARGES: A THEORETICAL AND EMPIRICAL EVALUATION IN THE PAPER INDUSTRY

prepared for:

Office of Solid Waste Management Programs
Environmental Protection Agency

by

Allen K. Miedema
Bun Song Lee
Joanne T. Rogoff
Philip C. Cooley

Attachment 2-1

Some of the factors adduced to explain that trend are discussed in appendix C.

5.2 Reuse Ratio Effects

Figure 5-1 arrays predicted virgin fiber shares in 1985 versus charge/subsidy rates. Under all three generic policy specifications the virgin fiber share will decline from the predicted baseline level of 82 percent in 1985, i.e. the predicted baseline wastepaper reuse rate of 18 percent in 1985. The rate of descent, however, differs considerably among the three policies. For example, at a $25 rate the virgin fiber shares are predicted at 64, 81.6, and 73.3 percent for the charge, subsidy, and mixed policies, respectively. These imply reuse rates of 36, 18.4, and 26.7 percent respectively. It is interesting to note that the predicted 36 percent reuse rate under the $25 charge policy is nearly identical to the reuse rates that were experienced in the U.S. during World War II. At the extreme rate of $50 per ton the virgin fiber shares would be 47, 79.2, and 65 percent under the charge, subsidy and mixed policies, respectively. Clearly, the subsidy policy appears completely ineffective. Furthermore the effectiveness that the mixed policy does have is associated with the increasing charge rate over the ten-year period.

Since the subsidy policy was found uniformly ineffective it may be useful, at this point, to mention the two main reasons for this observation. First, the elasticity of secondary fiber supply is very low, .09. Therefore, virtually none of the subsidy would likely be passed forward. It would be absorbed as economic rent by paperstock suppliers and/or paper producers. Second, the subsidy has a perverse demand effect as noted in chapter 3. This results because the little subsidy that does get passed forward lowers overall fiber furnish costs and, hence, paper production costs. This, in turn, shifts the paper supply functions rightward and downward. Therefore, with small substitution effects this shifting paper supply function may actually serve to increase total virgin fiber consumption above what it would have been in the absence of any policy.

5.3 Fiber Consumption Effects

5.3.1 Secondary Fiber Consumption Effects

Figure 5-2 shows projected secondary fiber tonnage consumption projections for 1985 under the three policies at the ten rates. At a $25 rate the

Attachment 2-2

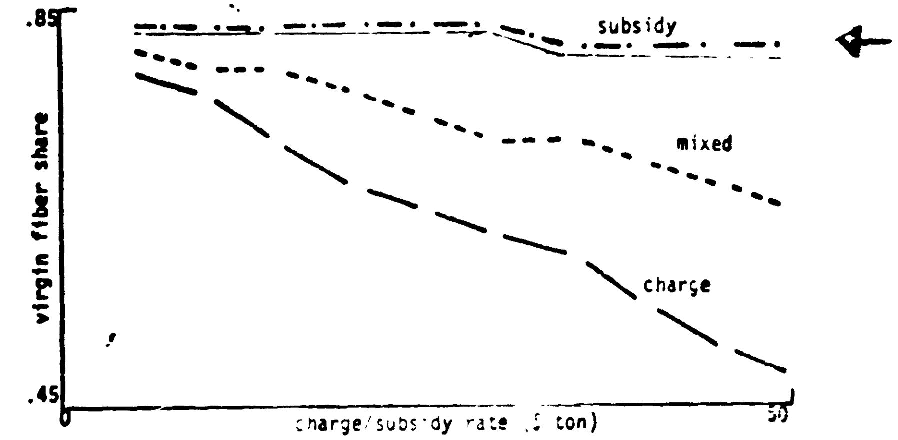


Figure 5-1. Charge/subsidy effects on the virgin fiber share in 1985.

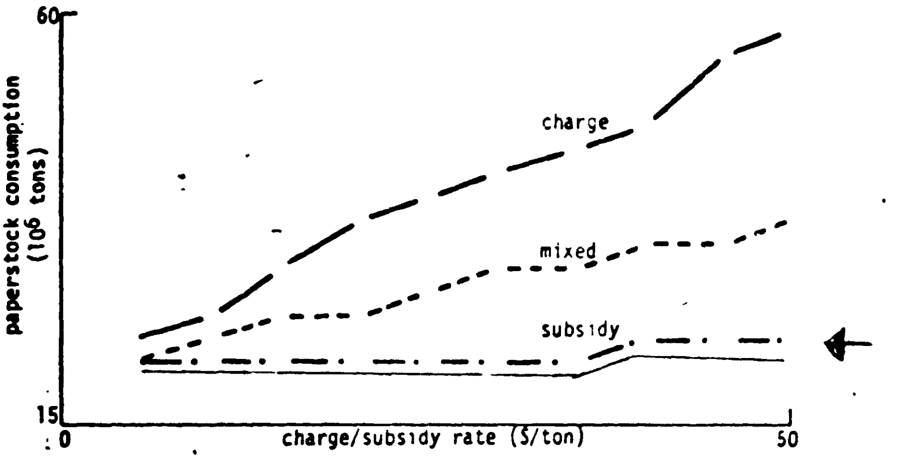


Figure 5-2. Charge/subsidy effects on paperstock consumption in 1985.

Attachment 3

MAXIMUM ESTIMATED IMPACT OF DISCRIMINATORY TAXES AND TAX BENEFITS ON THE COST OF SELECTED COMMODITIES - 1I

Tax Element	Aluminum ($ Per Ingot Ton)	Pulp & Paper: Newsprint ($ Per Ton)	Pulp & Paper: Paperboard ($ Per Ton)	Glass ($ Per Ton)	Steel ($ Per Ton of Raw Steel)	Petroleum ($ per BBL) For 1971	Natural Gas ($ per MCF) For 1971
Percentage Depletion	$ 1.35	$ -	$ -	$0.20	$0.90	$0.25	$0.015
Foreign Tax Treatment	1.51	-	-	-	0.27	0.13	-
Expensing of Mine Exploration & Development Expenditures	1.02	-	-	-	0.27	-	-
Expensing of Intangible Drilling & Development Costs	-	-	-	-	-	0.01	0.002
Capital Gains Treatment of Income From Timber Sales	-	1.14	2.48	-	-	-	-
Minimum Tax on Preferences	-	-	-	-	-	(0.04)	(0.002)
State and Local Resources Taxes	(0.08)	-	-	-	(0.19)	(0.06)	(0.007)
Total (After Tax)	$3.80	$1.14	$2.48	$0.20	$1.25	$0.29	$0.008
% of Price	0.7	0.7	1.4 - 2.2	1.4	1.7	9.8	4.4
Total (Before Tax)	$7.92	$2.28	$4.96	$0.40	$2.60	$0.60	$0.017
% of Price	1.5	1.4	2.8 - 4.3	2.7**	3.5*	20.2	9.3

* Percent of estimated average cost of producing raw steel @ $75.00 (ton)

** Includes estimated percentage depletion for limestone, soda ash (a limestone derivative) and feldspar

Note: Impacts are shown as tax savings associated with tax benefits (after tax basis). Before tax impacts represent the amount that prices would have to be increased to fully affect the effects of the removal of tax benefits.

Attachment 4

THE FEDERAL TAX CODE AS A DETERRENT TO RECYCLING*

Robert Anderson
and
Richard Spiegelman

Environmental Law Institute

* The authors wish to acknowledge assistance from Taylor Durham in the modeling of wastepaper markets, and helpful criticism from Michael Hay, Fred Smith, Fred Peterson, and Toby Page. An earlier version of this paper was presented at the 1975 meetings of the Western Economics Association.

Proposed running head: Taxation and Materials Use

Address correspondence to:
Robert C. Anderson
Environmental Law Institute
1346 Connecticut Ave. N.W. Room 620
Washington, D.C. 20036

from taxation.[8]

To the extent scrap supply and demand curves are inelastic, subsidies to either buyers or sellers have only a nominal impact upon quantities recycled. For example, a 10% ad valorem depletion allowance (or recycling tax credit as it was termed in pending energy conservation legislation) would, according to our estimated supply and demand elasticities, increase the quantity of wastepaper recycled by only 0.8%.[9]. A similar subsidy to the scrap steel industry would increase the quantity of steel recycled by 4.5%.

The equalization of effective tax rates in virgin and secondary materials industries achieved thorugh the elimination of some of the income tax subsidies currently accorded the virgin material producers, would as we have seen in the econometric section, have a negligible impact on recycling over the snort to intermediate term for which the elasticity estimate may be considered valid. The tax code may also be used to increase the final price of certain virgin based products so as to encourage greater recycling. HR 2172, for example, would tax beverage containers but would exempt all returnable containers from the tax.

The dilemma faced by those who would seek to increase recycling rates is that subsidization of either supply or demand fails to significantly increase recycling to the extent that production and consumption decisions are not responsive to price. In attempting to formulate a public policy which might have a greater impact one must first examine the underlying determinants of inelastic supply and demand curves. Inelasticity of

Attachment 4-2

demand with respect to the price asked by scrap dealers may be attributed to at least two factors. First, the full cost of scrap to a user includes transportation charges which occasionally exceed the dealer's price in magnitude.[10] This means that though dealer prices are quite volatile, the price perceived by the user will fluctuate over a much narrower range. The inclusion of transportion charges in the price to users substantially reduces the elasticity of demand in reponse to a change in dealer prices. Second, many users perceive supply as being unresponsive to market signals and consequently may be reluctant to depend upon scrap supplies as a regular source of raw materials. These users purchase scrap only when other sources of supply are unavailable, and demand for their final outputs is strong. During these periods such users probably care little what they must pay for raw materials - availability counting far more than price in their purchase decisions.

Scrap supplies tend to be inelastic for two related reasons. First is the fact that over half of all scrap generated is of the home or prompt variety and is recycled automatically, or at least with little reference to prevailing prices for scrap. Of the post consumer sources most of the high quality, generator separated metals and paper are subject to disposal contracts with scrap dealers and will be recovered irrespective of current market conditions. Only the widely dispersed post consumer wastes are available as new supply sources when scrap demand rises, and the marginal costs of processing these supplies is high. The second, related factor leading to supply inelasticity is the volatile nature of demand which increase the risk of financial ruin

Estimated Impact of Fully Effective Recycling Credit;
Five Major Recyclable Materials 1/

Recyclable material	Typical market price per ton	Unsubsidized recycling volume	Incremental recycling due to credit 2/		Cost per ton of incremental recycling 3/	
			Amount (tons)	Percent	Amount	Ratio to market price
Paper (overall)	$ 45	16,000,000	120,000	0.75	$ 230	5.15
Scrap iron (overall)	75	40,000,000	190,000	0.47	310	4.10
Copper	1,100	400,000	750	0.19	11,100	10.10
Aluminum	300	350,000	3,900	1.10	785	2.60
Lead	220	560,000	500	0.09	4,400	20.10

Office of the Secretary of the Treasury
Office of Tax Analysis

June 21, 1976,

1/ These calculations are based on assumptions intended to overstate response to the subsidy, hence understate the cost per incremental ton of recycling:
(1) Induced cyclable instability of the credit due to use of prior year bases is ignored.
(2) No allowance provided for administratively uncontrollable fraud.
(3) Estimates of market response rounded upward.

2/ This assumes that the base for the credit is purchases in excess of 75 percent of the taxpayer's base period quantity. If the base is redefined to be purchases in excess of 50 percent of the base period quantity, the numbers in this column would be doubled.

3/ Entries in this column are independent of the definition of the credit base, they depend only on price response of market demand and supply.

Attachment 5

REALTOR®

NATIONAL ASSOCIATION OF REALTORS

Philip C. Smaby, President
H. Jackson Pontius, Executive Vice President
Albert E. Abrahams, Staff Vice President
Government Affairs
925 15th Street, Washington, D C 20005
Telephone 202 628 5300

STATEMENT OF HOWARD M. BENEDICT

CHAIRMAN OF THE NATIONAL ASSOCIATION OF REALTORS® ECONOMICS AND RESEARCH COMMITTEE

BEFORE THE SENATE FINANCE COMMITTEE

ON TAX REVISION

WEDNESDAY, JULY 21, 1976

The NATIONAL ASSOCIATION OF REALTORS® is comprised of more than 1,700 local boards of REALTORS® and 50 State Associations. Combined membership of these boards is approximately 500,000 persons actively engaged in sales, brokerage, management, counseling, and appraisal of residential, commercial, industrial, recreational and farm real estate. The activities of the Association's membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and residential real estate development, including development, construction and sales of condominiums. The Association has the largest membership of any association in the U.S. concerned with all facets of the real estate industry. Principal officers are: Philip C. Smaby, President, Minneapolis, Minnesota; Harry G. Elmstrom, First Vice President, Ballston Spa, New York; and H. Jackson Pontius, Executive Vice President. Headquarters of the Association is at 155 East Superior Street, Chicago, Illinois 60611. The Washington office is located at 925 15th Street, N.W., Washington, D.C. 20005. Telephone: 202-628-5300.

SUMMARY OF STATEMENT OF HOWARD H. BENEDICT

ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS®

SENATE COMMITTEE ON FINANCE

JULY 21, 1976

A more adequate supply of housing plus needed balance of commercial and industrial real estate is vital to the social and economic health of our country. Investment in real estate is an important part of our competitive economy. Recent changes in the tax law, in addition to the threat of certain current tax revision proposals, have adversely affected the real estate industry and the nation's economy.

The amendment offered by Senators Haskell and Kennedy which applies an "at risk" limitation to limited partnerships, including real estate limited partnerships, has made the Tax Reform Act of 1976, H.R. 10612, extremely complicated and financially destructive to the real estate industry. This amendment will eliminate an important source of equity capital--particularly for new rental housing projects which rely heavily on limited partnerships for equity financing.

We respectfully request the members of this distinguished Committee on Finance to urge their fellow Senators to reconsider and reject this drastic "at risk" limitation.

STATEMENT OF HOWARD M. BENEDICT

CHAIRMAN OF THE NATIONAL ASSOCIATION OF REALTORS® ECONOMICS AND RESEARCH COMMITTEE

SENATE COMMITTEE ON FINANCE

JULY 21, 1976

Introduction

Mr. Chairman, members of this distinguished Committee, my name is Howard M. Benedict and I am engaged in the real estate business in New Haven, Connecticut. I have previously served as Real Estate Commissioner of the State of Connecticut, Vice Chairman of the Federal Taxation Subcommittee of the NATIONAL ASSOCIATION OF REALTORS®, and Chairman of the REALTORS Mortgage Finance Subcommittee. I presently serve as Chairman of the Economics and Research Committee of the NATIONAL ASSOCIATION OF REALTORS. I am accompanied by Albert E. Abrahams, Staff Vice President, Government Affairs, NATIONAL ASSOCIATION OF REALTORS and by Gil Thurm, Staff Legislative Counsel and Director of Tax Programs for the NATIONAL ASSOCIATION OF REALTORS Government Affairs Department. We appreciate this opportunity to testify on behalf of the Association.

The NATIONAL ASSOCIATION OF REALTORS is comprised of more than 1,700 local boards of REALTORS and 50 State Associations. The combined membership of the Association is approximately 500,000 persons actively engaged in sales, brokerage, management and appraisal of residential, commercial, industrial, and farm real estate. The activities of our membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and industrial real estate development. The NATIONAL ASSOCIATION OF REALTORS has the largest membership of any association in the United States concerned with all facets of the real estate industry.

The Competitive Nature of an Investment in Buildings and Other Improved Real Estate

Investors in real estate recognize that their capital investment is materially less liquid than most other investments. The sale of real estate at a fair price usually requires negotiation over an extended time period.

This factor, when added to such other factors as local taxes, increasingly stringent environmental considerations, local zoning regulation, and maintenance, financing and carrying costs, and escalating utility costs, usually makes real estate competitive with other investments only when the return on the real estate investment, if it is successful, can be anticipated to be larger than a successful investment in other, more liquid investment activities.

The traditional Federal tax provisions applicable to real estate have had the effect of permitting real estate investment to remain competitive despite the inherent risks and costs in real estate investments. Unfortunately, adverse tax treatment during the past decade, especially in the Tax Reform Act of 1969, greatly reduced the competitive position of the real estate industry at a time when private sector investment in real estate was of crucial importance to the welfare of the country as a whole. Further, persistent threats of imposition of drastic and discriminatory adverse tax provisions such as the limitation on accounting losses (LAL) has had and continues to have, a dampening effect on real estate investment.

We appreciate the wisdom of the members of the Senate Finance Committee and the Senate as a whole in rejecting the LAL proposal. This indicates the Senate's awareness of the many problems which beset the real estate industry. However, there are a significant number of other negative and adverse provisions already in the proposed Tax Reform Act of 1976, H.R. 10612. For example, inclusion of investment interest expenses and, particularly, long-term interest expenses of a limited partner, in the add-on minimum tax no doubt will have an adverse impact on the already depressed real estate industry. Further, although this Committee rejected an "at risk" provision for the real estate industry, the Senate has made the tax bill even more complicated and financially destructive by adopting a general provision (the so-called Haskell-Kennedy amendment) which is in fact an "at risk" limitation on real estate limited partnerships. This drastic "at risk" limitation is more fully discussed below.

The real estate industry needs strong private sector investment in order to continue to provide the single and multi-family housing, commercial buildings, industrial complexes, and shopping center complexes that are required for the continued growth and maintenance of our high standard of living.

The adverse actions mentioned above already have reduced the competitive position of real estate. If the Federal tax system is again changed to adversely affect the capital requirements of the real estate industry, the consequent discouragement to new real estate investment will inevitably cause a decrease in the supply of improved real property, an increase in rental rates, and a deferral of proper timely maintenance of our country's buildings. This conclusion is inescapable--for if real estate is to lose investment capital to other segments of the economy, it must either decrease the supply of houses and buildings or must regain its flow of capital through an increased rate of return from higher rents, thereby hurting the very people who can afford it least.

"At Risk" Limitation on Real Estate Limited Partnerships

On June 22, 1976, the Senate adopted an amendment by Senators Haskell and Kennedy to apply an "at risk" rule to limited partnerships, including real estate limited partnerships. For all practical purposes, this harsh amendment would substantially reduce (and perhaps even eliminate) the use of limited partnerships as an investment vehicle for real estate projects. The consequence of this would be the elimination of an important source of equity capital--particularly for new rental housing projects which rely heavily on limited partnerships for equity financing.

The "at risk" rule is so harmful for the real estate industry that the House Ways and Means Committee rejected it. The House of Representatives rejected it. The Senate Finance Committee rejected it. The Treasury Department and the Administration are opposed to it. We believe it is a serious mistake for the Senate to so drastically change the current tax law by imposing this discriminatory limitation on real estate investment. We respectfully request this Committee to take all appropriate action to cause the Senate to reverse its action on this provision and to reject this "at risk" rule for real estate.

Under current law, when none of the partners of a limited partnership is personally obligated on a partnership debt, a limited partner is allowed to include a portion of the nonrecourse (non-personal) liabilities of a limited partnership in the basis of his limited partnership interest. <u>This places the limited partner in the same position as a joint owner of property not held in partnership form</u>, and enables the limited partner to deduct the amount of his distributive share of partnership expenses in the same manner as the joint owner of property may deduct his share of the expenses of operating a property. Like individual owners, many limited partnerships hold and operate depreciable real estate constructed or purchased with nonrecourse loans secured by the depreciable property.

This partnership basis rule (which the Haskell-Kennedy amendment would revoke) is derived from Code Section 752(c) and the Income Tax Regulations promulgated thereunder. These provisions reflect the basic principle of <u>Crane v. Commissioner</u>, 331 U.S. 1 (1947) where the U.S. Supreme Court stated:

> ***We are no more concerned with whether the mortgagor is, strictly speaking, a debtor on the mortgage than we are with whether the benefit to him is, strictly speaking, a receipt of money or property. We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations (331 U.S. 14).

To the same effect is Treasury Regulations Section 1. 163-1(b) which holds that the owner of property is entitled to an interest deduction on a mortgage on his property, even though he is not personally liable for the mortgage, since in reality the mortgage on his property is his debt.

Whether a mortgage is recourse or nonrecourse, that is, with or without personal liability on the mortgagor, the owner of the property (including a limited partnership) has a continuing obligation to make payments on the mortgage. Failure to do this will certainly cause his equity to be foreclosed upon and lost. This is what the Supreme Court was talking about when it stated in the Crane case that as long as the value of the property exceeds the related debt, the owner "will treat the conditions of the mortgage exactly as if they were his personal obligations". That is, he will pay the mortgage to preserve his equity (cash investment) in the property, and this will be done regardless of whether or not he is personally liable on the mortgage.

The proposed change in the basis rule for limited partners would discriminate against real estate as an investment for the general public. It would provide a greater tax benefit for the wealthy, who can invest directly, and thereby discriminate against the small investor who must invest through some form of group ownership because he lacks the resources to buy the property directly.

Aside from the effect of not permitting a limited partner to deduct his full share of partnership losses, the "at risk" rule for limited partnerships will have another serious unintended adverse tax effect. That is, to the extent that a limited partner receives partnership cash flow, even though there is no limited partnership taxable income, any such partnership cash distributions will be fully taxable to the limited partner if they exceed his equity investment in the partnership. This effect doesn't even occur in the Committee's "at risk" provisions found in Section 202 of the Bill. For this reason alone, the "at risk" rule should be reversed.

In terms of financing, investment real estate is significantly different from investment in other areas of the economy. In a real estate investment there is a large tangible value to the real estate property supporting the amount of the mortgage. Further, the investor will have placed perhaps 20% down in hard cash, which is a sizable outlay and which provides the impetus to avoid foreclosure. These factors are not as significant in non-real estate investments where nonrecourse financing is usually found and often not supported by real value. Therefore, there is an appropriate distinction between other investments and real estate for purposes of this "at risk" rule.

Furthermore, since the taxpayer who purchases property by obtaining a mortgage secured by that property can normally be expected to satisfy the payments on the mortgage (whether or not the taxpayer is personally liable for the mortgage), he will have the same equity cost for the property as the taxpayer who does not finance the property. Financing property (whether on a recourse or nonrecourse basis) does not create a loophole but is merely one of the many factors which an owner may use in causing construction and improving the value of a community. It should not be the subject of adverse tax legislation. Indeed, as noted above, the "at risk" provision would tend to force out of the real estate industry the thousands of small and middle-income property owners who must rely on mortgage financing. The long-term result would be to place real estate ownership in the hands of a relatively few large corporations and wealthy families who can make direct cash investments.

This Committee may be concerned with so-called "shelter" or gimmick arrangements where investments are sought on the basis of quick tax benefits rather than the basic economic feasibility of the project. The Committee should take into account the fact that the economics of the marketplace--even without the usual administrative action of the Internal Revenue Service--has significantly curtailed and will ultimately eliminate most of the "gimmick" arrangements. Additionally, so far as the unsophisticated investor is concerned, the danger of his being enticed into these losing situations has been and is being met by regulatory authorities, such as the Securities and Exchange Commission (SEC) and state security commissioners, who have more effective means of affording such protection than can be found in the tax system.

Again, we seriously question the need for any further adverse tax treatment, such as the "at risk" rule, for the real estate industry. Present law imposes the minimum tax on real estate excess accelerated depreciation. Also, in some cases, under present law there are significant limitations on the deduction of interest expense. The Committee's proposals (which have already been accepted by the Senate) would include construction period interest as a new item of tax preference, as well as investment interest and all interest allocated to a limited partner even though the partnership activity might otherwise be treated as a trade or business and not as an investment. To further add this "at risk" provision would in substance be a triple attack on the real estate industry; this Committee and the Senate should not have a part in hitting an industry already down.

In sum, we respectfully request that the members of this distinguished Committee urge their fellow Senators to reconsider and reject the drastic "at risk" limitation on real estate limited partnerships.

Thank you for this opportunity to present our views.

AD HOC COALITION FOR LOW AND MODERATE INCOME HOUSING

Suite 400 South
1800 M Street, N.W.
Washington, D.C. 20036
Telephone: (202) 457-6800

STATEMENT OF GEORGE W. DEFRANCEAUX WITH RESPECT TO H. R. 10612 ON BEHALF OF THE AD HOC COALITION FOR LOW AND MODERATE INCOME HOUSING BEFORE THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE

July 21, 1976

SUMMARY OF MAJOR POINTS

1. The Haskell-Kennedy Amendment would greatly reduce private production of low and moderate income housing, and should be eliminated.

2. In any event, the exemption for low income housing contained in the Haskell-Kennedy amendment should be expanded to exempt the Section 8 Leased Housing Program, state assisted housing, and the Section 515 Farmers Home Loan program.

AD HOC COALITION FOR LOW AND MODERATE INCOME HOUSING

Suite 400 South
1800 M Street, N.W.
Washington, D.C. 20036
Telephone: (202) 457-6800

STATEMENT OF GEORGE W. DEFRANCEAUX WITH RESPECT TO H. R. 10612 ON BEHALF OF THE AD HOC COALITION FOR LOW AND MODERATE INCOME HOUSING BEFORE THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE

July 21, 1976

Mr. Chairman, I am George W. DeFranceaux, Chairman of the Board of the National Corporation for Housing Partnerships. I am appearing today on behalf of the Ad Hoc Coalition for Low and Moderate Income Housing. With me is Bruce S. Lane, Counsel to the Coalition.

The Ad Hoc Coalition represents individuals and organizations from all parts of the country who are engaged in providing decent housing for low and moderate income families. The Coalition includes the Council of State Housing Agencies, which represents nearly all of the 35 states that have enacted state housing programs, the National Leased Housing Association, and the National Housing Rehabilitation Association. The National Corporation for Housing Partnerships, is also a member. This organization is a private corporation established, at the direction of Congress in the Housing and Urban Development Act of 1968, "to encourage maximum participation by private investors in programs and projects to provide low and moderate income housing."

Pursuant to Section 236 of the National Housing Act, Section 8 of the United States Housing Act of 1937, as amended in 1974, the Section 515 Farmers Home Loan program, and similar state housing legislation, over 650,000 multi-family dwelling units have been built since 1968 for low and moderate income American families. As we have stated in previous testimony before this Committee, tax benefits, by design of Congress, are the essential means of encouraging the private sector to develop, construct, and market this housing.

The Department of Housing and Urban Development stated in a recent memorandum by Secretary Carla Hills to the House Ways and Means Committee:

> The fact is that builders will not build subsidized projects unless they are able to sell the projects to investors. And the fact is that investors will not purchase subsidized apartment projects unless their investment produces the substantial tax advantages available under current law.

In other words, without tax incentives it would be impossible to raise the equity capital necessary to produce low and moderate income housing.

Today, I would like to express our objection to the Haskell-Kennedy amendment which was adopted by the Senate on June 22, 1976. That amendment would limit the deductions of a limited partner to the amount that he has invested in a limited partnership, plus any amount that he is obligated to invest under the partnership agreement.

The Haskell-Kennedy amendment does contain an exemption for limited partnerships which are formed prior to January 1, 1982 and which construct or rehabilitate low income housing. However, the definition of low income housing in the amendment is based on Section 1039(b) of the Internal Revenue Code. That definition fails to include Section 8 housing, any state assisted housing programs, or the Section 515 Farmers Home Loan program. At the present time, these are the principal operating programs. Thus, the exemption is meaningless for most practical purposes.

This is inconsistent with the action that the Senate has taken with respect to the minimum tax provisions. There the Senate has voted to exempt as tax preference items construction period interest and excess investment interest attributable to all low income housing, including Section 8, state assisted housing, and Section 515 Farmers Home Loan program housing, if such housing is underway by January 1, 1982. In so doing, the Senate recognized that, for better or worse, the present tax benefits are necessary until Congress can establish substitute incentive programs for low income housing. The Haskell-Kennedy amendment would nearly eliminate the tax benefits produced for investors by those low and moderate income housing programs which are presently operational. Consequently, if Haskell-Kennedy is adopted in its present form, virtually no one will invest in Section 8, state assisted and other low and moderate income housing, and little or no such housing will be built.

Accordingly, we urge the Senate to amend the Haskell-Kennedy provision to bring Section 8, state assisted housing and Section 515 Farmers Home Loan projects within the exemption. That would be consistent with the exemption presently provided under the minimum tax. It is our understanding that Senator Haskell would agree to such an amendment.

Even if the exemption is amended to include all low income housing projects, we respectfully submit that the Haskell-Kennedy amendment is nonetheless ill-advised and unnecessary. This is true first because the amendment would still not exempt moderate income housing and secondly because the producers of low income housing and of other residential real estate do not exist in separate worlds.

Housing financed with a mortgage insured under Section 221(d)(4) of the National Housing Act is one example of the type of moderate income housing that would be adversely affected by the Haskell-Kennedy amendment if it were to become law. Assuming that the low income housing exemption in the Haskell-Kennedy provision is amended to be consistent with the exemption under the minimum tax provisions, Section 221(d)(4) housing and other moderate income housing would still be fully subject to the limitations on deductions by limited partners. If so, it will no doubt significantly curtail building activity financed under Section 221(d)(4), a program which, on the other hand, Congress and HUD have strongly encouraged through the recently concluded $3 billion dollar GNMA Tandem program, which, in effect, provides the builder with a 7-1/2% mortgage.

Moreover, the Haskell-Kennedy amendment will seriously affect and reduce the production of all residential housing, and it is often the producers of non-low income residential housing who build the best low income housing. We do not want to see them out of business. The Senate has already adopted significant changes affecting real estate. The effect of these changes with respect to the minimum tax provisions and depreciation recapture may be to seriously wound the industry, and in any event they are more than adequate to deal with any abuses that may now exist in the real estate area of the tax law.

We strongly urge the Senate to reconsider and reverse its prior decision adopting the Haskell-Kennedy amendment. However, if the Senate fails to take that action, we urge that the provision be amended to exempt Section 8 housing, state assisted housing and the Section 515 Farmers Home Loan program.

Thank you.

SUMMARY OF

NATIONAL REALTY COMMITTEE, INC. STATEMENT

BEFORE

THE SENATE FINANCE COMMITTEE

July 21, 1976

The National Realty Committee, Inc. opposes the Haskell-Kennedy Amendment which would add a new subsection (e) to Internal Revenue Code Section 752 on the following grounds:

1) During the current period of declining real estate construction and substantial unemployment among construction workers, increasing tax disincentives to real estate investment is unwise and counterproductive.

2) In today's market, the real estate industry requires increasing amounts of equity capital investment, much of which is reasonably obtainable only from limited partner investors.

3) Limiting a limited partner's right to currently deduct partnership losses will substantially deter limited partnership investments in real estate, particularly in view of the treatment of both construction period interest and a limited partner's share of post-construction period "excess investment interest" as tax preference items.

4) The Haskell-Kennedy Amendment, together with the other investment disincentives in the Senate bill, will increase real estate unemployment by at least 540,000 jobs.

5) The Haskell-Kennedy Amendment is unnecessary to deter large scale syndication of "tax shelter" investments. A logical solution would be to limit the eligible number of participants in such a partnership.

6) At the very least, Congress should give serious consideration to "phasing in" the various tax changes affecting real estate investment in order to minimize immediate adverse economic effects.

STATEMENT OF

NATIONAL REALTY COMMITTEE, INC.

BEFORE

THE SENATE FINANCE COMMITTEE

July 21, 1976

Mr. Chairman and members of the Committee.

My name is Albert A. Walsh and I am appearing today as President of the National Realty Committee, Inc., a non-profit business league of owners and developers of all types of real estate throughout the United States. I am accompanied by Alan J.B. Aronsohn, Esq., NRC's tax counsel.

We appreciate this opportunity to testify in opposition to the Haskell-Kennedy Amendment to HR 10612 which would, for all practical purposes, eliminate the use of limited partnerships as an investment vehicle for real estate projects and, thus, cut off an important source of equity capital, particularly for new rental housing which relies heavily on limited partnerships for equity financing. This, in turn, would have the effect of substantially exacerbating the current depressed condition of the construction industry, would delay economic recovery and re-employment in that industry and, in fact, would create further construction industry unemployment and a concomitant reduction in Federal tax revenues from the real estate industry.

The full impact of the Haskell-Kennedy Amendment cannot be ascertained by viewing this proposed change alone. It is the combination of this proposed change together with others already adopted by the Senate which produces extraordinarily severe consequences.

The Senate has already determined to treat construction period interest as a tax preference item, both for purposes of a substantially more onerous add-on minimum tax and for purposes of the preference offset in determining income subject to the benefits of the maximum tax on earned income.

In addition, the Senate has adopted a proposed rule treating a limited partner's interest in a partnership trade or business as an investment for purposes of the excess investment interest preference. Thus, long term mortgage interest becomes potentially a tax preference item, which has the effect of converting all losses incurred by a limited partner, including even losses resulting from straight line depreciation, into tax preference items; again for purposes of both the new, more severe minimum tax and the maximum tax on earned income.

What is the practical result of these changes, particularly after the Haskell-Kennedy Amendment is added as an additional disincentive to construction?

A taxpayer willing to risk money in a speculative construction project is first told that he will probably be subject to an extra 15% tax on any deduction for interest during the construction period and that he will lose any benefits he might otherwise be entitled to under the maximum tax on earned income to the extent of such interest deductions. The total tax impact of such deductions could therefore be an additional 35% tax.

If he is still willing to invest in a speculative venture despite these tax detriments, he must then be advised that if he attempts to limit his liability by investing as a limited partner, any loss incurred by the partnership after completion of the construction of the building attributable to the payment of interest on the permanent mortgage may be excess investment interest subject to another 15% tax and a similar adverse effect on the taxpayer's right to secure the benefits of the maximum tax on earned income.

The severity of these results is accentuated by the fact that the taxpayer has absolutely no control over them. While a taxpayer does have the option to capitalize construction period interest rather than deduct it immediately, no such option is granted with respect to interest payable under a permanent mortgage. Therefore, where, for example, a taxpayer invests in a new project which produces losses after completion of construction as a result of rental receipts being insufficient to cover mortgage interest, taxes, operating expenses and straight-line depreciation, such losses, when incurred by a limited partner, may be treated as tax preference items and the taxpayer will not have the option to defer the deduction of such losses in lieu of paying the 15% tax. In addition, if a taxpayer exercises the option to capitalize construction interest, capitalization of such interest will create potentially greater future operating losses subject to treatment as tax preferences under the "excess investment interest" rules applicable to limited partners under the Senate Bill.

The combination of adverse treatment of construction period interest and adverse treatment of post-construction period losses will obviously deter investment in any construction projects other than those involving minimum risk and exceptionally high rewards.

The Haskell-Kennedy Amendment, by imposing a further overall limit on the deductions to which a limited partner will be entitled, without regard to the legitimacy of those deductions or whether or not they are already "tax preference items" subject to the minimum tax, simply adds a final, compelling disincentive to investment in speculative construction projects by limited partners. Under the Haskell-Kennedy Amendment, an investing limited partner will be denied the current deductibility of certain losses which, under present law, cushion the risks of speculative investment, particularly when projects are less successful than anticipated. Many real estate projects currently in financial trouble, and the subject of "work outs" with banks and REITs, will not be able to successfully reorganize if the Haskell-Kennedy Amendment is retained.

It is clear that eventually the real estate market will adjust to any level of new rents required to accommodate tax disincentives to real estate construction. However, it is also clear that current rental markets in the United States will not presently absorb the substantial rental increases which will be required to attract investment capital into new construction under the tax burdens imposed upon such activity by the Senate Bill. Unlike many other short-lived commodities traded in the economic market-place, new rental buildings, whether residential, commercial or industrial, must compete with available space in older structures. New buildings can command a premium rental rate by virtue of newness but there are limits on the size of such premium which cannot be effectively exceeded. During any period in which the cost of new construction increases more rapidly than the ability of the market to absorb the rental premium such new construction requires, there will be a substantial reduction in construction activity and a substantial increase in construction industry unemployment.

We are currently witnessing such a period, the effects of which will be substantially exacerbated if the Senate Bill, with the Haskell-Kennedy Amendment, becomes law. Across the nation, construction trades unemployment is currently running 19-20 percent, with as much as 40 percent unemployment in some of our older, urban areas.

74-620 O - 76 -- 7

Using the "Tax Impact Model" which he created for the National Realty Committee, Dr. Norman B. Ture, a well-regarded Washington economist, estimates that the Senate bill with the Haskell-Kennedy Amendment would actually increase unemployment within the construction and real estate industries by 540,000 to 890,000 jobs. Furthermore, instead of raising $50 million in additional federal tax revenues, the Amendment would actually reduce federal tax revenues from the real estate industry by $6-9 billion.

Admittedly, Dr. Ture's estimates are not infallible; but they are based on three years of research, the most reliable and up-to-date data available and the use of extremely conservative assumptions. For example, in estimating the effect of the Haskell-Kennedy Amendment Dr. Ture assumed that limited partnerships account for only 15-33 1/3 percent of all real estate partnerships.

Perhaps, over time, some of these losses will be offset elsewhere in the economy as the "reformers" claim; but this hardly seems the time to take this kind of a gamble with an industry that is just beginning to recover from the throes of its biggest slump since the '30's.

The real estate industry requires outside investment from limited partners particularly during periods, such as the present, when lending institutions are decreasing the proportion of debt capital which is available for construction projects and increasing the rates of interest charged. At the very moment when the economy requires additional equity investment in the real estate industry in order to make up for declining debt investment and to reduce unemployment, the Senate is proposing a Bill which contains tax credits for recycling waste paper but offers the real estate industry a package of substantial tax disincentives.

We respectfully submit that this is a most inappropriate time for adoption of tax legislation which would further discourage real estate investment. We believe that the Haskell-Kennedy Amendment is an unnecessary addition to the Senate Bill. If, as Senator Kennedy stated during the debate on the Senate floor on June 22nd, "what we are really interested in is the large syndication which may involve twelve hundred to fifteen hundred limited partners" it surely is not necessary to throw the baby out with the bath water. If sound tax policy requires that use of the limited partnership entity be curtailed, the logical solution would be reasonably to circumscribe the eligible number of participants in such a partnership.

In any event, we believe that Congress should give serious consideration to phasing in the changes reflected in the various proposals discussed in this statement over a period of time so that the economics of the industry can adjust to the new rules with less detrimental effects upon overall activity and employment.

NATIONAL ASSOCIATION OF HOME BUILDERS

National Housing Center

15TH AND M STREETS, N.W., WASHINGTON, D.C. 20005

JOHN C. HART
PRESIDENT

TELEX 89-2600 TELEPHONE (202) 452-0200

STATEMENT OF

THE NATIONAL ASSOCIATION OF HOME BUILDERS

before the

COMMITTEE ON FINANCE

UNITED STATES SENATE

on

AMENDMENTS TO

H. R. 10612, TAX REFORM ACT OF 1976

July 21, 1976

* * * * * * * * * * * * *

SUMMARY

NAHB opposes the At Risk Limitation for Limited Partners Amendment based upon two factors: (1) From an economic standpoint, it will severely retard the housing industry's recovery from the 1975 recession: and (2) From a tax structural standpoint, the Amendment is a patchwork approach to the complex problem of the proper measurement of taxable income from real estate construction and operation.

My name is Leonard L. Silverstein. I am a partner in the firm of Silverstein and Mullens in Washington, D. C. and appear this morning in my capacity as Tax Counsel to the National Association of Home Builders. I am accompanied by Nathaniel H. Rogg, Executive Vice President of the NAHB.

The National Association of Home Builders is the trade association of the home building industry with a membership totalling over 79,000 firms and individuals engaged in the construction of homes, apartments and commercial properties throughout the United States.

We appear today to express the home building industry's unequivocal opposition to the At Risk Limitation for Limited Partners adopted as a floor amendment to H.R. 10612.

Our opposition is not based upon the view that the tax laws as applied to real estate work perfectly.

We appreciate that some anomalies do exist and that correction as part of a tax reform program which deals comprehensively with partnerships may well be in order.

NAHB has consistently, and today continues to support the principle that every American should pay his fair share of taxes -- either directly as a percentage of taxable income or through the application of the minimum tax rules.

Our opposition to the Haskell amendment is based upon two factors:

(1) From an economic standpoint, it will severely retard the housing industry's recovery from the 1975 recession.

(2) From a tax structural standpoint, the Haskell amendment is a patchwork approach to the complex problem of the proper measurement of taxable income from real estate construction and operation.

First, consider the Haskell amendment in light of the very severe economics which continue to face the housing industry. In 1975, housing production was at the country's lowest level since the conclusion of World War II. Today, although single family housing starts have moderately increased, multiple housing starts remain, on a national basis, at unacceptably low levels. This occurs at a time when household formations are at record levels due both to the arrival of the postwar baby population and the swelling ranks of the elderly. Both categories of persons, together with the general population, need -- but are not receiving -- adequate housing accommodations.

Today there is a national vacancy rate of only 5.4 percent, attributable to the lack of new rental units. Thus, national needs for housing exceed current resources to satisfy those needs. Among those resources are inducements, whether or not technically perfect, which are currently provided by the tax laws.

