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TAX REFORM ACT OF 1976

H.R. 10612

TESTIMONY TO BE RECEIVED THURSDAY, JULY 22, 1976

AND

Additional Administration Views

COMMITTEE ON FINANCE
UNITED STATES SENATE
RUSSELL B. LONG, *Chairman*

JULY 1976

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CONTENTS

WITNESSES

	Page
Ad Hoc Committee for Equitable Tax Treatment of the Publishing Industry and the Association of American Publishers, Townsend Hoopes	39
Aetna Life & Casualty Co., John H. Filer, chairman	27
Allen, Hon. James B., a U.S. Senator from the State of Alabama	1
American Bankers Association, Daniel L. Davis	75
American Council of Life Insurance, Blake T. Newton, Jr., president	149
American Gas Association, Richard A. Rosan	137
American General Capital Management, Inc., John E. Chapoton	323
American Hospital Association, Leo J. Gehrig, M.D., senior vice president	375
American Totel & Motel Association and the National Restaurant Association	60
American Livestock Show and Rodeo Managers' Association, Kenneth H. Liles	265
American Society of Association Executives, James P. Low, president and chief administrative officer	271
Association of American Publishers and the Ad Hoc Committee for Equitable Tax Treatment of the Publishing Industry, Townsend Hoopes	39
Association of American Railroads, John P. Fishwick, president and chief executive officer, Norfolk & Western Railway Co., and James H. Evans, vice chairman, Union Pacific Railroad	165
Association of Art Museum Directors, Kenneth H. Liles, of Sutherland, Asbill & Brennan	285
Association of Closed-End Investment Companies, W. David MacCallan, director	143
Authors League of America, Irwin Karp, counsel	51
Badger Meter, Inc	33
Barrett, Richard F., for Stackpole-Hall Foundation	243
Belco Petroleum Corp., Robert A. Belfer, president	123
Belfer, Robert A., president, Belco Petroleum Corp	123
Biegel, Herman C	159
Bradley, John A., president, Federation of American Hospitals	287
Butt, Sheldon H., president, Solar Energy Industries Association	13
Carter, Thomas S., president, Kansas City Southern Railway Co	183
Chapoton, John E., for:	
Domestic Wildcatters Association	85
American General Capital Management, Inc.; Boston Company Exchange Associates; Fidelity Exchange Fund; and State Street Exchange Fund	323
Cohen, Edwin S	159
Davis, Daniel L., for the American Bankers Association	75
Dement, Sandy, executive director, National Consumer Center for Legal Services	295
Domestic Wildcatters Association, John E. Chapoton	85
Dozier, M. Gardner, vice president and director, Vance, Sanders & Co., Inc	339
Edison Electric Institute, W. Reid Thompson, chairman of the board and president of Potomac Electric Power Co	131
Eggers, Paul W., president, Geothermal Kinetics Inc	195
Engineers' and Scientists' Joint Committee on Pensions, Dr. Robert M. Sanders	385
Evans, James H., vice chairman, Union Pacific Railroad, Association of American Railroads	165
Federated Research Corp., Charles H. Morin	367
Federation of American Hospitals, John A. Bradley, president	287
Filer, John H., chairman, Aetna Life & Casualty Co	27
Fishwick, John P., president and chief executive officer, Norfolk & Western Railway Co., Association of American Railroads	165
Florida East Coast Railway Co., W. L. Thornton, president	171
Gehrig, Leo J., M.D., senior vice president, American Hospital Association	375
Geothermal Kinetics, Inc., Paul W. Eggers, president	195
Governors of the Knights of Ak-Sar-Ben, Kenneth H. Liles	265
Halvorson, Newman T., Jr., Covington & Burling, for May Department Stores Co	231

	Page
Healy, Edward, president, National Association of Water Companies	127
Hoopes, Townsend, for Association of American Publishers and the Ad Hoc Committee for Equitable Tax Treatment of the Publishing Industry	39
Hotel & Restaurant Employees & Bartenders International Union, AFL-CIO, Robert E. Juliano, legislative representative	65
Independent Petroleum Association of America, A. V. Jones, Jr., president	115
International Association of Fairs & Expositions, Kenneth H. Liles	265
Investers Syndicate of America, Inc., Kenneth R. Wahlberg, president	55
Johnson, Lane Space, Smith & Co., Inc	359
Jones, A. V., Jr., president, Independent Petroleum Association of America	115
Juliano, Robert E., legislative representative, Hotel & Restaurant Employees & Bartenders International Union, AFL-CIO	65
Kansas City Southern Railway Co., Thomas S. Carter, president	183
Karp, Irwin, counsel, Authors League of America	51
Klineman, Kent M	399
Kreutzer, Arthur C., vice president and general counsel, National LP-Gas Association	219, 413
Liles, Kenneth H., of Sutherland, Asbill & Brennan, for Association of Art Museum Directors; International Association of Fairs & Expositions; Governors of the Knights of Ak-Sar-Ben; Los Angeles County Fair; Maryland State Fair; Pacific International Livestock Exposition; American Livestock Show and Rodeo Managers' Association	265, 285
Los Angeles County Fair, Kenneth H. Liles	265
Low, James P., president and chief executive officer, American Society of Association Executives	271
MacCallan, W. David, director, Association of Closed-End Investment Companies	143
Maryland State Fair, Kenneth H. Liles	265
May Department Stores Co., Newman T. Halvorson, Jr., Covington & Burlington	231
McIntyre, Hon. Thomas J., a U.S. Senator from the State of New Hampshire	11
Mighdoll, M. J., executive vice president, National Association of Recycling Industries, Inc	201
Morin, Charles H., for Federated Research Corp	367
National Association of Recycling Industries, Inc., M. J. Mighdoll, executive vice president	201
National Association of Water Companies, Edward Healy, president	127
National Consumer Center for Legal Services, Sandy Dement, executive director	295
National LP-Gas Association, Arthur C. Kreutzer, vice president and general counsel	219, 413
Newton, Blake T., Jr., president, American Council of Life Insurance	149
Nolan, John S., Miller & Chevalier	251
Pacific International Livestock Exposition, Kenneth H. Liles	265
Rogers, Dr. N. Jay, partner, Texas State Optical Co	59
Rosan, Richard A., for the American Gas Association	137
Sanders, Dr. Robert M., for Engineers' & Scientists' Joint Committee on Pensions	385
Savage, Carroll J	159
Sebits, Carl W	407
Snarr Advertising, Inc., Douglas T. Snarr, president	417
Society of Manufacturing Engineers, R. William Taylor, executive vice president and general manager	281
Solar Energy Industries Association, Sheldon H. Butts, president	13
Stackpole-Hall Foundation, Richard F. Barrett	243
Taylor, R. William, executive vice president and general manager, Society of Manufacturing Engineers	281
Texas State Optical Co., Dr. N. Jay Rogers, partner	59
Thompson, Myron B., Honolulu, Hawaii	391
Thompson, W. Reid, chairman of the board and president of Potomac Electric Power Co., for Edison Electric Institute	131
Thornton, W. L., president, Florida East Coast Railway Co	171
Vance, Sanders & Co., Inc., M. Dozier Gardner, vice president and director	339
Wahlberg, Kenneth R., president, Investers Syndicate of America, Inc	55

APPENDIX

Additional administration views	427

SUMMARY OF WRITTEN STATEMENT SUBMITTED BY
SENATOR JAMES B. ALLEN OF ALABAMA
TO THE
SENATE COMMITTEE ON FINANCE
ON SECTION 1308 OF H.R. 10612

I urge the adoption of Section 1308 of the Senate version of the Tax Reform Act which amends Section 543(a) of the Internal Revenue Code.

1. Under Section 543(a)(6) of the Internal Revenue Code rents received by a corporation from a 25 percent or more shareholder for the use of corporate property is treated as personal holding company income unless its other personal holding company income is 10 percent or less of its gross income.

2. The Internal Revenue Service has taken the position that payments received for the lease of intangible property to a shareholder are royalties under Section 543(a)(1) rather than rents under Section 543(a)(6).

3. There should be no distinction between tangible and intangible properties leased to a shareholder where they are part of an integral group of business assets used by the shareholder in an active trade or business.

4. This provision retroactively corrects the statute to allow similar treatment for tangible and intangible assets leased to a shareholder for use in his business. It does not, however, allow shareholder rents to be used to shelter other

passive income and preserves the intent of the personal holding company provisions.

5. Retroactive relief is even more justified for this provision than when the Congress granted similar retroactive relief in 1950 and 1955.

STATEMENT SUBMITTED BY SENATOR JAMES B. ALLEN OF ALABAMA TO THE SENATE COMMITTEE ON FINANCE ON SECTION 1308 OF H.R. 10612

Mr. Chairman, I wish to thank the Committee for giving me an opportunity of appearing before it in support of Section 1308 of the Committee bill. This provision is the same as S. 3288 which Senator Sparkman and I introduced last April as an amendment to Section 543(a) of the Internal Revenue Code.

The purpose of this provision is to correct what I believe is an unintended result occasioned by the personal holding company provisions dealing with rental payments by shareholders to their corporations. Specifically, the problem involves the treatment of payments received for leasing intangible property as royalties under Section 543(a)(1) rather than shareholder rents under Section 543(a)(6).

The problem was first presented to me through a company in my home state of Alabama whose stock is owned by two trusts. The Company owns and leases to several partnerships assets used by each partnership in the business of making and selling a soft drink product within a specified area. The two trusts own a majority of the partnership interests of each partnership, and three individuals own the minority partnership interests. The assets used by these partnerships consist of land and buildings, machinery and equipment, automobiles, delivery equipment and coolers, <u>and the exclusive right to make and sell</u>

the product within such specified area. The reason for this manner of operating the business is that in 1934 ownership of all of the assets, tangible and intangible, used in the business was transferred to the Company in order to conserve and preserve title to these assets in a continuing entity, thereby insulating these assets from the death of, or other changes in, the partners of the partnerships.

The Internal Revenue Service has taken the position that the Company was a personal holding company on the grounds that a substantial portion of the payments to the Company from the partnerships should be treated as royalties under section 543(a)(1) of the Code rather than as compensation for the use of corporate property under section 543(a)(6). The Internal Revenue Service takes the position that the payment for the exclusive right to make and sell the product is a royalty.

Section 543(a)(6) of the Code provides that amounts received as compensation for the use of, or right to use, property of the corporation, where 25 percent or more of its stock is owned by an individual entitled to use the property, constitutes personal holding company income, unless its other personal holding company income (excluding rents under section 543(a)(2)) is 10 percent or less of its ordinary gross income. That is, payments for the use of corporate property by its

shareholders will not constitute personal holding company income unless these payments are used to shelter passive income in excess of 10 percent of the corporation's ordinary gross income. Since the portion of the payments from the partnerships which are treated by the Service as income (i.e., the royalties) under section 543(a)(1) was greater than 10 percent of the ordinary gross income, all of the payments from the partnerships constituted personal holding company income under sections 543(a)(1) and 543(a)(6).

The Company had no other personal holding company income other than a minor amount of interest income in several years amounting to far less than 10 percent of its ordinary gross income for any such year.

Thus, the Company has not been used to shelter passive investment income since practically all of its income comes from the payment for use of business properties--i.e., those in connection with the manufacture and sale of the product. Nevertheless, it has been unwittingly trapped into personal holding company status because, although all of the income which it receives from the partnerships is for the use of assets comprising a single business, some of this income is treated unfairly as income under section 543(a)(1) rather than as compensation for the use of corporate property under section 543(a)(6).

The statute should be amended to provide that all of such payments should be treated as compensation for the use of corporate property under section 543(a)(6), so that such payments will constitute personal holding company income only if these payments are used to shelter substantial amounts of other passive investment income. The legislative history of section 543(a)(6) clearly demonstrates that rents from stockholders for the use of property in legitimate business enterprises are not intended to be classified as personal holding company income unless these rents are used to shelter other passive investment income.

In the past Congress has provided retroactive relief under a similar set of circumstances. Prior to the Revenue Act of 1950, personal holding company income included amounts received for the use of corporate property by 25 percent shareholders. By 1950 the attention of the Finance Committee had been called to examples "where, through a set of fortuitous circumstances, corporations have become closely held and also have rented most of their assets for use in the operation of businesses to the individuals holding the stock of the companies. Thus, unwittingly the corporations have become personal holding companies and subject to the penalty tax." S. Rept. No. 2375, 81st Cong. 2nd Sess. (1950), 65. To take care of this problem,

section 223 of the Revenue Act of 1950 provided for the elimination of rents for the use of a corporation's property by its shareholders from the category of personal holding company income, where the property is used "in the operation of a bona fide commerçial, industrial, or mining enterprise." This provision applied retroactively to taxable years ending after 1945 and before 1950. In 1955, the application of this relief provision was extended again retroactively to years before 1954, in recognition of the fact that the Internal Revenue Code of 1954 provided relief from this problem for years beginning with 1954. See H. Rept. 1353, 84th Cong. 1st Sess. (1955), 1955-2 C.B. 844.

The 1954 Code relieved this problem by exempting shareholder rents from personal holding company income unless the corporation has other personal holding company income in excess of 10 percent of its ordinary gross income. Thus, the basic purpose of section 543(a)(6) is to prevent payments from shareholders to corporations from sheltering outside passive investment income. See S. Rept. No. 1622, 83rd Cong. 2nd Sess. (1954), 74, where in connection with section 543(a)(6) the Finance Committee stated that "in the absence of appreciable amounts of other investment income, rental income received from shareholders does not constitute a tax avoidance problem."

The continued concern of Congress since 1950 for exempting from personal holding company income payments for the use of corporate property by shareholders in their active business clearly should cover situations, like the instant case, where the assets of the corporation used in the shareholders' business consist of intangible, as well as tangible, property. Such a corporation is no more the "incorporated pocketbook" at which the personal holding company provisions are aimed than a corporation whose assets happen not to include intangible rights necessary for the business, and such corporation should not be trapped into personal holding company status in the absence of the proscribed amount of outside investment income.

It is important to note that this amendment will apply only where the intangible assets are part of an integral group of business assets consisting of tangible and intangible assets, and will not apply where the corporation merely licenses an intangible asset. Also, the amendment leaves undisturbed and preserves the existing prohibition against using payments from shareholders for the use of business assets to shelter substantial amounts of outside investment income. The amendment also insures that rents and royalties which are described under section 543(a)(6) and are excluded from personal holding company

income under that section will be excluded from sections 543 (a)(1) and 543(a)(2).

Since the purpose of this amendment is to relieve the unintended hardship of section 543(a)(6) on a taxpayer who unwittingly became trapped into personal holding company status this amendment should be made retroactive in a manner similar to what we did in 1950 and 1955. Actually there is more justification for retroactive relief here than in the previous cases since here we are correcting a situation not intended by the statute while before we merely granted relief from a clear statutory provision.

The Treasury voiced no objection to this amendment in its Administrative Position dealing with this bill dated June 15, 1976. However, apparently because of the recent publicity surrounding this and other amendments, the Treasury now attempts to criticize the amendment by claiming that the favorable treatment for rents should not apply to passive income such as royalties. But this claim is specious, since it is clear that the amendment covers only the limited situation of payments for intangible property which is leased along with tangible property for use in a single active business, in which case the payment for the intangible property should be treated the same as the payment for the tangible property. This situation does not

allow circumvention of the personal holding company provisions, as would exist in the case of the mere receipt of royalties by a corporation existing to hold title to intangible assets. The Treasury has confused this latter situation with the one covered by the amendment, since the lease of an integrated business consisting of tangible and intangible property does not constitute a technique for avoiding the personal holding company provisions.

This same confusion underlies the Treasury's claim that it is inappropriate to permit individuals to accumulate royalty income in their corporation. Where an integrated business consisting of intangible and tangible property is leased, the payment for the intangible property cannot be characterized as passive income, as in the case of mere royalty payments received by a corporation for the use of intangible property alone. The payments for the integrated business should, as in the case of rents under present law, be free from personal holding company taint.

While it is true that the amendment does not provide relief for payments from non-shareholders for intangible assets leased along with tangible assets in an integrated business, such relief is fully warranted and should be provided in future legislation.

STATEMENT BY U. S. SENATOR THOMAS J. MCINTYRE (D-N.H.)

BEFORE THE

COMMITTEE ON FINANCE -- ON H.R. 10612, THE TAX REFORM ACT

JULY 22, 1976

Mr. Chairman, thank you for the opportunity to speak before the Committee on Finance today. I am here to urge that the Committee give its full support, both on the Senate Floor and in conference with the House, to the solar energy tax credit provision as reported in the Senate version of H.R. 10612.

My statement at this time is very brief, but I wish to include for the Committee's information, as an appendix to my statement, the testimony of Sheldon Butt, President of the Solar Energy Industries Association, showing that the tax credit for solar energy can significantly reduce the Nation's dependence on foreign oil while providing jobs for American workers.

I shall forward more detailed remarks of my own to the Committee at a later date.

Thank you.

STATEMENT

OF THE

SOLAR ENERGY INDUSTRIES ASSOCIATION

TO THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

H.R.10612

TAX REFORM ACT

JULY 22, 1976

Submitted by:
Sheldon H. Butt
President
Solar Energy Industries Assn.

74-659 O - 76 - 2

The Solar Energy Industries Association is pleased to be able to comment on H.R.10612, the Tax Reform Act, which provides for tax credits for the installation of solar energy equipment. We believe that the tax treatment proposed is amply justified and extremely important to accelerating the use of solar energy equipment and technology.

The technology required for solar heating applications is, indeed, available today. Solar space heating equipment and solar water heaters are available commercially from an increasingly large number of manufacturers. The number of installations is increasing. A survey made recently by the Federal Energy Administration indicates that installations of medium temperature solar collectors in 1975 were over four times those made in 1974. However, volume is still small as compared to the magnitude of the energy problem.

The applications involved, heating building space both in residences and in nonresidential structures and heating domestic hot water, are important. Together, they account for over 20 percent of the entire national energy budget. Furthermore, the scarce fuels which we seek to conserve -- oil and gas -- account for a large part of the energy used in these applications. Thus, the energy application area which will be impacted is one which is peculiarly important to the nation.

It is anticipated that, within no more than fifteen years, with vigorous government programs designed to support accelerated utilization of the solar resource, solar energy can replace 1,000,000 barrels of crude oil per day. This will represent 15 to 20 percent of our continuing energy imports (primarily foreign oil) otherwise required, even after credit is taken for planned accelerated development of other "new" and existing convention energy resources and for the probable effect of accelerated conservation efforts.

The tax credit proposed for solar energy equipment amounts to 40 percent of the first $1,000 of expenditures, plus 25 percent of the next $6,400 for a maximum credit of $2,000. SEIA is in favor of this "step" proposal for two reasons. In the first place, it will provide the largest incentive to the owner of the relatively small home who needs a relatively smaller and less expensive installation. The owner of the smaller home is characteristically in a lower income bracket than the owner of the large home and needs additional help.

Secondly, a 40 percent credit on the first $2,000 will particularly provide an incentive to the installation of solar water heaters. These are the most productive in terms of energy savings, the most ready to move into the marketplace in large quantity, and they will lead to general acceptance of solar energy for heating and cooling.

Attached to these comments is a detailed projection of solar water heater, space heating and cooling sales in new construction and for retrofit of existing installations.

An important concept to understand with regard to an individual who installs solar equipment is that he becomes a producer of energy. In fact he becomes an energy producer just as much as is the electric utility company which purchases and installs new generating capacity, the coal mining company which purchases and installs mining equipment, or the oil and gas producer who drills an oil or gas well or builds a refinery or pipeline. All of these industries receive specialized tax treatment, in common with other industries. Indeed, the only exception is the homeowner who becomes an energy producer but who receives no specialized tax treatment under existing legislation.

Simply stated, we are asking for equitable treatment for the homeowner-energy producer.

We do not dispute the need for the tax benefits presently received by the conventional energy industries. They, as well as other industries, deserve and need the investment tax credits and depreciation allowances now received, as well as, in many cases, the depletion allowances granted them as a means of assisting them to attract and generate the capital funds required to support and expand their production. We are asking that equivalent treatment not be denied to producers of solar energy.

We believe that it is important that we look at the government investment required and compare it with the government investment required -- through the existing tax laws -- by the electric alternative.

If we look at the solar installation by itself (without the use of off-peak electric energy married to it), we find that government investment in tax credits would be $60 to $70 per barrel of oil saved per year. This would total $22-$25 billion spread over ten or fifteen years to save a million barrels of oil per day. At today's prices for imported cruide oil, the foreign exchange savings would repay the government investment in five or six years.

We may compare the $60 or $70 investment per barrel saved through solar alone with the government investment required to replace the same barrel of crude oil with new electric generating capacity. Based upon the present investment tax credits and depreciation allowances now received and their effect upon taxes paid, the electric alternative would require a much larger government investment. It would cost $150 per barrel saved or over twice as much as solar alone. The total government investment involved in saving a million barrels of oil per day with electric energy

is $55 billion. However, if we marry solar energy for 60 percent of the structure's thermal energy requirements with off-peak electricity for the remaining 40 percent, the taxpayers need only invest $40 per barrel of oil saved or only $15 billion over the ten or fifteen year period to save a million barrels per day. The $40 per barrel investment would be repaid by foreign exchange savings in less than three years.

One of the effects of the government's investment in solar facilities or in other energy producing facilities is to stimulate investment and spending in the private sector. The government's investment increases economic activity and increased economic activity increases tax revenues which offset the government investment. This is particularly true in the case of the government investment in solar heating facilities. As we indicated previously, solar equipment and solar installations are relatively labor intensive and therefore are particularly effective in stimulating economic activity. Stimulation is rapid since the lead time for new solar energy producing facilities is very short as compared to the long lead times involved in the building of new electric generating facilities.

In conclusion we have seen that solar water heating, space heating and cooling can provide a substantial input to the nation's energy budget in the next ten to fifteen years. We have seen that it can do this cost-effectively using existing technology. We expect that this technology will continue to be used in the more distant future and that, ultimately, it can provide from 10 percent to 15 percent of our total energy budget.

In that light, it appears that it is in the national interest to undertake aggressive government action which will stimulate the growth of the infant solar industry and benefit from the reduction in oil imports that will be achieved. We believe that the solar energy tax credit presently provided for in H.R.10612 will be a most important step in that direction.

PROJECTED SOLAR WATER HEATER, SPACE HEATING AND COOLING SALES IN NEW CONSTRUCTION AND RETROFIT OF EXISTING INSTALLATIONS GIVEN GOVERNMENT INCENTIVE

One of the important characteristics of solar systems is that, once purchased, they "fix" the cost of the energy they produce at a level equal to the carrying cost of the capital investment required. Thus, they represent a form of "inflation insurance." Therefore, it is important to note that these projections are based upon the expectation that general inflation will average 5% per year and further, that escalation in electric energy prices will be 2-1/2% per year higher than the general rate of inflation and that escalation in heating oil and natural gas prices will be 5% per year greater than the general inflation rate.

Most economists anticipate that inflation will average 5% to 6% per year. Inflation in this range appears to be "institutionalized" within our economic structure. There is little, if any, honest expectation that inflation rates will be lower. There is significant danger that they might be higher in the event of future worldwide food crises or in the event that the O.P.E.C. nations elect to become less restrained and more predatory in their crude oil pricing policies.

The 2-1/2% higher escalation rate projected for electric energy costs is based upon the expectation that primary fuel costs, after allowing for inflation, will continue to increase and upon the reality that new generating capacity costs a great deal more than existing capacity. As new capacity is added to the mix, the average cost of all existing capacity included in the utility rate base increases and rates correspondingly increase.

Projected escalation in fuel oil prices is based on the expectation that, first of all, the O.P.E.C. nations will raise prices to keep up with worldwide inflation (which is higher elsewhere than in the United States) and that the prices of domestically produced crude oil will continue to increase, eventually reaching the "world price" level. This will increase the average price paid by U. S. refineries for crude oil.

RESIDENTIAL SOLAR WATER HEATERS

Solar water heaters will become a major market factor most rapidly. There are several reasons. Hot water requirements are year-round and thus, the user's investment in a solar hot water heater achieves maximum utilization. Solar water heater installations are small as compared to space heat-

ing installations. The task of finding a suitable place to install the collector in a retrofit water heater installation is relatively simple. Furthermore, a normal solar hot water heater installation consists of the collector system and its associated controls and other hardware, and a solar hot water storage tank placed in series with a conventional hot water heater. To make a retrofit installation, it is only necessary to make a modest change in the plumbing so that the solar hot water storage tank is placed in the line ahead of the existing conventional water heater. A solar hot water heater, which can be conveniently added to existing structures as a retrofit installation, commands a large market potential. During the earlier years of solar market development, while the total number of solar installations is still modest and long term operating experience is lacking, the fact that the user's investment in a solar water heater is small as compared to a solar space heating investment, will lead many users to limit their risk by investing only in a water heater.

The table which follows details our projection of residential solar water heater sales in new construction and for retrofit:

RESIDENTIAL SOLAR WATER HEATERS

	NEW CONSTRUCTION		RETROFIT			
			Market Penetration, Percent			
Year	Market Penetration, Percent	Solar Water Heaters, Thousands Of Units(1)	Year	Cumulative	Solar Water Heaters, Thousands Of Units(1)	TOTAL, Thousands Of Units
1	0.5%	9	0.03%	0.03%	21	30
2	2.0	36	.10	.13	72	98
3	3.5	64	.25	.38	183	247
4	5.5	102	.60	.98	444	546
5	8.0	152	1.00	1.98	750	902
6	11.0	211	1.32	3.3	1,003	1,214
7	15.0	291	1.70	5.0	1,309	1,600
8	20.0	392	2.0	7.0	1,560	1,952
9	25.0	495	2.3	9.3	1,817	2,312
10	30.0	600	2.7	12.0	2,160	2,760
11	36.0	727	3.1	15.1	2,511	3,238
12	44.0	898	3.4	18.5	2,788	3,686
13	52.0	1,071	3.65	22.15	3,030	4,101
14	59.0	1,227	3.85	26.0	3,234	4,461
15	65.0	1,365	4.00	30.0	3,4[illegible]	4,765

(1) 1 unit equals the water heater for one dwelling unit. An installation to provide hot water for 10 units in a multiple family apartment is counted as 10 units.

As in the case of subsequent tables, "Year 1" is the first full year after the Government programs which have been called for by S.E.I.A. have been enacted and implemented. If this is accomplished in 1976, "Year 1" is 1977.

The next table converts unit sales of residential solar water heaters into dollar sales, expressed in 1976 dollars (without further inflation), and also shows the barrels of crude oil or its equivalent which will be saved through their use. Since fuel savings depend upon the cumulative number of units installed, the cumulative total installed is given:

RESIDENTIAL SOLAR WATER HEATERS

Year	Solar Water Heaters Installed, Thousands of Units		Dollar Value (1976 Dollars) Of Units Installed In The Year Millions	Barrels of Crude Oil (Or Equivalent) Saved	
	Year	Cumulative		Per Year	Per Day
5	902	1,833	$ 795	6,844,000	18,750
10	2,760	11,671	2,165	44,530,000	122,000
15	4,765	31,922	3,500	121,180,000	332,000

NONRESIDENTIAL SOLAR WATER HEATERS

Although residential applications are the major potential markets for solar water heaters, substantial market potential exists in nonresidential applications, including:

Schools
Hospitals
Office Buildings
Launderies
Car Washes
Other businesses using hot water

Initial significant penetration of this market is expected to be somewhat slower than in the case of residential water heaters. One reason is the very diverse nature of the market and the fact that many of the individual applications are highly specialized. In the long run, market penetration is expected to be substantial since in the present regulatory climate, many areas of energy consumption by "business" are more subject to curtailment and reduced allocation of scarce fuels during periods of shortage than are residential users. For example, regulatory bodies may well consider that energy required for heating domestic hot water for use in office buildings or energy required for heating hot water used in car washes is relatively nonessential. Our market projection for solar water heating for nonresidential applications follows:

NONRESIDENTIAL SOLAR WATER HEATERS

Year	Energy Consumption 10^{15} Btu/Year	Market Penetration, % Year	Market Penetration, % Cumulative	Square Feet Of "Standard" Solar Collectors Installed, Thousands
1	.61	.0005%	.0005%	7.6
2	.63	.001	.0015	16.0
3	.65	.003	.0045	48.8
4	.67	.01	.0145	167.5
5	.69	.03	.0445	517.5
6	.71	.08	.12	1,420
7	.73	.16	.28	2,920
8	.75	.32	.59	6,000
9	.77	.6	1.18	11,550
10	.80	1.0	2.13	20,000
11	.82	1.4	3.48	28,700
12	.84	1.7	5.10	35,700
13	.87	2.0	6.92	43,500
14	.90	2.3	9.00	51,750
15	.92	2.5	11 3	57,500

In turn, we have converted unit sales (expressed as the square feet of "standard" solar collectors used in the system) into dollar sales for complete systems, and we have also tabulated the crude oil or its equivalent replaced by solar energy. This tabulation follows:

NONRESIDENTIAL SOLAR WATER HEATERS

Year	Square Feet Of "Standard" Solar Collectors Installed, Thousands: Year	Cumulative	Dollar Value (1976 Dollars) Of Units Installed In The Year Millions	Barrels of Crude Oil (Or Equivalent) Saved: Per Year	Per Day
5	517.5	757.4	$ 8	58,400	160
10	20,000	42,600	250	3,285,000	9,000
15	57,500	259,800	635	20,075,000	55,000

RESIDENTIAL SOLAR SPACE HEATING

In most cases, solar space heating will be combined with solar domestic hot water heating--there will be few solar systems which are intended for heating only and do not also generate hot water. To simplify presentation of our projections, the dollar figures and crude oil saving figures presented represent only the additional sales value attributable to solar space heating itself and the additional crude oil savings resulting from solar space heating. The information presented is additive to the solar water heater projections. For example, we project 30,000 residential solar space heating installations in the fifth year in new construction and 152,000 solar water heaters in new residential construction. This means that there will be 30,000 installations made which perform the functions of both space heating and water heating and 122,000 which are water heaters only. Our projections follow:

	NEW CONSTRUCTION					
Year	Market Penetration, Percent	Solar Space Heaters, Thousands Of Units(1)	Market Penetration, Percent: Year	Market Penetration, Percent: Cumulative	Solar Space Heaters, Thousands Of Units(1)	TOTAL Thousands Of Units
1	0.1%	2	0.0006%	0.0006%	.4	2.4
2	.2	4	.0012	.002	.9	4.9
3	.4	7	.0024	.004	1.8	8.8
4	.8	15	.005	.009	3.7	18.7
5	1.6	30	.01	.019	7.5	37.5
6	3.2	61	.02	.039	15.2	76.2
7	6.0	116	.04	.078	30.8	147.4
8	11.0	216	.09	.17	70.2	286.2
9	18.0	356	.2	.37	158	514
10	24.0	480	.4	.76	320	800
11	30.0	606	.7	1.45	567	1,173
12	35.0	714	1.2	2.63	984	1,698
13	39.0	783	2.0	4.60	1,660	2,443
14	40.0	832	2.8	7.35	2,352	3,184
15	42.0	882	3.5	10.76	2,975	3,857

(1) 1 unit equals the water heater for one dwelling unit. An installation to provide hot water for 10 units in a multiple family apartment is counted as 10 units.

The following table converts unit sales into dollar sales and into barrels of crude oil or its equivalent saved:

Year	Solar Space Heaters Installed Thousands of Units Year	Cumulative	Dollar Value (1976 Dollars) Of Units Installed In The Year Millions	Barrels of Crude Oil (Or Equivalent) Saved Per Year	Per Day
5	7.5	14.3	120	912,500	2,500
10	320	608.5	2,300	25,550,000	70,000
15	2,975	9,147	10,800	173,375,000	475,000

NONRESIDENTIAL SOLAR SPACE HEATING

In the longer term, good penetration of this market is expected and again, particularly because of the greater vulnerability of many segments of this market to curtailment and allocation of conventional energy resources. Our projection for nonresidential space heating follows:

NONRESIDENTIAL SOLAR SPACE HEATING

Year	Energy Consumption 10^{15} Btu/Year	Market Penetration, Percent Year	Cumulative	Square Feet Of "Standard" Solar Collectors Installed, Thousands
1	4.28	.0002%	.0002%	29
2	4.37	.0004	.0006	60
3	4.45	.0008	.0014	123
4	4.54	.002	.0034	311
5	4.63	.005	.0083	793
6	4.73	.015	.023	2,430
7	4.82	.035	.058	5,778
8	4.92	.07	.13	11,796
9	5.01	.12	.24	20,591
10	5.11	.20	.44	35,004
11	5.22	.35	.78	62,575
12	5.32	.6	1.37	109,326
13	5.43	.9	2.24	167,380
14	5.54	1.3	3.49	246,669
15	5.65	1.7	5.13	328,971

The following table converts square footage of "standard" collector into dollar volume of the complete solar systems in 1976 dollars (excluding inflation) and to barrels of crude oil or equivalent saved per day:

NONRESIDENTIAL SOLAR SPACE HEATING

Year	Solar Space Heating Installed, Thousands Of Square Feet Of Standard Collectors		Dollar Volume (1976 Dollars) Of Units Installed In The Year	Barrels of Crude Oil (Or Equivalent) Saved	
	Year	Cumulative	Millions	Per Year	Per Day
5	800	1,300	16	73,000	200
10	35,000	77,000	600	4,380,000	12,000
15	330,000	992,000	5,000	54,750,000	150,000

SOLAR AIR-CONDITIONING

Air-conditioning, for both residential and nonresidential application, will be the slowest developing solar application. Although technically suitable solar air-conditioning equipment is now available, it is cost-effective only in a very limited range of applications. Additional engineering development is required to reduce cost and increase efficiency so as to broaden potential market base. Of course, the rising cost of conventional energy sources will also contribute to eventually making solar air-conditioning broadly cost-effective.

Residential air-conditioning applications will grow more slowly than nonresidential. This presents a contrast to the water heating and space heating market in which residential applications are expected to grow the most rapidly. The "cooling season" for commercial buildings, such as stores and office buildings, is longer than the residential cooling season. Thus, in these important markets, the solar equipment will be better utilized than in residential applications. In the southern part of the country, air-conditioning of stores and office buildings is very nearly a year-round load. The majority of nonresidential air-conditioning systems are chilled water systems in which the "product" of the air-conditioning machinery is chilled water. These systems lend themselves to retrofit with a solar unit in which the collectors and solar heat driven chiller supplement the existing conventional equipment. In some cases, only the solar collection system must be added since a substantial number of heat actuated chillers are now in use. Finally, the typical solar driven, heat actuated chiller requires the use of a cooling tower. Cooling towers are now widely used for heat rejection in commercial air-conditioning installations but are not generally used in residential installations. The operating complexity imposed by the cooling tower is not a material deterrent to the use of solar air-conditioning in nonresidential applications. It is a meaningful deterrent in the case of the residential applications, particularly so in single-family residences.

Our projection for residential solar air-conditioning installations follows. As in the case of residential space heating and residential water heating, the figures are additive to those for space heating and water heating. For example, in the tenth year in which we project 30,000 residential solar air-conditioning installations, 800,000 solar space heaters and

2,760,000 residential solar water heaters, this means 30,000 residential systems with solar air-conditioning, space heating and water heating; 770,000 with space heating and water heating and 1,960,000 water heaters alone. Our projections follow:

RESIDENTIAL SOLAR AIR-CONDITIONING

Year	Solar Air-Conditioner Installed Thousands(1)	Market Penetration, Percent
1	.01	.0006%
2	.02	.0011
3	.04	.0022
4	.08	.0043
5	.20	.011
6	.77	.04
7	2.9	.15
8	7.8	.4
9	15.8	.8
10	30.0	1.5
11	50.5	2.5
12	81.6	4.0
13	124.	6.0
14	166.	8.0
15	210.	10.0

(1) 1 unit equals the water heater for one dwelling unit. An installation to provide hot water for 10 units in a multiple family apartment is counted as 10 units.

The next table converts installed units to dollar sales in constant 1976 dollars (without inflation) and savings in barrels of crude oil or its equivalent per year and per day:

RESIDENTIAL SOLAR AIR-CONDITIONING

Year	Solar Air-Conditioners Installed, Thousands		Dollar Volume (1976 Dollars) Of Units Installed In The Year Millions	Barrels of Crude Oil (Or Equivalent) Saved	
	Year	Cumulative		Per Year	Per Day
5	.2	.35	.9	767	2.1
10	300	57.6	60.	94,900	260
15	210	690.	675	1,423,500	3,900

As discussed previously, nonresidential solar air-conditioning will grow much more rapidly than residential. In this one particular case, the totals are generally not additive to the totals for space heating and water heating. Our projection follows:

NONRESIDENTIAL SOLAR AIR-CONDITIONING

Year	Energy Consumption 10^{15} Btu/Year	Market Penetration, % Year	Market Penetration, % Cumulative	Square Feet Of "Standard" Solar Collectors Installed, Thousands
1	1.62	.00003%	.00003%	5
2	1.68	.00006	.00009	10
3	1.73	.00011	.00019	20
4	1.78	.00021	.00040	40
5	1.83	.0005	.00089	100
6	1.89	.0015	.0024	300
7	2.02	.005	.0072	1,060
8	2.08	.012	.019	2,600
9	2.15	.03	.048	6,800
10	2.21	.06	.11	14,000
11	2.28	.11	.21	26,000
12	2.34	.20	.41	49,000
13	2.41	.35	.75	88,500
14	2.49	.6	1.32	157,000
15	2.56	.9	2.19	240,000

The following table converts these projections into dollar volume in 1976 dollars (without inflation) and to barrels of crude oil or its equivalent saved per year and per day:

NONRESIDENTIAL SOLAR AIR-CONDITIONING

Year	Square Feet Of "Standard" Solar Collectors Installed, Thousands: Year	Cumulative	Dollar Value (1976 Dollars) Of Units Installed In The Year Millions	Barrels of Crude Oil (Or Equivalent) Saved: Per Year	Per Day
5	100	175	2.1	3,650	10
10	14,000	25,000	260	438,000	1,200
15	240,000	585,000	3,900	10,950,000	30,000

SUMMARY OF PROJECTIONS

Our next table summarizes dollar volume of solar units in all heating and cooling applications:

SUMMARY - SOLAR HEATING & COOLING
MILLIONS OF 1976 DOLLARS
(WITHOUT INFLATION)

	5 Yrs.	10 Yrs.	15 Yrs.
Water Heaters			
New Residential	120	435	950
Retrofit Residential	675	1,730	2,550
Nonresidential	8	250	635
Space Heating			
New Residential	90	1,200	1,900
Retrofit Residential	30	1,100	8,900
Nonresidential	16	600	5,000
Air-Conditioning			
Residential	.9	60	675
Nonresidential	2.1	260	3,900
TOTAL	942	5,635	24,510

Similarly, the final table summarizes crude oil savings in barrels per day:

SUMMARY - SOLAR HEATING & COOLING
BARRELS OF CRUDE (OR EQUIVALENT)
SAVED PER DAY

	5 Yrs.	10 Yrs.	15 Yrs.
Water Heaters			
New Residential	3,750	25,000	80,000
Retrofit Residential	15,000	97,000	252,000
Nonresidential	160	9,000	55,000
Space Heating			
New Residential	2,000	50,000	175,000
Retrofit Residential	500	20,000	300,000
Nonresidential	200	12,000	150,000
Air-Conditioning			
Residential	15	2,500	30,000
Nonresidential	10	1,200	30,000
TOTAL	21,635	216,700	1,072,000

It should be noted that these projections are predicated upon the development and implementation of a comprehensive and aggressive Government program designed to stimulate the growth rate of solar applications. Without the Government programs which the Solar Energy Industries Association has recommended, growth rate would be slower, although ultimately the same level of market penetration, sales and crude oil savings would be reached.

Summary of Statement of
John H. Filer
Before the Senate Finance Committee
July 22, 1976

1. Section 1508 of H.R. 10612 allows the filing of consolidated returns by both life insurance companies and mutual property-casualty insurance companies with their non-life affiliates, and thus eliminates existing discrimination against such companies by according them the same consolidation privilege that has long been enjoyed by industrial companies with non-life affiliates.

2. Through consolidation, section 1508 will permit immediate, rather than delayed, use of the tax benefits derived from losses that would otherwise shrink the insurance writing capital base of casualty affiliates. In that way, the provision will help to preserve the capacity of such companies to write insurance at precisely the time when the public interest most urgently requires the maintenance and increase in that capacity. It also will eliminate pressures which distort the investment policies of casualty affiliates to the detriment of capital markets.

3. The amendment has been fully and openly presented to both tax-writing committees of Congress. It was the subject of a hearing by this Committee in April of this year, when all interested parties had a full opportunity to present their views. It has also received favorable comment from the Joint Committee Staff, the Treasury Department and the Administration.

4. Section 1508 corrects a tax inequity, and helps alleviate a serious social and economic problem. In its presently modified form, it is a sound provision which should be retained in the bill.

Statement of John H. Filer
Before the Senate Finance Committee
July 22, 1976

Mr. Chairman and Members of the Committee:

My name is John H. Filer. I am Chairman of the Aetna Life & Casualty Co. of Hartford, Connecticut.

I am appearing today, as I had the privilege of appearing at your hearing on April 5, 1976, on behalf of an ad hoc group of twelve*/ stock and mutual life insurance companies to urge your support of what is now section 1508 of H. R. 10612. Section 1508 eliminates existing discrimination in the Internal Revenue Code, by allowing both life insurance companies and mutual property-casualty insurance companies to file consolidated returns with their non-life affiliates, a privilege that has long been accorded industrial companies with such affiliates.

As I explained in my prior testimony, the recent severe losses incurred by the property-casualty insurance industry have dramatically accelerated the erosion of its surplus position. Since surplus is the ultimate measure of capacity to insure risks, the result has been to place severe limits on both new risk assumption and the renewal of existing coverage by casualty insurance companies. Consolidation as contemplated by section 1508 would permit the tax savings

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*/ The twelve companies are: Aetna Life & Casualty, Hartford; CNA Financial Corp., Chicago; Connecticut General Life Insurance Company, Hartford; Equitable Life Assurance Society of the U.S., New York; Fidelity Mutual Life Insurance Company, Philadelphia; IDS Life Insurance Company, Minneapolis; Metropolitan Life Insurance Company, New York; Penn Mutual Life Insurance Company, Philadelphia; Prudential Insurance Company of America, Newark; Reserve Life Insurance Company, Dallas; State Mutual Life Assurance Company of America, Worcester; and Travelers Insurance Company, Hartford.

attributable to the losses of a casualty affiliate to be recognized and assigned immediately to the affiliate, thereby easing its surplus crisis on a current, rather than a delayed, basis. By permitting immediate recognition of losses, consolidation would also eliminate present pressures to distort the investment policies of casualty affiliates in a way that would be detrimental to the capital market for corporate equities and state and municipal bonds. In short, consolidation will have its most significant effect when losses threaten further shrinkage of the capital base of the casualty industry, and that is precisely the time when the public most urgently needs insurance capacity to be maintained and increased.

In its present form, section 1508 contains several modifications of the original proposal with respect to which I previously testified. These include a 50 percent limit on losses of affiliates that may be offset against life insurance company taxable income in any one year, a delayed effective date of January 1, 1978, and an elective provision. These modifications reflect a careful balancing of various interests affected by the provision, without detracting from its overall objectives. Accordingly, I am pleased to indicate our continued strong support for section 1508 today.

In addition, through this statement I would like to furnish the Committee with a complete chronology of the genesis of section 1508, so as to dispel any doubts regarding the full

74-650 O - 76 - 3

and complete consideration it has received by the Congressional tax-writing committees.

-- On April 27, 1973, over three years ago, a statement on the subject from counsel for our ad hoc group was filed with the House Ways and Means Committee and printed in its Hearings on Tax Reform.

-- On July 25, 1973, the statement together with lengthy, additional detailed memoranda were submitted to the Staffs of the Joint Committee on Internal Revenue Taxation and the Treasury Department for their review and analysis.

-- House and Senate bills on this subject have been before the Congress since January, 1975.

-- On September 15, 1975, Tax Analysts and Advocates analyzed the proposal in its publication, Tax Notes.

-- In February 1976, the proponents of the amendment requested permission to testify orally at the Senate Finance Committee hearings on tax reform.

-- In April 1976, I appeared before the Committee in support of the provision, and two groups opposed to the provision filed written testimony with the Committee.

-- On May 25, 1976, the Treasury Department submitted a written report to Chairman Long, stating that

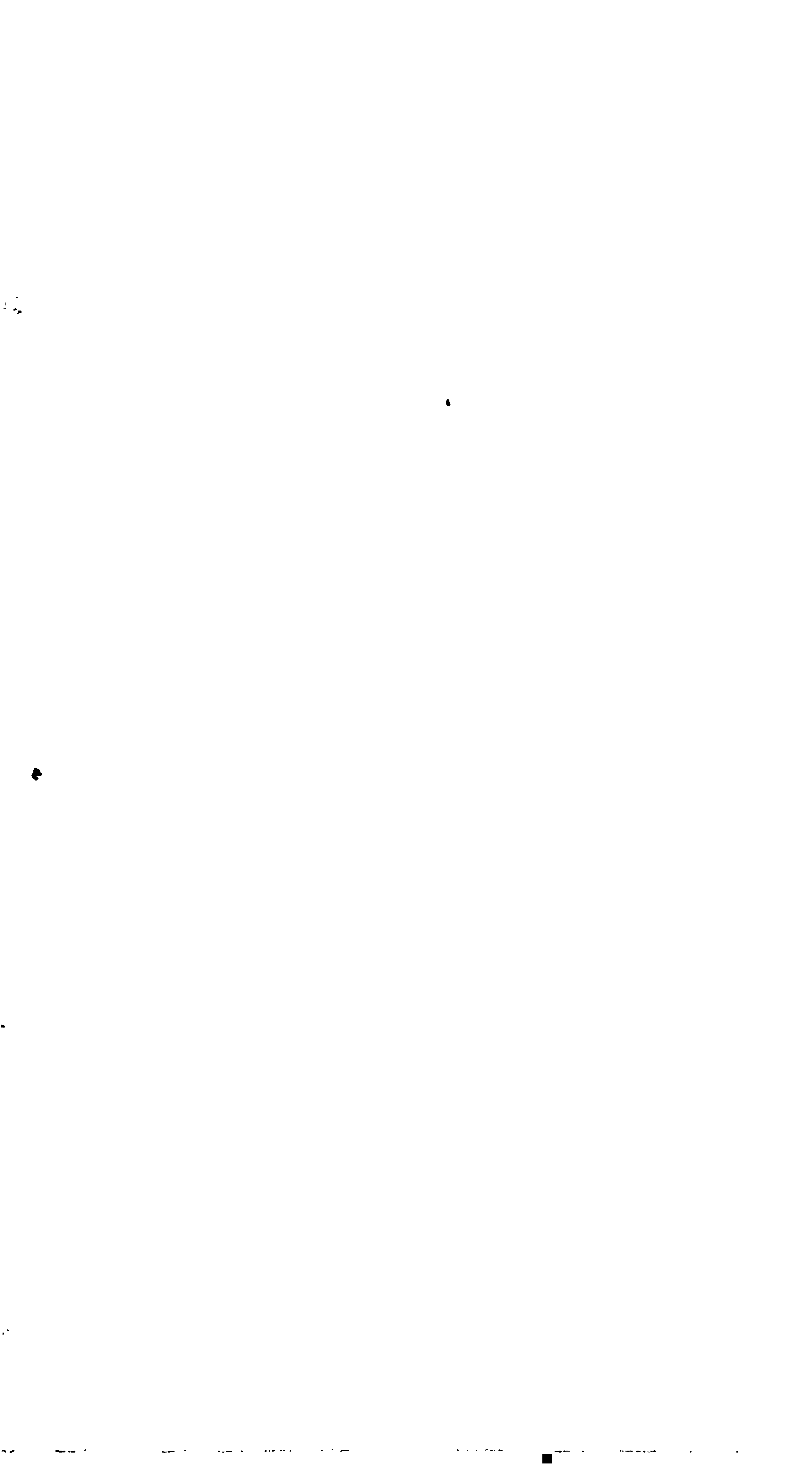
it was not opposed to the concept of consolidation embodied in the original proposal.

-- On May 27, 1976, the Finance Committee discussed and debated the proposal as it was presented by Senator Ribicoff in open session. Favorable comment was secured from the Joint Committee Staff. The Treasury Department also restated its views at that session. The Committee then approved the amendment, with the modifications I mentioned earlier, on a roll call vote.

-- On June 15, 1976, after the Committee reported the bill, the Administration stated that it had "no objection" to section 1508.

It is apparent, therefore, that the amendment has been fully and openly presented to the tax-writing committees of Congress. It was in fact the subject of a hearing by this Committee in April of this year, when all interested parties had a full opportunity to present their views before the Committee reached its decision to adopt the proposal in its present form and include it in the pending bill.

For these reasons, we believe it is clear that section 1508 has received full and careful consideration by the Committee. The provision corrects a tax inequity, and helps alleviate a serious social and economic problem. We urge its retention in the bill.



Foley, Lardner, Hollabaugh & Jacobs
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John W. Byrnes
July 22, 1976

Summary of Testimony
In Support of Section 2101 -- Modification of
Transition Rule for Sale of Property
By Private Foundations
On Behalf of Badger Meter, Inc.,
Milwaukee, Wisconsin

1. Section 2101 of H.R. 10612 does not involve a gain or loss in revenue. It relates only to certain regulatory matters affecting private foundations.

2. The Tax Reform Act of 1969 in effect prohibited certain transactions between a private foundation and its "disqualified persons" (generally, persons with an economic or managerial interest in the operation of the foundation). Among the transactions prohibited by the Act are the sale, exchange or leasing of property by the foundation to such persons (section 4941).

3. In recognition of the hardship that would result if certain existing leases of property by a private foundation to a "disqualified person" were immediately terminated, the Congress provided a transition rule permiting a continuation, under certain circumstances, of such leases until taxable years beginning after December 31, 1979. Prior to that date the leases must be terminated.

4. In some cases, such as the property currently leased by the Charles Wright Foundation to Badger Meter, Inc., a disqualified person, the property was designed to meet the particular needs of the leasee and the continued use of the property by Badger Meter, Inc., represents the highest and most economical use of the property. To sell or lease the property to a third person would only be possible at a financial sacrifice, while at the same time Badger Meter, Inc. will not be able to acquire similar property to meet its needs or will be able to do so only at very substantial additional cost.

5. As the law presently stands, after December 31, 1979, Badger Meter, Inc. can no longer continue to rent the property from the Charles Wright Foundation, nor can it purchase the property from the Foundation.

6. If undue hardship to a foundation and its "disqualified person" is to be avoided under these circumstances, a transition rule is needed to permit a sale of the property to the disqualified person in those cases where the lease qualifies under the existing transition rule relating to leases and the foundation receives an amount which equals or exceeds the fair market value of the property.

7. It is believed that the failure to provide such a transition rule in the Tax Reform Act of 1969 was an oversight. As stated in the Committee Report, "It appears likely that if this particular point had been presented in 1969, the Act would have been modified to deal with the situation".

8. Section 2101 of H.R. 10612, Tax Reform Act of 1976, as reported by the Committee on Finance, provides such a transition rule for those cases where the sale occurs before January 1, 1978.

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John W. Byrnes
July 22, 1976

Statement Submitted on Behalf of Badger Meter, Inc.
In Support Of
Modification of Transition Rule For
Sale of Property by Private Foundations

Section 2101 of H.R. 10612, Tax Reform Act of 1976

Background

Badger Meter, Inc. of Milwaukee, Wisconsin, is a substantial contributor to the Charles W. Wright Foundation, a private foundation, and comes within the definition of a "disqualified person" under the terms of the Tax Reform Act of 1969.

The manufacturing plant and administrative office of Badger Meter, Inc. is located in the Village of Brown Deer, Wisconsin. The administrative office was constructed to meet the needs of Badger Meter by the Charles Wright Foundation in 1957 on land acquired from Badger Meter. This land is contiguous to some 51 acres of Badger Meter property on which there is 187,000 square feet of buildings. A part of the administrative building is on land owned by Badger Meter.

In 1957, a 20-year lease was entered into whereby the Foundation leased the administrative building and surrounding land to Badger Meter. Subsequently, Badger Meter, at its own expense, made substantial improvements to the buildings and land.

Because of the close integration of the administrative building and other lease-hold improvements with the manufacturing plant and other facilities of Badger Meter, the continued use of the property by Badger Meter represents the highest and most economically feasible use of the property from the standpoint of both Badger Meter and the Foundation. Subsequent to the enactment of the Tax Reform Act of 1969, the property was appraised as required by the Act. The appraisers concluded that the highest and best use of the property is its present use, that the location of the office layout is not suited to multi-tenant occupancy and that in all likelihood, another single tenant would not be found because of the geographic location, existing and planned freeways and public transportation. They also concluded that the sale of the property to a third party would be extremely disadvantageous to the Foundation for the same reason.

Tax Reform Act of 1969

The Tax Reform Act of 1969 made substantial changes in the law with respect to private foundations. Included in the changes was the imposition of taxes and penalties that in effect prohibit certain transactions between a private foundation and its "disqualified persons" (generally, persons with an economic or managerial interest in the operation of the foundation). Among the transactions covered by the prohibitions on such "self-dealing" is the sale or leasing of property.

Recognizing that the application of the new rules to existing arrangements would, in certain circumstances, cause unnecessary disruption, the Congress provided transition rules to cover certain arrangements which had come to the attention of the Congress.

To cover the case where there was an existing lease between the foundation and a disqualified person, the law permits a continuation of those leases in effect on October 9, 1969 until taxable years beginning after December 31, 1979, as long as the lease remains at least as favorable to the private foundation as it would have been between unrelated parties. However, after December 31, 1979, the leasing arrangement must be terminated.

Another transition rule permits a private foundation to sell to disqualified persons any business holdings that the private foundation was required to dispose of because of the business holdings provisions of the Act.

Overlooked in providing transition rules were situations where it would be advantageous for a foundation which has a lease with a disqualified person to sell the property to such person. Under the law as it presently stands, the foundation can neither continue to lease the property to the disqualified person after December 31, 1979, nor can the foundation sell the property to the disqualified person. The foundation must either find a new tenant or sell the property to a third person. In some situations, the leased property was designed or so modified to accommodate the disqualified person's business that it would be of little value to the foundation or anyone else, while the disqualified person will incur substantial additional cost if it has to acquire other property (which might not be available at any cost locally). Unless the transition rules are modified to make allowance for these cases, both the foundation and the disqualified person will suffer unnecessary losses.

Solution - Section 2101

Section 2101 of H.R. 10612, Tax Reform Act of 1976 as reported by the Committee on Finance, makes a perfecting amendment to the transition rules to permit, for a limited period, a private foundation to sell to a disqualified person property previously leased to such disqualified person and which lease is within the present transition rule relating to leases to disqualified persons. It provides that such foundation shall receive for the disposition an amount which equals or exceeds the fair market value of the property.

The provisions of Section 2101 were unanimously reported to the House of Representatives by the Ways and Means Committee in the 92nd Congress (H.R. 9520, Report 92-965), but because of procedural problems, it was not considered by the House. In the 93rd Congress, the Ways and Means Committee approved the inclusion of the bill in the so-called Tax Reform Bill of 1974. The Committee, however, did not conclude its work on the bill and it was not reported to the House.

The Treasury Department filed reports on the bill in the 92nd and 93rd Congress raising no objections to the bill.

Similar bills have been introduced in the 94th Congress. (H.R. 11118 and H.R. 12564 by Congressmen Schnnebeli and Karth, respectively.)

Because the time during which a private foundation can continue to lease to a disqualified person is running out, it is imperative that Congress act at an early date to avoid severe and unintended penalties being imposed on certain foundations and their leasees who find themselves in situations similar to that of Badger Meter, Inc. and the Charles Wright Foundation. Section 2101, as reported by the Committee on Finance, provides such a transition rule.

July 22, 1976

Statement of
The Association of American Publishers
and
The Ad Hoc Committee for Equitable
Tax Treatment of the Publishing Industry
Submitted to
The Committee on Finance
United States Senate

Summary of Principal Points

1. The publishing industry of the United States strongly supports Section 1305 of H.R. 10612.

2. Section 1305 prevents retroactive application of Revenue Ruling 73-395 which purports to require publishers to capitalize prepublication expenditures directly attributable to development of textbooks and teaching aids.

3. A comprehensive survey establishes that such capitalization would be contrary to a long-standing and substantially uniform practice of deduction previously accepted by the Internal Revenue Service.

4. Deduction of these amounts is directly comparable to the deduction of research and development expenses allowed to other industries.

5. The impact of Revenue Ruling 73-395 would fall most heavily on educational publications, which should not be subjected to additional burdens.

6. Section 1305 does no more than preserve the status quo unless and until the Treasury Department adopts new rules through the Regulation process, which affords interested parties an opportunity to be heard.

7. No revenue loss is involved since prior law is preserved.

8. For the foregoing reasons, Section 1305 which was approved by the Committee on Ways and Means and passed by the House of Representatives, should be adopted by this Committee and the Senate.

Statement of
The Association of American Publishers
and
The Ad Hoc Committee for Equitable
Tax Treatment of the Publishing Industry
Submitted to
The Committee on Finance
United States Senate

July 22, 1976

I. Introduction

The Association of American Publishers, a not-for-profit trade association, represents publishers of 80 to 85 percent of the general books, textbooks and educational materials produced in the United States. The Ad Hoc Committee for Equitable Tax Treatment of the Publishing Industry represents Harcourt, Brace, Jovanovich, Inc.; Macmillan, Inc.; W.W. Norton, Inc.; and G. P. Putnam's Sons as well as all members of the Association of American Publishers. The Ad Hoc Committee thus represents publishers of approximately 90 percent of the books published in the United States.

The Association of American Publishers and the Ad Hoc Committee file this statement in support of Section 1305 of H.R. 10612, which in substantially its present form was contained in the bill as passed by the House of Representatives and was approved by the Finance Committee during its open mark-up session on May 27, 1976.