Housing is the country's largest user of borrowed funds. It is, on the other hand, the one industry which is most vulnerable to cyclical economic fluctuations. It has the greatest difficulty in meeting competition in the financial marketplace for available debt */ and equity capital. The industry's access to the private equity marketplace has always been severely limited. Unlike the stock market, there is no stock exchange for the small volume builder, who makes up the great bulk, not only of the NAHB membership, but of the housing industry in the country today. Tax inducements, provided by realty partnerships, contribute materially to their equity capital. If this resource is stripped away, favorable alternatives must not only be available, but in place and functioning. This is not the case today, and the Haskell amendment, in conjunction with other provisions of the tax bill, would

*/ Since the end of World War II, the housing market has been one of the largest users of borrowed funds in the American economy. Between 1947 and 1971 the total net public and private debt outstanding in the United States rose from $415.7 billion to $1,996.4 billion -- an increase of $1,580.7 billion, or 380 percent. During this same period, residential mortgage debt outstanding on nonfarm properties rose from $34.8 billion to $374.6 billion -- an increase of $339.8 billion, or 976 percent. By comparison, private corporate debt outstanding increased by 660 percent during this same period as it rose from $108.9 billion to $827.3 billion. Overall, the increase in nonfarm residential mortgage debt accounted for 21 percent of the increase in total outstanding net debt.

therefore eradicate the housing industry's access to non-institutional private equity investors. The amendment, therefore, comes at precisely the wrong time in housing history.

The Committee's attention is next directed to the specifics of the amendment. By limiting deductions to the aggregate of cash and recourse obligations, depreciation and other deductions attributable to borrowed funds in excess of that amount are precluded. Such deductions are available, if at all, at some later date in the partnership history; for example, if and when the property is sold. The economic inducement to a potential investor is, therefore, severely, if not fatally, reduced. At the same time, no comparable constraints are placed upon a sole proprietor who acquires the building, nor upon a general partnership. Additionally, the exception to the Haskell amendment for subsidized housing in tax policy terms is internally inconsistent. If the objective of the legislation is to eliminate structural aberrations in the tax law affecting real estate, the amendment should be applied to all categories of real estate -- reaching a result which would be even more devastating economically. Under the Haskell amendment, however, all that occurs is that tax shelter inducements are skewed in the direction of subsidized housing, thus depriving other forms of housing from this equity capital resource. If deductions in excess of investment are an improper application of the tax laws, then from the standpoint of the investor, that impropriety is, in fact, still available. To the extent that the Haskell amendment is directed at large heavily promoted real estate syndications, remedies already exist under the Code -- taxing such entities as corporations, for example.

NAHB suggests that the real estate taxation problem -- transitionally at least -- be approached through the minimum tax. All taxpayers should have opportunity and inducements to invest in any form of real estate -- with the tax laws available to cushion both the economic risk and the lack of liquidity -- as a recognized tax expenditure -- until such time as more adequate equity and debt support of the housing market appears.

SUMMARY OF STATEMENT OF PAUL R. IGNATIUS, PRESIDENT AIR TRANSPORT ASSOCIATION OF AMERICA ON H. R. 10612 JULY 21, 1976

1. This statement supplements our testimony of March 31, 1976, concerning airline industry capital formation problems. We support Sections 802 and 803, which apply to all taxpayers, large or small, and not to any single industry or group. We also urge approval of Amendment No. 1906.

2. A combination of large investments and low earnings have resulted in airline inability to utilize substantial amounts of investment credits.

3. Airlines earlier advocated refundability of previously earned, but unused and expiring credits as provided for in S. 3080 (Senator Stevenson).

4. After extensive public hearings, the Committee, however, approved in Section 802 refundability of future generated credits for all taxpayers beginning in 1984. Revenue impact attributable to the airlines in 1984 would not exceed $25 million.

5. Section 802 assures that every taxpayer making qualified investment will receive credit and provides greater incentive for future investment.

6. Section 803 provides two-year general extension of credits which otherwise would expire in 1976. Credits which otherwise might expire in 1977 also should be extended.

7. Airline capital formation problems are similar to those of public utilities and railroads (as described on page 486 of Committee Report). The FIFO and credit utilization provisions of Section 1701 applicable to the railroads should be extended to the airlines as provided for in Amendment No. 1906, offered by Senator Curtis.

8. U.S. world leadership in commercial aircraft sales is threathened by inability of U.S. airlines to order new technology aircraft because of capital formation difficulty.

Statement of Paul R. Ignatius, President
Air Transport Association of America
Before the Senate Finance Committee
on H. R. 10612 -- July 21, 1976

My name is Paul R. Ignatius. I am President of the Air Transport Association of America which represents virtually all of the scheduled airlines of the United States. We appreciate this opportunity to comment further on certain provisions of H. R. 10612 on which the Committee has invited additional testimony, particularly those relating to capital formation and the utilization of investment credit.

We strongly support Sections 802 and 803 of the Committee reported tax bill, which provide for a refundable investment credit and a two-year extension of the carry-over period for investment credits which otherwise would expire in 1976. We also urge approval of Amendment No. 1906, which extends to the airlines the first-in-first-out and increased credit utilization provisions contained in Section 1701 of the bill.

The hearing record on capital formation and the utilization of investment tax credit in both the Senate and the House is very extensive. We, among others, testified in public hearings before both the House Ways and Means Committee and the Senate Finance

Committee concerning the serious capital formation problems of the airline industry, and how those problems could be alleviated through changes to the investment tax credit law. Specifically, we advocated adoption of pending bills providing for the refundability of investment credits which may expire because of the inability of the taxpayer to utilize them.

Refundable Investment Credit

In our appearance before this Committee on March 31, 1976, we urged your favorable consideration of the provisions of Senator Stevenson's bill, S. 3080, which provided for the refundability to any taxpayer of previously earned, but unused and expiring investment credits. This proposal would have provided capital for necessary investments in new technology aircraft. The Committee, however, adopted provisions for the refundability of future earned credits, a principle endorsed by Treasury Secretary Simon when he appeared before the Committee on April 13, 1976.

As approved by the Committee, Section 802 of H.R. 10612 provides for the future refundability of credits, beginning 7 years hence, if earnings do not permit their full utilization before that time. The airlines fully support this provision of the bill. It provides an incentive for future investment and assures equitable treatment for all investors in new plant and equipment, since they would receive the benefit of the investment credit through tax off-sets or refundability. The benefits of this provision would be available to all taxpayers, large or small, corporate, partnership, or individual proprietorship, who make investments which qualify.

The Committee Report accompanying H.R. 10612 points out that the provision in Section 802 would have no revenue impact for the next 7 years. Whether it would have any revenue impact after that period would depend on a multitude of events and circumstances over the next 7 years which no one, of course, can now foresee with precision. For example, in making an estimate, assumptions have to be made as to the level of qualified investment in 1976, as well as corporate profits and taxes for each of the next 7 years. Based upon such assumptions, the Committee report estimates on page 178 that the revenue impact of Section 802 for all taxpayers would be $300 - $500 million.

It has been suggested in several recent statements that Section 802 would primarily benefit the airlines. This is not the case. As stated earlier, this Section would apply to all taxpayers, and the Committee's $300 - $500 million revenue impact estimate was based on the availability of this provision to all such taxpayers. As a matter of fact, we estimate that the maximum amount that would be refunded to the airlines in 1984 will not exceed $25 million.

74-620 O - 76 -- 8

The Committee decided, after hearing several witnesses on the subject, to provide for future refundability in order to equalize the incentives for investment by both profitable and unprofitable companies. It was recognized that unprofitable companies needed this incentive more than profitable companies. It was also recognized that present law is inequitable since it has the effect of requiring unprofitable companies to pay more than a profitable company does for the same piece of equipment.

The airlines are faced with the need to replace their aircraft with less noisy, more fuel-efficient planes. They have very heavy capital requirements. However, because of their generally poor earnings record, the airlines are limited in their ability to raise new outside capital. Many representatives of the investment community have stated that they will not lend the airline industry substantial amounts of long-term capital. With the current earnings record, equity capital is not available. Yet, there exists an urgent need for capital to accomplish essential fleet modernization and expansion to meet the accelerating demand for air transportation.

It is for these reasons that we have advocated the principle of refundability. Section 802 would help assure that the investment incentive, which formed the basis of the credit, will not be lost. Only in this way can the investment credit law assure equal treatment to all who make new investments.

Two-Year Extension

We also fully support Section 803 of H.R. 10612, which provides for a two-year extension of the carryover period for credits which otherwise would expire in 1976. This provision would apply to all businesses, not just the airlines. It would provide a temporary solution to the problem of expiring investment tax credits, and is similar to the three-year extension of the carryover period enacted in 1971 (P.L. 92-178) with respect to investment tax credits earned prior to 1971.

The Committee's report on H.R. 10612 stated that this two-year extension would "... make it possible to use these credits against income generated in these two additional years. In addition, this will provide time in the next two years to see whether any other relief needs to be provided in these cases."

We support Section 803 and urge that credits otherwise expiring in 1977 also be extended to 1978.

Amendment No. 1906

Amendment No. 1906, offered by Senator Curtis, recognizes that the serious problems facing the railroads and public utilities also confront the airlines. This amendment would extend to the airlines two provisions which the Committe has approved for the railroads in Section 1701 of H. R. 10612 to meet a virtually identical problem. These provisions relate to (1) first-in-first-out utilization of the credit, and (2) a temporary increase in the utilization of credits against tax liability.

The Committee described the railroad problem necessitating the change contemplated by Section 1701 on page 486 of its report as follows:

> "Railroads have been investing heavily in equipment and facilities during the past several years in order to expand the ability of the railroad system to handle an increasing volume of traffic and to modernize the system through replacement of obsolete and obsolescent equipment and facilities. Additional expansion of the railroad system also is needed to connect new and reopened coal mines with principal railroad routes as reliance on coal as a fuel and energy source increases relative to other sources. Railroad equipment and facilities tend to be capital intensive and long-lived.
>
> "In contrast with the growth in investment requirements, earnings of railroad companies have been relatively small. Because the limitations on the amount of investment credit that may be claimed in a given year are expressed in terms of a percentage of tax liability, the low earnings has left railroad companies with substantial amounts of unused investment credits which soon will expire. The railroads also face the prospect that future investment credits earned on the installation of new equipment and facilities will accrue faster than profits and tax liabilities grow. As a result, railroads may continue to lose unused investment credits at the end of the carryforward period even though the investment was undertaken in anticipation of reducing future tax liabilities to the full extent of the credits they earned.
>
> "The Committee's decision to relieve all taxpayers of the problem of unused credits by making them refundable in the future does not provide any taxpayer relief currently or

in the future before 1984. The decision to allow two additional years (1977 and 1978) of carryforward for credits that expire at the end of 1976 would not be helpful to the railroads because present investment plans through 1978 will generate enough credits for most railroads to virtually use up the full amount of the limitation against current tax liability."

The airline situation is substantially the same as that described in the above quotation from the Committee Report. In short, the airlines:

1. Have heavy investment in essential equipment;
2. Face additional expansion to meet growth;
3. Have relatively low earnings;
4. Have substantial amounts of unused credits which will expire soon;
5. Will have future investment credits accruing faster than growth in profits and tax liabilities;
6. Anticipate continued losses of credits; and
7. Believe that relief offered by Sections 802 and 803 may be of minimum help in the near-term future.

Accordingly, like the railroads, the airlines need the additional measures contained in Section 1701 to more fully utilize the investment credit. Sound public policy and simple tax equity would suggest that these two essential, regulated transportation industries be treated similarly.

The investment credit law originally required that a taxpayer utilize his currently generated credits before any credit carryover could be used. This requirement resulted in large accumulations of unused credits. Because of this problem, in 1971, Congress provided first-in-first-out utilization of credits generated prior to 1971. The Senate Finance Committee, as well as the House Ways and Means Committee, in proposing this provision, stated:

> "The desire of taxpayers to use these credit carryovers as quickly as possible (to avoid losing them) could significantly dampen the stimulative effect of restoring the investment credit."

However, Congress left unchanged the requirement that credits generated after 1970 be used after currently generated credits. Unless this requirement is changed, the airlines will be faced in future years with the potential situation where, by making an investment and generating additional credits, they will lose previously generated credits which expire. Unless a taxpayer has some assurance that he will ultimately receive a benefit from both his existing and new investment credits, he is unlikely to make the investment that will generate new credits. Application of the first-in-first-out provision to the airlines will provide increased assurance that the credits they have earned can be utilized without destroying their incentive for future investment.

Moreover, under present law, a taxpayer is allowed to offset a maximum of 50 percent of his tax liability with investment credit. In 1975, because of an anticipated problem with investment stimulus in the regulated public utility industry, Congress authorized the utilities to increase their utilization of credit to 100 percent of tax liability for two years, declining gradually to 50 percent at the end of 5 years.

Section 1701 extends this investment stimulus to the railroads, and Amendment No. 1906 would extend it to the airlines. Extension to the airlines of the increased utilization provision would provide the airlines with resources to assist in acquiring new aircraft. The stimulative effect of this additional capital investment, and the jobs created, would be felt throughout the economy. Accordingly, we strongly urge approval of Amendment No. 1906.

U.S. Leadership in World Air Transport Sales is Threatened

There is more at stake in the capital formation issue than the immediate needs of the U.S. airlines. U.S. leadership in the world of aviation is in jeopardy because of the limited ability of the U.S. airlines to place orders for new technology aircraft. U.S. aircraft manufacturers have consistently obtained over 90 percent of the total free world commercial airplane market. U.S. aircraft sales have traditionally been among the leading exports of the United States. However, other nations now seek a major share of the world's commercial airplane market. Recent European aircraft manufacturer successes, encouraged by aggressive government assistance, are beginning to erode the U.S. position. It would be a tragedy if the U.S. lost its world leadership in this important area.

Historically, it has been the initial orders of one or more U.S. airlines which have launched new airplane manufacturing programs in this country. Orders from other U.S. airlines and from foreign airlines have then followed. But, while the airlines of the United States face the need in the next decade to acquire more than $20 billion worth of new aircraft, they simply do not have the financial resources to place these essential initial orders. Attached to my statement (Attachment A) are charts and tables prepared by The Boeing Company which illustrate this serious threat to U.S. aircraft manufacturing leadership.

For all of these reasons, we reaffirm our support of Sections 802 and 803 of H.R. 10612, and urge approval of Amendment No. 1906.

ATTACHMENT A

Tables from The Boeing Company

Presentation on

"Importance of Adequate U.S. Airline

Earnings to Continued World Leadership

By U.S. Commercial Aircraft Manufacturers"

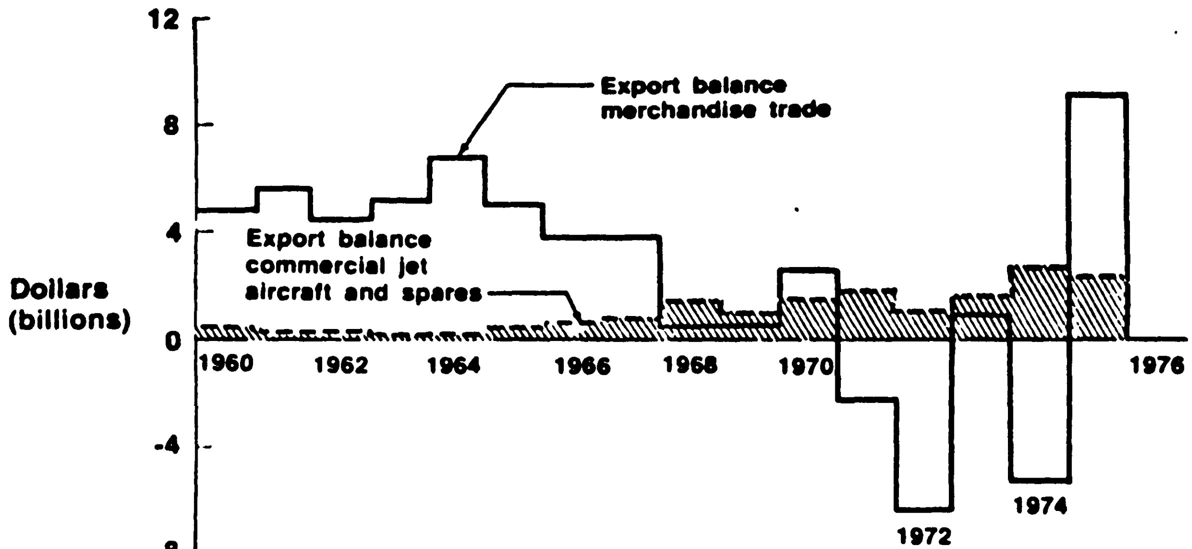
Conclusions

- U.S. Trunk earnings are key to continued U.S. dominance of world commercial aircraft market.
- U.S. Trunks unable to undertake required replacement program or kick-off new airplane program.
- Continued operation of older, inefficient aircraft will delay public environmental improvement and seriously impact airline efficiency.
- Lack of U.S. sales will erode U.S. manufacturing leadership and capability, decreasing employment base and positive balance of payments contribution.

V1786
6-11-76

(Public Data)

Commercial Aircraft Contribution to the Balance of Trade

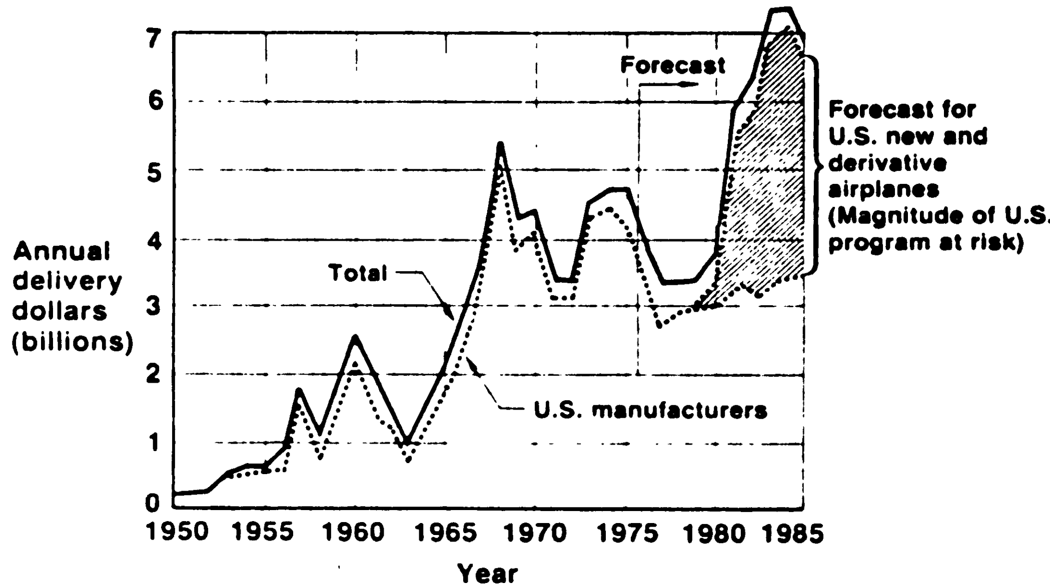


Source: Department of Commerce and AIA

(Public Data)

V1920
6-11-76

World Commercial Aircraft Annual Deliveries
(1975 Constant Dollars)

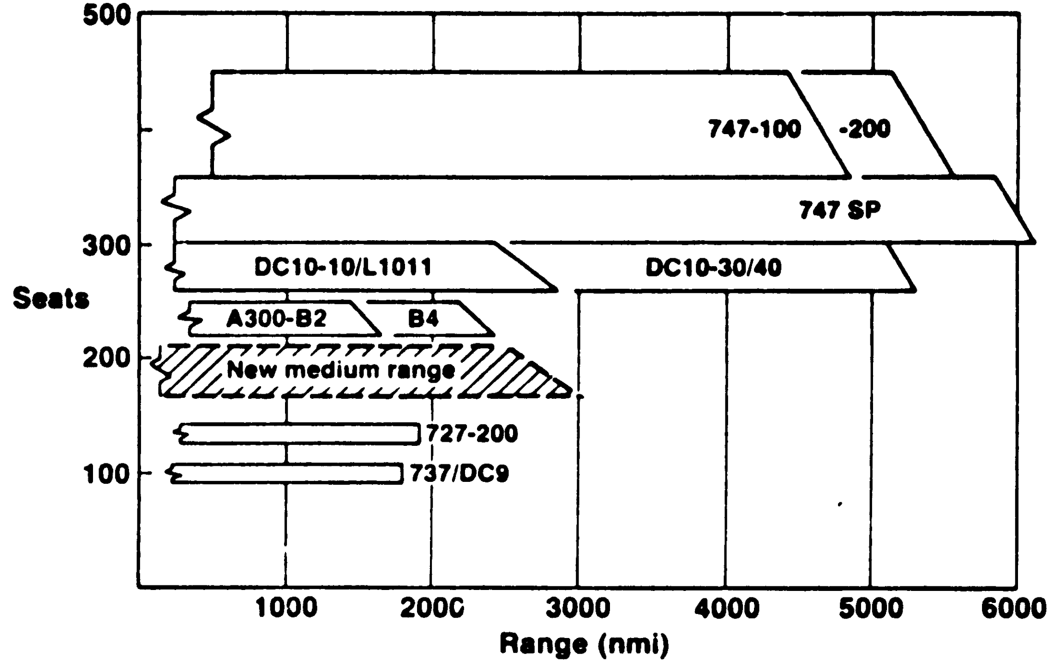


Note: Excludes USSR, Peoples Republic of China, and non-ICAO countries

V1779
6-11-76

(Public Data)

Major Product Offerings

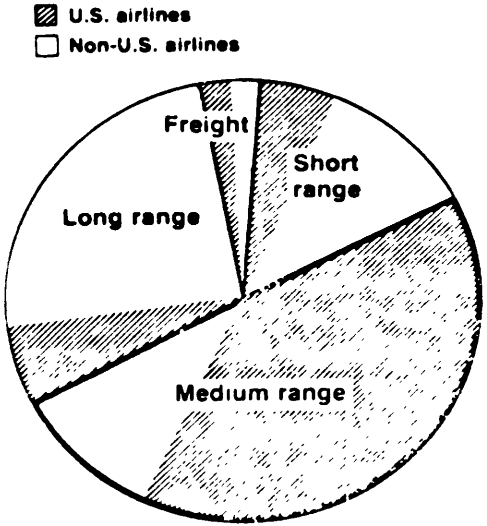


V1781
6-11-76

(Public Data)

World Commercial Jet Transport Market

($46 Billion Total Open Market Through 1985 in Constant 1975 Dollars)



Product assumption			
Category	Market	Current	Future
Short range	$7 3 billion	737-200 DC 9-30 50 747SR BAC III	737 derivative DC-9 derivative 7X7 Mercure 200
Medium range	$23 1 billion	727-200 A300 DC-10 10 L 1011 747	7X7 DC-X-200 A300B-10
Long range	$13 6 billion	707 DC 10-30 40 747 100 200 747SP Concorde	707 derivative 7X7 747 derivative A300 derivat ve
Freighter	$2 0 billion	747 F C DC 10C F	
	$46 0 billion Total		

V1782
6-11-76

(Public Data)

Role of U.S. Carriers in Kicking Off New Airplane and Derivative Programs

Boeing products		
Type	**Model**	**Initial customers**
707	-120	Pan Am
	-320	Pan Am/Air France/Sabena
	-720	United
727	-100	Eastern/United
	-200	American/Northeast
737	-100	Lufthansa
	-200	United
747	-100	Pan Am
	-200	Northwest
	SP	Pan Am

Other U.S. manufacturers		
Type	**Model**	**Initial customers**
DC-8	Std	United/Pan Am
	-61	Eastern/United
	-63	KLM
DC-9	-10	Delta
	-30	Delta
	-50	Swissair
DC-10	-10	American/United
	-30	KSSU
	-40	Northwest
L-1011	-1	Eastern/TWA

V1784
6-11-76

(Public Data)

Impact of Current Market Situation

Who is going to provide new medium range aircraft for U.S. and world market for next 20 years?

Primary considerations

- Foreign airlines will continue to provide major portion of all sales opportunities for several years.
- Continued access to major foreign markets probably requires U.S. manufacturers' involvement with foreign industry.
    - Many foreign carriers are partially or wholly owned by governments.
    - Government policies transcend airline interests.
- Lack of U.S. sales also causing U.S. manufacturers to seek foreign industry involvement to bear some portion of new aircraft development risks.
- French/German A-300 program represents major threat to U.S. manufacturers' dominance of medium range market.

V1785
6-11-76

(Public Data)

CHRYSLER CORPORATION

SUMMARY

SENATE COMMITTEE ON FINANCE

July 21, 1976

1. The so-called $44 million "benefit" to Chrysler of a Committee accepted investment tax credit amendment does not exist!

2. Chrysler supports a change in the foreign tax credit provisions of the law, for the following reasons:

   a. This amendment would provide jobs for workers as foreign source income is repatriated for investment in this country.

   b. It would place foreign tax credits on an equitable basis with investment tax credits.

   c. It would create no current drain (1976-77), in Chrysler's case, on the United States Treasury.

74-620 O - 76 -- 9

TESTIMONY

of

BRIAN T. O'KEEFE
ASSISTANT CORPORATE COMPTROLLER

CHRYSLER CORPORATION

Before the

SENATE COMMITTEE ON FINANCE

July 21, 1976

At the outset I would like to clear up some of the confusion which has been created about any so-called "benefit" to Chrysler through a provision which has been approved by this Committee. It has been reported that Chrysler will benefit from the Committee's expiring investment tax credit provision which, if adopted, will cost the Treasury $44 million in 1977 and 1978. This is not true. Chrysler has no unused investment tax credits which expire before 1980. Not one dime of this $44 million will benefit Chrysler Corporation.

Chrysler does support a technical change which would apply to an amendment to the tax law which has been approved by the Committee extending the period of use for certain foreign tax credits. Specifically, Chrysler has sought an amendment to H. R. 10612 which would extend the period in which

1972 foreign tax credits may be utilized, and would make possible the use of such carry-forward credits before any new credits generated in 1976-78.

The facts in support of the proposed amendment are as follows:

First -- in a period in which the creation of jobs is of paramount importance to the nation, this amendment represents a "jobs bill" in the best sense. To remain fully competitive in the U. S. automotive market, Chrysler has begun a multi-billion dollar investment in new, more fuel-efficient models for introduction over the next several years. Those investments create jobs for American workers. If this amendment becomes law, Chrysler will initiate plans immediately to repatriate up to $100 million of foreign source income as a vital part of that total investment.

Second -- this amendment creates equity out of inequity. Because of the severe economic recession which the nation has just endured, Chrysler was unable to claim foreign tax credits in the same manner as companies which were less seriously hurt. This amendment would correct that discriminatory situation. Briefly stated, Chrysler generated foreign tax credits in 1972 from repatriated foreign earnings. Subsequent recession losses in 1974-75 were required to be carried back to 1972, thereby displacing the 1972 foreign tax credits and forcing them to be carried forward. Unless utilized, these displaced credits will expire at the end of 1977. Under current law, these older credits can be used in later years only if substantial amounts of new foreign source income are repatriated. Even then, any new credits which are generated must be used first, thereby again displacing the older credits. The proposed amendment would enable us to use these 1972 credits prior to any new credits in the next few years. This would equalize the treatment of foreign tax credits with that of expiring investment tax credits.

Third -- while this amendment would result in the immediate repatriation of foreign source income, the current drain on the United States Treasury, insofar as Chrysler is concerned, would be zero. Any cost to the Treasury would come after 1978, and would be more than offset by the jobs created as a result of the earlier repatriation.

Finally, the proposed amendment provides a needed stimulus to U. S. employment through investment from credits already earned by the tax-paying company. Favorable action by the Senate will insure that foreign source income is made available as soon as possible to finance investment in new jobs for American workers.

The Committee has already recognized these facts in its own report accompanying the Tax Reform Bill:

> "During 1970-1971 and 1974-1975 the economy suffered two serious recessions ... Nonetheless, in order to remain competitive domestically and internationally, many firms in these industries have continued to invest in new plant and equipment in the U.S. and maintain their overseas business operations. In some cases, funds have been brought back from

overseas to support domestic operations. However, where domestic operations have subsequently worsened and created net operating losses, these losses have often eliminated the domestic income in the earlier years and resulted in carryforwards of previously absorbed tax credits. The committee is concerned that the expiration of the carryforward period for both of these credits may adversely effect the domestic investment programs of U.S. firms, and, as such, impact adversely on the long run structure of capital formation in the economy."

######

STATEMENT

OF

ERNEST S. CHRISTIAN, JR.

ON BEHALF OF

THE AMERICAN MARITIME ASSOCIATION

BEFORE THE

SENATE COMMITTEE ON FINANCE

BEGINNING July 20, 1976

SUMMARY OF STATEMENT

Twenty organizations representing all segments of labor and management in the shipbuilding and ship operating industries in the ocean trades, Great Lakes and the fisheries strongly support section 806 of the Committee's Bill to eliminate an unintended obstacle to investment in U.S. flag vessels. Section 806 clarifies that the investment tax credit is available for vessels built in the United States with withdrawals from capital construction funds established under the Merchant Marine Act of 1970.

This same matter was earlier the subject of public testimony before the Senate Committee on Finance on March 31, 1976, and before the House Ways and Means Committee on December 15, 1975. It was also earlier unanimously approved by the Senate Commerce Committee (S. 1542) and passed by the Senate on April 25, 1975.

I. SUPPORT OF ELIGIBILITY OF SHIPS BUILT OR PURCHASED WITH CAPITAL CONSTRUCTION FUNDS FOR THE INVESTMENT TAX CREDIT

1. U.S. flag merchant ships constructed in U.S. shipyards should not be singled out as the only item of machinery, equipment and transportation facilities excluded from the investment tax credit: a reduction in capital cost designed to apply across the broad spectrum of the economy.

2. In fact, such ships properly are eligible for the credit the same as aircraft and railroad cars. Congress never even considered excluding them and did not intend that they be denied

the credit. Thus, section 806 is not some new or special extension of the basic investment tax credit.

3. Indeed, the purpose of section 806 is to clarify present law and settle a longstanding dispute between the Departments of Treasury and Commerce over the interpretation of a statutory technicality which has frustrated the availability of the credit for ships.

4. The U.S. merchant fleet faces tremendous capital requirements over the next several years, estimated by the Government to total $7.6 billion.

5. A 10-year shipbuilding program initiated in 1970 set forth certain incentives to encourage investment because the Congress recognized that a viable U.S. merchant fleet is essential to meet national defense and economic needs, and that incentives for a private fleet are far less costly than maintaining a government-owned fleet.

6. One of the primary incentives enacted in 1970 was the Capital Construction Fund (CCF). The CCF is a form of cost recovery, much like depreciation, pursuant to which the vessel owner or operator enters into an agreement with the Secretary of Commerce to establish reserve funds out of shipping income to build or purchase agreed-upon ships. The CCF does not provide a double cost recovery since it is <u>in lieu of, and a substitute for, depreciation</u>.

7. The investment tax credit was intended to be a 10 percent reduction in capital cost. It applies to the full cost of property even though through accelerated depreciation that cost is also fully deducted against income (and the tax basis of property reduced to zero) within a relatively short time.

8. Since the capital construction fund is merely another method of accelerated depreciation and since the investment tax credit applies to all other machinery, equipment and transportation facilities subject to accelerated depreciation, there is no reason why it should not be equally applicable to U.S. flag merchant ships.

9. Uncertainty about the availability of the investment credit for CCF-built ships discourages investment in U.S. ships and puts U.S. flag merchant ships at a relative disadvantage compared with other capital goods. This clearly frustrates the national policy of encouraging investment in U.S. ships and

negates the CCF incentive which was passed by the Senate in 1970 by a record vote of 68 to 1.

10. Denial of the credit has the additional effect of exporting jobs. CCF-built ships must be constructed in U.S. shipyards. The shipbuilding industry employs 44 man-years per $1 million of contracts, one of the highest levels in all manufacturing, and also employs a very high percentage of minority workers. Further, seven out of ten major shipyards are located in chronically high unemployment areas and provide jobs where most needed.

11. Earlier in this Congress, the Senate passed maritime legislation (S. 1542) amending the CCF to clarify that the investment credit is not to be denied. Because of a jurisdictional question in the House, the matter was deleted in conference, although the House conferees unanimously stated they supported the provision on the merits. The Conference Report (H. Rept. No. 94-529) on the Maritime Appropriation Authorization Act of 1975, adopted by the House and Senate, makes clear that these U.S. flag merchant ships were not intended to lose the benefits of the investment tax credit. The Chairman and other members of the House Committee on Merchant Marine and Fisheries introduced H.R. 10551 which would clarify that the credit should be allowed for taxable years beginning after 1969 which coincides with the effective date of the Merchant Marine Act of 1970.

II. REBUTTAL OF ARGUMENTS THAT MAY BE MADE AGAINST ALLOWING THE INVESTMENT TAX CREDIT

Thomas F. Field, Executive Director, Taxation With Representation, has circulated arguments and testified against allowing the investment tax credit for these ships.

1. The arguments basically are arguments against the CCF under the 1970 Act, but that is not the subject of debate. The arguments now being used against the capital construction fund were raised by the identical witness in 1970, carefully considered, and overwhelmingly rejected.

> "This authority [capital construction fund] will do more than any other provision of this bill to build ships in United States shipyards to be operated under the American flag." (S. Rept. No. 91-1980).

2. The example (likely to be used) of a $78 million "revenue loss" from a single $50 million tanker is wrong. In fact, there is ultimately a $69 million tax liability in the transaction described which fails to take account of amendments in the 1970 Act.

3. The principal beneficiaries are not banks, oil companies and integrated steel companies. Of 96 capital construction funds, only 10 have been established by such companies.

4. Moreover, no matter who owns them, the CCF and the credit would be available only for U.S. flag merchant ships constructed in U.S. shipyards.

5. Arguments that the "cabotage" laws protect certain U.S. shipping trades from foreign competition is irrelevant. The question is whether the capital costs of U.S. ships are to be increased relative to other transportation equipment and capital goods. Vast amounts of other property receive similar benefits or protection from tariffs, licenses, etc., but all that property is also eligible for the investment tax credit.

6. The argument that the CCF is a substitute and that ships do not need the credit is wrong. The pre-credit after tax cost of a ship under CCF using a typical financing pattern is about 60 percent compared to a pre-credit after-tax cost of a railroad car of 65 percent under ADR depreciation. In addition, until 1982 a railroad car gets a 12 percent credit under provisions of the Bill. There is a 10 percent credit under present law for railroad cars. Since railroad cars get a 10 to 12 percent credit, why should U.S. flag merchant ships constructed in U.S. shipyards get a zero investment tax credit.

7. The argument that the CCF is a "tax exemption" is wrong. All property eligible for the investment tax credit is depreciable which means the full cost is deducted against income. Deduction of the cost under the CCF method of depreciation is no more a "tax exemption" than deduction of the cost of an airplane under another method of depreciation.

STATEMENT

OF

ERNEST S. CHRISTIAN, JR.

ON BEHALF OF

THE AMERICAN MARITIME ASSOCIATION

BEFORE THE

SENATE COMMITTEE ON FINANCE

BEGINNING July 20, 1976

This statement is submitted on behalf of the American Maritime Association for which I am special tax counsel.

The American Maritime Association consists of 37 companies operating 104 American flag ships in the foreign and domestic commerce of the United States.

We strongly support section 806 of H.R. 10612 as added by the Senate Committee on Finance to clarify that the investment tax credit is allowed for investments in U.S. flag fishing and merchant ships constructed or acquired with withdrawals from capital construction funds under the Merchant Marine Act of 1970.

This legislation is broadly supported throughout the fishing and merchant shipping industries, including employee unions. Specifically supporting the legislation are the following groups: American Institute of Merchant Shipping; American Maritime Association; International Longshoremen's

Association; International Protien Corporation; Labor-Management Maritime Committee; Lake Carriers Association; Marine Engineers Beneficial Association, AFL-CIO; Maritime Trades Department, AFL-CIO; Matson Navigation Company; Moore-McCormack Resources, Inc.; National Fish Meal and Oil Association; National Ocean Industries Association; Offshore Marine Services Association; Seacoast Products, Inc.; Seafarer's International Union; Sea-Land Service, Inc.; Shipbuilders Council of America; Standard Products Company, Inc.; Transportation Institute; Wallace Menhaden Products, Inc.; and Zapata Corp.

In order to avoid unduly enlarging an already extended record, this statement will partly incorporate by reference previous testimony which explains the policy of the Merchant Marine Act of 1970 to encourage private investment in the American merchant marine, and which explains why allowing the investment tax credit for the ships is not only fully consistent with, but required by, the policy of the investment tax credit in the Internal Revenue Code. See statements of James R. Barker before the Senate Committee on Finance on March 31, 1976, and before the House Committee on Ways and Means on December 15, 1975. See also, statements of Ernest S. Christian, Jr., before the Senate Committee on Finance on March 31, 1976, and before the House Committee on Ways and Means on December 15, 1975.

Thus, this statement will first merely summarize the maritime and tax policies supporting allowance of the investment credit. Secondly, this statement rebuts in detail arguments that have been made by an opponent of allowing the investment tax credit for U.S. flag merchant ships. These arguments that are rebutted are contained in testimony before the House Committee on Ways and Means, December 15, 1975, by Mr. Thomas F. Field, Executive Director, Taxation With Representation, which included an Appendix consisting of Tables 1-4 entitled "Use of Capital Construction Funds for Tax Avoidance Purposes". Copies of this testimony were submitted to members of the Senate with a letter from Mr. Thomas Reese, Legislative Director, Taxation With Representation, dated June 21, 1976, and it is understood that the substance of this prior testimony also will be submitted for the record of these hearings of the Senate Committee on Finance.

The following summation of the reasons for allowing the investment tax credit for ships and the following clear rebuttal of all arguments against allowing the investment tax credit, lead inescapably to the conclusion that the Committee's decision as reflected in section 806 of H.R. 10612 is correct.

GENERAL POLICY IN SUPPORT
OF ALLOWING THE CREDIT

A viable U.S. flag merchant fleet is essential to meet national defense needs, and incentives for a private fleet are far less costly than maintaining a government-owned fleet. This is the only case where the commercial market is expected to provide the capital, and to construct and operate the defense facility.

The U.S. merchant fleet faces tremendous capital requirements over the next several years, estimated by the government to total $7.6 billion. A 10-year shipbuilding program was initiated in 1970 and set forth certain incentives to encourage investment.

One of the primary incentives enacted in 1970 was the Capital Construction Fund. The capital construction fund is a form of cost recovery, much like depreciation, pursuant to which the vessel owner or operator enters into an agreement with the Secretary of Commerce to establish reserve funds out of shipping income to build or purchase agreed-upon ships. The capital construction fund was adopted in 1970 with only two dissenting votes and is recognized by Congress as essential to shipbuilding in the United States:

> "This authority [capital construction fund] will do more than any other provision of this bill to build ships in United States shipyards to be operated under the American flag". (S.Rept. No. 91-1080).

The investment tax credit is another incentive for high-cost U.S. shipbuilding which is relatively modest compared to tax and other incentives provided by most other maritime nations.1/

1/ Sweden (depreciation deductions in excess of cost, and tax-deferred reserves); United Kingdom (immediate write-off of cost of new ship); West Germany (30 percent first-year depreciation, progress payments, tax-deferred reserve and 50 percent credit against tax on income from foreign trade); Japan (25 percent first-year depreciation of new ships, tax deferred reserves, and credit against tax from foreign trade). S.Rept. No. 94-96, 94th Cong. 1st Sess.

The capital construction fund was not intended to be, and should not be, a substitute for the investment tax credit which is available for all other machinery, equipment and transportation facilities and is designed to be applied as broadly as possible throughout the economy to have its intended effect. U.S. flag merchant ships constructed in U.S. shipyards should not be the only significant items of machinery, equipment and transportation facilities excluded from the investment credit. Denial of the investment tax credit puts these ships at a relative disadvantage in attracting investment capital.

Denial of the investment tax credit also negates the intended effect of the capital construction fund which was passed by the Senate in 1970 by a record vote of 68 to 1.

Denial of the credit has the additional effect of exporting jobs The shipbuilding industry employs 44 man-years per $1 million of contracts, one of the highest levels in all manufacturing, and also employs a very high percentage of minority workers. Further, seven out of ten major shipyards are located in chronically high unemployment areas and provide jobs where most needed.

Allowance of the investment tax credit for ships constructed with capital construction funds is not a new or a novel idea. It is in fact fundamental to both the Merchant Marine Act of 1970 and the Internal Revenue Code. Likewise, arguments that are made against allowing the investment tax credit are not new or different arguments that require special consideration again. All such arguments are in fact arguments against the capital construction fund, were made by the same witnesses in 1970, and were overwhelmingly rejected by the Congress.

It is also clear that Congress did not even consider excluding ships from the investment tax credit and did not intend that such ships be excluded from the investment tax credit, although for the last 5 years the allowance of the credit has been frustrated by a dispute between the Departments of Commerce and Treasury over a technical interpretation of statutory language. The Conference Report (H. Rept. No. 94-529) on the Maritime Appropriation Authorization Act of 1975, adopted by the House and Senate, makes clear that these U.S. flag merchant ships were not intended to lose the benefits of the investment tax credit.

Indeed, the Internal Revenue Service has settled at least one case in litigation and allowed the investment tax credit on a 50/50 basis. Properly interpreted, the credit is allowed under present law and the amendment in section 806 should be considered as a clarification of present law. It was for that reason that H.R. 10551 introduced by the Chairman and other members of the House Committee on Merchant Marine and Fisheries would provide that the credit should be allowed for taxable years beginning after 1969 which coincides with the effective date of the Merchant Marine Act of 1970. The investment tax credit was not reinstated until 1971 which would, of course, be the first year of application. Section 806 of H.R. 10612 only applies to taxable years after 1975 and does not provide clarification for prior years.

TAX ANALYSIS AND POLICY IN SUPPORT OF ALLOWING THE CREDIT

A. Operation of Capital Construction Fund

The capital construction fund is a method of cost recovery for U.S. merchant ships constructed in U.S. shipyards that is similar to accelerated methods of depreciation in the Code. A shipowner may either deduct the cost in accordance with an accelerated depreciation schedule or make a tax-deductible deposit of income from ships in a capital construction fund under the supervision of the Secretary of Commerce.

These deposits provide a cash reserve with which to replace the ship or acquire an additional ship. When the accumulated funds are withdrawn and invested in a replacement ship, the "tax basis" of that ship is reduced to the extent paid for out of the capital construction fund. As a result of that reduction in tax basis, depreciation deductions on the ship in the future are smaller, just as depreciation deductions are smaller after accelerated depreciation is taken and the tax basis is reduced.

In both cases, the result is a deferral of tax that must be repaid by smaller deductions and greater tax payments in the future. The major differences are as follows:

a. The amount taken as a deduction under the capital construction fund method must actually be set aside in a fund for a replacement vessel; whereas in the case of depreciation deductions there is no such requirement.

b. Capital construction fund deductions may be taken only against shipping income.

c. The rate of cost recovery may in some cases be more rapid under the capital construction fund method, but the rate of cost recovery is generally irrelevant to the application of the investment tax credit. Larger differences in the rate of cost recovery may result by application of the ADR system of depreciation.

B. The Investment Tax Credit

The investment tax credit was intended to be a 10 percent reduction in capital cost. It applies to the full cost of property even though through accelerated depreciation that cost is also fully deducted against income (and the tax basis of property reduced to zero) within a relatively short time.

Since the capital construction fund is merely another method of accelerated depreciation and since the investment tax credit applies to all other machinery, equipment and transportation facilities subject to accelerated depreciation, there is no reason why it should not be equally applicable to U.S. flag merchant ships.

Clearly, these ships are property of the category to which the investment tax credit was intended to apply. Ships constructed in the U.S. meet the policy criteria underlying the credit: to offset higher capital costs and thereby help redress competitive advantages of foreign trading partners; and to stimulate employment in this country. In addition, merchant ships have declined in number to the point of causing the Department of Defense, "the greatest concern". See testimony of Deputy Assistant Secretary, John J. Bennett, before the House Committee on Merchant Marine and Fisheries, June 5, 1975.

The revenue cost is small and ships are the only property ever singled out and required particularly to justify receiving the credit: a reduction in capital cost designed to apply across the broad spectrum of the economy and which is available to all other property without such particular justification. Vast amounts of property eligible for the credit also receive other governmental benefits -- through tariffs, licenses, etc. -- but those benefits have never been sought to be negated by denying the investment tax credit. Obviously, that would be illogical and self defeating. Only in the case of ships has this occurred.

C. Comparison Of Relative Capital Costs

Having in mind that all property eligible for the investment credit is allowed accelerated depreciation and that ships are merely allowed the similar CCF deduction in lieu of depreciation, comparisons of pre-credit "after tax" costs are instructive. The full cost is deducted in all cases (by depreciation or by CCF deposits in the case of ships).

Comparative pre-credit after-tax costs of railroad cars under ADR accelerated depreciation and of a ship financed under a typical pattern using a capital construction fund are as follows:

	Expressed As 2/ Percentage Of Actual Cost
Railroad Car	65%
Ship	60%

The railroad car is allowed an additional 10 percent investment credit; and under section 703 of H.R. 10612 the railroad car would until 1982 be allowed a 12 percent investment credit.

If ships constructed with capital construction funds are denied the investment tax credit, the after-tax cost will be substantially greater than for railroad cars. If, as provided in section 806 of H.R. 10612, the credit is not denied to ships, their after-tax costs would be about the same as railroad cars.

2/ The ship is assumed to be purchased for a 25 percent down payment and financed under a 20-year mortgage with level annual principal payments, and the entire cost is paid for by capital construction funds that are deposited in the same year that each of the payments are made. If the ship were paid for in a lump sum with an amount deposited in a fund, the pre-credit after-tax cost would be 52 percent, but this is not a realistic assumption or representative of the manner in which the CCF is permitted to operate under the supervision of the Secretary of Commerce.

Certainly no bias should be created against construction of U.S. flag merchant ships in U.S. shipyards. If any bias is created, it should be in favor of, not against, the vital U.S. flag merchant fleet.

REBUTTAL OF ARGUMENTS AGAINST ALLOWING THE CREDIT

This rebuttal is addressed to testimony by one witness, Mr. Thomas F. Field, Executive Director, Taxation With Representation, before the House Committee on Ways and Means which included an Appendix consisting of Tables 1-4 entitled "Use of Capital Construction Funds for Tax Avoidance".

A. Summary

The principal points sought to be made by the witness are (i) to try to illustrate by Tables 1-4 of the Appendix that investment of $50 million in a tanker results in a $78.70 million "revenue loss", (ii) that the principal beneficiaries of capital construction funds are banks and integrated oil and steel companies, and (iii) that the credit is not needed since "cabotage" laws protect some shipping trades from foreign competition.

All these assertions are patently incorrect.

First, the witness' Appendix entitled "Use of Capital Construction Funds for Tax Avoidance Purposes", is devoted entirely to analyzing a situation in which the eligibility of capital construction fund-built ships for the investment tax credit is not even an issue. The ship was not acquired with capital construction funds and the investment tax credit clearly is applicable even without clarification of existing law.

The example in the witness' Appendix also misrepresents the application of the capital construction fund. It fails to take into account amendments in the Merchant Marine Act of 1970 and is wrong in its assertion that purchase of a $50 million tanker results in a "revenue loss" of $78.70 million. In fact, at the end of the transaction described, there is a tax liability of at least $69.4 million payable immediately along with interest upon a non-qualified withdrawal from the fund or thereafter upon reduction in the basis of ships.[3/]

Second, it is argued that the principal beneficiaries of the capital construction fund -- and the investment tax credit -- would be banks and integrated steel and oil companies that also own ships. These repeated claims remain unsubstantiated. Of the 96 existing funds, only 10 have been established by such

---

3/ This basic error is in addition to others. The most serious are (i) that accumulated deposits of the magnitude indicated would not be permitted for a one ship fleet; and (ii) that both the interest and principal schedules are distorted and do not reflect the liability of the related lender on the interest income (actual and imputed). It should also be understood that depreciation of capital investment is characterized as an "artificial loss" and that $5 million of the "revenue loss" is the investment tax credit. All these errors are discussed in detail hereinafter in this statement.

companies. The overwhelming percentage of capital construction funds are established by shipping companies and shipping companies are the primary beneficiaries of the program. Furthermore, the purpose of the capital construction fund is to encourage private investment in U.S. shipbuilding to modernize and revitalize the American merchant fleet to serve our national needs. The benefit to the nation from such investment exists regardless of the identity of the investor.

Deposits in a capital construction fund can only be made to purchase or construct ships and the tax deduction can be taken only against income from ships. The investment tax credit also would be allowed for investment in ships. The credit could be taken against income either from ships or from some other source, but the effect is only to reduce the capital cost of ships, not some other property.

Third, the argument that the "cabotage" laws protect certain U.S. ships from foreign competition in some trades is irrelevant. The question is whether the capital costs of U.S. ships are to be increased relative to other transportation equipment and capital goods. Other types of capital investment are protected by tariffs and otherwise, but all these other investments are eligible for the investment tax credit.

Such extraneous and incorrect arguments should not divert attention from the fact that allowance of the investment tax credit for U.S. flag merchang ships at modest revenue cost is not only consistent with existing law, it is compelled by basic principles of tax and maritime policy.

The attached Exhibit to this statement reviews and rebuts in detail all the general arguments as well as the examples in Tables 1-4 of the Appendix to the witness' testimony before the House Committee on Ways and Means.

* * * * * *

EXHIBIT

TO STATEMENT OF

ERNEST S. CHRISTIAN, JR.

ON BEHLAF OF

THE AMERICAN MARITIME ASSOCIATION

BEFORE THE

SENATE COMMITTEE ON FINANCE

BEGINNING July 20, 1976

This Exhibit consists of a detailed rebuttal of arguments made against allowing the investment tax credit in testimony on December 15, 1975, before the House Committee on Ways and Means, by Mr. Thomas F. Field, Executive Director, Taxation With Representation.

I. Rebuttal of General Objections To Allowing the Credit

The witness' asserted that the capital construction fund is an indefinite deferral of tax amounting to a tax "exemption"; that because of the capital construction fund the investment tax credit is an unneeded additional benefit; that integrated companies that also own ships would somehow avoid section 482 and other fundamental principles of the Internal Revenue Code and "convert" their other income into shipping income eligible for deposit; that allowance of the credit is conceptually inconsistent because there would be a break in "the highly important link" between "basis" for depreciation and "basis" for investment credit; and that there would be formidable administrative difficulties.

None of these objections is correct or warrants denial of the investment tax credit.

1. Deferral of tax is fundamental to both accelerated depreciation and the capital construction fund method of cost recovery. In reality, there is in every industry (not just merchant shipping) some limited degree of continuing deferral depending on the rate of growth in capital investment, but that is inherent in all forms of cost recovery and cannot in any case be considered inconsistent with the investment tax credit.

A ship is no more "tax-exempt" because its cost is deducted through the capital construction fund, than a railroad car is "tax-exempt" because its cost is deducted through depreciation. In fact, taking into account the discount rate and the respective rates of cost recovery for each, the "after-tax" cost of a railroad car under ADR is 65 percent and the "after-tax" cost of a ship (with a

20-year mortgage) under the capital construction fund is typically in the range of about 60 percent.

2. The investment tax credit was enacted as an additional reduction in capital costs, thereby to increase investment in productive capacity, create jobs, and enhance the economic growth overall. It is vital to maintenance of a U.S. merchant fleet and to employment in U.S. shipyards. Accordingly, the legislation is supported by both labor and management throughout the merchant shipping industry.

It is well known that the U.S. fleet, built in U.S. shipyards and operated under U.S. flag with American seamen, must compete with lower construction costs in foreign shipyards, with other investment incentives for foreign construction, and with substantial income tax advantages offered by other countries to ships of their registry. 2/

It cannot be denied that the allowance of the investment tax credit will reduce the impact of such foreign competitive advantages and increase construction of U.S. merchant ships in American shipyards.

3. The assertion that section 482 of the Code is ineffective and integrated companies convert manufacturing, etc. income into shipping income eligible for deposit in a fund, simply has no foundation in fact.

4. Regs. § 1.46-3(c) expressly provides that for purposes of the invesment tax credit "the basis of property would generally be its cost (see section 1012), unreduced by... any other adjustment to basis, such as that for depreciation." The cost of these merchant ships includes the amount paid for out of the capital construction fund. Certainly the part of the cost paid with a deductible deposit in a capital construction fund (accompanied by an offsetting reduction in basis) is no less a part of the ship's cost than the amount deducted as depreciation (also with an offsetting reduction in

---

2/ Nearly all other maritime nations provide substantial incentives for shipping: Sweden (depreciation deductions in excess of cost, and tax-deferred reserves); United Kingdom (immediate write-off of cost of new ship); West Germany (30 percent first-year depreciation, progress payments, tax-deferred reserve and 50 percent credit against tax on income for foreign trade); Japan (25 percent first-year depreciation of new ships, tax deferred reserves, and credit against tax from foreign trade).

basis). The full amount of cost is the ship's basis for investment tax credit purposes "unreduced by...any other adjustment to basis" (such as the reduction required by the Merchant Marine Act of 1970).

Moreover, pursuant to the provision of section 48(d) of the Code where the lessor of the new section 38 property elects to treat the lessee as the purchaser, the lessee is entitled to the investment tax credit which is based not on the tax basis of the asset, but on the fair market value of the property.

5. The Code already embodies the concept of basis and adjusted basis. The adjusted basis (which is basis reduced by depreciation) and the basis for investment tax credit purposes are never the same after the date the property is placed in service. The additional 20 percent first-year depreciation allowance under section 179 of the Code reduces the basis of property for depreciation purposes as of the date placed in service, but not for investment tax credit purposes. Also, the Treasury has urged that legislation be adopted to allow the investment tax credit on the full basis of property, but to reduce the basis of the property for depreciation purposes by the amount of the investment tax credit. No administrative problems result.

II. Rebuttal of Tables and Analysis in Appendix

A. Fundamental Error in Appendix

The Appendix to the witness' testimony entitled "Use of Capital Construction Funds for Tax Avoidance Purposes", purports to show a revenue loss of $78.70 million from investment in a single $50 million tanker and attributes that effect primarily to the capital construction fund under the Merchant Marine Act of 1970. In fact, at the end of the transaction described there is a tax liability of at least $69.4 million.

The false proposition is sought to be illustrated by three Tables (Tables 2, 3 and 4) which taken together (i) present an unrealistic picture of the way in which ships are financed and the way the capital construction fund operates; and (ii) ignore the effect of amendments in the

Merchant Marine Act of 1970 that designated the statutory "order" of withdrawals from the fund.

The basic structure and operative principle of the capital construction fund method of cost recovery is as follows: a tax deduction is taken when income is deposited in the fund, but that deduction is later recaptured either by (i) reducing the basis and future depreciation of a ship when a qualified withdrawal is later made for further investment in shipping; or by (ii) taxing as ordinary income (with interest) a nonqualified withdrawal.

There is only a deferral of tax and by the time the cycle is complete, the total tax paid is the same whether cost is recovered by the capital construction fund method, by accelerated depreciation or by straightline depreciation. (See Tables 2(a) and 2(b))

Typically -- having in mind the way ships are financed -- deposits of income are made in the fund and then withdrawn to pay the mortgage on that ship or to make the downpayment and mortgage payments on some other ship; so that subsequent to each deductible deposit there is one or a series of reductions in basis of ships that result in lesser depreciation deductions.

The examples in Tables 2-4 of the Appendix reverse this typical pattern, in an attempt to show extreme tax results. First, Table 2 shows a ship purchased with borrowed funds not withdrawn from a capital construction fund. Accelerated depreciation is taken which produces losses through the seventh year where the Table stops, although positive taxable income is produced beginning in the eighth year. Then, Table 3 shows that the annual depreciation charges are deposited in the "capital account" of a fund and that the income of the capital account is also redeposited. Thereafter, Tables 4 and 3, respectively, show that (i) beginning in the eighth year when positive taxable income is produced, that income is deposited in the fund and deducted; and (ii) beginning in the sixteenth year amounts are withdrawn from the "capital account" to pay off the mortgage.

The point of the illustration is supposed to be that the taxpayer has "beat the system" first by taking large accelerated depreciation deductions through the seventh year, and then when the ship starts to produce positive taxable income in the eighth year, by making offsetting deductible deposits of that income in a fund. Tables 2 and 4. (The mortgage is paid beginning in the sixteenth year by withdrawals from the capital account which do not reduce basis or otherwise result in taxable income. Table 3.)

The fundamental error in the illustration is that in the Merchant Marine Act of 1970 it was expressly provided that withdrawals would be deemed first to be made out of the capital account. This was done to assure recapture into ordinary income of the income previously deposited into the fund. It might otherwise be possible first to withdraw from the ordinary income and pay the mortgage in years 16-20 after the basis of the ship had already been reduced nearly to zero by depreciation.

Under the Merchant Marine Act of 1970, since the mortgage was deemed paid out of the capital account, the taxpayer, in the example set forth in the Tables 2-4, is left with $138.8 million (i.e. $108.7 of earnings on total previously deposited assets and redeposited earnings thereon, and $30.1 of deposited net ship earnings after interest and depreciation) in the ordinary income account which under the agreement with the Secretary of Commerce would either have to be withdrawn and taxed or withdrawn and applied to reduce the basis of a ship which will have the same effect. The tax liability is $69.4 million.

The example in the Appendix is simply wrong.

B. Specific Deficiencies and Errors in Tables

1. The situation described where an investor would keep $142.3 million "tied up" in a capital construction fund is unrealistic. Section 607(a) provides that the Secretary of Commerce may enter into a capital construction fund agreement which will provide for deposits into the fund of amounts agreed upon as necessary and appropriate to provide funds for a specific shipbuilding program.

2. The regulations require that the program specify the types and number of vessels to be constructed, the estimated costs, the estimated completion dates, where the vessels will be constructed, and other such data. Regulation 390.7(e)(2) provides a maximum level of deposit. Deposits are permitted only to the extent necessary to accomplish the approved shipbuilding program, and deposits in excess of what is necessary to complete the approved program are not permitted. Accordingly, if the example assumes a one vessel fleet, deposits in excess of $50 million would be prohibited. If additional vessels are assumed, the example is wrong in that it does not take into account the reductions in tax basis which will result from subsequent required withdrawals.

3. Even if a taxpayer were permitted to accumulate in the capital construction fund $142.3 million, which is the accumulation in the example, there would be no incentive to do so. Section 607(c) and Regulation 390.8 regulate the investments permitted with fund assets. Since safety of investments is essential, the investments are required to be conservative in nature.

4. No lender would allow the borrower to defer for 16 years the repayment of the principal on the debt as the example assumes. Interest paid to the related lender, as the example assumes, would be taxable income to the related lender (the parent corporation) thus offsetting any benefit.

5. In a real situation where (i) the cash deposited in the capital construction fund for any given year is the cash flow generated from the the taxpayer's operations which is equal to the gross ship earnings less the interest on mortgage, (ii) the ship mortgage is paid in 10 annual payments, and (iii) interest on borrowings and available funds accrues and is paid at 10 percent rate, there would be no tax-free accumulation related to deposit deductions. Deposits and interest earned thereon are insufficient to meet debt payments.

C. Correct Tax Result of Purchase of $50 Million Tanker Using the Capital Construction Fund

In reality the cash that a taxpayer deposits in the capital construction fund for any given year is the cash flow generated from the taxpayer's operations which is equal to the gross ship earnings less the interest on the mortgage. This is because the cash flow is less than the amount of depreciation charges that could be deposited in the fund. The ship mortgage is paid in ten annual payments and interest on borrowings and available funds accrues and is paid at 10 percent rate. The following Illustration is predicated upon these realistic premises and shows that there would be no tax-free accumulations related to deposit deductions, since deposits and interest earned thereon are insufficient to meet debt payments.

Illustration of Correct Tax Result of Purchase of $50 Million Tanker

(1) Year	(2) Deposit Ceiling for Depreciation Charges	(3) Revenue from Operation	(4) Interest on Mortgage	(5) Cash Flow from Operations (3-4)	(6) Deposit in Year (Lesser of 2 or 5)	(7) Redeposit of Prior Years' Earnings	(8) Payments on Ship Mortgage	(9) Balance in Fund	(10) Tax Deferral Attributable to Deposit
1	5.0	7.5	5.00	2.50	2.50	-	2.50	0	0
2	4.5	7.5	4.75	2.75	2.75	-	2.50	.25	0
3	4.1	7.5	4.50	3.00	3.00	.02	2.50	.77	.03
4	3.6	7.5	4.25	3.25	3.25	.08	2.50	1.6	.04
5	3.3	7.5	4.00	3.50	3.30	.36	2.50	2.58	.08
6	2.9	7.5	3.75	3.75	2.90	.26	2.50	3.22	.33
7	2.7	7.5	3.50	4.00	2.70	.52	2.50	3.74	.36
8	2.3	7.5	3.25	4.25	2.30	.58	2.50	3.32	.39
9	2.2	7.5	3.00	4.50	2.20	.40	2.50	4.02	.20
10	2.0	7.5	2.75	4.75	2.00	.41	2.50	3.93	.20
11	2.7	7.5	2.50	6.00	3.70	.40	2.50	3.53	.20
12	3.5	7.5	2.25	3.25	3.50	.36	2.50	3.15	.18
13	1.4	7.5	2.00	5.50	2.40	.32	2.54	2.31	.16
14	1.3	7.5	1.75	5.75	1.30	.24	2.50	1.25	.12
15	1.1	7.5	1.50	6.00	1.10	.13	2.45	-	.07
16	1.0	7.5	1.25	6.25	1.00	-	1.00	-	-
17	.9	7.5	1.60	6.50	.90	-	.90	-	-
18	.8	7.5	.75	6.75	.80	-	.80	-	-
19	.7	7.5	.50	7.00	.70	-	.70	-	-
20	.6	7.5	.25	7.25	.60	-	.60	-	-
	43.5	150.0	52.5	97.5	30.0	3.48	41.48	-	-

D. Analysis of Table 2

Table 2 of The Appendix

(1) Year	(2) Gross Vessel Earnings	(3) Interest on Construction Loan	(4) Depreciation Charges	(5) Artificial Loss	(6) Tax Loss Attributable to Use of Artificial Loss to Reduce Non-Shipping Income
1	7.5	5.0	5.0	2.5	1.25
2	7.5	5.0	4.5	2.0	1.00
3	7.5	5.0	4.1	1.6	0.80
4	7.5	5.0	3.6	1.1	0.55
5	7.5	5.0	3.3	0.8	0.40
6	7.5	5.0	2.9	0.4	0.20
7	7.5	5.0	2.7	0.2	0.10
8	7.5	5.0	2.3	-	-
9	7.5	5.0	2.2	-	-
10	7.5	5.0	1.9	-	-
11	7.5	5.0	1.7	-	-
12	7.5	5.0	1.5	-	-
13	7.5	5.0	1.4	-	-
14	7.5	5.0	1.3	-	-
15	7.5	5.0	1.1	-	-
16	7.5	4.0	1.0	-	-
17	7.5	3.0	0.9	-	-
18	7.5	2.0	0.8	-	-
19	7.5	1.0	0.7	-	-
20	7.5	-	0.6	-	-
Totals	150.0	85.0	43.5	8.6	4.30

The above Table illustrates depreciation. It also alleges that interest charges combined with depreciation in the early years of a vessel's useful life create an "artificial loss".

These deductions are no more artificial with a ship than with all other property which receives the investment tax credit.

The Table, however, is predicated upon the assumption that the firm using such system of accelerated depreciation has non-shipping income. Tax losses derived from the use of this method of depreciation would then be used to offset such income. However, if the interest paid on the construction funds borrowed is artificially inflated by a delay in the payment of the principal, such interest would be taxable income in the hands of the lenders. Thus, it will offset the benefits derived by the parent from the use of such method of accelerated depreciation.

Table 2 shows depreciation deduction taken without the use of the capital construction fund method of tax recovery. The effect of the use of accelerated depreciation is that any acceleration of depreciation reduces the basis of an asset. Beginning in the eighth year that additional deduction is recaptured.

Early accelerated depreciation increases taxable income after the eighth year. Thus, income, as shown on column (5) of Table 2(a) and taxes, as shown on column (6) of Table 2(a), are increased as a result of prior depreciation.

In fact, all Table 2 shows is that the same deferral of tax achieved by the capital construction fund method of cost recovery is inherent in all accelerated depreciation.

Table 2(a) Showing the Tax Consequences After The 8th Year of Accelerated Depreciation

(1) Year	(2) Gross Vessel Earnings	(3) Interest on Construction Loan	(4) Depreciation Charges	(5) Income Which Is Increased by Prior Depreciation	(6) Taxes
8	7.5	5.0	2.3	0.2	0.1
9	7.5	5.0	2.2	0.3	0.15
10	7.5	5.0	1.9	0.6	0.3
11	7.5	5.0	1.7	0.8	0.4
12	7.5	5.0	1.5	1.0	0.5
13	7.5	5.0	1.4	1.1	0.55
14	7.5	5.0	1.3	1.2	0.6
15	7.5	5.0	1.1	1.4	0.8
16	7.5	4.0	1.0	2.5	1.25
17	7.5	3.0	0.9	3.6	1.8
18	7.5	2.0	0.8	4.7	2.3
19	7.5	1.0	0.7	5.8	2.9
20	7.5	-	0.6	6.9	3.4
Totals	150.0	85.0	43.5	29.1	15.05

The purpose of Table 2(b) is to show that in a 20 year period the tax result of using early accelerated depreciation or straight line depreciation is the same.

Table 2(b), Showing the Tax Result in Case of Straight Line Depreciation

(1) Year	(2) Gross Vessel Earnings	(3) Interest	(4) Depreciation Charges	(5) Income	(6) Taxes
1	7.5	5.0	2.5	--	--
2	7.5	5.0	2.5	--	--
3	7.5	5.0	2.5	--	--
4	7.5	5.0	2.5	--	--
5	7.5	5.0	2.5	--	--
6	7.5	5.0	2.5	--	--
7	7.5	5.0	2.5	--	--
8	7.5	5.0	2.5	--	--
9	7.5	5.0	2.5	--	--
10	7.5	5.0	2.5	--	--
11	7.5	5.0	2.5	--	--
12	7.5	5.0	2.5	--	--
13	7.5	5.0	2.5	--	--
14	7.5	5.0	2.5	--	--
15	7.5	5.0	2.5	--	--
16	7.0	4.0	2.0	1.5	0.75
17	7.0	3.0	1.0	3.5	1.75
18	7.0	2.0	1.0	4.5	2.25
19	7.0	1.0	1.0	5.5	2.75
20	7.0	--	1.0	6.5	3.25
Totals		85.0	43.5	21.5	10.75

E. Analysis of Table 4

Table 4 is combined in the Appendix with Table 2 in an attempt to show that an indefinite tax deferral is created when net earnings which are negative in the first seven years because of the use of accelerated depreciation, at the beginning of the eighth year are placed in a capital construction fund.

Table 4 of the Appendix

(1) Year	(2) Net Vessel Earnings After Interest and Depreciation	(3) Deposited Net Vessel Earnings After Interest and Depreciation	(4) Tax Loss Attributable to Deferral of Tax on Deposited Net Earnings
1	(2.5)	--	--
2	(2.0)	--	--
3	(1.6)	--	--
4	(1.1)	--	--
5	(0.8)	--	--
6	(0.4)	--	--
7	(0.2)	--	--
8	0.2	0.2	0.10
9	0.3	0.3	0.15
10	0.6	0.6	0.30
11	0.8	0.8	0.40
12	1.0	1.0	0.50
13	1.1	1.1	0.55
14	1.2	1.2	0.60
15	1.4	1.4	0.70
16	2.5	2.5	1.25
17	3.6	3.6	1.80
18	4.7	4.7	2.35
19	5.8	5.8	2.90
20	6.9	6.9	3.45
Totals	21.5	30.1	15.05

However, the $30.1 million of ordinary income previously deducted when deposited in the capital construction fund will be taxed when withdrawn or after investment in a ship the tax basis of which is reduced by $30.1 million.

F. Analysis of Table 3

Table 3 of the Appendix

(1) Year	(2) CCF Deposits of Income Producing Assets Equal to Deprec.Charges on Agreement Vessel	(3) Redeposit of Prior Yr. Earn. On Total Prev. Depos. Assets & Earnings, as shown Col. 5	(4) Nontaxable Payments out of Capital Acct. to Disch. Ship Mort.	(5) Total Prev. Depos.Assets & Redepos. Earnings Thereon, i.e. 2+3, less 4	(6) Tax Loss Attrib. to Deferral of Tax on Re-depos, Prior Year Earnings
1	5.0	-	-	5.0	-
2	4.5	0.5	-	10.0	0.25
3	4.1	1.0	-	15.1	0.50
4	3.6	1.5	-	20.2	0.75
5	3.3	2.0	-	25.5	1.00
6	2.9	2.5	-	30.9	1.25
7	2.7	3.0	-	36.6	1.50
8	2.3	3.6	-	42.5	1.80
9	2.2	4.2	-	48.9	2.10
10	1.0	4.0	-	55.7	2.45
11	1.7	5.6	-	63.0	2.80
12	1.5	6.3	-	70.8	3.15
13	1.4	7.1	-	79.3	3.55
14	1.3	7.9	-	88.5	3.95
15	1.1	8.8	-	98.4	4.40
16	1.0	9.8	(10.0)	99.2	4.90
17	0.9	9.9	(10.0)	100.0	4.90
18	0.8	10.0	(10.0)	100.8	5.00
19	0.7	10.0	(10.0)	101.5	5.00
20	0.6	10.1	(3.5)	112.2	5.05
Totals	43.5	108.7	(43.5)	112.2	54.35

Table 3 ignores the real effect of the amendments introduced by the Merchant Marine Act of 1970 providing that withdrawals are deemed first to be made out of the capital account. Since the mortgage would be paid out of the capital account, the taxpayer would then be left with $108.7 million in his ordinary income account which, together with the $30.1 million of operating earnings (See Table 4), would either have to be withdrawn and taxed (with interest) or applied to reduce the basis of a ship which will have the same effect.

Table 3 also overlooks a cash flow problem. Column (2) of the Table is based upon the assumption that "the capital construction fund deposit of income-producing assets equal to depreciation charges on agreement vessel" is equal, in the first year, to $50.0 million, however, in Table 2 the amount of cash in the hands of the taxpayer is only $2.5, i.e., the difference between the gross vessel earnings and the interest on construction costs. As shown in the Illustration of Correct Tax Result of Purchase of $50 Million Tanker, supra, in a real situation a taxpayer would deposit in the capital construction fund only the cash generated from its shipping operations.

APPENDIX A

USE OF CAPITAL CONSTRUCTION FUNDS FOR TAX AVOIDANCE PURPOSES

Analysis of the capital construction fund mechanism, as presently constituted, indicates substantial opportunities for tax avoidance. These opportunities are summarized in Tables 1-4. As they indicate, use of the construction fund mechanism in connection with a single $50 million tanker can result in undiscounted revenue losses over the life of the ship that come to more than $78 million.

Because these tax avoidance techniques are so attractive, it is likely that they will be used by substantially all the banks, oil companies, and other firms that are now preparing to build tankers for use in the Alaska oil trade. Most of those firms have both liquid corporate assets that are now yielding taxable income and a need to build ships to move oil from Valdez, Alaska, where the Alaska pipeline ends, to the West Coast of the United States. The capital construction fund mechanism enables them to shelter from tax the income on substantial amounts of corporate assets, and thus permits them to build their tanker fleets with essentially tax exempt income.

Similar tax avoidance techniques are also available in the case of ore carriers engaged in the Great Lakes trade. As in the Alaska trade, ships operating between U.S. ports on the Great Lakes must be built in U.S. yards and manned by U.S. sailors. Accordingly, those ships are also eligible to make use of tax-deferred capital construction funds.

The three principal tax avoidance techniques available to shippers are detailed in Tables 2 through 4. Table 2 shows how the excess depreciation charges generated in the early years of a vessel's life can be used to reduce nonshipping income.

Table 3 shows how the technique of depositing income producing assets in a capital construction fund can be used to shield from tax the income produced by those assets. Table 3 involves deposits in a capital construction fund of assets equal to the depreciation charges on a vessel. The earnings on those assets are then re-deposited tax free in the fund for use in building future ships, and the assets themselves are eventually withdrawn, tax free, to discharge the ship mortgage on the vessel in question.

Finally, Table 4 shows the revenue losses that result when shipping income that would otherwise be subject to tax is deposited in a capital construction fund.

Conservative Assumptions Used

Tables 1 through 4 have been constructed on the basis of conservative assumptions about vessel earnings, depreciation charges, asset earnings, and interest rates. Less conservative assumptions would have produced substantially larger revenue losses. Hence, the $78.7 million loss shown in Table 1 must be regarded as a minimum figure.

Tables 1 through 4 are particularly designed to sketch the situation of a typical oil firm or bank holding subsidiary which has income producing assets and which wishes to build a tanker to serve the Alaska oil trade. The assets in question are assumed to be yielding a return of 10 percent before tax (i.e. about the current rate for corporate bonds). If higher yield assets are deposited, the revenue loss would be correspondingly larger.

Tables 1-4 also assume that the tanker in question will cost $50 million, substantially all of which is to be borrowed at 10 percent interest, giving a ship mortgage in return. In addition, they assume that the ship's annual net earnings before depreciation and interest charges will be $7.5 million (i.e. a 15 percent rate of return on investment), that depreciation will be calculated by the double declining balance method, (leaving an unrecovered basis of $6.5 million at the end of 20 years), and that the corporate tax rate is 50 percent.

Finally, the tables assume that the investor is determined by the Maritime Administration to be otherwise qualified to open a capital construction fund.

Basic Construction Fund Rules

Two basic Merchant Marine Act rules are crucial to the operation of the proposed tax avoidance mechanism. The first rule limits the amount of the deposits that a shipper can make in a tax-deferred capital construction fund. These deposits are limited to: (a) taxable vessel earnings, if any, (b) depreciation on the agreement vessel, (c) net proceeds, if any, from the sale of the vessel, and (d) earnings on the reserve fund itself. The second rule relates to the order or priority in which withdrawals may be made from the reserve fund, and provides that withdrawals must come first from "capital account" -- e.g. from deposits of capital assets equivalent to the depreciation charges on an agreement vessel. These two rules, taken together, mean that substantial amounts of income producing assets can be put into a capital construction fund, that the subsequent earnings on those assets can be allowed to accumulate tax free, and that the original capital investment can later be withdrawn tax free, to pay off the ship mortgage relating to an agreement vessel. The earnings produced by those assets will then remain untaxed in the fund to build additional ships.

The operation of these basic rules is illustrated in Table 3. Column 2 of that Table shows the deposit in a construction fund of income producing assets equivalent to the depreciation charges on an agreement vessel, and column 3 shows the deposit in that fund of the earnings on those assets and on previously deposited earnings.

Table 1

SUMMARY OF REVENUE LOSSES ON A TANKER COSTING $50 MILLION, WHERE A CAPITAL CONSTRUCTION FUND MECHANISM IS UTILIZED TO DEFER TAX PAYMENTS

1. Decrease in federal revenue caused by application of artificial losses to reduce nonshipping income....................$4.30 million
   (See Table 2 for details)

2. Decrease in federal revenue caused by deferral of tax on earnings of income producing assets which are deposited in a capital construction fund in an amount equal to depreciation charges on an agreement vessel...........................$54.35 million
   (See Table 3 for details)

3. Decrease in federal revenue caused by deferral of tax on net shipping earnings, after interest and depreciation, through deposit in a capital construction fund.......15.05 million
   (See Table 4 for details)

4. Decrease in federal revenue attributable to proposed investment credit...................5.00 million

TOTAL REVENUE LOSSES $78.70 million

Table 2

COMPUTATION OF REVENUE LOSS RESULTING FROM ATTRIBUTION TO NONSHIPPING INCOME OF ARTIFICIAL LOSSES CREATED BY ACCELERATED DEPRECIATION

(1) Year	(2) Gross Vessel Earnings	(3) Interest on Construction Loan	(4) Depreciation Charges	(5) Artificial Loss	(6) Tax Loss Attr table to Use Artificial Lo to Reduce Non-Shipping Inco
1	7.5	5.0	5.0	2.5	1.25
2	7.5	5.0	4.5	2.0	1.0
3	7.5	5.0	4.1	1.6	0.80
4	7.5	5.0	3.6	1.1	0.55
5	7.5	5.0	3.3	0.8	0.40
6	7.5	5.0	2.9	0.4	0.20
7	7.5	5.0	2.7	0.2	0.10
8	7.5	5.0	2.3	-	-
9	7.5	5.0	2.2	-	-
10	7.5	5.0	1.9	-	-
11	7.5	5.0	1.7	-	-
12	7.5	5.0	1.5	-	-
13	7.5	5.0	1.4	-	-
14	7.5	5.0	1.3	-	-
15	7.5	5.0	1.1	-	-
16	7.5	4.0	1.0	-	-
17	7.5	3.0	0.9	-	-
18	7.5	2.0	0.8	-	-
19	7.5	1.0	0.7	-	-
20	7.5	-	0.6	-	-
Totals	150.0	85.0	43.5	8.6	4.30

Table 3

COMPUTATION OF REVENUE LOSS CAUSED BY DEPOSIT IN CAPITAL CONSTRUCTION FUND OF (a) INCOME PRODUCING ASSETS EQUIVALENT TO DEPRECIATION CHARGES ON AGREEMENT VESSEL, AND (b) THE EARNINGS PRODUCED BY SUCH ASSETS

(1) Year	(2) CCF Deposits of Income Producing Assets Equal to Deprec. Charges on Agreement Vessel	(3) Redeposit of Prior Yr.Earn. on Total Prev. Depos.Assets & Earnings, as shown Col.5	(4) Nontaxable Payments out of Capital Acct. to Disch. Ship Mort.	(5) Total Prev. Depos.Assets & Redepos. Earnings Thereon,i.e. 2+3,less 4	(6) Tax Loss Attrib.to Defferal of Tax on Re-depos. Prior Year Earnings
1	5.0	-	-	5.0	-
2	4.5	0.5	-	10.0	0.25
3	4.1	1.0	-	15.1	0.50
4	3.6	1.5	-	20.2	0.75
5	3.3	2.0	-	25.5	1.00
6	2.9	2.5	-	30.9	1.25
7	2.7	3.0	-	36.6	1.50
8	2.3	3.6	-	42.5	1.80
9	2.2	4.2	-	48.9	2.10
10	1.9	4.9	-	55.7	2.45
11	1.7	5.6	-	63.0	2.80
12	1.5	6.3	-	70.8	3.15
13	1.4	7.1	-	79.3	3.55
14	1.3	7.9	-	88.5	3.95
15	1.1	8.8	-	98.4	4.40
16	1.0	9.8	(10.0)	99.2	4.90
17	0.9	9.9	(10.0)	100.0	4.95
18	0.8	10.0	(10.0)	100.8	5.00
19	0.7	10.0	(10.0)	101.5	5.00
20	0.6	10.1	(3.5)	112.2	5.05
Totals	43.5	108.7	(43.5)	112.2	54.35

Table 4

COMPUTATION OF REVENUE LOSS CAUSED BY DEPOSIT IN CAPITAL CONSTRUCTION FUND OF NET VESSEL EARNINGS AFTER INTEREST AND DEPRECIATION

(1) Year	(2) Net Vessel Earnings After Interest and Depreciation	(3) Deposited Net Vessel Earnings after Interest and Depreciation	(4) Tax Loss Attributable to Deferral of Tax on Deposited Net Earnings
1	(2.5)	-	-
2	(2.0)	-	-
3	(1.6)	-	-
4	(1.1)	-	-
5	(0.8)	-	-
6	(0.4)	-	-
7	(0.2)	-	-
8	0.2	0.2	0.10
9	0.3	0.3	0.15
10	0.6	0.6	0.30
11	0.8	0.8	0.40
12	1.0	1.0	0.50
13	1.1	1.1	0.55
14	1.2	1.2	0.60
15	1.4	1.4	0.70
16	2.5	2.5	1.25
17	3.6	3.6	1.80
18	4.7	4.7	2.35
19	5.8	5.8	2.90
20	6.9	6.9	3.45
Totals	21.5	30.1	15.05

SUMMARY OF STATEMENT OF
JOHN H. HALL TO THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
HEARINGS ON THE TAX REFORM ACT (H.R. 10612)
July 20, 1976 to July 22, 1976

A. The effective date of Section 1013 of H.R. 10612, 94th Cong., as reported by the House Ways and Means Committee was May 21, 1974, the date on which the Committee's tentative decision was announced.

B. There was no generally published announcement of this decision until May 29, 1974.

C. On or before May 8, 1974, our clients commenced execution of instruments creating a foreign trust. On May 28, 1974 execution was completed in reliance on existing law and without knowledge of the then unpublicized proposed change in law.

D. The Senate Commiteee on Finance acted properly in changing the effective date of the legislation to May 29, 1974, the date on which the bar could reasonably have been aware of the proposed change.

TESTIMONY BY JOHN H. HALL
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE
HEARINGS ON THE TAX REFORM ACT (H.R. 10612)
July 20, 1976 to July 22, 1976

Section 1013 of H.R. 10612, 94th Cong., for the first time taxes grantors of irrevocable foreign trusts. We do not quarrel with the legislative decision to take this step. However, the effective date of this Section, as reported by the House Ways and Means Committee, was retroactive to May 21, 1974. This was the date on which the Ways and Means Committee announced its tentative decision on the subject. To our knowledge there was no generally published announcement indicating that the Ways and Means Committee proposed to change the taxation of foreign trusts in this manner until May 29, 1974 when the Committee's tentative decision was disclosed in a BNA Daily Tax Report. Prior press coverage of the May 21 Ways and Means Committee action did not refer to the taxation of U. S. grantors of foreign trusts, nor was this proposed change referred to in the Ways and Means Committee's tax reform agenda for 1974, as reported in the BNA Daily Tax Report. The Daily Tax Report, generally the most current publication for tax practitioners, carried the story on May 29, 1974.