Section 1305 will prevent the unfair retroactive application of Revenue Ruling 73-395 by permitting publishers

to continue their customary treatment of prepublication expenditures without regard to that ruling until Treasury decides that these consistent practices should be changed. Any change would be through prospective regulations issued with notice of proposed rule-making, thus providing the public an opportunity to comment formally.

The prepublication expenditures affected by Section 1305 are those paid or incurred in connection with the taxpayer's trade or business of publishing or writing for the writing, editing, compiling, illustrating, designing or other development or improvement of a book, teaching aid or similar product. These prepublication expenditures are the equivalent for the publishing industry of the research and development expenses of other industries which Section 174 of the Code allows to be deducted currently.

Section 1305 is identical to the provision in the House bill, except for clarifying technical changes and its extension to cover professional authors.

II. Need for Legislation

The need for the proposed legislation arises from the Internal Revenue Service's pronouncement in Revenue Ruling 73-395 on September 24, 1973, that publishers could not currently deduct expenditures incurred in writing, editing, design and art work, which were directly attributable to the

development of textbooks and teaching aids. The ruling held that such costs must be capitalized, and amortized over the useful life of the copyright of the book for which such expenditures were made, unless the taxpayer were able to prove a shorter useful life for the book.

Although the ruling affected the entire publishing industry, it was issued without prior notice and opportunity for industry comment. The publishers' accounting practices for these costs have, in many cases, been consistently followed for more than 50 years, have been approved by competent, reputable accounting firms, and have, until recently, been approved by IRS audit personnel either tacitly by not raising the issues, or explicitly by dropping the issue after it was raised.

The extent to which the ruling would alter the dominant industry methods of accounting was clearly revealed by a recent Ad Hoc Committee survey of the tax treatment of prepublication expenditures. The segments of the industry covered by the Ad Hoc Committee survey included some forty publishers of elementary and secondary school textbooks, college textbooks, technical, scientific, medical and business books and subscription reference books (primarily encyclopedias). Publishers of these types of books represent over 50 percent of the total publishing industry sales, and are those which have been most directly affected by the IRS ruling. The companies which responded to the Ad Hoc Committee survey account for some 83 percent of the dollar sales of the publishers in the surveyed

segments of the publishing industry. A detailed analysis of this survey was given several months ago to the Joint Committee Staff, to the Finance Committee Staff and to the Treasury and the Internal Revenue Service.

The Ad Hoc Committee survey showed that there has been a substantially uniform practice among publishers of currently expensing all "editorial" and "production" expenditures (primarily art, design, purchasing and administrative functions), with the possible exception of expenditures for editorial and production work performed under contract by outsiders. Approximately one-sixth of the responding publishers indicated they employ some method of deferral for outside editorial and production costs. With respect to "plant" costs (primarily outside artwork, composition, negatives and plates), about one-third of the responding companies have currently expensed those amounts, and about two-thirds of them have written the amounts into inventory or amortized them over a number of years. The substantial uniformity of publishers expensing prepublication expenditures, particularly editorial and production costs, as revealed by the survey, underscores the inequity of the sudden reversal of IRS audit practice by its issuance of Revenue Ruling 73-395.

The results of this survey demonstrate that the compulsory retroactive change attempted to be imposed by Revenue

Ruling 73-395 affects a large segment of the industry. Over one-third of the responding companies reported that the IRS has challenged the company's income tax accounting for one or more categories of prepublication expenditures. Since many companies still have back years open for audit, the number of companies directly affected could be far greater if Section 1305 is not enacted. Thus, this is clearly an industry-wide problem.

The costs which the ruling asserts to be not currently deductible are the publishing industry's equivalent of the research and development expenditures that are paid or incurred by other business taxpayers in the creation of new products.*/ They include salaries and fees paid to employees and consultants who design, edit, illustrate, compile and revise the books and teaching aids published by the industry. Like any other industry which must develop and market its own products, the publishing industry's development expenditures are a normal and recurring cost of doing business. Many of these expenditures in any event should be deductible under Section 162 as ordinary and necessary business expenses. In

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*/ Compare Revenue Procedure 69-21, 1969-2 Cum. Bull. 303 in which the IRS ruled that the costs of developing computer software in many respects so closely resemble research and experimental expenditures within the purview of Section 174 as to warrant accounting treatment similar to that accorded under Section 174.

enacting Section 174 as part of the 1954 Code, Congress intended to eliminate controversy as to whether a particular expenditure for research, product development and the like is or is not covered by Section 162. Nonetheless, the ruling arbitrarily singles out and excludes the publishing industry from expensing these amounts, and thereby increasing the cost and discouraging the development of publishing textbooks, reference works and teaching aids, thereby penalizing school systems, students and every American who reads.

Because it represents such an abrupt change in tax accounting practices, the ruling has created considerable confusion in the publishing industry, posing questions as to potential retroactive tax liability for amounts spent on books already published and creating uncertainty as to the proper handling of the costs of publications to be undertaken in the future. Since the promulgation of the ruling, IRS auditing agents have proposed disallowing deductions previously consistently taken by a number of publishers in their development of new books. However, it appears that no two audits have resulted in selection of the same expenses for capitalization or an equivalent amortization treatment of items capitalized. Indeed, in each case to date in which the ruling has been invoked on audit, it has been applied in markedly different ways. The impact of the ruling on a

74-659 O - 76 - 4

publisher now seems to depend greatly upon the location of the IRS office responsible for the audit.

Despite the longstanding practice of current deduction of prepublication costs shared by most of the Publishing industry, the IRS insisted that the ruling reversing that practice be applied retroactively. On February 11 of this year, despite earlier votes by the House and by the Senate Finance Committee approving legislation to end the retroactivity, the IRS National Office instructed a field office to proceed with enforcement of retroactive tax assessments under the ruling. A subsequent IRS press release of March 11, 1976, which announced the suspension of audit and appellate activity under the ruling pending the completion of a project to re-examine the matter, does not obviate the need for prompt enactment of this legislation, since the IRS has given the industry no assurance that it will alter its insistence on the retroactive application of the tax rules announced in the ruling.

III. Legislative Solution

Section 1305 merely provides a "do-not-disturb" rule to preserve the status quo for the period before a long-run solution is put into effect. Under this legislation, for the period before regulations for the future go into effect, a taxpayer is allowed to treat his prepublication expenditures in the manner in which he consistently treated them before the issuance of Revenue Ruling 73-395.

The publishing industry will continue its co-operation with the Joint Treasury - IRS Task Force that is studying the problem and attempting to develop a permanent administrative solution to be applied prospectively. However, if the Task Force is unable to devise an adequate administrative solution, the industry will be forced to seek a permanent resolution of the problem by means of additional legislation.

IV. Revenue Effect

No revenue loss will result from enactment of the stop-gap legislation. Rather, the legislation will prevent the IRS from retroactively producing tax revenue by administrative action from a source never intended by Congress. The House Ways and Means Committee report to the House on the legislation as passed by the House in December, 1975, stated that no revenue loss will result, and the Finance Committee Report on H.R. 10612 (p. 405) confirms that little or no revenue loss is involved.

V. Status of the Legislation

The Association of American Publishers and the Ad Hoc Committee requested the opportunity to testify on this subject before the House Ways and Means Committee in July, 1975, in its hearings on tax legislation that became H.R. 10612, but were not called to testify. In lieu of oral testimony, a statement in support of H.R. 8736 (identical to S. 2340)

was filed, and appears in the printed transcript of the Ways and Means hearings on the subject of tax reform (commencing on page 839). The Committee on Ways and Means did not adopt a permanent solution to the problem, but in its open mark-up sessions in October 1975 did approve the stop-gap do-not-disturb provision which was passed by the House on December 4, 1975, as Section 1306 of H.R. 10612.

The Association and the Ad Hoc Committee made written request to testify before the Finance Committee in connection with its public hearings on H.R. 10612, but were not called to testify. Accordingly, they filed with the Finance Committee a written statement dated April 23, 1976, in support of this provision. The statement was referred to in the Staff pamphlet dated April 30, 1976, summarizing statements that had been submitted (p. 32).

The provision was considered by the Finance Committee in an open mark-up session on May 27, 1976, and was approved with technical clarifying changes and an extension to cover professional authors.

Thus Section 1305 has been under public consideration and discussion approximately a year, statements in support of it have been filed in hearings before both Committees and it has received the approval of both Committees in open mark-up sessions.

VI. Conclusion

For the reasons stated above it is respectfully submitted on behalf of the publishing industry that Section 1305 as previously approved by the Committee on Finance, at least as it applies to publishers, should be enacted.

July 21, 1976

Before the Committee on Finance
United States Senate

Statement of The Authors League of America

on

Deduction of Authors' Research and Other Expenses: Sec. 1306, H.R. 10612

Mr. Chairman and Members of the Meeting:

My name is Irwin Karp. I am Counsel for The Authors League of America, the national society of professional writers. I respectfully request that this statement by The Authors League be included in the record of the Committee's hearings on H.R. 10612.

This statement concerns the tax treatment of research, travel and similar expenses incurred by professional authors in gathering information, preparing and writing books and other literary works. As the Courts have ruled, these are ordinary and necessary expenses of the professional author's trade and business of writing which he is entitled to deduct in the year they are incurred. However, a 1973 Ruling by the Internal Revenue Service disputes that right. Section 1306 (H.R. 10612) would suspend application of the Ruling to professional authors, and to publishers.

The Authors League respectfully urges that Section 1306 be approved by the Committee on Finance and adopted by the Senate. We should stress that the Section does not grant professional authors new rights. On the contrary, it preserves rights which the Courts have held they possess.

Background

In 1971, a District Court opinion reaffirmed the right of professional authors to currently deduct research and similar expenses incurred by them in preparing and writing books and other literary works. Stern v. United States, 1971-1 USTC 86,419 (Par. 9375). Professional authors had long followed this practice. Courts upheld it.

The IRS did not appeal the Stern decision. Instead, it issued Rev. Rul. 73-395, contending that these "prepublication expenses" could not be currently deducted by publishers, and had to be depreciated over a period of years. The Ruling concludes with a refusal by the IRS to follow the Stern decision and has been applied to authors.

Sec. 1306 of the House Tax Reform Bill, also submitted as an amendment by Senator Bentsen, suspended application of the Ruling with respect to publishers. Professional authors were not protected by the Section, although the Ruling is aimed at a decision that correctly upheld their right to deduct these expenses in the year incurred.

Your Committee amended Section 1306 to also apply it to authors engaged in the trade or business of writing. The Authors League had, on April 20, 1976, submitted a statement to the Committee urging that amendment. It should be noted that Section 1306, as thus amended, would apply only to professional authors, i.e. those engaged in "the trade or business of writing"; this criterion is often applied by the IRS and the courts in distinguishing professional authors from amateurs under various sections of the Internal Revenue Code.

A recent "News Release" by the IRS announces it will "suspend audit and appellate activity with respect to cases in which the deductibility of these prepublication expenses is an issue" pending completion of a "project" which may lead to new regulations or additional rulings. However, the release is limited to publishers. And it leaves professional authors completely in the dark as to the position the IRS would take if they continued to currently deduct research, travel and similar expenses, as the Courts have ruled they are entitled to do.

Reasons for Adopting Section 1306

(i) In the case of novels, histories, biographies and other books of general interest, it is the self-employed author, not the publisher, who pays the travel, research and other expenses incurred in gathering information and material for a book. As the Court indicated, in Stern v. U.S., these expenditures are not non-deductible expenditures for the improvement of a capital asset (which must be depreciated). On the contrary, ruled the Court,

> "(these) expenses were ordinary and necessary expenses of carrying on plaintiff's business of a writer and hence are deductible under 26 U.S.C. 162(a). See Doggett v. Burnet (65 F2d 191); Brooks v. C.I.R. (274 F.2d 96.)"

Travelling to conduct interviews, consulting research sources and similar preparatory work are as much part of the process of writing a book as are putting the words down on paper. The expenses of doing this work are ordinary business expenses.

(ii) It is totally inconsistent to rule that these ordinary business expenses must be capitalized and depreciated. Sec. 1221(3) of the Internal Revenue Code prohibits authors from treating their literary, dramatic and musical works as "capital assets." In this and other sections, authors are held to be persons who earn "ordinary income" by their personal efforts. As this Committee stated in regard to Sec. 401 (c)(2)(C), "income from an author's writing ... is (so) clearly a result of his individual efforts."

(iii) An author must pay his research and travel expenses as they are incurred. And he does not have the financial resources to spread their deduction over a period of years through depreciation. If he cannot deduct them in full in the year they are incurred, he suffers a much harder financial blow than a publishing corporation. Moreover, these prepublication

expenses usually are incurred during the same period that the author receives compensation from the publisher (in the form of an "advance") from which he pays these expenses. This compensation is fully taxable to the author at the time of its receipt.

We thank the Committee for the opportunity to submit this statement.

The Authors League of America

By: Irwin Karp, Counsel

SUMMARY
OF
STATEMENT OF KENNETH R. WAHLBERG
ON BEHALF OF INVESTORS SYNDICATE OF AMERICA, INC.
BEFORE SENATE COMMITTEE ON FINANCE
ON
TREATMENT OF FACE-AMOUNT CERTIFICATES
(SECTION 1307 OF COMMITTEE BILL)

For over fifty years, the holders of face-amount certificates have been taxed on the interest element in the certificates when they received the proceeds of the certificates either at maturity or earlier surrender.

The holder is typically a cash-basis taxpayer. It is sensible for him to pay the tax on the interest when he receives the interest.

The Internal Revenue Service considers that the 1969 Act changed the law to require these cash-basis taxpayers to pay tax each year on the interest in their certificates as it accrues. Requiring ratable payment will adversely affect the sale of face-amount certificates.

The Committee amendment clarifies the law to restore the long-standing treatment of taxing holders of face-amount certificates when they receive the proceeds of their certificates.

STATEMENT OF KENNETH R. WAHLBERG
ON BEHALF OF INVESTORS SYNDICATE OF AMERICA, INC.
BEFORE SENATE COMMITTEE ON FINANCE
ON
TREATMENT OF FACE-AMOUNT CERTIFICATES
(SECTION 1307 OF COMMITTEE BILL)

Mr. Chairman:

My name is Kenneth R. Wahlberg. I am President of Investors Syndicate of America, Inc. whose headquarters are in Minneapolis, Minnesota.

Investors Syndicate of America, Inc. is engaged in the business of issuing face-amount certificates. Under an installment certificate, the certificate holder makes installment payments over a period of 30 years; upon maturity of the certificate, the holder is entitled to receive an amount equal to its face amount which is the cumulative installment payments plus an interest element.

At the present time Investors Syndicate of America, Inc. has face-amount certificates outstanding in the amount of $2.2 billion. At the end of 1975 there were approximately 250,000 persons holding these face-amount certificates. The sales of new certificates in 1975 equaled approximately $468 million in face amount.

From the time the 1954 Code was enacted until the 1969 Act, the tax treatment of payments by the issuing company to the holder of a face-amount certificate was very clear. The rule was that a face-amount certificate was to be treated for federal income tax purposes in the same way as an endowment contract under §72 of the Code. This treatment is confirmed by the specific statement in §72(l) that "the term 'endowment contract' includes a face-amount certificate." Consistent with §72(l), it is provided in §1232 that face-amount certificates are not to be treated as original issue discount paper under that Code provision; §1232(d) states that "for special treatment of face-amount certificates on retirement, see section 72."

When the 1969 Act was enacted, there was nothing in the law itself or in its legislative history that indicated that Congress, in any respect, had in mind face-amount certificates when it made changes in §1232 affecting original issue discount bonds. In fact, since the amendments to §1232 did not expand the scope of that Code provision, nor change the language of §72(l) and §1232(d), it appears that Congress did not intend to

change the taxation of face amount certificates which historically have been separately defined and separately treated by the Code.

Our problem arises because the Treasury, relying upon the 1969 Act, amended its regulations to tax face-amount certificates under §1232, thereby requiring a certificate holder to include in taxable income each year his ratable part of the interest element that he will not receive until the certificate matures at the end of 30 years.

Since Congress appeared to have no intent to change the treatment of face-amount certificates in the 1969 Act, we asked your Committee to confirm our understanding of the state of the law. We asked that the tax reform bill provide that the taxation of face-amount certificates is to continue as it had existed during the period 1954 through 1969.

The committee amendment clarifies §1232(d) of the present law to provide that face-amount certificates are not subject to the rules under §1232, but rather are to be taxed under §72. As a result, the interest element in a face-amount certificate would not be ratably included in the gross income of the holder over the term of the certificate since a typical certificate holder is on a cash basis. Instead, the interest element would be included in the gross income of the holder upon actual receipt by him, either at maturity of the certificate, or upon an earlier redemption.

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Summary of Principal Points of Testimony of Dr. N. Jay Rogers, Partner, Texas State Optical Co. (TSO)

1. TSO is a partnership for the practice of optometry and sale of eyeglasses and frames with approximately 128 outlets, some of which have been sold, and some owned in partnership with managing optometrists.

2. TSO advertises its services and provides low cost eyecare.

3. General advertising and small size of outlets dictates certain controls being imposed which have resulted in adverse tax impact.

4. 1969 franchise transfer tax law directed at fast food outlets dictates ordinary income treatment for income from transfers of franchise, trademarks, and trade names, rather than capital gains.

5. Contrary to almost invariable practice, the law failed to consider binding contracts entered into prior to the date of enactment based on previous law.

6. The Committee on Finance passed an equitable grandfather clause amendment which we support applying to transfers of professional practices.

7. Another part of the amendment adopted closes off capital gains treatment of a franchise transfer to a partnership and then the sale of a partnership interest, thereby otherwise circumventing 1969 franchise tax provision.

Testimony of Dr. N. Jay Rogers On Section 1311 of H.R. 10612 Relating To Certain Franchise Transfers

Thank you, Mr. Chairman, for allowing me the opportunity to express my views on section 1311 of H.R. 10612, relating to the transfer of certain franchises. My name is Dr. N. Jay Rogers and I am a partner in the firm of Texas State Optical (TSO), a partnership which operates in Texas and Louisiana. TSO is owned by myself and my brother. We started our optometry practice in 1936, and have, over the years, opened approximately 128 outlets, usually also connected with the sale of eyeglasses and eye frames. From about 1944 to the present we sold approximately 60 of these outlets. We operate 39 others in partnership with the optometrists who operate the offices, and own the other 29 outright.

Over the years, we have been able to provide to our customers inexpensive but quality eye care, eyeglasses, and prescriptions. In fact, because of the way we operate, we have been able to furnish these glasses and prescriptions at a price which is significantly below what would be charged in most other areas of the country. One of the methods we use in providing this is to have an extensive program of advertising. This program obviously benefits all of the outlets in the advertising area, with the result that we must require all outlets to participate in the advertising. We were innovators in the advertising of eyeglasses and eye frames, something which the Federal Trade Commission has recently adopted as one of its recommended policies. However, because of our advertising operation, and the small size of our outlets which dictate certain controls being imposed for good business purposes, we have

been adversely affected by a tax provision which was adopted by the Congress in 1969 and which became effective the following year.

Prior to 1970, if someone transferred a franchise, trademark, or trade name to another person, the character of any gain recognized on the transaction would be subject to the normal tax rules. Under these rules, some situations would give rise to ordinary income treatment and others would result in capital gains treatment. In 1969, Congress adopted a provision aimed at the fast food industry which became effective in 1970 which mandated ordinary income treatment for all of these transfers. In doing so, however, it failed to take into account that taxpayers might have already entered into binding contracts and would be caught in this amendment. As you know, Congress generally "grandfathers" binding contract situations when they adopt rules which change the tax law. Because this was not done for this change, the economics of our transactions covered by these contracts were significantly and adversely affected. They obviously had been negotiated under the prior law, which we believe in our situation would have given rise to capital gains treatment. Instead, because of the law change, we now find ourselves having binding contracts with prices which presume capital gains treatment but which now may result in ordinary income treatment. Most of these contracts were not entered into in 1970 or subsequent years but in 1968 or earlier years.

When our accountants called this situation to our attention, we gave considerable thought to whether or not to petition the Congress, as is our constitutional right, to consider our situation,

and decided to ask for the adoption of an equitable grandfather clause which would take into consideration that certain binding contracts had been entered into before 1970. We rejected an approach which we felt equitable, after consultation with the congressional staffs, that would have excluded all professional practices from these rules which were originally adopted because of abuses in the fast food franchise area. Obviously, when this provision was first adopted nobody thought that professional practices and businesses connected thereto would be swept under this provision. In order to correct this inequity which we pointed out, the Committee on Finance adopted a provision which grandfathered those contracts entered into before 1970, which were entered into with employees or partners of the transferor, and which involved the transfer of a franchise, trademark, or trade name which was connected with a business in which a professional practice is involved. It is my opinion that this is a very sound approach. These tests cover those situations which Congress found deserved attention but at the same time are restrictive enough so that they do not cover situations which, if brought to the attention of Congress, would be considered inequitable.

The Committee also adopted as part of this section a reform provision which has the effect of denying taxpayers a method of avoiding the ordinary income treatment provided under the franchise rules. It is possible under present law for taxpayers to transfer a franchise, trademark, or trade name to a partnership and then sell the partnership interest and receive capital gains therefrom, rather than deriving ordinary income if this sale had been made directly to the purchaser. TSO has opinion of counsel that certain of our transactions would also be covered by this

provision. We recognize that Congress may want to close this avenue of avoiding the franchise rules, and accept the Committee's decision on this point. We would, however, like to point out that the effect of this entire provision is to drive the price of these outlets up for very small entrepreneurs who are trying to establish a business. Furthermore, we might also point out that these rules were originally developed for problems which had arisen in the fast food franchise area and nobody at the time thought they covered the sale of a professional practice.

Because of situations like this, it is our opinion that the Committee on Finance is doing a commendable job in reviewing broad based legislation subsequent to its enactment in order to determine if the legislation should be changed to cover situations that were not covered under the original draft or to exclude equitable situations which should not have been covered but which were because of the breadth of the statute.

On my behalf and for my brother, I wish to state we seek no unfair tax advantage, but we respectfully ask what is wrong with our requesting that an obvious legislative oversight be corrected by the addition of a binding contracts clause, a provision common to almost every tax law change.

TESTIMONY BEFORE SENATE FINANCE COMMITTEE

SENATOR RUSSELL B. LONG, CHAIRMAN

JULY 22, 1976

SUBMITTED BY:

ROBERT E. JULIANO
LEGISLATIVE REPRESENTATIVE
HOTEL & RESTAURANT EMPLOYEES
& BARTENDERS INTERNATIONAL
UNION, AFL-CIO

Mr. Chairman, In behalf of our General President, Edward T. Hanley, and the 500,000 members we are proud to represent, We are gratified at the opportunity to appear before your Committee to discuss a matter of vital importance to our International Union.

First of all we would like to extend our thanks to the Committee for their thorough deliberation of the tip income issue which culminated in a clarifying amendment being overwhelmingly adopted on May 27, 1976. The merits of this issue today are as strong as they were when this Committee adopted the aforementioned amendment. I am pleased to appear today in behalf of a Union which represents a half million members, approximately 25 percent of whom are classified as tipped employees. We also realize our appearance in this matter will assist thousands and thousands of tipped employees who are not part of the organized labor movement. Our members, as well as the working people of America, are in fact our "Special Interest."

Mr. Chairman, tipped employees have been covered under the Fair Labor Standards Act since 1966. The system created by the Congress heretofore has been fair. It required the employee to keep track of his own tips, report them to the employer in writing, and be taxed and subjected to withholding on them as so reported.

Last year the Internal Revenue Service promulgated Revenue Ruling 75-400, which was subsequently superseded in May, 1976, by Revenue Ruling 76-231. Unless there has been a change in our constitutional process that I am

unaware of, we are laboring under the impression that Congress is the legislative branch of the government and is supposed to create laws, and the Internal Revenue Service is part of the Executive Branch of government which is supposed to implement the laws. There has not been a change regarding the area of tipped income since the Fair Labor Standards Act of 1966 covered tipped employees for the first time. The Legislative intent and the legislation itself is clear. Revenue Ruling 75-400 and subsequently 76-231 apparently make no effort to take into account existing law. The clarifying amendment which your Committee overwhelmingl adopted on May 27, wisely reiterates the law as written by the Congress of the United States.

Due to the Revenue Ruling, Mr. Chairman, there was another unfortunate development which occurred. In many cities our members are on a check-off system, which means that by signing a form they authorize the employer to deduct union dues from their payroll check, and these monies are forwarded to the union. A matter such as this is spelled out in a duly negotiated collective bargaining agreement between labor and management. We received word from our local union in Minneapolis, that due to the Revenue Ruling our members received payroll checks which were so low, and some which were even blank, that the employer could not deduct union dues and was telling the union that they would have to go to the member directly and get the union dues themselves. So a further consequence of these Revenue Rulings has been in some instances to abrogate a collective bargaining agreement which has been duly and legally negotiated between

labor and management. Again, here we have an intrusion into the sacrosanct area of collective bargaining agreements by an agency of the Executive Branch with no regard for existing law or any negative consequences that might be engendered.

When H.R. 6675 was passed in 1965 specifically covering the taxation and reporting of tip income, the whole subject was treated and the legislative history from that time makes it clear that the reporting burden should properly be on the employee. The legislative history included the following statement:

"...the only equitable way of computing tips toward benefits is on the basis of actual amounts of tips received and that the only practical way to get this information is to require employees to report their tips to the employer."

With this in mind Mr. Chairman, we sincerely believe that there is no basis for the recent ruling of the Internal Revenue Service regarding the handling of tipped income. It is our strong feeling that the Committee wisely adopted, after very thorough debate, the clarifying amendment on May 27, 1976. We appear here today in behalf of all of our gratuity employees and all others affected by this matter and urge strongly that the Committee adhere to the amendment which they adopted by an overwhelmingly vote and is now a part of H.R. 10612.

STATEMENT OF THE AMERICAN HOTEL AND MOTEL ASSOCIATION AND THE NATIONAL RESTAURANT ASSOCIATION BEFORE THE COMMITTEE OF FINANCE, UNITED STATES SENATE WITH REFERENCE TO COMMITTEE BILL SECTION 1312, H.R. 10612

SUMMARY OF PRINCIPAL POINTS IN STATEMENT OF AMERICAN HOTEL AND MOTEL ASSOCIATION AND NATIONAL RESTAURANT ASSOCIATION IN SUPPORT OF COMMITTEE BILL SECTION 1312, H.R. 10612

1. The amendment in Committee Bill Section 1312: Clarification of an Employer's Duty to Keep Records and to Report Tips, does not bestow any tax benefit on any employer or employee; nor does it free employers from reporting tip income received by their employees.

2. In enacting the 1965 amendments to the Internal Revenue Code, Congress decided that the only practical way to determine actual tip income for tax purposes was to require the employee who receives the tips to report the amount received to his employer. Section 6053 was added to the Code in 1965 for this purpose.

3. Congress also recognized the common practice of tip splitting and tip pooling and determined that only tips received by an employee in his own behalf would constitute wages or income to that employee. Any portion of a tip which an employee splits or gives to a tip pool is income to the ultimate recipient. As a result of this determination, section 6051 of the Code was amended in 1965 to provide that an employer's report of tip income on Form W-2 "shall include only" that tip income reported by the employee to his employer.

4. The legislative history of the 1965 amendments shows that Congress was fully aware of the practices and customs of tipped employees, and was deeply concerned that employers reporting and record-keeping requirements be minimal.

5. For nearly a decade employers and employees have followed these procedures as prescribed in the law and as clearly intended by Congress.

6. The need to reaffirm and clarify Congress' intention to limit the employer's tip income, record-keeping, and reporting burdens to only that tip income reported by the employee arises from an IRS ruling that would require employers to keep a record of all charge tips passed over to each employee and to reflect the total amount on the Form W-2, whether or not this amount had been reported by the employee.

7. Compliance with this ruling would be inconsistent with the law and Congressional intent; would impose a new and extensive record-keeping and reporting burden on employers; would unjustifiably impugn the honesty of many thousands of tipped employees; and would create a source of conflict between employer and employee.

Mr. Chairman and members of the Committee:

The National Restaurant Association and the American Hotel and Motel Association are the principal trade associations in the foodservice and hotel-motel industries. We both have the firm support of our large nationwide membership in urging the enactment of Committee Bill Section 1312: Clarification of an Employer's Duty to Keep Records and to Report Tips (sec. 1312 of the bill and secs. 6001 and 6051 of the Code.)

At the outset it should be noted that this amendment does not bestow any tax benefit on any employer or employee; nor does it free employers from reporting tip income received by their employees. The amendment simply states the intent of Congress as reflected by the legislative history surrounding the 1965 amendments to the Internal Revenue Code.

The need for this clarifying amendment arose in this way. From the inception of the tax laws in 1917 until 1965, employers were not involved in reporting on or withholding taxes related to tip income. Employees were merely required to report their tips and to pay taxes thereon on a calendar year basis. In 1965, however, Congress changed all this by making employers responsible for including tip income on employees' earnings reports (Form W-2) and for withholding income and social security taxes thereon. The legislative history demonstrates that Congress did not do this lightly. It spent several years studying and planning the administrative provisions governing the taxation and reporting of tip income. These provisions reflect the Congressional concern to minimize to the maximum degree possible the burdens placed on employers in reporting and withholding taxes on tip income.

In establishing the employer's responsibility to report and withhold taxes on tip income, Congress confronted and resolved troublesome issues, two of which are especially important here. The first of these arose because of the pervasive practice of tip pooling and tip splitting among tipped employees in the restaurant and hotel-motel industries. Congress recognized these practices and determined that the tax burden should fall upon the ultimate recipient of the tip.

> "Only tips received by an employee on his own behalf and not on behalf of another employee constitute wages. Thus, where employees practice tip splitting, the ultimate recipient of the tip (or portion thereof) is the employee who is receiving the tips as wages. [H.R. Rep. No. 213, 89th Cong., 1st Sess. 219 (1965).]"

Recognizing the nature of the tipping transaction, a second principal issue was how does the employer determine the amount of tip income on which to report and withhold taxes? Congress concluded that:

"The only equitable way of counting tips... [would be] on the basis of actual amounts of tips received and that the only practical way to get this information [would be] to require employees to report their tips to the employer. [H.R. Rep. No. 213, 89th Cong., 2d Sess. 96 (1965).]"

Following this logic, Congress added a new section 6053 to the Code which requires employees to report tips received on their own behalf by the 10th day after the month in which they are received. Section 313 of Public Law 89-97 effected corresponding changes to the income tax withholding provisions (sections 3401 et sequi), the social security tax withholding provisions (sections 3101 et sequi), and the general reporting provision (section 6051) of the Internal Revenue Code to make reporting and withholding of social security and income taxes on tip income "applicable only to such tips as are included in a written statement furnished to the employer pursuant to section 6053(a)." Finally, Congress amended section 6051 of the Internal Revenue Code to similarly limit the amount of tips to be shown on the annual statements which employers prepared for employees to reflect income and withholding during the year (Form W-2). As amended in 1965, section 6051 provides:

"In the case of tips received by an employee in the course of his employment, the amounts required to be shown ... shall include only such tips as are included in statements furnished to the employer pursuant to section 6053(a)." [Emphasis added.]

We see no reason to burden the Committee with an extended expedition through the Code and Treasury Department Regulations to establish that under the Code and the regulations the Form W-2 constitutes the only report of wages, compensation, remuneration, and income paid to employees which is required to be made by an employer. This is not disputed. As you are all aware, copies of the Form W-2 are supplied for IRS and to the employee for his records.

For nearly a decade after the enactment of the 1965 amendments to the Internal Revenue Code, employers followed the prescription of section 6051 and withheld taxes on and reported only that tip income reported by their employees. Then, in 1975, without any change in the law, IRS issued a ruling (Rev. Rul. 75-400) which required the employer to keep a record of all charge tips which he pays over to an individual employee and to report the sum total of those charge tips on that employee's Form W-2. This sum total of charge tips was to be reported to IRS whether or not the tips had been reported by the employee and without regard to the identity of ultimate recipients of the tip through tip splitting and pooling arrangements. We contested this ruling with IRS, without success. Our contention was and is that the ruling is inconsistent with the intent of Congress when it enacted the amendment to section 6051 of the Internal Revenue Code in 1965 which requires that the amount to be reported as tips "shall include only such tips as are included in statements furnished to the employer pursuant to section 6053(a)." We were and are now

also deeply concerned that, due to the practice of tip splitting and tip pooling, assigning the entire charge tip to an individual employee will require the employer to knowingly make a false, inaccurate report. That such reports will result in conflicts between the employer and his employees and in an unjustifiable reflection upon the honesty of our industries' employees are also disturbing probabilities. While the Committee was considering an amendment to clarify this matter, IRS issued a new revenue ruling (Rev. Rul. 76-231) which, while more detailed than its predecessor, continues the same burdensome requirement.

As we understand it, the Internal Revenue Service finds its authority to circumvent section 6051 of the Code in section 6041. Section 6041 provides that,

> "all persons engaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensations, remuneration, emoluments, or other fixed determinable gains, profits, and income... of $600 or more in any taxable year, ... shall render a true and accurate return to the Secretary or his delegate... setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment."

We believe that section 6051 of the Code and the legislative history of the 1965 amendments make it eminently clear that Congress intended to limit an employer's obligation to report tip income to, "only such tips as are included in statements furnished to the employer pursuant to section 6053 (a)." and that section 6041 does not apply. We base this conclusion on the following facts:

a. The entire legislative history of the 1965 amendments as it relates to taxing and reporting tip income reflects a thorough understanding by Congress of the practices and customs of tipped employees and a deep concern for the accounting problems these amendments would present to employers. This concern was reflected in the House Committee Report in these words,

> "The employee would be required to report to his employer in writing the amount of tips received and the employer would report employees' tips along with the employees' regular wages... A provision is included under which the Secretary of the Treasury or his delegate is authorized to issue regulations under which the employer will be permitted to gear these new reporting procedures into his usual payroll. <u>It is the understanding of your Committee that regulations will be issued along these lines to the end that the procedures required of the employer with respect to this reporting requirement will be minimal.</u>" [House Report No. 1548, 88th Cong., 2d Sess. 11 (1964) (Emphasis added.)]

b. One cannot argue that Congress did not anticipate or have knowledge of charge tips as opposed to tips received directly

from the customer, for the House Committee Report specifically refers to charge tips in these words,

"The employee would be required to report to his employer in writing the amount of tips received and the employer would report the employee's tips along with the employee's regular wages. The employee's report to his employer would include tips paid to him through the employer as well as those received directly from customers of the employer." [House of Representatives Report No. 312, 89th Cong., 1st Sess. (March 29, 1965) (Emphasis supplied.)]

c. As mentioned above, Congress clearly established that "only tips received by an employee on his own behalf and not on behalf of another employee constitute wages." Yet, IRS relies upon section 6041 to require employers to keep independent records of charge tips paid directly to each employee and to reflect this amount on the Form W-2, even though in most cases a portion of that amount will not fall within the terms of the salaries, wages, compensation, and remuneration to which 6041 applies. We should also note that the transfer by the employer to the employee of the amount designated by the customer on the charge slip does not constitute a "payment" by the employer within the meaning of section 6041 any more than a meal charged on a credit card account constitutes a sale of the meal to the company issuing the credit card. The employer is nothing more than a conduit through which the payment passes from the customer to the employee, just as a bank is a conduit when it cashes a check.

d. Section 6041 upon which the IRS relies makes no mention of tip income. Since section 6041 preceded section 6053 and the 1965 amendment to section 6051 limiting the employer's reporting obligation to that tip income reported by the employee under section 6053, the more recent and specific requirements of sections 6051 and 6053 clearly supersede the earlier general requirements of section 6041. Further it is abundantly clear from the legislative history that Congress was concerned that the employer's record keeping and reporting obligations not become burdensome and that it was fully aware of the problems posed by tip splitting and pooling. Congress did not intend that the employer be saddled with a reporting and record keeping burden of the nature which IRS now seeks to impose. It was the intent of Congress that sections 6051 and 6053 control the matter of reporting tip income

The amendment in Committee Bill Section 1312 will serve to reinforce and clarify the plain intent of Congress when it passed the 1965 amendments and preclude the imposition of a requirement which is unduly burdensome and expensive for employers; creates a source of conflict between employer and employee; and unjustifiably calls into question the honesty of many thousands of tipped employees.

We respectfully urge the Committee to reaffirm its adoption of Committee Bill Section 1312.

STATEMENT OF DANIEL M. DAVIS
ON BEHALF OF THE AMERICAN BANKERS
ASSOCIATION BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ON SECTION 1317 OF H.R. 10612

July 22, 1976

Mr. Chairman and Members of the Committee:

My name is Daniel M. Davis. I am a Vice President of The First National Bank in Dallas. I am accompanied by Robert L Bevan, an Associate Federal Legislative Counsel of the American Bankers Association. The American Bankers Association is an association composed of about 14.000 banks or some 96% of the banks in the country. Approximately 4,000 of the banks exercise fiduciary powers serving their customers as trustees and executors. Thus, the Association is keenly interested in any changes in the tax laws affecting trusts and estates.

The list of subjects to be considered at these hearings includes Section 1317 of H.R. 10612 which is now before the Senate. This Section contains needed amendments to section 613A of the 1954 Code which was enacted as part of the Tax Reduction Act of 1975. The ABA is particularly concerned with the amendments proposed in sub-section(b) of Section 1317, which relates to trusts. We strongly support these amendments, which do nothing more than cure inequities in our tax law, but also recommend for reasons I will mention that additional action be taken by your Committee to cure other inequities.

Section 613A eliminates the percentage depletion deduction for oil and gas produced on or after January 1, 1975 subject to certain exceptions which include a so-called "small independent producer" exemption. In order to prevent fractionalization of interests and the multiple use of the exemption, section 613A(c)(9) provides that the exemption is not available "in the case of a transfer . . . after December 31, 1974 of an interest (including an interest in a partnership or trust) in any proven oil or gas property" except "a transfer of property at death" or a transfer in a section 351 exchange. This provision is uncertain in scope and if applied literally produces inequitable results in the case of "transfers" of oil and gas interests by trusts and estates.

Section 613A(d) is even worse. It provides that the depletion deduction for small independent producers cannot exceed 65% of the taxpayer's "taxable income" for the year involved computed without regard to depletion and certain other items. The use of "taxable income" is inappropriate for a trust because in arriving at this amount distributions to beneficiaries under sections 651 and 661 are deducted. The law of many states requires a trust to add an amount equal to the depletion deduction to principal. In such cases the trust would, before the enactment of section 613A(d), have had no "taxable income" because the deduction would have offset the retained income. Under section 613A(d), the trust will now have to pay a tax as a result of a disallowance of 35% of the depletion deduction. To disallow a part of the deduction and to produce a tax

at the trust level without adding back the section 651 and 661 deductions is grossly unfair.

During December 1975 the ABA filed comments with the Commissioner of Internal Revenue on the proposed regulations to section 613A dealing with some of its defects. A copy of these comments is filed with this statement. No mention was made of section 613A(d) because of our belief that its inadequacy as to trusts could only be solved by amending the statute.

The amendments recommended by Section 1317 to section 613A(c)(9) and section 613A(d) would alleviate some of the inequities referred to above by providing that in applying section 613A(d) to a trust the 65% limitation would be computed before taking into account any deduction for distributions under sections 651 or 661, and by amending section 613A(c)(9) to provide that a change of beneficiaries of a trust by reason of the "death, birth, or adoption of any beneficiary if the transferor was a beneficiary or is a lineal descendant of the grantor or any other beneficiary". The change in section 613A(c)(9) is too narrow and does not solve other problems that exist in applying the "transfer" rule to trust and estate dispositions and which are referred to in our comments on the proposed regulations to section 613A.

We urge your Committee to approve additional changes in this section which will solve all of the problems referred to in our comments filed with the Commissioner. We note that the report of the Finance Committee on H.R. 10612 states that the transfer rule was not intended to apply to "some cases of transfers which occur by operation of law". This intent should certainly exempt transfers

74-659 O - 76 - 6

from pre-existing trusts from the scope of 613A(c)(9).

Mr. Chairman, we also submit with this statement a memorandum on the following provisions of H.R. 10612, as reported:

1. Tax-Exempt Annuity Contracts (Section 1505).
2. Swap Funds (June 11 Committee action).
3. Extension of Study of Salary Reduction and Cash or Deferred Profit-Sharing Plans (Section 1507).
4. Extension of Time to Conform Charitable Remainder Trusts for Estate Tax Purposes (Section 2104).

AMERICAN BANKERS ASSOCIATION
MEMORANDUM ON MISCELLANEOUS PROVISIONS

1. Tax-Exempt Annuity Contracts (Sec. 1505 of the Committee bill)

Section 1505 of the Committee bill would add closed-end mutual funds to open-end mutual funds as permissible investments under section 403(b) of the Code whereby certain tax-exempt employers may purchase tax-sheltered annuities for their employees. The ABA believes that just as the distinction between open-end and closed-end funds was found irrelevant for purposes of 403(b) investment, likewise the exclusion of deposit accounts (savings accounts, certificates of deposit and time-open accounts) is inappropriate.

The tax-exempt employer making contributions for 403(b) purposes should have the choice of investment in deposits of banks, savings and loans, and credit unions which often offer a more stable and reliable source of retirement benefits than might be true of mutual funds. Long term deposit accounts may earn interest at annual rates of 7.5% and above.

Federal depository institutions offer the additional assurance of federally-backed insurance up to $40,000 as do state insured banks.

2. Swap Funds (June 11 Committee Action)

The Finance Committee of June 11 regarding the treatment of so-called "swap funds" appears intended to parallel the House approved bill on this subject, H.R. 11920. Assuming that the Finance Committee would in fact track the House language, the Association wishes to point up one result, apparently unintended, which would be totally inappropriate.

The House bill makes clear that the beneficiaries of a trust should not be allowed to obtain tax-free diversification of portfolio stocks through an exchange for an interest in a common trust fund. The language of the bill would seem to

make the merger of common trusts funds, typically occuring subsequent to bank mergers, subject to taxation. Such common trust fund mergers are totally beyond the control of trust beneficiaries and their purpose is in no way to achieve tax-free diversification. Rather their purpose is to achieve efficiency of operation and a reduction in costs. The investment interest of the trust remains basically unchanged. The bill should make clear that such mergers are not taxable events.

3. Extension of Study Reduction and Cash or Deferred Profit-Sharing Plans (Sec. 1507 of the Committee bill).

A large number of employees, in banking and other industries, could be adversely affected if the current freeze of section 2006 of the Employee Retirement Income Security Act expires without an orderly resolution of tax treatment of salary reduction and cash-deferred profit-sharing plans.

The Association strongly supports the proposed extension of time to complete the study contemplated by ERISA section 2006 since it is virtually impossible to do so prior to the present January 1, 1977 deadline.

4. Extension of Time to Conform Charitable Remainder Trusts for Estate Tax Purposes (Section 2104 of the Committee bill).

Section 2104 of the Committee bill would amend Code Section 2055(e)(3) to extend for two years the time by which the governing instrument of a charitable remainder trust may be amended so as to allow the remainder interest to qualify for the estate tax charitable contribution deduction. The complexities of the 1969 Tax Reform Act relative to charitable remainder trusts dictate such time extension to insure fairness to the taxpayers.

The American Bankers Association urges approval of this extension.

July 20, 1976

AMERICAN
BANKERS
ASSOCIATION

1120 Connecticut Avenue, N.W.
Washington, D.C.
20036

ROBERT L. BEVAN
Associate Federal
Legislative Counsel
202/467-4206

December 15, 1975

Commissioner of Internal Revenue
Attention: CC:LR:T
Washington, D.C. 20224

Re: Proposed Regulation §1.613A

Dear Mr. Commissioner:

The following comments are submitted on behalf of the American Bankers Association regarding the above-captioned regulation published in the Federal Register of October 17, 1975 at pages 48691 through 48696. The deadline for comments on the proposed regulation has been extended from November 17, 1975 to December 17, 1975.

Section 613A continues the availability of percentage depletion under section 613 to small producers (including a trust) subject to certain limitations. One of these limitations is that a "transfer" (other than a "transfer at death") of the producing oil and gas interest has not been made after December 31, 1974. Proposed regulation §1.613A-7(n) states:

> "Transfer. The term 'transfer' means any change in legal or equitable ownership by sale, exchange, gift, lease, sublease, assignment, contract, a change in the membership of a partnership or the beneficiaries of a trust, or other disposition (including any contribution to or any distribution by a corporation, partnership, or trust). However, the term does not include a transfer of property at death (including a distribution by an estate) nor an exchange to which section 351 applies (until the tentative quantity determined under the table contained in section 613A(c)(3)(ii) ceases to be allocated under section 613A(c)(8) between the transferor and transferee). A transfer is deemed to occur on the day on which a binding contract to transfer such property is executed, or, if no such contract is executed, on the day on which the document which causes title to the property to pass is executed."

We believe that for the reasons set forth below this definition, as applied to trusts and their beneficiaries, is both uncertain in operation and too expansive in scope.

Revocable Trusts

The first sentence of proposed §1.613A-7(n) refers to "any change in legal * * * ownership by" certain stated events, including a "gift" or "other disposition". In the past there have been a significant number of cases where member banks have acted as trustees of fully revocable trusts consisting in whole or in part of oil and gas interests. A revocable trust is not an independent income tax entity and is ignored for income tax purposes. All income received by the trust is considered as income received directly by the grantor. An important non-tax reason exists for the creation of such a trust - probate costs at the grantor's death (including the expense of ancillary administration for oil and gas interests) that would be incurred if the interest formed a part of his probate (testamentary) estate are avoided. If the interest were a part of the grantor's probate estate, the transfer at death exception would be applied.

The placing of oil and gas interests in a revocable trust after December 31, 1974 is not a "transfer" after that date for purposes of section 613A because, as a result of the second sentence of proposed §1.613-7(o), there is no "transferee". However, under the proposed regulations, a distribution from the trust at the grantor's death is not specifically covered by the transfer at death exception. We recommend that the second sentence of the proposed regulation be amended to provide:

> "However, the term does not include a transfer of property at death (including a distribution by an estate or by a trust which was fully revocable at death) nor an exchange to which section 351 applies (until the tentative quantity determined under the table contained in section 613(c)(3)(ii) ceases to be allocated under section 613A(c)(8) between the transferor and transferee)." (underscored words added)

Change in Beneficiaries

The first sentence of proposed §1.613A-7(n) also refers

Commissioner of Internal Revenue

to "any change in * * * equitable ownership by * * * a change in the beneficiaries of a trust". These words may be interpreted to result in a "transfer" when any event (other than perhaps death) causes a change in the trust beneficiaries. For example, consider a trust which directs that income be paid to A for 10 years and thereafter to B for his life with the principal to be distributed to B's issue who survive him, per stirpes. Does a "transfer" take place at the expiration of the 10 year period when A ceases to be a beneficiary? Does a "transfer" take place upon the birth of a child of B during the trust term? These questions should be answered in the negative. Our difficulties with the proposed language could be overcome by eliminating the words "or the beneficiaries of a trust" in the first sentence of proposed §1.613A-7(n). We believe consideration should also be given to eliminating the words "legal or equitable" in this sentence which tend to create uncertainty in application.

Transfer at Death

The December 31, 1974 transfer rule does not apply to a "transfer at death". The proposed definition of "transfer" does not give a clear explanation as to the scope of this exception. To illustrate, in the example discussed in the preceding paragraph the trust terminates at the death of B and the trust property is distributed to B's then living issue, per stirpes. Is the transfer at death exception applicable? The regulations should answer this question, which is important because the death of a beneficiary is the most frequent event causing a trust to terminate.

Acquisition by Estate

In some cases an estate will acquire after the decedent's death oil and gas properties which turn out to be producing and then distribute the properties to the beneficiaries, which may include one or more trusts. This case differs from the case where such a property is owned by the decedent at death. The transfer at death exception clearly applies to the latter case, but arguably does not apply to property acquired after death. Nevertheless, since the beneficial interests in the estate take effect at death there should be no "transfer" of any such interest when distributions are made. One way or another, the regulations should provide that property acquired by an estate after a decedent's death is not deemed to be transferred for purposes of section 613A when distributed by the estate.

Commissioner of Internal Revenue

Pre-Existing Trusts

The intent of the December 31, 1974 transfer rule is to prevent the intentional creation of multiple "small producers" by post-1974 transfers. See Statement of Senator Cranston on page S4260 of the Congressional Record of March 18, 1975. This cannot occur with respect to oil and gas property held in an irrevocable trust on December 31, 1974 where the distribution from the trust to a beneficiary occurs as a result of a mandatory provision rather than the exercise of a discretionary power. The application of the December 31, 1974 transfer rule to a mandatory distribution would be unfair and amount to retroactive legislation. We suggest the addition of the following new sentence to the proposed regulations §1.613A-7(n):

> "A distribution from a trust which was irrevocable on December 31, 1974 of property held in the trust on such date shall be deemed a 'transfer' only if made pursuant to the exercise of a discretionary power."

In the normal property law context the "transfer" takes place when the trust is created.

Respectfully submitted,

Robert L. Bevan
Associate Federal Legislative Counsel

Richard B. Covey
Special Counsel

AMERICAN BANKERS ASSOCIATION

JOHN E. CHAPOTON

OUTLINE OF STATEMENT BEFORE THE

SENATE COMMITTEE ON FINANCE

July 22, 1976

Page

Background 1

Ambiguities in the 1975 legislation 4

Section 1317(a) - Retailer Exclusion 5

Exclusion of bulk sales from the definition of retail sales 5

Limitation of prohibited retail activities to those having combined gross receipts exceeding $5,000,000 8

Section 1317(b) - The Transfer Rule 12

Computation of the 65% limitation in the case of trusts 18

Section 1317(c) - Partnership rules under section 613A of the Tax Reduction Act of 1975 . . 21

JOHN E. CHAPOTON

SUMMARY OF STATEMENT
BEFORE THE SENATE COMMITTEE ON FINANCE

July 22, 1976

The Tax Reduction Act of 1975 repealed the percentage depletion deduction for oil and gas. One exception retained the deduction for a limited quantity of domestic production under a "small producer exemption." The small producer exemption provisions, contained in new section 613A of the Internal Revenue Code, were adopted by Senate floor amendment and thus did not receive the careful attention usually afforded Internal Revenue Code provisions through the committee process. As a result many technical defects and inequities have been found in this new section. This Committee's adoption of section 1317 of H.R. 10612 corrects the most glaring errors of section 613A.

The attached statement makes the following points:

1. Bulk sales of oil and gas. -- The exclusion of bulk sales to industrial and commercial users from the term retail sales implements the intent of Congress in adopting section 613A(c), gives effect to the common usage of the term retail sales, and will prevent inefficient realignment of direct producer-industrial consumer sales.

2. <u>Retail sales in excess of $5,000,000</u>. -- The limitation of prohibited retail activities to those exceeding $5,000,000 in gross receipts is consistent with the Congressional purpose of adopting the small producer exemption and will resolve ambiguous factual situations which would otherwise invite needless controversy and litigation.

3. <u>Transfers of interests in trusts</u>. -- Exempting certain transfers of beneficial interests in trusts from the possible loss of the small producer exemption is clearly necessary and desirable. It is submitted, however, that a more general exemption from the transfer rule of section 613A(e)(9) is necessary to remove the arbitrary and inequitable results which flow from the strait-jacket approach of the present provision (a suggested statutory draft is attached as Exhibit B).

4. <u>65% limitation in the case of trusts</u>. -- Applying the 65% of taxable income limitation to trusts before the deduction for distributions to beneficiaries is necessary to make the statutory scheme for taxation of trusts and their beneficiaries work correctly. This amendment should be broadened to cover estates as well.

5. <u>Partnership basis rules</u>. -- It is necessary to correct technical deficiencies relating to the computation of depletion and basis with respect to oil and gas properties in the case of a partnership and its partners.

STATEMENT OF JOHN E. CHAPOTON
HOUSTON, TEXAS
ON BEHALF OF THE DOMESTIC WILDCATTERS ASSOCIATION
BEFORE THE SENATE FINANCE COMMITTEE ON
July 22, 1976

My name is John E. Chapoton. I am an attorney in Houston, Texas. I am appearing on behalf of the Domestic Wildcatters Association, an association composed of more than 30 independent explorers and producers of oil and natural gas in Texas and Louisiana.

I am here today to testify with respect to certain provisions in section 1317 of H.R. 10612, the Tax Reform Bill of 1976, as reported to the Senate by this Committee on June 10, 1976. Section 1317 of H.R. 10612 makes certain changes, mostly technical, in section 613A of the Internal Revenue Code ("Code"), which was enacted by the Congress as a part of the Tax Reduction Act of 1975 enacted in March 1975.

Background

By the enactment of section 613A of the Code the Tax Reduction Act of 1975 repealed the percentage depletion deduction for oil and gas effective January 1, 1975. It did not, however, affect the percentage depletion deduction allowed all other minerals under the Code. Two exceptions were provided

in section 613A. One permits the continuance of the percentage depletion deduction at the old 22% rate and under the pre-1975 rules for (i) natural gas sold under a fixed contract in effect on February 1, 1975, and (ii) natural gas produced and sold before July 1, 1976, while subject to federal price regulation. This natural gas exemption is not the subject of my testimony today.

The second exemption, referred to generally as the "small producer exemption," retains the percentage depletion deduction on a limited amount of domestic oil and gas production at a diminishing depletion rate. The maximum amount of production eligible for percentage depletion under the small producer exemption is 2,000 barrels average daily production of crude oil or its Btu equivalent in cubic feet of gas (established at a 1:6000 ratio in the legislation), for 1975 and phases down to 1,000 barrels of oil per day or 6 million cubic feet of gas per day for 1980 and thereafter. The percentage depletion rate for production which is eligible under the small producer exemption is retained at 22% through 1980 and then is phased down to a permanent rate of 15% for 1984 and later years. Production resulting from secondary and tertiary processes is treated differently under the legislation

only by retaining the 22% rate through 1983 (however, the total amount of production eligible for depletion under the small producer exemption is not increased). In 1984 and later years secondary and tertiary production is subject to the same 15% rate as primary production.

The percentage depletion deduction allowed a taxpayer under the small producer exemption is subject to a ceiling equal to 65% of the taxpayer's taxable income for the year, computed without regard to the depletion deduction taken under the small producer exemption and without regard to any net operating loss or capital loss carrybacks to the taxable year.

In addition, no depletion deduction is allowed a taxpayer, even though he may otherwise qualify, with respect to production from his interest in an oil or gas property if his interest in the property was transferred after 1974 and the property was "proven" at the time of the transfer.

Finally, a taxpayer is not allowed any depletion deduction under the small producer exemption during any period for which such taxpayer or a related person is classified as a retailer of oil or gas, or any product derived therefrom, or engages in the refining of crude oil (if the refinery runs

of the taxpayer and such related person exceed 50,000 barrels on any day during the taxable year).

Ambiguities in the 1975 legislation.

The computation of percentage depletion under the small producer exemption introduced many new rules and concepts into the computation of percentage depletion for oil and gas. In many instances the new rules are simply not set forth in sufficient detail in new section 613A of the Code. In other instances, new and inprecise terms, such as "retail outlet," the meaning of a "related person" in this context, and the definition of a "proven property," are utilized in the legislation. Many of these problems could have been solved by the prompt promulgation of reasonable interpretative regulations by the Treasury Department. However, this administrative clarification has not been forthcoming. The Treasury Department published very abbreviated proposed regulations on October 17, 1975, and although a hearing was held on the proposed regulations in January 1976, no final regulations have been issued to date.

What is worse, the abbreviated proposed rules evidenced an inclination on the part of the administrator to follow the cold statutory language to totally illogical results, clearly

inconsistent in many instances with the purposes of the small producer exemption as indicated by its legislative history. This was particularly evident in the provisions of the proposed regulations defining a retailer. The proposed regulations would have found a "retail outlet" to exist, for example, by reason of direct bulk sales of natural gas from the wellhead to an industrial consumer. As another example an independent producer could be denied a percentage depletion deduction in toto by reason of relatively small retail sales of oil products resulting from a business activity totally unrelated to the taxpayer's oil or gas production business. Although the Treasury Department indicated informally some inclination to temper the most absurd results flowing from its proposed rules, it has failed to do so in the nine months which have elapsed since the publication of the proposed regulations.

Section 1317 of H.R. 10612 handles many of these problems in a logical manner, giving effect to the obvious intent of Congress in adopting the small producer exemption.

Section 1317(a) -- Retailer Exclusion.

Exclusion of bulk sales from the definition of retail sales.

As discussed earlier, the small producer exemption is

denied if the taxpayer, directly or through a related person, operates a retail outlet which sells oil or natural gas or any product derived therefrom. In the Treasury Department's regulations proposed under section 613A, bulk sales of oil or natural gas, or products derived therefrom, would be considered retail sales if made to an end-user of the item. For example, a direct sale of natural gas by a producer from the wellhead to an electric utility for use as fuel for its furnaces would constitute a retail sale. The proposed regulations went on to provide that if such retail sales constituted more than 5% of the gross receipts from the "place" where such sales are made, then such place constitutes a retail outlet operated by the producer, resulting in the loss of percentage depletion on all of that producer's oil and gas production, wherever located and to whomever sold. The proposed regulations added a perplexing rule that bulk sales to industrial or commercial users would be disregarded in making this 5% computation if such sales accounted for less than 25% of the taxpayer's gross receipts derived from all sales of oil or natural gas, or products derived therefrom, during the taxable year. The purpose or logic of this 25% rule, which could cause the existence of the "retail outlet" to be dependent on the

74-659 O - 76 - 7

taxpayer's total production from other fields, was never adequately explained.

The proposed regulation definition of retail outlet was clearly inconsistent with the common usage of that term and would most assuredly impede the Congressional intent of making the small producer exemption available to normal independent producers who operate no service stations for the retail distribution of their production. Moreover, because of the devastating impact of classification as a retailer, (causing the loss of the entire percentage depletion deduction on all of the producer's domestic oil and gas income), such a nonsensical rule would result in wholesale realignment of sales arrangements to avoid direct sales to industrial and commercial users. The result would be the economically unnecessary insertion of a middleman with somewhat higher costs to the industrial consumer and eventually higher costs to the customers who use its product. Moreover, the proposed Treasury rule would frustrate the policy of the Federal Power Commission, adopted in its Order No. 553 dated August 28, 1975, to encourage direct interstate sales of natural gas to industrial consumers.