Without knowledge of the proposed change our clients took the irrevocable action of establishing a foreign trust for the benefit of their children on May 28, 1974. As evidenced by the British Consulate General's stamp dated May 8, 1974 on the trust instrument, our client had begun execution of the trust well before the tentative decision but did not obtain signatures of the foreign trustees until May 28. We believe therefore that the Senate Committee on Finance acted properly when it decided to make the effective date of the Bill the earliest date on which the tax bar could reasonably have learned of the House Ways and Means Committee's tentative decision.

Criticism that the change of the effective date would set a precedent allowing persons to take advantage of the inherent time lag between announcement of a tentative decision and publication of that decision in the media is without merit. First, this decision has no weight as precedent unless future cases arise under the same circumstances. In this case there was an unusually long delay in the public announcement, the taxpayer consummated an irrevocable act during the period of delay, and the period of retoractivity of the proposed legislation reaches back unusually far, to 1974.

Furthermore, no action by Congress is binding as precedent unless in future cases Congress determines that the public interest is served by reaching the same result. The only precedent which could be established by a delay in the effective date of this legislation would be a recognition that under some circumstances the social utility of changing the tax laws on the very day of decision may be outweighed by the undesirability of defeating reasonable expectations that actions may be taken in reliance upon existing tax laws in effect for many years. Under the particular circumstances here, we submit that no fair minded person should disagree with the Senate Finance Committee's action.

**WRITTEN STATEMENT
BY JOHN H. HALL
TO THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
HEARINGS ON THE TAX REFORM ACT (H.R. 10612)
July 20, 1976 to July 22, 1976**

Section 1013 of H.R. 10612, 94th Cong., as reported by the House Ways and Means Committee and the Senate Committee on Finance would tax currently to a United States grantor the income of a foreign trust with United States beneficiaries. The effective date of the version of this Bill reported by the House Ways and Means Committee was retroactive to May 21, 1974. This date was selected because on May 21, 1974 the House Ways and Means Committee announced its tentative decision on this subject. However, there was, to our knowledge, no generally published announcement indicating that the House Ways and Means Committee proposed to change the taxation of foreign trusts in this manner until May 29, 1974 when the Committee's tentative decision was first publicized in the BNA Daily Tax Report. Press coverage concerning changes affecting foreign income appeared in the May 22, 1974 issue of the Wall Street Journal, the New York Times and the BNA Tax Report, but none of these articles referred to the taxation of United States grantors of foreign trusts. Furthermore, the House Ways and

Means Committee's tax reform agenda for 1974 as reported in the BNA Daily Tax Report of April 30 did not refer to proposals regarding the taxation of foreign trusts.

Having no notice or knowledge of the proposed change, our clients established on May 28, 1974 a foreign trust which would be treated as a grantor trust under H.R. 10612. The trust was created for the benefit of their children. The trust instrument bears the stamp of the British Consulate General in Los Angeles dated May 8, 1974, evidencing that our clients had commenced execution of the trust instrument prior to any decision by the House Ways and Means Committee. However, the signature of the foreign trustee was not obtained until May 28, 1974, and the irrevocable transfer of the assets was completed on that date.

Prior to May 29, 1974, the first date on which the BNA Tax Report carried news of the decision, neither our clients nor their trust counsel had actual knowledge of the proposed legislation. By the time the tentative decision was reported, our clients had taken irrevocable action by funding the trust. We believe, therefore, that the Senate Finance Committee acted correctly when it decided to make the effective date of the Bill the first date on which the bar could reasonably have been expected to know of the House Ways and Means Committee's tentative decision.

Criticism that the change of the effective date would set a precedent allowing persons to take advantage of the inherent time lag between announcement of a tentative decision and publication of that decision in tax journals or the media is without merit. First, this decision has no weight as precedent unless future cases arise under the same circumstances or involve the same set of facts. In this case there was an unusually long delay in publication of the House Ways and Means Committee's tentative decision. Such reports are usually carried the next day by the press. Under normal circumstances it would be virtually impossible to set up a foreign trust between the decision date and the date on which the announcement would be carried by the reporting services. Moreover, in this case the action taken in reliance on the continuance of existing law was irrevocable and the effective date of the proposed legislation was retroactive for an unusually long period. There are few instances in which the effective date of legislation adversely affecting a taxpayer reaches back over a period in which two tax returns would have been filed. Therefore, this case can easily be distinguished from different cases which may follow where a taxpayer happened to get word of a proposed action and moved quickly to "get in under the wire".

Furthermore, no action by Congress is binding as precedent unless in future cases Congress determines that the public interest would be served by reaching the same result. In any event the only precedent which could be established by the Senate Finance Committee's decision would be a recognition that under some circumstances the social utility of establishing an early cut-off date may be outweighed by the undesirability of defeating the reasonable expectation that irrevocable action may be taken in reliance upon existing laws in effect for many years. It would be difficult to say that there are no circumstances in which it would be approrpiate to defer the effective date of new legislation until persons acting in reliance upon existing law could reasonably have become aware of the proposed change, even if a delay in the effective date permitted the continuation for one or two more days of an activity which had been permitted for many years. We submit that this is a case where such delay in the effective date is appropriate and that the Senate Finance Committee's decision to move the effective date of the Bill to May 29, 1974 was entirely proper and fair.

DATED: July 16, 1976.

Respectfully submitted,

John H. Hall

John H. Hall

July 21, 1976

**SUMMARY OF PRINCIPAL POINTS IN
STATEMENT OF THE SUPERIOR OIL COMPANY
BEFORE THE
COMMITTEE ON FINANCE
IN SUPPORT OF SECTION 1021 OF H.R. 10612**

1. The Superior Oil Company ("Superior") owns 53 percent of the stock of Canadian Superior Oil, Ltd. ("Canadian Superior"); the remaining stock is publicly owned. Canadian Superior explores for oil and gas throughout the world, and since 1964 has made investments in oil and gas leases on the Outer Continental Shelf in the Gulf of Mexico, more than 12 miles beyond the U.S. coastline. The amounts paid for these leases were paid to the U.S. Treasury and the wellhead oil and gas have been sold to unrelated U.S. companies.

2. The Tax Reform Act of 1969 added Section 638 to the Internal Revenue Code to provide that the Outer Continental Shelf, even though outside the 12-mile limit, should be treated for certain purposes as being within the United States.

3. Section 1021(d)(2) of H.R. 10612 provides that investment in property situated on or used exclusively in connection with the Outer Continental Shelf made by foreign corporations subsequent to the Tax Reform Act of 1969 will not be treated under Section 956 as dividends to their U.S. shareholders.

4. This provision was approved by the Ways and Means Committee after discussion in public mark-up session, where the companies involved were disclosed and the problem fully discussed, and was included in the bill as passed by the House of Representatives.

74-620 O - 76 -- 12

STATEMENT OF THE SUPERIOR OIL COMPANY
BEFORE THE
COMMITTEE ON FINANCE
IN SUPPORT OF SECTION 1021 OF H.R. 10612

July 21, 1976

My name is Edwin S. Cohen. I am of counsel to the law firm of Covington & Burling, Washington, D.C. I appreciate the opportunity to appear before the Committee this morning on behalf of The Superior Oil Company in support of the provisions of Section 1021 of H.R. 10612, modifying Section 956 of the Internal Revenue Code.

Section 956 of the Code now provides that if a United States corporation owns more than 50 percent of the stock of a foreign corporation and the foreign corporation makes certain investments in United States property, the amount so invested is to be treated as a dividend to the U.S. corporation.

The Superior Oil Company ("Superior") is a U.S. corporation which owns about 53 percent of the stock of Canadian Superior Oil, Ltd. ("Canadian Superior"), a Canadian corporation that is engaged in the exploration for oil and gas in Canada and throughout the world. Canadian Superior's remaining stock is publicly held, and a majority of Canadian Superior's directors are Canadian residents. Canadian Superior has explored for oil and gas off the Outer Continental Shelf of the United States, as well as elsewhere throughout the world.

Since 1964, Canadian Superior has advanced substantial funds to Canadian Superior's wholly-owned U.S. subsidiary for use in the acquisition, exploration and development of interests in Federal oil and gas leases on the Outer Continental Shelf in the Gulf of Mexico, more than 12 miles beyond the coastline of the United States. The U.S. subsidiary was organized because Federal leasing regulations require that such leases be held by a U.S. corporation.

The amounts paid for these leases have been paid into the United States Treasury. Any oil or gas discovered on these leasehold interests is sold by Canadian Superior to unrelated U.S. companies.

Superior has derived no tax or other benefit from the expenditures made by Canadian Superior. Indeed, since Canadian Superior and its U.S. subsidiary do not have U.S. income from other sources, the usual tax deductions for the oil and gas exploration and development expenditures by Canadian Superior's U.S. subsidiary in excess of its income therefrom have produced no tax benefit. Superior could not properly prevent Canadian Superior, with 47 percent of its stock publicly held, from using Canadian Superior's own funds to acquire oil and gas leases on the Outer Continental Shelf or elsewhere in the world if Canadian Superior considered it desirable to do so.

Superior believes that it was not the intent of Section 956 to cause the expenditures made by Canadian Superior on the Outer Continental Shelf in the ordinary course of its business of exploring for oil and gas to be taxable as dividends to Superior. If Canadian Superior's expenditures in past years were taxable to Superior when made, then under Section 959 of the present law dividends in corresponding amounts paid by Canadian Superior to Superior in future years would be tax-free. The uncertainty of the status of the past expenditures also produces uncertainty as to the tax status of future distributions.

The Tax Reform Act of 1969 added Section 638 to the Internal Revenue Code to provide that for certain purposes the Outer Continental Shelf, even though outside the 12-mile limit, should be treated as being within the United States. It does not appear that Congress contemplated the effect this amendment might have in broadening the scope of Section 956 when the amendment was enacted in 1969. Accordingly, Section 1021(d)(2) of H.R. 10612 provides that investments in property situated on or used exclusively in connection with the Outer Continental Shelf made by foreign corporations subsequent to the Tax Reform Act of 1969 and prior to January 1, 1977 will not be treated as dividends to their U.S. shareholders.

This provision was approved by the Ways and Means Committee after discussion in public mark-up session, where the companies involved were disclosed and the problem fully discussed, and it was contained in the bill passed by the House of Representatives. It was approved by the Finance Committee subject to the limitation that it apply only to investments prior to January 1, 1977.

We believe that this provision, previously approved by both Committees, is fair and reasonable and we respectfully urge its enactment.

**SUMMARY OF PRINCIPAL POINTS IN
STATEMENT OF PYRAMID VENTURES, INC.
BEFORE THE
COMMITTEE ON FINANCE
IN SUPPORT OF SECTION 1021 OF H.R. 10612**

July 21, 1976

Pyramid Ventures, Inc. is a United States corporation with two wholly-owned foreign subsidiaries which made portfolio investments in stocks of unrelated publicly-owned United States corporations between August 15, 1974 and January 30, 1975.

On May 21, 1974 the Ways and Means Committee issued a press release announcing a tentative decision to amend Section 956 to permit such portfolio investments without dividend tax to the U.S. shareholders of the foreign corporation. The amendment was contained in the bill as passed by the House.

Pyramid supported the provision in a written statement filed with the Finance Committee on April 23, 1976, and asked that it be made effective at the election of the taxpayers for investments made after May 21, 1974, the date of the Ways and Means Committee announcement. The bill reported by the Finance Committee makes this change in the effective date.

Since the provision is remedial legislation that eliminates a trap and is desirable for the U.S. economy, it seems entirely fair and reasonable to make it effective from the date it was first publicly announced by the Ways and Means Committee, and Pyramid urges that this provision be retained in the bill.

STATEMENT OF PYRAMID VENTURES, INC.
BEFORE THE
COMMITTEE ON FINANCE
IN SUPPORT OF SECTION 1021 OF H.R. 10612

July 21, 1976

My name is Edwin S. Cohen. I am of counsel to the law firm of Covington & Burling, Washington, D.C. I appreciate the opportunity to appear before the Committee this morning on behalf of Pyramid Ventures, Inc., in support of Section 1021 of H.R. 10612.

Pyramid Ventures, Inc., a U.S. corporation, urges the enactment of Section 1021, which would amend Section 956 of the Internal Revenue Code to permit controlled foreign corporations to make certain investments in United States property without adverse tax consequences so long as the investment is not in a related United States person. Pyramid also urges that the Committee retain Section 1021(d)(2), allowing taxpayers to elect to apply Section 1021 to investments in United States property made after May 21, 1974, the date on which the Ways and Means Committee first announced its tentative decision in favor of amending Code Section 956.

Pyramid publicly supported this provision in a written statement filed with the Finance Committee on April 23, 1976. That statement disclosed that in 1974 Pyramid was caught in a "trap for the unwary" created by Section 956 when its foreign subsidiaries invested in stocks of publicly-held, unrelated U.S. corporations. Pyramid requested that the revision of Section 956 be applicable to investments made after May 21, 1974, when the Ways and Means Committee first announced its intention to exclude these types of investments from Code Section 956.

Pyramid's position was summarized on page 29 of the Joint Committee Staff's "Summary of Statements Submitted to the Finance Committee on Tax Revision and Extension of Tax Reductions" dated April 30, 1976.

Pyramid organized two foreign subsidiaries in 1970 and 1972, respectively, to carry on a shipping business by time-chartering vessels to transport bulk cargo between U.S. Gulf Coast ports and foreign ports. The charters expired in mid-1974 and neither subsidiary has engaged in the shipping business since then.

Both foreign subsidiaries then invested the funds remaining after cessation of the shipping business in publicly-traded shares of unrelated U.S. companies. These investments were made between August 15, 1974 and January 30, 1975.

Under present law (Int. Rev. Code Sec. 956) the amount of these U.S. investments is technically treated as dividends taxable to the U.S. parent, Pyramid, simply because the investments were made in United States property (the shares of U.S. corporations) rather than foreign property, even though the corporations were unrelated to Pyramid.

On May 21, 1974, some three months before Pyramid's foreign subsidiaries made their first investments in U.S. securities, the House Ways and Means Committee issued a press release announcing a tentative decision to amend Section 956 to allow controlled foreign corporations to invest in United States property without dividend treatment to their U.S. shareholders so long as the investment is not in a related U.S. person. H.R. 10612, as passed by the House, ultimately contained a provision reflecting this decision. The change was made because Section 956 has been a trap for those not familiar with its existence; it has encouraged foreign investment rather than U.S. investment to the detriment of the U.S. economy; and the investment does not, in fact, resemble a dividend if it does not represent funds furnished to the parent stockholder or its affiliates.

The Finance Committee agreed that Section 956 should be amended so that portfolio investments by foreign corporations in unrelated U.S. corporations do not give rise to dividend consequences to the U.S. shareholders of the foreign corporations. It made the new rule effective with respect to investments made after May 21, 1974, the date when the Ways and Means Committee announced the change without specifying an effective date.

This is remedial legislation that eliminates a trap and encourages investment in the U.S. economy. Other remedial provisions designed to stimulate U.S. investment, such as the investment credit, have been made effective when announced, prior to the date of enactment. Pyramid respectfully submits that the Committee should affirm its earlier decision to allow controlled foreign corporations to make portfolio investments in the U.S. economy without dividend treatment tc their shareholders, effective at their election from May 21, 1974, when the amendment was first announced by the Ways and Means Committee.

SUMMARY OF STATEMENT IN SUPPORT OF SECTION 1023, H.R. 10612, TAX REFORM ACT OF 1976

Section 1023 of H.R. 10612, the Tax Reform Act of 1976, as reported by the Senate Finance Committee, adopts §1023 of the House bill, as reported by the Ways and Means Committee and passed by the House. It extends a long-standing exclusion from Subpart F (in the Internal Revenue Code since 1962) in order to prevent the unintended application of Subpart F to certain income earned in the ordinary course of business of a foreign casualty insurance company. This is necessary because Subpart F changes enacted in the Tax Reduction Act of 1975 could inadvertently result in treating such income as a constructive dividend to U.S. shareholders even though it cannot in fact be paid to them. This result clearly is not intended.

Subpart F has always been inapplicable to income from investment of the insurance reserves and unearned premiums of foreign insurance companies. In actual practice, however, foreign casualty insurance companies are also required to maintain intact an amount of their surplus equal to one-third of premiums earned. Such earnings cannot be distributed in dividends and serve as additional protection to policyholders. This requirement is imposed by U.S. and foreign insurance regulatory authorities to meet certain solvency requirements.

Prior to the Tax Reduction Act of 1975, these earnings were effectively protected from Subpart F treatment by the so-called 70-30 rule. That rule was changed to 70-10, posing a serious risk of taxing such earnings which may not in fact be distributed. Section 1023, with appropriate safeguards to prevent its application to income received from related persons and earnings attributable to premiums from insuring risks of related persons, would prevent the unintented application of Subpart F to such earnings realized in the ordinary course of business of a foreign insurance company.

Section 1023 clearly does not "exclude Bermuda operations of American Investors Group, Inc." or any other corporation from U.S. tax.

This problem was fully explained by letter to the Staff of the Joint Committee on Internal Revenue Taxation and to the Treasury Department well before its consideration by the House Ways and Means Committee. It was carefully considered by that Committee, and section 1023 was included in the Ways and Means Committee bill and was passed by the House. The Senate Finance Committee has done no more than approve the House action. Section 1023 should in all events be continued in the Senate Finance Committee bill.

July 20, 1976

John S. Nolan

John S. Nolan
Miller & Chevalier
Washington, D. C.

STATEMENT IN SUPPORT OF SECTION 1023
OF H.R. 10612, TAX REFORM ACT OF 1976

Section 1023 of H.R. 10612, the Tax Reform Act of 1976, as reported by the Senate Finance Committee would, in effect, extend the existing exclusion from Subpart F of certain income from investments by an insurance company of its insurance reserves. This existing exclusion would be extended to income from investments of assets of a foreign casualty insurance company equal to one-third of premiums earned by such a company. This is designed to recognize the fact that insurance regulatory authorities within the United States and some foreign jurisdictions require that surplus to this extent be maintained as additional protection to policyholders of casualty insurance companies. Thus, such income is earned in the ordinary course of business of a foreign casualty insurance company, just as in the case of investment of insurance reserves as such, and U.S. shareholders of such a foreign insurance company should not be treated as receiving a constructive dividend of income which cannot in fact be distributed to them.

This same provision was contained in the House bill after being approved by the House Ways and Means Committee. The necessity of such a provision arose because in the Tax Reduction Act of 1975, the so-called 70-30 rule in Subpart F was amended, creating a much greater likelihood of Subpart F treatment of such income.

Under the prior 70-30 rule, none of the income of a "controlled foreign corporation" was treated as Subpart F income if less than 30% of gross income consisted of such amounts. The rule excluding from Subpart F income the investment of reserves and unearned premiums, previously described, prevented Subpart F treatment of income from investment of surplus required by insurance regulatory authorities to be maintained to meet insurance solvency requirements. In the Tax Reduction Act of 1975, however, this 30% test was reduced to 10%, so that Subpart F income was treated as such, and became a constructive dividend, unless it was less than 10% of total gross income. This created, for this first time, the very serious risk of applying Subpart F to a foreign casualty insurance company which is a "controlled foreign corporation" under our Subpart F provisions with respect to income which cannot in fact be distributed. This is clearly beyond the purpose of Subpart F, and section 1023 of H.R. 10612 is designed to prevent this unintended and unfair result.

The provision is explained fully at pages 219-220 of the House Ways and Means Committee report (H.R. Rep. 94-658, 94th Cong., 1st Sess.) and pages 229-230 of the Senate Finance Committee report (Sen. Rep. 94-938, 94th Cong., 2d Sess.). The provision is succintly explained in both reports as follows:

> Those assets maintained by these insurance companies in order to meet this ratio test are necessarily in the form of investments, which, in turn, generate passive income such as dividend and interest income. Just as in the case of the maintenance and investment of unearned premiums or reserves, these insurance companies, in compliance with the high ratio requirement, must maintain and invest a certain portion of their

> assets in connection with the active conduct of their trade or business. The committee believes that it is appropriate to provide the same type of exception from subpart F for surplus which is required to be retained as is provided for unearned premiums or reserves.

This problem had been presented to the Staff of the Joint Committee on Internal Revenue Taxation by letter dated July 8, 1975, and by an identical letter of that date to the Assistant Secretay for Tax Policy, U. S. Treasury Department. The latter letter was available for inspection by any interested person. The problem was considered and acted upon by the House Ways and Means Committee in open mark-up session, and until reference was made to it by Senator William Proxmire on June 28, 1976, on the Senate floor, it has never been criticized by anyone.

Senator Proxmire erroneously described the provision as designed to exclude Bermuda operations of American Investors Group, Inc. from U.S. tax. American International Group, Inc. (not American Investors Group, Inc.) is a U.S. corporation controlled by American International Reinsurance Company, Inc., the parent company of a worldwide group of insurance companies with principal offices in Bermuda. This AIRCO group is one of several well-known and highly-respected groups of insurance companies doing business throughout the world. Section 1023 clearly is not designed to exempt Bermuda operations of American International Group, Inc., or the AIRCO group, from U.S. tax. As previously stated, it does no more than extend, in effect, a well-established principle that income from operations which are ordinary and necessary in the conduct of a foreign insurance business are not to be subject to Subpart F. This extension has become necessary only because of an unintended effect of the change in the 70-30 rule to a 70-10 rule in the Tax Reduction Act of 1975.

Section 1023 will in fact apply to the operations of many foreign casualty insurance companies which are "controlled foreign corporations" under our Subpart F provisions. Continental Corporation, unrelated to the AIRCO group, joins in this Statement to emphasize that fact.

The rule in Subpart F that an insurance company is not subject to Subpart F treatment with respect to income from investment of insurance reserves and unearned premiums has existed ever since Subpart F was first enacted in 1962. It exists <u>because</u> such income is ordinary and necessary for the proper conduct of the insurance business, and it is so described in §954(c)(3)(B) itself. Section 1023 is an implementation of the same policy underlying that provision. Similar rules render Subpart F inapplicable to dividends and interest in the conduct of a banking, finance, or similar business (§954(c)(3)(B)) and rents and royalties derived in the active conduct of a trade or business (§954(c)(3)(A)).

Section 1023 contains important safeguards to limit its effect to proper cases. It does not apply with respect to income received from a related person. It does not apply with respect to premiums attributable to the insurance or reinsurance of related persons; thus, it cannot apply to so-called captive insurance companies. It also applies, in effect, with respect to surplus maintained with respect to casualty insurance, not life insurance, where different considerations are involved.

Section 1023 is clearly sound on its own merits. It is not designed to benefit only one company; it will protect all foreign casualty insurance companies which are controlled foreign corporations from an unintended application of Subpart F. It was contained in the House bill, and it has been carefully considered over a period of time by the Staff of the Joint Committee on Internal Revenue Taxation and the Treasury Department, without objection. It should be retained in the Tax Reform Act of 1976.

July 20, 1976

John S. Nolan
Miller & Chevalier
Washington, D. C.

SUMMARY OF STATEMENT IN SUPPORT OF SECTION 1035(d) OF H.R. 10612 AS AMENDED BY SENATE FINANCE COMMITTEE

The Tax Reduction Act of 1975 imposed a special limitation on the foreign tax credit for foreign taxes paid in connection with foreign oil and gas extraction income. The Congressional purpose was to prevent high foreign taxes on such income from being used to offset U.S. taxes on <u>other</u> foreign source income. The foreign tax credit was accordingly limited to 2 percentage points above the U.S. <u>corporate</u> rate. This will limit the credit for such taxes to 50%.

This limitation is also applicable to individuals, however, who may be subject to U.S. tax on such income at a rate well above 50% - up to 70%, or at a much lower rate -- down to 14%. This was apparently overlooked in drafting the 1975 Act. The limitation with respect to <u>individuals</u> should be the effective U.S. rate applicable to such foreign oil and gas extraction income.

Section 1035(d) of H.R. 10612 would cure this deficiency, allowing a foreign tax credit for foreign taxes paid on foreign oil and gas extraction income up to, <u>but not in excess of</u>, the effective U.S. rate on such income. This will prevent any excess credits from offsetting U.S. tax on <u>other</u> foreign source income. Sen. Rep. 94-938, 94th Cong., 2d Sess. 250-251 (1976).

This provision should in all events be continued in the bill; it does no more than insure that the purpose of the Tax Reduction Act of 1975 is carried out fully and fairly.

July 20, 1976

John S. Nolan
Miller & Chevalier
Washington, D. C.

STATEMENT IN SUPPORT OF §1035(d) OF H.R. 10612, AS AMENDED BY SENATE FINANCE COMMITTEE

Under present law, §907 imposes certain limitations upon the foreign tax credit with respect to foreign oil and gas extraction income and also with respect to foreign oil-related income. Foreign oil-related income includes, in addition to foreign oil and gas extraction income, income from the processing, transporting, and distributing of foreign oil and gas. Section 907 was added to the Code by the Tax Reduction Act of 1975.

Since the enactment of §907, certain unfair and unintended consequences to individual taxpayers have been discovered. The results were not intended and were probably the result of a drafting oversight. Section 1035(d) of H.R. 10612, added by the Committee to the House bill, is designed to correct this unintended oversight. The Committee is strongly urged to continue §1035(d).

Section 907(a) of the Code imposes a limit upon the foreign tax credit with respect to foreign oil and gas extraction income. The purpose of this provision is to prevent high foreign taxes on this income from being used to offset U.S. taxes on other foreign source income. See Conference Report on Tax Reduction Act of 1975, House Rep. 94-120, 94th Cong., 1st Sess. 69 (1975). For taxable years ending in 1975, this limit is expressed in terms of 110% of the regular corporate tax; for taxable years ending in 1976, 105%; and for taxable years thereafter, 2 percentage points above the regular corporate rate. This translates, for both corporate and individual taxpayers, into a 52.8% limit for 1975, a 50.4% limit for 1976, and a 50% limit thereafter.

Unlike corporations, however, individual taxpayers are taxed at progressive rates ranging from 14% to 70%. The limitation imposed by §907(a) therefore can be unduly generous to individual taxpayers in brackets below the corporate tax rate and unfair to individual taxpayers in brackets above the corporate tax rate. The Senate Finance Committee Report on the Tax Reform Act of 1976, Sen. Rep. 94-938, 94th Cong., 2d Sess. (1976), illustrates this point with the following example at 251:

> * * * For example, if an individual has a high effective rate of tax (in excess of the corporate rate), his disallowed foreign tax credit will cause him to pay U.S. tax on his foreign extraction income, while a corporation would owe no U.S. tax.

Section 1035(d) would amend §907(b) of the Code in case of individual taxpayers to provide that the above-described limits in §907(a) would not apply and a new limitation would apply. As explained at 251 of the Committee Report --

> The committee amendment provides that the allowable foreign tax credit on foreign oil and gas extraction income is to equal

> the average U.S. effective rate of tax on that incœme. Thus, in any case there will be sufficient tax credits to offset the U.S. tax on the foreign oil and gas extraction income but no excess credits to offset U.S. tax on other foreign source income. The committee amendment achieves this result by limiting the taxpayer to a separate overall foreign tax credit limitation for foreign oil and gas extraction income. . . . [Sen. Rep. 94-938, 94th Cong., 2d Sess. (1976)]

Section 1035(d) therefore is designed to fully and fairly accomplish the purpose of §907 when it was added to the Code by the 1975 Tax Reduction Act. The §907 rules with respect to corporations would not be changed.

July 20, 1976

John S. Nolan
Miller & Chevalier
Washington, D. C.

OUTLINE OF MAJOR POINTS

Testimony of William Mayberry
Executive Director of the Offshore Marine Service Association

SECTION 1024(a) of H.R. 10612

I urge the adoption of that portion of section 1024(a) of H.R. 10612, which exempts income derived overseas from the transportation of men and supplies from a point onshore to offshore locations on the continental shelf from the Subpart F provisions of the Code for the following reasons:

1. The members of the Offshore Marine Service Association (OMSA) are not "tax exempt". They pay income taxes to virtually every foreign country which they operate.

2. OMSA members do not generally transport persons or property from a port in one country to a port in a different country. Thus, such operations do not constitute "foreign commerce" as that term is generally understood.

3. The vessel-owning members of OMSA provide their services to unrelated parties. The rendition of services to unrelated persons does not constitute a "base company" operation of the type at which the Subpart F provisions of the Code are directed.

4. Exempting the foreign affiliates of OMSA members from current taxation under Subpart F is necessary to allow the United States vessel-owning members of OMSA to compete on an equal basis with foreign-owned operations which provide similar services throughout the world.

WRITTEN SUBMISSION

of William Mayberry
Executive Director of Offshore Marine Service Association

SECTION 1024(a)

Foreign Base Company Shipping Income
Continental Shelf Exception

My name is William Mayberry and I am the Executive Director of the Offshore Marine Service Association (OMSA). This association was founded in 1957 and today has a membership of seventy United States vessel-owning companies located in several states throughout the United States. These member companies of OMSA own and operate approximately 1,500 vessels providing support services to the offshore exploration industry domestically as well as overseas. The majority of OMSA's vessel-owning membership comes from the states of California, Texas, Louisiana, Mississippi, Alabama, Florida and Massachusetts. These member companies currently have under construction some 124 new vessels costing hundreds of millions of dollars which are being built throughout the United States, including the states named above and the State of Washington. Equipment to construct these vessels is manufactured in many states, notably Wisconsin and Illinois. Our member companies, both large and small, have a vital interest in the Tax Reform Act of 1976 which is presently before your Committee.

Specifically, we urge the adoption of the special exclusion, contained in section 1024(a) of H.R. 10612 as reported by this Committee, for foreign base company shipping income:

> "....derived from the transportation of men and supplies from a point in a foreign country to a point on the continental shelf of such country or the continental shelf adjacent to the continental shelf of such country."

This exclusion would relieve the offshore vessel service industry from current taxation by the United States under Subpart F of the Code of certain undistributed income of foreign affiliates. This provision is necessary to allow the United States-owned companies engaged in this industry to continue to compete abroad.

The vessel-owning members of our Association furnish transportation and supply services to unrelated oil companies and drilling contractors engaged in exploring for, developing and producing oil or gas in offshore locations throughout the world. We are in direct competition with a growing number of foreign-owned companies which stand ready to perform these functions if American firms are no longer able to compete with them on an equal basis.

As I will explain in greater detail later, the foreign subsidiaries of the members of our industry, should not be categorized as "tax-haven" operations and subjected to current United States tax under the Subpart F provisions. The members of our Association pay foreign income taxes to virtually every foreign country in which we operate. Moreover, the vessel-owning members of OMSA render their services to unrelated parties, and, therefore, their foreign subsidiaries are not "base companies" (which deal with related entities) of the type at which the Subpart F "sales" and "services" provisions are directed.

The Tax Reduction Act of 1975 imposed a current tax on United States shareholders of foreign subsidiaries deriving income from the use of any aircraft or vessel in "foreign commerce". Prior to that legislation, all shipping income of controlled foreign corporations was specifically exempted from current taxation under the Subpart F provisions of the Code. Whether this change is in the best long-term interest of the United States is certainly debatable, since it applies only to the United States owners of foreign flag vessels, thereby making them non-competitive with foreign-owned shipping companies. Whatever the merits of that provision, it is clear that the offshore explorat[illegible] vessel support industry was accidentally "caught" in the legislative net.

The "shipping income" amendment to the Subpart F provisions in the Tax Reduction Act of 1975 was obviously aimed at "shipping corporations, operating on the high seas" which paid little or no tax to any country. As described in the House Ways and Means Committee Report accompanying H.R. 17488 (which was the first bill in which that provision appeared), this total exemption from tax "results because most countries (including the United States) do not tax the profits from shipping into and out of their ports, and most shipping corporations are based and incorporated in countries which do not tax foreign shipping operations". This is simply not the case in our industry. American-owned offshore service companies are not exempt from foreign tax. Affiliates and subsidiaries of our members pay foreign tax in virtually every foreign country in which they operate.

Allow me to describe briefly the general organization of the members of our Association and the manner in which their operations in foreign countries are conducted. Vessels utilized by our offshore service companies are generally based in a specific foreign area for a period of years. The vessels are usually operated out of foreign countries on the continental shelves off which the offshore installations are located. The vessels are operated by controlled foreign subsidiaries incorporated under the laws of or registered to do business in those foreign countries. Indeed such local incorporation or registration of the operating entities is generally a condition precedent to being permitted to operate there. The operating companies are thus subject to the laws of the foreign countries including their tax laws. In order to permit these vessels to be transferred from one area to another and to avoid the practical and legal problems which would be involved in registering the vessels locally, such vessels are usually chartered by another foreign affiliate of the offshore service company to the ultimate customer (e.g., the oil company or the drilling contractor). A separate contract is entered into simultaneously with the "local" subsidiary of the offshore service company to operate the vessel.

The members of our association are United States-owned companies who must compete with foreign-owned counterparts. Prior to the adoption of the Tax Reduction Act of 1975, United States tax was deferred with respect to shipping income (both charter income and operating income of foreign subsidiaries) of foreign affiliates. Those provisions permitted the United States-owned offshore service companies to compete with foreign-owned vessels and foreign-owned operators throughout the world because the tax burden on the foreign-owned companies and the American-owned companies was the same. I submit that without re-instituting the deferral of United States tax for this industry, United States-owned offshore service companies will no longer be able to compete abroad because of the increased burden.

This industry is extremely competitive and investment decisions will be responsive to the increased United States tax burden. Since only United States owners of foreign flag ships will be taxed it will be uneconomic for United States firms to own such vessels. Foreigners will be able to continue to operate their vessels and only pay current taxes to the local country in which the operations are conducted. Consequently, the foreigners will be able to realize a greater after-tax profit on identical operations. Obviously, they can and would underbid the American-owned companies and would eventually become the owners and operators of all the vessels engaged in this industry. This change in ownership will benefit neither the United States Treasury nor American industry.

As generally understood, "foreign commerce" involves the transportation of persons and property between ports in different countries. This is not the function of the vessel-owning member companies of this Association. Normally, OMSA members transport men and materials only from a point onshore to a drilling rig or production platform located on the continental shelf of the same country. Occasionally, there will be transportation of materials and supplies to a location on the same geographic shelf which may be legally a part of the territory of an adjacent country. This is certainly not the type of "foreign commerce" at which the foreign base company shipping income provisions of the Tax Reduction Act of 1975 were directed.

In its statement issued on June 15, 1976, the Treasury Department did not oppose this amendment. However, in its statement issued on July 20, 1976, the Treasury opposed this amendment on the grounds that the income derived by offshore supply vessels is "traditional base company income." This is not true. Traditional base company income requires two elements:

(1) The corporation's business must be conducted outside the country of incorporation and

(2) Sales or purchases must be to or from a related party or services must be rendered for on or behalf of a related party.

The Treasury's opposition to this amendment is based solely on the first criterion. Their position is simply incorrect. A controlled foreign corporation which renders services (other than shipping) to unrelated parties outside its country of incorporation does not have "Subpart F" income. Such income is not "base company" income because there is no related party involved. The vessel-owning members of the Offshore Marine Service Association do not render services to related parties. Their services are rendered to oil companies and drilling contractors who are completely unrelated to the vessel-owning and operating companies, and, consequently, their income is not "traditional base company income."

Moreover, the Treasury Department has used an unfair and inaccurate example to butress its position by claiming that:

> "the exclusion would permit foreign supply vessels to service rigs located on the continental shelf of the U. S. without paying U. S. tax."

In the first place, supplying an offshore drilling rig on the U. S. continental shelf from a port in the United States is "coastwise trade" under the Jones Act, and, consequently, foreign flag vessels may not perform such services. Although it is theoretically possible for a foreign flag vessel to supply a location on the U. S. continental shelf from a foreign port, as a practical matter, such operations are unfeasible. To the best of my knowledge there are no continuous operations of this type. Thus, the Treasury Department is describing a factual situation which simply does not exist.

More importantly, even if a foreign flag vessel could supply offshore locations on the U. S. continental shelf, under current law only a United States shareholder of a foreign corporation owning the vessel would be taxed. The United States would not tax either the foreign corporation owning the vessel or a foreign shareholder of such a corporation. It is precisely this competitive disadvantage created by current law which would be corrected by this amendment. For the

Treasury Department to cite this example in order to deny relief to United States owners of foreign corporations engaged in servicing offshore installations is completely misleading. Actually, the Treasury's example demonstrates that this amendment is necessary to allow American firms to compete with foreign-owned firms on an equal basis.

I respectfully submit that exempting the transportation of men and supplies from a point onshore to a point on the continental shelf or adjacent continental shelf from the definition of "foreign commerce" in the Subpart F shipping provisions is necessary to permit American-owned offshore service companies to continue to compete abroad. Normally, the foreign affiliates of our vessel-owning members render services only to unrelated persons and, therefore, are not subject to tax under the "foreign base company services income" provisions of Subpart F. Our operations are not tax exempt abroad. Therefore, our operations are not of the type at which any of the Subpart F provisions were directed. This amendment is necessary to allow American-owned firms to continue to participate in this vital industry which is of growing importance in connection with supplying the energy needs of the United States.

STATEMENT OF D. CHASE TROXELL
ON BEHALF OF
FRANK A. AUGSBURY, JR. AND FRANK A. AUGSBURY, III

SUMMARY OF PRINCIPAL POINTS

1. Tax Reduction Act of 1975 contains a provision under which shipping income of a foreign corporation is taxed directly to its U.S. shareholders except to the extent plowed back into ships.

2. 1975 Act provision was aimed at tax haven, flag-of-convenience shipping controlled by U.S. corporations but also affects Hall Corporation Shipping Ltd., a Canadian company owned by U.S. individuals. Hall -

   a. is incorporated in Canada because Canadian law requires local incorporation and registration of ships;
   b. is subject to Canadian tax on worldwide income;
   c. pays U.S.-scale wages to its crews, who are unionized; and
   d. is not affiliated with any U.S. business organization.

3. If no relief is granted, this family business is likely to be destroyed.

4. Full disclosure of identities of interested parties was made to Ways and Means, Finance and Joint Committee staff.

5. Proposal was examined by Joint Committee and discussed by both Congressional Committees at some length in open executive sessions.

STATEMENT ON BEHALF OF FRANK A. AUGSBURY, JR.
AND FRANK A. AUGSBURY, III

This statement is made by Chase Troxell, a partner in the law firm of Burke & Burke, Daniels, Leighton & Reid, New York City, on behalf of Frank A. Augsbury, Jr. of Ogdensburg, New York, and his immediate family, who own all of the stock of Hall Corporation Shipping Ltd. of Montreal.

* * *

I. General Nature of Problem

Section 602 of the Tax Reduction Act of 1975 amended Subpart F of the Code in such a way as to cause shipping income earned by a controlled foreign corporation to be taxed currently to U.S. shareholders as if declared as a dividend, except to the extent that the foreign corporation spends the income fcr additional ships or repays mortgage loans on its existing fleet.

The Conference Committee Report* states that the intent was to repeal prior law "which permits a deferral of U.S. tax for shipping income received by a foreign subsidiary of a U.S. corporation." The provision was in fact aimed at "flag of convenience" fleets - ships owned by foreign subsidiaries of U.S. corporations incorporated in such tax haven countries as Bermuda and the Bahamas and registered in such countries as Liberia and Panama, ships that are operated as integral parts of U.S.-controlled international businesses, ships that could be operated by U.S. corporations, under U.S. flag and with U.S. seamen but are instead operated under foreign flag and ownership by low-wage foreign crews.

The provision was, however, written so broadly that it has exactly the same tax impact on Hall Corporation, a Canadian corporation which can only operate as a Canadian corporation with Canadian-flag ships; which is subject to tax by Canada on its world-wide income; which pays American-scale wages to its crews; and which is owned by U.S. individuals and is not part of a multinational combine in any sense.

---

* The provision was not in either the House or Senate version of the Tax Reduction Act of 1975 but was added by the Conference Committee. Consequently no reference to it appears in either the House or Senate Committee Report. For fuller discussion please see Part VIII (G) below.

II. Requirement of Canadian Incorporation and Registry

Few people outside the shipping industry have ever heard the term "cabotage." It means coasting, carrying passengers or goods between points within a single country.

Many countries have cabotage laws which restrict the coasting trade to vessels which are registered in that country and which are owned by citizens or corporations of that country.

The United States has had a cabotage law since 1920. No foreign ship can pick up goods in New Orleans and deliver them to Baltimore, for example.

Canada has a cabotage law too, forbidding, for example, an American ship from carrying goods between Montreal and Toronto. Only Canadian-flag ships owned by Canadian corporations or Canadian or other British Commonwealth citizens may do so. Consequently, if an American wants to engage in that trade he must do so through a Canadian corporation.

Hall Corporation Shipping Ltd. is a Canadian company headquartered in Montreal which ships grain, ore, coal and petroleum products on the St. Lawrence River and the Great Lakes. It is wholly owned by one American family, the Augsbury family who live in the small St. Lawrence valley city of Ogdensburg, New York, and who have owned the company since it was formed fifty years ago.

About 70% of Hall's income comes from coasting in Canada. The remaining 30% is from shipping goods - primarily Labrador iron ore - between Canada and the U.S. Since each of Hall's ships earns a significant part of its income from coasting, each must be registered in Canada and owned by a Canadian corporation.