This Committee's amendment would correct this situation by providing that bulk sales of oil and natural gas and products

derived therefrom to commercial or industrial users shall not be considered in determining whether a producer is a retailer. This is a proper clarification of the 1975 legislation.

It is my understanding from public statements by Treasury Department officials that the Treasury Department had already decided its inclusion of such bulk sales within the definition of retail sales was erroneous. Nonetheless, a clarification of the law is clearly desirable in view of the Treasury's proposed rules and the absence of final corrective regulations. It is obviously desirable to prevent further inefficient and inflationary realignment of sales arrangements between independent producers and commercial and industrial users.

Limitation of prohibited retail activities to those having combined gross receipts exceeding $5,000,000.

The retailer exclusion from the small producer exemption contained in section 613A would literally apply to a producer if he sells "oil or natural gas, or any product derived from oil or natural gas" directly through a retail outlet operated by the taxpayer, or indirectly through a retail outlet operated by a related person. It is clear

from the legislative history that the intent of the retailer exclusion was to deny a percentage depletion deduction under the small producer exemption to oil and gas producers who are large integrated producers carrying on both production and marketing (and/or refining) activities. (Attached as Exhibit A are exerpts from the Senate floor debate of the small producer exemption indicating this Congressional intent.) It is difficult to interpret the statutory language in such a way as to limit its application to major integrated businesses, but it is obvious that some rule of reason must be utilized in applying its provisions in order to prevent totally nonsensical results.

Under the small producer exemption a taxpayer is a related person to another entity if he owns a 5% or more interest in that entity. Thus numerous independent producers became alarmed after the passage of the Tax Reduction Act of 1975 that they might be denied the small producer exemption by reason of interests in other businesses, perhaps as only passive investments, that operate retail establishments involving the sale of oil or gas products. For example, the ownership of a 5% interest in a clothing store by an independent producer could technically result in denial of the small producer

exemption to him if the clothing store sold at retail synthetic materials derived from oil and gas products. The lack of any connection whatsoever between the taxpayer's production activity and the retail sales in question are technically irrelevant under the small producer exemption.

The Treasury Department in its proposed regulations attempted to limit the scope of the potential absurdities flowing from this statutory scheme by defining the term "any product derived from oil or natural gas" to include only "gasoline, kerosene, distillates (including Number 2 fuel oil), refined lubricating oils, diesel fuel, methane, butane, propane, and similar products which are recovered from petroleum refineries or field facilities." If this rule is adopted in the final regulations it would serve to prevent senseless results where synthetic materials or other secondary oil and gas products are sold at retail. It would not, however, be of any assistance to an independent producer who owns a small interest in a retail establishment which sells primary products derived from oil or natural gas such as machine oil, kerosene or other items, even though there is no connection whatsoever between such retail activity and the taxpayer's production activity and even though the quantity of retail sales is de

minimis in relationship to the taxpayer's oil and gas production income.

Section 1317(a) of H.R. 10612 as adopted by this Committee would resolve these very troublesome questions by providing that the retailer exclusion has no application unless the combined gross receipts for the taxable year of all retail outlets taken into account under the retailer exclusion do not exceed $5,000,000. This change would clearly remove the absurd result which could flow from de minimis and remote sales of primary products of oil or natural gas. It would also prevent potential litigation with respect to the Congressional intent and would provide taxpayers with needed certainty. It would, at the same time, preserve intact the original Congressional intent of denying the small producer exemption to producers who are integrated and operate significant marketing activities. In this regard it is consistent with the denial of the small producer exemption to refiners (which denial is not affected by the Committee's action) which applies only if the refinery runs of the taxpayer and the related person exceed 50,000 barrels on any day during the taxable year.

Section 1317(b) -- The Transfer Rule.

New section 613A contains a provision designed to prevent transfers of producing oil and gas properties for the purpose of enlarging the total oil and gas income which comes within the quantity limitations of the small producer exemption. Subsection (c)(9) of section 613A .rovides that percentage depletion under the small producer exemption is denied with respect to a taxpayer's interest in an oil or gas property if that interest was transferred after December 31, 1974, and the property was a proven property at the date of the transfer. This rule applies to beneficial interests in oil or gas properties held in a partnership or trust as well as direct ownership interests. Two types of transfers are exempted from the application of this rule. The first is the transfer of a property at death. The second is a tax-free transfer to a controlled corporation but only if following this transfer the transferor and the transferee are required to share one small producer exemption under the other provisions of section 613A* limiting related taxpayers to a single, common small producer exemption.

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* The so-called "aggregation" provisions are contained in section 613A(c)(8).

The obvious purpose of the transfer rule, as stated in this Committee's report on H.R. 10612 (at page 425), is to prevent a proliferation of the amount of proven oil and gas reserves that might be eligible for percentage depletion under the small producer exemption. It was thought that absent such a transfer rule, producers holding production in excess of the quantity of production qualifying under the small producer exemption would transfer producing properties to other taxpayers who were still under their quantity limitations in order to qualify the production income from the transferred property under the small producer exemption of the transferee. In reality this fear was probably not realistic since the transfer of a producing property in a commercial transaction will normally result in a high cost basis to the transferee with the result that cost depletion would be more advantageous than percentage depletion to the transferee. Thus he would have no desire to claim percentage depletion under the small producer exemption with respect to income from the transferred property. In the case of gratuitous transfers where no increase in basis would result, the attribution rules requiring related parties to share a single small producer exemption would generally be applicable to

prevent a proliferation of the amount of production qualifying under the small producer exemption.

This transfer rule, or perhaps more correctly described as an "anti-transfer rule" has caused consi able difficulty in normal financial planning in the oil and gas industry. For example, the difficulty of determining when a property is considered proven under this rule raises serious concerns whether a property which is the subject of a "farmout" arrangement might be ineligible for percentage depletion.* If the small producer exemption is lost by reason of a farmout, the economic benefits of this financing technique, through which a large percentage of exploratory wells are drilled in this country, would be drastically altered.

By the same token, estate planning by independent producers holding oil and gas properties is severely hampered by the transfer rule even though the transferee would ordinarily be a taxpayer who must share a single independent producer exemption with the transferor under the aggregation provision of section 613A(c)(8) mentioned earlier.

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* A farmout is a traditional method of sharing the tremendous financial risks involved in drilling exploratory oil and gas wells. It usually involves transfer of an interest in the oil or gas property to the persons who invest the money to drill the exploratory well with a retransfer of a smaller interest to the original owner when the exploration well has paid out the initial costs from production.

The proposed Treasury regulations provide rules which would solve some of these problems. For example, the proposed regulations state that a transfer is deemed to occur on the day on which a binding contract to make the transfer is executed, or if no such contract is executed, on the day on which the document which causes title to the property to pass is executed. This seems to be a correct rule. If the property was not proven on the date the original rights and obligations of the parties to make the transfer came into existence, then there is no opportunity for proliferation of the small producer exemption as long as those rights and obligations are not changed after the property is proven.

The amendment adopted by this Committee in H.R. 10612 would add a third exception to the anti-transfer rule. This exception would exclude from prohibited transfers any change of beneficiaries of a trust by reason of the death, birth or adoption of any beneficiary but only if the transferee was already a beneficiary of the trust or was a lineal descendant of the grantor of the trust or a lineal descendant of another beneficiary of the trust. The result which would be reached by this amendment is very obviously desirable. It would be tragic if a change in beneficiaries of a trust could result

in loss of the small producer exemption to the new beneficiary where that change occurred by reason of a death, birth or adoption of a beneficiary.

I am concerned, however, about the effect an amendment of such limited scope might have on the Treasury's ability to fashion a general rule of reason for applying the transfer prohibition. As stated earlier, it seems quite reasonable to provide, as the proposed regulations do, that a transfer is deemed to occur on the date on which the document which causes title to the property to pass is executed. In the case of a trust, if an oil or gas property was not proven on the date it was transferred into the trust, then later transfers of beneficial interests mandated under the original provisions in the trust agreement predating the date the property became proven should relate back to the date of the instrument requiring such transfers to be made. This does not offer an opportunity for proliferation of the small producer exemption since such transfers could have clearly been effected on the date the instrument was executed as the property was not then proven.

It is submitted that the Committee should consider broadening the exemptions from the transfer rule to prevent

the arbitrary results which flow from the straight-jacket approach of the present statutory provision. This could easily be accomplished by providing that the transfer rule will not be applied to cause loss of percentage depletion to the transferee of a proven oil or gas property if at the time of the transfer the transferor consents to a reduction of the maximum quantity of his remaining production which will qualify under the small producer exemption. To the extent of the reduction agreed to by the transferor, the transferee would be allowed depletion under the small producer exemption with respect to the transferred property (provided he was not otherwise disqualified to utilize the small producer exemption). I have prepared a draft which is attached to my testimony as Exhibit B which would effect this elective procedure. It would cause some recordkeeping problems, but they would not be substantially greater than the problems caused under present law. This approach would temper the inhibiting approach of the present transfer rule, and would at the same time absolutely prohibit proliferation of the small producer exemption since the transferor would automatically reduce his maximum production eligible under the small producer exemption by the amount allowed the transferee.

The transferor would, however, be allowed to increase his production qualifying for the small producer exemption back up to the maximum allowed by law by further exploration activity on his part or by acquisitions in which his transferor elected under this provision.

Computation of the 65% limitation in the case of trusts.

The 65% of taxable income limit on the depletion deduction allowed under the small producer exemption does not work correctly in the case of trusts and estates which establish a depletion reserve out of production income before distributions to beneficiaries are made. The taxable income of a trust or estate is the amount retained by the fiduciary after distributions to beneficiaries. However, in general the depletion deduction is allocated to the fiduciary to the extent he elects to, or is required to (under state law or the governing instrument), allocate production income to corpus. Thus there may be no depletion deduction allocable to the beneficiaries. In such an instance if most or all of the remaining income of the trust or estate is distributed to the beneficiaries, the trust or estate will have little or no taxable income and thus the 65% of taxable income limit, when imposed at the trust or estate level, will result in the denial of a

portion of the depletion deduction to the fiduciary.*

As an example, if a trustee had $100,000 of oil and gas income (and no other income) and the governing instrument was silent, under the laws of the State of Texas the trustee would be rquired to allocate 27-1/2% of the income, or $27,500, to corpus. The balance of $72,500 would be distributed to beneficiaries, leaving the trustee with taxable income of $27,500 less whatever depletion deduction is allowable. Under pre-1975 law the depletion deduction would be 22% of $100,000 (the total mineral income) or $22,000. If the 65% limit were applied after the deduction for distributions to beneficiaries, as is required under the 1975 legislation, the depletion deduction would be limited to 65% of the taxable income ($27,500), or $17,875. Thus $4,125 of the depletion deduction would not be allowed to either the trust or the beneficiaries. This obviously defeats the scheme of taxation under subchapter J of the Internal Revenue Code where

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* In addition, it may be technically impossible to determine taxable income of a trust or estate in such cases. Taxable income is dependent in these cases upon the amount of the 65% limit which determines the amount of the depletion deduction. The 65% limit cannot be computed until the deduction for distributions is determined, and the deduction for distributions cannot be determined until taxable income is computed.

all income is to be taxed, and all deductions are to be available, either to the trust or to the beneficiary.

The provision adopted by this Committee in section 1317(b) of H.R. 10612 would solve this problem quite simply by applying the 65% of taxable income limitation at the trust level before the deduction for any distributions to beneficiaries, rather than after such deduction. Thus in the example just given, the 65% limit would be 65% of $100,000, or $65,000, and the full depletion deduction of $22,000 would be allowed to the trust. This is the correct result since the depletion deduction does not have the effect in such a case of reducing the taxable income to zero. The deduction allowed the trust for distributions to beneficiaries is allowed because the amount distributed is taxable to the beneficiaries. Thus all of the income would be taxable, and all of the deductions would be allowed, either to the trust or to the beneficiaries under the Committee's approach.

While the solution adopted by this Committee is clearly sound, it is respectfully submitted that the rules should be also made applicable to estates. The problem is not as likely to occur in the case of an estate since in the usual case fiduciaries of an estate have more flexibility in determining what

portion of the estate's income shall be retained and what portion shall be distributed to the estate's beneficiaries. However, where large income distributions are required by the will or are otherwise desirable, such distributions should not cause the loss of a portion of the percentage depletion deduction.

Section 1317(c) -- Partnership rules under section 613A of the Tax Reduction Act of 1975.

Section 613A provides that percentage depletion under the small producer exemption is to be computed at the partner level rather than by the partnership. Since the law was silent with respect to depletion otherwise allowable to the partnership, it was not clear whether cost depletion or any depletion for natural gas (under the exemption for regulated or fixed contract gas provided in the 1975 amendment) would be computed by the partnership or the partner. Moreover, virtually insoluble technical problems are raised with respect to the basis of an oil or gas property in the hands of the partnership since the depletion claimed by each partner under the small producer exemption would affect the partnership's basis without the partnership necessarily having the information to make the correct computation of its basis. This would cause

difficulty, for example, in determining gain or loss on the sale of a partnership oil or gas property.

The Committee's amendment resolves these problems by providing that the partnership basis in oil or gas properties is allocated to the partners proportionately. Each partner would then be required to maintain an individual basis account and compute his own allowance for either percentage or cost depletion with respect to his proportionate part of any oil or gas properties held by the partnership. In addition, it was intended by the Committee that each partner will separately compute gain or loss on the proceeds from the sale or exchange of an oil or gas property.

It appears that the Committee's solution is a satisfactory one to a difficult technical problem caused by the 1975 law.

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EXHIBIT A

Exerpts from Senate Floor debates on Section 613A of the Internal Revenue Code (enacted by P.L. 94-12).

Exerpts from debate on the Senate bill, March 18, 1975:

[Senator Bentsen] What we are talking about here again is trying to save the independent oil producer, to see that he does not become an endangered species, and try to save him at a level where he is a true competitor for the major oil companies.

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The major is in the position to pass the increased cost of production downstream. He can pass them on to the refiners and to his retail outlets. The independent is not in the position to do that. (S4271).

[Senator Pearson] I do not believe that retention of the depletion allowance for the major integrated oil companies is any longer necessary or desirable. On the other hand, I am convinced that keeping the depletion allowance for the independent unintegrated producers is definitely in the national interest.

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The fact of the matter is that the industry is made up of two very different types of operation. The majors and the independents operate under different economic conditions and different rules. And it would be a great mistake, it seems to me in rewriting the Tax Code if we would fail to note this difference and take actions which would penalize the independents because we want to close a tax loophole that the major oil companies no longer need.

Mr. President, the major integrated oil companies, through their refineries and retail outlets and other sources of capital, simply do not need the depletion allowance to finance new exploration and development efforts. But the independents do. (S4277)

[Senator Long] Now, for the big ten companies, and mind you, Mr. President, these are the companies that we would propose to deny depletion allowance, these are the ones the Cranston Amendment would take it from. (S4279)

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The [the major integrated oil companies] can make it back under their filling stations and their marketing operations. They have all kinds of places where they can make it back. A lot of it they can make back on the independent's oil, their competitor.

Exerpt from floor debate on the Conference Bill, March 26, 1975:

[Senator Bayh] "First and foremost, after many years of trying, we were successful in passing a measure to eliminate the percentage oil depletion allowance for the large, integrated oil companies. This provision which for decades has permitted the oil companies to pay little or no taxes, did not belong in our tax code, and its repeal was one of the most significant victories for tax reform that I have seen since being elected to the Senate.

I would note that the Senate bill did allow independent producers to take percentage depletion on their first 2,000 barrels per day. It is the small independents who find the bulk of the oil in this country, and there is a real need for special treatment for them in order that they may attract the high risk capital needed for increased exploration and to permit them to retire debt incurred prior to this time. The complete elimination

of percentage depletion for the independents would destroy them and serve to increase the grip of the major oil companies in the energy market. I am very pleased that the conference report retains a special exemption for these small independent producers whose efforts are vastly needed in the face of our current energy problems." Congressional Record, March 26, 1975, p. S5256.

EXHIBIT B

AMENDMENT

Sec. __ DEPLETION ALLOWANCE CHANGES TO ENCOURAGE PRODUCTION BY INDEPENDENT PRODUCERS.

Allowance of Depletion to Independent Transferees. -- Section 613A(c)(9) of the Internal Revenue Code of 1954 (relating to limitations on percentage depletion in the case of oil and gas wells) is amended --

(1) by striking out "in" in subparagraph (A) and inserting in lieu thereof, "Except as provided in subparagraph (B) and (C) in", and

(2) by adding at the end thereof the following new subparagraph:

"(C) If subsection (c) otherwise applies to both a transferor and transferee, subparagraph (A) shall not apply in the case of a transfer of an interest in any proven oil or gas property, if, at the time of such transfer, the transferor consents, in such manner as may be provided under regulations prescribed by the Secretary or his delegate, to a reduction in his depletable oil quantity. Beginning with the year of transfer, the effect of the consent described in the preceding sentence is as follows:

"(i) the transferor shall reduce his tentative quantity of depletable oil for each year (as set forth in paragraph 3(B)) in an amount equal to the amount of reduction to which he consented; and

"(ii) the transferee shall be allowed to take into account, for purposes of determining his average daily production of domestic crude oil and domestic natural gas, the production from the transferred property to the extent of the amount to which the transferor has consented.

"Provided, however, that a transferor who reduces his tentative quantity of depletable oil pursuant to clause (i) above shall be allowed in any year subsequent to the transfer to increase his tentative quantity of depletable oil up to the applicable amounts set forth in paragraph 3(B) by the amount of his average daily production in such year from any oil or gas property that was not a proven oil or gas property at the time of the transfer under which the transferor's tentative quantity of depletable oil was reduced, and from any oil or gas property acquired by him in a subsequent transfer to which this subparagraph applies."

STATEMENT BY A. V. JONES, JR. PRESIDENT

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

Before the

UNITED STATES SENATE

COMMITTEE ON FINANCE

RE: H.R. 10612

JULY 22, 1976

SUMMARY

1. Independent producers account for most of the exploratory drilling for new crude oil and natural gas reserves in the United States.

2. Actions previously taken by Congress have severely hampered the ability of independents to generate sufficient capital for necessary exploration and drilling activities.

3. The Senate Committee on Finance has recognized some of the counterproductive features of previously-adopted legislation.

4. The Committee's proposed changes to the independent producer exemption to the repeal of percentage depletion contained in the Tax Reduction Act of 1975 are a step in the right direction.

5. Even if the bill as reported by the Senate Committee on Finance is adopted without substantial change, independent producers will still be confronted with serious obstacles in attracting and retaining the necessary capital for exploration and drilling activities.

STATEMENT BY A. V. JONES, JR. PRESIDENT

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

Before the

UNITED STATES SENATE

COMMITTEE ON FINANCE

RE: H.R. 10612

JULY 22, 1976

My name is A. V. Jones, Jr., an independent oil and natural gas producer of Albany, Texas. As President of the Independent Petroleum Association of America, I appear here today representing some 4,000 independent oil and natural gas producers from every producing area of the United States who have a vital interest in the subject of these hearings.

We appreciate this opportunity to present testimony concerning those provisions of the bill previously adopted by the Committee. On March 25, 1976, we presented detailed testimony setting forth the basic facts which must be considered in evaluating the impact of any changes in the tax treatment of producers of crude oil and natural gas. At that time we recommended several specific actions particularly with regard to intangible drilling costs and percentage depletion which are absolutely essential if independent producers--who account for the bulk of exploratory drilling--are to be able to generate the capital necessary to continue their efforts at finding new supplies of crude oil and natural gas.

We commend the Committee for adopting several of our basic recommendations and would urge the full Senate to accept the Committee's recommendations. If the Committee bill is adopted, domestic producers will still be confronted with many serious obstacles in attracting and retaining the necessary capital, but some of the more severe unintended limitations arising from adoption of the Tax Reduction Act of 1975 will have been corrected.

We strongly support the amendments set forth in Sec. 1317 of the Committee bill. They will do much to alleviate the unduly harsh application of Code Section 613A. We do suggest, however, that in Sec. 1317 on page 829 at lines 16 and 17 of the Committee bill, the word "governmental" should be inserted in the parenthetical expression concerning bulk sales to commercial or industrial users.

Turning to specific provisions contained in the Committee bill, we wish to commend the Committee for recognizing several deficiencies in the partial exemption of independent producers from the repeal of percentage depletion enacted by Congress last year. Since the adoption of the 1975 Act, it has been our understanding (confirmed by a review of the legislative history and after detailed discussions with most members of Congress) that with regard to percentage depletion in the case of oil and gas wells, it was the intent to retain percentage depletion for independent producers who rely primarily on the sale of crude oil and natural gas at the wellhead for their major source of income. However, the exemption for independent producers contains several overly broad provisions which to a considerable extent negate the intended exemption. These provisions have been of even more concern to independent producers because the 1975 Act was made applicable retroactively to January 1, 1975 and therefore applied to many transactions entered into in good faith which would not have been undertaken had the parties known of the provisions of the Act.

Perhaps the overly broad application of some of the provisions of the 1975 Act can best be illustrated by specific example:

Example 1: Assume that Producer "A" is an independent producer engaged in no business other than exploration for and production of crude oil and natural gas. Producer "A", during 1975, had an average daily production of 50 barrels of oil and would seemingly be a classic example of the type of individual for whom the independent producer exemption was intended. However, Producer "A", like many independents, operates 24 hours a day, seven days a week, and for the sake of convenience and efficiency, maintains a gasoline storage tank and pump at his place of business to service his trucks and other vehicles necessary to the operation of his business. Producer "A" has, for many years as a matter of courtesy and convenience to his employees, permitted them to fill their personal automobiles with gasoline from his pump, charging them only his actual cost for the gasoline. Under the "Retailers Excluded" provisions of paragraph two of Section 613A(d) of the 1975 Act, Producer "A" may be defined as a "retailer" and as such be ineligible for percentage depletion on his income derived from oil and gas production.

Example 2: Producer "B" also would appear to be within the classic definition of independent producer because he has for many years been engaged full time in the business of exploration for and production of crude oil and natural gas, and during 1975 had an average daily production of 120 barrels per day. However, Producer "B" is the owner of a ten percent interest in the office building in which his offices are located and the parking garage which is a part of the building has a retail gasoline pump for the convenience of parking patrons. Under the provisions of the 1975 Act, Producer "B" may find himself classified as a "retailer" and thus be ineligible for percentage depletion on his oil and gas production income.

These examples are just a small indication of how far-reaching the limitations within the independent producer and royalty owner exemption are when taken from the abstract and applied to actual situations within the industry. Other examples of unnecessarily broad application of many of the other provisions could be given, but will be omitted for the sake of brevity.

A substantial number of producers who could not be considered as anything other than "independents" under any common sense meaning of that term will not be eligible for percentage depletion because of these unforeseen limitations in the present independent producer exemption. We therefore support the Committee's amendments to the "Retailers Excluded" provision of Sec. 613A of the Code.

We support the Committee's amendment which would not penalize an independent producer who may have some financial interest in activity outside the United States. Certainly if we are to maximize domestic exploration and development, it makes no sense to reduce the exploration and drilling capital which would otherwise be available to a domestic independent producer. The real loss in such case is suffered by domestic consumers. Coupling this provision with a prohibition against exporting domestic crude oil and natural gas production is of further benefit to domestic consumers.

In our previous testimony to the Committee, in testimony and comments submitted to the Internal Revenue Service, and in numerous contacts by individual producers with members of Congress, the unnecessarily burdensome application of these provisions has been pointed out and numerous suggestions made for changes. We have repeatedly indicated that the intent of the legislation denying percentage depletion for integrated producers could be adequately accomplished without penalizing many independent producers.

The Committee's proposed amendment to the transfer rule set forth on page 830 of the Committee bill is in keeping with the spirit of recommendations made not only by IPAA, but numerous accounting groups and many individual producers. This Committee amendment will do much too alleviate undue hardship which would result from the denial of percentage depletion to producers who had in all good faith created trusts for estate planning or other purposes before the enactment of the 1975 Act. Certainly it does not in any way seem equitable to penalize taxpayers who would otherwise be eligible for percentage depletion merely because the legal title to the producing property is held in trust. The IPAA and many other industry representatives have recommended more extensive revision of the transfer rule than adopted by the Committee, but the Committee amendment is a substantial step in the right direction.

In 1969, Congress removed approximately $600 million from the domestic petroleum industry through the substantial reduction of percentage depletion. In 1975, the virtual repeal of percentage depletion effectively removed more than $2 billion that otherwise would have been available for exploration and development. Congress, through adoption of the Energy Policy and Conservation Act of 1975, has reduced by another $3 billion the revenues which would otherwise have been available this year for domestic exploration and drilling activity. As stated before, these actions already have been reflected in a substantial downturn in domestic drilling activity. As demonstrated by the Ture Economic Analysis which we previously furnished to the Committee, these actions are having substantial adverse effects on the general economy, particularly with regard to employment and reduction in gross national product, as well as a negative impact on tax revenues.

It is essential if we are to reverse our ever-increasing dependency on foreign crude oil and maintain our economic viability that we provide the domestic petroleum industry with every possible incentive to maximize domestic exploration and drilling activity. Consequently, we commend this Committee for the steps it has taken to minimize the negative impact of previously adopted adverse legislation. We urge the full Senate and Congress to recognize the necessity of these actions.

Thank you.

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Belco Petroleum Corporation

Belco

SUMMARY OF PRINCIPAL POINTS CONCERNING FOREIGN RETAIL ACTIVITY AND SECTION 613A OF THE INTERNAL REVENUE CODE

1. Belco Petroleum Corporation is an independent company engaged in the production of oil and gas in the United States and abroad.

2 Belco's sole retail activity in petroleum products is in the State of Israel and Belco does not engage in such retail activity in the United States. Belco's operations in Israel are in no way connected to its oil and gas activities in the U.S.

3. The Tax Reduction Act of 1975 preserved the depletion allowance for domestic oil and gas production for independents who were not retailers. However, this Act failed to state that what was meant was domestic, and not foreign, retail operations. Discussions with staff of the Senate Finance Committee and the Senate sponsors of the amendments creating the independents' depletion allowance show no intent to deprive a company such as Belco of depletion due solely to foreign retailing. Moreover, no one familiar with the situation has suggested that Belco should be so deprived.

4. Accordingly, Belco believes that Section 1317 of the Tax Reform Act of 1976 which restores depletion to Belco is a clearcut case of remedying legislative oversight.

[illegible]

Belco Petroleum Corporation

Belco

FOR SUBMISSION TO THE SENATE COMMITTEE ON FINANCE

FOREIGN RETAIL ACTIVITY AND SECTION 613A OF THE INTERNAL REVENUE CODE

These comments are submitted on behalf of Belco Petroleum Corporation. Belco is an independent company engaged in exploration and production of oil and gas primarily in the Gulf Coast and Rocky Mountain areas. It produces approximately 6,000 barrels of oil per day (much of which is being recovered by secondary mehtods) and 70,000 mcf of gas a day in the United States. Belco does not engage in any retail activities in the United States and has no refinery capacity or pipelines. Belco has foreign oil operations in Canada, Peru and Israel and a coal operation in the United States. Belco through Sonol has also engaged, without success, in oil exploration in Israel, drilling five dry holes on shore and six dry holes off shore over the last five years with two deep tests in progress for this year. Belco is and has been for a number of years the chief foreign exploration company in Israel.

Belco submits the following comments with respect to the proposed amendment to Section 613A of the Internal Revenue Code ("Code") contained in Section 1317 of the Tax Reform Bill of 1976 (H.R. 10612).

The Tax Reduction Act of 1975, while denying the benefits of the depletion allowance to the major integrated oil companies, sought to preserve some of [illegible] incentives afforded by those benefits through the exemption for independent producers embodied in section 613A(c) of the Code.

A taxpayer's foreign retail activities should not result in the loss of domestic depletion under the independent producers exemption.

Belco is the only sizable American petroleum company operating in Israel. Its Israeli subsidiary, Sonol Israel, Ltd. ("Sonol") markets refined products through retail outlets in Israel and is the

Belco

seventh largest corporation in that country. Sonol does not have any refinery capacity. The marketing of petroleum products in Israel is strictly cost regulated by the Fuel Authority of the Israeli government which owns the only refineries in the country.

The exemption of independent producers from the repeal of percentage depletion for oil and gas allows depletion for limited quantities of domestic crude oil and domestic natural gas. The term "domestic" is defined in the statute as referring to production from an oil or gas well located in the United States or in a possession of the United States. Subsection 613A (d) (2) of the Code denies the independent producers exemption to any taxpayer who sells oil or natural gas, or any product derived therefrom, through a retail outle operated by the taxpayer or a related person, but fails to repeat the word, "domestic," in relation to such retail sale. Nowhere does the record suggest, nor have discussions with anyone involved in drafting this legislation suggest, any reason why the word, "domestic," was left out. The reasonable inference is that the possibility of an independent producer having foreign retail sales, but not having domestic retail sales, was not considered.

Belco is apparently the only company in this unusual posture. Therefore, it is not surprising that this matter did not cross the minds of those drafting this legislation on the floor of the Senate. Had there been Committee hearings on the independent producers exemption containing the present language, Belco would certainly have called its unusual circumstances to the attention of the Committee. However, since Belco was not afforded such an opportunity at that time, it has been forced to embark upon an effort to correct this legislative oversight.

In short, Belco solely because of its ownership of Israeli marketing outlets will be deprived of its depletion allowance absent the adoption of Section 1317 of the Committee Bill. Section 1317 is required to insure that the operation of retail outlets located outside of the United States will not result in the loss of incentive depletion with respect to domestic production of crude oil and natural gas under the independent producer exemption. As Senators Kennedy and Hollings observed in their joint statement to this Committee when considering the Tax Reform Act of 1975:

> "Most of the major oil companies are vertically integrated firms. They have an unfair competitive advantage, since they do not care which stage in the production of petroleum products generates their basic profits. In fact, the top 20 integrated

Belco

now control 94% of known domestic oil reserves. In effect, the integrated firms are selling crude oil to themselves at artificially high prices, and thereby driving independent refiners and manufacturers out of business."

Belco does not possess any such attributes of integration. Belco does not market any of its domestic production through its Israeli outlets and, therefore, cannot shift its profits along a chain of distribution. But for Belco's Israeli marketing operations, Belco would qualify for the independent exemption.

Belco is apparently the only American company qualifying as an independent producer which has foreign retail outlets. To exclude Belco from the independent producers exemption due to its Israeli operations would be not only illogical and contrary to the overall statutory scheme, but also would have the extremely unfortunate result of placing an economic penalty on Belco's retail activities in Israel. This penalty could cause Belco to withdraw from Israel or to dispose of its retail operations there, both of which would be undesirable from the standpoint of the Israeli government and would obviously be an unintended consequence of the Tax Reduction Act of 1975.

CONCLUSION

Section 1317 of the proposed Bill states that retail outlets operated in foreign countries, where domestic production is not related to the foreign retail activity, will not exclude a taxpayer from the benefit of the independent exemption. Belco believes that this remedial section is required to prevent the inequity resulting from the hurried consideration and passage of the depletion provisions of the Tax Reduction Act of 1975.

Very truly yours,

BELCO PETROLEUM CORPORATION

Robert A Belfer
President

July 20, 1976

Summary of Principal Points of Testimony of Mr. Edward Healy, President, National Association of Water Companies

1. 20% of the water companies in America are investor-owned.

2. For over 50 years the IRS and courts have allowed these companies to treat contributions in aid of construction as contributions to capital.

3. A recent IRS ruling changes this long-standing treatment; the IRS now considers contributions in aid of construction as income.

4. Effect will either drastically raise taxes of water companies, halt expansion of water service, or cause general rate increases.

5. The Finance Committee adopted an amendment reinstating, with stringent safeguards, the previous treatment of these contributions as contributions to capital.

6. The amendment is supported by the National Association of Regulatory Utility Commissioners.

7. The amendment is carefully drawn to prevent abuses; the utilities will not be able to include contributed property in their rate base, take depreciation on it, or take the investment credit on such contributed property.

8. The amendment applies to the most capital intensive utilities, water and sewer companies, who need it the most.

**Testimony of Mr. Edward Healy Relating To §1322 of H.R. 10612
Contributions To Capital of Regulated Public Utilities
In Aid of Construction**

Mr. Chairman, and members of the Committee, I am Edward Healy, President of the National Association of Water Companies, the organization representing most of the investor-owned water utilities in the U.S. An amendment adopted during your consideration of H.R. 10612 relates to the 20% of the water companies in this country which are investor-owned, with the remaining 80% owned by municipalities and other governmental units. This 80% owned by governments is obviously exempt from any taxation by the Federal Government and is also in direct competition in many situations with the investor-owned water utilities which pay the regular corporate tax on any income they might have.

For over 50 years, investor-owned water utilities have treated the receipt of contributions in aid of construction as contributions to capital, not as income. This longstanding interpretation of the tax law was repeatedly affirmed by the courts and acquiesced in by the IRS. However, in 1975, the IRS abruptly reversed this longstanding interpretation, so that it now appears that these contributions may be treated as income to the water utilities. Since these contributions are an integral part of the providing of water service, this change (which particularly harms the smaller but expanding water utilities) has the effect of either significantly raising the taxes of investor-owned water utilities or halting the expansion of water service. To avoid curtailing any expansion of service, the water utilities would have to dramatically increase these contributions or secure a general rate increase affecting all their customers in order to recoup the [illegible] increase.

To correct this problem the Committee on Finance adopted at §1322, p. 839 of the Tax Reform Bill, an amendment to §118 of the Code providing that these contributions in aid of construction made to a water or sewer utility be treated as contributions to capital, the same manner in which they have been treated for over 50 years. This amendment was advocated by the National Association of Regulatory Utility Commissioners before this Committee in order to prevent the utility rate increases, housing cost increases, and building moratoriums that could result from the IRS' reversal of its interpretation.

This provision does not provide a new tax break; it merely reaffirms a 50 year old policy that these regulated utilities have come to rely upon and base their operations around.

The Committee amendment is carefully drawn in order to prevent abuse by denying any depreciation on contributed property, by requiring that the property not be included in its rate base, and by denying the investment credit on contributed property. The reason why the technical staffs of Congress readily recommended adoption of this provision is that it simply prevents the bunching of income in a given year. Questions concerning this amendment apparently arise from failure to perceive the need for the amendment, the stringent safeguards included in its provisions, and the adverse impact on consumers that will occur if the amendment is not adopted forthwith.

Mr. Chairman, I want to point out that this change in law imposed by the Internal Revenue Service has created a situation where many investor-owned water utilities will have to significantly increase their revenues in order to just pay for the increase in taxes. One company in Alaska, for instance, would

have to increase revenues well over 100% in order to just pay for this tax increase. Obviously, such a company has only a limited number of options available to it. It could ask for a general rate increase which probably would not be granted since the Utility Commission would say that these costs are attributable to only new customers, it could ask for an increase in contributions by the amount of the new taxes, or it could refuse to take new customers. Any of these alternatives are going to be inflationary and clearly detrimental to the customers of the company, the continued financial well-being of the company itself, and the economy of the area of Alaska served by this company.

Mr. Chairman, we believe that the water and the sewer companies to which the Committee directed its amendment, have a very meritorious case and have the most serious problem among the utilities with this change in interpretation of the tax law by the IRS. Considering the low rate of return for water and sewer companies, we are the most capital intensive of the utilities. This is another reason why this amendment is so crucial to us and why we need this reinstatement of prior law.

Mr. Chairman, and members of the Committee, thank you for this opportunity to appear before you and give you our views on S1322.

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STATEMENT BEFORE SENATE COMMITTEE ON FINANCE
OF W. REID THOMPSON, CHAIRMAN OF THE
BOARD AND PRESIDENT OF POTOMAC ELECTRIC POWER COMPANY,
ON BEHALF OF EDISON ELECTRIC INSTITUTE

ON

PROVISIONS OF H.R. 10612 OF PARTICULAR INTEREST
TO THE INVESTOR-OWNED ELECTRIC UTILITY INDUSTRY

SUMMARY

We support the actions of the Senate Committee on Finance in adopting:

(1) section 802, dealing with refunds of unutilized investment tax credits; and

(2) section 803, as it relates to expiring investment tax credits.

Section 1322, dealing with contributions to capital of regulated public utilities in aid of construction, should be amended to include contributions to capital of electric utilities. We would support section 1322 if so amended. No revenue loss would result from bringing electric utilities within the provisions of section 1322, since contributions in aid of construction have not heretofore been treated as taxable income. For over 50 years electric utilities have treated contributions in aid of construction as offsets to the capital costs of the facilities acquired with the contributions, with confirmation by the courts and acquiescence to by the Internal Revenue Service. Section 1322 should by statute specifically give recognition to this treatment.

July 20, 1976

EDISON ELECTRIC INSTITUTE
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STATEMENT BEFORE SENATE COMMITTEE ON FINANCE
OF W. REID THOMPSON, CHAIRMAN OF THE
BOARD AND PRESIDENT OF POTOMAC ELECTRIC POWER COMPANY,
ON BEHALF OF EDISON ELECTRIC INSTITUTE

ON

PROVISIONS OF H.R. 10612 OF PARTICULAR INTEREST
TO THE INVESTOR-OWNED ELECTRIC UTILITY INDUSTRY
(SECTIONS 802, 803 AND 1322 OF FINANCE COMMITTEE'S BILL)

Mr. Chairman:

I am appearing before you today on behalf of the Edison Electric Institute, the principal national association of the investor-owned electric utility industry. The Institute's member companies serve approximately 99 percent of the customers served by the nation's investor-owned electric utility industry.

Three provisions of the Finance Committee's bill are of particular interest to members of our industry. They are:

> Section 802, dealing with refunds of unutilized investment tax credits.
>
> Section 803, as it relates to expiring investment tax credits.
>
> Section 1322, dealing with contributions to capital of regulated public utilities in aid to construction.

I should like to discuss first section 1322, the provision of most immediate interest to us.

The electric utility industry endorses the intent of section 1322 but urges that it be amended so as to include the electric utility industry in its coverage.

No revenue loss would result from bringing electric utilities within the provisions of section 1322, since contributions in aid of construction have not heretofore been treated as taxable income.

For over 50 years, electric utilities have treated the receipt of a contribution in aid of construction as an offset to the capital cost of the facility acquired with the contribution. This treatment has been repeatedly

confirmed by the courts and until 1975 acquiesced to by the Internal Revenue Service. However, in 1975 the Tax Court (State Farm Road Corp., 65 T.C. ___, No. 19) and the Internal Revenue Service (Revenue Ruling 75-557, 1975-2 C.B. 33) reversed this longstanding position with respect to certain contributions to sewer companies and water companies, respectively, and the Internal Revenue Service has indicated that it will apply these interpretations broadly to contributions to capital of electric and other utilities. Section 1322 removes the problem created by the above interpretations for only water and sewer companies.

Contributions in aid of construction to electric utilities are contributions in cash or other property received from its customers to defray all or a portion of specific contruction costs. Contributions are received for construction of plant facilities which normally would not be built with the utility's own funds because the revenue to be earned would not justify the investment. If the utility were to construct such facilities without the benefit of the contributions in aid of construction, the cost thereof would, in effect, be borne in part by customers other than those receiving service from the facilities.

A utility is compelled by contract or regulatory requirements to use contributions for construction of facilities for which the contributions are received. Rules of the Federal Power Commission and of most state regulatory agencies require that the contributions be credited to a plant account. The property, or the portion thereof, constructed with such contributions, having no net cost to the electric utility, is excluded from the rate base, with the result that the utility cannot earn on it.

No investment tax credit is taken or depreciation deducted for Federal income tax purposes with respect to such property. Clearly, no tax "loophole" or "gimmick" exists with respect to the exclusion from taxable income of such reimbursements.

Amounts received by an electric utility as contributions in aid of construction may be used only for the purposes for which the contributions are intended. For taxable income to be realized, the contributions should be received under a claim of right without restriction as to use. These contributions are received with a complete restriction as to use. They act as a reimbursement for capital costs. Inasmuch as regulatory commissions impose continuing restrictions upon the use, enjoyment and disposition of these contributions, the receipt of such contributions by electric utilities should not be regarded as taxable income.

If the utility is required to pay Federal income taxes on each dollar collected as a contribution in aid of construction, it must, of necessity, file for increased rate tariffs to recognize its increased revenue requirements. If the rate tariffs are not increased, additional cash and financing burdens will be placed on those electric utilities continuing to provide such construction at a time when they are already confronted with great difficulty in financing construction of new facilities. This is contrary to current Congressional and Administration policies of encouraging electric utility cash generation for necessary plant additions as a key element in solving the nation's energy problems.

The taxability of contributions in aid of construction was the subject of a thorough and prolonged study by the Internal Revenue Service in 1958. It was concluded that the treatment of excluding customers' contributions from taxable income is correct and this policy was announced in Revenue Ruling 58-555, 1958-2 C.B. 25. For the reasons stated above, we urge that this legislation be amended and enacted to make it clear that no change in this long standing practice be made.*/ We understand that considerations with respect to contributions in aid of construction for gas transmission and distribution properties are similar and should be treated similarly to properties of an electric utility.

In conclusion, I wish to advise further the electric utility industry strongly supports the actions of the Finance Committee in adopting sections 802 and 803 of the Bill. The Finance Committee is to be commended for reporting out these two provisions which expand on the concept of the use of investment credits.

Section 802, which provides for refunds of unutilized investment tax credits commencing in 1984 for qualified investments made after 1975, is a sound provision which will serve to make certain that the credit accomplishes its purpose of stimulating investment. Without such a provision, the credit will at times fail in its purpose and will be of no benefit to taxpayers that most need assistance in meeting their capital requirements. Long-range planning for capital expenditures, which is critical to our industry, may proceed with greater assurance with this change in law.

Section 803 provides that investment credits which would otherwise expire as carry-overs in 1976 may be carried over for two additional years, to 1977 and 1978. This provision is of limited application to our industry; however, it is important as it will provide assistance to those companies which may be in the most need of help.

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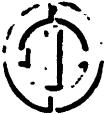
*/ Revenue Ruling 75-557 specifically revokes Revenue Ruling 58-555.

July 20, 1976



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STATEMENT BEFORE SENATE COMMITTEE ON FINANCE
OF W. REID THOMPSON, CHAIRMAN OF THE
BOARD AND PRESIDENT OF POTOMAC ELECTRIC POWER COMPANY,
ON BEHALF OF EDISON ELECTRIC INSTITUTE

ON

PROVISIONS OF H.R. 10612 OF PARTICULAR INTEREST
TO THE INVESTOR-OWNED ELECTRIC UTILITY INDUSTRY
(SECTIONS 2001, 2002 AND 2003 OF FINANCE COMMITTEE'S BILL)

SUMMARY

We support the actions of the Senate Committee on Finance in adopting

(1) Section 2001 dealing with residential insulation credits

(2) Section 2002 dealing with credits for the installation of residential heat pumps and solar or geothermal energy equipment and

(3) Section 2003 dealing with the business insulation credit

Mr. Chairman:

I am appearing on behalf of the Edison Electric Institute, the principal national association of the investor owned electric utility industry. The Institute's member companies serve approximately 99% of the customers served by the nation's investor owned electric utility industry.

I have previously filed a statement dealing with three technical provisions in the Finance Committee's bill, the most important being Section 1322 dealing with contributions to capital in aid of construction. The following comments supplement this statement and endorse the provisions of the Finance Committee's Bill dealing with certain energy-related matters.

These energy related provisions will make an important contribution to the national goals of fuel conservation and efficient use of our energy resources. By conserving fuel and reducing the financing

requirements of the capital intensive electric utility industry through load growth control and reduction, these measures will be of material importance in progress towards national energy goals.

The provisions of Section 2001, 2002 and 2003 relating to insulation credits and credits for the installation of heat pumps and other energy conserving equipment will contribute to the long run success of our energy program, to easing the financing burdens of electric utilities and to curbing necessary increases in the utility bills of their customers.

Many electric utilities have adopted or are studying adoption of programs to encourage their customers to install energy-saving insulation, storm windows and heat pumps. The advantages of both are obvious and consistent with national energy goals. Adequate insulation equipment will effectively conserve all fuel sources. The heat pump, which now is proven as an effective and highly efficient source of space heating and cooling, at an efficiency level which is 30 to 50% greater than that of electric furnaces or resistance heating, will allow substitution of electric energy, which can be produced from non-petroleum sources, for scarce petroleum.

The expanded use of adequate insulation, heat pumps and other energy efficient devices will not only conserve fuel but will assist in utility load management programs which are of critical importance. Over time these programs will contribute to a managed and reduced rate of growth in demand for electricity which in turn will reduce capital requirements to construct generating and other facilities. The electric utility industry, which has encountered serious difficulties in competing for capital to meet its construction requirements, can through effective load management programs reduce construction requirements, ease cash and financing burdens and limit the need for utility rate increases.

7/21/76

SUMMARY
OF
STATEMENT OF RICHARD A. ROSAN
ON BEHALF OF THE AMERICAN GAS ASSOCIATION
BEFORE SENATE COMMITTEE ON FINANCE

ON

CONTRIBUTIONS TO CAPITAL OF
REGULATED PUBLIC UTILITIES
IN AID OF CONSTRUCTION
(SECTION 1322 OF COMMITTEE BILL)

For almost fifty years, contributions in aid of construction to regulated public utilities have been excluded from income as contributions to capital. Recently, the Internal Revenue Service cast doubt on the continuance of this treatment for traditionally excluded types of contributions in aid of construction, such as contributions to gas utilities by governmental units in connection with gas line relocations required by road relocation and urban renewal projects and contributions by customers relating to line extensions.

The denial of capital contribution treatment to these traditionally excluded types of contributions in aid of construction (which do not include normal customer connection fees) would have a serious, adverse impact on gas utilities, but more important on gas customers in terms of higher rates.

We urge the Committee to continue by statute the long-standing exclusion of contributions in aid of construction to regulated gas utilities. This will involve no revenue loss since such contributions are not now and never have been subject to tax.

STATEMENT OF RICHARD A. ROSAN
ON BEHALF OF THE AMERICAN GAS ASSOCIATION
BEFORE SENATE COMMITTEE ON FINANCE

ON

CONTRIBUTIONS TO CAPITAL OF
REGULATED PUBLIC UTILITIES
IN AID OF CONSTRUCTION
(SECTION 1322 OF COMMITTEE BILL)

Mr. Chairman:

I am appearing before you today on behalf of the American Gas Association (A.G.A.) in support of §1322 of the Tax Reform Act of 1976 and of an amendment to that section. The A.G.A. is composed of more than 300 member companies, including both gas distribution and gas transmission companies. A.G.A. member companies serve approximately 93 percent of the 43 million homes, businesses, and industrial facilities in the 50 states using natural gas, including some 160,000,000 of our population.

Under present law, contributions to the capital of a corporation, whether or not contributed by a shareholder, are not includible in the gross income of the corporation. This rule has been applied for almost fifty years to regulated public utilities which traditionally have obtained significant amounts of the capital for the construction of facilities through contributions in aid of construction. By a recent administrative ruling, however, the Internal Revenue Service has cast doubt on whether these contributions may be excluded from gross income. The current proposal seeks to continue by legislation the long-standing rule that contributions to regulated utilities in aid of construction are not includible in gross income.

On December 4, 1975, the Internal Revenue Service, without advance notice and the opportunity for public comment, announced the issuance of Rev. Rul. 75-557 which would include in income a "connection fee" charged the customer by regulated public utilities. We are concerned that the Ruling will be applied broadly to reach other contributions in aid of construction. In the case of gas utilities these include contributions by governmental units relating to the relocation of gas pipelines,

both distribution and transmission, required by road relocation projects and urban renewal projects, and contributions by customers relating to line extensions.

The Service has cited as its sole authority for including customer contributions in the income of public utilities, a Supreme Court case which pertains to government subsidies paid to a railroad for certain signals and crossing facilities even though the case deals only with the issue of depreciable basis under the Internal Revenue Code of 1939 (which issue was statutorily resolved in the 1954 Code) and the Court expressly stated that the qualification of subsidies as income "is an issue not raised in this case, and we intimate no opinion with respect to it". U.S. v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401, 37 L.Ed.2d 30, 93 S.Ct. 2169 (1973).

The issuance of the administrative ruling by the Internal Revenue Service portends a change in almost 50 years of consistent administrative practice whereby contributions to public utilities in aid of construction have been excluded from gross income. The ruling challenges this 50-year practice notwithstanding that --

(1) The Service has long acquiesced in many court decisions holding such contributions to be excludable from the income of regulated utilities. (Since the contributions are excluded from income, they are not included in the basis for depreciation deductions.)

(2) The Service considered the problem carefully in the late 1950's, concluded that such contributions should continue to be excluded and published Rev. Rul. 58-555, 1958-2 C.B. 25, to that effect.

(3) In a letter dated May 20, 1960, the Commissioner of Internal Revenue told the A.G.A. that the Service had again "studied the problem thoroughly" and had decided that "no change will be made in its position" and "the matter is therefore concluded".

(4) The Federal Power Commission and many state regulatory commissions require the investments made with such contributions to be excluded from the utility's rate base and therefore no return thereon is earned and included in charges to customers.

The effect of the anticipated administrative change of concern may be demonstrated in an example by assuming that an urban renewal program will require the expenditure of $4,000,000 for relocation of gas distribution lines, or a road relocation program will require the expenditure of $4,000,000 for relocation of gas transmission lines. This capital expenditure of $4,000,000 will be contributed by a governmental agency. If this amount is included in gross income, the gas utility must raise at least an additional $2,000,000 to pay the tax and must charge the customers not only this tax but also a reasonable rate of return.

The additional $2,000,000 cannot be reflected in customer rates without a new rate determination. Thus, if this increase in income taxes becomes a stockholder burden [decreases return on equity] and decreases the overall rate of return, it will remain so until another rate determination. This lag in recovery of cost decreases the utility's earnings and adversely affects its ability to furnish other needed public service projects. When the regulatory commission adds the increased tax to cost of service, it becomes a burden to be passed on to customers. As a rule of thumb, the annual cost of capital in rates is about 20%. Thus the $2,000,000 of taxes will cost the ratepayers a minimum of $400,000 additional in their rates.

It is thus clear that any major change in the income tax treatment of any item of deduction or exclusion which will result in increased income taxes for regulated public utilities is an extremely serious matter. As public utilities operate under a regulatory philosophy of earning a return sufficient to maintain financial integrity and to enable the utilities to attract the capital necessary for the proper discharge of their public duties, the loss of tax deductions or exclusions previously used to reduce customer rates immediately becomes the stockholders' burden and reduces the net income of the utilities dollar for dollar by the amount of the tax increase. This will trigger scores of applications and filings with regulatory agencies for immediate rate relief.

While we have no way of determining the exact amounts, it is obvious the rate increases would total millions of dollars and would add to the inflationary spiral. A recent informal survey of 22 natural gas companies indicates that in a single typical year, receipts of contributions in aid of construction totaled approximately $25,000,000. These companies are, of course, only a small segment of the total industry. For the entire natural gas industry, the amounts would probably exceed $125,000,000. Exposure in other regulated public utility industries would likewise be very heavy.

It should be noted that an increase in customer rates tends to hit the low income groups the hardest; on the other hand, if rate adjustments are not quickly forthcoming, the financial structures of the utilities themselves can be adversely affected, thereby further compounding the difficulties in development of gas supply.

Section 1322 of the bill would continue the prior, long-standing rule and provide that contributions in aid of construction would not be included in the gross income of regulated water and sewage disposal companies. We urge the Committee to extend the proposal to those contributions in aid of construction of gas distribution and gas transmission companies which traditionally have been excluded from income by the industry. These principally involve contributions by governmental units for gas line relocations in connection with urban renewal and road relocations and contributions by customers in connection with gas line extensions. They do not include normal customer connection fees and other service fees, which as a general practice have been included in income by the industry.

It has been suggested that this would result in an unacceptable revenue loss. This is not so because the government is not now collecting and never has collected taxes on contributions in aid of construction of regulated public utilities. To forego the collection of new taxes is not a revenue loss.

If these contributions become taxable, the utility must charge its customers $2 for every $1 needed for construction -- $1 for actual construction and $1 to pay the tax. This further increase in customer bills would be most unfortunate.

Since there is no compelling need for the anticipated administrative change, we urge the Committee to continue by statute the long-standing rule of excluding contributions in aid of construction to regulated gas utilities. This can be done by enlarging §1322 of the bill to include gas distribution and gas transmission companies. We also support the extension of §1322 to electric utilities since it is our understanding that the practices of, and potential problems confronting, the electric and gas utilities in this regard are essentially the same.

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SUMMARY OF THE STATEMENT OF THE ASSOCIATION OF CLOSED-END INVESTMENT COMPANIES BEFORE THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE ON SECTION 1505 OF H.R. 10612, THE TAX REFORM ACT OF 1976 JULY 22 , 1976

1. The purpose of Section 1505 is to eliminate the present discriminatory treatment of custodial accounts for employees of tax-exempt organizations and public school systems created by Subparagraph (C) of Section 403(b)(7) of the Internal Revenue Code of 1954, as amended. That discrimination results from the unjustified limitation of investments by such custodial accounts to stock of "open-end" investment companies (commonly called mutual funds), rather than all regulated investment companies, including "closed-end" investment companies.

2. Section 1505 would permit custodial accounts for employees of tax-exempt organizations and public school systems to invest in all regulated investment companies, including closed-end investment companies. Thus, custodial accounts would be able to enjoy the same investment opportunities as do all other types of tax-qualified pension funds, including other custodial accounts. Section 1505 removes the present discrimination by deleting the provision "and which issues only redeemable stock" from the definition of a "regulated investment company" in Section 403(b)(7)(C) of the Internal Revenue Code of 1954, as amended.

3. The principal difference between mutual funds and closed-end investment companies is that mutual fund shares are redeemable at their prevailing value by the issuer, whereas the shares of closed-end investment companies are traded on established securities markets, such as the New York and American Stock Exchanges, in the same manner as stock of most other publicly held companies. Except for this difference, closed-end investment companies and mutual funds are substantially similar.

4. There is no basis for any suggestion that mutual funds as a group are any more or less suitable investments for such custodial accounts than closed-end investment companies. Both closed-end investment companies and mutual funds offer investors the opportunity of professional management of diversified investment portfolios. Both are engaged in competition for the same investment dollars and provide the same retirement benefits. To interfere with the competitive forces in the allocation of those investment dollars through discriminatory tax treatment in Section 403(b)(7) is inconsistent with the basic precepts of equal tax treatment generally accorded all regulated investment companies throughout the rest of the Internal Revenue Code and the Pension Reform Act.

**STATEMENT OF THE
ASSOCIATION OF CLOSED-END INVESTMENT COMPANIES
BEFORE THE COMMITTEE ON FINANCE
OF THE UNITED STATES SENATE
ON SECTION 1505 OF H.R. 10612, THE TAX REFORM ACT OF 1976
JULY 22, 1976**

Mr. Chairman and Members of the Committee, my name is W. David MacCallan. I am Chairman of the Board and Chief Executive Officer of Adams Express Company and Petroleum Corporation of America which, despite their names, are closed-end investment companies registered with the Securities and Exchange Commission under the Investment Company Act of 1940. I am also a director of the Association of Closed-End Investment Companies. I am accompanied by Carl Frischling, Senior Vice President and General Counsel of American General Capital Management, Inc. of Houston, Texas. American General is investment advisor to American General Bond Fund, Inc., a closed-end investment company which is a member of the Association of Closed-End Investment Companies. The Association appreciates this opportunity to present its views concerning Section 1505 of H.R. 10612, the Tax Reform Act of 1976.

The Association of Closed-End Investment Companies is the national association of the United States closed-end investment company industry. The Association's membership includes 23 companies representing approximately $4 billion in assets and over 400,000 shareholders.

Purpose and Effect of Section 1505

The purpose of Section 1505 is to eliminate the present discriminatory treatment of custodial accounts for employees of tax-exempt organizations and public school systems

created by Subparagraph (C) of Section 403(b)(7) of the Internal Revenue Code of 1954, as amended. That discrimination results from the unjustified limitation of investments by such custodial accounts to stock of "open-end" investment companies (commonly called mutual funds), rather than all regulated investment companies, including "closed-end" investment companies.

A custodial account holds pension funds for the benefit of employees. Section 1505 would permit custodial accounts for employees of tax-exempt organizations and public school systems to invest in all regulated investment companies, including closed-end investment companies. Thus, custodial accounts would be able to enjoy the same investment opportunities as do all other types of tax-qualified pension funds, including other custodial accounts. Section 1505 achieves this result by deleting the provision "and which issues only redeemable stock" from the definition of a "regulated investment company" in Section 403(b)(7)(C) of the Internal Revenue Code of 1954, as amended.

Reasons for Section 1505

With only one single exception, the definition of regulated investment companies in the Pension Reform Act broadly includes all types of regulated investment companies, including both mutual funds and closed-end investment companies. The single exception, however, precludes custodial accounts of tax-exempt organizations and public school systems

from investing in the stock of closed-end investment companies. Such a prohibition is without justification, and, indeed, no reason for such discrimination is expressed in the legislative history dealing with the Pension Reform Act.

The principal difference between mutual funds and closed-end investment companies is that mutual fund shares are redeemable at their underlying net value by the issuer, whereas the shares of closed-end investment companies are traded on established securities markets, such as the New York and American Stock Exchanges, in the same manner as stock of most other publicly held companies. Except for this difference, closed-end investment companies and mutual funds are substantially similar.

-- Closed-end investment companies provide investors the same degree and kind of professional management and investment diversification as do mutual funds.

-- Closed-end investment companies are subject to the same regulatory supervision by the Securities and Exchange Commission as mutual funds.

-- Tax-qualified closed-end investment companies must satisfy the same requirements and adhere to the same rules as tax-qualified mutual funds.

-- Closed-end investment companies provide investors with the same retirement benefits as mutual funds by providing stock redemption plans similar to those offered by mutual funds.