III. Absence of Wage or Tax Avoidance Motivation

Hall is not avoiding high labor costs or taxes by being Canadian. Its crewmen are all members of the Seafarers International Union of Canada, AFL/CIO, whose wage rates are very comparable to U.S. union rates. Moreover, all of its worldwide income is subject to Canadian tax at rates comparable to ours.

IV. Independence of Operation.

Hall is not part of a multinational group. It is owned by members of one family rather than by a U.S. corporation and all of its trade is with unrelated persons.

Hall is, therefore, not the sort of runaway operation which, we believe, the shipping income provision of the Tax Reduction Act of 1975 was aimed at. Nevertheless, under the Tax Reduction Act, Hall is treated no different from the offshore oil company subsidiary that runs Liberian-flag tankers from the Persian Gulf or the Caribbean to U.S. refineries--companies which could be incorporated in the U.S. and operate U.S.-flag ships with U.S. crews but choose not to.

V. Effect of Tax Reduction Act of 1975

The stockholders of Hall received a ruling from the Internal Revenue Service in December 1975 that any shipping income it earns in 1976 will not be Subpart F income because Hall was not formed or availed of to avoid tax. The ruling was issued under a general escape-valve section which was part of the original Subpart F when it was enacted in 1962.

If it were not for the ruling, the effect of the shipping income provision would be this: Hall would either have to pay out most of its income as dividends in order to enable the Augsburys to pay U.S. and State income taxes or purchase additional shipping, whether or not economic conditions justified such purchases.

The dividend alternative would strip the company of working capital.

The reinvestment alternative is impractical for two main reasons:

1. Strikes, collisions, weather along the St. Lawrence and in grain-growing areas of Canada and governmental actions, as well as rises and falls in the general economy, make profits very unpredictable. An independent shipping company like Hall, which carries spot cargoes when and as available rather than operating ships under long-term charters to substantial shippers, cannot project profits at the beginning of a year with anything like the certainty of a manufacturing company, so it cannot hope to time ship purchases, which must be committed for long before delivery dates, in such a way as to match profits.

2. The purchase of shipping depends not only on the availability of current cash flow but also the availability

of loans and shipyard berths and in many cases the concurrence of existing creditors and the host government.

As a practical matter, if not amended, the Tax Reduction Act would either force the sale of Hall to foreign interests or gradually drive the company out of business.

The ruling saves Hall from this result for 1976, and we would hope that the Service would renew the ruling from year to year. However, our situation is so completely free of tax-avoidance and fair wage-avoidance motives that we feel justified in asking Congress to exempt us by statute from Subpart F.

VI. Effect of Section 1024 of Tax Reform Act of 1976

Section 1024 of the Tax Reform Act* would give substantial relief since it provides that income from the coasting trade and, according to discussion on the floor of House when it debated the Act, also from the sale of ships to the extent that they have been engaged in that trade, is not "foreign base company shipping income." However, it does not remove from that category the income that Hall's ships derive from carrying goods between Canada and the U.S., and we feel that this income too should be exempt because:

1. No ship may operate in the U.S.-Canada trade under U.S. flag and ownership unless the ship is taken out of the Canadian coasting trade, since Canada bars the coasting trade to non-Canadian vessels.

2. Taking any ship out of the Canadian coasting trade would deprive it of such a large amount of business that it could not come close to operating profitably unless some new source of business were substituted.

3. None of Hall's ships could coast in the United States because coasting here is forbidden to foreign-built ships.

4. Ships such as Hall's fleet of dry-cargo vessels (called "lakers"), which are designed for the Great Lakes and the St. Lawrence River service, are shallow-draught and of reduced strength criteria and therefore cannot operate

* Section 1024 of the House bill was directed at our situation alone. Section 1024 of the Senate bill covers three different situations, ours and two others which do not concern Hall.

in the open ocean. Because of their small size (5,000 to 12,000 deadweight tons), its tankers are limited to distribution of refined products from local refineries on the lakes and river. They are not economically viable for ocean operation, where tankers ten or twenty times their size are commonplace and even larger tankers are not unusual.

5. There is not enough Canada-U.S. business available in the St. Lawrence-Great Lakes for an independent fleet to operate in that trade alone.

As a result, Hall can only operate as it now operates, and, if the present version of section 1024 is enacted, almost a third of Hall's income will be Subpart F income regardless of the fact that it must be Canadian and is not avoiding taxes or unionization by being so.

We feel that Congress did not have our type of business in mind when it passed the Tax Reduction Act and that the relief provided in H.R. 10612 does not up until this point protect us adequately from the unintended harm that the Tax Reduction Act will do to us.

VII. <u>Relief Requested</u>

It is requested that the present version of section 1024 be modified to exempt from "foreign base company shipping income" any income derived from the operation or sale of ships which engage, regularly and to a substantial extent, in the coasting trade within a foreign country if the laws of that country prohibit ships owned by U.S. corporations and citizens from engaging in that trade.

Not a single job which an American seaman could fill would be lost through such an exemption and any revenue loss would be temporary and miniscule. It would, on the other hand, avoid the needless and, we believe, unintended destruction of a major family business which has benefited people on both sides of our northern border for 50 years.

VIII. <u>Procedure Followed in Requesting Relief</u>

Certain members of the Senate have objected to the fact that the Tax Reform Act contains many provisions, applicable to only one or a few taxpayers, which were slipped into the bill with little or no notice or opportunity for analysis and evaluation.

The relief provision Hall has asked for applies, we believe, to Hall and the Augsbury family only. We have never in any way attempted to make a secret of that fact but have, on the contrary, stated it orally and in writing to the House Ways and Means Committee, the Senate Finance Committee and the Staff of the Joint Committee on Internal Revenue Taxation. Moreover both Committees have discussed the provision at some length and the Staff of the Joint Committee has studied it in detail.

A summary of the procedural steps taken follows.

A. <u>Ways and Means Committee Hearings</u>

On July 24, 1975, I made an oral statement before the Ways and Means Committee. In that statement, and in the written statement which I submitted at that time, I identified my clients by name and address and stated that the relief requested would probably affect only them.

The transcript of that hearing shows that the Acting Chairman proposed to the Committee that our request be referred to the Staff of the Joint Committee on Internal Revenue Taxation and that his recommendation was supported by Committee members from both parties.

B. <u>Joint Committee Inquiry</u>

Our request was considered by the Staff of the Joint Committee during the summer of 1975. I had personal and telephone conversations with Staff members during that period and submitted data on Hall Corporation as well as proposals, ideas and arguments. There was no misapprehension on the Staff's part either as to whom I represented, what I sought or why I sought it.

The Staff made recommendations to the Ways and Means Committee when the Committee met in executive session in September and October 1975 to adopt the Tax Reform Bill.

C. <u>Ways and Means Committee Decisions</u>

The Committee adopted the viewpoint recommended by the Staff of the Joint Committee, in effect approving our request in part but not in full, and the provision became Section 1024 of the Committee bill. The House passed the bill as proposed by the Committee.

D. <u>House Debate</u>

The provision was the subject of a brief colloquy on the floor of the House between the Chairman of the Ways and Means Committee and a ranking minority member. The colloquy, which clarified an ambiguity in the provision, mentioned that the provision affected a particular Canadian corporation and its U.S. shareholders.

E. Finance Committee

When this Committee began consideration of the Tax Reform Act, I submitted a written statement to the Committee requesting the same relief that I had requested of the Ways and Means Committee. I also requested the opportunity to address the Committee, but that request was denied. In both the written statement and the request for leave to address the Committee, I identified my clients by name and address.

Our proposal was discussed by the Committee in executive session for perhaps 10 minutes, and the views of the Joint Committee Staff were requested and given. The Committee then approved the same partial relief as the House had and, though the wording of the applicable parts of Section 1024 of the Finance Committee bill differs from that of the House bill, to my mind the two bills mean exactly the same thing.

F. Conclusion

We believe that we have been completely candid and open with the Congress in requesting relief. We also believe that our proposal was thoroughly examined by an unbiased, expert body, the Staff of the Joint Committee. It was also discussed at some length by both the Ways and Means Committee and this Committee in executive sessions.

G. Postscript Regarding Congressional Procedure in Enacting the Tax Reduction Act of 1975

We would like to point out that the provision from which we have been seeking relief became part of the Tax Reduction Act of 1975 only in the Conference Committee. The concept was not considered by the Ways and Means Committee during its deliberations on the bill and was not part of the bill adopted by the House. Similarly, it was not considered by the Finance Committee.

On the floor of the Senate, an amendment to the Senate bill was adopted under which all net income of all controlled foreign corporations would be taxed as dividends to their U.S. shareholders; however, the amendment was a general one and did not apply particularly to the shipping industry. It applied to all business: finance, manufacturing, insurance, service, utilities, transportation, everything.

In the Conference Committee, the Senate floor amendment was eliminated and the particular provision involved here, that is, the provision applying to shipping alone, was adopted. The first notice to the public that there was a possibility that this provision would become part of the Tax Reduction Act of 1975 came after the Conference Committee had agreed on the provision and the House and Senate had by voice vote approved the Act and sent it to the President for signature.

The members who spoke on the floor on June 29 are unquestionably right in saying that special interest tax legislation should not be passed without adequate disclosure to and consideration by Congress, but at the same time we feel that Congress should not pass tax legislation without giving citizens any opportunity whatsoever to be heard and to demonstrate that a particular piece of legislation is unfair and would have an unintended and disastrous effect on many of them, a few of them or even just one of them.

SENATE FINANCE COMMITTEE

HEARINGS ON CERTAIN COMMITTEE TAX PROVISIONS

STATEMENT SUBMITTED

on

SECTIONS 1031 - 1032

BY FREEPORT MINERALS COMPANY
161 E. 42nd Street
New York, New York 10017

Repeal of Per Country Limitation

and

Recapture of Foreign Losses

MINING COMPANY TRANSITION RULE

(Finance Committee Minor Modification to Provision Contained In House-Passed H.R. 10612)

Dated July 20, 1976

74-620 O - 76 -- 15

FREEPORT MINERALS COMPANY

Repeal of Per Country Limitation

and

Recapture of Foreign Losses

MINING COMPANY TRANSITION RULE

SECTIONS 1031 - 1032

* * * * * * * * *

Summary of Principal Points Contained In Statement

ONE: Reliance on Present Rules Justified

Per country limitation is more appropriate for "pure" mining companies than overall limitation. Mining companies must go where the minerals are.

TWO: Stable Tax Climate Important

Overseas mining projects of U.S. based companies have traditionally depended heavily on funds borrowed from consortiums of multi-national lenders; required long lead time, usually five years or more, from date of initial development until production at design rates is achieved and therefore need a stable tax climate in their early stages of life.

THREE: Reason and Fair Play Is Basis For Transition Rule

A rule of reason and fair play suggests that a Mining Company Transition Rule of the type adopted by the Senate Finance Committee should be provided for newly established overseas mining ventures which have yet to demonstrate the ability to earn a profit on a consistent basis and have recently committed substantial additional capital (say in excess of $1,000,000) to reach design capacity.

FOUR: Revenue Impact Is Minor

The revenue impact of this limited mining company transition rule should not exceed $2,500,000 per year during the three-year transition period (1976-1979) and a portion or all of this amount will in all likelihood be recovered in later years under the Committee's per country loss recapture provision which is applicable to these projects.

FREEPORT MINERALS COMPANY
W. J. BYRNE, JR.

STATEMENT PRESENTED

TO

SENATE FINANCE COMMITTEE

HEARINGS ON SECTIONS 1031 AND 1032

HR 10612
Mining Company Transition Rule

My name is William J. Byrne, Jr. I am Vice President and Treasurer of Freeport Minerals Company, a domestic producer of fertilizer products and, through domestic subsidiaries, a producer of copper concentrates in Irian Jaya, Indonesia and a participant in a nickel and cobalt joint venture in Queensland, Australia.

I am pleased to have the opportunity to appear before your Committee to speak in favor of the Mining Company Transition Rule, which you have seen fit to include in Sections 1031 and 1032 of HR 10612. These Sections repeal the per country foreign tax credit limitation generally effective for taxable years beginning after December 31, 1975 and require the "recapture" of foreign losses again generally effective for taxable years beginning after December 31, 1975.

Accompanying me today is Mr. Dennis Bedell of the Washington law firm of Miller & Chevalier.

HOUSE DECISION

Per Country Limitation

The House passed bill provides a transition rule whereby certain mining projects can continue to use the per country method of computing the foreign tax credit limitation for three years. Specifically the House passed bill permits certain recently-established mining projects, where substantial investments of capital had been committed under the assumption that the foreign tax credit could be computed under the per country limitation, to avail themselves of this transition rule.

A domestic corporation to be eligible to benefit from this transition rule would, as of October 1, 1975, have to meet all of the following conditions:

1. Been engaged in the active conduct of the mining of hard minerals for less than five years; and
2. Had losses from the mining activity in at least two of the five years; and
3. Derived 80% or more if its gross receipts from the date of its incorporation from the sale of its mined minerals; and
4. Made commitments for substantial expansion of its mining activities.

Recapture of Foreign Losses

The House passed bill imposes, in the case of newly established mining ventures which qualify for the three year per country transition rule, a requirement that any foreign losses generated in taxable years beginning after December 31, 1975 be "recaptured". The "recapture" however was on a per country basis only during the three year transition period. However if these losses were not fully "recaptured" on a per country basis by the end of the three year transition period, all losses not so "recaptured" were to be immediately "recaptured" on an over-all foreign tax credit basis.

SENATE FINANCE COMMITTEE DECISION

Per Country Limitation

Agreed to House passed version.

Recapture of Foreign Losses

Agreed to House passed version except the Senate Finance Committee decision requires that foreign losses generated during the three year transition period be "recaptured" only on a per country foreign tax credit basis in future years.

DETAILED STATEMENT

Freeport Minerals respectfully submits that the transition rule for mining companies provided by the Senate Finance Committee pursuant to its decision to repeal the per country foreign tax credit limitation is essential to assure equitable tax treatment for those mining companies which have relied in good faith on the present law and which have, as a result of that reliance, recently made substantial financial commitments to the development of new sources of minerals for our industrial society.

Basis for the Per Country Method in the Present Law

The per country limitation has been a part of our tax laws since 1954. In 1960, when taxpayers were granted the ability to choose alternative limitations on the foreign tax credit, the pertinent committee reports recognized the appropriateness of the per country limitation for certain types of business operations by stating:

> "On the other hand it is recognized that in some cases taxpayers may think of their businesses in various foreign countries as separate ventures. This, of course, is especially likely when a company begins in a different foreign country a business which is risky and which is likely to result in losses at least for an initial period of years. In such cases the company is more likely to think of such a business as being separate and apart from its other more stable operations in other foreign countries. It seems appropriate in such cases to permit taxpayers to use the per country limitation, thus for tax purposes treating each as a separate operation."

The Per Country Method is Particularly Appropriate for Mining Companies

The foreign mineral operations of U.S. mining companies clearly fit the description of the types of business operations for which use of the per country limitation was deemed by Congress to be appropriate. The case of Freeport Minerals Company provides a specific illustration.

Freeport is presently involved in a nickel venture in Australia and a copper venture in Indonesia. Freeport's Australian nickel venture involves total capital costs in excess of $350,000,000 while the Indonesian venture has required a total capital cost in excess of $200,000,000. Both projects have been separately financed by international lending consortia. Each project is expected to service its debt from its own earnings, and the sales price of the output for each project is directly related to the world price of the particular mineral, and in the case of each venture, all sales are made to independent third parties.

With respect to the lead time required to bring these ventures into production, it should be noted that while the first development expenses for the Australian venture were incurred in 1969, sales of mineral products were not made until 1975. Although the Indonesian copper project was commenced in April 1967, first ore concentrate shipments did not begin until December, 1972.

As regards pre-production and operating losses, the Australian nickel project has recorded tax losses in all years to date, i.e., June 30, 1976, and expects to record a tax loss for its fiscal year ended June 30, 1977. In short, the tax losses from Freeport's Australian nickel venture, which at present substantially exceed its taxable income from its Indonesian copper mining project, can be expected to continue until the price of nickel rises from its current depressed level.

Furthermore, these operations were undertaken in a context of historical and continuing world-wide volatility of natural resources prices, recent and continuing world-wide violent currency fluctuations, and unprecendented recent and continuing high rates of inflation. As a result, the existence of the per country limitation, which would assure the stable tax climate necessary for bringing projects of this magnitude through the lengthy early stages of development, constituted a major factor in the decisions by both the company and the lenders to proceed with these projects. In view of the fact that the per country method has been available since 1954, and in view of the particular suitability of this foreign tax credit limitation to the practical realities of foreign mineral operations, there appeared to be little reason to expect that this limitation could not continue to be available. Freeport, therefore, moved forward with the large capital commitments required to secure the new reserves of industrial minerals which these projects could provide and included in the necessary preliminary feasibility studies the assumption that the per country method of computing the foreign tax credit would be available in determining the amount of funds available to repay borrowed capital.

Repeal of the Per Country Method Requires an Equitable Limited Transition Rule

The Senate Finance Committee has recognized that repeal of the per country limitation represents an abrupt change in long-standing tax policy which requires a degree of equitable relief for those most adversely affected by reliance on previous policy. While repeal of the per country limitation will undoubtedly inhibit prospective investment in foreign mineral ventures, the most severe impact will be felt by existing, newly established overseas mining ventures which have yet to demonstrate the ability to earn a profit on a consistent basis and which have recently committed substantial additional capital (i.e., in excess of $1,000,000) to reach design capacity and commercial viability. The Senate Finance Committee has therefore provided a limited and reasonable transition period in which companies with existing projects in this category can restructure their financial operations without placing such projects in undue jeopardy.

Revenue Impact of the Transition Rule

The revenue impact of the limited mining companies transition rule provided by the Senate Finance committee should not exceed $2,500,000 per year during the three year transition period (1976-1979) and a portion or all of this amount will in all likelihood be recovered in later years under the Committee's per country loss recapture provision which is applicable to these projects.

The rationale supporting a limited transition rule for mining companies is not dependent upon or related to the Possessions exception which is also included in Sections 1031-1032 of the Bill. By far the major part of the revenue loss of $32 million reported in the press, if correct, is related to the Possessions exception.

INDUSTRIES

PPG INDUSTRIES, INC./ONE GATEWAY CENTER/PITTSBURGH, PENNSYLVANIA 15222/AREA 412/434-2885

Tax Administration Department
T. J. Sheil
Director of Taxes

July 19, 1976

The Honorable Russell B. Long, Chairman
Senate Finance Committee
Room 2227, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Long:

Attached is statement on behalf of PPG Industries, Inc. in connection with the pending Tax Reform Bill of 1976.

Following is a summary of the principal points raised in the statement:

1.) Section 1031 of the Bill repeals the per-country limitation now contained in Section 904 of the Internal Revenue Code. With respect to Puerto Rico operations, it has a three year phase-in clause.

2.) Per-country limitation is a valuable option, especially to those investing in Puerto Rico; it ought not to be repealed.

3.) If it is repealed, then the repeal should not apply to investments already made; or, there should be an adequate phase-in period which will allow those taxpayers relying on the option, sufficient time within which to adjust to the change in the law.

4.) Charges have appeared in the press to the effect that Section 1031 of the Bill was altered in Committee, at the request of Senator Mike Gravel, which granted special concessions to PPG Industries, Inc. This is just not so.

Yours very truly,

T. J. Sheil

Theus J. Sheil
Director of Taxes

TJS:lf

Attachment

PPG INDUSTRIES

PPG INDUSTRIES INC ONE GATEWAY CENTER PITTSBURGH PENNSYLVANIA 15222 AREA 412 434 2885

Tax Administration Department
T. J. Sheil
Director of Taxes

TO: THE SENATE FINANCE COMMITTEE

My name is T. J. Sheil and I am Director of Taxes for PPG Industries, Inc. I am accompanied by John D. Lufie, Tax Manager for PPG Industries, Inc.

This statement is directed at Section 1031 of the Tax Reform Bill of 1976, as reported by the Senate Finance Committee. Section 1031 of the Bill provides for repeal of the "per-country limitation" which is now one of the two options contained in Section 904, IRC. The alternative option is the "overall limitation"; either option imposes a limit on the credit allowed against U.S. taxes for foreign taxes paid on foreign source income. Except for the special status of a corporation operating under Section 931, IRC, income and taxes emanating from U.S. possessions and Puerto Rico are governed by the foreign tax credit provisions of the code.

Section 1031 contains a phase-out of the impact of the repeal of the "per-country limitation" with respect to operations in U.S. possessions and Puerto Rico. It was reported in the press that one or more Senators alleged that Senator Mike Gravel introduced this part in the Senate Bill on behalf of PPG Industries, Inc. To set the record straight, Senator Gravel made no proposals relating to this subject and PPG had no part in the version of Section 1031 produced by the Senate Finance Committee. PPG has made representations to the U.S. Treasury Department and the Joint Committee on Taxation with respect to Section 1031 as it pertained to investment on the Island of Puerto Rico.

While the per-country limitation is not actually an incentive, it does provide a safety valve for industries investing in Puerto Rico should such investment result in losses. The valve isolates such losses, thus preventing mitigation or elimination of the foreign tax credit otherwise available to the taxpayer. Absent such relief, the price to be paid for an unprofitable investment in Puerto Rico is not only the normal business risk of operating at a loss but the additional penalty of the elimination of the foreign tax credit otherwise available when profits are brought home from foreign countries.

In the case of PPG Industries, Inc., the decision to invest $200 million in the Puerto Rican economy was made under the rules of the game which provided for the "per-country limitation" and thus protected PPG from the loss of its foreign tax credit should the investment not prove profitable. Statements from various sources, in addition to those noted above, have named PPG as seeking special treatment in this area. Nothing could be further from the truth. PPG went to Puerto Rico on the basis of the Code in existence at the time. Section 1031 would change the rules after PPG had invested a very substantial sum of money in Puerto Rico. If this is to be the case, PPG believes that a phase-in of the rule changes should be allowed in order that appropriate business decisions concerning existing Puerto Rico investment may be made without undue harm to the economy of Puerto Rico or the taxpayer.

If Congress should enact Section 1031, we believe that it should only apply to profits (and losses) derived from investments in Puerto Rico made subsequent to enactment. This would enable us to consider the jeopardy to our foreign tax credit when a business decision must be made as to future investment on the Island.

It is stated that the proposed changes in parts of the Code are designed to correct alleged abuses in foreign operations. What abuses exist in Puerto Rico? In fact, since 1898 Congress has attempted to encourage economic development in Puerto Rico. What person here considers Puerto Rico to be "foreign?" Earlier this year, this Committee heard testimony on the subject and concluded that the policy was still valid.

But what about losses? Of course, no companies are going to Puerto Rico, or anywhere else, to generate losses. Yet, as we know from our own experience, it can happen with capital intensive industries. If Section 1031 is to be enacted we urge the Committee to provide the safety valve of "per-country limitation", or at least a modest phase-out, with respect to operations in our possessions and territories.

Thank you.

STATEMENT SUBMITTED BY
BOISE CASCADE CORPORATION
REGARDING FOREIGN LOSS RECAPTURE PROVISIONS
IN SECTION 1032(c)(2) OF H.R. 10612

SUMMARY

Boise Cascade Corporation ("BCC") holds foreign government bonds which were issued years ago when the foreign governments took over local operating companies owned by predecessors of BCC. The bonds are presently worth much less than their face value and tax basis.

If the loss recapture provisions of H.R. 10612 were enacted in the form approved by the House, and the bonds became worthless or were sold after the effective date of the new law, BCC's normal foreign tax credit would be severely reduced for a number of years thereafter.

It seems highly unlikely that the House actually intended such a result. As passed by the House, the loss recapture provisions have no application to certain involuntary losses including "foreign expropriation losses". Because it is clear that the potential losses in question here are closely akin to expropriation losses, it seems virtually certain that the House would have excluded such losses from the coverage of its bill if it had been aware of the problem when it passed the bill.

In an open mark-up session on May 14, 1976 Senator Packwood described the foregoing problem to the Finance Committee and identified BCC as the US corporation involved. In response to that public presentation, the Finance Committee added Section 1032(c)(2) to the House bill to make the loss recapture rules inapplicable to losses incurred on disposition of foreign government obligations issued before May 14, 1976, in payment for the stock, debt or assets of local operating companies taken over by the foreign governments. Because Section 1032(c)(2) avoids a potential unintended hardship and implements the House's stated purpose of excluding expropriation-type losses, the amendment should be retained in the Senate bill.

BACKGROUND FACTS

In 1964 and 1970 agencies of the Chilean and Brazilian governments issued their bonds to corporate predecessors of BCC in payment for the stock and debt of foreign utility companies operating in Chile and Brazil. BCC's predecessors sold the stock and debt of the local utility companies to the Chilean and Brazilian governments under an implied or de facto threat of condemnation.

There is no public market for these foreign government bonds, but over a period of years, BCC has succeeded in selling some of them at a discount to third parties in private placement transactions. On July 2, 1976, BCC sold all of its remaining Chilean bonds, which had a face value and tax basis of approximately $61 million, for a total price of approximately $29.5 million. BCC still holds Brazilian bonds with a face value and tax basis of approximately $79 million. If BCC is able to dispose of the bonds at a discount prior to maturity, or if the Brazilian government defaults on the bonds, the IRS will probably treat the resulting loss as a foreign source loss.

EFFECT OF H.R. 10612 WITHOUT A CORRECTIVE AMENDMENT

Section 1032 of H.R. 10612 as passed by the House provides that if a taxpayer has an "overall foreign loss" in a taxable year beginning after December 31, 1975, the amount of that loss will reduce the amount of the taxpayer's otherwise allowable foreign tax credit in subsequent years. The House bill does this in two ways. First, for purposes of calculating the §904 foreign tax credit limitation, the amount of foreign source income realized by the taxpayer in subsequent years is reduced by 50% in each subsequent year until the aggregate reductions equal the amount of the original overall foreign loss. Second, the amount of creditable foreign tax paid or deemed paid in each such subsequent year is also reduced by 50%.*

On an average basis over the last three years, BCC has realized approximately $16 million of net foreign source income each year (excluding extraordinary items), and has paid foreign taxes of approximately $4 million each year. If these levels continue, enactment of H.R. 10612 without a corrective amendment would reduce BCC's allowable foreign tax credit by approximately $1.1 million over a seven year period if BCC's remaining Brazilian bonds were sold later this year at the same discount rate as the Chilean bonds and the losses on these sales were treated as foreign source losses.**

* The second adjustment contained in the House bill has been eliminated in the Finance Committee bill for reasons unrelated to BCC's submission.

** In 1976 there would be an overall foreign loss of $56 million ($31.5 million actual loss on sale of Chilean bonds plus $40.5 million assumed loss on sale of Brazilian bonds, less $16 million net foreign source income from other transactions). In each of the next seven years, foreign source income would be reduced by 50% from $16 to $8 million for purposes of calculating the section 904 limitation. The limitation would therefore be reduced by 50% each year to $3.84 million (50% of 48% of $16 million). Thus, in each year, $160,000 of foreign tax credit would be lost ($4 million tax paid less $3.84 million limitation). The total loss over seven years would be $1.12 million (7 x $160,000).

DISCUSSION

The basic concept of the loss recapture provisions is that "where a loss from foreign operations reduces U.S. tax on U.S. source income, the tax benefit derived from the deduction of these losses should, in effect, be recaptured by the United States when the company subsequently derives income from abroad." H. Rep. No. 94-658, 94th Cong. 1st Sess., p. 228. However, the concept is not intended to apply to involuntary foreign losses over which the taxpayer has no real control. Thus, H.R. 10612 as passed by the House already provides that foreign expropriation losses and casualty losses will not be taken into account in determining whether there is an "overall foreign loss". (See section 904(f)(2)(B) as added by section 1032(a) of H.R. 10612).

If the stock or assets of a foreign company are sold to a foreign government following express or implied threats of condemnation, and if the government issues its bonds in payment therefor, any loss realized on subsequent disposition or worthlessness of those bonds is clearly an involuntary loss, and it should be so treated for purposes of the new loss recapture rules. This is particularly true where the transaction with the foreign government occurred long before the new loss recapture rules were first proposed, with the result that the taxpayer will have a large "built-in" loss on the foreign government bonds when the new rules go into effect.

As previously stated, Senator Packwood described this problem and identified BCC's interest in it during a public Committee mark-up session on May 14, 1976. In response, the Finance Committee decided to amend the bill by adding the provisions now contained in Section 1032(c)(2). The Committee's decision--taken after full public discussion of the problem--was consistent with the real objectives of the House bill and should not now be reversed.

**STATEMENT SUBMITTED BY
SCM CORPORATION
REGARDING FOREIGN LOSS RECAPTURE PROVISIONS
IN SECTION 1032(c)(3) of H.R. 10612**

SUMMARY

SCM is a Fortune 500 U.S. company which is engaged in the production and sale of chemicals and coatings, paper, foods, and consumer and office products. It has some 45 foreign subsidiaries operating in 21 foreign countries throughout the world.

Because of declining demand resulting from the European economic recession, SCM was recently forced to sell its French paint business. The French subsidiary's operating assets were disposed of and the operations were terminated. SCM incurred a substantial loss on its investment. The Company is now faced with deciding whether it should continue certain of its foreign operations which have also been experiencing difficulties. As a result of operating losses which have not been deducted in SCM's U.S. tax returns, these foreign subsidiaries are now worth much less than the amount SCM has invested in them.

Under the loss recapture rules in Section 1032 of H.R. 10612 as passed by the House, SCM's regular foreign tax credit could be cut in half for several years as a result of losses

realized on the disposition of foreign subsidiaries which became largely worthless before the new law went into effect. To avoid this undue hardship, the new loss recapture rules should be made inapplicable to "built-in" losses which were incurred in an economic sense prior to enactment of the new law.

The Finance Committee has previously approved two transitional rules designed to reach this result in certain situations. The first of these transitional rules is contained in section 1032(c)(3) of the bill reported out by the Committee; the other is described in the Committee's press release for June 11, 1976. SCM strongly urges the Committee to retain both of these provisions in the bill.

DISCUSSION

Section 1032 of H.R. 10612 as passed by the House provides that if a taxpayer has an "overall foreign loss" in a taxable year beginning after December 31, 1975, the amount of that loss will reduce the amount of the taxpayer's otherwise allowable foreign tax credit in subsequent years. The House bill does this in two ways. First, for purposes of calculating the §904 foreign tax credit limitation, the amount of foreign source income realized by the taxpayer in subsequent years is reduced

50% in each subsequent year until the aggregate reductions equal the amount of the original overall foreign loss. Second, the amount of creditable foreign tax paid or deemed paid in each such subsequent year is also reduced by 50%.*

Under §1032 as passed by the House, losses realized after the effective date are taken into account in full in computing the foreign tax credit reduction in future years, even though those losses are attributable in an economic sense to events occurring before the enactment of §1032. Such losses are referred to as "built-in" losses.

For example, assume that a U.S. parent has invested $25 million in the stock of a foreign subsidiary. Over a period of many years, the subsidiary has incurred operating losses which have consumed most of its capital. Because the subsidiary is a foreign corporation, the U.S. parent has not been able to deduct or otherwise reflect any of these operating losses in its own U.S. return. In 1977, the subsidiary becomes insolvent. Under §165(g)(3) of the Code, the parent is entitled to a $25 million ordinary deduction in its 1977 return for its worthless stock investment in the subsidiary.

If §1032 were enacted without an exception to cover such cases, the entire $25 million deduction would be taken into

* The Finance Committee bill omits the second adjustment for reasons unrelated to this submission.

account under the new foreign tax credit limitation rules, even though most of this amount was economically attributable to the operating losses incurred by the foreign subsidiary long <u>before</u> §1032 was enacted. The results of applying §1032 without an exception for built-in losses could be catastrophic. For example, if the U.S. parent normally received $10 million of foreign source income and normally paid $4 million of foreign tax each year, recognition of the entire $25 million built-in loss would mean that the U.S. parent's normal foreign tax credit would be reduced by almost $5 million during the three year period following the year of the loss.*

In recognition of the undue hardship that could result if §1032 were applied to built-in losses, the Finance Committee has approved two transitional exceptions. As previously stated, the first is contained in §1032(c)(3) of the bill reported out by the Committee; the other is described in the Committee's Statement of Actions taken on June 11, 1976. Since

---

* In 1977, the parent would have an "overall foreign loss" of $15 million ($25 million stock loss - $10 million foreign source income). For purposes of computing the §904 limitation in each of the next three years, net foreign source income would be reduced by $5 million (50% of $10 million) for total reductions of $15 million (3 x $5 million). In each year, the revised §904 limitation would be $2.4 million (48% of $5 million) and $1.6 million of foreign tax credit would be lost ($4 million tax less $2.4 limitation). Over the three year period, the total loss of credit would be $4.8 million (3 x $1.6 million).

these provisions apply only to built-in losses that are realized in taxable years ending before January 1, 1979, they will not afford complete protection to SCM should it be forced to dispose of other subsidiaries currently operating at a loss. Indeed, it seems likely in some cases that four to five years will be required to make all of the studies and analyses, and to develop and implement programs designed to salvage these operations, before making the irrevocable decision to dispose of them. Nevertheless, SCM strongly urges the Committee to retain both provisions of the bill. Taken together, they should provide at least partial relief for SCM and numerous other similarly situated taxpayers that may be forced to shut down foreign operations in the immediate future as a result of the cumulative effect of pre-1976 operating losses for which no prior U.S. tax deduction has been taken.

SUMMARY
OF
STATEMENT OF RAPHAEL SHERFY
MILLER & CHEVALIER, WASHINGTON, D.C.
ON BEHALF OF NABISCO INC.
BEFORE SENATE COMMITTEE ON FINANCE
WITH RESPECT TO
SECTION 1032 of H.R. 10612, RELATING
TO FOREIGN LOSS RECAPTURE PROVISIONS

(1) Recommends that Committee reaffirm its decision of June 11, 1976, regarding the recapture of foreign losses caused by worthless securities. That Committee decision would provide that in the event a worthless securities loss is claimed with respect to a foreign subsidiary prior to January 1, 1979, the U.S. taxpayer's loss would not be recaptured to the extent of the cumulative negative earnings and profits of such subsidiary on December 31, 1975.

(2) Nabisco believes that the loss recapture provisions of section 1032 apply inequitably in certain cases involving worthless securities.

(3) Losses of foreign subsidiaries which have been incurred before January 1, 1976 should be excluded from these provisions if claimed in connection with a worthless security loss prior to January 1, 1979.

STATEMENT

ON BEHALF OF

NABISCO, INC.

BY

RAPHAEL SHERFY

MILLER & CHEVALIER, WASHINGTON, D.C.

TO THE

COMMITTEE ON FINANCE

JULY 21 1976

Mr. Chairman:

My name is Raphael Sherfy and I am testifying on behalf of Nabisco, Inc., which believes that Sec. 1032 of the Senate Finance Committee version of H.R. 10612, dealing with recapture of foreign losses, in particular the treatment accorded worthless securities, discriminates against many corporations operating through foreign subsidiaries, including Nabisco.

Section 1032 Position

Under Section 1032 any taxpayer who sustains an overall foreign loss for any taxable year which reduces the taxpayer's U.S. tax would be required to repay this tax benefit over future years by reducing the taxpayer's use of future available foreign tax credits.

Nabisco is not here to discuss the primary issue raised by Section 1032 of whether or not foreign tax credits should be restricted or eliminated in any way. Nabisco is here only to ask that tax legislation relating to loss recapture now being considered treat those corporate taxpayers who have operated overseas through foreign subsidiaries equally with corporations having operated overseas as branch operations of a U.S. corporation. Existing tax law allows corporations with branches abroad to reduce their U.S. taxable income by losses sustained in those branch operations in the year incurred. However, corporations operating through foreign subsidiaries may reduce their U.S. taxable income through foreign losses only if and when they go out of business and claim a worthless securities loss with respect to the foreign investment. We believe it is not the intention of the Committee to retroactively take away from U.S. corporations who have relied on the tax law in its present form, the tax benefits from a worthless securities deduction which stemmed from operating losses of those subsidiaries incurred in past years and for which no U.S. tax benefit has been claimed.

The outcome of any investment is never determinable at the outset. For those foreign investments of Nabisco which have negative earnings, the Company has not received a U.S. tax benefit because of the foreign subsidiary form of organization which was utilized. The Company has turned some of its past loss operations around. Nabisco has continued to operate abroad with the belief that if its efforts to remedy certain foreign problems ultimately prove to be unsuccessful, we would, under present law, eventually receive a U.S. tax benefit for prior years losses which were never taken previously if we terminate the operation and claim a worthless securities loss under Section 165(g)(3) of the Internal Revenue Code. Section 1032, in its present form would effectively negate this benefit.

In general, Section 1032 would be effective for taxable years beginning after December 31, 1975. We feel this rule is unreasonable and inequitable for the following reasons:

1. No prior U.S. tax benefit could have been taken by Nabisco on foreign subsidiary loss operations.
2. Because of the effective date proposed in this section, an insufficient time period is given the taxpayer in which to evaluate the worthlessness of his investment and adopt appropriate action to continue operations or to claim a security loss without recapture.
3. The Company relied on existing tax law when making past investment decisions, and now the rules are being changed in the middle of the game.

Recommendation

Nabisco recommends that the Committee reaffirm its decision of June 11, 1976, regarding the recapture of foreign losses caused by worthless securities. That action was an amendment which states that in the event a worthless securities loss is claimed with respect to a foreign subsidiary prior to January 1, 1979, the U.S. taxpayer's loss would not be recaptured to the extent of the accumulative negative earnings and profits of such subsidiary on December 31, 1975. This provides partial equity, since it puts the taxpayer who operated through a foreign subsidiary somewhat on a par with those who operated under the foreign branch concept. It also provides a reasonable period of time to continue to make the operation profitable before being forced to decide to accept the worthless nature of the investment.

July 20, 1976

SUMMARY OF TESTIMONY
OF
FELIX B. LAUGHLIN
FOR
AMERICAN CAN COMPANY

Before the

Senate Committee on Finance

on

Limiting the Retroactive Effect of the

"Recapture" of Foreign Loss Provision

(Section 1032 of H.R. 10612)

1. On March 5 of this year, American Can Company recognized a loss of more than $10,000,000 upon the abandonment of stock and debt investments in a group of seven foreign corporations, referred to as the "Elegance Group", whose overall operations had resulted in substantial losses since the Group's acquisition in 1970.

2. Under section 1032 of the House-passed version of H.R. 10612 (which would be applicable to losses recognized in taxable years beginning after December 31, 1975), American Can's anticipated "overall foreign loss" for 1976 resulting from the termination of its interest in the Elegance Group would be subject to "recapture" for foreign tax credit purposes. This would mean that, to the extent of such overall foreign loss, American Can's foreign source income in subsequent years from operations wholly unrelated to such loss would be treated as United States source income so that foreign taxes paid with respect to such unrelated foreign source income may never be creditable by American Can for U.S. Federal income tax purposes.

3. American Can strongly urges that the retroactive application of section 1032 of the Bill to termination losses should be limited by an appropriate transitional rule, such as the one contained in paragraph (3) of section 1032(c) of your Committee's amendments to the Bill (which paragraph is entitled "Substantial worthlessness prior to enactment"). Although American Can would prefer a permanent exception for termination losses, this transitional rule recognizes the unfairness of applying the recapture provision to foreign losses like the Elegance loss which were sustained in a very real economic sense prior to the effective date of section 1032, even though such losses may be technically recognized for tax purposes after such effective date.

July 20, 1976

STATEMENT
OF
FELIX B. LAUGHLIN
FOR
AMERICAN CAN COMPANY

Before the

Senate Committee on Finance

on

Limiting the Retroactive Effect of the "Recapture" of Foreign Loss Provision (Section 1032 of H.R. 10612)

Mr. Chairman and members of the Committee, my name is Felix B. Laughlin. I am a member of the law firm of Dewey, Ballantine, Bushby, Palmer & Wood. I am appearing today on behalf of American Can Company in support of limiting the retroactive application of section 1032 of H.R. 10612 (the Tax Reform Bill of 1976), through provisions such as the one contained in paragraph (3) of section 1032(c) of your Committee's amendments to the Bill (which paragraph is entitled "Substantial worthlessness prior to enactment").

American Can Company is a New Jersey corporation having its principal office at American Lane, Greenwich, Connecticut 06830. American Can is a publicly-held company engaged primarily in the production of container and packing products, consumer products and chemicals and in providing printing, solid waste processing, patterns and information technology. Since 1968, American Can has conducted certain international financing operations through its wholly-owned subsidiary, American Can International Corporation ("International").

On March 5 of this year, American Can and International recognized a loss of more than $10,000,000 upon the abandonment of their stock and debt investments in a group of seven foreign corporations, referred to as the "Elegance Group," which were wholly-owned first- and second-tier subsidiaries of International. The companies in the Elegance Group were engaged in the international mail order merchandising of high-fashion dresses and fabrics.

International had purchased the stock of the Elegance companies on July 10, 1970 for a total purchase price of $3,360,000. As a result of subsequent stock investments in, and loans to, the companies in the Elegance Group by International and American Can, certain open-account sales by American Can to companies in the Elegance Group and payments with respect to a guaranty of bank debt, the total basis to American Can and International in the stock investments in, and notes and accounts receivable from, the Elegance Group as of March 5, 1976 (the date on which American Can and International terminated their interest in the Elegance Group) was approximately $10,208,000.

The overall operations of the Elegance Group were not successful and resulted in substantial losses subsequent to the acquisition by International.* Because of these substantial losses, in late 1975 American Can began making efforts to sell the stock of the Elegance companies, but these efforts proved unsuccessful. On March 5, 1976, International abandoned its stock in the Elegance Group, and American Can and International cancelled all outstanding indebtedness to them from the Elegance companies. On the same day, in order to give certain employees of the Elegance Group the opportunity to attempt to salvage the business, International transferred the stock of the companies in the Elegance Group to those employees. The resulting loss amounted to approximately $10,208,000, and is so large that it is anticipated that American Can will suffer an "overall foreign loss" under the proposed statute with respect to its foreign operations in 1976.

Under section 1032 of the House-passed version of H.R. 10612, which would be applicable to losses recognized in taxable years beginning after December 31, 1975, American Can's overall foreign loss for 1976 would be subject to "re-

---

* A summary of the performance of each company in the Elegance Group, and the overall performance of the Elegance Group, during the past five fiscal years is shown in the attached schedule.

capture" for foreign tax credit purposes. This would mean that, to the extent of such overall foreign loss, American Can's foreign source income in subsequent years from operations wholly unrelated to such loss would be treated as United States source income so that the foreign taxes paid with respect to such unrelated foreign source income may never be creditable by American Can for United States Federal income tax purposes.

This result seems to go well beyond the purpose of the recapture provision, which appears intended to prevent a taxpayer from deducting "start-up" losses incident to the commencement of a foreign business and later taking a credit for foreign taxes paid on income received in subsequent years from such foreign business. As stated by Secretary Simon in his testimony before your Committee on March 17, 1976:

> "We view this [*i.e.*, the recapture rule] as a technical change to eliminate an unintended benefit. Under present law, a U.S. taxpayer can use foreign start-up losses to reduce U.S. tax and then pay no U.S. tax on subsequent foreign gains because of the foreign tax credit. In such a case it is only fair for the U.S. to recapture the tax lost during the start-up period."* (Emphasis added.)

Termination losses, *i.e.*, losses incurred on the discontinuance or other disposition of a business enterprise,

---

* Statement of the Honorable William E. Simon, Secretary of the Treasury, on Major Tax Revisions and Extension of Expiring Tax Cut Provisions, before the Senate Finance Committee, March 17, 1976, at page 89.

are not comparable to "start-up" losses; rather, they are economically similar to casualty and foreign expropriation losses which are excepted from the definition of "overall foreign loss" by proposed section 904(f)(2)(B) (contained in section 1032(a) of the Bill). As in the case of casualty and expropriation losses, such termination losses are unplanned, largely beyond the control of the taxpayer, and inherently unlikely to have offered any opportunity for the taxpayer to have obtained any unintended foreign tax credit advantage.

If, however, no permanent exception is to be provided for termination losses, we strongly urge that the retroactive impact of the recapture provision to such losses should be limited by an appropriate transitional rule. Such a transitional rule is presently contained in your Committee's amendments to the House-passed Bill. Although your Committee's modifications retain the general effective date of December 31, 1975, a transitional rule is provided in section 1032(c)(3) which excepts from the recapture provision all losses incurred by a taxpayer with respect to stock or indebtedness of a 10%-or-more owned corporation in which the taxpayer has terminated his interest by sale, liquidation or other disposition before January 1, 1977, where such stock or indebtedness is considered "substantially worthless prior to enactment." In order for the stock or indebtedness to be considered "substantially worthless", the issuing or obligor corporation (i) must have sustained losses in three out of the last five taxable years beginning before January

1, 1976, and (ii) must have sustained an overall loss for those five years.*

Although we would prefer a permanent exception for termination losses, this transitional rule would at least limit the retroactivity of the recapture provision in the case of termination losses. Where this exception applies (which requires satisfying the five-year "look-back" tests), it is clear that the foreign loss has been sustained in a very real economic sense prior to the effective date, and it seems unfair to apply the recapture provision to such loss simply because it is technically recognized for tax purposes after the effective date.

There are, of course, a number of other ways in which the retroactivity of the recapture provision could be limited. For example, your Committee could move the general effective date of the recapture provision to December 31, 1976, or to the date of enactment. Changing the effective date in this manner would be consistent not only with the traditional view of the Congress that retroactive tax legislation should be avoided,** but also with the "recapture of foreign oil re-

---

* Your Committee's Report on H.R. 10612 (S. Rep. No. 94-938, 94th Cong., 2d Sess., June 10, 1976), at page 241, notes that, in applying the five-year tests, a taxpayer should be permitted to aggregate the results of operations of all issuing or obligor corporations which are operated in the same line of business, where the taxpayer terminates its interest in all of the included corporations by January 1, 1977.

** See Statement of Senator Long and Senator Curtis, on Tax Revision Revenue Estimates, before the Senate Budget Committee, April 1, 1976.

lated loss" provision contained in section 907(f) of the Internal Revenue Code (added as part of the Tax Reduction Act of 1975), which apparently served as a model for the more general recapture provision here in question and which was made applicable to taxable years beginning after the calendar year of enactment.

Another approach would be to adopt a transitional rule which would exempt from the recapture provision any termination loss resulting from investments made by the taxpayer prior to the effective date of the provision (or prior to the House Ways & Means Committee's announcement relating to this provision) and recognized for tax purposes prior to, say, January 1, 1981. This approach would not result in a permanent "grandfather" rule, but would give taxpayers some period of time in which to decide either (i) to take their losses prior to the cut-off date with the tax consequences they could have expected when the investment was made or (ii) to continue the investment beyond the cut-off date having received adequate notice of the tax credit implications of the recapture provision.

* * *

I thank you for the opportunity to be here today and will be pleased to answer any questions you may have with respect to my testimony.

Attachment

SCHEDULE SHOWING FIVE-YEAR PERFORMANCE OF ELEGANCE GROUP

After Tax Income (or Loss) For Fiscal Year Ended October 31

Company	1971	1972	1973	1974	1975	Total
Elegance Rolf Offergelt GmbH	$(285,331)	$(15,790)	$332,708	$(1,095,524)	$(1,691,232)	$(2,755,169)
Elegance Publikations AG	8,149	27,791	52,205	60,126	7,070	155,341
Setalana Couture Stoffe AG	45,534	49,220	64,093	33,349	20,748	212,944
Goldfalter Modestoff Grosshandel GmbH	34,189	35,525	20,150	(29,156)	596	61,304
Tissus Elegance S.A.	6,009	(60,751)	(113,004)	72,406	(166,635)	(261,975)
Astor Modetyger AB	(20,349)	(12,011)	(38,609)	(14,504)	(22,081)	(107,554)
Elegance Tissus et Nouveautes SpA	Nil*	(115,225)	(448,213)	(97,663)	64,343	(596,758)
Consolidation Adjustments	(2,755)	20,542	258,723	637,047	129,326	1,042,883
TOTALS	$(214,554)	$(70,699)	$128,053	$ (433,919)	$(1,657,865)	$(2,248,984)

* Not in existence in fiscal 1971.

§1035(b) of H.R. 10612, A Section to Provide a Transition Rule Relating to the Recapture of Foreign Oil and Gas Related Losses

WRITTEN TESTIMONY

Presented to

The Senate Committee on Finance

July 21, 1976

On behalf of Sun Company, Inc.

by

Cornelius C. Shields
Chief Tax Counsel
Sun Company, Inc.

and

H. Lawrence Fox
Pepper, Hamilton & Scheetz
Counsel

SUMMARY

1) Section 907 of the present Code was added by the Tax Reduction Act of 1975. Subsection 907(f) provides rules for recapture of foreign oil-related losses. Although Congress intended that Section 907(f) operate prospectively, in its present form the Section can operate retroactively by requiring a taxpayer who relied upon prior law to recapture losses incurred pursuant to pre-existing contractual obligations even though such obligations were entered into well before the 1975 Tax Act.

2) Section 1035(b) of H.R. 10612 is a technical amendment which provides a deferral-type transition rule to the foreign loss recapture provision. It does not eliminate loss recapture in the case of pre-existing contracts, but only extends the time period over which recapture occurs. Specifically Section 1035(b) provides that foreign oil-related losses which are sustained in a taxable year ending before January 1, 1979, and which are incurred pursuant to a binding contract entered into on or before July 1, 1974, need not be recaptured in an amount exceeding 15 percent of such loss for the first four years after they become subject to recapture and are fully subject to recapture thereafter.

3) Sun is requesting relief from Congress because of an oversight contained in Section 907(f) when enacted. Classification of the Company's petition as special in nature and therefore questionable would be as unfair as the statute itself. The Company has not suggested eliminating the principle of law contained in Section 907(f) but merely reducing its inequitable application. Section 1035(b) of the Bill provides significantly less relief than most "grandfather" amendments and does not reduce Sun's ultimate tax burden.

4) Finally, in addition to filing testimony with this Committee on April 22, the Company has brought its position to the attention of one, the Treasury Department, two, the entire U.S. Senate, and three, many of the so-called public interest groups. Clearly, the Company has not sought this amendment without public scrutiny or a public hearing.

INTRODUCTION

Prior Testimony and Finance Committee Action

Sun Company filed testimony with the Committee on Finance on April 22, 1976, indicating its concern with the apparent but unintended requirement of present Code Section 907(f) that a taxpayer which relied upon existing law must recapture, to its detriment, losses incurred pursuant to binding contractual obligations entered into with foreign governments or their national oil companies well before the Tax Reduction Act of 1975.

Following this testimony, the Finance Committee adopted a deferral-type transition rule to redress this inequity. The technical amendment is in Section 1035(b) of H.R. 10612 as reported to the Senate.[1] Prior to the Committee's determination, Sun representatives met with each Senator on the Committee or his staff to ensure that the equities of this amendment were understood. Subsequent to the Committee's favorable decision, correspondence was sent to all other members of the Senate explaining the amendment, along with a copy of the testimony.

July 21, 1976 Testimony

Due to concern expressed by several members of the Senate that this provision and numerous others contained in

---

1 Present Code Section 907(f) is renumbered as Section 904(f) in the Bill as a consequence of other decisions made by the Finance Committee. References in this statement to present Code Section 907(f) should be understood as equally applicable to the proposed renumbered Section 904(f).

the Bill were not subject to sufficient public hearings, the Finance Committee issued a press release on July 8, 1976, announcing that additional hearings would be held on over 60 provisions of H.R. 10612 including Section 1035(b). On behalf of Sun Company, we are here to offer additional testimony.

EFFECTIVE DATE OF 907(f)

Statute to be Prospective

The Tax Reduction Act of 1975 added Section 907 to the Code. In general, this Section applies a strict limitation on the use of foreign tax credits from foreign oil extraction income and foreign oil-related income. Section 907(f) provides rules for recapture of foreign oil-related losses. When enacted, Congress intended that it be prospective by providing an effective date after December 31, 1975, instead of the general effective date, December 31, 1974, for Section 907. However, in Sun's case it is unintentionally retroactive because it requires this taxpayer, who relied upon prior law, to recapture losses incurred pursuant to pre-existing contractual obligations, even though such obligations were entered into well before the 1975 Tax Reduction Act.

Application of 907(f) to Sun Company

Before July 1, 1974, Sun entered into contracts with a number of foreign governments or their national oil companies pursuant to which Sun is required to expend over $100 million through 1978 in drilling and exploring new areas. This program was initiated a number of years ago in reliance on the tax law prior to the enactment of Section 907(f) in order to develop additional sources of crude oil for Sun's U.S. refineries.

It is anticipated that as a result of Sun's contractual foreign exploration effort, the Company will have net foreign losses totaling approximately $70 million over the next two to three years. As enacted, Section 907(f) would recapture these losses thereby requiring Sun to pay approximately $33 million in additional Federal income taxes. This retroactive tax increase is directly attributable to contracts entered into prior to the enactment of Section 907(f). It is a burden that the Company could not have anticipated in making its financial commitments. Notwithstanding the unfair windfall to the Federal Government, the amendment contained in Section 1035(b) of the Bill will not relieve Sun of its obligation to pay these increased taxes. It will only provide a measure of relief by extending the time over which they must be paid.

EQUITABLE RELIEF

In General

As previously stated, Section 907(f) produces an inequitable and unintended tax burden on Sun. It is fair to assume that this would not have occurred if Congress were aware of Sun's facts at the time of enactment. For example, it probably would have provided a transition rule "grandfathering" binding contracts as it did in Section 604(b)(2), relating to the investment credit on drilling rigs used outside the northern part of North America. This would have been consistent with the historic policy of Congress in providing equitable transition rules in cases where tax law changes alter the economics of existing binding contracts.[2]

Deferral Concept

When Senator Carl T. Curtis (R-Neb.) suggested a grandfather amendment to Section 907(f) last December, this Committee recognized the need for a technical amendment to Section 907(f) and directed the Joint Committee Staff to study an appropriate amendment.

From Sun's perspective, losses under binding contracts existing prior to the enactment of Section 907(f) should not be subject to recapture at all. From the Staff's view, that type of amendment might reopen the statute. Therefore, it suggested in the alternative a deferral transition rule.

Section 1035(b)

On May 18, 1976, this Committee unanimously adopted Senator Curtis' deferral amendment as Section 1035(b). This provision provides that foreign oil-related losses which are sustained in a taxable year ending before January 1, 1979, and which are incurred pursuant to a binding contract entered into on or before July 1, 1974, need not be recaptured in an amount exceeding 15 percent of such loss for the first four years after they become subject to recapture and are fully

[2] The Code is replete with examples (in particular, the investment tax credit).

subject to recapture thereafter.[3] Accordingly, Sun continues to be subject to the full $33 million of tax under Section 907(f). However, the amendment provides Sun with some deserved relief by allowing the tax to be paid over a 5-year period. This means that the revenues to the Federal Government are not lost. Also, Sun's projections indicate that there would be no recapture under present Section 907(f) until 1978. Therefore, in Sun's case, this provision will have no effect on the Federal revenues in 1977.

SUMMARY

Sun is requesting relief from Congress because of an oversight contained in Section 907(f) when enacted. Classification of the Company's petition as special in nature and therefore questionable would be as unfair as the statute itself. The Company has not suggested eliminating the principle of law contained in Section 907(f) but merely reducing its inequitable application. Section 1035(b) of the Bill provides significantly less relief than most "grandfather" amendments and does not reduce Sun's ultimate tax burden.

Finally, in addition to filing testimony with this Committee on April 22, the Company has brought its position to the attention of one, the Treasury Department, two, the entire U.S. Senate, and three, many of the so-called public interest groups. Clearly, the Company has not sought this amendment without public scrutiny or a public hearing.

---

3 The intent of this provision is to eliminate any unforseen and inequitable application of the Code. Accordingly, it should be optional, as appears to be the intent of the Committee when Section 1035(b) of the Bill is read in conjunction with Section 1032(a) of the Bill.

STATEMENT BEFORE
THE COMMITTEE ON FINANCE
OF THE UNITED STATES SENATE
WEDNESDAY, JULY 21, 1976

BY ROBERT H. MILLER
VICE PRESIDENT, TENNECO, INC.

SUMMARY

Under the foreign tax credit limitations on oil and gas income imposed by the Tax Reduction Act of 1975, gain on the sale of assets used in a foreign oil and gas business is included in the definition of foreign oil related income. However, it is not clear whether this definition includes gain on the sale of stock of a foreign corporation included in an affiliated group filing a consolidated U.S. tax return to the extent the gain is attributable to assets used in the foreign oil and gas business. The gain from the sale or exchange of such foreign subsidiary's stock should be treated the same as gain from the sale or exchange of the subsidiary's oil and gas business assets. This is consistent with the purpose of the foreign tax credit limitations of section 907 which were intended to apply to all income arising from foreign oil and gas business activities, including the sale or exchange of the business assets.

STATEMENT BEFORE
THE COMMITTEE ON FINANCE
OF THE UNITED STATES SENATE
WEDNESDAY, JULY 21, 1976

BY ROBERT H. MILLER
VICE PRESIDENT, TENNECO, INC.

REGARDING SECTION 1035(c)(2)(B) OF H.R. 10612

I am Robert H. Miller, Vice President of Tenneco, Inc. Tenneco is a Houston-based multi-industry company. I am accompanied by F. Cleveland Hedrick, Jr., of the Washington, D.C. law firm of Hedrick and Lane, tax counsel to the company.

On June 4, 1976 the Committee on Finance approved an amendment to the Tax Reform Act of 1976 (H.R. 10612) to clarify the definition of foreign oil related income and foreign oil and gas extraction income in the case of the sale of stock of a foreign subsidiary corporation included as a member of an affiliated group filing a consolidated tax return. In general terms the Committee's amendment provides that gain on the sale of such stock shall be treated as "foreign oil and gas extraction" or "foreign oil-related" income to the extent attributable to the foreign subsidiary's assets used for the production of either foreign oil related income or foreign oil and gas extraction income.

Pursuant to the Committee's July 9, 1976 announcement of hearings on this and other amendments to H.R. 10612, the following information is submitted for inclusion in the record in support of proposed section 1035(c)(2)(B) of H.R. 10612 as reported on June 10, 1976 by the Committee on Finance.

The Tax Reduction Act of 1975 imposed certain new foreign tax credit limitations for taxable years ending after December 31, 1974, in the case of foreign oil and gas income. For the purposes of these limitations, gain from the sale of a foreign oil and gas business by means of a sale or exchange of assets used by the taxpayer in that business is included in the definition of foreign oil and gas extraction income or foreign oil related income, as the case may be. However, it is not clear under present law how to treat gain from the sale of an oil and gas business in a foreign country by means of a sale of all of the stock of the foreign corporation conducting the business.

Since foreign oil related income of a taxpayer includes gain from the sale or exchange of the taxpayer's business assets giving rise to that income, gain from the sale of the foreign subsidiary's stock should be treated the same as gain from the disposition of the subsidiary's oil and gas business assets. This is consistent with the purpose of the foreign tax credit limitations of section 907 which were intended to apply to all income arising from foreign oil and gas business activities, including the sale or exchange of the business assets.

The need for a clarification of the definition contained in the Tax Reduction Act of 1975 with respect to foreign oil and gas income subject to the new foreign tax credit limitations became apparent in connection with Tenneco's 1975 sale of part of its foreign oil and gas business in Canada.

Under Canadian law, a United States corporation may operate certain Canadian federal oil and gas properties only through a Canadian subsidiary corporation. For about 50 years United States taxpayers have been permitted an election to include wholly-owned contiguous country foreign corporations (organized and maintained to comply with the foreign law) in an affiliated group filing a consolidated tax return.

For a number of years Tenneco operated a Canadian oil and gas exploration and production business through one of these contiguous country foreign corporations and included all of the taxable income of its Canadian subsidiary in its U.S. consolidated tax return. Tenneco also owned through two domestic subsidiaries certain oil and gas properties, related production facilities, and real estate in Canada which were not required to be held by a Canadian corporation.

During 1975, Tenneco determined that it no longer had the prospect of exporting Canadian oil for its United States refinery. Since Tenneco has no plans to enter refining and marketing operations in Canada, it decided to sell all of the Canadian oil and gas business assets of its two domestic subsidiaries and one-half of the oil and gas business of its Canadian subsidiary to Canada Development Corporation ("CDC"), a corporation owned in part by the Canadian government. The sale permitted Tenneco to retrieve and repatriate a significant part of its investment in Canada, while continuing to operate in Canada on a more limited scale.

Tenneco's initial negotiations with CDC called for the direct sale of all of the assets in Canada of the two domestic subsidiaries and approximately one-half of the assets of the Canadian subsidiary. In fact, all of the Canadian assets of Tenneco's two domestic subsidiaries were sold directly to CDC and the gain thereon attributable to assets used in Tenneco's oil and gas business was treated as foreign oil related income pursuant to section 907 of the Code. A substantial Canadian income tax was paid on the gain arising from this part of the transaction in addition to a Canadian withholding tax on the return of the proceeds to the United States. However, in the case of Tenneco's Canadian subsidiary, it was not feasible to make the sale by a direct disposition of the subsidiary's oil and gas assets because the large amount of Canadian tax which would have been incurred would have substantially reduced the amount that could be returned and reinvested in the United States. As a practical matter, this part of the transaction could only be consummated as a stock sale.

In order to facilitate the transaction, Tenneco conducted a reorganization pursuant to favorable rulings by the Internal Revenue Service and the Canadian counterpart. All of the assets to be retained by Tenneco (approximately 50%) were transferred to a newly created Canadian subsidiary and all of the assets to be sold to CDC (and only those assets) remained in the original Canadian subsidiary. Tenneco then sold all of its stock in the original Canadian subsidiary as a means of disposing of the underlying oil and gas business assets.

If the disposition of Tenneco's Canadian subsidiary had been structured as an asset sale the gain from the sale of its business would have been foreign oil related income. Since the sale of stock in this case was essentially a disposition of oil and gas business assets described in section 907(c)(2), Tenneco assumed that the gain would be treated as foreign oil related income.

In order to confirm its interpretation of section 907 of the Code and to obtain some assurance that its treatment on its 1975 tax return of the gain on the sale of the stock of its Canadian subsidiary will be accepted, counsel for Tenneco met with the Treasury Department earlier this year to request administrative confirmation of its position with regard to the definition of foreign oil related income. Although Tenneco believed the required clarification could be accomplished administratively, the Treasury gave no assurance of its position on this question pending the promulgation of regulations under section 907, which may take several years. However, it is understood that the Administration does not object to legislation amending the definition of foreign oil related income to cover gain on the sale of stock in any foreign corporation which holds oil related assets.

Summary of Principal Points of Testimony
of John T. Jackson, Chairman
of the Executive Committee,
IU International Corporation

1. IU International, an American Corporation, has operated gas utilities in Canada through subsidiaries for decades and has been authorized to explore for and produce gas in Canada for these utilities in order to insure sufficient supplies of gas for their customers.

2. The 1975 Tax Reduction Act limited foreign tax credits of large, multinational, integrated oil companies.

3. The Committee on Finance amendment exempted from this limitation regulated public utility income related to distribution and transportation of gas and we support this move.

4. Also, the Committee should consider that the limitation of tax creditable is 50%, designed to equal U.S. taxes, but fails to consider withholding taxes, which makes the effective rate in Canada over 57%.

Testimony of Mr. John T. Jackson Relating to §1035 of H.R. 10612

My name is John T. Jackson and I am Chairman of the Executive Committee of IU International Corporation. I would like to address my remarks to an amendment adopted by the Committee on Finance during its consideration of H.R. 10612 which relates to foreign tax credit limitations which were adopted last year by the Congress.

The Congress adopted, as part of the Tax Reduction Act of 1975, separate limitations on the use of foreign tax credits from foreign oil extraction and foreign oil related income (§907 of the tax law). These rules separately limit the amount of foreign tax on foreign oil related income which is treated as creditable for U.S. foreign tax credit purposes. The language from which these rules evolved was adopted on the Senate floor, and the debate clearly indicates that they were meant to apply to the foreign tax credits of large multinational-integrated oil companies. However, their scope goes far beyond this. For example, the 1975 limitations also cover the situation of a regulated public utility in a foreign country which distributes gas locally in that foreign country, and whose U.S. parent is not an oil or gas company. I understand that the sponsor of the 1975 legislation, Senator Hartke, has stated in response to a question during the recent committee markup on H.R. 10612 that it was not his intent to have regulated foreign public utilities included within the scope of §907.

IU International Corporation was originally called International

Utilities. Many years ago we started operating in Canada through regulated public utility subsidiaries. Today, IU continues to operate these local gas distribution systems and electrical distribution systems through subsidiaries in Canada. Our gas utilities serve the same type of customers as any other local gas company does, homes, factories, offices, and the like. Under the 1975 legislation, we are subjected to the same limitations as is a multinational-integrated oil company. Additionally, a number of years ago the subsidiaries were granted permission by the Canadian regulatory body to invest in local gas fields in order to assure our utility customers of a continuing source of supply at a cost subject to regulatory rules. I should stress at this point that we would be treated the same way as a multinational-integrated oil company even if we had not discovered any gas to be used in our own system, simply because of the fact that gas is merely transported in our pipelines and distributed to our utility customers.

It is my understanding that this Committee decided to adopt a rule which would make this special foreign tax credit limitation not applicable to regulated public utility income. I applaud this action. This amendment also has the effect of treating in a parallel manner the foreign tax credits of competing regulated public utilities that produce energy; foreign electric and gas utilities will now be taxed alike on their transportation and distribution income.

Nevertheless, because we produce our own gas we would continue to be subject to the 1975 special foreign tax credit limitation on our extraction income even though our extraction income is derived by these same regulated public utilities. Under this special limitation, the maximum rate of tax which is authorized to be creditable with respect to oil/gas extraction income is approximately 50%. This figure is designed to approximate the U.S. rate of tax. However, it fails to take into consideration withholding taxes on this income which can, as in the case of Canada, drive up the effective rate of tax to over 57%. We request that consideration be given to this point, perhaps by arriving at an appropriate percentage limitation to which any legitimate withholding tax by the foreign government may be added.

Needless to say, any remaining allowable credits generated from IU's operations in Canada continue to be subject to all of the other rules and limitations normally applicable to foreign tax credits.

Thank you, Mr. Chairman, and members of the Committee, for giving me this opportunity to present our views. We feel that if the Committee is to properly discharge its duties, it must remedy inequities in the tax laws through the exercise of oversight jurisdiction. It is clear the provision we are supporting remedies an unintended and patently unfair application of a general provision to our particular situation. We believe we were inadvertently placed within this general provision and at the time the provision was passed there was no opportunity for a hearing. We respectfully suggest that there is nothing unfair, illegal, immoral, or inappropriate about seeking legislative relief.

STATEMENT

OF

D. P. HERTZOG

GENERAL TAX COUNSEL

TEXACO INC.

Before The

SENATE COMMITTEE ON FINANCE

Washington, D. C.

July 21, 1976

74-620 O - 76 -- 19

SUMMARY OF PRINCIPAL POINTS
IN STATEMENT BEFORE THE
SENATE COMMITTEE ON FINANCE
BY
D. P. HERTZOG
JULY 21, 1976

1. The amendment to Section 1035 of the Tax Reform Bill of 1976 which would include interest from domestic corporations within the definition of foreign oil-related income should be adopted.

2. This would correct a drafting error made in the Tax Reduction Act of 1975. See statement on House Floor on March 26, 1975 (Congressional Record, H. 2383).

3. Foreign earnings of both domestic and foreign subsidiaries are subject to foreign tax credit limitations based upon foreign oil-related income. Both dividends and interest from foreign subsidiaries are treated as foreign oil-related income. Dividends from domestic subsidiaries are treated as foreign oil-related income and it is inconsistent to treat interest from domestic subsidiaries as non-foreign oil-related income.

4. The error should be corrected retroactive to January 1, 1975, and not from January 1, 1977, as provided in the Tax Reform Bill.

**STATEMENT OF
D. P. HERTZOG
GENERAL TAX COUNSEL
OF TEXACO INC.
BEFORE THE
SENATE COMMITTEE ON FINANCE
JULY 21, 1976**

Mr. Chairman, my name is Donald P. Hertzog. I am General Tax Counsel of Texaco Inc.

I strongly support that portion of the amendment of Section 1035 which would include interest received from domestic corporations (i.e. companies incorporated in the United States) within the definition of foreign oil-related income. The purpose of this provision is to correct a drafting error which occurred in the Tax Reduction Act of 1975. This error was pointed out in testimony before this Committee on March 25, 1976, by Mr. W. R. Young appearing on behalf of the American Petroleum Institute as follows:

> "Technical problems of 1975 Tax Reduction Act
>
> In addition, perhaps due to the haste in which the 1975 changes were enacted, there are many technical questions of interpretation which make it difficult for taxpayers to know the tax results of future activities. There are also several technical errors and apparent oversights. In the latter category is the apparent omission of interest income from U. S. incorporated oil companies operating abroad as oil-related income, whereas such income from foreign affiliates would be oil-related. ***" Testimony of Mr. Wilford R. Young, Tax Reform Act of 1975, H.R. 10612, Senate Committee on Finance, Hearings, Part [illegible], p. [illegible]13, March 25, 1976.

The Tax Reduction Act of 1975 created a new category of income known as foreign oil-related income. The purpose was to apply limitations to foreign tax credits which could be utilized by oil companies. These provisions apply to earnings of both foreign corporations (i.e. companies incorporated in foreign countries) and domestic corporations. Regardless of whether a company

chose to operate in foreign areas through a foreign corpora[illegible]
subsidiary, restrictions were imposed on the amount of [illegible]
which could be used.

Section 907(c)(3) created by the Tax Reduction [illegible]
definition of foreign oil-related income dividends [illegible]
a foreign corporation and dividends received [illegible]
statutory provision did not specifically refer [illegible]
domestic corporation.

The Tax Reform Bill of 1976 would corre[illegible]
within the category of foreign oil-related [illegible]
domestic subsidiaries. It is pointed out [illegible]
Committee (p. 249) that the change is [illegible]
between taxpayers who carry on foreign oil-re[illegible]
subsidiaries, and those who carry on such [illegible]
domestic subsidiaries.

It is clear for a number of reasons that [illegible]
the Tax Reduction Act was not intended. First[illegible]
foreign subsidiaries and domestic subsidiaries [illegible]
credit limitations based upon foreign oil-rela[illegible]
to penalize taxpayers who choose for business rea[illegible]
sidiaries. Second, foreign income earned by a [illegible]
oil-related and interest paid out of such income [illegible]
as foreign oil-related income. Third, there is [illegible]
between payments of interest and payments of dividends [illegible]
corporation.

interest income from domestic

if we consider the

affiliated group filing a

corporation paying the

all of its income is

-related

interest is treated

e a clear

affiliated group.

dent from

the

dividends from

were to be

March 26,

Senate Finance

the effective

January 1, 1977,

subject tax-

we note that

unintentional

July 19, 1976

Summary of Statement by American Independent Oil Company in support of section 1035(e) of H.R. 10612 as reported to the Senate by the Committee on Finance.

The purpose of section 901(f) of the Internal Revenue Code, as stated in the report of the Committee on Finance on the pending Bill, was to deny foreign tax credits where payments for normal purchases of petroleum are disguised as payments of tax.

This purpose is not applicable to cases of discounts on purchases granted by a foreign government to an oil company in connection with nationalization by the foreign government of the properties and operations of the company. The discounts in such cases in substance amount to compensation granted by the government to the oil company for the takeover in addition to inadequate lump sum compensation based on book values.

In these takeover situations, there is nothing inappropriate or artificial in taxation by the foreign government of profits resulting from the discounts as a substitute for loss of the company's future operating profits or as gain to the company on the takeover.

Where such a takeover arrangement involving discounts on future purchases from the government was entered into before the enactment of the 1975 Act, there was no reason to anticipate that continuance of an economic interest was necessary to sustain credit for the tax. While it is believed that in the case of the agreement negotiated in Iran in 1973 an economic interest did continue, this is a technical question which is not altogether free from doubt, and section 901(f) should be inapplicable to such cases in order to prevent the possibility of an inequitable retroactive effect.

Section 901(f) should be made inapplicable to any past or future takeover situations if the oil company had an economic interest on or before March 29, 1975, in order to make the use of discounts on purchases from the government clearly available as a method which can be used in future negotiations to obtain compensation for loss of the properties and future profits of the oil companies.

July 19, 1976

Statement submitted on behalf of American Independent Oil Company in support of section 1035(e) of H.R. 10612 as reported to the Senate by the Committee on Finance.

My name is Fred. L. Morefield. I am Vice President-Finance of American Independent Oil Company ("Aminoil"), which is a wholly owned subsidiary of R. J. Reynolds Industries, Inc. ("Reynolds"). Aminoil is an independent oil company that was formed in 1947 to search for oil in the Middle East. Aminoil operated principally in Kuwait and Iran until 1970 when it was acquired by Reynolds. Since that time Aminoil has obtained exploration properties in the United States and last month Reynolds purchased all of the United States oil and gas properties of Burmah Oil Incorporated, including both producing and exploration ventures in the United States.

Aminoil produces about 80,000 barrels of oil per day in the Kuwait-Saudi Arabia Divided Zone and refines the oil in Kuwait. In Iran, Aminoil through a subsidiary holds a 5/6 of one per cent interest in the Consortium and its share of the available oil is approximately 40,000 barrels per day. Aminoil markets its Kuwait and Iranian production to third-party customers in the Far East and occasional sales are made to Europe and Brazil. Aminoil also holds interests in petroleum ventures in Paraguay and other foreign countries as to which no production has been obtained. Affiliates have interests in an oil field located in Argentina, in a gas field located in the Dutch sector of the North Sea and are developing a geothermal steam operation in California. Also, the affiliates engage in (i) retail and wholesale marketing of fuel oil, natural gas liquids and natural gas liquid products, principally in the United States Mid-West and North East, and (ii) the wholesale marketing of motor gasoline in the United States West Coast.

Aminoil urges the enactment of section 1035(e) of H.R. 10612 as reported to the Senate by the Committee on Finance. This provision would amend section 901(f) of the Internal Revenue Code, as added by the Tax Reduction Act of 1975, in order to prevent the inequitable operation of section 901(f) in certain cases where foreign countries nationalize the properties of United States companies.

Section 901(f) denies foreign tax credit for any foreign income taxes incurred in connection with the purchase and sale of oil or gas extracted in the taxing country if the taxpayer has no economic interest in the oil or gas and the purchase or sale is at a price which differs from the fair market value for such oil or gas at the time of such purchase or sale. As stated in the Committee's report on H.R. 10612 (pp. 251-253), the intent of section 901(f) was to deny foreign tax credits "where payments for the purchase of oil owned by the foreign country are disguised as the payment of a tax by casting normal crude purchase and sale arrangements in non-commercial formats" with the effect of creating an artificial profit on which a tax could be imposed, so that the net economic effect is the same, for the foreign government, as a simple purchase of the oil.

The amendment proposed to be made by section 1035(e) of the pending Bill to section 901(f) of the Code recognizes that the purpose of section 901(f) is not applicable to cases of discounts on purchases granted by foreign governments to oil companies in connection with nationalization by the foreign governments of the properties and operations of the companies. A number of the major oil-producing countries have taken over ownership and control of oil operations within their territories and others are preparing to do so. While recognizing an obligation to compensate the companies for the properties and the oil reserves which have been developed by the capital and expertise of the companies, the governments have refused to pay outright compensation beyond the "net book value" of the properties, which is far below the actual value of the properties, based on the profits which the oil companies would have derived. As noted in the Committee's report, in some cases the governments have been and may in the future be willing, in addition to payment of net book value, to allow the former owners to participate to some extent in the future profits of the operations by permitting them to purchase some of the oil or gas at a discount.

In 1973 the government-owned National Iranian Oil Company took over from the Consortium of which Aminoil is a member, control of the operations and the right to the production. The compensation received by the Consortium members for this takeover consisted of the right to buy quantities of oil out of future production at a formula price which might be considered to be less than the fair market value of the oil, and the right to credit against the price of such purchases, in installments, 60% of the net book value of their investments, such net book value being extremely small in comparison with the value of the right of the companies to continue such operations under the former agreement.

Since the profits which may be realized by the Consortium members on purchases under the new agreement are in substitution for the normal operating profits which would have been realized by them under continuance of the former agreement, and can be regarded as a profit to them from disposition of their former rights and interests for a total consideration in excess of the book value basis, there is nothing inappropriate of artificial in the imposition of income tax on those profits by Iran.

As pointed out in the Committee's report, it may not be clear that the oil companies' rights under new arrangements involving discounts on purchases of oil from the governments after nationalization will be recognized as falling within the limitations of the technical concept of an "economic interest." While it is believed that the Consortium members still have an economic interest in Iran, the question is not altogether free from doubt. However, such new arrangements, whether or not they continue the companies' economic interests, do not fall within the intent of section 901(f) as described in the Committee's report on H.R. 10612.

Until the enactment of section 901(f) in 1975, there was no reason, from the veiwpoint either of law or fairness, to anticipate that the continuance of an economic interest would be requisite for the allowance of a foreign tax credit for Iranian taxes on profits from purchases of oil under the new agreement. Construction of section 901(f) in a manner which would deny such credits would retroactively and inequitably alter, to the disadvantage of the companies, the financial effect of the 1973 agreement which they entered into in good faith and in reliance on the existing U. S. tax law.

The Iranian government is now insisting on further revision of its agreement with the Consortium companies. The form of such new revision cannot yet be predicted. Other foreign governments are in the process of working out with the oil companies the terms of nationalization of existing concessions. There would seem to be no reason why section 901(f) should be continued in a form which hampers the companies in these negotiations by preventing, or at least casting a cloud on, the use of discounts on future purchases of oil or gas as a method by which the companies can obtain some measure of compensation for the loss of their properties and future profits.

American Independent Oil Company therefore urges the enactment of section 1035(e) of H.R. 10612 as reported to the Senate by the Committee on Finance, in order to make it clear that section 901(f) will not apply to any oil purchase arrangements made at any time in the past or in the future, in connection with nationalization or takeover of the purchaser's properties, provided that such purchaser had an economic interest in the property on or before March 29, 1975. In the interest of clarity, it is suggested that the words "if, on March 29, 1975, the taxpayer has made an investment" be changed to "if, on or before March 29, 1975, the taxpayer had made an investment."

We also suggest that the effectiveness of the amendment should not terminate in 1986. The length of time over which the discounts should be regarded as compensation to the companies for the taking of their rights depends on the per-unit amount of the discount and on other terms of the new agreements, and the period agreed on between the parties should speak for itself as the appropriate period.

MAJOR POINTS IN STATEMENT OF
JAMES Q. RIORDAN, MOBIL OIL CORPORATION

Section 1035(e) of H.R. 10612
Foreign Oil and Gas Extraction Income
Section 901(f) of the Code

1. At the time section 901(f) was drafted, it was widely assumed that the new foreign producing arrangements would follow the equity-buyback pattern in which companies would make a profit on the equity oil but not on the buyback oil. Under this pattern, the taxes paid by U. S. companies that had invested in foreign producing operations would clearly have been creditable, irrespective of section 901(f).

2. Instead of equity-buyback, however, some of the producing governments are moving toward 100% participation, while establishing a new structure for the companies to continue to render service, earn profits and acquire oil. The wording of section 901(f) now creates an additional question, albeit unintended, as to the creditability of all income taxes paid by U. S. companies under these new agreements.

3. Section 901(f) was designed to assure that taxpayers could not manipulate the purchase price of non-profit oil (buyback oil or oil simply purchased from a producing country by a company having no prior connection with the country) to convert a part of the purchase price into creditable taxes. It was not intended to create a problem for U. S. companies which have made prior substantial investments in foreign concessions.

4. It now seems likely that there will be cases where all of the legal title to an existing concession will be taken over by a foreign government and that government, to compensate the former concessionaire for the value of the concession taken, will grant the concessionaire the right to earn a profit by buying at a discount the oil produced from the concession. Although section 901(f) was not intended to deny foreign tax credits in this case, it is unclear whether the oil company has, technically speaking, retained an economic interest in the oil or gas. Also, the determination of whether or not a discount for prior investments is reasonable will usually be difficult.

5. The Finance Committee recognized these problems and resolved them by assuring that at least for a period of time there will be no unintended application of section 901(f).

WRITTEN STATEMENT OF
JAMES Q. RIORDAN, MOBIL OIL CORPORATION

Section 1035(e) of H.R. 10612
Foreign Oil and Gas Extraction Income
Section 901(f) of the Code

My name is Jim Riordan. I am Senior Vice-President Finance of Mobil Oil Corporation. I am pleased to have the opportunity to participate in today's hearing, and to discuss the Finance Committee's amendment to section 901(f) dealing with the foreign tax credit.

There are two basic principles which I feel should guide the Congress in taxing U. S. businesses operating abroad.

First, we should avoid double taxation. Second, U. S. companies operating abroad should be able to compete fairly with foreign companies. We should especially avoid double taxation of U. S. companies when competing French, German, English, Dutch and Japanese companies are not subject to double taxation. For reasons I will explain, there is a risk this will happen to U. S. oil companies as a result of the unanticipated operation of section 901(f). If the availability of the foreign tax credit to U. S. oil companies is impaired, foreign business opportunities will simply fall to our foreign competitors who will not be burdened by double taxation. America's economy will then be doubly dependent upon foreign oil controlled by foreign companies.

As you know, the international oil industry is going through a period of dramatic change. Foreign producing governments are revising drastically the historic relationships which exist with private companies in respect of both established and new exploration and producing operations. When making these revisions it seems clear that those governments assumed that income taxes payable to them under the new arrangements would continue to be creditable against the home country taxes in the U. S., Japan and the European countries.

When the Congress undertook to revise the U. S. tax law in 1975 as it bore on foreign exploration and producing operations, certain assumptions were obviously made about how the new foreign arrangements would evolve and how the U. S. law would be applied to those new arrangements. The U. S. Treasury Department and the Internal Revenue Service are reviewing the U. S. tax law implications of the diverse new arrangements that are now evolving. Furthermore, the Service has begun to re-examine a number of basic foreign tax credit principles that had been established in earlier years, and are beginning to consider the implications of the new provisions added to the law in 1975. It now appears that the U. S. tax assumptions made by the producing countries and the Congress are in doubt, and that certain parts of the 1975 legislation, namely section 901(f), which were drafted under difficult time deadlines, could have unintended application with disastrous and unfair results to U. S. oil companies.