Conclusion

Section 403(b)(7) of the Internal Revenue Code of 1954, as amended, is designed to permit the establishment of custodial accounts to provide retirement benefits for employees of certain organizations. The only justification for precluding such accounts from investing in the stock of closed-end investment companies must be based upon investment suitability. We submit that there is no basis for any suggestion that mutual funds as a group are any more or less suitable investments for such custodial accounts than closed-end investment companies. Both closed-end investment companies and mutual funds offer investors the opportunity of professional management of diversified investment portfolios. Both are engaged in competition for the same investment dollars and provide the same retirement benefits. To interfere with the competitive forces in the allocation of those investment dollars through discriminatory tax treatment in Section 403(b)(7) is inconsistent with the basic precepts of equal tax treatment generally accorded all regulated investment companies throughout the rest of the Internal Revenue Code and the Pension Reform Act. Such an inconsistency should not be perpetuated. Consequently, we submit that Section 1505 should be adopted into law.

STATEMENT OF

THE AMERICAN COUNCIL OF LIFE INSURANCE

BEFORE THE

SENATE FINANCE COMMITTEE

ON CERTAIN TAX PROVISIONS BEING CONSIDERED
IN CONNECTION WITH H. R. 10612

PRESENTED BY

BLAKE T. NEWTON, JR.

July 22, 1976

SUMMARY OF STATEMENT OF AMERICAN COUNCIL OF LIFE INSURANCE BEFORE THE SENATE FINANCE COMMITTEE ON CERTAIN TAX PROVISIONS BEING CONSIDERED IN CONNECTION WITH H. R. 10612

July 22, 1976

I. Contiguous Country Branches of Domestic Insurance Companies. The American Council of Life Insurance supports section 1043 of H. R. 10612 (as reported by the Committee) which would provide tax neutrality in the case of United States life insurance company operations in contiguous countries.

II. Pension Fund Investments in Segregated Asset Accounts of Life Insurance Companies. The Council proposed this provision (section 1506 of H. R. 10612, as reported by the Committee) and urges that it be retained in the bill. It would clarify the tax treatment of qualified pension contracts with reserves based on life insurance company segregated asset accounts.

III. H. R. 10 Plans. This amendment, which would correct a conflict between two provisions affecting the allowable pension contributions by self-employed individuals, was sponsored by the Council. It is urged that the Committee continue to recommend its inclusion in H. R. 10612.

FULL STATEMENT OF AMERICAN COUNCIL OF LIFE INSURANCE BEFORE THE SENATE FINANCE COMMITTEE ON CERTAIN TAX PROVISIONS BEING CONSIDERED IN CONNECTION WITH H. R. 10612

July 22, 1976

My name is Blake T. Newton, Jr., and I am President of the American Council of Life Insurance. I am accompanied by Mr. William B. Harman, Jr., Executive Vice President of the Council.

The Council has a membership of 435 life insurance companies which, in the aggregate, have 90 percent of the life insurance in force in the United States and hold 99 percent of the assets of insured pension plans.

My testimony will cover three of the provisions listed in the Committee's Press Release, dated July 8, 1976. Following my statement, Mr. Harman and I will be happy to attempt to answer any questions the Committee may have.

I. Contiguous Country Branches of Domestic Insurance Companies (section 1043 of H. R. 10612, as reported by the Committee). Section 1043 of H. R. 10612 amends the Internal Revenue Code to remove the tax impediments to United States life insurance company operations in contiguous countries involving mutual or participating business. This section was initially added to the bill by the Ways and Means Committee and was in the bill as passed by the House. It was discussed by your Committee in its mark-up sessions and the provisions of the House bill, with a minor amendment, were adopted.

For reasons I will discuss, the Council supports the amendments contained in section 1043. My statement here today parallels the views set forth in our statement filed with the Committee on April 16, 1976.

Most of the foreign operations of domestic life insurance companies are in Canada, where U. S. companies have been doing business since around the beginning of the century. At present, Canadian branch life insurance operations are subject to a U. S. income tax that currently exceeds the comparable Canadian taxes payable by non-U. S. life insurance companies. Incorporation of branch operations is generally not a viable alternative for mutual companies.

This U. S. tax treatment of Canadian branch life insurance operations is inequitable because it has the effect of taxing foreign source income of non-residents. This is because the income that is taxed is essentially generated by Canadian capital (derived from the premiums paid by Canadian policyholders), investments and underwriting experience, and such income inures to the benefit of Canadian policyholders. In these circumstances the burden of the higher U. S. tax inevitably falls on the Canadian policyholders.

Moreover, the added cost to U. S. companies (as compared to foreign insurers) resulting from the U. S. tax places these companies at a competitive disadvantage. This is particularly acute in the pension market. In this regard, the U. S. companies' share of the Canadian market has steadily declined over a period of time.

In evaluating the tax status of Canadian branch life insurance operations, it is important to note that such operations are not analogous to the branch or subsidiary operations of other types of U. S. businesses. This is because, under the concept of the mutual or participating insurance policy and the branch accounting required by the amendment, the income of the Canadian life insurance

branch operations is dedicated to the Canadian customers, rather than intended for the eventual use of the company's U. S. operations.

The objective of Section 1043 is to remove the inequities described above by providing tax neutrality in the case of a U. S. life insurance company's branch operations in contiguous countries. In this regard, the Internal Revenue Code would be amended to exclude from the computation of a mutual life insurance company's taxable income all of the items relating to contracts insuring risks in connection with the lives or health of residents of contiguous countries through branches in those countries.

As I indicated, the Council supports this provision.

II. Pension Fund Investments in Segregated Asset Accounts of Life Insurance Companies (section 1506 of H. R. 10612, as reported by the Committee). This section would amend the Internal Revenue Code to clarify the tax treatment of qualified pension contracts with reserves based on life insurance company segregated asset accounts. The Council, which proposed this amendment, urges that it be retained in the bill. In this regard, I would note that about 120 life insurance companies presently maintain segregated asset accounts which include qualified plan funds.

I would now like to explain the background and nature of the amendment in more detail. My testimony parallels the substance of a letter, dated April 22, 1976, which we wrote to Senator Long for inclusion in the record of the Committee's hearings on H. R. 10612.

Life insurance companies are a major funding medium for qualified pension and profit-sharing plans. They issue contracts funding retirement benefits for individual retirement accounts, small businesses, major corporations and Taft-Hartley plans. These types of plans are also funded through tax-exempt trusts in which plan assets are managed by banks and investment advisors.

One form of life insurance company pension funding is through contracts with reserves based on segregated asset accounts. These contracts are used where the contract-holder wishes to participate directly in the investment experience of a segregated pool of investments.

In 1959 and 1962, Congress enacted provisions in the life insurance company income tax structure designed, in part, to exclude from tax income earned by life insurance companies on segregared asset account reserves held for qualified pension funds--thereby taxing life insurance company segregated asset accounts on a basis similar to that applied to banks and other pension funding agencies.

Under present law, one of the requirements that must be satisfied to qualify for this segregated asset account treatment is that the life insurance company must issue a "contract which provides for the payment of annuities". (Section 801(g)(1)(B)(ii).) This requirement has raised many questions of interpretation and has spawned protracted discussions and disagreements with the IRS over the exact nature of various contract provisions. For example, in

several private rulings and in two published rulings, the Internal Revenue Service has taken the position that a contract does not qualify under this provision unless it contains permanent annuity purchase rate guarantees with respect to all separate account funds held under the contract. In fact, a qualified plan may wish to self-insure, either wholly (by not providing for annuity purchases at all) or during the active life of the employee, or to share the insurance risk with the life insurance company. Nevertheless, under the IRS position, the life insurance company may not issue a separate account contract to such a pension plan without inserting a rigid form of annuity purchase rate guarantees.

We believe that the type of annuity features, if any, included in life insurance company contracts should be left to the contracting parties and not dictated by the tax laws. In this regard, the presence or absence of such features would seem clearly irrelevant as a matter of tax policy. As long as the reserves the insurance company hold in the separate account are dedicated to a qualified plan, no tax should be imposed with respect to them.

Section 1506 would reflect this policy by removing the requirement in section 801(g) that a qualified plan contract "must provide for the payment of annuities" in order for the underlying separate account to qualify for taxation as a segregated asset account. Moreover, it would make clear that such a contract need not be held in trust.

The revenue effect from this amendment would be negligible. This is because the tax disadvantages to a separate account and its customers of failing to qualify for taxation under section 801(g) would be so great as to preclude their use to any significant extent.

III. H. R. 10 Plans (page 8 of the Press Release announcing provisions approved by the Committee on June 11, 1976). This amendment would correct a conflict between two provisions in the Internal Revenue Code that has developed because of an IRS interpretation. The problem relates to the contributions that may be made by a self-employed individual to his firm's pension or profit-sharing plan. The amendment was proposed by the Council on behalf of the more than 240 of our members that underwrite H. R. 10 plans. It would allow self-employed individuals who contribute to over 80,000 H. R. 10 plans to maintain these plans without fear that they will be disqualified. This would be done without any revenue loss. We urge that the Committee continue to recommend its inclusion in H. R. 10612.

I would now like to explain the problem and nature of the amendment in more detail.

Since 1962, self-employed persons have been allowed to use level premium insurance contracts to fund their H. R. 10 plans even where, because of fluctuating income, the contract premiums may be greater in certain years than the allowable contributions under the H. R. 10 limitations. Under these provisions, an owner-employee may contribute the contract premiums to his H. R. 10 plan, where the premiums are based on his average earnings for the previous 3-year period. The

owner employee's deductions are based on his current income, however, and not his 3-year average income. Thus, the 3-year averaging rule does not allow any increased tax deductions. It merely allows self-employed people to keep in force their insurance contracts in years when their incomes fluctuate. This provision was carried over in section 401(e) of the Code as amended by ERISA.

Recently proposed IRS regulations would provide that the new general limitations on contributions, contained in section 415 of the Internal Revenue Code (as added by ERISA), are to override this three-year averaging provision. (Proposed regulations 1.401(e)-4(a).) Under this interpretation, the payment of the level premium would disqualify the plan if, in any year, it exceeded 25 percent of the self-employed individual's earnings. If allowed to stand, this rule would severely limit the usefulness of the averaging provision--and, thus, level premium insurance contracts--without affecting, in any manner, the amount actually deductible. We do not believe this result was intended by the enactment of ERISA.

To remove this conflict and, in our opinion, clarify the original intent of Congress, the amendment would revise section 415 to provide that a level premium which meets the conditions of the 3-year averaging provision in section 401(e) is not to be considered to violate the 25 percent limitation under section 415. This provision would not be available in any year in which the owner-employee is an active participant in any defined benefit plan established in the same trade or business or by any other trade or business that he controls. It also would not be available if any current additions were made to his account under any defined contribution plan under the same, or any controlled, trade or business.

74-659 O - 76 - 11

There will be no revenue gain or loss from this provision since the amount of tax deductible contributions, and tax-deferred earnings, will not be affected.

I appreciate this opportunity to express the Council's views on these important amendments and will be happy, along with Mr. Harman, to attempt to answer any questions you may have.

SUMMARY OF PRINCIPAL POINTS
OF STATEMENT OF CARROLL J. SAVAGE,
HERMAN C. BIEGEL AND EDWIN S. COHEN
IN SUPPORT OF SECTION 1507 OF H.R. 10612

1. Section 1507 would extend for two years the time for Congress to study so-called "salary reduction," "cash or deferred profit sharing" and "cafeteria" plans. The study period, provided for in Section 2006 of ERISA, will otherwise expire on December 31, 1976.

2. This issue relates to the tax treatment of the employees participating in the plans of 100 or more companies, many of which have been in effect for over 15 years. It does not involve any tax consequences for the employers.

3. The staff of the Joint Committee on Internal Revenue Taxation is working on a permanent solution to this problem, but it appears that there will be insufficient time remaining this year for completion of this study and enactment of a permanent solution.

4. Unless the time for this study is extended, the tax treatment of over 100,000 employees will be thrown into question beginning January 1, 1977. Section 1507 is merely a technical amendment continuing the status quo pending formulation and enactment of a permanent solution.

STATEMENT TO THE
SENATE FINANCE COMMITTEE
IN SUPPORT OF SECTION 1507 OF H.R. 10612
REGARDING CONGRESSIONAL STUDY OF SALARY REDUCTION
AND CASH OR DEFERRED PROFIT SHARING PLANS

Section 1507 of H.R. 10612 would extend the existing tax treatment of so-called "salary reduction", "cash or deferred profit sharing" and "cafeteria" plans, presently set forth in Section 2006 of the Employee Retirement Income Security Act of 1974 ("ERISA"), from December 31, 1976, until December 31, 1978, pending further Congressional study of these plans.

Section 2006 of ERISA was added by the House-Senate Conference Committee in 1974 to provide time for Congress to study the question of the appropriate tax treatment of employees covered by these types of plans, which involves the issue of whether and under what circumstances employer contributions applied to a qualified profit sharing plan or to certain nontaxable fringe benefits should nevertheless be taxed currently to the participant because of a prior right which the participant had to receive the contribution in cash or another taxable form, even though he had irrevocably elected not to exercise that right.

This issue relates solely to the tax consequences for employee participants and does not have any tax implications for employers. Well over 100,000 employees of more than 100

companies, many of which have had these plans in effect for fifteen years or more, are affected. It is a tax matter which is not involved in any way with those portions of ERISA falling under the jurisdiction of other committees.

Under existing practice, employees are not currently taxed on employer contributions to qualified profit sharing plans or cafeteria plans. However, in 1972, the Treasury proposed regulations which would have made employer contributions to salary reduction plans taxable, and discussion of that proposal called into question the status of contributions to cash or deferred profit sharing and cafeteria plans.

The approach taken by the Conference Committee in Section 2006 of ERISA was to provide that employees covered by plans in effect on June 27, 1974, are to continue to be taxed under prior rules through December 31, 1976, but such treatment is not available to participants in new plans established during that period. ERISA provides that the regulations proposed in 1972 are to be disregarded and no further regulations are to be issued prior to January 1, 1977, the date by which Congress expected it would have adequately reviewed the matter and enacted legislation.

In the absence of the enactment of Section 1507, the tax treatment of the large number of employee participants in existing plans would be thrown into question beginning

January 1, 1977. Moreover, although this issue does not have any tax implications for employers, the employers would be faced with most difficult decisions in designing plan changes by December 31, 1976 without knowing what permanent rules the Congress wishes to prescribe when it completes its study.

The undersigned attorneys, representing numerous employers affected, have had extensive discussions for some months with the staff of the Joint Committee on Internal Revenue Taxation concerning a permanent legislative solution. While we believe much progress has been made, it became apparent by May 1976 that with the heavy load of tax measures pending both in the House and Senate it was unlikely that the Congressional staff study could be completed in the present Congress in time to meet the present December 31, 1976 expiration date.

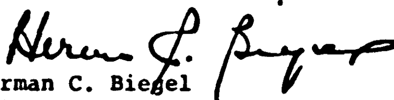
Accordingly, it seemed prudent for the Congress to extend the present expiration date until December 31, 1978 to permit the completion of the study and a permanent solution to be reached in the next Congress. The Finance Committee approved this in adopting Section 1507 on May 27, 1976. Senate Rep. No. 94-938, dated June 10, 1976, states (p. 453) this Committee's conclusion that "it is not possible to study adequately the questions involved in order to enact permanent legislation [on this subject] prior to the January 1, 1977 end of the temporary freeze of the status quo provided

for in section 2006 of ERISA." The Treasury Department has publicly stated that it has no objection to this extension.

For these reasons, we urge the Finance Committee to retain Section 1507 in H.R. 10612.

Carroll J. Savage
Ivins, Phillips & Barker
Washington, D. C.

On behalf of Eastman Kodak Company, Rochester, New York, and Xerox Corporation, Stamford, Connecticut



Herman C. Biegel
Lee, Toomey & Kent
Washington, D. C.

On behalf of Profit Sharing Council of America

Edwin S. Cohen
Covington & Burling
Washington, D. C.

On behalf of Irving Trust Company, New York, New York

STATEMENT OF THE ASSOCIATION OF AMERICAN RAILROADS TO THE COMMITTEE ON FINANCE, U.S. SENATE JULY 22, 1976

JOHN P. FISHWICK, President and Chief Executive Officer,
Norfolk and Western Railway Company
JAMES H. EVANS, Vice Chairman, Union Pacific Railroad

On April 6, representatives of the railroad industry appeared before this committee to discuss the capital requirements of railroads and suggest ways in which this committee through tax legislation could contribute to the goal of developing an efficient transportation system. At that time we outlined a number of proposals which would better enable railroads to continue as a strong free enterprise segment of the American economy in preference to becoming a burden on the country as a nationalized transportation industry. The proposals which the committee adopted were discussed at that time. Previously each proposal had been discussed with the staffs of the Joint Committee and the Finance Committee and had received the favorable endorsement of both offices. The revenue impact of the total package is minimal but is critically important to our industry.

The provisions constitute, we believe, sound and progressive ways of encouraging capital development and assisting our industry in improving its chronic cash flow shortages. Without being unnecessarily repetitive of what was covered in the earlier public hearing, we would like to summarize a few comments on the provisions included in H.R. 10612 as reported to the Senate.

1. <u>10-Year Amortization of Railroad Track Additions (Bill Section 1702)</u>

The railroad industry faces problems in building additional lines to reach undeveloped mineral deposits and upgrading existing track structure to accommodate heavier loads at reasonable speeds. The investment must be made from internally generated funds because the form of existing railroad mortgages generally precludes new financing for track. Under the retirement-replacement-betterment method of accounting for depreciation used for track, new investments are not now subject to tax recovery until the line is abandoned years in the future.

The 10-year amortization provision of the bill will permit a ratable recovery of new track investments against taxable income. It will provide the industry with internally generated cash, the only realistic private source of funds for adding to and upgrading track.

2. <u>50-Year Amortization of Railroad Grading and Tunnel Bores (Bill Section 1702)</u>

Railroads have invested substantial sums in grading and tunnels, the foundation on which track is constructed -- but have been unable to recover this investment by way of depreciation because of uncertainty about useful life. In the Tax Reform Act of 1969, the Senate passed legislation that would have permitted railroads the option of amortizing all railroad grading and tunnels

over 50 years. However, this provision was amended in conference and limited to costs incurred after 1968. Thus, present law perpetuates the historical inequity of railroads' inability to recover their investment in these assets acquired before 1969. The railroad industry is unique in having such substantial frozen costs in business assets which cannot be recovered through tax deductions. Ironically, the counterparts of these assets -- highways, airports, and waterways -- are supplied to the railroads' competitors at public expense.

The bill permits 50-year amortization of pre-1969 investments and we believe that is a fair and long-needed provision.

3. Proposals on Fuller Utilization of the Investment Tax Credit for Railroad Property (Bill Section 1701)

A. Utilization of carryover credits before currently generated credits.

The railroad industry is one of the most capital intensive industries in the United States. As a result, all roads, even those which are marginal or loss roads, generate large investment tax credit. The present limitation of 50% of tax liability on use of the investment credit has rendered a substantial portion of the credit generated unusable to the railroads, particularly the marginal railroads. As a result the industry has some $328 million of investment credit carryover.

Under the bill taxpayers would be permitted to utilize the investment credit carryovers generated in the earliest carryover year ahead of the investment credit generated in the current year. This would salvage for the railroad industry investment credit that would otherwise expire and will keep in the industry the cash benefit of these credits which can be used for needed road and track improvement projects.

B. Increase in percentage limitation.

As indicated earlier, the use of the investment tax credit in any taxable year is presently limited to 50% of the taxpayer's tax liability. In the Tax Reduction Act of 1975 the limitation for regulated public utilities was liberalized by an increase to 100% of tax liability for two years, reduced by 10% each year until the 50% of tax liability level is again reached. The bill would make comparable treatment available to railroads. This proposal will enable our capital intensive industry to realize more rapid cash generation to assist in capital expenditures in badly needed projects.

4. 12% Investment Credit for Certain Railroad Property (Bill Section 2003)

The House in its version of the energy tax bill provided for 5-year amortization of new investment in rolling stock, railroad classification yards, communications and signal equipment and facilities for loading and unloading trailers and containers.

The Finance Committee concluded that an increase in investment credit, from 10% to 12%, would be a simpler and more desirable alternative to 5-year amortization.

The committee decision properly recognizes what an important tool investment credit can be in the railroads' effort to raise capital to acquire these badly needed assets and achieve productivity increases. It has immediate value not only to the profitable railroads but more importantly, through the use of leasing, to the marginal and loss roads.

The sound tax policy provisions of H.R. 10612 which we have outlined would enable our industry to meet its responsibilities as a viable free enterprise part of the American economy. Railroads are the most energy efficient form of transportation and as such can make a vital contribution to the nation's economic strength. The capital formation which will be made possible by railroad related tax provisions which we have mentioned will help do that. We hope the provisions as proposed by this committee in H.R. 10612 will be enacted. We would be happy to answer any questions members of the committee might have.

STATEMENT OF

W. L. THORNTON
PRESIDENT
FLORIDA EAST COAST RAILWAY COMPANY

BEFORE

SENATE FINANCE COMMITTEE

WITH RESPECT TO

SECTION 1701 OF H.R. 10612

JULY 22, 1976

SUMMARY

1. Railroads in general, and the Florida East Coast in particular, have found it necessary to seek an acceptable alternative to the replacement of wooden crossties with wood. Approximately 50% of the almost 900 million crossties now in service on this nation's railroads will require replacement in the next 15 to 20 years. Federal legislation giving financial assistance to railroads to assist in their urgently needed rebuilding will probably result in unprecedented demand for crosstie renewals in the immediate future, and there will be an insufficient supply of quality wood to meet this demand.

2. Thus an acceptable alternative must be found. However, the existing Internal Revenue Service position on tax accounting for such non-wooden alternatives severely frustrates, and could, if allowed to stand, bring an end to, efforts to develop substitutes for wooden ties.

3. While both the House and the Senate have recognized the need for change and have acted to provide some relief, very serious consideration should be given to the suggestion that the Senate version be amended to allow the same treatment as that afforded in the House provision.

4. The provision in the House bill as to the effective date be changed to make it applicable to all years open for tax purposes, in order to avoid discriminatory treatment of those railroads which installed the non-wooden ties with the understanding that they would be treated as wooden ties for tax purposes. It was not until 1968, several years after alternative ties were installed in significant numbers, that IRS published a ruling covering accounting for concrete ties which is genuinely believed to be contrary to tax accounting for every other component of railroad track structures. The IRS applied such ruling on a retroactive basis. If any action by the Congress is prospective only, it might be possible to imply that the previous position of the IRS, which we are contesting, was correct.

5. The proposed provision does not provide special favorable treatment for non-wooden ties; rather, it would only give them the same treatment given wooden ties. The ICC and governmental agencies other than the IRS treat concrete ties and wooden ties in the same manner for accounting and other purposes.

Mr. Chairman, my name is W. L. Thornton, and I am President of the Florida East Coast Railway Company. I am appearing here today in support of a provision which will give equitable tax treatment to expenditures for non-wooden crossties. Non-wooden crossties have been tried sporadically for many years in this country. However, it was not until the early 1960s that any serious effort was made to substitute non-wooden for wooden ties. This project was undertaken primarily by our railroad, the Kansas City Southern and the Seaboard Coast Line. Other railroads have continued to experiment with alternatives to the wooden tie and are still conducting these experiments today; but as of December 31, 1974, the latest full-year figures available, out of 882,800,000 crossties in service in this country, only 1,048,000 were other than wooden, less than two-tenths of one percent of all ties.

Our decision to use a non-wooden tie was mandated by the shortage of good quality wooden ties and the consequent increase in the cost of wooden ties as well as by a desire to use raw materials available in our immediate area. In some instances, wooden ties became so scarce that railroads were trying to import them from other countries. We, therefore, decided to try to replace our existing wooden ties with an acceptable alternative,

74-659 O - 76 - 12

concrete ties. Since we undertook this program in 1965, we have replaced through 1975 approximately 450,000 wooden ties, out of a total of 2,800,000, with concrete ties. While we expect that the concrete tie will one day be at least as durable as the creosote-impregnated hardwood tie, the results to date do not establish this. To demonstrate this fact, in the first 34 miles of concrete crossties installed by Florida East Coast during 1965 and 1966, some 22 percent had failed in service by 1971 and were replaced with new concrete ties. This would indicate a life expectancy for the entire 34 miles of far less than the life expectancy of between 29 and 42 years for creosoted wooden ties as reported by a recent Federal Railroad Administration study.

With this brief introduction, I would like to describe our tax problem with respect to concrete ties. Railroads are not allowed the typical depreciation method of deducting a stated percentage of capitalized cost each year over the life of the asset for any of the components of the track structure. Rather, these assets are capitalized without deduction until and unless they are replaced or completely abandoned. For example, if a stretch of track were to run from Washington to Richmond and was built 50 years ago, the entire cost of the ties, rail, spikes, ballast, etc., would be capitalized during the year of construction. If the stretch of track were taken out of service next year, 1977,

the entire capitalized cost, less applicable salvage, would be deducted from income for that year. During the intervening 50 or so years, no deductions for depreciation on that capitalized cost would be allowable. However, during that 50 year period, the various components would naturally suffer wear and have to be replaced. In the year of any such replacements, the entire cost of the replacement asset and the cost of labor associated with the replacement would be deductible from income as a proper operating expense item. If, however, the replacement asset is a betterment of the original asset, the portion of the cost attributable to the "betterment" is capitalized. A definition of "betterment" is something that either extends the life; increases the capacity; or increases the productivity of a particular asset. For instance, if 80 pound rail is replaced with 100 pound rail, obviously a betterment has been effected due to increased capacity, and the difference in the current cost of 80 pound rail and that of the 100 pound rail is added to the capital account with the remainder expensed in the year of replacement. The Internal Revenue Service recognizes and applies this system as a valid method of accounting for depreciation of railroad track structure capital accounts. The difficulty,

and the reason I am here today, is the manner in which the IRS has applied this system to concrete crossties replacing wooden crossties in existing tracks. In 1968, approximately three years after we began our replacement program, IRS issued a ruling which held that the cost of a concrete replacement tie and the cost of labor associated with replacement must be entirely capitalized. The ruling further held that the capitalized cost of a wooden tie and its installation cost must be written out of the capital account and expensed.

The effect of this ruling in the case of track many years old would be to allow an expense deduction of approximately $3.00 for the old tie and increase capitalization approximately $25.00 for each non-wood replacement tie, such amount remaining in the capital account until replaced or for possibly 25 years. Whereas if the non-wood replacement tie had been afforded the same treatment as a wooden tie (or any other element of the track structure, i.e., rail, ballast, fastenings, etc.) the full $25.00 cost would be charged immediately as an operating expense item. Clearly such tax treatment will eliminate consideration of alternate materials for crossties. I believe that there is unanimous agreement that the ruling is incorrect and not in accordance with the basic tenets of accounting for depreciation of railroad track structure capital accounts.

The question is how to treat concrete ties replacing wooden ties for tax purposes. It is our position that concrete ties replacing wooden ties should be treated exactly the same as wooden ties. This is the approach taken by the House of Representatives in H.R. 10612. Your Committee has, however, reported a provision which requires "betterment" treatment requiring the difference in current cost between wooden ties and concrete ties to be capitalized if in fact there is a betterment and the remainder to be deducted in the year of replacement. Neither in our experience nor in that of the industry, however, has the concrete crosstie met the standards of being a betterment. Since concrete ties do not meet any of the criteria for a "betterment," that is, the life is not extended nor is there increased capacity or productivity, we support the House provision and submit it should be made applicable to all open years for several reasons. (1) It is consistent with interpretation by the Interstate Commerce Commission with respect to accounting for concrete ties which holds that concrete ties are not a betterment, and that all material and labor costs associated with the replacement of wooden ties with concrete ties shall be included in operating expenses. (A copy of this interpretation is attached.) To our knowledge, no Federal agency has taken a position that concrete ties constitute a betterment. (2) It will encourage further development of an acceptable alternative for wooden ties in the

future. As we all know, there is a massive amount of repair needed on our nation's railroads. Federal assistance and other legislative programs will soon result in an unprecedented and sudden demand for crossties, literally tens of millions. Wooden crossties cannot possibly meet this demand. (3) Discriminatory tax treatment will discourage development of non-wooden ties. (4) It will be consistent with the actual facts concerning concrete crossties wherein no betterment exists and will provide uniform tax treatment, for the entire period that concrete crossties have been installed, consistent with all other elements in the track structure. (5) The revenue impact for future years will be the same under either the House provision or the Senate Finance Committee bill. The amount of the deduction is the same in both instances and only the timing of a portion of the deduction is treated differently.

Finally, let me discuss for a moment the modification to the House version which we desperately need. We have treated concrete ties as an expense item, based upon what we believe to be a valid assumption that we would be able to account for our costs in all respects as we did for all other elements of the track structure. The position taken by the IRS in 1968 was a great shock and we believe totally without foundation in fact or law. We, tnerefore, are contesting the ruling. Further,

I would plead that the provision in this bill as to its effective date be changed. At this juncture, it is our firm opinion and belief that the Internal Revenue Service position requiring capitalization is totally wrong. We have long advocated this position even before 1968, when IRS first issued its ruling and stated its opinion and position that capitalization was required. The danger of inserting the currently prescribed effective date is a possible interpretation that the position of the Internal Revenue Service in prior years was a correct one. This, in truth, would be a serious potentially adverse step and, we believe, one unintended by your committee. We plead with you to clearly state that this bill is effective for all taxable years open for tax purposes. Accordingly, we suggest that the following change be made in Section 1701(b) of your Finance Committee bill:

"(g) Certain Railroad Ties -- in the case of a domestic common carrier by rail (including a railroad switching or terminal company) which uses the retirement-replacement method of accounting for depreciation of its railroad track, expenditures for acquiring and installing replacement ties which are not made of wood (and fastenings related to such ties) shall be accorded the same tax accounting treatment as expenditures for replacement ties of wood (and fastenings related to such ties). This subsection

shall apply to all taxable years for which an amended federal income tax return or claim for refund may be filed or for which a suit for refund may be or has been filed in which a final order has not been entered."

The revenue impact of this change is minimal since the use of concrete ties has, as outlined, been extremely minimal during any years which are open. What we request with respect to concrete or other non-wooden ties is not special treatment but exactly the same treatment now given wooden ties. We do not want an advantage, rather we do not want to be disadvantaged.

Thank you for giving me this opportunity to appear before you. If you have any questions, I will be happy to answer them or submit additional information.

CASE 87

What is the proper accounting when wooden ties are replaced with concrete ties?

All costs associated with replacement of wooden ties with concrete ties shall be included in operating expense.

CASE 88

What is the proper accounting for side track deposits under a refund agreement?

The cost of constructing the side track shall be charged to account 731, Road and Equipment Property, and the related deposit credited to account 782, Other Liabilities. Deposit amounts refunded shall be charged to account 782. Upon termination of the agreement period, any remaining balance in account 782 shall be cleared to account 731. If the side track is retired, the balance in account 731 shall be cleared and accounted for as if it represented the retirement of the property.

CASE 89

Roads A, B and C file a joint tariff with the Commission with respect to the transportation of a certain commodity. Under a related pooling agreement, (1) Road A will use its equipment to perform the entire line-haul movement of the commodity, (2) Roads B and C will maintain, on a standby basis during the period of the agreement, sufficient equipment and track facilities to enable alternate movement of the commodity should Road A be unable or unwilling for any reason, to handle this traffic, and (3) Road A will allocate to the alternate routes of Roads B and C, and pay to these roads, a proportionate amount of the revenues it receives for performing the line-haul services based on an arbitrary determination as agreed between the parties. What is the proper accounting to be performed by the respective roads?

The payments by Road A to Roads B and C do not represent normal divisions of revenues since Roads B and C do not perform any portion of the line-haul movements. The payments are considered to represent a standby charge to compensate these roads for maintaining alternate track facilities and equipment which will be available to meet the shipper's needs, even though they are not used. Road A shall credit the entire revenues from the line-haul movement to account 101, Freight, and charge the amounts payable to Roads B and C to account 411, Other Expenses. Roads B and C shall credit their respective amounts receivable to account 143, Miscellaneous.

MAY 24 1976

INTERSTATE COMMERCE COMMISSION
BUREAU OF ACCOUNTS
WASHINGTON, D. C. 20423

April 30, 1976

ACCOUNTING SERIES CIRCULAR NO. 130, REVISED

TO ACCOUNTING OFFICERS OF ALL RAILROAD COMPANIES:

Interpretations of the Uniform System of Accounts
for Railroad Companies

Enclosed is a copy of Accounting Series Circular No. 130, Revised, which reflects substantive changes to the initial issue of September 1, 1962. A summary of the revisions by case numbers is also enclosed.

The interpretations, which are effective immediately, express the views of the Bureau of Accounts concerning application of the Uniform System of Accounts for Railroad Companies.

Any questions or clarification of the above should be directed to the Bureau of Accounts in writing or by calling on 202-275-7448.

John A. Grady
Director

Enclosure

STATEMENT OF THOMAS S. CARTER

PRESIDENT, THE KANSAS CITY SOUTHERN RAILWAY COMPANY

Before The

Committee on Finance, United States Senate

IN RE TAX REFORM BILL OF 1976

H.R. 10612 Section	I.R.C. Code Section	Title
1701(b)	263(g)	Treatment of Certain Railroad Ties ("Non-Wood" Ties)
1702	185	Amortization Over 50-Year Period of Railroad Grading and Tunnel Bores Placed in Service Before 1969

July 22, 1976

Statement of Thomas S. Carter

President, The Kansas City Southern Railway Company

Summary of Statement

Section 1701(b) - Railroad Ties:

1. The concrete tie is presently in use by seven different United States railroads; it is still in a largely experimental stage.

2. Present engineering estimates contained in the study of Thomas K. Dyer, Inc. for the Federal Railroad Administration indicate that the useful life of the concrete tie will be substantially the same as that of the treated-timber tie.

3. The use of steel ties on railroads in the United States is not feasible because it would preclude the effective operation of signal and centralized traffic control systems.

4. The engineering development of plastic ties is virtually nonexistent.

5. Usage of continuing fluctuations in market price between concrete ties and treated-timber ties does not constitute a sound legislative criteria for changing established retirement-replacement accounting rules.

Section 1702 - Railroad Grading:

1. Pre-1969 railroad grading has a determinable useful life; the 50-year amortization for post-1969 grading costs should be extended to pre-1969 grading.

Statement of Thomas S. Carter

My name is Thomas S. Carter. I am president of Kansas City Southern Railway Company and its subsidiary, Louisiana & Arkansas Railway Company, with principal offices in Kansas City, Missouri. I am here for the purpose of testifying with respect to House Bill 10612 (Tax Reform Bill of 1976), as reported to the Senate on June 10, 1976, and specifically concerning Section 1701(b) relating to railroad ties and Section 1702 relating to railroad grading. I am a graduate civil engineer, and am licensed to practice engineering in six states. I have worked in the railway industry for over 30 years and have had a great deal of experience in connection with the operating characteristics of railroad ties and grading.

Sec. 1701(b) - RAILROAD TIES

Kansas City Southern Railway Company serves six midwestern and southern states, namely, Missouri, Kansas, Arkansas, Oklahoma, Texas and Louisiana. It operates approximately 1,670 miles of main line track, principally from Kansas City to the Gulf of Mexico down through Louisiana and southern Texas.

Kansas City Southern Railway Company has approximately 7.1 million ties in service on its lines. Because of the extreme moisture conditions in the Gulf Coastal region, we have historically experienced difficulties with treated-timber ties on Kansas City Southern. Realizing that this condition exists,

we have made several attempts to experiment with the use of concrete ties in lieu of treated-timber ties in an effort to bring our average tie life to at least that of the national average. The results to date do not indicate that the concrete tie is an effective solution to our problem.

Some of our competitors have imported foreign species of timber into this country and installed ties made of such timber in their tracks. Some railroads, including Kansas City Southern, looked to concrete ties as an alternative to treated-timber ties.

It may be helpful to discuss briefly the initial use of concrete ties in this country in the early 1900's. Early designs of concrete ties were based on the same dimensions as the treated-timber tie, but the concrete tie did not absorb impact to the same degree as the timber tie. As a result some of the early designs of concrete ties failed prematurely. This was discouraging to a number of the carriers. A major passenger train accident on the famous hairpin curve on the old Pennsylvania Railroad was caused by the failure of the hold-down device of the concrete tie. Thus, concrete ties in this country received a severe black eye which set the development back a number of years.

From 1930 to 1960 there was very little development of the concrete tie. During the period from the early thirties to World War II, the severe economic recession in the railroad industry, as well as in the country generally, resulted in a minimal number of cross-tie insertions. During the World War

II years a substantial amount of tie-insertion work using timber ties was done by major railroads. A large number of such ties were insufficiently aged. Shortages of materials, particularly of creosote, resulted in many ties being insufficiently treated. Although a large number of replacement ties were inserted, their deficient quality resulted in operational problems that the railroad industry really is just getting over today.

As a result of these conditions, new focus was placed upon the development of alternative tie materials and a renewed look taken at the use of concrete ties. Several designs were made and tested in various laboratories, including those of the Portland Cement Association, the Association of American Railroads, and in some cases, private laboratories. From the designs that appeared feasible, concrete ties were manufactured and inserted in track at various locations by a number of railroads. On my own railroad, we have actually inserted concrete ties of three distinct designs and have used four different types of hold-down devices. We are now in the process of developing an additional design for the concrete tie and have done some work in the development of a new hold-down device. The first concrete cross ties were actually inserted in our track in 1966.

The Kansas City Southern Line is not the only railroad in the United States that has been experimenting with concrete

ties. Some of the other carriers that are using concrete ties are the Southern; St. Louis-San Francisco; Norfolk and Western; Florida East Coast; Seaboard Coast Line; and Atchison, Topeka and Santa Fe Railroads.

The state-of-the-art in the development of the concrete tie at this time has not met the full expectations of the rail industry. It is my opinion that much more engineering work has to be done in the development of the concrete tie before it is uniformly accepted in the industry. The Department of Transportation, through its Research, Development, and Demonstration Program under the management of the Federal Railroad Administration, is experimenting with concrete ties at the High Speed Ground Transportation Test Center at Pueblo, Colorado. The Federal Railroad Administration has also established a concrete tie study on a Santa Fe Railway test track in western Kansas. In addition to the development of the cross section design of the concrete tie, another serious problem has been the design of the hold-down or fastening device for such tie.

Under the Railroad Rehabilitation and Regulatory Reform Act of 1976, the Federal Railroad Administration engaged Thomas K. Dyer, Inc. to make an estimate of deferred maintenance in track materials for United States Class I Railroads. In his report, dated June 15, 1976, Mr. Dyer estimates that the average

life of concrete ties for these railroads will be similar to that of treated-timber ties. His estimates of the useful life to the using railroads range from 29 to 42 years.

The Dyer report confirms my own opinion it is far too early in the state of the engineering development of concrete ties to reach the conclusion that such ties will have an appreciably longer life than the treated-timber ties.

Kansas City Southern has considered the use of steel cross ties. From a safety standpoint they are highly impractical for the reason that traffic on our main lines is controlled by our Signal and Centralized Traffic Control Systems. When a train occupies the track, the flow of electrical current goes from one rail through the wheels and axles of the cars and locomotives to the other rail and causes the signals to turn red. If steel ties were used, the signals would stay red all the time because the electrical current would continuously flow from one rail to the other rail through the steel tie. For this reason, the use of steel ties in Signal and Centralized Traffic Control Territories is not practical. Steel ties are used in a number of European railroads, but in each of those cases the railroads are electric railroads. The third rail, or overhead cantinary, together with the two rails, is used to activate their signal systems.

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With respect to the application of plastic ties, we have no experience with the use of this product. We have yet to see a plastic tie that has sufficient amount of stress resistance to accommodate the load of the modern American diesel locomotive and heavy freight cars. If such a product becomes available, we would like to experiment with it also.

In my opinion steel and plastic ties do not in the foreseeable future constitute a viable alternative to the treated-timber tie.

Kansas City Southern uses the Uniform System of Accounts for Railroads as prescribed by the Interstate Commerce Commission. This means that it uses the so-called "retirement-replacement method" of accounting for Account No. 8, Ties. From the very first concrete tie that was inserted in our line in 1966, we have consistently followed the practice of charging the cost of the concrete ties and related fastenings and labor to insert such ties exactly the same way as we charge the same costs of a replacement treated-timber tie.

The present prices of concrete ties are quite high in relation to timber ties because so few are purchased annually. For the most part concrete ties have to be custom made. I look at the price of a concrete tie much like that of a pocket calculator. In the early development stage, the pocket calculator cost $100. With the advent of mass production it can be purchased

for $10 today. With mass production in the United States, I am confident that the unit price of the concrete tie would come down to the range of the treated-timber tie. There is a very limited number of concrete tie manufacturers in this country, but once the state-of-the art has produced a satisfactory degree of durability and mass use of such ties commences, then many more manufacturers of concrete ties will come into existence.

I can see no justification why the replacement concrete tie and related fastening costs should be given a different accounting treatment than the costs for replacement timber ties and related fasteners. If subsequent engineering developments and uses reduce the cost of the concrete tie below that of the treated-timber tie, then under the proposed language of Section 1701(b), the accounting treatment of the replacement concrete tie would be the same as that of the replacement treated-timber tie. My understanding is that there is no present provision of the Internal Revenue Code which makes the capital v. expense classification depend upon fluctuations in current market prices.

It is my opinion that if concrete ties and related fastenings are required to be capitalized as set out in the present language of Section 1701(b), then the incentive for further development of concrete ties will be severely hampered.

I recommend that favorable consideration be given to a provision which would treat the handling of concrete ties and related fastenings in the same manner as treated-timber ties for Federal income tax purposes for all open and future years.

Section 1702 - RAILROAD GRADING

Current Section 185 of the Internal Revenue Code of 1954 allows railroads to amortize over a fifty-year period railroad grading placed in service after December 31, 1968. Grading placed in service prior to that date has historically been treated as non-depreciable by the Internal Revenue Service and the Interstate Commerce Commission because of the assumption that grading has an indeterminable useful life for depreciation purposes. The current bill under consideration would allow grading placed in service prior to 1969 to be amortized over a fifty-year period, identical to the provision for grading placed in service after 1969 under the present Section 185.

Recently, Kansas City Southern litigated in the United States Tax Court the question of the useful life of its grading placed in service prior to 1969. We are awaiting a decision in this case. The Tax Court has decided this issue favorably to the taxpayer in Chesapeake & Ohio Rwy. Co., 64 T.C. 352 (1975). This issue is also before the United States Court of Claims in cases involving the Burlington Northern and Baltimore & Ohio

railroads, and before the United States Tax Court in the Southern Pacific and Louisville & Nashville railroad cases.

In connection with the trial of the grading issue before the Tax Court, we presented extensive life analysis studies of grading placed in service by Kansas City Southern between 1917 and 1969. These studies, prepared by experts in the life analysis field, analyzed retirements from our grading accounts by year of original construction. The analyses conclusively established that pre-1969 grading has a determinable useful life to Kansas City Southern. This was the finding of the Tax Court in the Chesapeake & Ohio case, and in my opinion should be of universal application to all domestic railroads.

I recommend that favorable consideration be given to Section 1702 of the Bill, providing for the amortization of pre-1969 grading.

SUMMARY OF TESTIMONY OF PAUL W. EGGERS IN SUPPORT OF GEOTHERMAL TAX PROVISIONS, SECTION 2004 OF H.R. 10612

1. This is not special interest legislation, but is a provision of general applicability throughout the geothermal industry.

2. Similar legislation has been supported by the Federal Energy Administration, and was previously passed by the Senate in 1975.

3. Testimony was offered and statements submitted urging the enactment of geothermal tax legislation at hearings held by the Senate Finance Committee both on energy related tax provisions (H.R. 6860) and on H.R. 10612. No adverse testimony was received.

4. The legislation is consistent with existing court decisions and would eliminate uncertainty as to the tax treatment of geothermal resources.

5. The legislation is sorely needed to create a viable geothermal industry with great potential for future clean energy development from domestic resources.

STATEMENT OF PAUL W. EGGERS,
PRESIDENT, GEOTHERMAL KINETICS, INC.
BEFORE THE SENATE COMMITTEE ON FINANCE

July 22, 1976

I am Paul W. Eggers, President of Geothermal Kinetics, Inc. I am accompanied by Dr. Carel Otte, Vice President and Manager of Geothermal Division of Union Oil Company of California. Dr. Otte is an eminent geologist and an expert in geothermal technology.

I am appearing on behalf of Geothermal Kinetics, Inc., and in support of Section 2004 of H.R. 10612, which clarifies that geothermal resource development should receive the same type of tax treatment as that provided other wasting assets. A number of other small companies engaged in geothermal development activities requested an opportunity to testify. Had they done so they would all have testified in favor of this section. These companies are Republic Geothermal, Inc., Magma Power Company, and Geothermal Resources International, Inc.

I should like to emphasize to the Committee that this is not so-called "special interest" legislation, nor was it enacted without full consideration by this Committee. Similar legislation has been endorsed by the Federal Energy Administration, and was passed previously by the Senate as part of the Tax Reduction Act of 1975, although unfortunately it was dropped in conference. On the present provision, hearings were held, testimony was offered, and statements were submitted for the record before the Committee acted.*

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*SEE: 1. Hearings before the Subcommittee on Energy of the Committee on Finance, United States Senate, March 17, 1975, p. 85.
2. Hearings before the Committee on Finance, United States Senate, on H.R. 6860, relating to energy conservation and conversion, July 15, 16, 17, and 18, 1975, p. 936.
3. Statements submitted for insertion in the record of Hearings before the Committee on Finance, United States Senate, on H.R. 10612, by Geothermal Kinetics, Inc., Union Oil Company of California, and Magma Power Company, 1976.

Furthermore, Section 2004 is not designed to benefit any single company, but has general applicability to all who engage in geothermal exploration or development. Enactment would, in our judgment, be a major factor in creating a viable new industry with vast potential for meeting future energy needs.

This legislation would be of greatest benefit to small, struggling geothermal companies which desperately need to raise capital if they are to survive. For example, Geothermal Kinetics, Inc. is a small independent operator which, together with its subsidiaries, has approximately 30 employees. It is engaged exclusively in geothermal research, exploration and development. It has spent approximately $5 million in acquiring leases and drilling geothermal wells, and it now has an interest in approximately 650,000 acres with geothermal prospects. In fully developing these prospects, it will be necessary to raise additional capital and to bring in outside investors. There is little likelihood that this can be done with the uncertainty of tax consequences now existing.

Mr. Chairman, what is at stake here is the development of an industry which has the potential for replacing almost one million barrels of daily oil production by 1985. Indeed, the Project Independence report set this approximate amount as a 1985 goal for the nation. But we are starting from scratch. Probably not more than 75 geothermal wells will be drilled during all of 1976. To create a viable industry and to come anywhere close to the target, we have to have this legislation.

The projected investment for achieving the 1985 goal includes the costs of drilling at least 800 exploratory wells and 6,000 development

wells at a minimum cost of $500,000 per well, or a total of $3.4 billion in 1975 dollars in drilling costs alone. Depreciable investment in hook-up facilities will add another $2 billion. Moreover, some 2,000 replacement wells will be required, with the attendant depreciable investment, bringing the total investment requirement to about $10 billion. This type of capital simply cannot be raised without certainty as to the tax laws.

Given the current energy situation, this nation cannot afford to overlook the geothermal potential; nor to leave the tax treatment of geothermal development in the present state of uncertainty. Moreover, I emphasize that the industry is not asking for special treatment, but only that it be assured the tax treatment to which court decisions indicate it is now entitled--a type of tax treatment that has long been accorded mining and drilling industries.

One last point, Mr. Chairman. Geothermal is primarily in competition in the West with strip-mined coal. To deny geothermal, a clean energy resource, similar tax incentives to those presently available to the coal mining industry simply makes no sense.

We urge the Committee to retain Section 2004 as it appears in H.R. 10612.

Thank you.

* * *

TAX REFORM

Public Hearings before the
Committee on Ways and Means
House of Representatives
July 22, 1975, Part 3 of 5, p. 2108

FEDERAL ENERGY ADMINISTRATION,
Washington, D.C., June 13, 1975.

Mr. KARL S. LANDSTROM,
Arlington, Va.

DEAR MR. LANDSTROM: Mr. Zarb has asked me to thank you for your letter of April 14, 1975, regarding the tax treatment of income derived from geothermal resource exploitation.

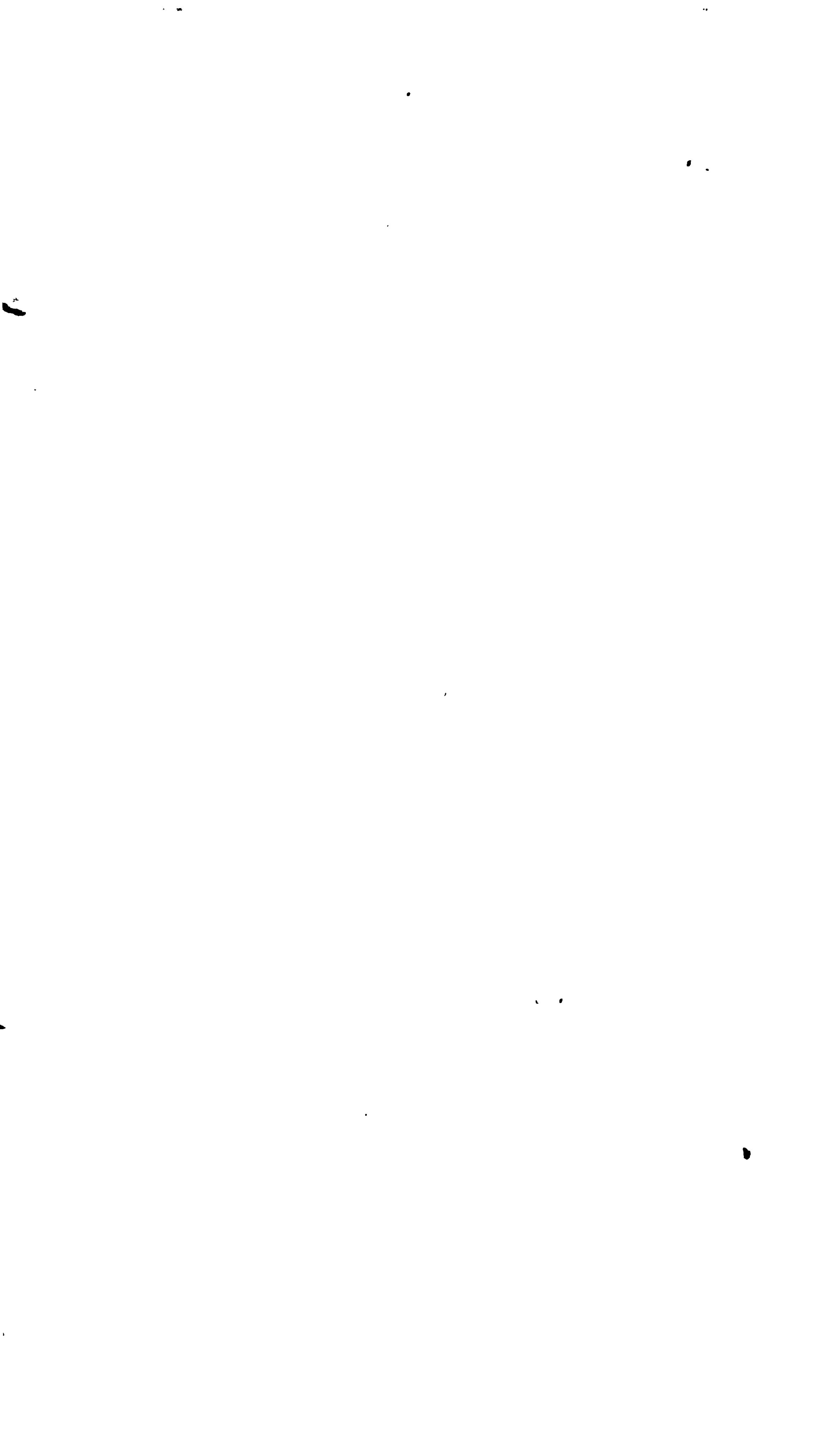
We have determined that income derived from geothermal development should be accorded the same tax treatment as income derived from oil and gas exploration and development. Accordingly, we feel that the percentage depletion allowance should apply to geothermal resource exploration and development to the same extent it applies to oil and gas exploration and development.

By the same token, we have taken the position that intangible drilling and development costs for geothermal resource exploitation should obtain the same treatment accorded such costs in the case of oil and gas drilling and development. We have made our views in this area known both within and without the Administration. We hope that legislation will soon be passed putting the tax treatment of geothermal resource development on a par with the tax treatment of oil and gas drilling and development.

Thank you for your interest in these matters.

Sincerely,

DONALD B. CRAVEN,
Acting Assistant Administrator, Energy Resource Development.



NATIONAL ASSOCIATION OF RECYCLING INDUSTRIES, INC.
330 MADISON AVENUE / NEW YORK, N.Y. 10017 / AREA CODE 212 867-7330

Consolidated Statement Of
National Association of Recycling Industries, Inc.

Re: H.R. 10612 - Tax Reform Act Recycling Tax
Credit Provisions

Summary Of Principal Points

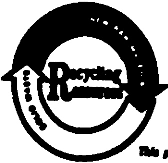
1. The 775 recycling firms represented by the National Association of Recycling Industries, as well as the U.S. Conference of Mayors, the National League of Cities, the National Governors Conference, the National Solid Waste Management Association and State Resource Recovery Boards and Authorities throughout the United States fully support the Recycling Tax Credit (Sect. 2006), and the Tunney-Gravel Amendment (No. 2017).

2. The baseless opposition registered by a few seemingly blind, selfish or misguided opponents must be branded as absolutely unjustified, totally misleading and exceedingly damaging to the best interests of the United States — in the critical areas of natural resource conservation, resource recovery and recycling; energy conservation, balance of payments, and solid waste management and disposal.

3. When the Senate recently overwhelmingly passed the Solid Waste Utilization Act of 1976, and committed hundreds of millions of dollars to finance new State and Municipal Resource Recovery Facilities, the Public Works Committee Report warned:

> "If new markets are not developed for these materials [to be recovered from garbage], resources recovered from municipal wastes will only succeed in substituting for existing secondary materials"

The Recycling Tax Credit is urgently needed to supplement the Solid Waste Utilization Act, or the latter is doomed to costly wasteful failure from the outset.



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4. Environmental Action Coalition, contrary to the completely negative view espoused by Environmental Action's Washington lobbyist before this Committee, urges approval of the Recycling Tax Credit reported by the Senate Finance Committee.

5. The Recycling Tax Credit must continue, as it presently does, to cover all recyclable commodities, including wastepaper, aluminum, and copper. Each year, cities and states bury 44,300,000 tons of paper and 12,500,000 tons of metals, including 1,000,000 tons of aluminum —— all of which is lost forever in landfills. No small segment of American industry, fearful of competition, should be permitted to impede full new recycling in all of these recyclable commodities.

6. The Recycling Tax Credit will not result in large revenue losses or windfalls to existing recyclers. Indeed, as the Committee Report states, properly administered by the Government, the Recycling Tax Credit should not result in any net revenue losses to the Treasury.

7. The base period and moving base period concepts embodied in the Recycling Tax Credit strictly limit and eliminate "windfalls" to existing recyclers.

8. The Tunney-Gravel amendment should be approved by the Committee or the Senate.

9. Passage of the Recycling Tax Credit will result in 100% increases in paper, aluminum, copper, lead and zinc recycling by 1986. Extension of the 5% Recycling Tax Credit to fuel produced from garbage residues, after all recyclables have been removed, will eliminate landfills and coupled with recycling of secondary materials, save the United States huge volumes of precious oil, gas and coal energy.

NATIONAL ASSOCIATION OF RECYCLING INDUSTRIES, INC.
330 MADISON AVENUE / NEW YORK, N.Y. 10017 / (AREA CODE 212) 867-7330

Before The
Senate Finance Committee
Washington, D.C.

H. R. 10612
Tax Reform Act of 1976
July 22, 1976

Consolidated Statement Of

1) National Association of Recycling Industries, Inc., New York
2) Harlan Carroll, Vice President, Southwire Company, Inc., Carrollton, Georgia
3) Harold Gershowitz, Executive Vice President, Waste Management, Inc., Chicago, Illinois
4) Stanton Sillmore, Executive Vice President, Keystone Resources, Pittsburg, Pennsylvania; Greensboro, Georgia
5) Paul Thanos, Vice President, Commercial Metals Co., Dallas, Texas
6) Richard Wand, Administrative Vice President, Bergstrom Paper Company, Neenah, Wisconsin

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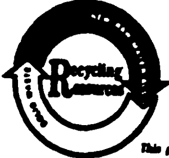
Mr. Chairman:

My name is M. J. Mighdoll, Executive Vice President of the National Association of Recycling Industries, Inc. (NARI). The Association's offices are located at 330 Madison Avenue, New York City, and our membership consists of more than 775 recycling firms located throughout the United States. Those firms are the leading collectors, processors and users of recyclable wastepaper, aluminum, copper, lead, zinc and textile solid waste materials.



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I appear here today to testify on behalf of NARI and to present this consolidated statement on behalf of the above-named leaders of the national recycling and solid waste management industries who have traveled from many corners of the United States ——

(i) to support the Recycling Tax Credit provision contained in Section 2006 of the Tax Reform Act, as reported by the Senate Finance Committee;

(ii) to support the Tunney-Gravel amendment to Section 2006; and

(iii) to brand as absolutely unjustified, totally misleading and exceedingly damaging to the best interests of the United States —— in the critical areas of natural resource conservation, resource recovery and recycling, energy conservation, balance of payments, and solid waste management and disposal -- the baseless opposition registered against the Recycling Tax Credit provisions by a few seemingly blind, selfish or misguided opponents who have either appeared before the Committee or registered written criticism.

It seems plain, we respectfully submit, that none of those critics even bothered to read the Committee Report in support of the Recycling Tax Credit[1/], and of course, they must not have been present when the Committee held detailed public hearings on the Recycling Tax

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1/ Senate Finance Committee Report, pgs. 575-578.