At the time the Congressional draftsmen were working on section 901(f) it was widely assumed that the new foreign producing arrangements would follow the equity-buyback pattern that seemed to be emerging. Under that pattern, profits are made, taxes are paid and tax credits are available on equity oil, but it is assumed that profits are not made and taxes are not paid on buyback oil purchased from the government. Buyback oil was assumed to be purchased from the government and sold to customers at the same market price. In these circumstances, buyback oil gives rise to no tax credits, just as a purchase of a cargo of oil from the government at the market price by a customer with no prior connection with the country, would give rise to no tax credit. Had that happened, the taxes paid by the U. S. companies that had established foreign producing operations would have clearly been creditable under section 901(f). As I understand it, section 901(f) was designed to assure that there could be no manipulation of the purchase price of buyback oil or oil purchased by a company having no prior connection with the producing government by converting part of the purchase price into creditable taxes. It now appears, however, that the equity-buyback pattern will not be universally adopted. Instead, some of the producing governments are moving toward 100% participation, while establishing a new structure for the companies to continue to render service, earn profits and acquire oil. Unfortunately, the wording of section 901(f), designed for the equity-buyback situation, now creates, albeit unintentionally, an added question as to the creditability of all income taxes paid by U. S. companies under these new agreements.

Under section 901(f) no credit is allowed for foreign taxes paid with respect to purchases or sales of oil or gas where the taxpayer has no economic interest in the oil or gas and if the purchase or the sale is at a price other than fair market value. Some believe that section 901(f) is needed to deal with possible "gimmicky" arrangements where the taxpayer has never made a substantial investment in the oil and manipulates the purchase price by converting a part of the purchase price into an income tax. It is my understanding, however, that it was never intended to create a problem for United States companies which earn profits because they have actually made substantial investments in foreign concessions. In some countries that do not adopt the equity-buyback pattern but take over the entire legal title to the concession, the former concessionaire will continue to earn profits through the mechanism of a price discount on oil or gas as compensation for the value of the concession. Section 901(f) was not aimed at disallowing foreign tax credits in this situation since legitimate foreign taxes would be levied on the profit arising from these discounts. It is not clear, however, as the Senate Finance Committee Report points out, whether an oil company would be treated as continuing to have, as a technical matter, an economic interest in the oil or gas in this instance. Also, as the Report states, the determination of whether or not a discount for prior investments is reasonable will usually be difficult.

The amendment to section 901(f) made by the Senate Finance Committee recognized these problems and resolved them by not applying section 901(f) for ten years to transactions involving the purchase and sale of oil or gas from a field if the taxpayer had an economic interest in that field on March 29, 1975 (the date of enactment of the Tax Reduction Act of 1975). Thus, the amendment only protects taxpayers who actually had an economic interest in the oil or gas by virtue of investments made prior to the enactment of the provision and provides such relief for only ten years (through 1984).

On a broader basis the present confusion surrounding the creditability of all foreign taxes convinces me that what we really need is a comprehensive review of the U. S. tax rules relating to foreign income. This review should produce a simple set of rules that are fair and consistent with those established by other nations such as Britain, France, Germany, Japan and the Netherlands. I recognize that we have neither the time nor the facts available to do that review in the course of considering this legislation. We believe, therefore, that the approach adopted by the Finance Committee of assuring at least for a period of time that there will be no unintended application of section 901(f) to situations that were clearly not meant to be covered, is a practical and reasonable solution, albeit one that it is limited and temporary. It is in this context that I support the proposed amendments to section 901(f).

Finally, section 901(f) was added to the law in the 1975 conference. It was not subject to hearings. We understand that section 901(f) was prompted by suggestions made to the staff of the U. S. Treasury Department and Congress by representatives of European governments who were concerned that somehow U. S. companies were going to gain a competitive tax advantage by manipulating purchases of oil from foreign governments. The ultimate irony is that it now appears that section 901(f) may produce double taxation of U. S. companies that will not be borne by foreign companies. If it does so, there will be a competitive advantage for foreign oil companies. These potential foreign beneficiaries of section 901(f) were not publicly identified in 1975. As I understood the thrust of the testimony at the beginning of yesterday's session, under these procedural circumstances, section 901(f) should never have been enacted. For substantive reasons, I believe that it should never have been enacted.

STATEMENT OF
THOMAS C. DRISCOLL
IN SUPPORT OF §1035(f) OF H. R. 10612
DEALING WITH PRODUCTION-SHARING CONTRACTS
SUMMARY OF POINTS

---

1. §1035(f) of H. R. 10612, dealing with oil and gas production-sharing contracts and the foreign tax credit, is needed to give relatively small and medium-sized independents operating in Indonesia a reasonable opportunity to renegotiate their contracts with Indonesia so as to satisfy IRS requirements for allowance of foreign tax credits.

2. The amendment does not reverse Rev. Rul. 76-215, issued on May 7, 1976, but merely postpones its effective date for five years in the case of small and medium-sized independent oil companies operating in Indonesia. The amendment was designed not to benefit the larger oil companies having world-wide operations. The affected companies can probably live with a shorter period of postponement than five years, but a reasonable period is needed so that negotiations with Indonesia do not have to be conducted on a crash basis. The short six-months' transition period given by the IRS in Rev. Rul. 76-215 is just not enough.

3. The affected companies have invested hundreds of millions of dollars in Indonesia on the reasonable assumption

that foreign tax credits were available. The IRS change in position could reduce after-tax profits of these concerns by as much as 50 percent, if the present contracts with Indonesia are not renegotiated in a manner satisfactory to the IRS.

4. Indonesian oil is of considerable strategic and economic importance to the United States. The financial well-being of the independent U. S. oil companies investing in Indonesia is properly a matter of concern to this country.

5. Rev. Proc. 76-215 was issued as the result of a ruling request filed by one of the major oil companies. The smaller companies affected by the postponement of the effective date of the ruling had no opportunity to participate in the development of the ruling, although they are the ones most adversely affected by it.

6. Rev. Rul. 76-215 was published on May 7, after the Finance Committee hearings on H. R. 10612 had been concluded. The smaller independents immediately brought their problem before the Finance Committee and its staff and assisted in the development of the limited amendment embodied in §1035(f) of the bill as reported by the Committee.

7. The Committee' estimate of the decrease in budget receipts for fiscal years 1977 and 1978 resulting from the postponement of the effective date of Rev. Rul. 76-215 is a strong indication the revenue estimators believe it will take

at least two years for the companies involved to work out their problems with Indonesia. There would be no pick up in revenue if new contracts with Indonesia could be negotiated before the end of the year which would meet IRS requirements for allowance of foreign tax credits.

8. Newspaper stories, Senate floor statements and testimony presented to this Committee yesterday have described this amendment as a rip-off and dismissed production-sharing contracts as a "gimmick" used to avoid the 1975 Tax Reduction Act amendments. Those responsible for these misrepresentations are completely uninformed as to the significance of the amendment and the temporary problem it is intended to resolve. For example, Indonesian production-sharing contracts were first entered into in 1966 and in no way were designed to avoid the impact of a tax bill enacted last year. It would be most distressing if the amendment should be stricken from the bill based on such false and misleading representations.

STATEMENT OF
THOMAS C. DRISCOLL
IN SUPPORT OF §1035(f) OF H. R. 10612
DEALING WITH PRODUCTION-SHARING CONTRACTS
BEFORE THE
SENATE FINANCE COMMITTEE
July 21, 1976

- - - - - - - - - - -

My name is Thomas C. Driscoll. I am Chief Financial Officer of Roy M. Huffington, Inc., of Houston, Texas. I have with me Mr. C. W. Leisk, Chairman and Chief Executive Officer of Austral Oil Company, Incorporated, of Houston, General A. A. Sproul, Chairman and President of Virginia International Company of Staunton, Virginia, and Mr. D. L. Commons, President of Natomas Company of San Francisco. We all have one thing in common: our companies are operating in Indonesia under oil and gas production-sharing contracts. Further, each of us is a small or middle-sized independent oil company operating overseas in competition with the largest oil companies in the world, both domestic and foreign.

We appear to-day in support of the Finance Committee amendment of May 27, which added Sec. 1035(f) to the Tax Reform Bill of 1976 (Committee Report, pp. 253-255).

This amendment relates to the foreign tax credit and production-sharing contracts, and is a limited transitional rule which will provide time for the smaller and medium-sized U. S. contractors that have invested substantial amounts of capital in Indonesia to renegotiate their contracts with Indonesia so as to satisfy the requirements of the IRS. A reasonable time to accomplish this task and to clear the proposed changes with the IRS is essential in order to avoid extreme financial hardships which we must otherwise face. It should be emphasized at the outset that this amendment is drafted so that no benefit will inure to the major oil companies.

The problem that has arisen is that the IRS issued a published ruling on May 7 of this year (Rev. Rul. 76-215) which announced the position that U. S. contractors operating under certain production-sharing arrangements are not entitled to a foreign tax credit for payments made on their behalf to the host foreign government and treated by the foreign government as income taxes. The IRS concluded that if a U. S. contractor is operating under the type of agreement described in the ruling, the entire amount paid to the foreign government was a royalty. The effect of the IRS rule is that the U. S. contractor is treated as having paid a royalty to Indonesia ranging from 50 percent to 70 percent, but is regarded as having paid no income tax whatever to the foreign government.

It is important to have an understanding of how these smaller companies got into this problem with the IRS. In the late 1960's and early 1970's Indonesia refused to offer its natural resources for development under the normal type of concession arrangement. Rather, it developed the production-sharing concept. Under this new concept, Indonesia retained control over its natural resources while sharing the benefits of their development with the U. S. contractors which supplied all the capital and technology. This new concept was consistent with the nationalism of a developing country like Indonesia. In general, the major international oil companies rejected the production-sharing contracts and this provided smaller U. S. companies with the opportunity to enter these areas.

The smaller companies have been successful in Indonesia and have invested hundreds of millions of dollars in that country under production-sharing contracts. The joint undertakings of the smaller companies and Indonesia were proceeding in a satisfactory manner until the IRS problem arose in the Spring of this year. It is not our intention to criticize or complain about the actions of the major companies or any single major company. However, it is relevant to the consideration of the proposed amendment that the Committee clearly understand that the IRS developed its ruling as the result of a ruling request filed by one of the major companies and, under IRS procedures, the smaller independent companies, who were most significantly affected by the IRS action, were precluded from any meaningful participation in the process which developed the substantive IRS position. We blame no one for the fact that we were shut out of the IRS substantive considerations. The major company that sought the ruling owed us no duty of consultation and the IRS personnel would probably have acted improperly if they had invited our participation.

The existing production-sharing contracts of the smaller companies which benefit from this amendment were entered into with the reasonable expectation that the foreign tax credit would be allowed. Even the IRS ruling reflects this understanding since the ruling is to apply prospectively only to years beginning after June 30, 1976. The chief problem with this ruling is that the six months' turn-around time given to calendar year taxpayers is just not enough for us to carry out the necessarily protracted negotiations with the Government of Indonesia and to obtain the required clearance of any proposed new arrangement from the IRS.

What the IRS ruling has done is to substantially alter the economic consequences of these existing contracts after the companies have invested large amounts of capital in these operations. If the companies had known that the foreign tax credit was not to be available, the terms of these contracts governing the division of the recovered oil would have been negotiated on a vastly different basis. Primarily, the U. S. companies would have been forced to insist upon a much larger share of the oil and gas to make their operations economically feasible in the absence of a credit for Indonesian tax payments. Had we done so, we probably would not have received our contracts from the Indonesian Government, and the United States would probably not have available to it the substantial amounts of oil being supplied to it to-day from Indonesian sources.

It is important to note that Sec. 1035(f) does not reverse the IRS ruling. The Finance Committee amendment and the Committee Report are silent as to whether the ruling is or is not correct. The amendment merely defers implementation of the ruling with respect to existing contracts for a period of five years. If upon further consideration the Committee should conclude that five years is too long a time to allow for renegotiation of existing production-sharing contracts and their subsequent clearance with the IRS, our companies can probably live with a shorter period such as two or three years. However, we would note that the IRS spent more than two years considering the existing Indonesian production-sharing arrangements before publishing its present position on the subject. The U. S. companies and Indonesia are now engaged in the process of modifying the existing contracts. This is being undertaken because Indonesia is desirous of obtaining a large share of the profits from these operations and both Indonesia and the companies are hopeful of restructuring the contracts so as to resolve the IRS problem. These changes are of the greatest significance to the smaller companies and it is absolutely essential that the new agreements be mutually beneficial to the long-term interests of all involved, including, of course, the companies and Indonesia.

Without the Finance Committee amendment, the smaller U. S. companies will find themselves in a real time bind; we will be forced to strike a new arrangement with Indonesia prior to year-end in order to avoid harsh U. S. tax consequences that will reduce after-tax profits by up to one-half. Such an artificial time constraint severely diminishes the companies' bargaining position and it does so unnecessarily. It may well be that an agreement can be reached with Indonesia by a few companies in the next few months, but a longer period will be needed to complete the renegotiation of all existing contracts. Certainly everyone hopes that the current negotiations can be brought to a rapid and satisfactory conclusion. But it is clear that the prospects of a mutually beneficial agreement will be greatly enhanced if the time available for negotiation can be extended considerably beyond year-end.

If we smaller companies are forced to press for modifications of our contracts on a crash basis, the resulting arrangement may be so unfavorable to us as to make further oil and gas development activities in Indonesia uneconomic. If so, we may have no alternative but to sell our contracts to either the major companies or the oil companies of foreign countries. This can hardly be viewed as being in the best interests of the United States or the taxpaying public.

We note with concern that Senator Bumpers has had printed an amendment to H. R. 10612 (Amendment No. 1979) which would strike Section 1035(f) from the bill. The reason he gives for his proposed amendment is that it is a narrow, special interest provision which is not necessary because the IRS has given us six months to revise our contracts with Indonesia. Last Wednesday, the Service put out a Press Release (IRS Information Release 1638) in which it listed five characteristics that tax payments made to a foreign government by taxpayers engaged in extracting mineral resources owned by the foreign government must have in order to be eligible for the U. S. foreign tax credit. At least 3 and possibly 4 of the 5 factors listed by the IRS call for very basic changes in our production-sharing contracts with Indonesia. It is clearly unreasonable to expect that the necessary modifications to our contracts can be negotiated with Indonesia and approved by our Internal Revenue Service in the five months remaining in this year. All we seek is a reasonable time for negotiations to be carried on in an orderly manner without having a critical time factor as a millstone around our necks.

The question may be asked, why didn't we appear before the Finance Committee on the production-sharing contract matter during the public hearings on the tax bill last March and April? The obvious answer is that we were not sure we even had a problem until the IRS published its ruling on May 7, 1976 that no foreign tax credit would be allowable for Indonesian tax payments for years beginning after June 30, 1976. Thereafter, we immediately brought this matter, which is absolutely vital to our operations, to the attention of the Finance Committee and its staff, and worked with them in developing the very limited amendment set forth in §1035(f) of the bill. This amendment simply postpones the effective date of the IRS production-sharing ruling for those smaller and middle-sized companies that would suffer most from the abrupt change of the IRS with respect to the allowance of foreign tax credit with respect to taxes paid to Indonesia.

A word about the estimated decrease in budget receipts in fiscal years 1977 and 1978 of $23 million and $27 million set forth at page 255 of the Committee Report. These estimates are based on the assumption, erroneous we hope, that the U. S. companies operating in Indonesia will not be able to reach agreement within this two-year period with the Government of Indonesia on new contracts which will clearly permit the allowance of foreign tax credits for Indonesian income tax imposed upon their oil and gas extraction income. As such, the revenue estimates themselves suggest that we should be given at least a two-year transition period to work out our problems with Indonesia.

Finally, I can't close without commenting on the newspaper stories, Senate floor statements and testimony presented to this Committee yesterday, which have described this amendment as a rip-off and dismissed production-sharing contracts as a "gimmick" used to avoid the 1975 Tax Reduction Act amendments. Those responsible for these misrepresentations are completely uninformed as to the significance of the amendment and the temporary problem it is intended to resolve. For example, Indonesian production-sharing contracts were first entered into in 1966 and in no way were designed to avoid the impact of a tax bill enacted last year. It would be most distressing if the amendment should be stricken from the bill based on such false and misleading representations.

SENATE COMMITTEE ON FINANCE
HEARINGS ON CERTAIN FINANCE COMMITTEE AMENDMENTS TO H.R. 10612
JULY 21, 1976

STATEMENT OF JOSEPH H. GUTTENTAG

SOURCE OF UNDERWRITING INCOME
(Section 1036 of H.R. 10612)

SUMMARY OF STATEMENT

1. Determination of the source of underwriting income is important to all U.S. and foreign insurers.

2. The Internal Revenue Code contains no general rule for determining the source of underwriting income but certain rules of specific application provide that such income has its source where the risk is located.

3. The proposed legislation would extend these rules of limited application generally to define the source of underwriting income as the place of the location of the insured risk. Adoption of the proposal would provide a single rule applicable to all provisions of the Code.

4. The "location of the risk" rule eliminates the opportunity for manipulation of the source of underwriting income and helps avoid double taxation of such income. Adoption of any other rule would mean there would be two disparate rules under the Code for determining source of underwriting income -- for no good reason.

5. Adoption of the proposed rule would have minimal adverse revenue consequences. It would result in revenue gain as well as some revenue loss. It would provide for the first time a specific nonmanipulative rule which would simplify the Code and the administration of the tax law.

SENATE COMMITTEE ON FINANCE
HEARINGS ON CERTAIN FINANCE COMMITTEE AMENDMENTS TO H.R. 10612
JULY 21, 1976

STATEMENT OF JOSEPH H. GUTTENTAG

SOURCE OF UNDERWRITING INCOME
(Section 1036 of H.R. 10612)

My name is Joseph H. Guttentag. I am a partner in the law firm of Surrey, Karasik and Morse. I appear here today on behalf of Continental Corporation, Chubb Insurance Company, American International Group, Inc., U.S. Fidelity & Guaranty Co., and the Hanover Insurance Company, in support of the provisions of H.R. 10612 contained in section 1036, dealing with the determination of the source of insurance underwriting income.

Summary

We urge the Committee to adopt this proposal which affects not only the companies for whom I appear, but taxation of all insurance companies, both U.S. and foreign, and, accordingly, has broad applicability. The proposal provides for the first time in the Internal Revenue Code a general rule for determining the source of insurance underwriting income. This rule would not apply to only one or two companies but to the entire internaional insurance industry. It would have the effect of in some cases increasing, and in some cases decreasing, U.S. revenue. The gross and net revenue effects will be negligible. There will be substantial benefits in the administration of the tax laws by having a definitive rule on this subject in the Code for the first time.

Source of Income Rules

Some rules for determining the source of income are set forth in the Code. For example, the Code provides specific rules governing the source of income of interest, dividends, the sale of goods, and the performance of personal services. The Code leaves open the determination of the source of other types of income including insurance underwriting income.

Reasons for Source of Income Rule

The source of income rules are important for many reasons under the Code. The two principal purposes for these source rules are for determining income subject to tax, particularly in the case of foreign individuals and companies whose U.S. tax is measured in whole or in part by the amount of U.S. source income, and secondly, for determining income, the U.S. tax on which may be offset by foreign taxes. Under the foreign tax credit rules, foreign taxes may be credited only against U.S. taxes imposed with respect to foreign source income.

The proposed source rule would be of general application and would be used for determining income subject to U.S. tax, as well as entitlement to the foreign tax credit.

Current Tax Rules Regarding Insurance Income

As explained above, under existing Internal Revenue Code provisions, there is no rule which sets forth the source of insurance underwriting income. Furthermore, there are no regulations which cover this issue. There are, however, other provisions of the Internal Revenue Code under which it is necessary to determine the source of insurance underwriting income. Under Subpart F of the Code, certain underwriting income of controlled foreign corporations is subject to tax. These provisions require a determination of the source of underwriting income, and the Code provides that for these purposes, insurance underwriting income has its source where the risk which is being insured is located. Regulations issued under these provisions of the Code set forth detailed rules for the purpose of determining where an insurance risk is located.

Additionally, the Code imposes an excise tax on insurance premiums paid to certain foreign insurers. While this is an excise tax, it is designed to replace the usually applicable withholding tax imposed by the United States on foreign individuals and companies not engaged in trade or business in the United States who receive U.S.-source income. For the purpose of the excise tax, U.S.-source insurance premium income is defined in terms of where the risk is located.

While the Internal Revenue Code does contain the above rules which determine the source of underwriting income as the place where the risk is located, these rules are of limited application. The Internal Revenue Service has issued only one published ruling with respect to the general rule as the source of insurance underwriting income. This ruling was issued in 1922, and could be interpreted to mean that the place of negotiation of the insurance contract is determinative of the source of the income. The ruling, however, is over fifty years old, involves an unusual factual situation, and is of doubtful precedential value.

Avoidance of Double Taxation

If the current IRS position were to be followed, U.S. companies insuring foreign risks may be subjected to double taxation.

Many of the major general insurance companies incorporated in the United States receive a portion of their business from brokers or agents situated in the United States, covering risks which are located exclusively outside the United States (hereinafter referred to as "Home Foreign Accounts").

Typically, a United States corporation or broker representing such corporation will approach a U.S. incorporated insurance company or its agent to provide insurance for the corporation's worldwide (excluding the United States) operations. The insurance risks covered may be exclusively those situated outside the United States and frequently are the risks of the foreign subsidiaries of the insured U.S. companies. The insurance companies, under an overall binder issued on the Home Foreign Account may cover property and other risks of the U.S. corporation and/or its foreign subsidiaries, and the insurance losses may be payable either in U.S. dollars or the currency of the country which the foreign risk is situated.

Frequently, the foreign subsidiary insured (rather than its U.S. parent) will pay the premiums in order to obtain an income tax deduction in the jurisdiction in which such subsidiary is incorporated and doing business. Also, in many instances, a policy covering the Home Foreign Account risk must be issued in the foreign jurisdiction in which the insured's risk is located in order to comply with the local insurance laws of such country or the requirements of the insured. In both these instances, the underwriting income derived from the Home Foreign Account would be subjected to foreign income taxation but would generate U.S. source income under the Internal Revenue Service's present position, thus prohibiting the utilization of foreign income taxes paid on such income as credits against the U.S. tax liability on such income. This results in double taxation. Adoption of the proposed rule would not affect the taxation by the U.S. of brokerage fees paid on such foreign risks. Such fees paid for services rendered in the U.S. would remain U.S. source income. Only the pure underwriting income would have its source where the risk is located.

Various Underwriting Income Source Rules Considered

The Congress now has the opportunity to set forth a definitive rule of general application to resolve the issue once and for all, and to avoid further administrative problems of determining tax liability.

There are various rules which could be adopted for determining the source of insurance underwriting income. Some of these rules are as follows:

1. The location of the risk that is being insured.

2. The location of the headquarters of the taxpayer issuing the policy.

3. The domicile of the taxpayer issuing the policy.

4. The place where the contract is negotiated or executed, or where other activities with respect to the generation of the business take place.

5. The place where the premium is paid or received.

Reason for Adopting Situs of Risk Rule

It is our position that for the reasons set forth below Congress should adopt a rule, as presently set forth in section 1036 of the pending Bill, which would define the source of underwriting income as the place where the insured risk is located. We believe that this is the most appropriate rule for the following reasons:

1. Several of the other possible rules set forth above can with facility be manipulated by taxpayers to place the source of the income artificially in one jurisdiction or another. Included in this category would be the rules which define the source in terms of the place where the contract was negotiated or executed, or the place where the premiums were paid or received. For example, if a place of negotiation rule were adopted, the source of income could be manipulated to generate foreign income simply by negotiating and executing a policy outside the United States insuring a building located in the United States which is both owned and insured by U.S. companies and where payments of premium and losses were made in the United States in U.S. dollars.

2. Other alternative rules set forth above should have no bearing on the source of the underwriting income subjected to tax as there is little connection between the criteria suggested and the income generated.

3. The situs of the risk rule would be consistent with the rules of many foreign countries which, through a combination of laws, effectively tax insurance income based on the place where the insured risk is located.* In some cases, however,

---

* Among these countries are Australia, Argentina, Brazil, Denmark, France, India, Jamaica, Japan, Pakistan, Spain, Sweden and Switzerland

under this rule, an insurer could be subject to tax by its country of residence on a worldwide basis (as in the U.S.) and by a country in which it has an insurance writing office. This problem has been recognized and resolved by tax treaties, including the pending U.K. treaty and the model U.S. treaty prepared by the Treasury Department.

4. Adoption of the proposed rule would help to eliminate double taxation since, as explained above, a rule related to the situs of risk would be consistent with taxing rules of other jurisdictions. When such jurisdictions do tax insurance income, which is also subject to U.S. tax, the United States would grant a credit for such taxes. Conversely, when foreign companies are subject to tax on insurance income earned with respect to insurance U.S. risks, they would be more likely, under the terms of applicable tax treaties or their domestic law, to avoid double taxation.

5. Adoption of this rule would be consistent with existing provisions of the Internal Revenue Code under sections 953 and 4371. These existing sections provide respectively that for purposes of Subpart F of the Code, and for purposes of the insurance premium excise tax, insurance underwriting income has its source where the risk is located.

6. As opposed to other rules which could be adopted, the location of the risk rule is also the most practical and realistic rule in that the location of the risk is the also the place where ancillary services in connection with the placing of the insurance would be performed. For example, prior to the

insurance contract being written, the insurer may inspect the property or hazard being insured to determine the risk involved. After the contract is written, the insurer may make periodic "onsite" inspections. Servicing of the insurance contract and claims adjustment in the event of loss would most likely take place at such location.

7. The situs of the risk rule would also substantially conform to rules adopted by the National Association of Insurance Commissioners. The rules are used for state regulatory purposes and for certain purposes under the Internal Revenue Code. See, e.g., New Hampshire Fire Insurance Co., 2 T.C. 708 (1943), aff'd. 146 F.2d 697 (1st Cir., 1945); Section 832(b)(6), IRC.

Effect of Adopting Situs Rule

Adoption of the proposed rule would have the following effect:

1. The rule is more likely to be internationally compatible than other rules which might be adopted.

2. Such a rule would tend to avoid double taxation.

3. For the first time, the Internal Revenue Code would contain a generally applicable rule with respect to insurance underwriting income which would apply both to United States and to foreign taxpayers.

The adoption of this rule would not have significant revenue impact. Based on a survey of over twenty United States companies, which are the major insurers of foreign risk, we estimate that the revenue loss with respect to such companies would not exceed $2.5 million. On the other hand, adoption of this rule would also serve to increase the U.S. tax on the income of foreign companies insuring U.S. risks. Furthermore, any income earned in the U.S. by brokers or agents for services in connection with the negotiation and execution of the contract would remain fully subject to U.S. tax as U.S. source income.

This estimate as well as a statement in support of the proposed legislation was originally presented to the Staff of the Joint Committee of Internal Revenue and U.S. Treasury Departments by letters dated May 6, 1976, by several insurance companies, and has been available for inspection by any interested person. The problem was considered and acted upon by the Senate Finance Committee. During the consideration of the proposal, Dr. Woodworth stated before the Committee that the proposal represented the better rule, as it avoided artificial manipulation by taxpayers. The proposal is a tax reform measure.

Joseph H. Guttentag
Surrey, Karasik and Morse
1156 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 331-4060

74-830 O - 76 -- 22

STATEMENT OF WILLIAM M. HORNE, JR.

ON BEHALF OF

THE AMERICAN BANKERS ASSOCIATION

BEFORE THE

COMMITTEE ON FINANCE

OF THE

UNITED STATES SENATE

ON THE SUBJECT OF

WITHHOLDING ON FOREIGN-OWNED DEPOSITS IN U.S. BANKS

JULY 21, 1976

I am William M. Horne, Jr., Chairman of the Taxation Committee of the American Bankers Association. I appreciate this opportunity to testify on behalf of the American Bankers Association before the Committee on Finance on the exemption from the 30 percent withholding tax for interest on deposits in U.S. banks owned by foreign individuals and corporations, which are unrelated to a trade or business in the U.S.

Section 861(c) of the Internal Revenue Code contains an exemption for this bank deposit interest, which expires on December 31, 1976. This exemption would be made permanent under § 1041(c) of the Tax Reform bill, as passed by the House and approved by this Committee. In our testimony before this Committee on March 26, 1976, the American Bankers Association urged the Senate to make the exemption permanent. Again, we urge the adoption of the permanent exemption, and we continue to stress the importance of this provision to the U.S. economy.

As we pointed out in our testimony before the Committee on March 26, 1976, the interest on foreign-owned deposits has been exempt from U.S. tax for more than half a century. For 45 years (1921 to 1966) the exemption was permanent. Beginning in 1966, the Congress made the exemption temporary by imposing a definite termination date. Since 1966, the Congress has reviewed the exemption several times, and has extended the termination date each time because of the impact on the balance of payments.

This longstanding exemption is not "special interest" legislation. Quite to the contrary, it is of importance to the economy. There are many banks and other financial institutions that are vitally interested in the continuance of the exemption for interest on foreign-owned deposits. Banks in states bordering Mexico, the Caribbean area, and Canada, and banks in regional banking states and money center states (i.e., NY, Ill., Mass., Cal., Penn., Ga., Tenn., NC, and Wash.) which have substantial foreign-owned deposits are vitally concerned with this issue.

Because the exemption expires in less than six months, banks with foreign-owned deposits have been receiving increasing numbers of inquiries from their foreign depositors concerning the tax status of their interest bearing time and savings accounts. Because of this uncertainty, these deposits are in danger of being withdrawn and deposited with foreign banks.

Foreign-owned deposits in U.S. banks take the form of time deposits, with maturities ranging from 30, 60, 90, 180 days to one year, and passbook savings accounts. Also involved in this issue is a probable loss of a substantial volume of non-interest bearing demand deposits owned by the same foreign individuals who maintain time and savings deposits in U.S. banks.

The average holdings of non-negotiable interest-bearing deposits in U.S. banks by foreigners other than official institutions was approximately $6.1 billion in 1975.

At the outset, we seriously question the accuracy of the Committee's statement that the continued exemption of these foreign-owned deposits will produce a decrease in tax liabilities and budget receipts. The Committee's Report on H.R. 10612, at page 261, states as follows:

> It is estimated that these provisions will result in a decrease in tax liability of $8 million for calendar year 1976, and $130 million for calendar year 1977. In 1977, $20 million is attributable to the exemption for nonbank account interest, and $110 million is attributable to the exemption for bank account interest. (Emphasis added.)
>
> This provision will reduce budget receipts by $73 million in fiscal year 1977, $137 million in fiscal year 1978, and $183 million in fiscal year 1981.

Similarly, the Report of the House Ways & Means Committee on H.R. 10612, at page 239, estimates that the revenue loss attributable to the exemption of bank deposit interest would be $110 million for the taxable year 1977.

Our reason for taking issue with the estimated revenue impact of the bank interest exemption contained in the Senate and House Reports is based upon the following considerations.

A number of countries, such as Canada, the United Kingdom, Germany, the Scandanavian countries, Belgium, etc., have tax treaties with the U.S. which contain reciprocal provisions relating to withholding-at-source on interest. For a majority of these countries, all interest is exempt from withholding. The remainder of these treaties provide a lower withholding rate of 5, 10, or 15 percent on the interest paid to residents of the respective treaty country.

Some unknown but presumably significant portion of the non-governmental foreign deposits in U.S. banks are owned by residents of foreign jurisdictions with which the U.S. does not have any tax treaty provisions relating to interest. It is safe to predict that virtually all of these highly mobile short-term deposits, in absence of a withholding exemption, would flow out of the U.S. into investment in countries which do not tax foreign-owned short-term funds. Thus, if a U.S. withholding tax were imposed on foreign-owned deposits, the resulting outflow of these funds from U.S. domiciled banks would cause the projected source of revenue to largely disappear.

While the withdrawal of foreign deposits would add nothing to Treasury receipts, however, it could be positively detrimental to the U.S. economy. In a real sense, foreign nationals who deposit funds in U.S. financial institutions are investing in the United States. The institutions channel deposits into mortgages that support construction of new housing and the sale of existing homes, into loans to businesses for inventory accumulation and investments in modernized or expanded productive capacity and to the purchase of securities issued by both the federal government and the governments of states and localities. If these funds are deposited in foreign banks, they would be employed in the Eurodollar market.

The Federal Reserve controls the total amount of deposits in the nation's commercial banks through its open-market operations, changes in reserve requirements, and changes in discount rates and availability. But it cannot control the way the total amount of funds in the economy is employed. Inflows of foreign funds make a meaningful contribution to investment spending. It would be counterproductive to terminate this contribution by imposing a tax that would raise no revenue.

A permanent exemption, as provided by H.R. 10612 as it passed the House and was approved by the Senate Finance Committee, would remove the continuing uncertainty in U.S. tax policy --- which has existed since 1966 --- for attracting foreign funds for investment in the U.S. through the bank deposit mechanism.

Accordingly, the American Bankers Association urges the Senate to approve the permanent withholding exemption for interest on foreign-owned bank deposits, as provided by Section 1041(c) of H.R. 10612.

Summary of Statement of Tom C. Frost, Jr.
Chairman of the Board, Frost National Bank
In Support of Section 1041(c) of H. R. 10612

July 21, 1976

1. Section 1041(c) would extend permanently the exemption from U. S. tax on interest on bank deposits owned by foreign persons--a provision that has been part of U. S. tax law since 1921.

2. This legislation is fully supported by the Treasury Department. It was considered by the Ways and Means Committee, was passed by the House of Representatives, and testimony was received by the Senate Finance Committee.

3. It is estimated that about $6.5 billion of time deposits in U. S. banks are held by foreigners. This money is on deposit in banks throughout the country, and benefits the communities of all of those banks.

4. If present law is not extended, a large outflow of funds can be expected to the detriment of the nation and the communities in which the depository banks are located.

Statement of Tom C. Frost, Jr., Chairman of the Board
Frost National Bank, San Antonio, Texas,
Submitted to the Senate Finance Committee
In Support of Section 1041(c) of H. R. 10612

July 21, 1976

My name is Tom C. Frost, Jr., and I am Chairman of the Board of Frost National Bank of San Antonio, Texas. I am appearing in support of Section 1041(c) of H. R. 10612, the Tax Reform Bill, which would amend Section 861(c) of the Internal Revenue Code. Section 1041(c) would extend permanently the exemption from U. S. tax on interest on bank deposits owned by foreign persons--a provision that has been part of U. S. tax law since 1921. This extension is supported by Treasury.

Mr. Chairman, I want to set the record straight, since some have charged that enactment of this provision would fall into the category of "special interest" legislation, and may not have been fully considered by the Congress prior to the time it appeared in the Senate Finance Committee bill dated June 10, 1976.

The record shows careful consideration of this issue by the House Ways and Means Committee, the full House, and this Committee. First, with respect to testimony, the American Bankers Association and Mr. Max Mandel, Chairman of the Executive Committee, Laredo National Bank of Laredo, Texas, appeared on this issue before the House Ways and Means Committee last year.[1] Second, I testified before the Subcommittee on International Finance and Resources of the Senate Finance Committee on March 1, 1976, on this same subject.[2] Third, on April 22, 1976,

---

[1] Public Hearings before the Committee on Ways and Means, House of Representatives, 94th Congress, on the subject of Tax Reform, Vol. 1, page 362, et seq., and Vol. 4, page 2571, et seq.

[2] Hearing before the Subcommittee on International Finance and Resources of the Committee on Finance, United States Senate, 94th Congress, March 1, 1976, page 38, et seq.

I submitted testimony on this issue to the Finance Committee during consideration of the Tax Reform Bill, H. R. 10612. Others, I am sure, also provided the Committee with comments on the issue.

Moreover, the issue came before this Committee after close scrutiny by the House of Representatives. An amendment adopted on the floor of the House struck part of Section 1041 of the Ways and Means bill, but left the permanent exemption relating to bank deposits (Sec. 861(c) of the Internal Revenue Code) intact.

I submit that the House Ways and Means Committee, the full House, and the Senate Finance Committee, have all recently discussed and debated this issue and concluded that permanent exemption is the best solution to the problems faced. This conclusion comes after repeated extensions of the law. I believe the exemption was a part of the Code from as far back as 1921, and when Congress in 1966 reviewed Sec. 861(c) in the Foreign Investors Tax Act of 1966, it extended the exemption through the end of 1972. The next review brought an extension through the end of 1975, and again in 1975 Congress extended the provision through the end of 1976. After repeated extensions of this statute, Mr. Chairman, I submit that the House and this Committee are correct in recommending that the exemption be made permanent.

Now let me dispel any thought that continuation of this provision would benefit a select few.

The ABA estimates that about $6.5 billion of time deposits in U. S. banks are held by foreign individuals or businesses. The totals are, of course, much smaller for the Southwestern banks, but I can personally testify to the tremendous significance of such funds, the biggest portion of which comes from citizens of Mexico and other Latin American countries. From my 25 years of banking experience in this market, I have concluded that the deposits provide a strong and stable base for extension of credit to domestic borrowers.

However, if the provision is not extended, a very large portion of these deposits will be shifted to banks in other countries--countries which require no payment of tax on the interest earned. Who will benefit? Banks and borrowers in those other countries. Who will suffer? Potential borrowers--business, consumer, and agricultural--from banks in the United States. For the simple fact is that we cannot lend what we do not have.

This is not simply theory. With the exemption due to expire next December 31, many foreign investors are carefully reconsidering the redeposit of these funds. This has occurred in the past as the various temporary extensions have approached expiration. And it is a compelling reason why this most worthwhile and defensible provision of the tax law should be made permanent.

Mr. Chairman, the provision has great merit; it was drafted, debated and passed in full public view; and in no way can it be said to benefit "special" or "narrow" interests--unless indeed the millions of borrowing customers of the affected banks are so classified.

I shall be happy to respond to questions.

* * * * * *

Statement of Tom C. Frost, Jr., Chairman of the Board
Frost National Bank, San Antonio, Texas,
Submitted to the Senate Finance Committee
In Support of Section 1041 of H. R. 10612
April 23, 1976

I am Tom C. Frost, Jr., Chairman of the Board of Frost National Bank of San Antonio, Texas. I appreciate the opportunity to submit my statement to this Committee in support of Provision 1041 of HR 10612 exempting from income tax the interest paid on deposits by commercial banks to non-resident aliens not doing business in the United States. This Provision also exempts these deposits from estate taxes.

This Legislation is important not only to the individual banks in the major money centers and in locations bordering Canada, Mexico, and the Carribean who receive the deposits, but also to the economies served by these banks. As evidence of the significance of this, The American Bankers Association in testimony before the House Ways and Means Committee in support of this Legislation on July 9, 1975, estimated these deposits at approximately six and one-half billion dollars. I personally can testify to the significance of these deposits to the economy of San Antonio and South Texas. During my 26 years of banking experience in this market and through conversations with bankers in other areas such as Florida, Arizona, and other money centers, I have observed that these deposits have been a good stable base for the extension of credit to domestic customers.

This exemption from taxes has been in effect since 1921 and was on a permanent basis until 1966. For the last ten years Congress has recognized repeatedly the benefit of these funds to our domestic economy and the need to maintain this exemption to protect this source of deposits by several extensions of the law.

Previous Congressional action is consistent with the conclusion that these deposits would not remain deposited with domestic banks in the United States without this exemption since other countries whose banking systems and economies are attractive to the potential depositors do grant similar exemptions. I refer to the United Kingdom, Canada, the Bahamas, Switzerland, Belgium, Germany, and the Netherlands as examples. Legislative action has supported the position that if the normal withholding taxes are extended to the interest earned on these deposits and estate taxes are levied on them upon death of the depositor that a significant amount of these deposits would leave this country and their benefit would be lost to us. In considering the extension of this law on previous occasions, Congress has also concluded that the outflow of these funds would cause a significant adverse affect on the balance of payments.

Ten years of repeated extensions have caused the depositors of these funds to be aware of these expiration dates. These deposits are now more sensitive than before to this exemption from taxes. Our bank has had direct experience with depositors who are carefully renewing their time deposits to mature within the present expiration date, December 31, 1976. In conversations with other bankers, similar experiences are occurring. It can be seen that a good and continuous stable deposit source has been affected adversely. Many depositors are carefully reconsidering the redeposit of these funds because of the expiration of this law. These monies then must be treated in a different light by the bankers who receive them. We in San Antonio and many banks in Texas have had a stable and normal source of funds from citizens in Mexico and have used these deposits to finance needs in the local economy. Under the present circumstances with the exemption from taxes on these deposits not on a continuous basis, we may have to look upon them as less permanent and stable. Thus they might not be used for the same long-term beneficial credit purposes if the exemption from taxes is not made permanent.

It is my opinion and the opinion of many other bankers involved in dealing with these funds that little additional revenue, or none at all, may be gained by taxing this source. First, a significant amount of the deposits would leave and would not be subject to any tax whatsoever. Secondly, the banks which handle these deposits could not gain a profit on these deposits which were withdrawn thereby reducing the taxes which might be paid by the recipient bank.