Credit in July, 1975, when it considered the Energy Tax Bill.

Anyone remotely familiar with the Recycling Tax Credit, as drafted and carefully restricted by this Committee and the staff of the Joint Committee on Internal Revenue Taxation, knows perfectly well that it is strenuously supported, not only by the national recycling industry as a whole, but also by the ---

1. U.S. Conference of Mayors,
2. National League of Cities
3. National Governors' Conference
4. National Solid Waste Management Association, and by
5. Resource Recovery Boards and Authorities in cities

and states such as Connecticut, California, Massachusetts, Louisiana and Wisconsin.

On June 10, 1976, for example, the President of the U.S. Conference of Mayors, Moon Landrieu of New Orleans, and the President of the National League of Cities took the unusual step of addressing a joint personal letter to every member of the United States Senate urging them to support the Recycling Tax Credit. That letter reads as follows:

> "Dear Senator:
> We have been informed that the tax bill H.R. 10612 is scheduled to be taken up by the Senate today. As the Presidents of the U.S. Conference of Mayors and the National League of Cities, we wish to call your attention to one provision placed in the bill by the Finance Committee which has the strong support of both our organizations.

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"That provision phases in a modest tax expenditure over a period of three years for those who increase usage of secondary materials recovered from solid waste. Nearly all of the solid waste involved would be municipal solid waste. Cities throughout the nation are running out of space for landfills and are struggling to pay for modernization of incinerators while the United States simultaneously struggles to conserve its supplies of depletable natural resources and energy. The provision which will be before you is a small step in the direction of equalizing the economic incentives as between utilizing recycled or virgin materials. From the cities' viewpoint, it has the added advantage of expanding markets for the materials recovered by scores of municipal Resource Recovery Plants which are on line or under construction throughout the country. Expanded markets would improve the economic viability of these present and future facilities.

"As the elected spokesmen of the Mayor and elected city officials throughout the nation, we are confident that the Mayors and City Council members of your state join us in urging your support for this brief provision in the tax measure."
(Emphasis provided)[2]

It is thus surprising and very regrettable indeed to find Senators such as Senator Kennedy of Massachusetts and Senator Gary Hart of Colorado apparently willing to carry their running vendetta against this Committee's version of the Tax Reform Act to the point of even opposing the Recycling Tax Credit provision of the bill.

Large urban centers in Massachusetts, like other municipalities throughout the United States, are becoming increasingly concerned with the problems of where and how to dispose of their growing mountains of solid waste. The answer, they believe, is resource recovery and

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2/ The Committee, of course, has received similar communications of support from City and State Resource Recovery Authorities from several sections of the country.

recycling of garbage. Thus, Massachusetts plans to operate in the near future several Resource Recovery Plants similar to the one already in operation in Saugus, Massachusetts which produces saleable steam from garbage received from Boston and eleven adjacent communities, inhabited by a half million of Senator Kennedy's constituents.

But, if Senator Kennedy's opposition to the Recycling Tax Credit contained in this Committee's bill is successful, it is doubtful the additional Resource Recovery Plants now in the planning stage will be built; or if built, whether they can successfully operate and retire the bonds issued to finance their construction. Why? Because the viability of each municipal or state Resource Recovery Plant depends on its ability regularly and consistently to market the wastepaper, the metals, glass and energy materials it produces from garbage. The Recycling Tax Credit adopted by this Committee is designed as an incentive to create new markets for those recyclable commodities and to guarantee sustained markets in the years ahead.

Certainly, Senator Gary Hart should understand this. He was one of the principal supporters of the Solid Waste Utilization Act of 1976, passed overwhelmingly by the Senate just before the last recess. That bill prohibits open dumping of garbage and authorizes the expenditure of hundreds of millions of dollars in federal grants and loan guarantees to create new state and municipal solid waste management and resource recovery programs.

But, the Senate Public Works Committee Report in support of

that Act, so strenuously supported by Senator Hart, candidly recognizes, at page 5:[3]

> "Evidence presented to the Committee indicates that demand for recycled or secondary materials is limited by factors other than supply availability. Such materials are not viewed favorably as a resource supply by industry. The relative value relations must be changed to improve acceptability. If new markets are not developed for these materials, resources recovered from municipal wastes will only succeed in substituting for existing secondary materials." (Emphasis supplied)

That, Senator Hart, is precisely why the Senate Finance Committee adopted the Recycling Tax Credit. Unless your Solid Waste Utilization Act is promptly supplemented by "recycling market incentives" and "tax parity" between competing virgin and recyclable materials, the hundreds of millions of federal dollars the Public Works Committee has earmarked for new solid waste management and resource recovery systems will, by the Committee Report's open admission, be doomed to wasteful failure. How then can you fairly join in a senseless, myopic attack on the Recycling Tax Credit?

Another truly amazing opponent of the Recycling Tax Credit is the Washington lobbyist for Environmental Action, Mr. Early. Many in the national environmental movement think he is running for top spot on his own organization's "Dirty Dozen" list. His position is simple: There are two ways to create "tax parity" between competing virgin and

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3/ Senate Report No. 94-988 (June 25, 1976)

recyclable commodities and to create new markets for recyclables:

(i) One way, Mr. Early's way and Senator Haskell's way, is to repeal the percentage depletion allowance on virgin ores and timber and the capital gains treatment of profits derived from the cutting of trees. Those "virgin tax benefits" presently cost the Treasury $1.5 billion a year.

(ii) The other way is to enact a modest Recycling Tax Credit which would reduce the existing tax disparity against recyclables, and thus improve their marketability in competition with virgin ores and timber.

Mr. Early concedes Congress is not ready to repeal the virgin benefits —— indeed this Committee twice defeated that proposal 12 to 2 in the last year —— so Mr. Early contends new, effective recycling and the related national benefits of resource recovery, resource conservation, energy conservation, reduced air and water pollution and reduced solid waste disposal problems and costs should be held "hostage" until the Congress is ready to do the job exclusively his way and Senator Haskell's way.

Fortunately for our national environment, that stubborn "all or nothing" attitude is not widely shared by other environmentalists whose job is, not to sit here in Washington and oppose everything Congress attempts to do as Mr. Early does, but to cope day in and day out with real, constantly-mounting solid waste disposal problems. For example, in a letter dated June 29, 1976 addressed to Senator Javits of New York,

the Environmental Action Coalition —— the New York arm of Environmental Action —— stated this far more realistic, reasonable position in support of this Committee's Recycling Tax Credit provision:

> "Having since 1970 coordinated a network of community recycling centers in New York City, and having urged large scale municipal and industrial recycling programs, the Environmental Action Coalition (EAC) is acutely aware of the many government-fostered obstacles that have prevented the natural expansion of recycling in this country. Most obvious of these obstacles are. .tax incentives to the virgin materials industries in the form of depletion allowances and capital gains.
>
> "Shortly to be considered by the Senate is the Tax Reform Act of 1976 (H. R. 10612). The section of the bill which provides a phased-in tax credit on purchases by a recycler of recyclable materials is a moderate step in the direction of equalizing the status in the marketplace of virgin and recycled products. The Environmental Action Coalition supports this provision as an acceptable interim measure while the ultimate goal of total repeal of capital gains and depletion allowances is being pursued."

Moreover, the national recycling industry represented by the National Association of Recycling Industries —— which consists of all the leading U.S. firms engaged in aluminum and copper recycling —— must categorically reject the selfish, short-sighted position taken before this Committee by the extremely tiny limited interest group known as the Aluminum Recycling Association. Three of the country's leading recyclers of aluminum and copper are here with me today to emphasize that it is vitally important to the nation for the Recycling Tax Credit to continue to cover —— as it presently does —— aluminum, copper,

wastepaper and all the other heavy volume solid waste commodities.

The United States simply cannot afford, in a devastating period of dwindling domestic supplies and increased dependence on foreign cartels for more than 50 to 95% of the metals it so critically requires to carve out "business sanctuaries" or "no new competition preserves" for any particular recycling group. Furthermore, since the Recycling Tax Credit is aimed at assisting the cities and states to market the vast new volumes of recyclable materials their new Resource Recovery Facilities will extract from garbage, it is vitally important to note that, according to the 1975 Report to Congress of the President's Council on Environmental Quality, those recyclables each year will be drawn from ——

Solid Waste Category	Current Recycling Rate	Present Volume Buried Each Year
Wastepaper (53,000,000 tons)	16.5%	44,200,000 tons
Metals (12,700,000 tons)	1.6%	12,500,000 tons
Glass (13,500,000 tons)	2.1%	13,200,000 tons
Plastics (5,000,000 tons)	0%	5,000,000 tons
Textiles (1,900,000 tons)	0%	1,900,000 tons

Plainly, therefore, all these recyclable commodities must continue to be included if the Recycling Tax Credit is to accomplish its intended goals of new recycling and conservation of scarce natural metal resources.

The Recycling Tax Credit Will Not Result In Large Revenue Losses Or Windfalls To Existing Recyclers.

As indicated above, anyone remotely familiar with the Committee Report in support of the Recycling Tax Credit knows that, as drawn by the Committee and Dr. Woodworth's staff, the Recycling Tax Credit will not result in either large revenue losses or unconscionable windfalls to manufacturers on their current recycling volumes.

(i) Revenue Loss

The Committee Report emphasizes that, because of the Recycling Tax Credit's "phase-in" provisions, the maximum estimated revenue loss for 1977 will be $9 million; and for 1978, $39 million.

It is vitally important to note, however, that both of those "estimates" are based on a projected 10% increase in recycling volume for all recyclable materials covered by the bill in 1977, and another 10% increase in each category in 1978.

If recycling volume in each category continues to increase by 10% a year in 1979, 1980, and 1981, the Joint Committee on Internal Revenue Taxation now projects the ultimate yearly revenue loss will rise, in 1981, to $228 million.[4/]

But, as stated above, all these revenue loss estimates are

4/ The Committee Report originally estimated an ultimate revenue loss of $345 million by 1981. The Joint Committee staff, however, admitted its calculations failed to take into account the "moving base period" in the bill, and thus corrected its estimate to $228 million in 1981.

predicated on resulting annual recycling increases of 10% in 1977, 1978, 1979, 1980 and 1981. Thus, the critics of the Recycling Tax Credit are again dead wrong in their spurious claim:

> "This provision will eventually cost an estimated $345 million a year, but it will do little to promote any new recycling of solid wastes."

First, the Recycling Tax Credit will not eventually cost $345 million, as alleged by the "chronic complainers", and unless it increases recycling volume in all commodity categories by 10% a year — that is, unless it promotes 10% "new recycling" each year from 1977 through 1981 - it will not cost $9 million in 1977, or $39 million in 1978, or $228 million in 1981.

Furthermore, the Committee Report, at page 575, correctly underscores the fact that, even with these 10%-a-year new recycling increases projected by the Joint Committee staff, no revenue losses at all should actually result from the Recycling Tax Credit, properly administered by the Government. In this regard, the Committee Report states:

> "The revenue loss from a recycling tax credit need not produce a net decrease in budget receipts [at all] if there is sufficient substitution of recycled materials for virgin materials to produce a decrease in revenue loss from percentage depletion allowances [currently claimed by users of virgin materials]."

In conclusion, therefore, when the Senate fairly weighs all the potential national benefits to be gained from the Recycling Tax Credit, together with the prospect it potentially can and should be administered without any net revenue loss to the Treasury, against the $1.5 billion

per year in revenue losses attributable to the competing virgin commodity tax benefits, how can anyone seriously argue the Recycling Tax Credit should be rejected out of hand?

Moreover, how can Senator Gary Hart fairly oppose the Recycling Tax Credit as too expensive, even assuming a $9 million revenue loss in 1977 or $39 million in 1978, when from his position on the Public Works Committee he recently helped push through the Senate a $35 million 1977 one-year authorization for the Office of Solid Waste Management of EPA whose function is simply to continue to study and theorize on possible resource recovery solutions and projects.

The Finance Committee's Recycling Tax Credit promises an immediate, effective 20% increase in recycling and resource recovery by the end of fiscal 1978 —— at just 1/4 the cost of the last mentioned EPA $35 million authorization for 1977, and at approximately the same maximun cost of that authorization for 1978.

(ii) No unconscionable Windfall To Existing Recyclers.

The opponents of the Recycling Tax Credit falsely allege: "What this tax credit will do, however, is provide a windfall to those who are already using recycled materials."

As the Committee surely knows, that is an outrageous misstatement.

The Recycling Tax Credit provision, carefully drawn by the staff of the Joint Committee on Internal Revenue Taxation, establishes both an original "base period", and then a "moving base period" to exclude from Recycling Tax Credit coverage 75% of all current recycling volume.

It allows a credit on only 25% of current recycling volume as a fair means of protecting existing recyclers from being caught "between the devil and the deep blue sea", so to speak.

As explained above, on one hand, large integrated companies already enjoy, on 100% of their utilization of competing virgin materials, either a depletion allowance or low 32% capital gains tax treatment of profits. Enactment of the Recycling Tax Credit, on the other hand, will undoubtedly bring many new firms into recycling, some of which will ultimately gain a recycling tax credit on a large portion of their new utilization of recyclable materials.

Thus, some fair economic protection must be afforded to existing recyclers, and this has been done by the Committee, but only to the extent of 25% of their 1973-1975 average recycling volume.

Thus, the "base period" concept, and the "moving base period" concept embodied in the Recycling Tax Credit are far more stringent than the base period concepts overwhelmingly approved by the Senate in connection with the DISC provisions. And, since they are so strictly limited by the Committee draft, they guarantee no one will enjoy any so-called unconscionable windfall as a result of this portion of the bill.

The Committee Should Approve
The Tunney-Gravel Amendment
To The Recycling Tax Credit

Before concluding, we want to urge the Senate Finance Committee to approve Amendment No. 2017 proposed by Senators Tunney and Gravel

to the Recycling Tax Credit provisions of the bill.

That amendment would only slightly modify the original "base period" provisions to substitute "volume" of recyclables purchased during the 1973-1975 base period for the "dollar value" of those base period purchases. The substitution of this base period test would not substantially increase the revenue loss projections, but it would guarantee that all recyclable metals and wastepaper would qualify for at least a small recycling tax incentive during the 1977-1979 "phase-in" period. Indeed, the record indicates this was the Committee's real intention in the first place, and seemingly, the "dollar value" test was inserted exclusively during the staff's drafting process.

The amendment would also extend a 5% Recycling Tax Credit to purchasers of fuel, steam or other saleable products produced from garbage residues —— after all recyclable wastepaper, metals, glass, textiles etc. are already recovered for recycling. This proposal promises to convert garbage residues which cannot otherwise be recycled into useful energy —— as substitutes for precious oil, gas or coal. Plainly, the credit should be thus extended by the Committee or by the Senate as a whole.

Conclusion

The Recycling Tax Credit, as approved by this Committee and as amended by the Tunney-Gravel amendment, should be enacted into law at the earliest possible date.

Coupled with the Solid Waste Utilization Act, passed by the Senate a few weeks ago, it promises to produce dramatic increases in

paper, aluminum, lead, zinc, copper and textile recycling in the years immediately ahead ––– as much as 100% increases by 1986.

At relatively no revenue cost to the Treasury in 1977 and 1978, or in the future for that matter, it will not create complete tax parity with virgin materials whose tax benefits total $1.5 billion a year. But, it does represent true tax reform in this area; a meaningful, effective change in direction from the days of tax encouragement of depletion of precious natural resources to the compelling days of tax incentives aimed at reaching new recycling goals.

As summarized by a report issued on June 30, 1976 by the House Committee on Government Operations entitled "Solid Waste-Materials And Energy Recovery",[5] at pages 6, 10:

> "The solid waste problem in the United States -- especially the municipal solid waste problem -- is an environmental predicament of staggering dimensions. . . .
>
> "A 1975 survey of Mayors and City Council members identified solid waste management as the number one urban problem. . . .
>
> "If the millions of tons of municipal solid waste can be viewed, not negatively as a problem of disposal, but positively as a source of valuable materials and energy, resource recovery can transform a major environmental, social and economic problem into a valuable resource. . . .
>
> "What is the potential? In energy alone, the Environmental Protection Agency calculates that if all the municipal solid waste generated in our Standard Metropolitan Statistical Areas had been tapped for its energy content, 900 million BTUs would have been preserved in 1973. This is equivalent to the energy of 154 million

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5/ See H.Rep. No. 94-1319, 94th Cong., 2d Sess.

barrels of oil per year. By 1980, the energy content of municipal solid waste is expected to climb to 187 million barrels of oil per year."

To delay the passage of the recycling tax incentive here involved is thus roughly equivalent to "fiddling while Rome burns."

STATEMENT ON BEHALF OF THE NATIONAL LP-GAS ASSOCIATION SUBMITTED TO THE SENATE FINANCE COMMITTEE AT HEARINGS ON FEDERAL EXCISE TAX REVISION BY ARTHUR C. KREUTZER, VICE PRESIDENT AND GENERAL COUNSEL*

SUMMARY OF PRINCIPAL POINTS

1. The present method of taxation and handling of the motor fuel excise tax on use of propane in industrial lift trucks is inequitable and discriminatory, for the reason that equal or comparable tax is not imposed on competitive industrial lift trucks powered by electricity or diesel.
2. The favored tax position provided for electric powered lift trucks represents stimulation of an inefficient use of energy resources.
3. Conversion to use of propane in the desire to provide a cleaner working atmosphere should not be penalized.
4. Revision in tax handling will eliminate substantial confusion for the lift truck user, the fuel supplier, and the tax collector.
5. The amount of tax revenue involved is insignificant.

It is our recommendation that Sec. 4041 of the Internal Revenue Code be amended to limit the tax on liquefied petroleum gas (propane) to use in a highway motor vehicle. A suggested revision is attached to this statement.

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*A supplement to this statement appears at page 413 of this volume.

INTERESTED PARTY AND PURPOSE

The National LP-Gas Association is a national trade association, having as members the producers of liquefied petroleum gas, the manufacturers of equipment and appliances using liquefied petroleum gas, and the distributors and dealers. LP-gas is the common name used for our product. The Association has over 5500 member companies and 43 affiliated states. The membership represents over 90% of the industry's volume of business. Its membership is predominately at the distributor and dealer level. The Association's position as set out in this statement would also reflect the position of other industry companies. The more direct marketing impact of the tax discussed herein is felt by these distributors and dealers who sell LP-gas at retail. The employment and economic well-being of over 75,000 employees is involved in the LP-gas dealer's business and the problem presented. The manufacturers of, and dealers in equipment utilizing LP-gas are also adversely affected. Again, to the degree indicated in this statement, this problem is of serious concern to thousands of users of LP-gas equipment.

Our purpose in appearing is to inform this Committee of the existing discriminatory tax treatment accorded LP-gas, as compared with competing fuels in their use for the same purposes, the adverse impact on other national goals, and to apprise you of the confusing, burdensome, and impractical administrative application and handling of the present tax on LP-gas in non-highway motor fuel use incurred by both the government and the user. In solution of these problems we recommend that the motor fuel

tax on LP-gas be limited to use in a highway vehicle. This recommendation is also aimed at limiting the tax to those who receive the benefit.

PRODUCT AND TAX INVOLVED

LP-gas is composed of propane, butane, propylene, butylene, and their mixtures. It is an energy source, or fuel, and a small part[1/] of total product usage is in motor fuel, principally off the highways. A portion of such motor fuel use is in industrial tractors, or industrial lift trucks. The tractor pulls or pushes a load and the lift truck carries it. It is herein that we encounter difficulties with federal excise tax administration and our statement is partially directed at that problem. In this usage LP-gas is a necessity in material handling and industrial processing, and its taxation becomes a business cost. To follow one step further, the tax burden on competitive products or business is not the same. It varies according to the means employed. Again, because of the diverse end products this tax impact cannot be evaluated.

The federal excise tax involved is the basic 2 cents a gallon tax on special motor fuel. (Sec. 4041) The additional gallonage taxes on highway vehicle use dedicated to the Highway Trust Fund are not involved. LP-gas is one of the special motor fuels subject to Sec. 4041. The others are bensol, benzine, naphtha, casinghead and natural gasoline, "or any other liquid". The other liquids that may be involved are unknown to us.

1/ Total internal combustion use in 1974, the latest year available was 1,309,750,000 gallons or under 10% of total product use (U.S. Bureau of Mines Report). The major portion of this 10% is on the farm, for tractors, irrigation pumping, etc.

The products, other than propane, have little, if any, motor fuel use.

Gasoline, or Sec. 4081 tax products, and kerosene, gas oil and fuel oil are specifically excluded, and diesel fuel is separately handled as will be later covered. The special fuel tax is imposed on use in a motor vehicle. A motor vehicle is defined by Treasury Department interpretation as a vehicle designed to carry or support a loan. Consequently, this tax applies on LP-gas use in an LP-gas powered industrial lift truck and this is our area of concern.

DEFECTS IN PRESENT TAXATION

1. The Present Special Motor Fuel Tax Is Inequitable And Creates Discrimination, Placing LP-Gas At A Competitive Disadvantage.

Competing electric battery powered or diesel fueled industrial lift trucks do not face similar fuel or power sources taxation. There is intense competition in this industrial tractor market and the LP-gas powered vehicle, and LP-gas use, is handicapped through unequal and discriminatory tax treatment that unfairly aids competition. Fuel cost is a substantial element in an industrial plant's decision on the type of lift truck to purchase and the 2 cents a gallon tax as reflected in total operating cost is many times the deciding factor.

Diesel fuel has a basic 2 cents a gallon federal excise tax but only on use in a highway vehicle. The tax is not imposed on use in an industrial plant non-highway motor vehicle. A tax element of fuel cost is not faced when a diesel fueled industrial lift truck is purchased, or diesel fuel is used.

The electric or battery powered industrial lift truck does not face this tax, or any comparable tax, as an element of operating cost. Lower operating costs as a result of the tax favored position are a strong competitive sales argument used by electric lift truck suppliers in their advertising and promotional material. Competitive promotion of the electric lift truck emphasizes this tax advantage. Removal of the handicapping tax on LP-gas will not completely eliminate this cost differential, but it will place LP-gas on a more equitable and competitive plane. The effect of this promotion is demonstrated in the following statistical data compiled by NLPGA.

INDUSTRIAL TRUCKS IN USE

	1966	1971	1976
Total #	623,200	774,000	984,000
Electric Walkers #	79,600	111,100	162,300
% of Total	12.8	14.4	16.5
Electric Riders #	76,200	121,100	182,100
% of Total	12.2	15.6	18.5
LP-Gas Riders #	289,800	335,900	396,600
% of Total	46.5	43.4	40.3
Gasoline & Diesel Riders #	177,600	205,900	243,000
% of Total	28.5	26.6	24.7

SHIPMENTS

	1965	1970	1975
Total #	59,900	69,800	66,400
Electric Walkers #	8,200	13,800	14,400
%	13.7	19.8	21.7

SHIPMENTS Cont'd

	1965	1970	1975
Electric Riders #	10,000	14,800	19,000
%	16.7	21.2	28.6
*LP-Gas Riders #	25,900	25,500	20,500
%	43.2	36.5	30.9
*Gasoline & Diesel #	15,800	15,700	12,500
%	26.4	22.5	18.8

* Revised to reflect field conversions

It will be seen that the market share, in the ten year period, of Electric Walkers increased by 3.7%, the Electric Riders by 6.3% while the LP-gas lift truck lost 6.2% of the market. While Gasoline and Diesel Riders also decreased by 3.8% the loss is believed to be primarily in gasoline units that were converted to propane. Contrasting 1965 and 1975 shipments reveal a much greater market takeover by electric fuel vehicles where in riders, the principal competitive unit, electric units showed a 11.9% gain, and LP-gas units dropped 12.3%. Not only did LP-gas market shares drop, but there was an actual decrease of 5400 units.

To carry this element of discriminatory treatment between competing methods one step further, as a material handler the lift truck serves as a conveyor of materials. There is no comparable tax on the power that supplies conveyors of the many other types, such as a built-in belt conveying system. There are also material handlers or conveyors in electric powered pallets.

The effect of this basic 2 cents a gallon federal excise tax on LP-Gas as a special motor fuel is to create an inequitable and discriminatory tax that encourages tax free competition.

2. The Tax Favored Position Provided For Electric Powered Lift Trucks Represents Stimulation Of An Inefficient Use Of Energy Resources And Impairs Energy Conservation.

In a governmental report 2/ it is estimated that the efficiencies in producing and delivering electricity range from 10 to 25 percent. In other words there is a loss of energy resource employed in the production of electricity of from 75 to 90 percent. The mentioned report further states that systems for providing fuels directly to the consumer are more efficient. "The greatest potential for energy conservation is often in the selection of the right energy system for a particular need". 2/ The direct use of propane in an industrial lift truck is both a more efficient use of a natural resource, and the selection of the right energy system for a particular need. We submit that instead of penalizing use of propane through inequitable taxation, its use should be encouraged. Or to express it otherwise inefficient and wasteful use of energy resource should not be stimulated. These twin objectives can be met by removing the federal excise tax on use of propane in an industrial lift truck.

3. Conversion To Use of Propane In The Desire To Provide A Cleaner Working Atmosphere Should Not Be Penalized.

2/ Energy - Environment and the Electric Power Prepared by the Council on Environmental Quality, August, 1973

Many industrial plants bought LP-gas fuel or converted existing lift trucks using other fuels to use of propane with the objective of providing a more desirable, or less polluted atmosphere through use of clean burning propane instead of fuels that place the worker in an atmosphere created by fuels with undesirable emissions. This upgrading of working environment should be encouraged by removal of any tax disincentive. National tax policy should encourage use of clean fuel. Propane is a clean burning gas, as contrasted with fuel used in other internal combustion engines. Some states with the objective of encouraging use of clean fuel have completely eliminated, or reduced, their highway motor fuel tax on propane. In this statement we are only requesting removal of the inequitable federal tax penalty.

4. Revision In Tax Handling Will Eliminate Substantial Confusion For The Lift Truck User, The Fuel Supplier, And The Tax Collector.

The administration of the present law by IRS, and tax handling by the LP-gas fueled industrial lift truck user, is complex, confusing and costly. To appreciate the problems involved it should be first noted that the tax is applied to use in motor vehicles, defined by the Treasury Department as vehicles designed to carry or support a load. Use in a vehicle that pulls or pushes a load is not taxable. An industrial lift truck is in the first category. An industrial tractor is in the second category. Industrial operations commonly involve both types of vehicles. Consequently, we find in the same industrial plant, drawing from a common fuel source, the two types of vehicles. In addition the fuel may be used for other non-taxable purposes in the plant. The determination of how much fuel is used for taxable purpose and how much

for non-taxable purpose presents problems of substantial difficulty both to the Government and to the taxpayers. Tax determination by the user and effective enforcement by the Government is costly.

Substantial confusion exists among users as to the tax application that understandably resists clarification when the complexity is recognized. This confusion is not limited to users. In the past we have seen differing interpretations from differing IRS District Offices. A simplification of this tax will serve both Government and the taxpayer with little effect on tax income.

5. The Tax Revenue Involved Is Insignificant.

The tax dollars involved on special motor fuels under Sec. 4041 are not consequential. While as earlier mentioned, this tax applies to specified other liquids, their taxable use is de minimis insofar as we can ascertain. This tax, in addition to being on use in motor vehicles, applies to use in motorboats and airplanes. LP-gas is not so used, and we understand that use of other special motor fuels, if any, is insignificant.

LP-gas taxable use in motor vehicles, other than in highway vehicles, would largely be confined to the industrial lift truck. Our calculations based on the number of LP-gas powered lift trucks in use at the end of 1976 and the average usage indicate that the tax involved would approximate $9.3 million dollars a year.[3/] Taxes would also fluctuate widely with industrial productivity.

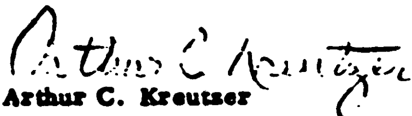
3/ 396,600 LP-Gas lift trucks in use with an average annual use of 1,200 gallons.

SUMMARY AND RECOMMENDATION

Therefore, in the interest of competitive equity, efficient use of natural resources, encouragement of use of clean fuel, tax clarity, and administrative convenience we recommend that the existing special motor fuel tax law be modified to limit tax application to special motor fuel use in a highway vehicle, or if such proposal covers too broad a field of tax producing special fuels, which we consider unlikely, the motor fuel taxation of LP-gas be limited to use in a highway vehicle as is the present treatment provided for diesel.

While Sec. 2009(c)(2) of the Tax Reform Act of 1976 would create this equity through providing for a refund of tax when non-highway use was involved, we suggest that equity can be better accomplished, tax handling simplified, and cost to user and government alike eliminated through tax revision to remove initial imposition of this tax. Amendatory language is attached.

Respectfully submitted,



July 22, 1976

Arthur C. Kreutzer
Executive Vice President
& General Counsel
National LP-Gas Association
1800 N. Kent Street
Arlington, Virginia 22209

SUGGESTED TAX REVISION

Sec. 4041. Imposition of Tax

(b) Special motor fuels. There is hereby imposed a tax of 4 cents a gallon upon benzol, benzene, naphtha, liquefied petroleum gas, casinghead and natural gasoline or any other liquid (other than kerosene gas oil, or fuel oil, or any product taxable under Sec. 4081 or subsection (a) of the Section) -----

(1) Sold by any person to an owner, lessee or other operator of a highway motor vehicle or motorboat for use as a fuel in such highway motor vehicle or motorboat; or

(2) Used by any person as a fuel in a highway motor vehicle or motorboat unless there was a taxable sale of such liquid under paragraph (1).

(Strike remaining language of Sec. 4041)

STATEMENT OF THE MAY DEPARTMENT STORES COMPANY ON TAX REVISION PROPOSALS SUBMITTED TO COMMITTEE ON FINANCE UNITED STATES SENATE

July 22, 1976

Summary of Principal Points

1. The May Department Stores Company ("the Company"), and The May Stores Foundation, Inc. ("the Foundation"), for the reasons set forth in the Company's written statement dated April 23, 1976, submitted to the Finance Committee, favor the enactment of Section 2101 of H.R. 10612 as reported by the Committee. That section would modify the transitional rules of the Tax Reform Act of 1969 for sales of property by private foundations.

2. Under arrangements entered into in 1965, and as permitted by the 1969 Act, the Company is leasing from the Foundation certain real property that houses facilities that are vital to the operation of the Company's Famous-Barr Co. department store in downtown St. Louis, Missouri. Other private foundations and disqualified persons around the country have similar arrangements.

3. The 1969 Act imposed broad restrictions on leasing and other "self-dealing" transactions between private foundations and disqualified persons. To avoid unnecessary disruptions and hardships with respect to pre-existing arrangements, various "transitional rules" were included in the Act.

4. Section 2101 of the present bill deals with a situation that falls between two existing transitional rules. One of those rules permits a "disqualified person" to lease property from a private foundation, until 1979, if the lease was entered into before the 1969 Act and if the rental paid under the lease is an arm's-length rental. The other transitional rule permits

a private foundation to sell "excess business holdings" to a disqualified person if the sale price equals or exceeds the fair market value of the property being sold.

5. Section 2101 would permit property being leased under the first transitional rule to be sold to a disqualified person under the safeguards required for sales of excess business holdings under the second transitional rule.

6. Both the Finance Committee and the House Ways and Means Committee (which unanimously approved a similar provision in 1972) have observed that this provision will benefit charity by helping to preserve asset values for the private foundations in question and that it would likely have been included in the 1969 Act if the Congress had been aware of these fact situations at that time.

[Full statement begins on page 3]

Statement

Mr. Chairman and Members of the Committee:

My name is Newman T. Halvorson, Jr. I am a lawyer with the firm of Covington & Burling, Washington, D. C., and I am testifying this morning on behalf of The May Department Stores Company, headquartered in St. Louis, Missouri, in favor of the provisions set forth in Section 2101 of H.R. 10612 as reported by the Senate Finance Committee.

We appreciate this opportunity to present our views on the proposed modification of the transitional rules for sales of property by private foundations. We have previously submitted to this Committee a written statement dated April 23, 1976, concerning this same subject.

A. Description of the property.

The May Department Stores Company (the "Company"), headquartered in St. Louis, Missouri, is a publicly owned corporation that operates 129 department and discount stores in major metropolitan markets coast to coast, 58 catalog showroom stores in the greater New York area and northern California, and 16 regional shopping centers. Major stores or groups of stores are located in St. Louis, Chicago, Akron, Cleveland, Youngstown, Denver, Baltimore, Washington, D. C.

(The Hecht Co.), Los Angeles, San Diego, Pittsburgh, Portland (Oregon), Hartford, and Jacksonville.

The May Stores Foundation, Inc. (the "Foundation"), is a charitable corporation, established under New York law in 1945, and is a "private foundation" as defined in Section 509 of the Internal Revenue Code. It receives charitable contributions from the Company and makes grants primarily for various civic and educational activities. After the enactment of the Tax Reform Act of 1969, the Company was a "disqualified person," as defined in Section 4946 of the Internal Revenue Code, with respect to the Foundation.

In 1965, four years prior to the enactment of the Tax Reform Act of 1969, the Company conveyed to the Foundation, as a charitable contribution, the Company's entire fee and leasehold interests in certain improved real property north of and across Locust Street from the Company's Famous-Barr Co. department store facility in downtown St. Louis. The Company claimed a charitable deduction for the value of the property interests so conveyed.

Immediately after receiving the property from the Company, the Foundation leased it back to the Company for an approximate 24-year term ending in 1989. Under the Company's leases with the Foundation, the property is used, as it had been previously, to provide vital support services to the

department store facility, such as a receiving, sorting and shipping center for goods involved in the Company's St. Louis retail department store operations. The support property also houses the power plant and other utilities for the department store facility and is connected with the department store facility through a system of underground tunnels and conveyors.

B. Effect of the 1969 Act and the proposed new transitional rule.

The provisions of the Tax Reform Act of 1969 permit the Company's leases with the Foundation to continue only until December 31, 1979. See Section 101(1)(2)(C) of the Act (Public Law 91-172). By that date the leases between the Company and the Foundation will have to be terminated to avoid violation of the self-dealing rules that were added to the Code by the Tax Reform Act as Section 4941 of the Code.

Although the Tax Reform Act requires that the leases be terminated by 1979, it does not permit the Company to purchase, at any price, the property previously conveyed to the Foundation and presently subject to the leases. Thus the likely effect of present law will be ultimately to deprive the Company of any use of this vital support property after 1979. In view of the "umbilical cord" relationship between the property and the Company's adjacent department store,

this could cause a serious disruption for the Company's retail operations in St. Louis. Nor would this have any offsetting benefit for charity, because the price that any third party could be expected to pay for this property, uniquely valuable only to the Company in connection with the operation of its downtown St. Louis department store facility, would be no greater than the price the Company would be willing to pay.

There are apparently a number of other foundations and disqualified persons around the country faced with a similar problem. This was recognized by the House Ways and Means Committee early in 1972 when it unanimously approved, without objection by the Treasury Department, an amendment (H.R. 9520) to the transitional rules in the Tax Reform Act. Similar bills have been introduced in subsequent Congresses. E.g., H.R. 1118 and H.R. 12546, introduced in the 94th Congress by Congressmen Schneebeli and Karth, respectively. The amendment contemplated by these bills, and by Section 2101 of the present bill, would permit a private foundation to sell to a disqualified person, for not less than fair market value, any property being leased by that person under a lease described in Section 101(l)(2)(C) of the Tax Reform Act. Although there was no known opposition to H.R. 9520 in 1972, the bill was never brought to a floor vote in the House.

The reasons for the legislation are cogently set forth in the House Report which accompanied H.R. 9520 and in the Senate Report accompanying the present bill. See H.R. Rep. 92-965, 92d Cong., 2d Sess. (1972) (copy attached) and S. Rep. No. 94-938, 94th Cong., 2d Sess. 591-93 (1976). As both reports indicate, if these situations had been called to the attention of Congress in 1969, Congress probably would have minimized the resulting hardships with a divestiture rule similar to the divestiture rule available for the disposition of excess business holdings under Section 4943 of the Code.

C. Conclusion.

For these reasons, Section 2101 of H.R. 10612 represents an important refinement of existing law and it should be retained in the final version of this legislation.

92d Congress } HOUSE OF REPRESENTATIVES { Report
2d Session } { No. 92-965

MODIFICATION OF TRANSITIONAL RULE FOR SALES OF PROPERTY BY PRIVATE FOUNDATIONS

March 29, 1972.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. Mills of Arkansas, from the Committee on Ways and Means, submitted the following

REPORT

[To accompany H.R. 9520]

The Committee on Ways and Means, to whom was referred the bill (H.R. 9520) to amend section 101(l)(2) of the Tax Reform Act of 1969, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are as follows:

Page 2, line 4, after "leasing" insert "substantially all of".

Page 2, line 6, strike out "persons" and insert "person".

Page 2, strike out lines 16, 17, and 18, and insert:

(b) The amendments made by subsection (a) shall apply to dispositions after the date of the enactment of this Act in taxable years ending after such date.

I. SUMMARY

H.R. 9520 makes a perfecting amendment to transitional rules provided in the Tax Reform Act of 1969 with regard to sales of property by private foundations to disqualified persons. The 1969 Act provided that a private foundation and disqualified persons could continue an existing lease through 1979 without violating the self-dealing rules, if the private foundation had the benefit of any bargain that might exist in the lease. Also, the 1969 Act permitted a private foundation to sell to disqualified persons any business holdings that the private foundation was required to dispose of because of the excess business holding provisions of that Act.

This bill deals with a situation that falls between these two transitional rules. It permits a private foundation to sell to a disqualified person (at a price at least as high as the fair market price) property substantially all of which is subject to a lease protected under the present law's transitional rule with regard to pre-1969 Act leases.

The committee has reported this bill unanimously and the Treasury Department does not object to its enactment.

67-006

BEST COPY AVAILABLE

II. REASONS FOR THE BILL

The Tax Reform Act of 1969 amended the Internal Revenue Code of 1954 to impose taxes upon certain transactions between a private foundation and its "disqualified persons" (generally, persons with an economic or managerial interest in the operation of that foundation). Among the transactions covered by these taxes on "self-dealing" are the sale, exchange, or leasing of property (sec. 4941). In order to avoid unnecessary disruption of existing arrangements, however, the Act provided transitional rules permitting the continuation of any existing lease (in effect on October 9, 1969) between a foundation and a disqualified person until 1979, so long as the lease remains at least as favorable to the private foundation as it would have been under an arm's-length transaction between unrelated parties. However, for taxable years beginning after the end of 1979, the leasing arrangements must be terminated (sec. 101(l)(2)(C) of the Act).

Cases have been brought to your committee's attention in which a private foundation is leasing to a disqualified person property of a nature which is peculiarly suited to the use of that person. In these cases, the value of the property to the disqualified person is greater than that to any other person. Since under present law such a leasing arrangement must be terminated not later than the end of the last taxable year beginning in 1979, and the property cannot be sold to the disqualified person by the private foundation, the foundation probably would be put in the position of being forced to dispose of its property to unrelated persons for less than the value of that property to disqualified persons.

Another transitional rule provided in the 1969 Act permits a private foundation to sell excess business holdings to a disqualified person, so long as the sales price equals or exceeds the fair market value of the property being sold. However, this rule applies only to business holdings, and not to passive investments, including passive leases (sec. 101 (l)(2)(B) of the Act).

This particular combination of circumstances regarding the sale of leased property was not brought to the attention of Congress when it was considering the Tax Reform Act of 1969. In effect, the sale-of-leased-property situation happens to fall between the above-noted existing transitional rules. It appears likely that if this particular point had been presented in 1969, the Act would have been modified to deal with the situation. Accordingly, your committee's bill minimizes this hardship by the addition of a new transitional rule.

III. EXPLANATION OF PROVISION

The bill amends the transitional rules applicable to the private foundation provisions of the Tax Reform Act of 1969 by adding a new transitional rule to deal with the sale of property by a private foundation to a disqualified person. Under this rule, a private foundation may sell, exchange, or otherwise dispose of property (other than by lease) to a disqualified person if, at the time of the disposition, the foundation is leasing substantially all of that property under a lease subject to the 1979 lease transitional rule described above, and the foundation receives in return an amount which equals or exceeds the fair market value of the property. In computing the fair market value

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of the property, no diminution of that value is to result from the fact that the property is subject to any lease to disqualified persons.

In order to qualify for the provisions of the bill, the sale, exchange, or other disposition must occur before January 1, 1975.

The bill applies to dispositions occurring after the date of enactment in taxable years ending after that date.

IV. COSTS OF CARRYING OUT THE BILL AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

In compliance with clause 7 of rule XIII of the Rules of the House of Representatives, the following statement is made relative to the effect on the revenues of this bill. Your committee estimates that this bill will have no effect, or at most less than $100,000, on the the revenues. The Treasury Department agrees with this statement.

In compliance with clause 27(b) of rule XI of the Rules of the House of Representatives, the following statement is made relative to the vote by the committee on the motion to report the bill. The bill was ordered reported unanimously, by voice vote.

V. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3 of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italics, existing law in which no change is proposed is shown in roman):

TAX REFORM ACT OF 1969

* * * * * * *

TITLE I—TAX EXEMPT ORGANIZATIONS

Subtitle A—Private Foundations

* * * * * * *

SEC. 101. PRIVATE FOUNDATIONS.

* * * * * * *

(l) SAVINGS PROVISIONS.—

(1) REFERENCES TO INTERNAL REVENUE CODE PROVISIONS.—Except as otherwise expressly provided, references in the following paragraphs of this subsection are to sections of the Internal Revenue Code of 1954 as amended by this section.

(2) SECTION 4941.—Section 4941 shall not apply to—

(A) any transaction between a private foundation and a corporation which is a disqualified person (as defined in section 4946), pursuant to the terms of securities of such corporation in existence at the time acquired by the foundation, if such securities were acquired by the foundation before May 27, 1969;

(B) the sale, exchange, or other disposition of property which is owned by a private foundation on May 26, 1969 (or

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which is acquired by a private foundation under the terms of a trust which was irrevocable on May 26, 1969, or under the terms of a will executed on or before such date, which are in effect on such date and at all times thereafter), to a disqualified person, if such foundation is required to dispose of such property in order not to be liable for tax under section 4943 (relating to taxes on excess business holdings) applied, in the case of a disposition before January 1, 1975, without taking section 4943(c)(4) into account and it receives in return an amount which equals or exceeds the fair market value of such property at the time of such disposition or at the time a contract for such disposition was previously executed in a transaction which would not constitute a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior law);

(C) the leasing of property or the lending of money or other extension of credit between a disqualified person and a private foundation pursuant to a binding contract in effect on October 9, 1969 (or pursuant to renewals of such a contract), until taxable years beginning after December 31, 1979, if such leasing or lending (or other extension of credit) remains at least as favorable as an arm's-length transaction with an unrelated party and if the execution of such contract was not at the time of such execution a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior law);

(D) the use of goods, services, or facilities which are shared by a private foundation and a disqualified person until taxable years beginning after December 31, 1979, if such use is pursuant to an arrangement in effect before October 9, 1969, and such arrangement was not a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior law) at the time it was made and would not be a prohibited transaction if such section continued to apply; [and]

(E) the use of property in which a private foundation and a disqualified person have a joint or common interest, if the interests of both in such property were acquired before October 9, 1969[.] *; and*

(F) the sale, exchange, or other disposition (other than by lease) of property which is owned by a private foundation to a disqualified person if: (i) such foundation is leasing substantially all of such property under a lease to which subparagraph (C) applies; (ii) the disposition to such disqualified person occurs before January 1, 1975; and (iii) such foundation receives in return for the disposition to such disqualified person an amount which equals or exceeds the fair market value of such property at the time of the disposition or at the time a contract for the disposition was previously executed in a transaction which would not constitute a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior law).

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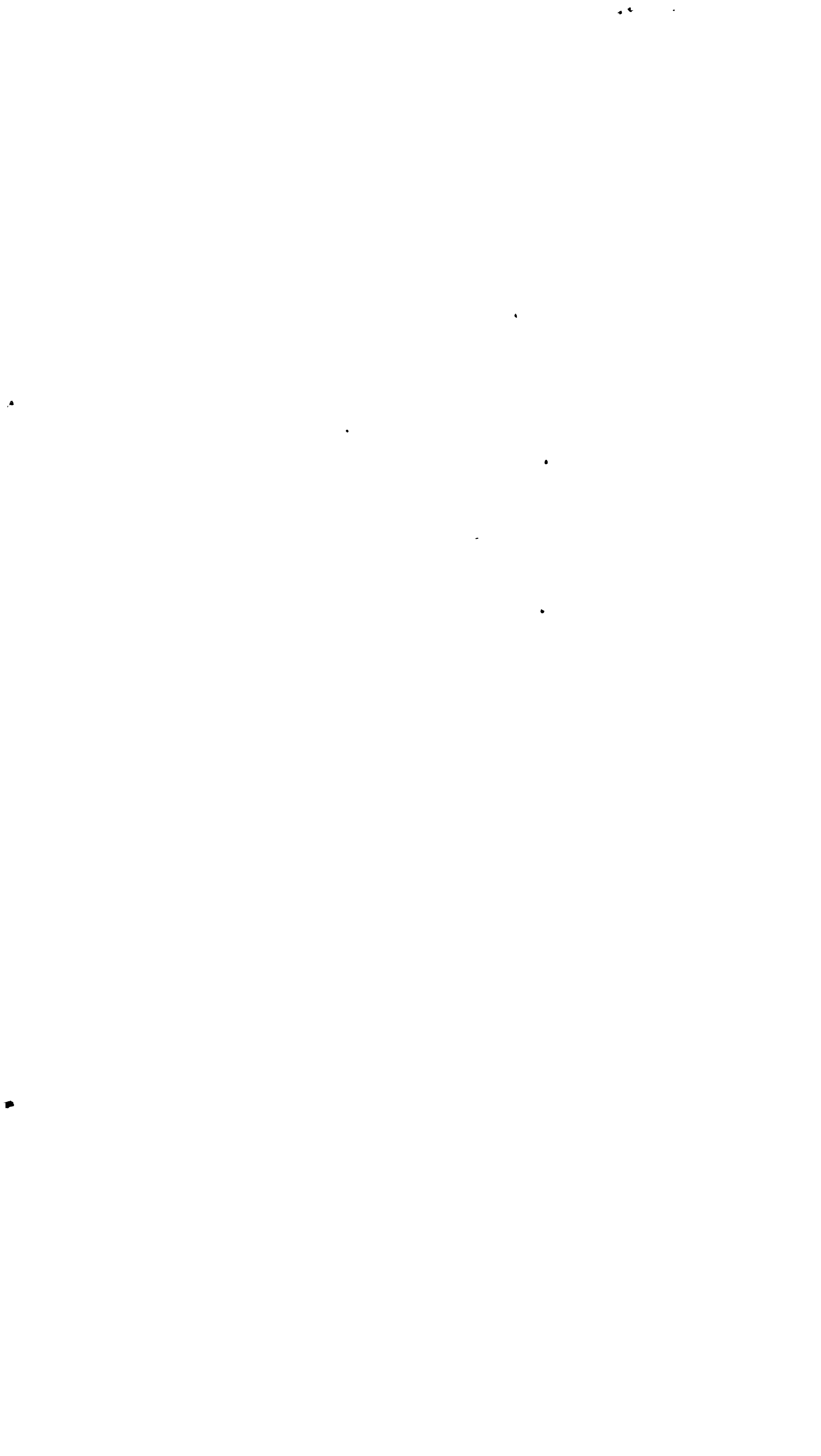

SUMMARY STATEMENT OF RICHARD F. BARRETT, ESQUIRE, ON BEHALF OF THE STACKPOLE-HALL FOUNDATION, BEFORE THE SENATE FINANCE COMMITTEE OF THE UNITED STATES SENATE

JULY 22, 1976

Re: Amendment of Section 101(1) of the Tax Reform Act of 1969

Section 4943 of the Internal Revenue Code requires private foundations to dispose of excess business holdings stock. In addition, Section 4941 imposes a penalty if a disposition is to a disqualified person. In order to promote the disposition of business holdings, Congress provided a transitional rule which permitted dispositions to disqualified persons at fair market value without imposition of the penalty, if the transfer occurred prior to January 1, 1975.

The effective utilization of the transitional rule has been hampered because the fair market value of the stock is uncertain and without advance review by the Internal Revenue Service may subject disqualified persons, as prospective purchasers from a foundation, and the foundation managers with a penalty on the full fair market value as ultimately determined, plus reversal of the transaction. As a result, the intended beneficiaries of the transitional rule, who were supposed to be foundations holding stock of closely-held corporations, have been unable to utilize the benefits.

Section 2514 of the Bill (H.R. 10612) provides for an extension of the transitional rule to January 1, 1977. It is hoped that this extended period will afford private foundations, their managers and disqualified persons with the opportunity to engage in such transactions in a manner which will reduce the risk of penalty to a reasonable limit and, to the extent practicable, to obtain Treasury Department or Internal Revenue Service guidance in such matters. It is of important significance that this extension will afford those private foundations holding stock of closely-held corporations the same benefits as other private foundations owning publicly traded stock and who do not have to confront the very factual problem of the fair market value of their stock.

We urge your continued support of this amendment.

STATEMENT OF RICHARD F. BARRETT, ESQUIRE,
ON BEHALF OF THE STACKPOLE-HALL FOUNDATION,
BEFORE THE SENATE FINANCE COMMITTEE OF THE
UNITED STATES SENATE

JULY 22, 1976

Re: Amendment of Section 101(l) of the Tax Reform Act of 1969

In enacting section 4943 of the Internal Revenue Code of 1954 (the "Code"), Congress required private foundations to dispose of excess business holdings stock. Contemporaneously, Congress enacted section 4941 of the Code (the "self-dealing" provisions) which, under its general application, would impose a severe penalty if the disposition of the excess business holdings stock were to be to the only available market in most cases, i.e., to one or more disqualified persons, as defined in section 4946(a). Recognizing the desirability of promoting the disposition of excess business holdings stock, Congress enacted P.L. 91-172, §101(l)(2) (the "transitional rule") to provide a transitional period in which disposition might be made to a disqualified person at fair market value without imposition of the section 4941 penalty.

The transitional rule had two major aspects: (1) the permitting of sale of excess business holdings owned on

May 26, 1969, to a disqualified person at fair market value at any time until expiration of the "grace periods" under section 4943(c)(4)(B), and (2) the permitting of sale of business holdings owned May 26, 1969, which were not "excess" business holdings by reason of section 4943(c)(4) prior to January 1, 1975, to a disqualified person at fair market value. It is the extension of this second aspect (2) to January 1, 1977, which section 2514 of the Bill would enact.

The effective utilization of the transitional rule to date has been limited because the fair market value of the stock of closely-held corporations is inherently uncertain and incapable of being established with precision in advance of review by the Internal Revenue Service. Accordingly, disqualified persons, as prospective purchasers from a foundation, and the foundation managers were faced with the risk of a section 4941 penalty on the full fair market value as ultimately determined, plus reversal of the transaction. Such a risk constituted a substantial deterrent to taxpayers seeking to come within the transitional rule; has prevented full utilization of the transitional rule; and thereby has frustrated the Congressional policy underlying its enactment.

The principal beneficiaries of the transitional rules have been those foundations holding publicly traded stock with established market values, not the intended beneficiaries,

the foundations holding stock of closely-held family corporations with unlisted untraded stocks with no known market value. These foundations have found themselves in an Alice-in-Wonderland atmosphere which it was never Congress' intention to create. The Ford Foundation, as an interesting, contrasting example, is understood to have sold to the Ford Motor Company a very large amount of Class A non-voting Common shares, commencing with an initial sale of $150,000 in 1972 under transitional rule (2) above and the existence of an advance ruling dealing with market value of the Class A.

In addition, many private foundations were and still are faced with the problem of ascertaining the precise amount of their excess business holdings. This calculation rests, in many cases, on the determination of whether the corporations in which they hold stock are themselves disqualified persons by virtue of being substantial contributors as defined in section 507(d)(2) of the Code, a determination which rests substantially on the question of the fair market value of the stock at the applicable date of contribution. The Stackpole-Hall Foundation, the private foundation involved in this proposed legislation, is in the position of uncertainty as to its holdings.

The risk of imposing the self-dealing tax was partially reduced by the Treasury Department by the issuance

of regulations in 1973 which provided that, if "good faith" efforts were made to determine the fair market value, the penalty would be limited to the excess of the fair market value of the stock transferred over the amount received by the foundation. However, the factual nature of the "good faith" test and the absence of any other published guideline relative to the determination of fair market value still make it quite risky for a taxpayer to proceed with any firm assurance of compliance with the self-dealing provisions. As of this date, the undersigned is advised by the Internal Revenue Service that it will not issue advance rulings that a proposed procedure outlined by the taxpayer will meet the "good faith" test.

Accordingly, this Bill provides for an extension of the transitional rule to January 1, 1977. It is anticipated that this extended period will afford private foundations, their managers and disqualified persons with the opportunity to engage in such transactions in a manner which will reduce the risk of penalty to a reasonable limit and, to the extent practicable, to obtain Treasury Department or Internal Revenue Service guidance in such matters. It is of important significance that this extension will afford those private foundations holding stock of closely-held corporations the same benefits as other private foundations owning publicly traded and quoted stock which, by reason thereof, do not have to confront the very factual problem of the fair market value of their stock.

It is, as has been stated, those private foundations which hold stock of closely-held corporations which should be the primary beneficiaries of the transitional rule but which have been unable to utilize it to date. To date, the effective use of the transitional rules by many private foundations has been stymied, a result not intended by Congress and which it can help greatly to avoid by enacting section 2514 of the Bill.

SUMMARY OF STATEMENT IN SUPPORT OF SECTION 2104 OF THE TAX REFORM ACT OF 1976

The Tax Reform Act of 1969 provided that a bequest or gift to charity of a remainder interest in trust could qualify for a charitable deduction only if rigid statutory requirements of a "charitable remainder trust" were satisfied. This was a radical departure from over 50 years of prior law. The reason for these provisions was to ensure that charity received its full remainder interest.

The Treasury Department in regulations issued without specific statutory authority allowed all trusts and wills to be amended to comply until December 31, 1972. As a relief measure, Congress added §2055(e)(3) to the Code in 1974, thereby generally extending the termination date of the regulations transition rule to December 31, 1975, but only for instruments drafted before September 21, 1974. Under H.R. 9889 (passed by the House by voice vote on June 22, 1976), the benefits of §2055(e)(3) would be further extended for an additional two years.

Section 2104 of the Tax Reform Act of 1976, as reported by the Senate Finance Committee, would also extend the transition rules of §2055(e)(3) of the Code for an additional two years but would allow reformation with respect to all wills and trust instruments drafted before

December 31, 1977. This is entirely proper; there is no reason to deny the relief based on the date the will or trust was executed. No one would have intentionally drafted a non-conforming will or trust. The purpose of §2104 is to protect against unintentional failures to comply and thus to protect the charities.

Section 2104 is a measure which furthers the Congressional policy underlying the reforms enacted in 1969 by preventing a loss of the charitable deduction, a loss which will ordinarily fall on the charity, not the donor. Section 2104 does not exempt trusts from meeting the statutory requirements but in effect requires that non-qualifying instruments be amended to comply with the charitable remainder trust provisions. Providing a "last chance" to amend all non-qualifying wills or trust instruments ensures that §2104, and the requirements of the Tax Reform Act of 1969, will be broadly publicized. Section 2104 is not a provision enacted by the Senate Finance Committee to assist only one or a few taxpayers. There are hundreds of non-complying wills and trusts in existence, with a potential loss to charities that could be very substantial. The Senate Finance Committee has merely incorporated and improved a provision which was thoroughly considered by the House Ways and Means Committee and was passed by the House.

July 20, 1976

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

STATEMENT IN SUPPORT OF
SECTION 2104 OF THE
TAX REFORM ACT OF 1976

Prior to the enactment of the Tax Reform Act of 1969, a charitable deduction was generally allowed to a decedent's estate for the present value of a bequest of a partial interest in property to a qualifying charity. Such gifts were commonly made in the form of a trust under which part or all of the income was payable to one or more individuals for life with the corpus of the trust to be paid over to one or more charitable institutions upon the termination of the life estates. Treasury regulations have recognized the deductibility of such a remainder interest in trust from the time that deductions for charitable gifts were first allowed by the Revenue Act of 1918. See Art. 53 of Regulations 37. The precise form such a remainder interest took was not important so long as the value of the interest was ascertainable and it was certain to be received by charity.

The Tax Reform Act of 1969, therefore, represented a radical departure from more than 50 years of prior law in providing that a remainder interest in trust could not qualify for a charitable deduction unless it was structured as a "charitable remainder

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annuity trust", a "charitable remainder unitrust" or a "pooled income fund." The statutory definition of each of these types of qualifying "charitable remainder trust" is highly restrictive and technical. Especially since the publication of final regulations interpreting these terms, there is no way a qualifying charitable remainder trust can be drafted without a detailed knowledge of the applicable provisions of the Code and regulations. In fact, the Service has rightly considered the area to be so complex that it has published sample clauses for wills and trusts which will be deemed to meet the Code's requirements. Rev. Rul. 72-395, 1972-2 C.B. 340.

For purposes of the estate tax, these new provisions of the Tax Reform Act of 1969 were generally made applicable to the estates of decedents dying after December 31, 1969. Congress recognized, however, that some transition period was necessary. Accordingly, trusts created under wills executed before October 9, 1969, and transfers in trust before that date, were exempted entirely from complying with the prescribed forms in the case of decedents dying before October 9, 1972, without having amended their will or trust or where the will and trust instrument could not be changed after October 9, 1969.

The provisions of the Tax Reform Act of 1969 regulating charitable remainder trusts were enacted to ensure that the charitable deduction allowed was consistent with the amount which charity would ultimately receive. Sen. Rep. No. 91-552, 91st Cong., 1st Sess. 87 (1969). Notwithstanding this concern to preserve the charity's remainder interest in such trusts, it became apparent that it was the charity which would most frequently suffer from a remainder interest failing to qualify for the charitable deduction. Commonly, the increased tax burden on the decedent's estate would be borne by the principal of the trust estate, which is the portion the charity would ultimately receive.

In recognition of this counterproductive result, and the fact that the charitable remainder trust provisions were so novel and complex as to require additional time to alert the bar to their requirements, the Internal Revenue Service proposed a set of transition rules in addition to those provided by the statute. Under proposed regulations issued in 1970, post-October 9, 1969, trusts, whether established by will or under an inter-vivos instrument, could be amended into qualifying charitable remainder trusts so long as the necessary amendments were accomplished by January 1, 1971, or within 30 days after the conclusion

of a court proceeding begun for that purpose before January 1, 1971. The Internal Revenue Service extended the January 1, 1971, date four times[1] and ultimately, under final regulations promulgated on August 22, 1972, fixed December 31, 1972, as the final date by which non-qualifying trusts must be amended or judicial proceedings to amend such trusts must be begun.

This administrative transition rule was adopted by the Internal Revenue Service without specific statutory authority and differs materially from the statutory transition rule in that the regulations do not exempt trusts from the charitable remainder trust provisions entirely but merely allow such trusts to be amended effective as of the date they were created. In contrast, a trust qualifying under the statutory transition rules need never be amended to conform to the restrictive requirements of a qualifying charitable remainder trust.

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1 T.I.R. 1060 (December 13, 1970) extended the date to June 30, 1971; T.I.R. 1085 (June 11, 1971) extended the date to December 31, 1971; T.I.R. 1120 (December 17, 1971) extended the date to June 30, 1972; and T.I.R. 1182 (June 29, 1972) extended the date to the ninetieth day after the final regulations were issued.

When the period of grace provided by the regulations ended on December 31, 1972, it became apparent from the number of non-qualifying post-1969 trusts which continued to come to light that the public was still not aware of the dramatic changes made by the Tax Reform Act of 1969. Also, because of the complicated nature of the statutory and regulatory requirements, many trusts were unable to make the necessary conforming amendments by the December 31, 1972, deadline. As a relief measure, therefore, the Senate in 1974 amended a House bill (H.R. 12035) to provide, in general, for the extension until December 31, 1975, of the transition provisions administratively adopted in the regulations. See Sen. Rep. No. 93-1063, 93rd Cong., 2d Sess. 1 (1974). Like the regulations, the measure proposed by the Senate would apply to any will executed or trust created before the chosen termination date, in this case December 31, 1975.

In conference, the House conferees generally agreed to the Senate amendment but proposed that only trusts or wills then in existence should be eligible for relief. 120 Cong. Rec. H10509 (daily ed. Oct. 11, 1974). The Senate conferees agreed to this change and P.L. 93-483, as finally enacted, extended the transition rules of the regulations only with respect to

trusts created or wills executed before September 21, 1974. As added by P.L. 93-483, section 2055(e)(3) of the Code provides that the governing instruments of such pre-September 21, 1974, trusts and wills can be amended to conform to the charitable remainder trust provisions of the Code at any time prior to December 31, 1975, or 30 days after the termination of a judicial proceeding to reform an instrument begun before that date.

As noted in this Committee's report on the Tax Reform Act of 1976 (Sen. Rpt. No. 94-938, 94th Cong.,.2d Sess. 600 (1976)), notwithstanding that the provisions of the Tax Reform Act of 1969 governing charitable remainder trusts have been in effect for over six years, wills and trusts continue to be drafted by laymen and lawyers who are unaware of the restrictive statutory requirements. This is especially likely to occur in wills, because stability and continuity are traditionally recognized as being of particular importance in this branch of the law, and practitioners are not wary of radical changes. Also, a testator frequently makes very small changes to an existing instrument which will result in it being considered a new will for purposes of the transition rules under section 2055(e)(3) of the Code, but which may not be major enough to trigger the attorney's reappraisal of

the entire instrument. There is a natural and understandable tendency to assume that a will drafted with care and precision once need not be reexamined in its entirety every time a minor change is made. Furthermore, there has never been a broad campaign to publicize the radical changes in this area brought about by the Tax Reform Act of 1969.

On September 29, 1975, Congressman Burke, of the House Ways and Means Committee, introduced H.R. 9889 to extend the transitional rule under section 2055(e)(3) of the Code by two additional years. H.R. 9889 would accomplish this by substituting December 31, 1977, for December 31, 1975, wherever the latter date appears in section 2055(e)(3) of the Code. The House Ways and Means Committee reported H.R. 9889 favorably (see H.R. Rpt. No. 94-1268, 94th Cong., 2d Sess. (1976)), and H.R. 9889 was passed by the House by voice vote on June 22, 1976.

On November 3, 1975, Senator Curtis introduced an identical bill in the Senate as S. 2602. Section 2104 of the Tax Reform Act of 1976 (referred to as section 2106 in Sen. Rpt. No. 94-938, 94th Cong., 2d Sess. 599 (1976)) corresponds to S. 2602, with this Committee's changes to allow trusts created after September 21, 1974, and before December 31, 1977, to also qualify for amendment to conform to the requirements of the Tax Reform Act of 1969, and to allow otherwise expired claims to be reopened.

Section 2104 is a measure which will further the Congressional policy underlying the reforms enacted in 1969. As noted in this Committee's Report (Sen. Rpt. No. 94-938, at 600), it is frequently the charity which would bear the additional tax burden resulting from the loss of the charitable deduction due to the failure of an uninformed testator or his advisor to be aware of the rigid requirements for charitable remainder trusts. Penalizing the charitable remainderman in this way runs counter to the legislative purpose of protecting the charity's interest which underlies the charitable remainder trust provisions.

It is also significant that the transition rules under section 2055(e)(3) of the Code which would be extended by section 2104 do not exempt non-qualifying trusts from the statutory requirements but rather enforce compliance by, in effect, requiring the amendment of the governing instrument. If a trust cannot be amended so as to become eligible for the charitable deduction, the charity may be penalized twice. Not only will the charity bear the burden of the increased Federal estate tax but, in addition, the trustee will not be circumscribed by the rigid rules applicable to qualifying trusts. Potentially, then, the charity could be penalized a second time by the trustee using its discretion to favor the life beneficiary, a result the charitable remainder trust provisions were designed to prevent.

Section 2104 differs from H.R. 9889 by allowing the reformation of all nonqualifying wills and trusts drafted before December 31, 1977. This is entirely appropriate, since the policy considerations for providing relief are equally compelling whether the non-qualifying instrument was drafted before or after September 21, 1974. In each case it is the charitable beneficiaries which suffer the loss resulting from the denial of a charitable deduction. This result runs directly counter to the legislative purpose underlying the charitable remainder trust provisions whatever the date of the will or trust instrument.

In limiting the relief offered by section 2055 (e)(3) of the Code to trusts created or wills executed before September 21, the House conferees stated that instruments not yet drafted should not be covered. Upon analysis, however, it is difficult to see what legislative purpose is served by this distinction. Certainly denying relief prospectively did not promote compliance. It is inconceivable that any attorney or testator would consciously draft a trust or will which would not qualify as either a charitable remainder annuity trust or unitrust. Furthermore, if an attorney or testator were unaware of the fundamental rules governing this area, a subtle change in the transition rules would not have served to notify him of such requirements. This Committee's decision to have section 2104

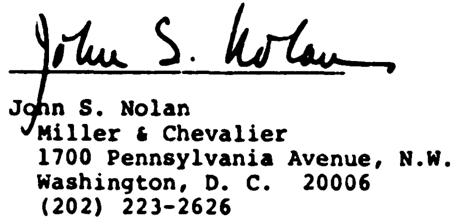
apply to all non-qualifying instruments drafted before December 31, 1977, justifiably refuses to perpetuate an unwarranted distinction between similarly situated taxpayers.

This Committee has decided that the extension of the Code section 2055(e)(3) transition period until December 31, 1977, for all wills or trusts executed before that date will be the last such extension allowed. Accordingly, section 2104 does not represent a significant threat to the revenue. By offering a "last chance" to amend all non-qualifying instruments to conform to the charitable remainder trust provisions, section 2104 will command the attention of the bar and other testamentary advisors in a way in which the previous gradual extensions of the transition rules by the Internal Revenue Service (through regulations) and Congress (by enacting section 2055(e)(3) of the Code) did not. Thus the campaign to publicize the requirements of the Tax Reform Act of 1969 envisioned by this Committee (see Sen. Rpt. No. 94-938, at 600-601) will have the maximum potential for success.

It is important to note that section 2104 is not a provision enacted by this Committee to assist only one or a few taxpayers. There are hundreds of non-complying wills and trusts in existence, with a potential

loss to charities that could be very substantial. This Committee has merely incorporated and improved a provision which was thoroughly considered by the House Ways and Means Committee and was passed by the House.

July 20, 1976



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July 21, 1976

Honorable Russell B. Long
Chairman
Senate Committee on Finance
United States Senate
2227 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Re: Income from Fairs, Expositions, and Trade Shows (Section 2106 of H.R. 10612 as reported by the Senate Finance Committee)

Dear Senator Long:

Reference is hereby made to the Press Release of July 8, 1976 announcing Hearings on certain Tax Provisions earlier approved by the Finance Committee. In lieu of the scheduled oral appearance of the undersigned on behalf of the International Association of Fairs and Expositions, the American Livestock Show and Rodeo Managers' Association, the Pacific International Livestock Exposition, the Maryland State Fair, the Los Angeles County Fair, and the Governors of the Knights of Ak-Sar-Ben, in the interest of saving the Committee's time, we are submitting this written statement for inclusion in the printed record of the Hearings. We wish to draw the Committee's attention to the following particular points in support of Section 2106 of the Bill as it pertains to the tax treatment of "qualified public entertainment activities" of fairs and expositions of an exempt §501(c)(3), (4) or (5) organization "which regularly conducts, as one of its substantial exempt purposes, an agricultural and educational fair or exposition":

1. Need for this Legislation. Enactment of Section 2106, which incorporates with staff revisions the provisions of S. 2404 (the so-called "Fair Bill"), is vital to the continued financial vitality of numerous agricultural and educational fairs and expositions throughout the country. State, county and regional agricultural and

Honorable Russell B. Long
July 21, 1976
page two

educational fairs and expositions traditionally have sponsored public entertainment activities such as horse racing, rodeos, livestock and horse shows, midway rides, shows and concessions, dramatic shows, athletic events, and other cultural activities in conjunction with the fairs as allowed by state law. Such fairs and expositions, traditionally run by state or local governmental agencies or instrumentalities, non-profit civic leagues, and agricultural and educational organizations are attended by millions of Americans every year.

Despite long-standing case law to the contrary, the IRS is now seeking to tax the income from public entertainment activities of such organizations on the basis that it is not substantially related to the fair, exposition, or non-profit civic league functions. The IRS is demanding substantial taxes, dating back to 1963 on the public entertainment activities of several fairs, thereby threatening the very existence of these worthwhile non-profit organizations. Moreover, the IRS has taken the position that the exempt status of such organizations can be revoked.

Section 2106 of the Bill would prevent the IRS from continuing this unwarranted attack on these non-profit organizations by providing that income received by them from "public entertainment activities" held in conjunction with an agricultural and educational fair, or if conducted under state law which allows only certain tax-exempt organizations or governmental units to conduct the specified activity, shall not be considered taxable as unrelated trade or business income, and shall not affect the tax-exempt status of such organizations.

2. This amendment as it pertains to fairs and expositions would clarify not change existing law. The IRS lost in its attempt to tax pari-mutuel horse racing held in conjunction with state fairs in 1955 in the test case of Maryland State Fair v. Chamberlin, 48 AFTR 1725 (1955). Significantly, the IRS did not choose to appeal that decision. However, many years later, in 1968, the IRS published Rev. Rul. 68-505, 1968-2 C.B. 248, which ruled that an exempt county fair association that conducts a horse racing meet with pari-mutuel betting is engaged in an unrelated trade or business because the conduct of racing with pari-mutuel betting was not deemed related to the organization's exempt purposes and because it was

viewed as neither contributing importantly to the educational objectives of the fair nor to be the type of recreational activity that was intended to attract the public to the fair's educational features. This ruling misses the point completely and misstates the law on the subject. Such races are traditionally run in conjunction with agricultural and educational fairs for the dual exempt purpose of (1) attracting people to the fairs so that they may thereby be exposed to its educational features and of (2) promoting the local breeding of fine horses.

The Treasury regulations have never held that horse racing at agricultural and educational fairs is an unrelated trade or business. All the regulations state is that horse racing is an example of an activity which is considered "regularly carried on" if it is conducted on a "seasonal" basis. Regs. §1.513-1(b)(2) states this rule as follows:

> "For example, the operation of a track for horse racing for several weeks of a year would be considered the regular conduct of trade or business because it is usual to carry on such trade or business only during a particular season."

Indeed, if the Regulations had provided that conducting horse racing with pari-mutuel betting at agricultural and educational fairs is an unrelated business, there would have been no need for the IRS to publish Rev. Rul. 68-505.

3. No unfair competition is involved. Enactment of the Fair Bill would not undermine or chip away at the basic principle of the unrelated business tax provisions. According to the Treasury Department's own Regulations, "The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete." Regs. §1.513-1(b). As the Senate Committee Report (S. Rep. No. 94-938 at p. 602) clearly and correctly states, there is and can be no unfair competition involved in those racing activties held under the circumstances covered by the proposed legislation. With respect to horse races in general, the state authorities control the racing dates on a statewide

Honorable Russell B. Long
July 21, 1976
page four

basis and prescribe exclusive dates to each organization for nonconflicting periods. Specifically, with respect to the Oregon situation, since the State law allows an exempt organization to have only five days of horse racing a year, it is not profitable for it to build a separate race track; as a result, a commercial track is rented; but in order not to compete with the fair itself, the period of time for racing is not conducted during the period the fair is being held. In the case of Nebraska, the State law does not permit horse racing by other than exempt organizations; thus, there is and can be no competition with any commercial activity.

4. It is appropriate to make 1963 the effective date of this provision as it pertains to fairs and expositions. The reason the effective date for fairs and expositions must be retroactive to the date indicated is because the IRS is taking the unwarranted position that it can tax both the Maryland State Fair and the Los Angeles County Fair for 1963 and all subsequent years on their horse racing activities held in conjunction with their agricultural and educational fairs.

As indicated in "2" above, the IRS lost the only case on this subject in 1955 but failed to appeal it. For many years the IRS did nothing further about the matter. However, the IRS then decided to publish the ruling indicated in 1968, which is inconsistent with the court decision it lost. Later, the IRS proceeded to go back on and try to tax such organizations as the Maryland State Fair, which had won the prior litigation on this very issue, and the IRS is also litigating with the Los Angeles County Fair, attempting to apply the tax all the way back to 1963 with respect to both organizations. It took the Internal Revenue Service from 1966 to 1974 to give technical advice with respect to the Revenue Agent's proposal to either revoke the tax exemption of the Maryland State Fair or tax its pari-mutuel horse racing revenues as unrelated business income. The IRS is trying to tax a Nebraska §501(c)(4) organization, Ak-Sar-Ben, back to 1970 (the effective date of the 1969 Act amendment which first subjected §501(c)(4) civic leagues to the unrelated business tax provisions). The IRS is also attempting to tax the Pacific International Livestock Exposition beginning with 1972. Fairs in Ohio and other states are currently under similar attack. Under the circumstances, the legislation should be made retroactive to 1963.

Honorable Russell B. Long
July 21, 1976
page five

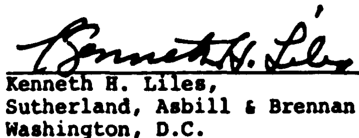
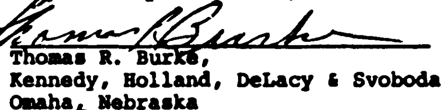
5. Enactment of the "Fair" Bill will cause no substantial loss of existing revenues. Indeed, the Committee Report states that "It is estimated that the revenue impact of these provisions [including trade shows] will be realtively small." So far as we are aware, the IRS has never succeeded in collecting any taxes that would have to be refunded if the fair legislation were enacted other than the amount paid under protest by the Los Angeles County Fair for 1963 so that it could test the issue in District Court. The sum paid by the L.A. County Fair for 1963 was less than $200,000.

6. It was appropriate for the Senate Finance Committee to add the provisions of S. 2404, as amended by the staff, to the Tax Reform Bill (H.R. 10612). The House Ways and Means Committee acted favorably on this general subject when it voted to include a similar provision in the so-called Tax Reform Bill of 1974. That Bill would have provided an exemption to the unrelated business income tax for public entertainment activities at certain state and local fairs. The House provision has merely been further refined in S. 2404, including the staff amendments incorporated into Section 2106 of H.R. 10612.

S. 2404, as introduced by Senators Packwood, Curtis and Mathias on September 24, 1975 was co-sponsored by many other Senators of both parties (Bartlett, Bayh, Burdick, Clark, Cranston, Hatfield, Hruska, McGee, McGovern, Stevens, and Tunney) and has gathered widespread bipartisan support in both the Senate and the House of Representatives. For all these reasons, it is entirely appropriate for the Senate Finance Committee to have included this proposal in its amendments of H.R. 10612.

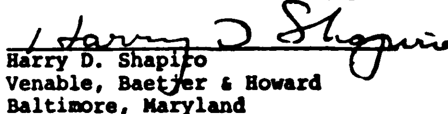
We strongly urge you and your colleagues to continue to support the provisions of Section 2106 of the Bill which will help insure the continued existence of the agricultural fairs and expositions, and non-profit civic leagues and agricultural organizations, throughout the country that are faced with this serious IRS threat.

Respectfully submitted,

Kenneth H. Liles,
Sutherland, Asbill & Brennan
Washington, D.C.

Thomas R. Burke,
Kennedy, Holland, DeLacy & Svoboda
Omaha, Nebraska



Harry D. Shapiro
Venable, Baetjer & Howard
Baltimore, Maryland

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SUMMARY OF STATEMENT

Submitted On Behalf

Of

The American Society of Association Executives, By James P. Low, President and Chief Administrative Officer at Public Hearings of the Senate Committee on Finance Beginning July 20, 1976

1. The American Society of Association Executives strongly supports section 2106 of the Committee's Bill which eliminates the misapplication of the "unrelated business income" tax to tax-exempt societies and associations which sponsor trade shows.

2. One of the most important functions of a trade association or professional society is the sponsorship of trade shows, where members of the particular industry may display their products and techniques and where manufacturers of products used in the industry may display their products.

3. Often an industry is composed of many small to medium-sized producers which are not national in scope. Trade shows permit these producers to display their new products, improved products, technological advances, etc. Other firms in the industry see these products and upgrade and improve their own products to remain competitive.

4. The contribution of trade shows to the tax-exempt function of such organizations is undeniable. The contribution of such shows to our domestic and international economies, to the advance of technology, competition and employment, is also undeniable.

5. It is equally clear that application of the tax on "unrelated business income" is improper in the case of trade shows. The purpose of that tax is to preclude tax-exempt organizations engaging in business activity in competition with a taxable commercial enterprise. Trade shows do not compete with commercial activity.

6. Absent the Committee's Bill, imposition of the tax in accordance with recent rulings by the Internal Revenue Service, will disrupt all trade shows and threatens the Commerce Department's "Foreign Buyers Program" which was launched in 1974 to encourage foreign buyers to attend U.S. trade shows. The United States stands to lose millions of dollars in export sales and jobs. Other countries subsidize trade shows. Why should we penalize them. What logic is it for one part of the Federal government to encourage trade shows for a vital national economic purpose and another branch of the same government tax them in a way which is inconsistent with the basic framework and policy of the tax law.

7. As a result many associations are reconsidering future shows, especially those designed to attract foreign buyers. For example, the Society of the Plastics Industry, Inc., New York City, has recently cancelled joint plans with the Department of Commerce to invite 4,000 foreign buyers to attend its 1976 trade exposition.

8. Therefore, we strongly support and urge enactment of section 2106 of the Committee's Bill, although we also strongly urge that trade shows sponsored by scientific and educational organizations exempt under section 501 (c)(3) of the Code also be covered. Such organizations clearly are within the policy and intention of section 2106 of the Bill and only a minor technical correction is required.

STATEMENT BEFORE THE
SENATE COMMITTEE ON FINANCE,
AT PUBLIC HEARINGS
BEGINNING JULY 20, 1976 ON
SELECTED PROVISION OF H.R. 10612

This statement is submitted on behalf of the American Society of Association Executives by James P. Low, President and Chief Administrative Officer.

ASAE strongly supports the decision of this Committee to add section 2106 to H.R. 10612 to eliminate an unintended and unfair burden on associations and other tax exempt organizations which conduct trade shows that are in furtherance of their tax exemptions and important to our overall domestic and international economies, export sales, technological advance, and employment in the United States.

In many cases, one of the most important functions of a professional society or trade association is the organization and operation of trade shows, where members of a particular industry may display their products and techniques, and where manufacturers and distributors of products used in the industry may display their products.

The primary purposes of trade shows are to provide a giant display window to enable the public and potential

purchasers to view that industry's products and, at the same time, permit smaller members of that industry to become conversant with the ever-changing government standards for such products.

The contribution of trade shows to the exempt functions of the association is undeniable. The purpose of trade shows is to provide members of a particular industry or profession, whether or not members of the sponsoring organization, with a method of displaying industry products and services to the public and to other industries. Often, an industry is composed of a great many small to medium-sized producers which are not national in scope. The trade show provides such producers with an opportunity to display their products, new products, improved products, technological advances, etc. Other firms in the industry are forced to review their own products with a view to upgrading in order to remain competitive.

Trade shows began in order to fill a void, displaying the products of smaller industry members and assisting them to maintain an awareness of changing industry and government standards. Trade association-sponsored shows do not compete with other organizations, but merely foster competition within a particular industry or profession. It provides the little guy an opportunity to display his product side by side with the biggest member of the industry on a product basis without the intervention of national advertising or franchised dealerships.

Further, it allows a person to expose his product to potential foreign buyers who, but for the show, would not even be aware of his existence.

Thus, the Committee is clearly correct in providing in section 2106 of the Bill that tax-exempt societies and associations will not be taxed for carrying on trade shows in furtherance of their tax-exempt purpose.

Trade shows are conducted in various ways, some of which result in receipts by the sponsoring organization. Section 2106 of the Bill provides that amounts received by the sponsoring organization will not be subject to the tax on "unrelated business taxable income" if appropriate standards are met. These standards are as follows:

First, it must be conducted in conjunction with an international, national, State, regional, or local convention or show;

Second, one of the purposes of the organization in sponsoring that activity must be the promotion and stimulation of interest in, and demand for, the industry's products and services in general; and

Third, the show must promote that purpose through the character of the exhibits and the extent of the industry products displayed.

We support these standards and strongly believe they will facilitate the appropriate conduct of trade shows by professional

societies and associations which play an important role in our domestic and international economies.

Application of the "unrelated business tax" to amounts received by the sponsoring organization is inappropriate and contrary to the basic purpose of that tax. The tax on "unrelated business income" in the Code is designed to deal with the situation in which a tax-exempt organization is carrying on a business activity in competition with a taxable commercial enterprise. But the conduct of a trade show under the Committee's standards is not such a situation. Taxable enterprises do not normally sponsor trade shows. Trade shows conducted under section 2106 of the Bill merely fill a void, not susceptible to commercial activity, and further the tax-exempt purpose of the organization to encourage economic development, competition, technological development and employment within the industry.

Therefore, the Committee is right in correcting a misapplication of the tax on "unrelated business income". We would, however, point out a further technical modification that needs to be made in section 2106 of the Bill which excludes from tax organizations exempt under sections 501 (c) (5) or (6) of the Code, but does not exclude scientific, educational, etc., organizations which are exempt under section 501(c)(3) of the Code. Such organizations also conduct trade shows. An example is the Society of Manufacturing Engineers

which consists of 45,000 engineers and which sponsors trade shows related to technological development and new products of interest to members. Moreover, it should be pointed out that another provision of section 2106 of the Bill eliminates the tax on such activities as county fairs and applies to organizations exempt under section 501(c)(3) of the Code. The same rule should be applied in the case of trade shows.

The decision of this Committee in eliminating the misapplication of the tax with respect to trade shows and similar activities is further supported by consideration of the alternative.

Under existing law, the Internal Revenue Service has felt it necessary to issue rulings that would impose the tax on a tax-exempt organization which sponsors a trade show even though the trade show is in furtherance of the exempt purpose and meets the Committee's standards. Under these rulings, the organization is required to enforce a "no selling" rule on exhibitors which is generally recognized as impractical and is not required to assure that trade shows will remain within the proper scope intended for tax-exempt organizations. Nevertheless, the Internal Revenue Service has felt constrained by present law to issue those rulings and impose the tax.

Not only will this tax be highly destructive of the proper activity of associations in furthering economic development which the Congress has long recognized as worthy of tax

exemption, it threatens the Commerce Department's "Foreign Buyer Program" which was launched in 1974 to encourage foreign buyers to attend trade shows in the United States. Further, the United States stands to lose millions of dollars in export sales and jobs.

Foreign countries subsidize the organization and operation of trade shows. Why should we penalize U.S. associations and societies in their efforts to compete with foreign producers or professionals? To combat foreign competition, the Department of Commerce initiated a program of encouraging foreign nationals to attend U.S. trade shows and to buy products at U.S. shows. The "Foreign Buyers Program" of the Department of Commerce is in direct conflict with imposing a tax on trade shows.

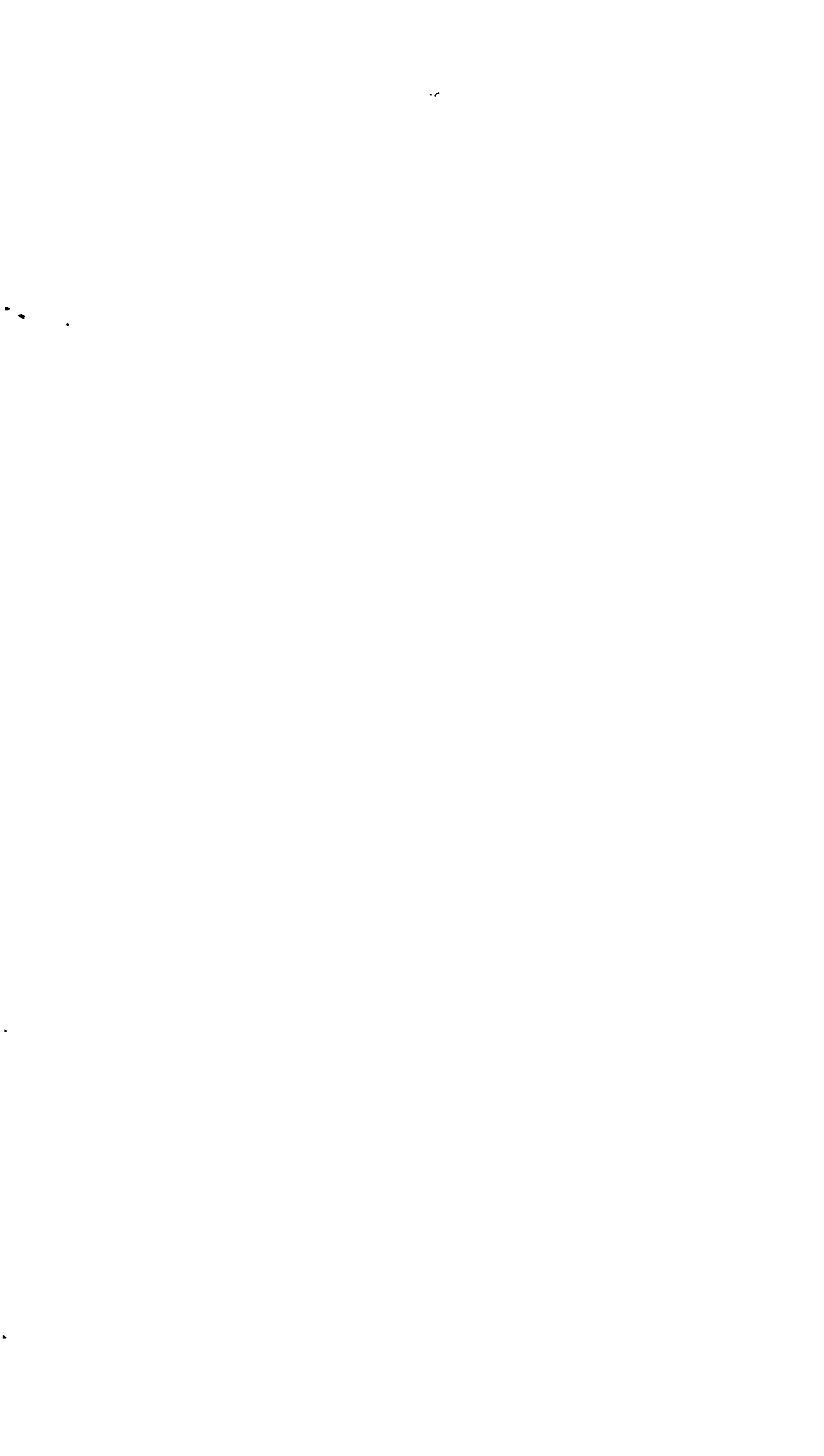
Absent enactment of section 2106 of the Bill, many U.S. associations are reconsidering plans for future trade shows, especially those to attract foreign buyers who purchase millions of dollars of U.S. products and services which, in turn result in jobs for many thousands of Americans. For example, the Society of the Plastics Industry, Inc., New York City, has recently cancelled joint plans with the Department of Commerce to invite 4,000 foreign buyers to attend its 1976 trade exposition. It seems incredible that one branch of our Federal government is restricting trade shows while another is encouraging foreign buying at U.S. trade shows.

Therefore, we reiterate our strong support for section 2106 of this Committee's Bill.

Respectfully submitted,

AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

By: JAMES P. LOW
President and Chief Administrative Officer



SUMMARY OF STATEMENT

SUBMITTED ON BEHALF

OF

The Society of Manufacturing Engineers
By R. William Taylor, Executive Vice
President and General Manager
at Public Hearings of the
Senate Committee on Finance
Beginning July 20, 1976

1. Subject to technical modifications, the Society of Manufacturing Engineers strongly supports section 2106 of the Committee's Bill which eliminates the misapplication of the "unrelated business income" tax to tax-exempt societies and associations which sponsor trade shows.

2. Trade shows, and the opportunity provided to display and review technological, are particularly important to sicentific societies such as ours.

3. Section 2106 of the Bill should be modified also to cover scientific, eductional, etc., organizations exempt under section 501(c)(3) of the Code.

STATEMENT BEFORE THE
SENATE COMMITTEE ON FINANCE,
AT PUBLIC HEARINGS
BEGINNING JULY 20, 1976 ON
SELECTED PROVISION OF H.R. 10612

This statement is submitted on behalf of the Society of Manufacturing Engineers by R. William Taylor, Executive Vice President and General Manager. SME is a society of 45,000 engineers.

Although we urge that a technical modification be made fully to carry out its purpose, SME supports the principle of section 2106 of the Committee's Bill to eliminate an unintended and unfair burden on professional societies and other tax-exempt organizations which conduct trade shows that are in furtherance of their tax-exempt purposes, the professional interests of the members, and the industry in which they work. These shows also contribute to the economy, advance technology, and stimulate economic growth and employment.

An important function of a professional society is the organization and operation of such shows, where members may view new products and techniques.

The primary purpose of trade shows is not to make money for the sponsoring society.

Society-sponsored shows do not compete with other organizations, but merely foster competition and technology within a particular industry or profession.

The Committee is clearly correct in providing in section 2106 of the Bill that tax-exempt societies and associations will not be taxed for carrying on trade shows in furtherance of their tax-exempt purpose. Trade shows are conducted in various ways, some of which result in receipts by the sponsoring organization. Section 2106 of the Bill provides that amounts received by the sponsoring organization will not be subject to the tax on "unrelated business taxable income" if appropriate standards are met. These standards are as follows:

First, it must be conducted in conjunction with an international, national, State, regional, or local convention or show;

Second, one of the purposes of the organization in sponsoring that activity must be the promotion and stimulation of interest in, and demand for, the industry's products and services in general; and

Third, the show must promote that purpose through the character of the exhibits and the extent of the industry products displayed.

We support these standards and section 2106 of the Bill subject to modification.

Section 2106 of the Bill presently excludes from the tax only organizations exempt under section 501(c)(5) and (6) of the Code, and wrongly leaves subject to tax educational, scientific, etc., societies such as SME which are exempt under seciton 501(c)(3) of the Code. Moreover, section 2106 of the Bill which eliminates the tax on such activities as county fairs, applies to organizations exempt under section 501(c)(3). The same rule should be applied in the case of trade shows.

Subject to this modification which we believe to be in accord with the Committee's intention, we reiterate our strong support for section 2106 of the Committee's Bill.

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July 21, 1976

Honorable Russell B. Long
Chairman
Senate Committee on Finance
United States Senate
2227 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Re: Private Operating Foundations, Including Museums and Libraries

Dear Senator Long:

Reference is hereby made to the Press Release of July 8, 1976 announcing Hearings on Certain Tax Provisions earlier approved by the Senate Finance Committee. In lieu of the scheduled oral appearance on behalf of the Association of Art Museum Directors, in the interest of saving the Committee's time, we are submitting this written statement on the Association's behalf for inclusion in the printed record of the Hearings.

For your information, the Association has already presented oral and written testimony on this subject before the Subcommittee on Foundations of the Senate Committee on Finance. (See Hearings on Private Foundations, May 13, 14 and June 3, 1974, pp. 98-108.) Previously, the Association had also presented oral and written testimony on this same subject before the House Committee on Ways and Means in support of a remedial bill introduced by Representative Koch of New York. (See Public Hearings on General Tax Reform, Committee on Ways and Means, 93rd Cong., 1st Sess., Part 15, pp. 6097-6105.) On April 8, 1975, Representative Koch introduced H.R. 5696 incorporating the modifications proposed by the Association in its testimony before the Ways and Means Committee. Earlier this year, Senator Dole submitted Amendment No. 1672 to H.R. 10612 to incorporate the substance of H.R. 5696 with improvements suggested by the

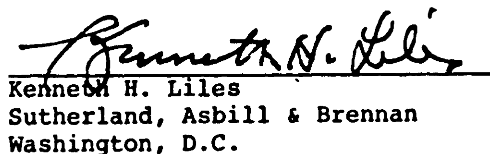
Honorable Russell B. Long
July 21, 1976
page two

Staff of the Joint Committee on Internal Revenue Taxation. Senator Dole's statement in support of this proposal, appearing at S. 7803 of the Congressional Record for May 24, 1976, includes a letter addressed to Chairman Long from Virginia H. Knauer, Special Assistant to the President for Consumer Affairs, in support of the proposed amendment. Mrs. Knauer's letter emphasizes the detrimental effect which the 4% excise tax on museums and libraries that are wrongly treated as private operating foundations under the Treasury's Regulations is having on the public's interest in causing these non-profit institutions to have to consider imposing admission charges to make up needed revenues unfairly taken away by this tax. Mrs. Knauer's letter also refers to a letter from Dr. Woodworth, Chief of Staff of the Joint Committee on Internal Revenue Taxation, which estimates that the revenue loss to the Treasury for remedying this inequity would be small.

In all of its testimony on this subject, the Association has taken the position that the tax exemption should be expressly limited to those operating foundations that are no longer controlled by substantial contributors or their families, and both H.R. 5696 and Senator Dole's proposed amendment to H.R. 10612 so provide. There is no reason to suppose that museums and libraries are susceptible to private abuse where they are not under the private control of substantial contributors or their families; accordingly, it is inappropriate to apply a private foundation audit fee against such organizations. Very few such museums and libraries are involved and so exemption of such organizations from this penalty tax would not represent a significant "chipping away" from the private foundation provisions. "Museums" and "libraries" are not especially difficult terms to define. In short, there is no reason justifying continuation of this onerous tax burden on the museums and libraries involved.

For all these reasons, it is entirely appropriate for the Senate Finance Committee to have approved an amendment to H.R. 10612 establishing that the excise tax on net investment income (Sec. 4940) is not to be applied to a qualifying museum or library. We strongly urge you and your colleagues to continue to support this amendment to the Tax Reform Bill.

Respectfully submitted,



Kenneth H. Liles
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Washington, D.C.

FEDERATION OF AMERICAN HOSPITALS

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WASHINGTON D C 20036 Telephone 202/833-3070

SUMMARY OF TESTIMONY

HOSPITAL REVENUE BONDS

JULY 22, 1976

The Federation of American Hospitals recommends that the ceiling on issuance of industrial revenue bonds be increased from $5 million to $20 million for the construction of hospitals, as previously approved by the Senate Committee on Finance. Such an amendment would:

1. Recognize soaring inflation in hospital construction costs;
2. Help assure an adequate supply of health services in rural and inner-city areas of the country by providing needed capital financing for expansion and modernization;
3. Ease the burden on federal, state, and local budgets for providing health facilities in underserved areas; and
4. Help curb rising hospital costs and charges.

Passage of such legislation would not result in the construction of large numbers of hospitals through this financing mechanism. The use of industrial revenue bonds would be limited to construction of facilities with a certificate of need, as well as by the ability to obtain bond financing, and state legislation authorizing the use of such bonds.

FEDERATION OF AMERICAN HOSPITALS

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TESTIMONY OF

JOHN A. BRADLEY, Ph.D.

PRESIDENT

FEDERATION OF AMERICAN HOSPITALS

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON HOSPITAL REVENUE BONDS

JULY 22, 1976

I am John Bradley of San Antonio, Texas, President of the Federation of American Hospitals, the national trade association representing the 1,051 investor-owned hospitals in this country, as well as Vice President of American Medicorp, Inc. American Medicorp is a large multi-facility hospital company, owning and/or managing fifty-three hospitals with a total of 11,044 beds. Accompanying me today is Mr. Michael Bromberg, Director of the National Offices of the Federation.

I would like to thank the Committee for the opportunity to appear before you today, in order to lend our support to passage of a previously approved Committee amendment that would raise the ceiling on issuance of industrial revenue bonds for the construction of hospitals from $5 million to $20 million. Originally, we had sought to have hospitals added to the list of categories which are completely exempt from a ceiling on

bond issues because of their public need and high construction cost. Senator Bentsen sponsored such legislation, and after discussion of the proposal on June 4, the Committee approved the compromise of a $20 million ceiling for hospitals.

The hospital bond amendment under consideration would not create a new usage for industrial bonds. Approximately twenty new hospitals have been financed by this source since 1968, mostly in rural areas of the southern United States. The amendment would recognize the soaring inflation in hospital construction costs and adjust maximum bond issues for hospitals to $20 million. We are unaware of any new hospital projects using industrial bonds which have been initiated in the past two years, solely because the current $5 million limitation has made it impossible to continue to utilize that source of financing.

As Senator Bentsen has noted, liberalizing the use of industrial revenue bonds for the construction of hospitals, "is needed to assure an adequate supply of health services in rural and inner-city sections of the United States." Health care in this country is desperately in need of capital financing for facility expansion and modernization. The usual sources are not always open to hospitals. Non-taxable hospitals are presently able to market their own bonds bearing tax exempt

interest. At the present time, non-profit hospitals finance over forty percent of all new construction and/or modernization through the use of general revenue bonds. There is no limit on such issues, and last year they financed $4.3 billion in hospital projects.

In contrast, investor-owned hospitals must use industrial revenue bonds which are subject to a $5 million limit per issue. This limit applies to all capital expenditures related to the project which are made during the three years preceding and three years following the issuance of the bonds. The ability to finance construction and modernization projects in large part determines whether or not they will exist. Industrial development bonds figure prominently in underwriting the costs involved, and although the maximum issue adequately covered these costs in 1968, to build a similar 200 bed facility today would run over $12 million. Put another way, the $5 million limit will permit the construction of an 80 bed hospital at the present time, and generally speaking, such a small physical plant may be uneconomical unless it is a part of an integrated system.

Although the amendment already approved by this Committee to raise the ceiling on issuance of industrial revenue bonds from $5 to $20 million will still preclude the construction of larger facilities that could have been built with a total exemption, at least the amendment would provide some urgently needed

relief. In 1974, investor-owned hospitals paid $46.3 million in property taxes and $125.8 million in state income taxes. Raising the ceiling to $20 million will provide a vital inflation adjustment factor that recognizes the fact that a bed which cost $25,000 to build several years ago now costs approximately $60,000.

One of the most important reasons for warranting the liberalized use of these bonds is the development of effective areawide planning authorities, largely through the passage of P.L. 93-641, the Comprehensive Health Planning Law. This law, which requires state certificate of need programs as a condition for receiving federal planning funds, effectively limits future construction of projects to those which serve a demonstrated and proven need in the community. As a matter of course, bond underwriters normally require an extensive feasibility study to document the community needs before considering marketing the proposed bonds. Thus, to the extent that there are excessive beds in a geographic area, the expansion of industrial revenue bond financing will not result in the creation of additional beds--unneeded facilities simply will not be constructed due to the planning authorities.

It is the common desire of both Congress and the health care industry to provide high quality care in the most efficient manner possible. An expansion of the tax exempt industrial revenue bond

financing mechanism would contribute directly and immediately to the lowering of hospital costs and charges. If construction of private hospitals was financed through tax exempt industrial revenue bonds (at least up to the proposed $20 million ceiling), the savings in annual interest cost would be approximately 30%. The annual savings that would result could be passed along to patients in terms of eventual lower costs.

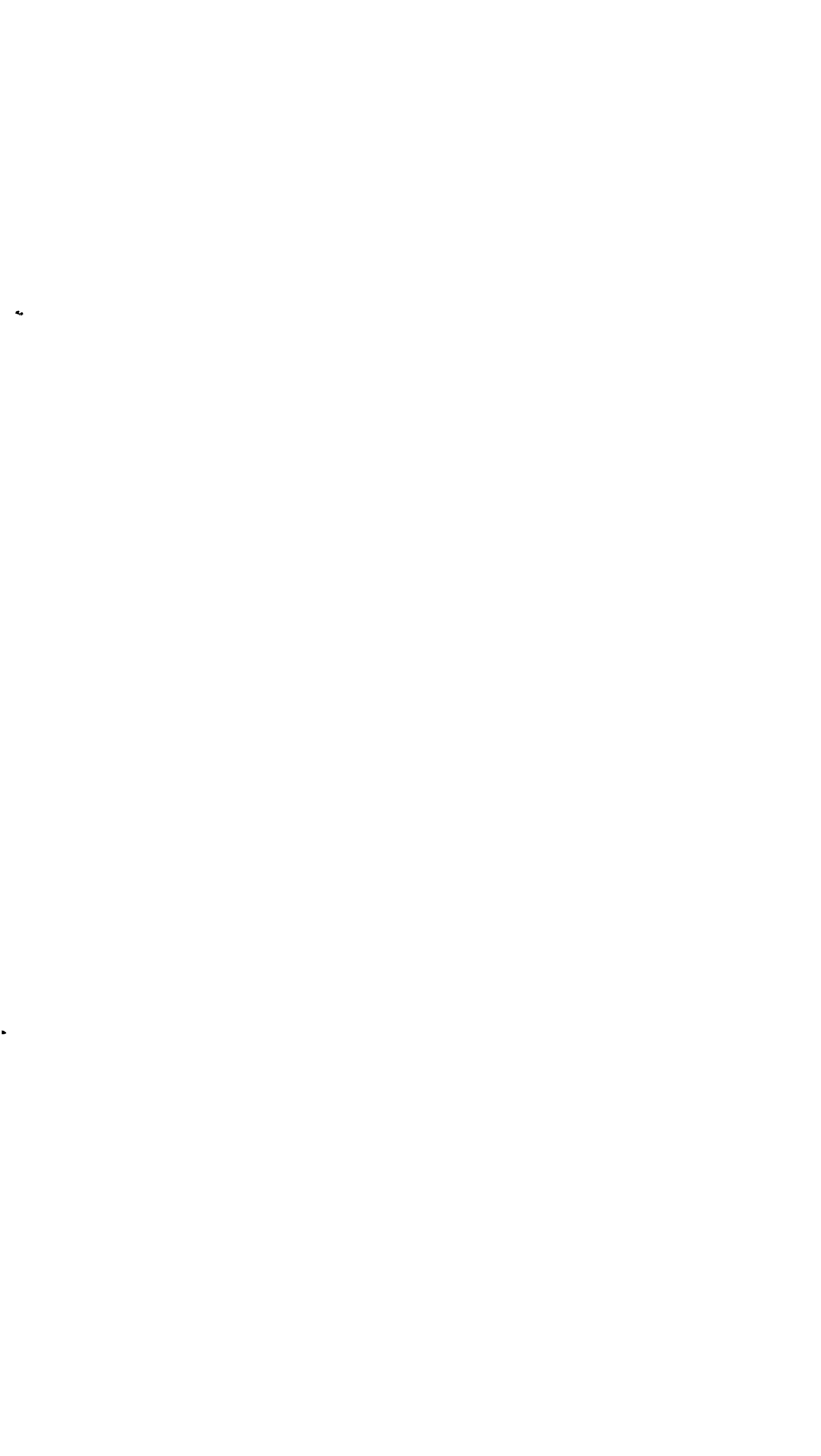
In brief, we urge the Committee to once again support raising the ceiling on the issuance of industrial revenue bonds from $5 to $20 million for the construction of hospitals for the following reasons:

1) to attract investment of private capital in needed hospital construction;
2) to ease the burden on strained federal, state, and local budgets for construction of health facilities in underserved areas;
3) to encourage necessary modernization of existing investor-owned hospitals;
4) to provide relief for investor-owned hospitals which paid over $172 million in property and income taxes in 1974;
5) to curb rising hospital costs and charges through general tax relief; and
6) to provide greater capital resources to meet increasing demand for access to hospital care.

Since investor-owned hospitals are tax paying institutions, there would be an increase in federal tax revenues in cases where industrial bonds are utilized as opposed to projects in which general revenue bonds are made available for tax exempt hospitals. Private groups and companies also build facilities in areas where there is a real public need and in communities which cannot afford to finance hospital construction.

The Department of Health, Education and Welfare has estimated that several billion dollars will be needed in the next decade to build needed new facilities and replace existing substandard ones. These projections have not even been adjusted for the impact of national health insurance. Even if the amendment that we support becomes law, we do not anticipate the construction of large numbers of hospitals through the use of industrial revenue bonds. Their use will still be limited to construction of facilities with a certificate of need, as well as by the ability of project sponsors to obtain bond financing, and appropriate state legislation authorizing such industrial bonds.

However, I believe that it is absolutely vital that this means of ready -- if limited -- financing be made available so that the investor-owned hospital industry is able to deliver quality health care to countless underserved areas across the country.



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SUMMARY OF POINTS IN SUPPORT OF THE PREPAID LEGAL SERVICES TAX AMENDMENT (PACKWOOD AMENDMENT)

Background. In 1973, Congress amended the Taft-Hartley Act so that legal services could be a subject of collective bargaining just as health services are. No consideration was given at that time to the tax treatment of these prepaid legal service plans. Now, legal service plans are being established by employers and unions and their tax problems have become crucial.

Under Present Law. 1) It is unclear whether the employer contribution to a legal service fund on behalf of the employee is taxable income to the employee; 2) The value of benefits received is definitely taxable income to the employee; and 3) For not reporting this "miscellaneous income", legal services funds and their trustees are liable to certain penalties.

This means that: 1) Employers are uncertain about the ultimate cost of the plan, since any withholding requirement would reduce the plan's assets accordingly; 2) Employees face unexpected and possibly sizeable tax bills because benefits presently constitute taxable income; and 3) Few employers or unions are willing to negotiate legal service plans under these circumstances.

Under the Proposed Amendment. The proposed amendment would amend the Internal Revenue Code to exclude from employee taxable income the value of the benefit received under a legal service plan, and the contribution made to the plan in his behalf.

Revenue Loss. There are approximately 75 prepaid legal service plans in operation, covering 175,000 employees. Estimates show present revenue loss to fall between $900,000 and $1.4 million per year. Even if, in future years, 10 million employees (roughly half of the unionized work force) are covered by such plans, the revenue loss would still only be between $50-$80 million.

The Status of the Amendment. The Prepaid Legal Service Tax Amendment (the Packwood Amendment) is currently part of the Supplemental Amendments to the Tax Reform Act of 1976 (H.R. 10612). A vote is expected sometime during the week of July 19. The measure has the support of the AFL-CIO and other international unions, the American Bar Association and many state bar associations, as well as the support of insurance companies and consumer groups such as The Cooperative League of the U.S.A., the Consumer Federation of America, the National Student Association and others.

AFL-CIO • Consumer Federation of America • Cooperative League of the U.S.A. • Family Service Association of America • National Association for the Advancement of Colored People • National Climate Council • National Council of Senior Citizens • National Education Association • National Farmers Union • National Legal Aid and Defender Association • Public Citizen, Inc. • United Auto Workers • United States Catholic Conference • United States National Student Association

STATEMENT BY SANDY DEMENT
EXECUTIVE DIRECTOR
NATIONAL CONSUMER CENTER FOR LEGAL SERVICES
Before the
SENATE COMMITTEE ON FINANCE
July 22, 1976

The National Consumer Center for Legal Services is pleased to have the opportunity to offer additional testimony on the subject of the tax problems of prepaid legal services. The National Consumer Center for Legal Services, a coalition of consumer, labor and client organizations, strongly supports the prepaid legal services amendment. The American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) and the United Auto Workers (UAW) support it. The American Bar Association supports it, as do the state bar associations of Connecticut, Georgia, Kansas, Louisiana, Michigan, New York, Ohio, Oregon, Texas and Wisconsin. A number of insurance companies support it, including Insurance Company of North America and Connecticut General. Consumer organizations such as The Cooperative League of the U.S.A., the Consumer Federation of America and the National Student Association, among others, are supporters.

A Brief History of Prepaid Legal Service Plans

Prepaid legal service plans grew directly from the growing realization by groups and by the organized bar that a sizeable proportion of the American population is not served at all by lawyers. The preliminary report of a massive study of legal needs conducted by the American Bar Foundation reveals that two-thirds of the population is "legally indigent." Of these, half have never seen a lawyer; half have seen a lawyer only once in their lives.[1]

Efforts to establish group legal plans date from the 1930's when automobile clubs attempted to offer auto-related legal assistance. The running battle between consumer groups seeking services for their members and state bar associations determined to stop these unorthodox arrangements continued until the 1960's, when the Supreme Court issued a series of four rulings which established "meaningful access to the courts" as a First Amendment right.[2] In the final case, United Transportation Union v. Michigan State Bar, Justice Black wrote:

> "[T]he principle here involved cannot be limited to the facts of this case. At issue is the basic right to group legal action, a right first asserted in this Court by an association of Negroes seeking the protection of freedoms guaranteed by the Constitution. The common thread running through our decisions...is that collective activity undertaken to obtain meaningful access to the courts is a fundamental right within the protection of the First Amendment. However, that right would be a hollow promise if courts could deny associations of workers or others the means of enabling their members to meet the cost of legal representation."[3]

Soon after the UTU decision, steps were taken to amend Section 302 of the Taft-Hartley Act (Labor Management Relations Act of 1947) so that legal services could be negotiated as a fringe benefit. Passage in late 1973 was made possible by a working coalition that included the AFL-CIO, the UAW, the International Brotherhood of Teamsters, and a number of other unions; the American Bar Association; a number of major insurance companies such as Insurance Company of North America, Fireman's Fund, and others; and consumer groups, including the Consumer Federation of America, The Cooperative League of the U.S.A.

In 1974, a further step was taken when Congress included legal service plans as one of the employee welfare benefit plans

subject to Title I of the Employee Retirement Income Security Act. The impact of ERISA on legal service plans was principally to create a regulatory framework within which the plans are free to develop.

Unfortunately, Congress has not yet addressed the question of the tax treatment to be given to the contributions and benefits of such plans. Presently, there is great confusion as to whether the employer contribution to a legal service fund constitutes income to the employee. Several revenue rulings in analogous areas suggest that it is not. And, the unresolved question of the taxability of the benefits to the employee is 1) creating uncertainty as to the costs of such funds, 2) confusion as to the proper course to be followed in informing employees of their potential tax liability or in withholding for tax purposes, and 3) considerable reluctance on the part of employers and unions to proceed ahead under these conditions.

The Structure and Operations of Prepaid Legal Service Plans

Section 302(c)(8) of the Taft-Hartley Act stipulates that prepaid legal service plans may not be used to sue either the employer or the union, nor may they be used for defense of union officials charged with violations of certain federal labor statutes. These plans are required, like other collectively-bargained benefits, to be jointly administered by trustees selected by the employer and the union. Legal services funds established unilaterally by either the employer or the union are treated like other welfare funds; they are also subject to the reporting, disclosure and filing requirements of ERISA.

Services delivered under the plans may be administered internally by the trustees, who might hire a staff of attorneys or

contract with outside law firms. The trustees might also contract with a bar association-sponsored plan; or might purchase a group policy of legal insurance. Whichever delivery system is selected, the plans are designed to deliver the routine, personal, non-business legal services which the ordinary employee customarily faces. These include divorce and family matters, wills, real estate, consumer credit problems, traffic matters, and misdemeanors, etc. The Laborers Legal Service Plan in Washington, D.C., for example, reported the following cases:[4]

Family problems	17%
Consumer & Creditor actions	17%
Traffic cases	30%
Housing matters	15%
Criminal/Juvenile cases	9%
Other	12%

However, there is no standard coverage; groups are free to shape the coverage to meet the special needs of their members. A large number of plans offer a "major litigation benefit" for members involved in more expensive litigation. Coverage ordinarily extends to dependants.

Prepaid legal service plans ordinarily are bargained at \$.03-\$.05 per hour, the higher figure being common in construction unions whose members may only work 1000-1200 hours per year. Thus costs per member per year range from \$30-\$100, the figure also depending on the size of the covered group. In two and a half years, approximately 75 prepaid legal service plans have been established, covering perhaps 175,000 employees. The utilization rate for the plans is typically low in the first year, usually around 10%. In later years, utilization climbs to 15% and in a very few plans, utilization rates of 20% have been achieved.

The Tax Problem

The Internal Revenue Code currently provides for the exclusion from employee gross income of premiums and benefits provided under accident and health plans. The prepaid legal services tax amendment would amend the Code so that parallel exclusions would exist for contributions paid to and benefits received through legal service plans. Legislation was introduced in both the House of Representatives and the Senate in 1975 to amend the Internal Revenue Code. H.R. 3025 was introduced by Representative Joseph Karth (D-Minnesota) and sixteen other members of the Ways and Means Committee. S. 2051 was introduced by Senators Jackson, Javits, Ribicoff, Taft and Williams. On June 4, 1976, the Senate Finance Committee adopted the measure as part of its Supplemental Amendments to the Tax Reform Act of 1976. The measure will soon be before the full Senate.

It should be made absolutely clear at this point that the tax treatment of the employer is not an issue here. Employer contributions to legal service plans are deductible as "ordinary and necessary expenses" of doing business under Section 162 of the Internal Revenue Code. Nor are we dealing here with the tax status of the funds themselves, although there are perplexing problems unresolved in that area. The prepaid legal services tax amendment pertains solely to the tax consequences to the employee.

Labor and management representatives interested in establishing a legal service plan face two distinct problems, both of which primarily concern the taxability of legal services contributions and benefits to employees: first is the question of the taxability

of the contribution (premium) made to the fund on the employee's behalf, and second is the question of the taxability of the benefits themselves.

Taxability of the Contribution

With respect to contributions made to legal service funds on behalf of employees by the employer, considerable confusion exists as to whether or not these contributions would constitute income. Despite the fact that a number of plans have filed requests for revenue rulings, none have been issued on which plans feel they may safely rely. Careful reading of revenue rulings on related questions suggests that the Internal Revenue Service would not consider these contributions to be taxable income to the employee because the employee has no vested right in the funds at the time the contribution is made. However, the prepaid legal services tax amendment would remove all question by granting an explicit exclusion of these contributions from employee gross income, comparable to the exclusion granted in Section 106 of the Internal Revenue Code to contributions to health and accident plans.

An amendment excluding the contribution from income would have an additional benefit: the guarantee of equal treatment between negotiated legal service plans and those paid for unilaterally by the employer or through individual insurance contract plans. In other words, the prepaid legal services tax amendment would accomplish equal tax treatment for employees, regardless of whether the legal service benefit is provided through collective bargaining, as an employer-instituted benefit, or by employer-purchase of individual legal insurance contracts for employees.

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The cost of the confusion concerning the taxability of the contribution is high. Employers are uncertain about the ultimate cost of a legal service plan, since any withholding requirement would reduce the plan's assets accordingly. Few employers or unions are willing to negotiate legal service plans under these circumstances.

Taxability of Benefits

With respect to the taxability to the employee of the value of the benefits received under such plans, the Internal Revenue Code language is clear: "Gross income includes income realized in any form, whether in money, property, or services." (Treasury regulation 1.61.1(a).) Without amendment, an employee might receive several thousand dollars in legal services benefits and face the prospect of having to pay taxes on those benefits as income. This could have a serious effect, particularly since prepaid legal service plans typically cover people whose earnings are between $5,000 and $15,000 per year. Employees would have to ask themselves whether they can afford to take advantage of their legal services benefit program.

There is also a more practical consequence of thus amending the Code: it avoids the difficult problem of assessing the value of services which may be provided by a panel of staff attorneys who do not bill on a fee-for-service basis. Even more difficult valuation problems loom with services which are related to legal services but do not constitute legal services *per se*, such as paralegal assistance, marital counseling and so on. Since the Supreme Court's recent decision in *Goldfarb*, it is unlikely that there will be any bar association minimum fee

schedules on which to base such valuations. Furthermore, the valuation problem is not merely one of plans which do not bill for services provided, (i.e., one where members are entitled to a limited number of prepaid hours of service for staff attorneys) but even more seriously, of plans whose delivery mechanisms enable them to deliver services far less expensively than prevailing legal practice. The use of a market valuation system would now produce real injustices.

In the meantime, most employers and legal services trust funds are <u>not</u> reporting benefits as miscellaneous income. While they wait for Congress to deal with their dilemma, they risk incurring penalties of $25 per filing for their failure to file. A plan which serves 1000 members in a year has potentially built up a $25,000 fine, in addition to the risks taken by trustees whose fiduciary duties require strict compliance with law.