Next, any jeopardy of these funds penalizes the smaller banks without offshore operations to a greater extent than those larger banks in the major money centers who could entice their depositors to transfer these funds to a foreign branch in a country which does grant the exemption on a continuous basis. Foreign branch funds currently are not recycled to the domestic economy but are lost to the United States. The result would be an inequity favoring the larger banks.

It is my understanding that this committee may be asked to consider a proposal to exempt from taxes the income from certain other portfolio investments such as stocks and bonds held by non-resident aliens. I would like to point out that my remarks are directed to the making permanent an exemption which has existed since 1921 on the passive and short-term vehicle of commercial bank deposits only.

I should like to submit to you for your records as additional information in support of Provision 1041 of HR 10612 a letter dated November 28, 1975, from Max Mandel, Chairman of the Executive Committee of the Laredo National Bank, Laredo, Texas, to Senator Russell B. Long, Chairman of the Finance Committee.

In conclusion, I ask that you agree that Provision 1041 of HR 10612 is beneficial to the general domestic economy of the United States and that this Provision be adopted by the Senate as passed by the House so that the exemption is on a permanent basis without an expiration date. I would also respectfully suggest that reasonably prompt action is needed since the present exemption expires December 31, 1976. At this time banks are experiencing a reluctance on the part of depositors to extend time deposits to mature after this date.

I will be happy to attempt to answer any questions or obtain any additional information which you might desire. Thank you for the privilege of appearing before you.

TESTIMONY ON BEHALF OF

H. H. ROBERTSON COMPANY

STATEMENT OF

MICHAEL ABRUTYN
SPECIAL TAX COUNSEL
TO
H. H. ROBERTSON COMPANY

July 21, 1976

SUMMARY OF PRINCIPAL POINTS OF SUPPLEMENTAL TESTIMONY

ON BEHALF OF

H. H. ROBERTSON COMPANY

1. This testimony supplements earlier testimony before this Committee in order to correct certain subsequent inaccurate descriptions of the effect of the amendment. The prior testimony fully analyzed the problem which was also carefully considered by the Staff of the Joint Committee on Internal Revenue Taxation and the Treasury Department with adequate time for thorough study and full disclosure indicating that the proposal was being submitted on behalf of Robertson.

2. Congressional relief from double taxation is appropriate where it was inadvertently caused by the technical working of the tax law and the insistence of the Commissioner upon using inappropriate standards in circumstances where review of the Commissioner's judgment was prohibited.

3. The amendment does not provide for a totally tax-free liquidation of a foreign subsidiary, but limits the amount required to be included in income upon liquidation of a foreign subsidiary to historical earnings minus declared dividends so that double taxation will not occur.

4. The Court decision defined the term earnings and profits. This amendment will not overturn the Court's definition of that term.

5. From its inception to its liquidation the foreign subsidiary earned $9.1 million and the total amount of its income which was included in Robertson's income as a dividend was $10.7 million. The amendment would limit the total amount to $9.1 million.

STATEMENT OF

MICHAEL ABRUTYN, ESQUIRE
On Behalf Of
H. H. ROBERTSON COMPANY

Before The

COMMITTEE ON FINANCE, UNITED STATES SENATE

July 21, 1976

We would like to thank the Finance Committee for affording the H. H. Robertson Company ("Robertson") the opportunity to submit additional material and to testify for a second time with respect to the Senate amendment to H.R. 10612 which relieves it from the harsh result of double taxation. The circumstance resulting in Robertson having $1.6 million of income being subject to double taxation, which circumstance is similar to a wage earner being taxed upon $10,700 of salary income where the actual salary is only $9,100, was previously fully, openly and publicly discussed in testimony before the Finance Committee on March 26, 1976, and was fully considered by both the staff of the Joint Committee on Internal Revenue Taxation and the Treasury Department with adequate time for a thorough analysis. The written statement of Mr. Robert E. Holmgren, Vice President, H. H. Robertson Company, and Robert T. Cole, counsel to Robertson, both dated March 26, 1976, submitted for the record in connection with their earlier oral testimony included an attachment of an extensive 57-page technical printed brief discussing the issue. All of the material clearly indicated that the proposed amendment was being submitted on behalf of Robertson. Since that material fully sets forth a technical explanation and analysis of the intermeshing of the complex rules which created this unwarranted double taxation, the explanation will not be repeated. Also, the reason for this amendment was correctly described on the top of page 270 of the Report of your Committee. The purpose of this supplemental testimony is to correct certain misleading descriptions of the effect of this amendment (section 1042(c)(3)).

Overruling a Court Decision

The description of this amendment as overruling a court decision may lead to the erroneous implication that a court carefully considered the issue presented and that justice, which is generally provided by our court system, is now being overturned by precipitous legislative action. This is simply not the case. The court decision is not being overruled, although obviously the result will be altered.

The issue presented to the court arose in the following way: When Robertson liquidated its U. K. subsidiary and applied for a section 367 ruling from the Commissioner, the Commissioner, pursuant to his unilateral and absolute authority granted under section 367, extracted the so-called section 367 "toll-charge" in the form of a condition to the favorable issuance of the ruling. The condition was geared to the standard of "earnings and profits." The decision to use the standard of earnings and profits was totally and absolutely within the sole discretion of the Commissioner with no availability for court review. Although Robertson assented to the condition, it interpreted the term earnings and profits in a manner which was different than the interpretation of the Commissioner. Earnings and profits is a term of art used throughout the tax law. Ultimately, the issue as to the proper interpretation of that term was litigated and the government's interpretation prevailed. However, the litigation did not deal with, discuss or in any way involve the question as to whether the Commissioner's insistence upon using the standard of earnings and profits as the basis for the condition was appropriate. That question was not (and could not have been) litigated.

The provision in the bill merely provides that in the Robertson circumstances, earnings and profits is not the appropriate standard upon which to base the condition because it can produce an inequitable result. The bill in no way alters the definition of earnings and profits as clarified in the Robertson litigation.

Additionally, it is noted that unlike the circumstances that were presented to Robertson in that it could not dispute the use of the standard of earnings and profits, the present bill provides that taxpayers who feel the Commissioner is basing the toll charge condition on inappropriate standards can present the issue to a court for review.

Nontaxable Liquidation of Foreign Subsidiary

The description of this amendment as resulting in an income tax refund to Robertson attributable to a tax-free liquidation could leave the erroneous implication that the amendment would improperly provide for a totally tax-free liquidation of a foreign subsidiary. Again, this is simply not the case.

The income earned by Robertson's U.K. subsidiary was not subject to tax in the United States on a current basis. Only declared dividends were subject to U.S. tax. When Robertson decided to liquidate its U.K. subsidiary, it recognized that this deferral would end and it would have to include an amount in its income attributable to the deferred earnings. As computed by the Internal Revenue Service under its toll-charge standard of earnings and profits (as defined by the court), the amount required to be included in Robertson's income was equal to approximately $2.9 million, whereas under the toll-charge standard of the bill, the amount required to be included in Robertson's income would be equal to approximately $1.3 million. From its inception to its liquidation the U.K. subsidiary earned $9.1 million and after the IRS toll-charge the total amount included in Robertson's income was $10.7 million. The inclusion of $1.3 million in income is certainly not a circumstance where the taxpayer was urging to have the liquidation on a totally tax-free basis. Since the difference between the two numbers is approximately $1.6 million of income, the tax effect of the amendment would result in a refund to Robertson of approximately $800,000 and not, as has been described, $1.6 million.

Conclusion

Since our tax system is complex and not a perfect mechanism, it can and often does operate inadvertently to produce an incorrect result in circumstances not foreseen when the specific statutory provisions were enacted. This is particularly the case when domestic principles are applied in the international area. A linchpin of our self-assessment tax system is the ability of Congress to provide specific relief where the technical operation of the tax law produces inequitable, inappropriate or unintended results, or when the Internal Revenue Service overreaches or applies inappropriate standards. This safeguard insures taxpayers that Congress will serve as a court of last resort when the tax system operates defectively.

The reasons Robertson was subject to double taxation, which is not sanctioned by our tax system, was because of (1) a technical intermeshing of several provisions of the tax law in the foreign area which were designed for other purposes, and (2) the insistence of the Commissioner on applying an inappropriate standard in a circumstance where the taxpayer had no opportunity for review. Under such circumstances, Congress is the only forum where relief can be provided. We respectfully suggest that the Senate amendment properly grants such relief.

STATEMENT OF ROYAL BANK OF CANADA
IN SUPPORT OF SECTION 1044 OF H.R. 10612

This material is presented by Sage Gray Todd & Sims, 140 Broadway, New York, New York, 10005, and Miller & Chevalier, 1700 Pennsylvania Avenue, N.W., Washington, D.C. 20006, which are registered under the Foreign Agents Registration Act of 1938, as amended, with the Department of Justice, Washington, D.C., as agents of a foreign principal, the Royal Bank of Canada, Montreal, Quebec, Canada. This material is filed with the Department of Justice, where it is available for inspection by the public. Registration by the above-named agents of a foreign principal, as required by the Foreign Agents Registration Act of 1938, as amended, does not indicate approval by the United States Government of the contents of this material.

SUMMARY OF
STATEMENT OF ROYAL BANK OF CANADA
IN SUPPORT OF SECTION 1044 OF H.R. 10612

Section 1044 corrects an anomalous result inadvertently created by the Tax Reform Act of 1969. Prior to 1969, domestic banks were permitted to treat gains on the sales of debt instruments as capital gains, while treating losses on such sales as ordinary losses. In 1969, Congress sought to prevent abuse of that provision by requiring all such gains and losses to be treated as ordinary gains or losses.

The 1969 Act also applied to foreign banks, which had been recognizing capital gains and losses from such transactions, and which therefore, unlike domestic banks, had carryovers of capital losses from pre-1969 transactions. Because post-1969 ordinary gains on such transactions could not be offset by capital-gains carryovers, an unintended result of the 1969 Act was to prevent foreign banks from using those carryovers.

Section 1044 would correct this oversight by permitting foreign banks to treat gains on the sales of debt instruments as capital gains to the limited extent necessary to permit the normal five-year carryover of pre-1969 capital losses. Thus, enactment of section 1044 would vindicate the basic principle that a taxpayer is taxed only on net income, and would grant foreign banks the rights already enjoyed by domestic banks.

Section 1044 resolves an inequity that the Royal Bank of Canada presented to the House Ways and Means Committee in public hearings in 1973, and again in 1975. A House bill was introduced, and the Treasury Department issued a favorable bill report. The problem was carefully considered by the House Ways and Means Committee, and section 1044 was included in the Tax Reform Bill to correct the inequity. It should in all events be retained in H.R. 10612.

July 20, 1976

Ralph K. Smith, Jr.
Sage Gray Todd & Sims
New York, N. Y.

John S. Nolan
John S. Nolan
Miller & Chevalier
Washington, D. C.

STATEMENT OF ROYAL BANK OF CANADA
IN SUPPORT OF SECTION 1044 OF H.R. 10612

Prior to 1969, a domestic bank was permitted by section 582(c) to treat net losses on sales or exchanges of bonds and other debt instruments as ordinary losses, while treating net gains as capital gains. In its consideration of the Tax Reform Act of 1969, Congress found that this nonparallel treatment had encouraged banks to time their dispositions of debt instruments so as to recognize gains (as capital gains) in selected years and losses (as ordinary losses) in other years, thereby circumventing the netting principles of the Internal Revenue Code and obtaining "preferential treatment over other taxpayers". H. Rep. No. 91-413 (Part 1), 91st Cong., 1st Sess. 129-30 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 167 (1969). Indeed, domestic banks had thus gained preferential treatment even over foreign banks, which were not covered by section 582(c) and which were thus required to treat both gains and losses as capital gains or losses.

Congress reacted to this abuse by amending section 582(c) to require both gains and losses on such transactions to be treated as ordinary gains or losses for taxable years beginning after July 11, 1969. P.L.

74-620 O - 76 -- 24

91-172, §433(a), 83 Stat. 623 (1969). The impact on domestic banks, with respect to debt instruments held on July 11, 1969, was mitigated by the transitional rule of section 582(c)(2), which provided for capital gains treatment for a prorated portion of the excess of long-term gains over short-term losses.

Section 582(c), as amended, however, applied not only to domestic banks, as it had before 1969, but to "financial institutions," including foreign banks, small business investment companies, and business development corporations. Small business investment companies and business development corporations were provided a transitional rule, which made the application of section 582(c) optional for five years. In other words, such taxpayers were permitted to treat their gains and losses as either ordinary or capital, so long as gains and losses were treated alike.

Congress neglected, however, to provide any transitional rule for foreign banks. Those banks, which had never been guilty of the abuses that prompted the 1969 legislation, suddenly became subject to severe financial hardship. As required by law, the Royal Bank of Canada, before 1969, had consistently given parallel treatment to such gains and losses, treating them as capital gains or losses. During its fiscal year ending October 31, 1969, the Bank realized substantial losses from the sale of bonds, and reported a net capital loss. Principles of netting, reflected in section 1212, dictated that the Bank would have a capital-loss carryover to the succeeding five fiscal years. These, significantly, were the same principles of netting that guided the congressional committees in 1969 when they sought to prevent the abuses of the domestic banks. Indeed, in its fiscal year ending October 31, 1970, the Royal Bank of Canada did have substantial gains on the sale of bonds, against which it would normally have been entitled to apply its capital-loss carryover. Nevertheless, because those gains were treated as ordinary gains under the new rule, the capital-loss carryover could not be used.

This unfair result could have been avoided only if the Bank had realized sufficient capital gains from other sources within five years of October 31, 1969. But the Bank, being a foreign bank, holds very few other capital assets in the United States, and its capital gains during the five-year period therefore fell far short of its pre-1969 carryover, which therefore went largely unused.

It is essential that this problem be viewed in proper perspective. Domestic banks, whose abuses had given rise to the 1969 amendment, had no problems with pre-1969 capital-loss carryovers, because their pre-1969 losses had been recognized (or carried over) as ordinary losses. Small business investment companies and business development corporations could avoid losing the benefit of pre-1969 capital-loss carryovers, by electing during the five-year period to treat gains from the sale of bonds as capital gains. Significantly, this is the same five-year period as that prescribed for capital-loss carryovers under section 1212. Foreign banks, such as the Royal Bank of Canada, however, were given no option, but were required to treat post-1969 gains on bonds as ordinary income. Moreover, such foreign banks, simply because they were foreign banks, with limited domestic holdings, found themselves with very few other opportunities to use their pre-1969 capital-loss carryovers. In other words, the taxpayers most likely to have the problem of unused carryovers were the taxpayers that had been rendered incapable of solving the problem, because they had been overlooked in the mitigation and transition provisions of the 1969 amendment. Since it is a fundamental principle of United States income taxation that taxpayers should be taxed only on their net income, and since it was that same principle of netting which Congress actually sought to vindicate by amending section 582(c), it is most anomalous that the intended remedy should operate to prevent a foreign bank from offsetting its losses on the sale of securities against its gains on the sale of the same type of securities.

This anomaly is especially striking when it is considered that Congress chose to treat both gains and losses on debt instruments as ordinary gains and losses, rather than capital gains and losses, partly because such treatment "gives financial institutions more effective tax relief for their losses." S. Rep. No. 91-552, 91st Cong., 1st Sess. 167 (1969); cf. H. Rep. No. 91-143 (Part 1), 91st Cong., 1st Sess. 130 (1969). Surely, with a stated purpose of giving more effective tax relief for losses, Congress could not have intended foreign banks to be denied the use of losses altogether.

Section 1044 of H.R. 10612 would correct this unintended anomaly, by allowing a foreign bank to treat gains from post-1969 sales of debt instruments as capital gains, but only to the extent those gains would be offset by available capital-loss carryovers from pre-1969 transactions. The identical result would be achieved if pre-1969 capital-loss carryovers were deemed to be ordinary-loss carryovers, to the extent of post-1969 gains from such sales. The objective is simply to provide for parallel treatment, so as to permit proper offsetting of similar items.

Viewed against this background, it is clear that section 1044 would not convert ordinary income to capital gains, except for the very limited purpose of permitting the operation of the netting principles that underlie the 1969 amendment. When the distinguished senior Senator from Wisconsin attacked section 1044 on the floor of the Senate, he simply misconstrued this purpose of the section. 122 Cong. Rec. S10814 (June 28, 1976). In contrast, the explanation inserted in the Record by the Senator stated: "The 1968 [sic] Tax Reform Act . . . would accidentally prevent using capital loss carry-forwards . . . ." Id. at S10817. Section 1044 has been drafted to correct that "accident."

The Senator also misconstrued the circumstances when he implied that section 1044 was added to the bill by this Committee "at the last minute, without very much discussion." Id. at S10813. In fact, section 1044 is identical to H.R. 13009, 93d Cong., 2d Sess. (1974), which had received a favorable report from the Treasury Department. Letter from Acting Assistant Secretary Ernest S. Christian, Jr., to the Honorable Wilbur D. Mills, Aug. 30, 1974. The identical language appeared in H.R. 4998, 94th Cong., 1st Sess. (1975) and was supported in the House Ways and Means Committee's hearings on tax reform. Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means, 94th Cong., 1st Sess., pt. 4, at 3280-83 (1975). The identical language again appeared as section 1044 of the first complete Ways and Means Committee print of the Tax Reform Bill (dated November 3, 1975), and as section 1044 of H.R. 10612 as introduced, as reported by the Ways and Means Committee, and as passed by the House last December. The unintended effect of the 1969 amendment and the remedial purpose of section 1044 were correctly described in both the Ways and Means Committee report and the report of this Committee. H. Rep. No. 94-658, 94th Cong., 1st Sess. 252-53 (1975); S. Rep. No. 94-938, 94th Cong., 2d Sess. 276 (1976). In short, the thoughtful consideration of section 1044 by both Congress and the Administration is a matter of clear public record.

Because of the history of section 1044 as a separate House bill, however, it is respectfully pointed out that it will be necessary to correct one technical error which has persisted in the text. In section 1044 (b)(2), page 541, line 7, the words "the first section of this Act" should be deleted and the words "subsection (a)" inserted in lieu thereof.

July 20, 1976

Ralph K. Smith, Jr.
Sage Gray Todd & Sims
New York, N. Y.

John S. Nolan
John S. Nolan
Miller & Chevalier
Washington, D. C.

SUMMARY
OF
STATEMENT OF WILFRED J. TREMBLEY
ON BEHALF OF THE HANNA MINING COMPANY
BEFORE SENATE COMMITTEE ON FIANCE
WITH RESPECT TO
SECTION 1052(b) OF H.R. 10612, RELATING
TO FOREIGN TAX CREDIT COMPUTATION
OF WESTERN HEMISPHERE TRADE CORPORATIONS

1. The Iron Ore Company of Canada (IOC) and Quebec North Shore and Labrador Railway Company (QNS&L) are parent and subsidiary corporations.

2. IOC and QNS&L operate solely in Canada in related activities (mining and transportation) and file consolidated returns.

3. QNS&L, a Canadian Corporation, is a WHTC but IOC is not a WHTC. Under present law, all Canadian income taxes paid by both can be averaged for foreign tax credit purposes under the per-country limitations.

4. With the elimination of the per-country limitation, income taxes paid by a WHTC will not be able to be averaged with the income taxes paid by non-WHTC under the present provisions of the overall limitation.

5. The Committee adopted an amendment as a transition rule which permits averaging under the overall limitation, so that ICC and QNS&L can continue its present treatment.

6. This amendment is exactly similar in principle to an exception already in present law which applies to public utilities operating in the same country.

7. It is urged that the Committee reaffirm its decision to extend this exception to the IOC and QNS&L situation in Canada.

STATEMENT

ON BEHALF OF

THE HANNA MINING COMPANY

BY

WILFRED J. TREMBLEY

DIRECTOR OF TAXES

TO THE

COMMITTEE ON FINANCE

JULY 21 1976

Mr. Chairman:

My name is Wilfred J. Trembley, and I am Director of Taxes of The Hanna Mining Company ("Hanna"). I am appearing before you today in support of the provision in §1052(b) of the Committee bill.

Hanna is a publicly-held corporation, headquartered in Cleveland, Ohio, which engages principally in the production and sale of iron ore in the United States and abroad.

One of Hanna's principal sources of iron ore is through the equity interest in the Iron Ore Company of Canada ("IOC") for which Hanna has management responsibility. IOC is a U. S. corporation organized in 1949 to develop and operate large iron ore deposits which are located in remote sections of Quebec and Labrador. Its shareholders, in addition to Hanna, were five (now six) U.S. steel companies and three (now two) Canadian corporations; two of the latter were the original holders of the mining rights. Nearly $1 billion has been invested in the mining, concentrating, pelletizing, railroad, dock, townsite and related facilities of IOC.

An integral segment of the IOC operation is a railroad system. In the ordinary development of such a mining operation, the railroad would have been organized as an operating division of the mining company. In this case, however, since the railroad would be operating in both Quebec and Newfoundland, the Canadian government required that it be incorporated as a Canadian corporation and operated as a common carrier. As a result, the railroad was organized as the Quebec North Shore and Labrador Railway Company ("QNS&L"), a wholly-owned Canadian subsidiary of IOC. QNS&L qualifies as a Western Hemisphere Trade Corporation ("WHTC") while IOC does not, solely because of the dividends it receives from QNS&L. QNS&L and IOC file a consolidated U. S. income tax return. This situation is unique and involves circumstances over which neither IOC nor its owners have any control whatever.

Up to the present time this consolidated group has elected to use the per-country limitation so that the Canadian taxes paid by each corporation were averaged together. The Tax Reform Act of 1976, H.R. 10612, which is presently under consideration by the Senate, provides for the repeal of the per-country foreign tax credit limitation for all industries. Thus, the overall limitation will, in the future, have to be used by IOC and QNS&L.

Under present law, an affiliated group using the overall limitation and filing a consolidated return which includes a WHTC may not average any excess foreign income taxes of the WHTC with the foreign income taxes of the non-WHTCs in the affiliated group for foreign tax credit purposes. However, a special exception makes this rule inapplicable in the case of certain public utilities on the overall limitation where the affiliated group includes non-WHTCs which have utility-type income from sources in the same foreign country.

IOC and QNS&L, whose operations are in the same foreign country and are integrally related, are in essentially the same position as the public utility WHTCs for which present law provides an exception to the non-averaging rule. Up until now, since IOC and QNS&L have used the per-country limitation, the non-averaging rule has not applied. Under the bill, however, IOC and QNS&L will be required to use the overall limitation. This would make the non-averaging rule applicable. Since IOC and QNS&L are in essentially the same position as the utilities for which present law provides an exception to the non-averaging rule, we believe that, during the phase-out of the Western Hemisphere Trade Corporation provisions, a similar exception should be provided for IOC and QNS&L.

An amendment was offered and approved by this Committee which can be found in section 1052(b) of the Committee Bill (H.R. 10612) which is intended to accord the benefits of the exception of present law to IOC and QNS&L's type of situation. It should be noted that, since the Committee Bill phases out the WHTC provisions by the end of 1979, the exception in reality is only a short-term, transition rule.

The amendment accomplishes this purpose by modifying Section 1503(b) of the Code to provide that no reduction shall occur in the amount of foreign income taxes paid to a contiguous foreign country (i.e., Canada) by a WHTC which is a corporation treated as a domestic company by reason of Section 1503(d) (i.e., QNS&L) to the extent that other domestic companies in the same affiliated group (i.e., IOC) have an unused foreign tax credit limitation. The rule contained in the amendment would apply only to taxes paid to a contiguous country by a corporation of that country and only insofar as the other affilited corporations have an excess credit limitation with respect to taxes paid to, and income from, that contiguous country. It further provides that all corporations in the affiliated group must derive 95% or more of their gross income from sources within the contiguous country and must be primarily engaged in a mining or related transportation business within that contiguous country.

In brief, this amendment closely parallels the similar exception contained in present law and is necessitated solely because of an inadvertent and unintended side effect of the repeal of the per-country limitation on the foreign tax credit.

I trust that in the reconsideration of this amendment ot Section 1503(b), the Committee will resolve this matter on the same equitable basis that is previously did.

Respectfully submitted,

THE HANNA MINING COMPANY

W. J. Trembley

W. J. Trembley
Director of Taxes

COMMITTEE ON FINANCE

UNITED STATES SENATE

ADDITIONAL HEARINGS ON H.R. 10612
JULY 21, 1976

STATEMENT OF STEPHEN A. NAUHEIM

INCOME EARNED ABROAD
(Section 1011 of H.R. 10612)

SUMMARY OF PRINCIPAL POINTS

1. Contrary to popular belief ,the tax treatment accorded to an American working abroad is less favorable than the tax treatment accorded to his counterpart in the United States.

2. The Committee's proposed revision to Section 911 would, in many cases, be tantamount to repeal, and, in some cases, worse than repeal.

3. Retention of present law is needed to maintain the competitiveness of U.S. companies abroad and to maintain the use of U.S. labor by these companies.

4. Provisions of the Code other than Section 911 operate inequitably with regard to Americans working abroad, particularly, the inclusion in income of cost of living allowances and the failure of the Code to take into account the value added tax ,either as a deduction or credit.

5. Alleged "unintended benefits" of Section 911 (resulting in the Committee's amendments denying, in part, the foreign tax credit and taxing included income at higher brackets) are not caused by Section 911 but rather by the operation of other provisions of the Code which apply any time income is excluded from taxation; already over-burdened Americans working abroad should not be made the scapegoats for a problem of general applicability.

6. The Committee's Third amendment, making ineligible for exclusion certain income received outside the country in which earned adds considerable subjectivity, uncertainty and complexity in an area where complexity is already at a premium; the idea that a taxpayer who uses legitimate and accepted means to reduce the burden of foreign taxes should be penalized by the U.S. while others pay no foreign tax without penalty appears to make no sense.

7. The Committee should defer any action with respect to Section 911 until it has had an opportunity to consider the broader picture, including the tax inequities and complexities presently faced by Americans living abroad; Section 911 should be retained in its present form and the Committee should give consideration to more equitable tax treatment for Americans working abroad.

COMMITTEE ON FINANCE

UNITED STATES SENATE

ADDITIONAL HEARINGS ON H.R. 10612

JULY 21, 1976

STATEMENT OF STEPHEN A. NAUHEIM

INCOME EARNED ABROAD
(Section 1011 of H.R. 10612)

I am pleased to have the opportunity to appear before you today to discuss United States tax policy with regard to American citizens working abroad. I am a member of the law firm of Surrey, Karasik and Morse. Surrey, Karasik and Morse is a Washington based law firm with additional offices in New York and Paris. We have 12 American attorneys working in our Paris office and I appear before you today formally on their behalf. Their interests in this subject matter, however, coincides to a substantial extent with the interests of approximately 100,000 American citizens working abroad.

In Sectior 1011 of the Senate Bill, this Committee wisely rejected the House provision which would have repealed Section 911 of the Internal Revenue Code, the section which allows an exclusion from gross income of up to $20,000, or $25,000, of income earned abroad. This Committee has heard, on various occasions in the past, the reasons for retention of Section 911. It is not my purpose today to repeat those reasons, as it appears from the Committee's explanation of its decisions with regard to Section 911 you fully understand and accept the arguments in favor of retaining the basic approach of Section 911. This Committee, however, in its decisions, proposed three modifications to the present law which, ironically, for some American citizens, could result in more burdensome taxes than would have resulted had the House decision to repeal Section 911 been enacted and, for many others, will be tantamount to repeal. I am here to urge the deletion of the changes which this Committee has proposed to Section 911 and the retention of the provisions of present law.

I am submitting for the record an exhibit which compares the effect of present law with that of: the House proposal to repeal Section 911, the Senate Finance Committee modifications to Section 911, and present tax law as applied to a domestic taxpayer similarly situated to the foreign-based taxpayer used as a model in the exhibit. The exhibit illustrates two basic points: First, that this Committee's modifications to the present law would, in the typical case, have virtually the same effect as repeal of Section 911 and, second, contrary to popular belief, the typical American citizen working abroad does not enjoy an overall tax benefit over his counterpart in the United States. The exhibit uses as a model a taxpayer receiving a basic salary of $25,000 who is sent abroad by his employer and receives various allowances to compensate him for the increased out-of-pocket expenses he incurs as a result of living abroad. Under current law, this taxpayer would pay income taxes of $8,592 compared to his domestic counterpart who would pay income taxes of only $4,620. Both under the House proposal to repeal Section 911 and under this Committee's proposal to modify Section 911, our model taxpayer ends up paying total income taxes of $11,128. As a result the American who stays in the United States at a $25,000 salary nets $20,380 after taxes whereas his counterpart who is transferred abroad by his employer would, under either the House or Senate version of the Bill, end up with a net after taxes of $13,872. I would emphasize that the model we have used is not an exaggerated case; rather, I believe it most likely represents the fact pattern of a large portion of American citizens working abroad.[1/]

Factors Supporting the Retention of Present Law

1. Decline in Competiveness of U.S. Companies and in the Use of U.S. Labor.

In its Committee Report, this Committee explained its rejection of the House proposal to repeal Section 911 on the basis that it was doing so so that the competitive position of American firms abroad would not be jeopardized. The exhibit amply illustrates that this Committee's modifications to Section 911 achieve virtually the same result as repeal in many cases. The resultant additional difficulty recruiting

---

1/ The Compendium on Tax Expenditures published by the Senate Committee on the Budget March 17, 1976 tends to support this. The Compendium shows that 56.7% of the tax expenditure for Section 911 is derived from taxpayers with adjusted gross incomes (after the exclusion) of $15,000 or less (p.14).

U.S. personnel for overseas assignments and the additional expense involved for those companies that reimburse their overseas personnel for increased tax burdens will quite obviously result in the decline in the use of U.S. labor replaced by local nationals and will lessen the ability of American companies to compete with foreign companies.

2. Present U.S. Taxation of Cost of Living Adjustments.

Retention of the current provisions of the law can be justified not only on the basis of maintaining the competitive position of American firms abroad but also as a matter of tax equity to balance against the tax detriments suffered by U.S. citizens working abroad. The high rate of inflation in most foreign countries, compared to that of the United States, results in a much higher cost of living in most foreign countries. (For example, the October 1975 cost of living index issued by the Bureau of Labor Standards reflects a cost of living index for Paris of 170 using a Washington D.C. base of 100.) The cost of living and other allowances paid typically to Americans working abroad generally falls far short of meeting the full increase in the cost of living. Adding to the burden is the fact that any allowances paid to the employee to compensate him (in part) for this increased cost of living is included in full in the employee's income as additional earned income and no deduction is allowed for the expenses which these payments are intended to reimburse.[2/] There are other similar inequities such as the combined effect of the inclusion of reimbursed or in kind moving expenses in the employee's income and a partial disallowance of deductions for these same moving expenses under section 911.

3. Failure of U.S. Tax Law to Take into account Value Added and Similar Taxes.

In addition, most foreign countries, particularly in Europe, rely more heavily on indirect taxation for sources of revenue than does the United States. Thus, for example, in France, the basic rate of the value added tax is 20% and rises to as high as 33%. As an alternative to direct income taxes as a source of revenue, this value added tax can be viewed as being similar in concept to the "in lieu of" taxes allowed as a foreign tax credit under Section 903 of the Code. However, Americans who pay these heavy value added taxes are not allowed to credit these alternative taxes against their U.S. income tax liability. Not only that, but they are not even allowed to deduct these and a variety of other indirect taxes, such as general sales taxes, gasoline taxes and personal property taxes, in computing their U.S.

2/ The Committee Report reflects that this Committee has decided to allow a limited exclusion for cost of living allowances. However, the Committee Report goes on to state that the amount excluded as housing allowance will reduce the amount of available exclusion under Section 911, thereby offsetting, in large part, the ameliorative nature of the proposed new exclusion for cost of living allowances. Report No. 94-938 at p. 212.

tax liability in spite of the fact that they are comparable in nature to (although significantly greater in amount than) state taxes which are deductible.

The Committee's Modifications

The Committee Report suggests that the modifications proposed to Section 911 are intended to curtail unintended benefits under Section 911. Whether or not these benefits were intended, they would appear to be fully justifiable in equitable terms as offsetting, in part, the inequities of other provisions of the tax law. Further, these supposedly unintended benefits are not caused by, nor unique to, Section 911. Rather, they are benefits which result whenever income is excluded under any provision of the Code and arguably apply whenever income is indefinitely deferred from taxation under any provision of the Code.

One of these modifications would require income derived by individuals in excess of the excluded amount to be subject to U.S. tax at the higher rate brackets which would apply if the excluded income were not so excluded. The Committee Report notes that this additional income is now taxed at the marginal rate that would apply to an employee who had not earned the excluded amount. This same result occurs, however, any time income is excluded from taxation whether it be income from municipal bonds, the result of the capital gains deduction, possessions source income, social security payments, or any other of a long list of excluded income items.

Similarly, the Committee proposal denies a foreign tax credit for foreign taxes imposed on income which has been excluded from U.S. taxation under Section 911. However, again, this same result will occur any time a taxpayer earns income excluded from U.S. taxation but subject to foreign taxation.

One can legitimately question whether American citizens working abroad, who already suffer a greater tax burden than their counterparts in the United States, should be singled out for this special treatment which does not apply to other taxpayers who may have other forms of excluded income. If this Congress feels that our present tax structure with regard to the interaction of the multitude of provisions allowing for exclusion of amounts from gross income with the foreign tax credit and the progressive rate structure is unwarranted, the problem should be attacked directly and the one group of taxpayers that already suffer a heavier burden than other taxpayers similarly situated should not be made to suffer alone for this alleged defect in our tax system.

I do not mean to suggest by this that these basic interrelationships should be adjusted. I believe that as long as our basic U.S. international tax policy allows for computation of the limitation on the foreign tax credit on an overall basis, the results criticized in the Committee Report can be fully justified. The overall limitation on the foreign tax credit has the effect of limiting the amount of U.S. taxes which can be offset by foreign taxes under the foreign tax credit mechanism to those U.S. taxes attributable to all of the taxpayer's foreign source income and, under that limitation, the Congress has consciously allowed the averaging of income subject to high taxation, low taxation and no taxation. This can be fully justified both on the grounds of simplicity and equity.

Certainly, in the context of the limited amount of exclusion under Section 911, taxation of the remaining income at the highest brackets does not seem justifiable. While $20,000 (and in some cases $25,000) may not sound like a minimal amount, it really is when one considers the high cost of living adjustments that have to be taken into account when an American is transferred abroad. The dollar amounts of the exclusion were set at their present levels in 1964 and no adjustment has been made since that time to take into account the effects of inflation.

In addition to the equitable argument in support of not taxing included income at the highest brackets, the system proposed under the Bill adds significantly to the complexity of the tax law in this area. The complexity involved in the simple filing of a tax return for an American living abroad is significantly greater than the complexity involved for his counterpart living in the United States and, even in the pure domestic context, this complexity has risen to a level where it is bearly tolerable.

The third of the amendments made by this Committee to

Section 911 would make ineligible for the exclusion any income earned abroad received outside of the country in which it was earned if one of the purposes of the receipt of that income outside the country was the avoidance of taxes. Obviously, this "one of the purposes" test is going to be a highly subjective test, difficult to administer. We already have in our tax law principal purpose tests, primary purpose tests, insubstantial purpose tests, etc., which have led to large volumes of administrative and judicial controversy. This proposal will not only add significantly to the complexities of preparing a tax return for an American living abroad but will also add uncertainty. About the only certainty that will result is that, if the taxpayer attempts to exclude any income received outside the country in which it was earned, he will be challenged by the Internal Revenue Service, adding further to his already burdensome costs of living abroad. More importantly, why should a taxpayer be penalized for legitimate tax planning to minimize taxes? Why should the American working in a tax-free country, who obtains the maximum benefit under section 911, be treated more favorably than an American whose earnings are subject to foreign income taxes, but who has used well-accepted means, specifically sanctioned by the foreign country's own law, to reduce the foreign tax burden?

It is also important to note in the context of this third proposed modification to Section 911 that the taxes which are being reduced are not United States taxes; rather, they are the taxes of the foreign country. This raises two further questions: Why should the United States encourage U.S. taxpayers to pay higher foreign income taxes with no benefit to the U.S. treasury? Also, if the taxpayer intentionally receives income in a manner so that it will be subject to the foreign tax where he could have received it in a manner that would have avoided the foreign tax, whatever foreign tax he may have left as eligible for the credit after this Committee's denial of a part of them may be lost. The Internal Revenue Service is increasingly taking the position that foreign taxes paid by a taxpayer which did not have to be paid do not qualify as creditable foreign income taxes. Thus, the American working abroad will be caught in the middle of two conflicting principles of tax law if this proposal is passed. He either avoids the foreign tax and loses the exclusion under Section 911 or he pays the foreign tax and loses a foreign tax credit under Section 901.

The Committee's proposal would place the Internal Revenue Service in the position of interpreting, analyzing and, in some cases, policing the tax laws of other countries, adding further to the complexities in this area.

Conclusion and Summary

I have in this testimony attempted to convey three basic points regarding this Committee's proposals with respect to Section 911. First, there is a basic misconception that American citizens working abroad receive tax treatment more than favorable than their counterparts working in the United States. The contrary is true. Second, the alleged unintended benefits of Section 911 attacked in this Committee's proposals are not the result of Section 911 but are the result of other provisions within the basic U.S. tax structure which can be fully justified as applied to Americans working abroad. American citizens who are already faced with the more burdensome tax than others similarly situated should not be the scape goats who are singled out for different treatment. Third, any unintended benefit which results by virtue of the interaction of Section 911 with other provisions of the Code are more than offset by the tax and non-tax detriments suffered by Americans working abroad and by the substantial increase in complexity which would be involved in administering and complying with the proposals which this Committee has made.

The Internal Revenue Service is now in the process of collecting and analyzing the 1975 income tax returns of Americans claiming the Section 911 exemption. The data base resulting from this analysis will provide a much sounder basis for consideration of revisions to Section 911 than the data resulting from the samplying of 1968 returns as reflected in the Treasury Department's position paper in this area. Section 911 should not be considered in isolation. This Committee should defer any changes in Section 911 until it has had an opportunity to both review the up-to-date data now being compiled and to consider, at the same time, the present tax inequities, outside of Section 911, and the complexities facing Americans living abroad.

If any change is to be made in the U.S. taxation of American citizens working abroad it should be to allievate the tax detriments suffered by these American citizens rather than increasing already disproportionate burdens suffered by them. This Committee should seriously consider, for example, treating the value added tax as a creditable tax and, at a minimum, if not as a creditable tax, the value added tax and other foreign indirect taxes should be deductible taxes as are similar state taxes in the United States. I urge the Committee, therefore, to delete the proposed modifications it has made in Section 911 and consider instead provisions which will provide more equitable tax treatment for Americans working abroad. I thank you for your time.

EXHIBIT

(Accompanying the Testimony of Stephen A. Nauheim, of Surrey, Karasik and Morse, before the Senate Finance Committee on H.R. 10612, July 21, 1976)

The following is a comparative analysis of the income tax burden suffered by an American citizen receiving a basic salary of $25,000 under the following four circumstances: (1) Employed in the United States; (2) Employed abroad (in France) under present law; (3) Employed abroad, under the Senate Finance Committee's proposed modifications to present law; and (4) Employed abroad, under the House's proposal for repeal of Section 911. The analysis makes certain assumptions as to how the Committee's proposals would be interpreted, in a manner which minimizes the increased tax burden and ignores the value added tax ("VAT"), both in terms of its effect as an increase in the tax burden and the failure of U.S. tax law to make any adjustment for the VAT in the computation of U.S. tax liability.

	U.S. Citizen Working in the U.S.	U.S. Citizen Working in France: Current law	Section 911 as modified	Complete repeal of Section 911
Base salary	25,000	25,000	25,000	25,000
Cost-of-living & housing allowances		12,500	12,500	12,500
Child's education		1,500	1,500	1,500
Home leave		1,000	1,000	1,000
Total "earned income"	25,000	40,000	40,000	40,000
Section 911 exclusion		(20,000)	(20,000)	-
Personal exemptions (3)	(2,250)	(2,250)	(2,250)	(2,250)
Standard deduction	(2,000)			
Taxable income	20,750	17,750	17,750	37,750
U.S. tax before credits	4,620	3,750	6,748[1]	11,128
Foreign tax credit	-0-	(3,750)	(4,212)[2]	(8,592)
Total U.S. tax liability	4,620	0	2,536	2,536
French income tax	-0-	8,592	8,592	8,592
Total U.S. and French taxes	4,620	8,592	11,128	11,128
Cash Flow:				
Salary	25,000	25,000	25,000	25,000
Less: Total Taxes	(4,620)	(8,592)	(11,128)	(11,128)
	20,380	16,408	13,872	13,872

1 Tax on "net taxable income": 11,128

Less: Tax on "net excluded earned income" ($20,000): (4,380)

Tax at higher rate on income exceeding Section 911 income 6,748

2 Disallowed French taxes on an "accrued basis", using U.S. progressive rates, would be: $4,380 (U.S. tax on $20,000).

The allowable portion would therefore be $8,592 less $4,380, or $4,212.

O