Finally, our experience suggests that both employers and employee organizations have some reluctance about participating in a program whose tax consequence to the employee are potentially so harsh. This result would defeat the very purpose of the Taft-Hartley Amendment and frustrate the intent of Congress to improve access to legal services.

<u>Revenue Loss</u>

This section attempts to touch briefly on the question of possible revenue loss, although it is an area subject to widely differing estimates. Employer contributions for comprehensive legal services range between $30 and $100,the bulk of them probably approximately $50. Tax counsel advise that these amounts would probably not now be considered income to the employee since

the employee has no vested right in the fund at the time the contribution is made.* Therefore, if this advice is correct and if such amounts are not presently taxable, the simple clarification of their status will not generate any revenue loss.

As to benefit limits, most plans use either dollar amounts or hours-of-service, averaging 50 or fewer hours of service per year. Whether measured in dollar amounts or in hours, no plans now operating offers more than an equivalent of $4,000 in benefits per year.**

Figures from the Shreveport Laborer's plan, the oldest legal service plan currently in operation, suggest more accurate data for illustration.[5]

Shreveport Legal Service Plan

Year	No Claims	Utilization Rate	Average Claim
1971	30	5%	$ 212
1972	56	9%	$ 223
1973	65	11%	$ 243
1974	92	15%	$ 211

The utilization pattern for Shreveport seems to be fairly typical for new plans, although the first year utilization rate is low. Most plans average 8-10% use the first year. An established plan seems to average 15-20% utilization. For example,

* See the tax memorandum attached as Appendix A, prepared by John Hendricks, at the request of the Special Committee on Prepaid Legal Services of the American Bar Association.

**Such limits would be reached by a beneficiary only in the unusual situation where the employee claimed all possible benefits allowable in a claim year. For example, under a plan using a schedule of benefits, the employee would have to be divorced, sued by his neighbor, involved in a traffic accident, arrested for drunk driving, default on a loan, buy or sell a house and request a will, etc., etc.

the Ohio Legal Services Fund serving employees of the City of Columbus, Ohio reported 15% utilization in its first 8 months of operation, averaging slightly more than $180 per claim. The Laborer's District Council (Washington, D.C.) plan, which handles 85% of its cases on a staff basis, and refers 15% to outside attorneys, pays an average of $210 per case to the outside attorneys. Cases handled on a staff basis probably average $150 per case.

Thus, in a hypothetical plan covering 100 workers (which is in actuality too small to effectively support a plan), assuming a 20% utilization rate, an average payout of $200, and a tax rate of 20%, the revenue loss if expressed on a per employee basis would amount to $8 per employee. On the other hand, if you assume a 15% utilization rate, a $175 payout rate and a tax rate of 20%, the revenue loss if expressed on a per employee basis would amount to $5.25 per employee. The figures could actually be lower or higher. Thus, for the 175,000 workers currently covered by such legal service plans, the revenue loss could be between $900,000 and $1.4 million.

All prepaid legal service plans now providing services limit benefits in some way. A worker who takes advantage of every possible benefit under a plan can still usually only receive services valued between $2,500 and $3,000. Thus fears of excessive usage are unwarranted. Further, most plans contain the standard ethics code language which allows attorneys to decline matters that are "frivolous or without merit." Even if they do not, attorneys serving the plan remain bound by the ethical code.

It is significant that income levels for the workers served by the plans are generally low, only rarely exceeding $15,000, and frequently ranging between $8,000 and $10,000 annually. Most workers served by these plans are married, with children. A sizeable proportion, therefore, will pay nominal or no taxes and thus would not contribute to a revenue loss at all.

It is difficult to make revenue loss estimates for the future when the popularity of legal services as a benefit cannot yet be guaged. However, even if 10 million employees are eventually covered by prepaid legal service plans, revenue loss still would only fall in the $50-$80 million range.

FOOTNOTES

1. Curren, Barbara A. and Spalding, Francis O., The Legal Needs of the Public, American Bar Association and American Bar Foundation, Chicago: 1974.

2. NAACP v. Button, 371 U.S. 415, 9 L.Ed.2d 405, 83 S.Ct. 328 (1963); Brotherhood of Railroad Trainmen v. Virginia ex rel. Virginia State Bar, 377 U.S. 1, 12 L.Ed.2d 89, 84 S.Ct. 1113 (1964); United Mine Workers v. Illinois State Bar Association, 389 U.S. 217, 19 L.Ed.2d. 426, 88 S.Ct. 353 (1967); United Transportation Union v. The State Bar of Michigan, 401 U.S. 576, 28 L.Ed.2d. 339, 91 S.Ct. (1971).

3. U.T.U. v. State Bar of Michigan, note 2 supra, at 585-586.

4. Laborer's Legal Services: A Progress Report, D.C. Laborer's Legal Services Plan, 1975.

5. Lawyers for Laborers: The Shreveport Plan of Prepaid Legal Services After Four Years, The American Bar Association, Chicago: 1975.

Supplement to Tax tab of Compilation of Reference Materials on Prepaid Legal Services

FEDERAL INCOME TAX ASPECTS FOR EMPLOYEE-PARTICIPANTS IN GROUP LEGAL SERVICE PLANS

A Memorandum Discussing Proposed Amendments to Sections 105 and 106 of the Internal Revenue Code of 1954

BY
JOHN C. HENDRICKS

In the past decade our society has come a long way in increasing the availability of legal services to a larger number of our citizens. The wealthy have always been able to afford counsel of their choice to meet their legal needs. Federally funded programs have provided legal assistance for many of the poor. However, the large class of moderate income Americans, having family incomes of between $5,000 and $15,000 per year, frequently does not have adequate counsel to meet its needs. Many knowledgable individuals believe that group legal service plans will help fill this gap. Group legal service plans attempt to make available a wide-range of legal services in such areas as protection against consumer fraud, debtor-creditor, will preparation, adoptions, divorces, and real estate settlements, to name but a few. The concept of such legal service plans, like group medical insurance, involves spreading the cost among a large number of people to minimize the cost to the particular individual participant.

The use of group legal service plans is becoming more frequent with each passing month. It is anticipated that such

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group legal service plans will soon become a common employee fringe benefit. The employer's contributions made on behalf of his employees to a group legal service plan will be deductible from his gross income as an "ordinary and necessary expense" under Section 162 of the Internal Revenue Code of 1954. Treasury Regulations Section 1.162-10(a) states that:

> " . . . Amounts paid or accrued within the taxable year for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or a sickness, accident, hospitalization, medical expense, recreational, welfare, or similar benefit plan, are deductible under Section 162(a) if they are ordinary and necessary expenses of the trade or business."

Thus the employer contributing to a group legal service plan will receive the same tax treatment for these expenditures as he does for employees' group medical insurance, unemployment benefits and other employee fringe benefits.

While the federal income tax treatment to the employer is clear, at the present time there are some uncertainties over the income tax treatment that may be expected by participants in such group legal service plans. Attached are proposed amendments to Sections 105 and 106 of the Internal Revenue Code of 1954. The purpose of these amendments is to insure that all participants in group legal service plans will have the same federal income tax treatment as participants in accident and health plans. The proposed amendment to Section 105 relates to

the taxability of benefits rendered by such a group legal service plan, while the amendment to Section 106 concerns the taxability to the participating employee of an employer's contributions to the group legal service plan.

Taxability of benefit received - Section 105

As has been indicated, it is expected that employers will frequently pay all or part of the premium in group legal service plans for their employees as an additional fringe benefit. The following question immediately arises: Is the value of the benefit received or the amount of the reimbursement made includable in the gross income of the employee?

It is imperative to look at Section 61(a)(1) of the Internal Revenue Code, which defines gross income to include "compensation for services, including fees, commissions and similar items." Treasury Regulations Section 1.61-1(a) states that:

> "Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash . . . "

Thus, unless explicitly excluded by some section of the Internal Revenue Code, the provision of services or the reimbursement for expenses incurred in areas such as medical or legal services would be considered income.

In attempting to point out some of the special rules relating to particular items of income, Treasury Regulations Section 1.61-2(a)(3)(iii) states that amounts received under accident and health plans as set forth in Section 105 of the Code and the regulations thereunder are excluded from gross income. Unless specific legislation is enacted, similar amounts received under group legal service plans would be included in gross income simply because they have not been excluded by a specific Code section.

Should Section 105 of the Code not be amended, the value of the legal services to be included in the employee's gross income would equal the amount of the reimbursement in the case of reimbursement by the plan. If the plan were to provide the service directly to the employee rather than reimbursing him for his legal fees incurred, the amount includable in gross income would be the fair market value of the services rendered. Needless to say, there could be difficult valuation problems in attempting to place values on the broad scope of legal services which could be rendered under group legal service plans. Because of uncertainty as to the income tax consequences, the plans might not be utilized fully. In order to avoid this harsh result, Section 105(b) of the Internal Revenue Code should be amended to grant group legal service plans the same tax treatment as is presently accorded health and accident plans.

Section 105(b) indicates that gross income does not include any payments made to an employee through accident or health insurance plans for personal injuries or sickness if such amounts are paid, directly or indirectly, to the taxpayer to reimburse him for expenses incurred by him for the medical care of himself, his spouse, or his dependents. The statute itself clearly excludes from gross income the reimbursement of an individual by a group health plan for the medical expe ses of himself, his spouse and his dependents. In amplifying the statute, the Regulations mention the payment of an individual's medical obligations by the health plan directly to the provider of the health services. Specifically, Treasury Regulations Section 1.105-2 states that "if the taxpayer incurs an obligation for medical care, payment to the obligee in discharge of such obligation shall constitute indirect payment to the taxpayer as reimbursement for medical care." For example, if a taxpayer incurs a doctor bill of $25.00 and his medical insurance plan pays the physician the $25.00 fee directly, without reimbursing the taxpayer and then having the taxpayer pay the physician, this is an indirect payment to the taxpayer. Under Section 105(b) such a payment is not includable in the taxpayer's gross income. In addition to including direct and indirect reimbursement of an individual's legal costs, the proposed amendment to Section 105 also includes a group legal

service plan's rendering services directly to an individual and insures that the value of such services would not be includable in gross income.

Since the concept behind group legal service plans is similar to that behind group medical plans, the same rationale should apply to the non-taxability of the benefits received. Section 105 of the Internal Revenue Code should therefore be amended to state that gross income includes neither benefits received by nor moneys paid to a taxpayer, directly or indirectly by a group legal service plan, to reimburse him for legal expenses he or his family have incurred.

Taxability to the employee of the employer contribution - Section 106

Section 61(a)(1) of the Internal Revenue Code of 1954 defines gross income to include "compensation for services, including fees, commissions, and similar items." Treasury Regulations Section 1.61-1(a) indicates that "gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock or other property, as well as in cash." When income takes some form other than cash, the fair market value of whatever is provided in lieu of cash is included in the recipient's gross income. For example, if as part of his overall compensation an individual receives the use of a house rent free and the fair market rental value of the house is $200.00 per month, the individual will ordinarily be deemed to have additional income in the amount of $200.00

per month as a result of his rent free use of the house.

It is envisioned that in the near future employers will begin making contributions to group legal service plans on behalf of their employees as an additional fringe benefit. If this occurs, will the employer's contribution to the group legal service plan be includable in the employee's gross income? In discussing this question, it is important to note that most of such group legal service plans will arise either from collective bargaining or unilateral adoption by an employer for a group of his employees. This is in contrast to a small employer's covering only one or two employees with individual insurance contracts to provide some sort of prepaid legal service benefits.

With respect to collective bargaining for group legal service plans, legislation was enacted in 1973 adding group legal service plans to the list of fringe benefits which can be administered under the trust fund provisions of Section 302(c) of the Taft-Hartley Act. These trust funds are the common and usual way of administering fringe benefit programs for union members. The amendment is expected to generate a rapid increase in the number of group legal service plans in existence. Section 501(c)(9) of the Internal Revenue Code grants tax exempt status to such trust funds, designated as voluntary employees' beneficiary associations in the Code. It is anticipated that the Internal Revenue Service will issue new Treasury Regulations

under Section 501(c)(9) relatively soon and that these Regulations will grant tax-exempt status to trust funds established to fund any fringe benefit designated in Section 302(c) of the Taft-Hartley Act. When this occurs, it will be possible to administer group legal service plans through such a tax-exempt trust.

Insofar as the federal income tax treatment of such fringe benefits is concerned, it might be instructive to review some of the supplemental unemployment benefit plans. In Revenue Ruling 56-249, 1956-1 C.B. 488, an auto maker contributed to a trust fund, which was held and administered by an independent trustee, to pay supplemental unemployment benefits to its employees who were laid off. Its contribution was based upon a formula considering the total hours for which its eligible employees were paid during each pay period. No employee had any right, title, interest in or to the assets of the fund or in any company contribution to the fund until he qualified to receive a benefit therefrom. Thus if the employee ceased working for the auto maker prior to his being laid off, he would never derive any benefits from the fund. The amount of supplemental unemployment benefits to be received by a laid off employer was dependent upon many detailed criteria set forth in the plan. The Revenue Ruling held that the benefits paid to former employees did not constitute wages for purposes of the Federal Unemployment Tax Act, Federal Insurance Contributions Act, and the Collection of the Income Tax at Source

on Wages. Nonetheless, the supplemental unemployment benefit payments did have to be included in the employee's gross income for federal income tax purposes in the year in which the benefits were received. Note, however, that no part of the contribution was included in the employee's income when the employer initially made the contribution to the trust fund.

The situation in Revenue Ruling 56-249, _supra_, is contrasted to another supplemental unemployment benefit plan where contributions were made by an employer to separate independently controlled trust accounts. There was a separate trust account for each participating employee. The purpose of this plan also was to furnish supplemental unemployment benefits to eligible employees. Since the contributions paid into the trust vested immediately and were non-forfeitable, the employee realized income in the year when the employer made the contributions. Revenue Ruling 57-37, 1957-1 C.B. 18.

In analysing these two Revenue Rulings, it appears that the determining factor is whether the employee has a vested and non-forfeitable right as a result of contributions made by the employer. If he is immediately vested and has a non-forfeitable right, the employee will have income in the year the contribution is made. Revenue Ruling 57-37, _supra_. If there is no vested interest and the employee must qualify for benefits in accordance with the criteria set forth in the

plan, the employee will not have income in the year the employer contribution is made. Revenue Ruling 56-249, supra.

The importance of this distinction can also be seen by comparing two Revenue Rulings dealing with vacation benefit funds. See Revenue Ruling 57-316, 1957-2 C.B. 620, for a situation in which the employees had no right or interest in the vacation fund except as the trustees determined. In that case, tax liability was not incurred until payments were made from the vacation fund to the participating employees. In Revenue Ruling 67-351, 1967-2 C.B. 86, payments were made by the employer to such a vacation plan and trust. In this case, however, the individual employee's account was fully vested and nonforfeitable from the time the employer's contribution was made. These vacation fund contributions by the employer were considered as additional compensation to the employee as soon as the employer made the payments to the trust. As the supplemental unemployment benefit plans and vacation fund plans have shown, so long as the employee- participants in a collective bargaining group legal service plan do not have a vested, non-forfeitable right, the employer's contribution to fund such a group legal service plan should not be income to the employees in the year made.

With respect to the federal income tax treatment for group legal service plans which are not a result of

collective bargaining, again a review of the federal income tax treatment for contributions to supplemental unemployment benefit plans is instructive. As previously indicated, the Internal Revenue Service, in Revenue Ruling 56-249, supra, held that contributions from an employer to a supplemental unemployment benefit plan instituted as a result of collective bargaining would not be included in the employee's income until benefits were actually paid to the employee. In Revenue Ruling 58-128, 1958-1 C.B. 89, the Internal Revenue Service extended identical tax treatment to plans which were similar in all respects except that they were unilaterally instituted by the employer rather than resulting from collective bargaining.

With the Internal Revenue Service policy concerning the taxation of employee fringe benefits well established, all legal service plans for groups of employees of the same employers should receive the same tax treatment. No amount of the employer's contribution should be includable in the employee's gross income when the contribution is made.

By far the greatest number of participants in group legal service plans will be in plans which are a result of collective bargaining or other group plans unilaterally instituted by employers as opposed to employers purchasing individual contracts for their covered employees. There will probably be, however, a small number of individual contract group legal service employee benefit plans. With respect to this small

category of individuals, it becomes necessary to look at the treatment accorded by the Internal Revenue Code with respect to employer contributions to accident and health plans.

Section 106 of the Internal Revenue Code deals with employer contributions to accident and health plans. This section states that "gross income does not include contributions by the employer to accident or health plans for compensation (through insurance or otherwise) to his employees for personal injuries or sickness." Treasury Regulations Section 1.106-1 indicates that "the employer may contribute to an accident or health plan either by paying the premium (or a portion of the premium) on a policy of accident or health insurance covering one or more of his employees, or by contributing to a separate trust or fund (including a fund referred to in §105(e)) which provides accident or health benefits directly or through insurance to one or more of his employees." No amendments have been made to Section 106 of the Internal Revenue Code since its enactment in 1954.

Prior to the enactment of Section 106 in the Internal Revenue Code of 1954, whenever an employer paid premiums on individual policies for accident or sickness benefits to his employees, the premiums paid were includable in the gross income of the employees and were thus subject to the income tax. Revenue Ruling 210, 1953-2 C.B. 114 and Revenue Ruling 58-90, 1958-1 C.B. 88. The change in the taxability of premiums paid by the employer occurred because of the addition of Section 106 to the Internal Revenue Code of 1954. Revenue Ruling 58-90 underlines this point by saying that:

"The amount of the premiums paid by the corporation should be excluded from the gross income of the employee for taxable years beginning after December 31, 1953, and ending after August 16, 1954, under the provisions of Section 106 of the 1954 Code. The amount of premiums paid by the corporation in prior taxable years should be included in the gross income of the employee for the taxable year in which paid under the provisions of Section 39.22(a)-3 of Regulations 118."

Section 106 is very specific in its terms and applies only to employer contributions made to accident or health plans. Since tax laws are strictly construed and deductions and exclusions from income are matters of legislative grace, employer contributions to purchase individual contracts for his employees in a legal service plan will be includable in gross income under Section 61 of the Code unless a specific legislative provision excludes such payments from gross income.

It is desirable that all employees who are receiving a group legal service plan as an additional fringe benefit should receive the same type of federal income tax treatment. Whether a person receives this benefit as a result of collective bargaining, an employer-instituted benefit, or an employer's purchase of an individual contract should have no bearing on the federal income tax treatment of the particular individual. Therefore, to insure that the employee for whom an individual contract is purchased receives the same tax treatment as a union member who receives his benefits as a result of collective bargaining, Internal Revenue Code Section 106 should be amended.

CONCLUSION

Sections 105 and 106 of the Internal Revenue Code of 1954 should be amended to give similar income tax treatment to group legal service plan participants as is now given group health and accident plan participants. At the present time the income tax treatment of some participants in such group legal service plans is uncertain. The use of group legal service plans as a fringe benefit is expected to increase dramatically, since Congress recently amended Section 302(c) of the Taft-Hartley Act to permit group legal service plans to be administered under the trust fund provisions of that Act. It is therefore imperative that Section 105 of the Code be amended to state that neither services rendered nor reimbursements made to individuals are to be considered gross income as that term is defined in Section 61(a)(1) of the Code. Moreover, Section 106 should be amended to state clearly that employer contributions to group legal service plans will not be includable in gross income of any participating employee.

AN ACT TO AMEND THE INTERNAL REVENUE CODE OF 1954

Section 1. Part III of Subchapter B of Chapter I of the Internal Revenue Code of 1954 is amended by adding at the end of Section 105 the following new subsection (b) and redesignating the present subsections (a) through (g) as paragraphs (1) through (7) of subsection (a), Amounts Received under Accident and Health Plans and the present paragraphs of subsections (c) and (e) are redesignated as subparagraphs:

"Section 105. AMOUNTS RECEIVED UNDER ACCIDENT AND HEALTH PLANS AND LEGAL SERVICES PLANS.

(a) Amounts Received under Accident and Health Plans.

(b) Services and Amounts Received under Legal Service Plans.

Gross income does not include:

(1) legal services provided by a group legal service plan to a taxpayer, his spouse, and his dependents (as defined in Section 152), or

(2) amounts paid, directly or indirectly, by a group legal service plan to a taxpayer to reimburse the taxpayer for expenses incurred by him for the provision of legal services to the taxpayer, his spouse, and his dependents (as defined in Section 152).

Section 2. Part III of Subchapter B of Chapter I of the Internal Revenue Code of 1954 is amended by adding at the end of Section 106 the following new subsection (b) and redesignating the present material in Section 106 as subsection (a):

"Section 106. CONTRIBUTIONS BY EMPLOYER TO ACCIDENT AND HEALTH PLANS AND LEGAL SERVICES PLANS.

"(a) Accident and Health Plans . . . .

"(b) Legal Services Plans. Gross income does not include contributions by the employer to legal services plans for compensation (through insurance or otherwise) to his employees for the costs of legal services incurred by his employees, his employees' spouses, and his employees' dependents (as defined in Section 152)."

Section 3. The amendments made by Sections 1 and 2 shall apply to taxable years beginning after December 31, 1973.

SUMMARY OF STATEMENT IN SUPPORT OF SENATE FINANCE COMMITTEE AMENDMENT TO ADD THE PROVISIONS OF H.R. 11920 DEALING WITH SWAP FUNDS, AS PASSED BY THE HOUSE, WITH AMENDMENTS, TO H.R. 10612, THE TAX REFORM ACT OF 1976

The transition provisions of H.R. 11920, the exchange fund (swap fund) bill, as passed by the House on May 3, 1976, should be continued when that bill is added to H.R. 10612, the Tax Reform Act of 1976, as a Senate Finance Committee amendment. These transition provisions provide equitable treatment to funds which have incurred extraordinary expenditures of money and time in reliance on existing law and the Internal Revenue Service policy of granting favorable rulings to such funds. Any other treatment would be extremely unfair and contrary to prior Congressional practice.

These provisions represent the careful judgment of the Ways and Means Committee after separate public hearings and a separate open mark-up session on this particular matter. The Treasury Department filed a formal statement which supported these transition provisions, and Treasury testified extensively in the mark-up session. The transition provisions were adopted by the House after debate on the House floor. They have been endorsed by the Senate Finance Committee and amplified to include some other funds which also relied heavily on the Internal Revenue Service ruling policy.

H.R. 11920 would amend section 721 of the Internal Code to deny tax-free treatment for transfers to partnership

exchange funds made after February 17, 1976. It contains transition provisions for transfers made after February 17, 1976, where a ruling request was filed with the Internal Revenue Service and a registration statement was filed (if required) with the Securities and Exchange Commission before February 17, 1976, or March 29, 1976, purusuant to this Committee's decision. In addition, ceiling and time limits are imposed on transfers qualifying under these transition provisions.

H. R. 11920, introduced on February 17, 1976, represents a change in the Internal Revenue Service ruling policy that such funds could be organized tax-free under section 721 of the Code. Before that date, in reliance upon that policy, a major expenditure of time and money was made by some groups in the organization of these funds, including the filing of ruling requests with the Service and registration statements (if required) with the SEC. The purpose of the transition provisions is to prevent H.R. 11920 from being inequitably applied to these cases. These provisions are sound and consistent with prior Congressional actions in this area. They should in all events be included in H.R. 10612, the Tax Reform Act of 1976, as reported by the Senate Finance Committee.

July 20, 1976

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Houston, Texas
for:
American General Capital Management, Inc.
Boston Company Exchange Associates
Fidelity Exchange Fund
State Street Exchange Fund

STATEMENT IN SUPPORT OF SENATE FINANCE COMMITTEE AMENDMENT TO ADD THE PROVISIONS OF H.R. 11920 DEALING WITH "SWAP FUNDS", AS PASSED BY THE HOUSE, WITH AMENDMENTS, TO H.R. 10612, THE TAX REFORM ACT OF 1976

This statement is submitted on behalf of State Street Exchange Fund, Fidelity Exchange Fund, American General Exchange Fund, and The Boston Company Exchange Associates. Each of these funds is a limited partnership organized as an "exchange fund" in reliance on assurances from the Internal Revenue Service that favorable rulings as to such funds could be obtained. The purpose of these exchange funds ("swap funds") is to allow investors to deposit appreciated securities with the funds without recognition of gain in order to obtain professional management and diversification.

Our interest in these proceedings is related to the Committee's action of June 11, 1976, with respect to swap funds. On that date, the Committee adopted certain amendments to H.R. 11920, which had been passed by the House on May 3, 1976, and the Committee voted to add the provisions of H.R. 11920 with such amendments to H.R. 10612, the Tax Reform Act of 1976.

The provisions of H.R. 11920 as passed by the House would make any transfer of appreciated securities in exchange for an interest in a limited partnership a taxable event if such exchange occurs after February 17, 1976, unless certain conditions exist. These conditions are that:

A. The Fund must have filed a ruling request with the Internal Revenue Service, and a registration statement with the Securities and Exchange Commission if such a registration

statement is required by law, on or before February 17, 1976 (the date the bill was introduced);

B. The securities being exchanged must be deposited with the Fund within 60 days after enactment of these provisions, and the exchange must take place within 90 days after enactment; and

C. The aggregate value of securities exchanged must not exceed $100,000,000, or $25,000,000 in the case of partnerships not required to file a registration statement with the Securities and Exchange Commission.

To the best of our knowledge, the four funds for whom this Statement is filed (supra, p. 1), plus the Vance Sanders Exchange Fund, are the only funds which satisfy these conditions.

The action taken by the Senate Finance Committee reflects, in effect, three separate determinations --

1. The House was correct in changing the tax laws to make an exchange of appreciated securities for an interest in a limited partnership a taxable event;

2. The House was equally correct in following the past consistent policy of Congress in these circumstances, where taxpayers have relied on existing law and IRS ruling policy, to include a transition or effective date rule which recognizes the legitimate interests of those who relied on existing law; and

3. Such transition or effective date rule should be broadened somewhat, by moving the date by which IRS and SEC filings must have occurred, from February 17, 1976, to March 29, 1976, to protect two other funds which also relied on existing law and the IRS policy of approving the creation of such funds.

This submission is directed solely to Point No. 2 above.

There are two questions relating to the determination by the Senate Finance Committee that such transition provisions should be included:

1. Was this matter "the subject of sufficient public hearings and discussion"? (Press Release, July 8, 1976. Committee on Finance, United States Senate.)

2. Was the decision an appropriate one?

As to the first question, immediately following the introduction of H.R. 11920 by Congressman Ullman and others on February 17, 1976, funds in process of organization had extensive discussions with the Staff of the Joint Committee on Internal Revenue Taxation. They provided full information as to their reliance on the IRS ruling policy. On March 29, 1976, a full day of hearings on H.R. 11920 was held by the House Ways and Means Committee. The principal matter considered in those hearings was the proper transition or effective date rule -- whether those funds which had been organized in reliance on existing law and the IRS ruling policy should be allowed to go forward, and if so, under what limitations. It was the primary focus of the testimony not only of the four funds for whom this Statement is submitted (supra, p. 1), but also of a variety of other witnesses, including the Legislative Director of "Taxation with Representation".

Testimony was given by the U.S. Treasury Department and by private parties supporting and opposing the inclusion of a transition provision to provide for funds which had relied on the IRS ruling policy. The Joint Committee summarized the issues and the various presentations for the consideration of the House Ways

and Means Committee. The Report of the Ways and Means Committee accompanying H.R. 11920 contained detailed discussion of the reasons for the transition provisions, and these provisions were the subject of debate on the House floor on May 3, 1976, when H.R. 11920 was passed by the House. Thus, while there have been no

Thus, while there have been no hearings before the Senate Finance Committee, the subject matter of transition provisions received active, open, and extensive consideration in the course of the passage of H.R. 11920 by the House. The same staff which serves this Committee was actively involved in that consideration.

As to the second question above, the press release giving notice of these hearings requested additional information relating to these amendments. As stated, our comments will be directed solely towards the question whether the transition provisions contained in H.R. 11920 are appropriate. We take no position on whether they should be expanded as was done by this Committee.

The transition provisions were included in H.R. 11920 for one reason and one reason only. The House recognized that funds which had been organized in reliance on existing law and the IRS ruling policy had proceeded in good faith and should be protected.

The planning and initial formation of each of the four funds covered by this submission began in October, 1975. Relying upon the policy of the Internal Revenue Service that tax-free transfers to exchange funds may be effected under section 721 of the Code, these funds and others expended

large sums of money, time, and energy before February 17, 1976, when H.R. 11920 was first introduced. Without transition relief, the enactment of H.R. 11920 would cause this effort to be wasted. Therefore, it is strongly urged that the Committee continue the transition provisions in H.R. 11920, at least to the extent they were passed by the House on May 3, 1976.

Since May, 1967, because of the 1966 amendments to section 351, it has been inappropriate to use a corporation as a vehicle for an exchange fund. On April 28, 1975, however, the Internal Revenue Service issued a ruling to Mr. William A. Penner, 33 Locust Road, Winnetka, Illinois, regarding a proposed Vance Sanders Exchange Fund. That ruling provided that the Vance Sanders Exchange Fund, a limited partnership under California law, would be treated as a partnership for federal income tax purposes. The ruling further provided that no gain or loss would be recognized to the fund or to any of the limited partners on account of their contribution of stock or securities in exchange for an interest in the fund. That ruling was reexamined and reapproved by the Internal Revenue Service on October 15 and October 29, 1975. It is our understanding that before such ruling was issued, it was reviewed by many responsible Internal Revenue Service personnel, including the Office of Chief Counsel, Internal Revenue Service.

While the ruling issued to Vance Sanders was technically a private ruling, it was issued by the Internal Revenue Service with full knowledge that it was issued in connection

with a proposed public offering of the Vance Sanders limited partnership interests, and that since such public offering would involve the filing of a registration statement with the Securities and Exchange Commission, the ruling would be widely publicized and would inevitably come to the attention of the investment community, which it in fact did.

The background of the organization of the State Street Exchange Fund illustrates the extent to which Internal Revenue Service policy on this subject was established; it also illustrates the extraordinary reliance placed upon this policy by each of the funds on whose behalf this statement is submitted (supra, p. 1).

Having become aware of the Vance Sanders ruling early in October, 1975, and because of their experience in the formation and management of the Federal Street Funds, which were organized as exchange funds in 1961 and 1967, State Street Research and Management Company became interested in forming a limited partnership to act as an exchange fund. After consultation with their attorneys, the State Street group authorized its attorneys to seek a favorable ruling from the Internal Revenue Service on behalf of the State Street Exchange Fund.

On November 7, 1975, a request for ruling was hand-delivered to the Chief of Ruling Section 2 of the Individual Income Tax Branch, Office of the Assistant Commissioner of Internal Revenue (Technical), who was the IRS official with responsibility for processing such a ruling request. State Street's attorney was informed at that conference that while the Service would require additional information with respect to the ruling request, such as a copy of the partnership agreement and copies of the material to be filed with the Securities and Exchange Commission, there appeared to be no difficulty issuing the ruling, and that it was not unreasonable to expect that it might be issued in January of 1976.

On November 18, 1975, a letter was received from the Chief of the Individual Income Tax Branch making reference to various Revenue Procedures dealing with the conditions necessary for obtaining a ruling, but containing no suggestion that a ruling would not be issued.

Thereafter, there was correspondence with various officials of the Internal Revenue Service on 11/18, 11/20, 12/11, and 12/30/75, and 1/6, 1/27, 2/6, 2/11, and 3/9/76. There were personal visits to Washington to keep current on the ruling's status on 1/22, 2/11, 2/18 and 2/26/76. There were at least forty telephone conversations with IRS officials.

Based upon the initial conversation with the IRS official on November 7, 1975, State Street's attorney advised State Street management that it was reasonable to anticipate that the Internal Revenue Service would rule that the State Street Exchange Fund would be treated as a partnership for federal income tax purposes and that depositors of securities in that partnership would not be required to recognize any gain or loss upon the transfer of their securities to the partnership in exchange for a limited partnership interest. Proceeding on this information, State Street thereupon instructed its counsel to prepare a registration statement to be filed with the Securities and Exchange Commission and to take appropriate action to comply with "Blue Sky" regulations. State Street also engaged Goldman Sachs & Company as its broker-dealer, engaged underwriters, engaged the services of a custodian and depository bank, instructed its accountants to prepare appropriate financial statements, authorized its attorneys to incur printing costs on its behalf, and directed its own personnel to proceed with all of the extensive activities necessary to the organization of the State Street Exchange Fund.

From November 7, 1975, through early January, 1976, nothing in the correspondence and conversations with the appropriate officers of the Internal Revenue Service concerning the pending ruling request contained <u>any</u> indication from the Service that a ruling would not issue in due course.

Sometime after the first week in January, 1976, counsel for State Street was informed for the first time by telephone that the Internal Revenue Service was temporarily withholding the issuance of rulings with respect to partnership exchange funds. He was also advised, however, that it was still anticipated that a favorable ruling would be issued after some brief delay. Continuing further conversations with IRS officials occurred, but it was not until February 11, 1976, that it became apparent that a ruling might not be issued. <u>It was not until H.R. 11920 was introduced on February 17, 1976, that any of the funds were definitely advised that the ruling would not be issued</u>.

Each of the funds submitting this Statement (supra, p. 1) had experience similar to that of State Street -- that is, knowledge in early October, 1975, of the issuance by the IRS of the Vance Sanders ruling; conferences with IRS officials as a result of which counsel concluded that a similar ruling would be issued to them; preparation of actual filings with the IRS, and, where required, with the SEC; and continuing contact with the IRS officials up until February 17, 1976, when they were advised for the first time that their rulings would not be issued despite the earlier issuance of a ruling to Vance Sanders.

Throughout this period, each of the funds submitting this Statement expended very considerable amounts on professional fees, printing, advertising, and promotion costs. Direct expenditures by State Street and Goldman Sachs in connection with

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the State Street Exchange Fund alone exceed $408,000. Large amounts of time of in-house personnel were devoted to the organization of these funds. In addition, the time and energy of underwriting personnel and of individual investment dealers throughout the country was expended. Each of these organizations have committed money, time, energy, and their reputations to this undertaking. All of this was the direct result of the issuance of the Vance Sanders ruling by the IRS and the subsequent affirmance to each of the funds that the Vance Sanders ruling was existing law which could be relied upon and on the basis of which similar ruling letters would be issued to the funds.

The Treasury Department has itself recognized that it "would be unfair" to enact what would amount to retroactive legislation for these funds in light of the assurances they had received from the IRS. Statement of William M. Goldstein, Deputy Assistant Secretary of the Treasury for Tax Policy, on H.R. 11920, Before The Ways and Means Committee, March 29, 1976. Consequently, in its testimony before the Ways and Means Committee, the Treasury Department recommended that the effective date provisions protect Vance Sanders and the four funds submitting this Statement. This recommendation was adopted by the Ways and Means Committee. The bill, as reported by that Committee, included such provisions. As the Committee's report (H.R. Rep. 94-1049) indicates, these provisions reflected Congressional recognition that funds which had relied on

existing law and the IRS ruling policy should be permitted to go forward because of their reliance. These were the groups which had taken "substantial steps toward establishing an exchange fund by applying for a tax ruling, registering their proposed offerings with the SEC, lining up brokers and dealer-managers, and soliciting expressions of interest from potential depositors". By including limitations on the time of deposit and on the value of securities which could be exchanged, the legislation has been structured in such a way that the effective date provisions will protect only those who substantially relied and will not frustrate the underlying purpose of the legislation.

There are ample precedents for limiting the retroactive effect of both rulings and legislation:

1. In the case of exchange funds organized as corporations under section 351 of the Code, in 1961, when the Service decided to terminate the granting of rulings, the IRS announced that its no-ruling policy would be applicable only to requests for rulings filed after February 9, 1961, the date the no-ruling policy was announced.

2. Similarly, in 1966, when the Service amended its regulations to eliminate the tax-free character of the exchange funds organized as corporations, though it first proposed to enter into closing agreements with existing funds if the transfer of securities occurred prior to July 14, 1966, this was later changed to cover securities deposited

prior to that date. Finally the Service announced it would enter into closing agreements with funds if the registration statement filed with the SEC became effective on or before July 14th and the transfer included only stock or securities deposited pursuant to solicitations made before that date.

3. In the meantime, legislation taxing transfers to exchange funds organized as corporations was introduced and was ultimately enacted on November 6, 1966. Section 351(d) provided, however, that the new law would not apply to transfers made before June 30, 1967 if: (a) the registration statement was filed before January 1, 1967, and (b) the property transferred was deposited before May 1, 1967.

Because of the justifiable reliance of the partnership exchange funds on existing law and the IRS ruling policy; because of the precedent of the remedial legislation in November, 1966, and many similar Congressional precedents; and finally because equity calls for it, Congress should adopt the transition provisions of H.R. 11920. Without them, the four funds submitting this Statement would each lose substantial investments in time and money. They might suffer a serious loss of reputation, goodwill, and credibility in the financial community. They relied on the Vance Sanders ruling and IRS indications they would receive identical rulings; they proceeded in good faith and should not suffer such losses as a result. They are entitled to fair treatment. The transition provisions of H.R. 11920 provide fair treatment

while limiting the relief allowed to that deemed proper in the judgment of the House Ways and Means Committee and this Committee. Those provisions should be continued in H.R. 10612.

July 20, 1976

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for:
American General Capital Management, Inc.
Boston Company Exchange Associates
Fidelity Exchange Fund
State Street Exchange Fund

**Summary Statement of Vance, Sanders & Company, Inc.
Regarding H.R. 10612
Before the Senate Committee on Finance
July 22, 1976**

My name is M. Dozier Gardner. I am a Vice President and Director of Vance, Sanders & Company, Inc. ("Vance, Sanders"). My testimony this morning is on behalf of Vance, Sanders and Vance, Sanders Exchange Fund (the "Fund"). I am submitting a written summary statement, which includes as an addendum the Summary and Statement of Vance, Sanders & Company, Inc. regarding H.R. 11920, which was made to the House Ways and Means Committee at the public hearing held on March 29, 1976.

Briefly stated, an exchange fund is formed for the purpose of providing an investment medium consisting of a diversified and supervised portfolio of equity securities to investors holding blocks of individual securities with large unrealized appreciation and who wish to exchange such holdings for shares of the Fund without realizing any gain for Federal income tax purposes at the time of exchange. Contributions of property are solicited by dealers for a stated period of time, and at the end of the solicitation period the Fund sends a report to depositors setting forth all securities then on deposit. Depositors have two weeks in which to exercise their rights to withdraw their deposits and shortly thereafter the actual exchange takes place. The exchange for shares of Vance, Sanders Exchange Fund took place on June 1, 1976.

It is our position that the exchange, which was not taxable under existing law or under a proposed change in the existing law, should not now be made taxable. Thus, we are not asking for any relief from action taken to date, but we recommend that no action be taken which would retroactively make the completed exchange taxable.

Compliance with Existing Law

Vance, Sanders has gone to great effort and expense to insure that the Fund complies with all applicable Federal and state law:

1. Vance, Sanders Exchange Fund was organized as a limited partnership rather than a corporation because a partner contributing property to a partnership does not incur any capital gains tax by reason of such contribution. In order to confirm the tax-free treatment of the exchange, a ruling request was filed with the Internal Revenue Service in November of 1972, and on April 28, 1975, the Internal Revenue Service issued a favorable ruling to the Fund confirming the tax-free basis of the exchange. Supplemental rulings were issued on October 15 and October 29, 1975. The original and supplemental rulings were issued with full knowledge by the IRS that a public offering of the shares of Vance, Sanders Exchange Fund would be made.

2. In order to make a public offering of shares of Vance, Sanders Exchange Fund, it was necessary to register the Fund as an investment company under the Investment Company Act of 1940. Accordingly, during the five months' period immediately following receipt of the ruling, officers and counsel for Vance, Sanders discussed compliance with the securities laws with the staff of the Securities and Exchange Commission. The problems presented were novel, for the Commission had not previously found that an investment company in limited partnership form could meet

the requirements of the Investment Company Act. Exempting the Fund from certain provisions of the Investment Company Act was necessary, and to issue such an order, the Commission had to find that such order was "in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act." On January 5, 1976, an exemptive order was issued, and the registration statement filed on September 30, 1975, also became effective on that date.

3. The laws of several states were satisfied in order to permit the shares of the Fund to be sold in all states.

Solicitation of Deposits

On September 30, 1975, a registration statement was filed with the SEC when it appeared, after numerous conferences with the SEC, that the exemptive order would be issued. In October, Vance, Sanders & Company, Inc. organized a dealer group to begin the solicitation of deposits. Physical deposits of securities were not permitted until the registration statement became effective, January 5, 1976, and deposits were received during January and February of this year. The solicitation of deposits ended on February 23, 1976, and only investors who had mailed or were in the process of mailing their securities on or before that date were eligible to participate as partners in the Fund. As a result of dealers' efforts, approximately 1,000 investors in 46 states deposited securities, which deposits totaled in amount approximately $140,000,000.

All actions taken by the Fund, Vance, Sanders, dealers and investors were taken in good faith in reliance on existing law as evidenced by the ruling and the effective registration statement with the Securities and Exchange Commission.

H.R. 11920

On February 17, 1976, Congressman Ullman, Chairman of the House Ways and Means Committee, along with other members of the Committee, introduced a bill, H.R. 11920, which provided, among other matters relating to investment companies, that the transfer of securities to a partnership which would be treated as an investment company would not be tax-free if such transfer was made after February 17, 1976.

Upon the introduction of such bill, and because the technical "transfer" had not yet occurred, Vance, Sanders Exchange Fund announced to its depositors that the Special Report to Depositors would not be mailed unless some relief was granted from the proposed February 17th date. The Fund protested to members of the House of Representatives, the Treasury Department and the staff of the Joint Committee on Internal Revenue Taxation that the proposed effective date of February 17th would be unfair because the Fund had acted in good faith prior to that date on existing law.

The House Ways and Means Committee held hearings on the bill on March 29, 1976, at which hearings the Treasury Department acknowledged the validity of the IRS ruling to Vance, Sanders Exchange Fund and recommended that the February 17th date should not be applicable to transfers to the Vance, Sanders Exchange Fund. On April 7, 1976, the House Ways and Means Committee considered the bill in open session. At such session the staff of the Joint Committee recommended that the bill be amended to grant the Fund relief from the February 17th date, with which recommendation the Treasury again concurred. The House Ways and Means Committee voted to amend the bill in a way which would

permit the transfer on a tax-free basis of those securities which were on deposit with the depository agent on February 29, 1976, whether or not transferred prior to enactment of the legislation. Thus, the House Ways and Means Committee, the staff of the Joint Committee and the Treasury Department considered the question as to whether the transfer of securities to Vance, Sanders Exchange Fund should be taxable, and concluded, in effect, that it would be inappropriate to apply the February 17th date in the case of the Fund.

On May 3, 1976, the House of Representatives, by a vote of 348 to 14, approved the bill as amended by the House Ways and Means Committee.

Action by the Fund Subsequent to May 3, 1976

In view of the relief granted from the proposed February 17th date, the Fund mailed the Special report to depositors on May 11, 1976, and the exchange of securities for shares of the Fund took place on June 1, 1976. The value of the securities so exchanged, after withdrawals and commissions, was approximately $105,000,000. In making the exchange, the Fund was in compliance not only with existing law but with the provisions of proposed legislation to change the law.

As stated by Congressman Ullman on the floor of the House with respect to Vance Sanders Exchange Fund:

> "I will say to the gentlemen that we attempted to achieve some equity in the tax law. In the one instance, a company had complied with existing law, had gotten permission from the Internal Revenue Service and the (SEC), had gone forward and invested a great deal of funds in developing a limited partnership and, for all practical purposes, had a consummated venture. It is very seldom in tax law that we get into a situation like that and eliminate the tax provisions that were the basis for the transaction."

It should be noted that in presentations to the Ways and Means Committee, staff of the Joint Committee on Internal Revenue Taxation and Treasury, we informed them of the fact that the Fund intended to make the exchange if the House granted relief from the February 17th date, and the bill, as passed, was drawn in such a way as to permit the exchange to take place before the enactment of the bill.

It is our position that the exchange, which was not taxable under existing law or under a proposed change in the existing law, should not now be made taxable. Thus, we are not asking for any relief from action taken to date, but we recommend that no action be taken which would retroactively make the completed exchange taxable.

**SUMMARY OF
STATEMENT OF VANCE, SANDERS & COMPANY, INC.
REGARDING H. R. 11920
BEFORE
THE COMMITTEE ON WAYS AND MEANS**

MARCH 29, 1976

**Effective date of H. R. 11920 -
Effect on Vance, Sanders Exchange Fund**

The transfer of property, including investment securities, to a partnership in exchange for a partnership interest is tax-free under existing law. Certain of the provisions of H. R. 11920, introduced February 17, 1976, would reverse existing law and impose an income tax on a person transferring securities to an investment company operating as a partnership. The Bill, as presently drafted, applies to transfers made after February 17, 1976, the date of its introduction.

In April, 1975, almost a year prior to the introduction of H. R. 11920, the Vance, Sanders Exchange Fund, a California limited partnership (the "Fund"), obtained a ruling from the Internal Revenue Service that the transfer of securities to the Fund would be tax-free to the transferors. In reliance on this ruling, Vance, Sanders & Company, Inc. ("Vance, Sanders"), as dealer-manager and a general partner of the Fund, sought and obtained an exemptive order and clearance from the Securities and Exchange Commission to solicit deposits of securities to the Fund. With a preliminary prospectus solicitation nationally was begun on September 30, 1975, and between the effective date of the prospectus on January 5, 1976, and the closing date for deposits on February 23, 1976, deposits of securities were made to the Fund by approximately 1,000 investors in 46 states. As a technical matter, the "transfer" of these securities to the Fund did not occur

at the time the securities were deposited, and that transfer has now been delayed because of the introduction of H. R. 11920.

In reliance upon the IRS ruling of April 28, 1975, which constituted formal governmental assurance of the tax consequences of the proposed program, Vance, Sanders invested substantial funds in successfully registering the offering with the SEC and in soliciting deposits of securities from investors. Moreover, investors incurred expenses in evaluating the Fund, and broker-dealers spent time and incurred expenses in explaining the objectives of the Fund to investors. The estimated direct expenses of Vance, Sanders to organize, register, and promote this Fund were $349,000. An allocation of the cost of legal, sales, administrative and top management time devoted to the Fund would add to that figure $197,000. This investment is more than double the earnings of Vance, Sanders & Company over the last two years. We are advised that the expenses of broker-dealers and some depositors were also substantial.

It has been longstanding Congressional policy that changes in the tax law are not made applicable to those who have in good faith relied on existing law. Accordingly, when transactions are undertaken based upon existing tax laws, and a taxpayer has made a substantial investment of time and money, the effective date of changes in these laws has consistently taken into account the taxpayer's reliance.

As presently drafted, the Bill would prevent the tax-free transfer of securities to the Fund even though efforts of broker-dealers, and the investment decision by investors, were substantially completed prior to February 17, 1976, the date of the introduction of H. R. 11920. We believe that all of the investors who have made deposits to the Vance, Sanders Exchange Fund should be allowed to complete their exchange in accordance with existing law. Our records and the records of the depository bank indicate that approximately ninety-six percent of the deposits to the Fund were made by persons who evidenced some type of commitment to make their deposits on or before February 17, 1976. In these circumstances, fairness dictates that if this legislation is enacted, its effective date should be cha ged so as not to affect adversely those who made deposits to the Vance, Sanders Exchange Fund during its solicitation period. Fairness to the Fund's depositors also dictates that the existing uncertainty in this regard be eliminated at the earliest time.

Recommendation

It is recommended that the Committee announce as soon as possible that H.R. 11920 will not apply in the case of a transfer to a partnership exchange fund which had, on or before February 17, 1976, received a ruling from the Internal Revenue Service, and had an effective registration statement, and that the securities transferred to the Fund were deposited during a solicitation period which existed on February 17, 1976, even though ending thereafter. Such an announcement would be a reasonable and responsible approach to the existing inequity in respect of the Vance, Sanders Exchange Fund.

**STATEMENT OF VANCE, SANDERS & COMPANY, INC.
REGARDING H.R. 11920
BEFORE
THE COMMITTEE ON WAYS AND MEANS**

March 29, 1976

MR. CHAIRMAN AND MEMBERS OF THE WAYS AND MEANS COMMITTEE,

My name is M. Dozier Gardner. I am a Vice President and Director of Vance, Sanders & Company, Inc. (Vance, Sanders). My testimony this m . ı-ing is on behalf of Vance, Sanders & Company, Inc. and the Vance, Sanders Exchange Fund (Fund). We appreciate the opportunity to appear before this Committee to express our views regarding H. R. 11920. This Bill would amend pro''isions of the Internal Revenue Code to impose an income tax on certain exchanges which are tax-free under existing law. My remarks are directed to that portion of H.R. 11920 which would amend section 721 of the Internal Revenue Code in order to impose a tax upon transfers of securities to an investment company operating in partnership form, usually referred to as an exchange fund.

Background

Vance, Sanders is an investment adviser for eleven investment companies. The total assets under our management exceed 600 million dollars. The company's origins go back to the 1920's. It is one of the oldest firms engaged in managing and distributing investment companies. It is a publicly held company with approximately 2,600 shareholders, and its stock is traded on the over-the-counter market. Vance, Sanders is the organizer and a general partner of the Vance, Sanders Exchange Fund, a California limited partnership.

Formation and Operation of Partnership Exchange Funds.

A partnership exchange fund, such as the Vance, Sanders Exchange Fund, is a diversified investment company operating in the form of a partnership. Its purpose is to permit holders of securities to exchange them for an interest in a partnership which has a diversified portfolio of securities and professional management.

Formation of a partnership exchange fund requires considerable time, effort and expense. First, the partnership must be organized. A partnership exchange fund may be either a limited partnership or a general partnership. A limited partnership is generally preferred because limited partners are not personally liable for obligations of the partnership.

In order to solicit deposits of securities from investors, the exchange fund must file a prospectus and registration statement with the Securities and Exchange Commission. The prospectus and registration stat ment must meet the disclosure requirements of the securities laws. The securities laws require disclosure of all aspects of the partnership, including the investment objectives and other details of the proposed method of operation, as well as tax consequences to investors exchanging their securities for an interest in the partnership. The partnership must also satisfy the requirements of the Investment Com pany Act of 1940, or qualify for an exemption from certain of the applicable provisions. In addition, in order to solicit deposits from investors in certain states, the exchange fund must satisfy the other requirements contained in the "Blue Sky" laws applicable in those states.

Certain securities are listed in the prospectus as being generally acceptable for deposit. Securities offered for deposit to the partnership which

are not listed in the prospectus are reviewed by the investment adviser to the partnership and can be accepted or rejected for deposit in its discretion. Limitations are generally stated in the prospectus regarding the amount of certain securities which will be accepted for deposit. The Vance, Sanders Exchange Fund, for example, may not invest more than 5 percent of its assets in the securities of any one issuer, nor hold more than 10 percent of any class of security of any one issuer, and may not have more than 10 percent of its assets in "restricted securities."

Investors must make deposits to the partnership prior to the close of a deposit period stated in the prospectus. After the close of the deposit period, a report is mailed to depositors listing the portfolio of securities deposited. A limited period of time (generally 2 weeks) is established during which depositors are given the opportunity to withdraw deposits. The actual exchange takes place after the expiration of this period. On the exchange date, investors receive partnership interests in exchange for their securities in accordance with a predetermined dollar value. For example, in the Vance, Sanders Exchange Fund, investors will receive one partnership unit for each $50.00 of market value of securities transferred to the Fund. Partners may redeem their partnership interests at any time after the exchange has taken place with the redemption made in securities or cash at the option of the Fund's management.

Summary of Existing Tax Law Regarding Exchange Funds.

Section 721 of the Internal Revenue Code provides:

> "No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership."

Thus, it is clear that the provisions of existing tax law provide that a transfer of securities to a partnership exchange fund in exchange for a partnership interest

does not result in the recognition of taxable gain or loss to the partnership or the partner.

A person who transfers securities to a partnership exchange fund in exchange for a partnership interest has a tax basis for his partnership interest equal to his basis in the securities which he transferred. The partnership takes the same basis for the securities as the transferring partner. Accordingly, gain which is not recognized at the time of the transfer of the securities to the partnership will be recognized when a partner converts his partnership interest to cash, or when the partnership sells the securiites.

The provisions of existing law do not permit a tax-free transfer of securities to an investment company operating as a corporation. These provisions regarding corporations were adopted in 1966. At that time, section 351 of the Internal Revenue Code was amended to provide that gain or loss would be recognized upon the transfer of securities to a corporate exchange fund. These provisions were enacted on November 13, 1966. However, a "transitional" rule was adopted. The transitional rule provided that the new legislation did not apply in the case of a transfer of securities made on or before June 30, 1967, to a corporate exchange fund that registered with the Securities and Exchange Commission. The transitional rule was applicable if a registration statement was filed before January 1, 1967; the securities were deposited before May 1, 1967; and the actual exchange occurred on or before June 30, 1967.

The provisions of existing law are inconsistent. They prohibit tax-free transfers of securities to corporate exchange funds, but permit tax-free transfers of securities to partnership exchange funds. There does not appear to be any

policy reason which would support this distinction. We believe that there are substantial arguments which support the position that tax-free transfer of securities to both partnership and corporate exchange funds should be permitted. Others appearing before your Committee are presenting these arguments. We believe that those who argue that an income tax must be imposed where a person exchanges an interest in one security for a proportionate interest in many securities cannot reconcile their position with the fact that many of the provisions of existing tax law permit tax-free diversification. The reorganization provisions of the Code are a case in point. Under those provisions, a sole shareholder of a small corporation is permitted to achieve tax-free diversification if he exchanges his stock for a stock in a much larger diversified corporation. Prohibition of tax-free exchanges in the case of exchange funds is inconsistent with the principles of these reorganization provisions.

This Committee should also recognize that if an income tax is imposed on a transfer of securities to an exchange fund, the effect is frequently to prevent any transfer of these securities. In such event, the income tax law has the effect of "locking-in" an investor to one investment because of the income tax which would be incurred to obtain diversification. Our experience in this area convinces us that investors in an exchange fund pay more in taxes in the aggregate than would be paid if they were not participants in the fund. Accordingly, we believe that the decision regarding the merits of H. R. 11920 depends upon whether, as a matter of tax policy, tax-free diversification of investment assets ought to be permitted. Substantial arguments can be made on both sides of this question. However, that debate should not be distorted by what we believe is the mistaken notion that partnership exchange funds are a tax loophole. There is no convincing evi-

74-650 O - 76 - 23

dence that the provisions permitting tax-free diversification through partnership exchange funds will result in any loss of tax revenue.

Proposed Legislation

H. R. 11920, among other changes, would impose an income tax on persons who transfer securities to a partnership exchange fund. Our principal concern is with the damaging impact of its effective date. The Bill, as drafted, is effective with respect to any transfer after February 17, 1976, and therefore would apply to all depositors in the Vance, Sanders Exchange Fund. This effective date is extremely harsh and unfair to the Fund's depositors, broker-dealers who solicited these deposits, and Vance, Sanders. Each of these parties acted in reliance upon existing law and formal actions taken by the Internal Revenue Service and the Securities and Exchange Commission.

Reliance by Vance, Sanders, Broker-Dealers, and Investors

The reliance of Vance, Sanders upon the provisions of existing law and formal governmental assurance of favorable tax consequences is clear. It has been the view of knowledgeable tax experts that transfers of securities to a partnership exchange fund would be tax-free. However, in order to confirm this treatment, a ruling request was filed with the Internal Revenue Service in November of 1972. After two years of study, response to the ruling request confirming this view of the law was issued to the Vance, Sanders Exchange Fund in April of 1975. We understand that it received the attention of the Office of the Chief Counsel of the Internal Revenue Service. It was issued with full knowledge that a public offering was involved. Copies of the rulings issued to the Vance, Sanders Exchange Fund by the Internal Revenue Service are being submitted for the record.

Although the Internal Revenue Service ruling confirmed the tax consequences, another difficult hurdle was presented by the application of the securities laws to partnership exchange funds. Accordingly, during the five-month period immediately following receipt of the ruling, officers and counsel for Vance, Sanders discussed compliance with the securities laws with the staff of the Securities and Exchange Commission. The problems presented were novel, for the Commission had not previously found that an investment company in partnership form could meet the requirements of the securities laws. On September 30, 1975, a preliminary prospectus and registration statement were filed with the Commission when favorable action appeared probable. After the filing with the SEC, steps were taken to permit the Company to offer partnership interests in all 50 states and Puerto Rico. During the next several months, further meetings were held with the staff of the SEC. Prospectus changes were required in order to obtain clearance and compliance with or exemption from certain portions of the Investment Company Act of 1940. Clearance and an exemptive order were finally obtained from the SEC, and the Vance, Sanders Exchange Fund's prospectus became effective on January 5, 1976.

Beginning in October of 1975, with a preliminary prospectus which described applicable tax and securities law and contained a full description of the Internal Revenue Service ruling issued the Fund,Vance, Sanders' officers made trips to explain the concept and objectives of the Fund to prospective investors and broker-dealers in the various states. Meetings were held in 66 major cities in the United States. Substantial expenditures were also made by Vance, Sanders to establish the mechanics of Fund deposits and to research various securities to establish their acceptability for the Fund. In reliance on the tax ruling described in the Fund's preliminary prospectus, brokers began soliciting their clients.

Actual deposits of securities were not permitted until the registration statement became effective, January 5, 1976, and deposits were received during January and February of this year. As a result of our efforts, and those of broker-dealers throughout the country, more than 1,000 investors in 46 states deposited securities with the Fund's custodian, the New England Merchants National Bank. The efforts of broker-dealers, and the investment decisions by our investors, were substantially completed prior to February 17, 1976, the date of the introduction of H.R. 11920. Pursuant to our announcement on February 10, 1976, the exchange offer expired on February 23, 1976, and only investors who had mailed or transmitted their securities on or before that date were eligible to participate as partners in the Fund.

The total direct expenses of Vance, Sanders in organizing the Vance, Sanders Exchange Fund, soliciting deposits, and establishing deposit procedures, were approximately $349,000. An allocation of the cost of legal, sales, administrative and top management time devoted to the Fund would add to that figure $197,000, or a total figure of $546,000. This investment is more than double the earnings of the Company over the last two years. A detailed breakdown of these expenses is contained in an appendix to this statement. Substantially all of these expenses were made only after the Internal Revenue Service issued its ruling.

We have queried brokers and dealers who solicited deposits for the Fund as to their expenses. Many held sales meetings, incurred travel, telephone, literature, legal, and programming costs. Their most significant expenditure by far was the time devoted by salesmen which could have been used in other income-producing activites. Though I cannot provide an aggregate of all of these

expenses, the informed judgment of the two firms which were the most successful in soliciting deposits and accounted for $12.1 million and $11.7 million, or 8.1% and 7.8% of deposits, was that their direct and indirect expenses combined were $100,000 and $80,000 respectively.

At present, brokers participating in the solicitation have earned commissions from their efforts of $4.7 million under the terms of the Vance, Sanders Exchange Fund prospectus.

Finally, many individuals who have deposited securities have incurred legal expense in connection with ascertaining or securing the Fund's right to sell those securities, without restriction, as well as accounting expense in determining the tax cost basis of the securities deposited.

Effective Date of H.R. 11920

We respectfully request this Committee to announce a change in the proposed February 17, 1976 effective date of H.R. 11920 to assure that all of the investors who deposited securities in the Vance, Sanders Exchange Fund in reliance on its tax ruling will be permitted to complete the proposed exchange. This would include all of those who, under the terms of the Fund's prospectus, had securities or Letters of Transmittal either at or in transit to the depository bank before the close of the solicitation period on February 23, 1976.

Substantially all these investors had committed themselves with regard to their investment in the Fund prior to February 17, 1976. But, as a technical matter, the tax-free exchange of the investors' shares for interests in the Fund

could not occur until several weeks after the close of the deposit period. This is because before the exchange occurs, each investor has the opportunity to review for two weeks the portfolio of securities deposited for transfer to the Fund. Had H.R.11920 not been introduced on February 17, 1976, the exchange would now have occurred. It has been delayed solely because of the effective date of H.R. 11920 which if enacted as presently drafted, would make taxable the transfer of securities to Vance, Sanders Exchange Fund.

Congressional Action in Prior Revenue Acts.

In the past, when Congress has determined that the tax consequences under existing law should be changed, it has drawn the legislation in a manner which avoids detrimental consequences to those who have relied in good faith upon existing law. Thus, the 1966 legislation which eliminated tax-free transfers to corporate exchange funds did not apply to transactions in progress. Instead, for a limited time, the effective date permitted new funds not yet in process, to be formed and to qualify for tax-free exchange treatment. The situation of the Vance, Sanders Exchange Fund is substantially more equitable than the situation of corporate exchange funds in 1966. The Vance, Sanders Exchange Fund not only was in the process of accepting deposits, but also had received a ruling from the Internal Revenue Service that the transfer of securities to the Fund would be a non-taxable exchange under existing law.

Another example of Congressional sensitivity to this type of problem occurred in 1969 when Congress restricted the application of new legislation in circumstances similar to those present in the case of the Vance, Sanders Exchange Fund. The Tax Reform Act of 1969 contained a provision (section 311(d) of the Code)

imposing a capital gains tax on a corporation which redeemed its own stock with appreciated property. Prior to the introduction of this new legislation, some taxpayerr had received Internal Revenue Service rulings that no gain or loss was recognized by the corporation in such cases. At the time the legislation was being considered, there were a number of corporations in various stages of a redemption program. The Congress determined that this change in the law should not apply if, for example, a corporation had offered to redeem its own stock, or had filed a request for a ruling with the Internal Revenue Service, or a registration statement with the Securities and Exchange Commission prior to a date much later than the date the legislation was first proposed. The ruling request need not even have been granted, nor did the registration statement need to have become effective, in order to qualify for the treatment of then-existing law. Clearly, the position of the Fund, which has received a ruling and has an effective registration statement, is deserving of similarly equitable consideration.

Conclusion

In summary, all of the work necessary to organize the Fund, to comply with Federal and state law, to solicit and arrange for deposits and complete the exchange has been nearly accomplished. All that remains to be done is to prepare and mail a portfolio list to depositors, wait two weeks and then issue Fund shares in exchange for securities remaining on deposit. The mailing tc depositors should be made promptly. Depositors need to be informed that although the tax law may be changed by Congress after the exchange is made, this change in the law will not retroactively make taxable an exchange which was not subject to tax under the laws which existed during the solicitation period and on the day the exchange was made. The imposition of a tax in such circumstances would be extremely unfair and inequitable.

Moreover, fairness to the Fund's depositors dictates that the existing uncertainty be eliminated at the earliest time. I cannot over emphasize the critical nature of the timing of action by your Committee. Unlike other exchange funds which have solicitation periods ahead of them, Vance, Sanders Exchange Fund's solicitation period has ended. Depositors have already delivered securities to the Fund's custodian. Uncertainty is causing depositors to withdraw, and it is clear that delay will lead to further attrition. It would be unjust if the one fund that had obtained an Internal Revenue Service ruling and essentially completed its solicitation prior to the filing of H.R. 11920 should be injured by the Bill.

Recommendation

It is recommended that the Committee announce as soon as possible that H.R. 11920 will not apply in the case of a transfer to a partnership exchange fund which had, on or before February 17, 1976, received a ruling from the Internal Revenue Service, and had an effective registration statement, provided that the securities transferred to the Fund were deposited during a solicitation period which existed on February 17, 1976, even though ending thereafter. Such an announcement would be a reasonable and responsible approach to the existing inequity in respect of the Vance, Sanders Exchange Fund.

EXHIBIT

ESTIMATED EXPENSES PAID OR INCURRED
BY VANCE, SANDERS & COMPANY, INC.
IN CONNECTION WITH THE
VANCE, SANDERS EXCHANGE FUND
AS OF 2/28/76

Legal - Massachusetts	$ 50,000
California	35,000
Accounting	4,500
New England Merchants National Bank (Depository Bank)	50,000
S.E.C. Registration Fees	21,200
Blue Sky Fees (50 States and Puerto Rico)	23,000
Postage and Express Charges	18,500
Literature	75,000
Telephone	12,000
Officers' Travel	19,000
Promotion other than Road Shows	5,000
Road Shows (meeting expense only - does not include travel)	21,300
Additional Payroll (2 employees - salary only)	14,030
Estimated Direct Cost Incurred	$348,530
Officers' Salary Allocation	197,108
	$545,638

JOHNSON, LANE, SPACE, SMITH & CO., INC.
Member
New York Stock Exchange
American Stock Exchange
COMMERCE BUILDING. 34 BROAD STREET, N W
ATLANTA, GEORGIA 30303
PHONE 577-5577
AREA CODE 404

Summary of Attached Affidavit Dated May 7, 1976

1. In September, 1975, Johnson, Lane, Space, Smith & Co., Inc. ("JLSS") learned that Vance, Sanders had received a tax ruling concerning a limited partnership exchange fund. In reliance of such ruling and other existing laws, JLSS immediately began to explore the feasibility of sponsoring a similar fund. JLSS hoped to secure the services of Provident National Bank ("Provident") of Philadelphia, Pennsylvania, as investment advisor to the fund.

2. During October, November, and December, representatives of JLSS were continually in contact with representatives of Provident. Numerous telephone and written communications were exchanged and three meetings were held in Philadelphia on November 12, 1975, December 2 and 3, 1975, and December 21 and 22, 1975. As a result of these extensive communications and meetings, an agreement in principal was reached, finalized and executed by both parties on December 22, 1975. Under the terms of this agreement, Provident will act as Investment Advisor to the Chestnut Street Exchange Fund and JLSS will act as Dealer-Manager.

3. During the period between the execution of the above agreement and continuing to February 17, 1976, JLSS continued to devote substantial time and effort in connection with the formation of the Fund. In late December, 1975, accountants and lawyers were employed to (i) form a California limited partnership (ii) request a ruling from the IRS and (iii) prepare and file a S-5 registration statement with the S. E. C. Several drafting sessions were held and by February 17, 1976, both the S-5 and the IRS requests were virtually ready for filing.

4. A meeting was scheduled for February 23, 1976, to finalize the Registration Statement and the IRS ruling request. This meeting was postponed on February 19, 1976, when JLSS and Provident were advised that HR 11920 had been introduced and that the IRS would issue no further rulings pending the outcome of the legislation.

5. In view of the substantial amount of time and money which JLSS had already invested in the project, a decision was made in March, 1976, to continue. The S-5 Registration Statement was then duly filed with the S. E. C. on March 25, 1976, and the tax ruling request was filed with IRS on March 26, 1976.

6. As a result of its efforts in organizing the Fund, at May 7, 1976, JLSS had incurred expenses of about $80,000.00. Approximately half of these expenses were incurred prior to February 17, 1976.

But for the issuance of the April 28, 1975, ruling by the Internal Revenue Service to Vance, Sanders and the existing laws, upon which JLSS relied, the foregoing expenses would not have been incurred.

STATE OF GEORGIA

COUNTY OF FULTON

AFFIDAVIT

The undersigned HARRISON CLARKE, having been duly sworn, deposes and says:

1.

He is First Vice President of Johnson, Lane, Space, Smith & Co., Inc. (the "Company"), a registered broker-dealer under the Securities Exchange Act of 1934 with principal offices in Savannah and Atlanta, Georgia, and has held such position at all times relevant to the facts set forth in this Affidavit. Having held such position, he is familiar with the business of the Company and has personal knowledge of the facts set forth herein, all of which are true.

2.

In September, 1975 the Company was advised that the Vance, Sanders Exchange Fund ("Vance, Sanders"), a California limited partnership proposing to operate as an open-end diversified investment company, had on April 28, 1975 received a ruling from the Internal Revenue Service to the effect that:

(A) For Federal income tax purposes, Vance, Sanders would be characterized as a partnership and not an association taxable as a corporation.

(B) No gain or loss would be recognized to Vance, Sanders or to any of its limited partners on a contribution of stock or securities in exchange for an interest in Vance, Sanders.

(C) The basis of the partnership interest of the limited partners of Vance, Sanders would be the amount of any money and the adjusted basis of any property contributed at the time of the contribution.

(D) The basis of the property contributed to Vance,

Sanders by limited partners would be the adjusted basis of such property to the limited partners at the time of contribution.

3.

In reliance on the Internal Revenue Service's ruling to Vance, Sanders and other existing laws, the Company immediately began to explore the feasibility of sponsoring a similar exchange fund, later designated the "Chestnut Street Exchange Fund" (the "Fund"), for which the Company would act as dealer-manager.

The Company hoped to secure the services of Provident National Bank ("Provident") of Philadelphia, Pennsylvania as investment advisor and transfer agent of the Fund, and, as hereinafter described, Provident agreed to serve in such capacities. Because of certain prohibitions under existing law, including the Glass-Steagall Act, all of the expenses incurred in organizing and registering the Fund were to be paid by the Company.

4.

Accordingly, during the remainder of 1975 and prior to February 17, 1976, the Company spent substantial time and money in organizing and preparing to market the Fund.

5.

During October, November and December, 1975, representatives of the Company were continually in contact with representatives of Provident. In addition to numerous telephone and written communications between representatives of the Company and Provident during such period, the following meetings were held:

(A) a meeting attended by Mr. Richard M. Somers, Jr. of the Company and representatives of Provident was held on November 12, 1975 in Philadelphia;

(B) a meeting attended by Messrs. Somers and Reider A. Trosdal, Jr. and the undersigned on behalf of

the Company and representatives of Provident was held in Philadelphia on December 2 and 3, 1975; and

(C) a third meeting was held in Philadelphia on December 21 and 22, 1975, which was attended by Mr. Somers and the undersigned on behalf of the Company and by representatives of Provident.

As a result of the above extensive communications and meetings, an agreement in principle was reached between the Company and Provident, and the agreement (the "Agreement") was finalized and executed by both parties on December 22, 1975.

6.

During the period commencing with the execution of the Agreement and continuing to February 17, 1976, the Company continued to devote substantial time and effort toward the formation of, and the preparation of marketing plans for the offering of interests in, the Fund. Shortly after the Agreement was executed, the Company employed accountants and lawyers who were instructed to form a California limited partnership, request a ruling from the Internal Revenue Service as to the tax effects of investments in the Fund, and prepare and file with the Securities and Exchange Commission a Registration Statement on Form S-5. A detailed planning conference between the Company, Provident and their respective counsels was held on January 20, 1976 in Philadelphia to discuss the Fund and drafts of certain documents, including the Registration Statement on Form S-5 and the request for a ruling from the Internal Revenue Service, which had been prepared by counsel for the Company and to review and finalize the work assignment agenda. Counsel for the Company, together with employees of the Company, spent considerable time and effort prior and subsequent to the meeting, and prior to February 17, 1976, preparing, reviewing and revising these and other requisite documents.

7.

On February 19, 1976, the Company and Provident

were advised that H. R. 11920 had been introduced and that the Internal Revenue Service would issue no further rulings pending the outcome of this legislation. Accordingly, a meeting, originally scheduled for February 23, 1976 to finalize the Registration Statement, the request for a ruling from the Internal Revenue Service and other related matters, was postponed. Notwithstanding such postponement, in view of the substantial amount of time and money which the Company had already invested in the project, a decision was made in March, 1976 to continue to proceed with the preparation of the Form S-5 Registration Statement, which was duly filed with the Securities and Exchange Commission on March 25, 1976, and the preparation of the request for a ruling from the Internal Revenue Service, which was filed on March 26, 1976.

8.

As a result of its efforts in organizing the Fund, the Company has incurred expenses which are as follows:

Category of Expense	Prior to 2/17/76	2/17/76 - 4/30/76	Total
Travel	$ 2,770.74	$ 910.20	$ 3,680.94
Compensation To Personnel	18,300.00	7,750.00	26,050.00
Telephone	1,134.75	276.50	1,411.25
Filing Fees to the Securities and Exchange Commission	---	21,000.00	21,000.00
Miscellaneous	477.91	50.50	528.41
TOTALS	$22,683.40	$29,987.20	$52,670.60

In addition to the foregoing expenses, the Company has been advised by the law firms set forth below that the reasonable value of their services and the amount of expenses they have respectively incurred in connection with the Fund

are as follows:

Law Firm	Prior to 2/17/76	2/17/76 - 4/30/76	Total
Drinker, Biddle & Reath (Philadelphia, Pa.):			
Fees	$10,300.00	$6,750.00	$17,050.00
Disbursements	1,000.00	1,900.00	2,900.00
Gibson, Dunn & Crutcher (Beverly Hills, Ca.):			
Fees	$ 1,350.00	$1,450.00	$ 2,800.00
Disbursements	123.00	509.21	632.21
Kilpatrick, Cody, Rogers, McClatchey & Regenstein (Atlanta, Ga.):			
Fees	$ 1,170.00	$1,930.00	$ 3,100.00
Disbursements	180.23	143.22	323.45
TOTALS	$14,123.23	$12,682.43	$26,805.66

The total expenses, therefore, incurred by the Company through April 30, 1976 in connection with the Fund are $79,376.26, of which $36,706.63 were incurred prior to February 17, 1976, and $42,669.63 were incurred after that date but on or prior to April 30, 1976.

9.

But for the issuance of the April 28, 1975 ruling by the Internal Revenue Service to Vance, Sanders and the existing laws, upon which the Company relied, the foregoing expenses would not have been incurred.

10.

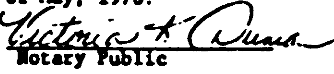
This Affidavit is made for presentation to the House of Representatives and the Senate of the United States and any and all committees or members thereof in connection with their consideration of H.R. 11920 (94th Congress, 2d Session) or any other legislation during the current session relating to the taxation of partnership exchange funds.

74-659 O - 76 - 24

IN WITNESS WHEREOF I have hereunto set my hand and seal 7 day of May, 1976.

HARRISON CLARKE (SEAL)

Sworn to and subscribed
before me this 7 day
of May, 1976.



Notary Public

Notary Public, Georgia State at Large
My Commission Expires Dec. 4, 197[illegible]

STATEMENT OF CHARLES H. MORIN ON BEHALF OF FEDERATED RESEARCH CORP. RELATING TO THE SWAP FUND AMENDMENT TO H.R. 10612

July 22, 1976

I am appearing today on behalf of Federated Research Corp. in support of the grandfather provision adopted by the Senate Finance Committee relating to the Committee amendment to prohibit tax-free transfers to limited partnership swap funds.

On April 27, 1976, the Ways and Means Committee reported H.R. 11920, a bill which terminates as of February 18, 1976, tax-free exchanges of stock to limited partnership "swap" funds. The bill passed the House and was approved on June 4, 1976, as a Committee amendment to H.R. 10612 by the Finance Committee.

H.R. 11920 as passed by the House included a grandfather provision which allows tax-free exchanges to swap funds which had filed a registration statement with the Securities and Exchange Commission and a ruling request with the Internal Revenue Service on or before February 17, 1976, provided certain other conditions are met. The February 17, 1976, grandfather date is the date the bill was introduced.

The effect of the House grandfather date was to allow tax-free exchanges for five swap funds and leave out three funds which were in the process of organizing limited partnerships at the time the bill was introduced. Based on information submitted to the Committee and the staff, the Finance Committee amended the grandfather provision in the House-passed bill to also grandfather the three swap funds which were in the organizational process.

In the case of Federated Research Corp., we respectfully submit that the change made to the grandfather provision by the Finance Committee is amply justified by the efforts and expenditures of Federated prior to the introduction of the swap funds bill in the House -- actions which were based on an existing IRS ruling.

Federated Research Corp. decided to proceed with a tax-free exchange fund in a partnership form in September, 1975. Federated proceeded from that date in an orderly and systematic development effort to organize this new fund. However, Federated had not abandoned its pursuit of a possible amendment to Section 351 of the Internal Revenue Code to permit exchange funds in a corporate form. Federated has been actively involved in exchange funds since the early 1960's. In fact, over the years Federated has offered eleven tax-free exchange funds to the public, more than any other sponsoring group.

Regular legal counsel for the Fund has been involved in all aspects of the Fund's legal matters since September, 1975. These efforts include review of matters of federal securities law, federal tax law, California law, Pennsylvania law and Blue Sky law, and the overall coordination of the Fund's legal problems and regulatory filings.

The Fund also hired California counsel in November, 1975, to represent the Fund on federal tax matters, to include filing for favorable tax rulings from the Internal Revenue Service.

By December, 1975, the S-5 registration statement for the Fund was ready for filing. In January, 1976, the executive committee of Federated made a final decision to proceed with the filing of the

registration statement. In early February, 1976, prior to the time the House bill was introduced, final arrangements were made to deliver the registration statement to Washington for filing with the S.E.C. However, at the same time, the President of Federated, John Donahue, became ill with pneumonia and requested that the registration be held up until he gave it final review. In the meantime, the House bill relating to limited partnership swap funds was introduced. Federated subsequently filed its registration statement on March 4, 1976.

Substantial amounts of time have been spent internally during the last ten months at Federated by legal, administrative, investment and executive personnel with respect to the development and organization of the Fund. These efforts include drafting original and revised legal documents, filing these documents and ruling requests with federal and state authorities, organizing the custodian, transfer and depository functions for the Fund, working with various members of the brokerage community, and planning the administrative and accounting aspects of a partnership exchange fund. These activities have generated substantial internal expenses, such as travel, telephone, printing and other administrative costs.

From the above discussion, it is quite obvious that considerabl amounts of both time and money have been expended in the organization and registration of Federated Exchange Fund.

In view of the foregoing, we strongly believe that the Finance Committee amendment to the swap funds grandfather provision was dictated by equitable considerations for those funds, not grandfathered in the House bill, which also expended considerable time and money in reliance on existing law. Accordingly, we urge adoption of the grandfather provision as approved by the Senate Finance Committee.

STATEMENT OF CHARLES H. MORIN ON BEHALF OF FEDERATED RESEARCH CORP. RELATING TO THE SWAP FUND AMENDMENT TO H.R. 10612

July 22, 1976

I am appearing today on behalf of Federated Research Corp. in support of the grandfather provision adopted by the Senate Finance Committee relating to the Committee amendment to prohibit tax-free transfers to limited partnership swap funds.

On April 27, 1976, the Ways and Means Committee reported H.R. 11920, a bill which terminates as of February 18, 1976, tax-free exchanges of stock to limited partnership "swap" funds. The bill passed the House and was approved on June 4, 1976, as a Committee amendment to H.R. 10612 by the Finance Committee.

H.R. 11920 as passed by the House included a grandfather provision which allows tax-free exchanges to swap funds which had filed a registration statement with the Securities and Exchange Commission and a ruling request with the Internal Revenue Service on or before February 17, 1976, provided certain other conditions are met. The February 17, 1976, grandfather date is the date the bill was introduced.

The effect of the House grandfather date was to allow tax-free exchanges for five swap funds and leave out three funds which were in the process of organizing limited partnerships at the time the bill was introduced. Based on information submitted to the Committee and the staff, the Finance Committee amended the grandfather provision in the House-passed bill to also grandfather the three swap funds which were in the organizational process.

In the case of Federated Research Corp., we respectfully submit that the change made to the grandfather provision by the Finance Committee is amply justified by the efforts and expenditures of Federated prior to the introduction of the swap funds bill in the House -- actions which were based on an existing IRS ruling.

Federated Research Corp. decided to proceed with a tax-free exchange fund in a partnership form in September, 1975. Federated proceeded from that date in an orderly and systematic development effort to organize this new fund. However, Federated had not abandoned its pursuit of a possible amendment to Section 351 of the Internal Revenue Code to permit exchange funds in a corporate form. Federated has been actively involved in exchange funds since the early 1960's. In fact, over the years Federated has offered eleven tax-free exchange funds to the public, more than any other sponsoring group.

Regular legal counsel for the Fund has been involved in all aspects of the Fund's legal matters since September, 1975. These efforts include review of matters of federal securities law, federal tax law, California law, Pennsylvania law and Blue Sky law, and the overall coordination of the Fund's legal problems and regulatory filings.

The Fund also hired California counsel in November, 1975, to represent the Fund on federal tax matters, to include filing for favorable tax rulings from the Internal Revenue Service.

By December, 1975, the S-5 registration statement for the Fund was ready for filing. In January, 1976, the executive committee of Federated made a final decision to proceed with the filing of the

registration statement. In early February, 1976, prior to the time the House bill was introduced, final arrangements were made to deliver the registration statement to Washington for filing with the S.E.C. However, at the same time, the President of Federated, John Donahue, became ill with pneumonia and requested that the registration be held up until he gave it final review. In the meantime, the House bill relating to limited partnership swap funds was introduced. Federated subsequently filed its registration statement on March 4, 1976.

Substantial amounts of time have been spent internally during the last ten months at Federated by legal, administrative, investment and executive personnel with respect to the development and organization of the Fund. These efforts include drafting original and revised legal documents, filing these documents and ruling requests with federal and state authorities, organizing the custodian, transfer and depository functions for the Fund, working with various members of the brokerage community, and planning the administrative and accounting aspects of a partnership exchange fund. These activities have generated substantial internal expenses, such as travel, telephone, printing and other administrative costs.

From the above discussion, it is quite obvious that considerabl amounts of both time and money have been expended in the organization and registration of Federated Exchange Fund.

In view of the foregoing, we strongly believe that the Finance Committee amendment to the swap funds grandfather provision was dictated by equitable considerations for those funds, not grandfathered in the House bill, which also expended considerable time and money in reliance on existing law. Accordingly, we urge adoption of the grandfather provision as approved by the Senate Finance Committee.

AMERICAN HOSPITAL ASSOCIATION
ONE FARRAGUT SQUARE SOUTH WASHINGTON, D C 20006 TELEPHONE 202-393 6066
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**SUMMARY OF STATEMENT OF THE AMERICAN HOSPITAL ASSOCIATION
TO THE
SENATE FINANCE COMMITTEE
SUPPORTING COMMITTEE APPROVED AMENDMENTS TO SECTION 501(e)
OF THE INTERNAL REVENUE CODE**

July 22, 1976

1. In 1968 Congress enacted Section 501(e) of the Internal Revenue Code to authorize hospital shared services organizations to help nonprofit hospitals make cost savings that benefit self-pay patients and the government as purchaser of services under the Medicare and other Federal programs. Intensive lobbying at that time by the commercial laundry industry led to exclusion of laundry services from Section 501(e).

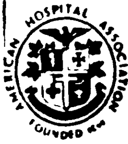
2. Senator Ribicoff's hospital shared services amendment which the Finance Committee approved June 11 would permit 501(e) shared services organizations to provide laundry services to their members.

3. Inconsistencies, inaccuracies, and self-serving and misleading statements raise serious questions as to the usefulness of a Position Paper of the Linen Supply Association of America which we have seen.

   A. Quotations from a magazine article give an incorrect impression of the author's views, and the position paper offers price comparisons without establishing that the costs cover the same range of services, a mistake the author of the article warned against.

   B. We cannot evaluate the validity of data presented in the LSAA position paper from a study by Michael Broadbent since we do not have access to the study.

   C. Instead of leading to unnecessary duplication of services and facilities claimed in the LSAA position paper, hospital shared services laundries, certificate-of-need laws, and P.L.93-641 (the health planning law Congress enacted a couple of years ago) are best designed to reduce capital outlays through avoidance of unnecessary duplication of health facilities and services.



AMERICAN HOSPITAL ASSOCIATION
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**STATEMENT OF THE AMERICAN HOSPITAL ASSOCIATION
TO THE
SENATE FINANCE COMMITTEE
SUPPORTING COMMITTEE APPROVED AMENDMENTS TO SECTION 501(e)
OF THE INTERNAL REVENUE CODE**

July 22, 1976

I am Leo J. Gehrig, M.D., Senior Vice President of the American Hospital Association, which represents some 7,000 health care institutions and more than 21,000 personal members. I appreciate the opportunity to appear before this Committee in support of the hospital shared services amendments the Committee has approved for incorporation in H.R.10627, the tax reform bill now before the Senate.

In the Association's April 14, 1976, statement to the Finance Committee on tax reform issues, the AHA recommended that Section 501(e) of the Internal Revenue Code, which grants tax exempt status to organizations providing certain services on a cooperative basis to nonprofit hospitals, be amended to permit and encourage expansion of such shared services activities as a means of helping hospitals in their efforts to hold down increases in the cost of hospital care.

The amendment offered by Senator Ribicoff and approved by the Committee would authorize under Section 501(e), in addition to existing authorities, cooperative activities in laundry services and clinical services. Further, it would permit nonprofit skilled nursing facilities to participate along with nonprofit hospitals in the formation of such shared services organizations.

The American Hospital Association has for many years urged hospitals to share services in order to hold down capital expenditures and to achieve the economic accessibility and quality advantages of such action where feasible. The term "shared services" in the hospital field is widely understood to mean services provided as the result of two or more hospitals or other health care institutions combining resources to provide better or more economical services for their patients. Such shared services can encompass both administrative and clinical functions. Let me emphasize that the objectives of such shared services are improvement in the accessibility and quality of care and economies of scale that can be attained through joint activities. Resultant cost-savings can help to restrain charges to self-pay hospital patients and third-party payors, including the government as the purchaser of services for beneficiaries of health programs.

As a result of the Section 501(e) hospital shared services authorization which Congress enacted in 1968, a variety of such shared services have been developed by hospitals that have made for more efficient provision of services than would be possible by institutions acting alone.

Intensive lobbying by the commercial laundry industry in 1968 led to the exclusion of laundry services from the list of activities that 501(e) hospital shared services organizations may perform for their members. The hospital field is now asking Congress to act to remedy this omission, and we were grateful when this Committee on June 11 approved both Senator Ribicoff's and Senator Curtis' hospital shared services amendments. So far as we know, the only opposition to these amendments has come from the Linen Supply Association of America which opposes a provision of Senator Ribicoff's amendment that would permit Section 501(e) shared services organizations to provide laundry services to their members.

Among the advantages hospital shared services offer are:

- savings of capital funds through avoidance of unnecessary duplication of facilities and services;
- lower operating costs through greater efficiency and economies of scale; and
- better quality controls and improved availability and accessibility of essential services.

Mr. Chairman, we have seen a paper prepared for the Linen Supply Association of America (LSAA) entitled "Position Paper in Opposition to the Senate Finance Committee" that on the one hand states no public hearings were held on this issue, and on the other charges that the American Hospital Association has provided the Congress with incorrect data. Both statements are untrue. I have already pointed out that the AHA's recommendations for amending Section 501(e) were submitted on April 14 and therefore have been a matter of public record for several months. Further, we have provided only accurate and verifiable data to the Committee.

I shall not attempt to deal with all of the inconsistencies, inaccuracies and self-serving and misleading statements in the LSAA position paper, but I would like to point to a few that raise serious questions as to the paper's usefulness:

1. References are made to an article written by Wilbur Stevens and published in the December 1975 issue of Hospital Financial Management magazine. Quotations from the article are presented to create the impression that the author is critical of hospital shared laundries. In fact, a careful reading of the article suggests that the author is merely pointing out that misconceptions arise in comparing costs of combined laundry (washing) services and linen supply services with other operations that do not include the costs of similar combinations of services. The LSAA statement then goes on to present cost comparisons without assuring that the services being compared are substantially the same.

   The Stevens article, in our view, actively supports the proposition that shared laundry services can effect cost savings through economies of scale, while emphasizing that accurate records must be kept of the elements of such services in order to measure savings.

2. We have not had access to the data collected by Michael Broadbent from 16 hospital laundry cooperatives as extensively quoted in the LSAA position paper. Therefore, we cannot evaluate the validity of the data and statements. I would point out, however, that more hospitals in this country perform both laundry and linen supply services for themselves than obtain such services through other arrangements. The motivation for a hospital to join with other institutions in the development of a shared laundry service is to obtain quality services more efficiently and economically than can be obtained by other means. Later in my testimony I shall cite examples involving a significant number of hospitals in which central cooperative laundries are providing high quality services to hospitals at lower costs than commercial laundries in their areas are charging.

3. In addition, the LSAA position paper discusses capital costs and duplication of facilities and arrives at inappropriate conclusions.

   Capital costs can be minimized by the sharing of laundry services, where feasible, in lieu of a number of individual hospitals maintaining in-house laundries. The American Hospital Association has over the years strongly supported the development of certificate-of-need programs to avert unnecessary duplication of resources, and fully supported the legislation providing for such programs which became P.L.93-641, The National Health Planning and Resources Development Act. We are convinced, in fact, that shared services can and do avoid unnecessary duplication in a variety of hospital activities and facilities.

   Moreover, P.L.93-641 specifically states that "the development of multi-institutional arrangements for the sharing of support services necessary to all health service institutions" is one of ten priority goals of federal, state and area health planning and resources development programs. (Section 1502 of Title XV of the Public Health Service Act, which is headed "National Health Planning and Development."

4. Throughout the LSAA position paper there is a suggestion that the amendment approved by the Committee would result in the development of cooperative shared laundries to serve all hospitals in the country. This would not be feasible, and it is completely erroneous to make such an assumption. The authority for shared laundry services under Section 501(e), as in the case of the authority for other shared services, would be used where such shared laundries could provide more accessible and economical service of acceptable quality.

Cooperative Laundry Services

Laundry services for hospitals are provided through a variety of arrangements. Data collected by the American Hospital Association in a 1975 special survey of selected hospital topics shows the following:

44.7 percent of 6,223 hospitals reporting processed their laundry in in-house plants;

10 percent of the hospitals had their laundry processed by cooperative laundries;

30.2 percent had their laundry processed by commercial laundries; and

10.6 percent used linen rental services.

(The remaining 4.5 percent were accounted for by various combinations of in-house, cooperative, and commercial laundry services, linen rental services, and a .2 percent nonresponse.)

Shared hospital laundry services are not authorized under Section 501(e) and this has impeded their development. However, some central hospital laundries have been formed despite this handicap and have demonstrated their value.

I believe it would be helpful to the Committee to cite specific examples of the achievements of some hospital shared services laundries in different parts of the country.

Western Kentucky Hospital Services, Inc.
North Main Street
P.O. Box 486
Madisonville, Kentucky

Kenneth Alexander
Executive Vice President

This laundry processes over 4 million pounds of laundry a year for its 12 hospitals, saving the participating institutions, in the aggregate, over $200,000 annually.

Central Services Corporation of Metropolitan New Jersey
646 Frelinghuysen Avenue
Newark, New Jersey

Peter Botbyl
Executive Director

In its four years of operation, this laundry has demonstrated it can provide participating hospitals efficient and economical laundry services. It processes 14.5 to 15 million pounds of laundry a year for its 21 hospitals at a cost of 19 cents per pound, which is approximately 1.5 cents per pound lower than commercial laundry rates in the service area. The laundry has the total support of the New Jersey State Department of Health as an activity that helps restrain hospital costs.

Virginia Hospital Laundry, Inc.
1601 North 17th Street
Richmond, Virginia

Thomas N. Vaughan, Jr.
General Manager

This laundry began operating in February of this year and is now serving 4 hospitals, with another to be added very soon. It now handles approximately 110,000 pounds of laundry per week and estimates it will handle some 6.7 million pounds per year. At the present time its charge is 21 cents per pound as compared with a 28 cents per pound charge by commercial laundries in the area. This 7 cents per pound difference is expected to yield a savings of approximately $460,000 per year, and the 21 cents per pound charge will be further reduced after debt service has been retired.

Associated Hospital Services, Inc.
7639 Townsend Place
New Orleans, Louisiana

LeRoy D. Kohler
General Manager

This laundry processed over 2.6 million pounds of laundry in 1975 for 6 hospitals at a savings of 2.5 cents per pound, or over $65,000 for its member hospitals. Let me note, also, that the central laundry has many letters from hospitals about the high quality, convenience and reliability of the laundry services being provided.

Hospital Central Services, Inc.
2139 28th Street
Allentown, Pennsylvania

Kenneth R. Crowly
Vice President

The laundry serves 18 hospitals and processes over 11 million pounds of laundry per year at a cost-savings of 3 cents per pound. The annual savings for its members is $330,000.

Hospitals Laundry Association, Inc.
175 Ipswich Street
Boston, Massachusetts

Samuel T. Church
General Manager

This laundry serves 28 hospitals (5,600 beds) and processes over 25 million pounds of laundry annually at an annual savings of some $250,000 for its member hospitals.

While the cost per pound of laundry varies, depending in part on the scope of services provided, these examples show that, contrary to the principal thesis of the position paper of the Linen Supply Association of America, cooperative shared laundry services can and do bring cost savings to nonprofit hospitals that can be passed on to patients.

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In addition to cost savings from more efficient operations and the economies of scale, where such shared services are feasible, cost savings can be realized through the elimination of unnecessary duplication of hospital in-house laundries. For example, in Madison, Wisconsin, the Madison United Hospital Laundry, 1310 West Badger Road, was constructed at a cost of $1.7 million, whereas the estimated cost of renovating or constructing in-house hospital laundries at the hospitals it serves was estimated at well over $2.5 million. Moreover, in this instance, there was no commercial laundry service of acceptable quality available to the hospitals, nor a commercial laundry rate available to compare with the central laundry's estimated cost of 17.5 cents per pound.

Quality of Services

Advantages other than cost savings can be realized by hospitals participating in shared laundry activities. Among these are quality control programs that often cannot or are not provided by commercial laundries but which can be carried out by laundries that service only hospitals and other health care institutions. For example, separate processing of contaminated linen and articles of clothing; separate processing of obstetrical, pediatric and surgical linens; the use of approved washing formulae, temperature and time, to provide necessary levels of cleanliness required by hospitals; specialized cleaning of linen carts and delivery vans through germicidal fogging, steam cleaning, etc.; and the preparation of special surgical packs, floor packs, discharge packs, and linen maintenance. Also, cooperative hospital laundries usually provide services six days a week so that hospitals can count on prompt delivery even on an emergency basis.

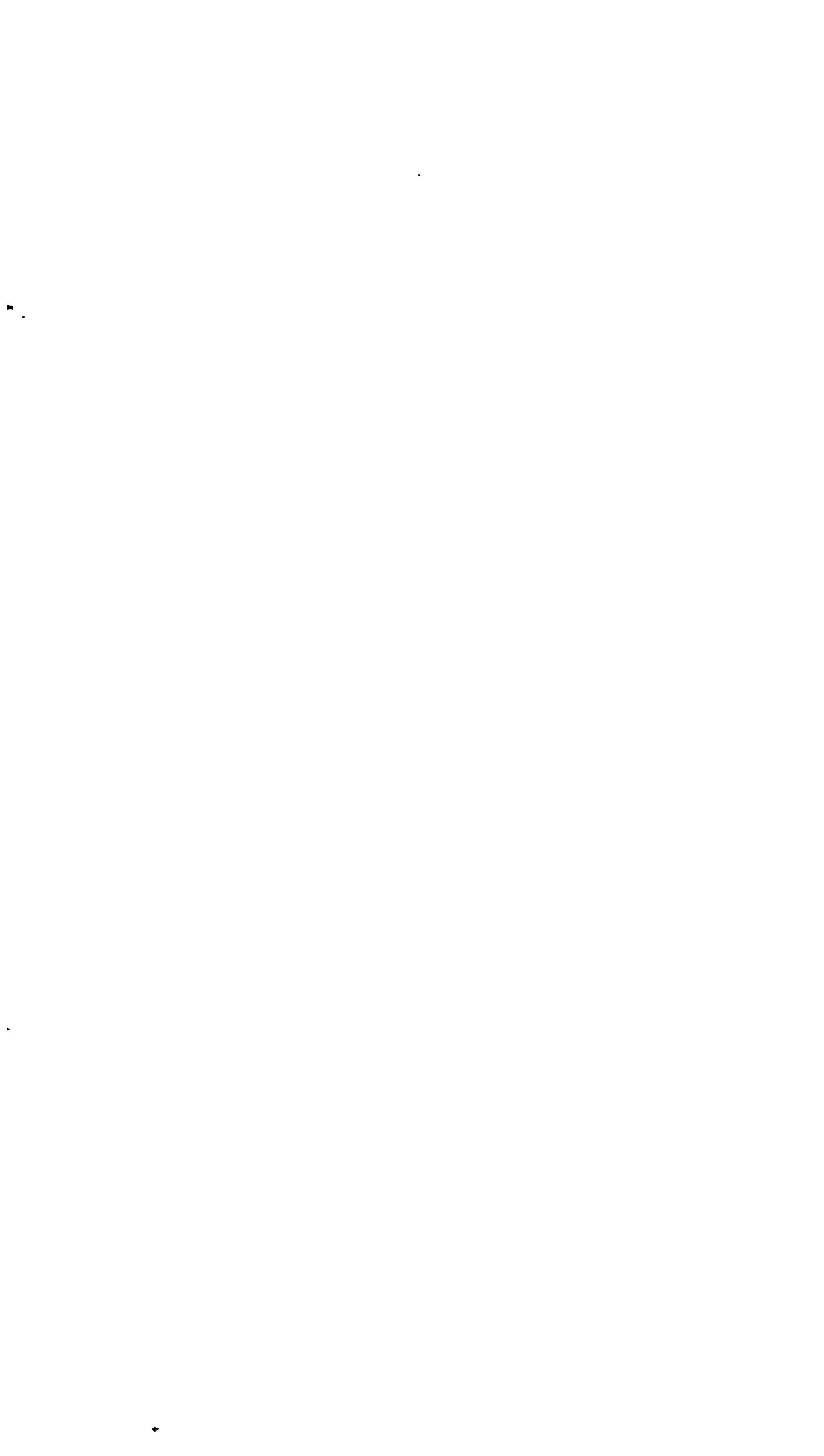
Availability of Services

At present, more hospitals obtain their laundry and linen supply services through in-house operations than by any other method. Further, in a number of instances the alternative of comparable commercial laundry services is not available.

As we indicated, hospitals must be concerned with the quality, cost and accessibility of these services. Several executives of hospital central laundries have verified that their cooperative laundries were initiated to more efficiently provide these services to groups of hospitals in areas where there were no commercial laundries willing or able to provide laundry services of acceptable quality.

In general, the decision to use an in-house plant, shared service, or commercial laundry is based on a comparison of available alternatives, their quality and cost. Making available the opportunity for hospitals to share laundry services under 501(e) does not suggest that such services will be either feasible or desirable in all areas. We believe, however, that hospitals should have the option under 501(e) of sharing laundry services when cost savings and other advantages such as improved quality of services can be realized through cooperative arrangements.

Mr. Chairman, amending the law to permit 501(e) hospital shared services organizations to provide laundry services to their members, would, in our view, be in the public interest and thus assist hospitals to deliver health care more efficiently and economically. The amendments approved by this Committee on June 11 would, we believe, lead to a more effective implementation of the original aim of Section 501(e). We urge the Congress to retain the Section 501(e) amendments your Committee has approved.



SUMMARY

SUMMARY OF TESTIMONY OF DR. ROBERT M. SAUNDERS ON BEHALF OF THE ENGINEERS' AND SCIENTISTS' JOINT COMMITTEE ON PENSIONS

The engineering and scientific professional societies urge this Committee to modify section 1502 of the Senate amendments to H.R. 10612, amending section 415 of the Internal Revenue Code, to delete the $15,000 limit on access to the "Mini-Keogh" permitting contributions to a small Keogh plan up to an annual limit of $750 or 100 percent of self-employment income, whichever is less. In the alternative, the Joint Committee on Pensions asks that eligibility be raised at least to permit contributions by employees with up to $30,000 adjusted gross income. Such amendments are necessary to permit working professional engineers and scientists to use the Keogh amendment as a method of providing a limited amount of retirement income, in light of the fact that such professionals are so highly mobile that they very frequently do not vest under corporate pension plans, even as amended in accordance with ERISA.

TESTIMONY OF DR. ROBERT M. SAUNDERS, ON BEHALF OF THE ENGINEERS' AND SCIENTISTS' JOINT COMMITTEE ON PENSIONS

The following is the statement of Dr. Robert M. Saunders, Vice President of Regional Activities of The Institute of Electrical and Electronics Engineers, Inc. on behalf of the Engineers' and Scientists' Joint Committee on Pensions, prepared for delivery at Tax Reform Hearings before the Committee on Finance, United States Senate, July 22, 1976

In Support of Restoration of the "Mini-Keogh" Provisions of the Internal Revenue Code

It is the position of the Joint Committee on Pensions of the several engineering and scientific professional societies that the pending Tax Reform Bill should include a restoration of the so-called "Mini-Keogh" provisions in § 404(e)(4) of the Code, intended to be included in ERISA, but without the proposed limits on access to those provisions presently included in § 1502 of the Senate amendment to H.R. 10612.

Who We Are

The Joint Committee on Pensions represents the principal and largest professional engineering and scientific societies in the nation. The Institute of Electrical and Electronics Engineers ("IEEE") has over 140,000 U.S. members, and is the largest professional engineering society in the world. The American Society of Mechanical Engineers . . . . the American Society of Civil Engineers . . . . The American Institute of Chemists . . . . The American Institute of Consulting Engineers . . . . The American Institute of Chemical Engineers . . . .The American

Institute of Aeronautics and Astronautics . . . . The Engineers' Joint Council represent additional hundreds of thousands of engineers and scientists.

In Support of Restoring the Original
Intent of Section 404(e)(4) of the Code

There is not the slightest doubt that Congress, in enacting ERISA and including a new section 404(e)(4) of the Code, intended to permit a person with some self-employment income to contribute the first $750 of that income to a Keogh plan, without regard to any otherwise applicable limit on that contribution. The current text of section 404(e)(4) reads as follows:

> "(4) Limitations Cannot be Lower Than $750 or 100 Percent of Earned Income -- The limitations of paragraph (1) and (2)(A) for any employee shall not be less than the lesser of --
>
> (A) $750, or
>
> (B) 100 percent of the earned income derived by such employee from the trades or businesses taken into account for purposes of paragraph (1) or (2)(A) as the case may be."

The heading of this subsection makes it clear that Congress intended that the first $750 of self-employment income could be contributed to a Keogh plan and that "the limitations cannot be lower" than that. But then there was still section 415, imposing an overall limit of 25% on earned income which is in conflict with 4(B) above.

We have no doubt that Congress simply forgot to exempt this small Keogh contribution from the otherwise applicable limits of section

415(c)(1)(B) of the Code ("25 percent of the participant's compensation"). Obviously, the term "100 percent" in section 404(e)(4)(B) must have been intended to have some meaning, and not to be a term to be wiped out utterly by another provision of the Code.

Nonetheless, this Committee, in its amendment, while recognizing the problem and seeking to correct it, has limited the benefit of its proposed correction, under section 1502 of the Committee amendment, by a proviso excluding any taxpayer whose adjusted gross income for the taxable year exceeds $15,000. It is that limitation which we oppose and we ask you to delete it, or substantially raise the limit, for otherwise the engineering and scientific community will virtually be excluded from participation.

We are not rich taxpayers looking for another loophole. We are ordinary working engineers and scientists, and not rich ones at that. And as we have told this Committee on a number of previous occasions, many of our engineers and scientists are among the most highly mobile of Americans, changing jobs more frequently than almost anyone else. Many are unlikely to vest under corporate pension plans -- even plans revised in accordance with ERISA.

Nonetheless, we are trying to find a way to provide some retirement protection for our members. And in that connection, the "Mini-Keogh" intended by section 404(e)(4) may provide at least a minimal measure of protection for our members.

Many of our members do consulting and writing on the outside. That generates a small amount of self-employment income which could qualify for a Keogh. But 25% of such a small amount of income would generate a triviality of a pension; whereas 100% of the first $750 could add up to something real in the long run. It is for that reason that our members are most anxious to see the restoration of the 100%/$750 limit as Congress originally intended it.

Accordingly we ask this Committee to delete the $15,000 limit on adjusted gross income currently proposed in the Senate amendments to the pending Tax Reform Bill; or, if this Committee feels strongly that some limit must be included, we would suggest some increase - perhaps up to $30,000.

In addition, the Joint Committee on Pensions also strongly supports the Limited Employee Retirement Account (LERA) provided in section 1502 of the House version of H.R. 10612. As indicated above, our members often fail to vest under their corporate pension plans, even as amended in accordance with ERISA, because of high job mobility. With the LERA, our members would still be able to obtain a limited benefit with respect to their own contributions, either to an IRA or to their own corporate plan, on the assumption that employee contributions are always 100 percent vested.

July 20, 1976

Committee Action on June 11, 1976 -
Acquisition Indebtedness

SUMMARY OF PRINCIPAL POINTS

My name is Myron B. Thompson of Honolulu, Hawaii. I am a Trustee of the Estate of Bernice P. Bishop, which operates the Kamehameha Schools in Hawaii.

1. In the State of Hawaii the improvement of lands with streets, curbs, sidewalks, sewers, utilities and storm drains generally is financed through the issuance of long term bonds. These bonds are eventually redeemed by funds raised either through real estate taxes or through annual special assessments against the land benefited by the public improvements they financed. In the State of Hawaii these special assessments are known as improvement district assessments.

2. The Internal Revenue Service treats real estate taxes as acquisition indebtedness only when the tax becomes due and payable and is not paid when so due. The same treatment should be afforded the annual installments of special assessments. Both taxes and special assessments serve the identical political and economic purpose -- to provide a public benefit. Plans for improvements financed by special assessments must be approved by a City Council, County Board or other governmental body.

3. Organizations exempt from Federal income tax such as the Kamehameha Schools are nevertheless taxed on their

income from property which is improved by means of acquisition indebtedness.

4. The purpose of Congress in enacting the acquisition indebtedness rule was to place tax-exempt organizations on a par with other taxpayers in the case of "bootstrap acquisitions".

5. The legislative background clearly illustrates that Congress never intended to treat the long term obligation to pay a special assessment in annual installments as acquisition indebtedness. However, the Internal Revenue Service feels constrained to interpret that definition technically, so as to treat such a long term obligation, even though payable in annual installments, as acquisition indebtedness.

6. Special assessments should be treated in the same manner as real estate taxes -- as each annual installment of a special assessment becomes due and payable, it will be considered acquisition indebtedness only if it is not paid when so due. The Treasury Regulations take this position with respect to real estate taxes. Treas. Reg. §1.514(c)-1(b)(2) provides that a lien for taxes does not become acquisition indebtedness until after the tax secured by the lien has become due and payable and the tax has not been paid when so due.

7. It is my understanding that the Treasury Department has no objection to this clarification, and that it considers it of a technical nature.

8. In conclusion, special assessments payable on

an installment basis over a period of years should receive the same treatment as annual real estate taxes -- such assessments should constitute acquisition indebtedness only at such time as an annual installment becomes due and payable and is not paid when so due.

July 20, 1976

Committee Action on June 11, 1976 - Acquisition Indebtedness

My name is Myron B. Thompson of Honolulu, Hawaii. I am a Trustee of the Estate of Bernice P. Bishop, which operates the Kamehameha Schools in Hawaii. These Schools provide the education for over 2,600 Hawaiian boys and girls on a full-time basis, and provide supplementary educational programs in the public schools of Hawaii to over 20,000 public school students.

1. In the State of Hawaii the improvement of lands with streets, curbs, sidewalks, sewers, utilities and storm drains generally is financed through the issuance of long term bonds. These bonds are eventually redeemed by funds raised either through real estate taxes or through annual special assessments against the land benefited by the public improvements they financed. In the State of Hawaii these special assessments are known as improvement district assessments. Chapter 67, Hawaii Revised Statutes.

2. The Internal Revenue Service treats real estate taxes as acquisition indebtedness only when the tax becomes due and payable and is not paid when so due. The same treatment should be afforded the annual installments of special assessments. Both taxes and special assessments serve the identical political and economic purpose -- to provide a public benefit. Plans for improvements financed by special assessments must be approved

by a City Council, County Board or other governmental body. See, for example, Hawaii Revised Statutes, §§67-10, 11 and 12.

3. Organizations exempt from Federal income tax such as the Kamehameha Schools are nevertheless taxed on their income from property which is improved by means of acquisition indebtedness (defined in Section 514 of the Internal Revenue Code).

4. The purpose of Congress in enacting the acquisition indebtedness rule was to place tax-exempt organizations on a par with other taxpayers in the case of "bootstrap acquisitions". S. Rep. No. 2375, 81st Cong., 2nd Sess., 1950-2 Cum. Bull. 483, 506-508 (1950); H.R. Rep. No. 2319, 81st Cong., 2nd Sess., 1950-2 Cum. Bull. 380, 408-411 (1950); S. Rep. No. 91-552, 91st Cong., 1st Sess. 62-67 (1969); H.R. Rep. No. 91-413 (Part 1), 91st Cong., 1st Sess. 44-48 (1969).

5. The legislative background clearly illustrates that Congress never intended to treat the long term obligation to pay a special assessment in annual installments as acquisition indebtedness. However, the Internal Revenue Service feels constrained to interpret that definition technically, so as to treat such a long term obligation, even though payable in annual installments, as acquisition indebtedness.

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8. In conclusion, special assessments payable on an installment basis over a period of years should receive the same treatment as annual real estate taxes -- such assessments should constitute acquisition indebtedness only at such time as an annual installment becomes due and payable and is not paid when so due.

Respectfully submitted,

Myron B. Thompson

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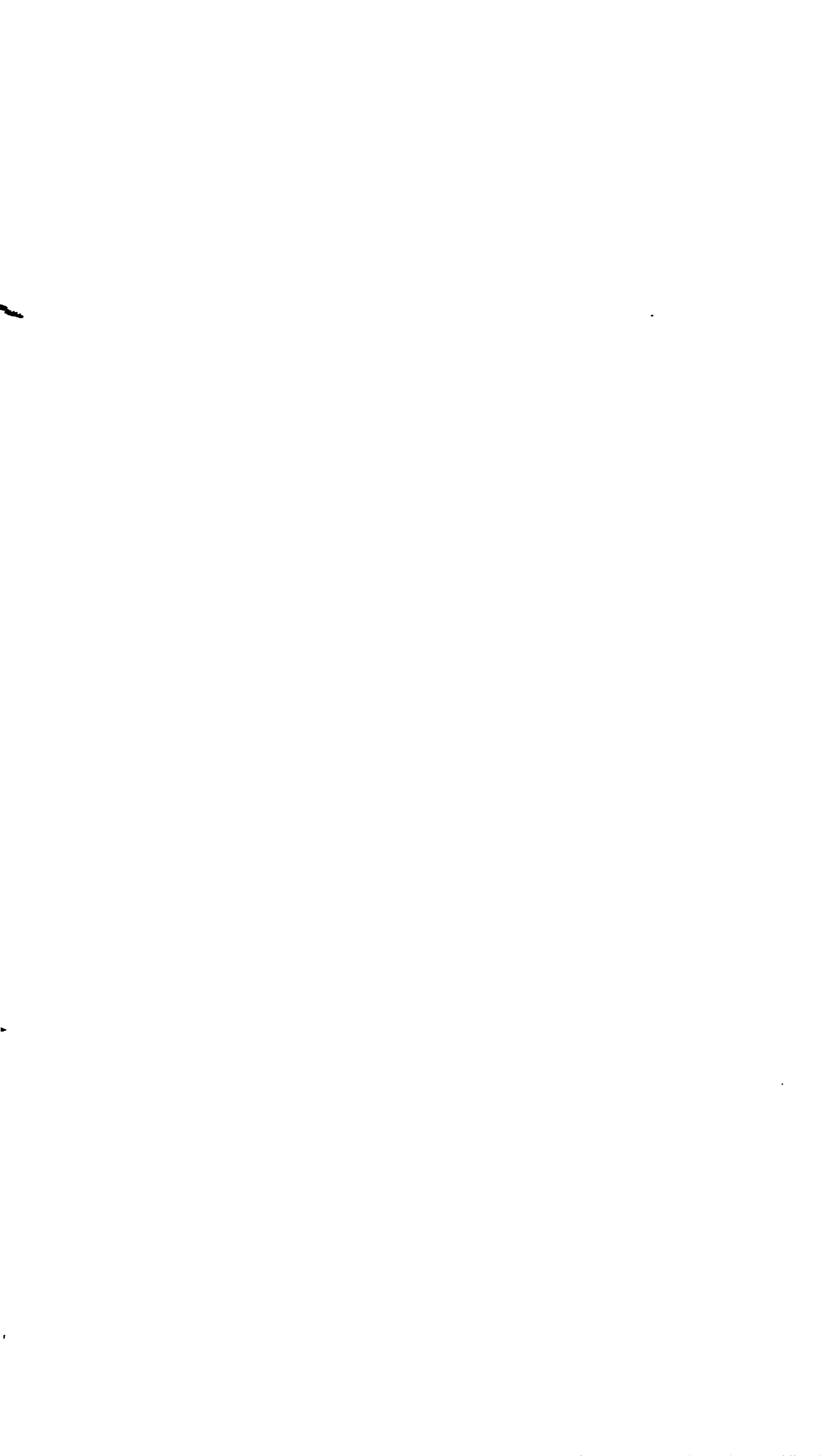


Before The
Senate Finance Committee
Washington, D.C.

H. R. 10612
Tax Reform Act

Summary Of Statement Of Kent M. Klineman

The attached statement of Kent M. Klineman pertains to the "at risk provisions" of the Senate Finance Committee's proposed tax reform bill as they retroactively relate to equipment leasing. The following is a summary of that statement:

1. Brief summary of Mr. Klineman's qualifications.

2. Brief description of the equipment leasing business.

3. An examination of the "at risk provisions" as they effect small business lessors of equipment and the possibility that adoption of these provisions will lessen competition in the equipment leasing business.

4. An examination of the retroactive effects of the proposed January 1, 1976 effective date for the "at risk provisions" as they pertain to equipment leasing.

5. Endorsement of Amendment 1986 as proposed by Senator Vance Hartke and co-sponsored by Senator Bennett Johnston, which Amendment fairly and properly eliminates the retroactive effect of the "at risk

provisions" with respect to equipment leases entered into prior to July 1, 1976.

Before The
Senate Finance Committee
Washington, D.C.

H. R. 10612
Tax Reform Act

Statement Of Kent M. Klineman In Support Of Amendment No. 1986 (Hartke-Johnston) To Remove Unfair, Disastrous Retroactive Effect Of Equipment Leasing At Risk Provision.

My name is Kent M. Klineman. I am a resident of the city and state of New York. I am a member of the New York Bar, a graduate of Harvard Law School and New York University Law School, from which I received a masters in taxation. I practiced law in New York City for over ten years. In 1972, I entered the equipment leasing business and I am extensively familiar with that business. I estimate that annually at least $5 billion of equipment, ranging from postage meters to airplanes and computers, is leased in the United States.

In many respects, the leasing business is similar to the banking business; however, there are several important differences. The lessor owns his property whereas, at most, the bank holds a lien on a borrower's property. Ownership entitles a lessor to a higher rate of return than a bank on an equivalent amount of money. The lessor's rate of return is not based upon simple interest calculations used by banks. Lease rates are based upon estimates of a property's future earning power

together with the benefits available from current income tax deferrals which arise mainly from the use of accelerated depreciation. This tax deferral is available without regard to the lessor's source of funds and without regard to whether loans used by the lessor to purchase assets are recourse or non-recourse.

Another difference between a lessor and a bank is that generally a lessor borrows funds on a non-recourse basis whereas the bank remains responsible to its depositors. The practice of non-recourse borrowing is wide-spread in the leasing business. Lenders place emphasis upon the credit rating of the prospective lessee and the value of the lease property. The credit of the lessor is often not a factor in a bank's loan decision. In a non-recourse loan, the bank's only security is the lease receivable and the property. The lessor is not responsible for the loan.

Although income tax deferrals and non-recourse financing are two important aspects of the equipment leasing business, in the case of individuals and small business lessors, the "at risk provisions" of the Committee's draft of the tax reform bill, would change these traditional practices. In their present form, the "at risk provisions" will severely affect a small lessor's attempt to compete with the large lessors who are able to afford to carry on their business in a corporate form. In order to compete, a small lessor will be forced to either "go recourse" on his equipment financing loans or incorporate without the benefits afforded by Sub-Chapter S. If the small lessor is unwilling to take

these steps, the "at risk provisions" will effectively operate to reduce or eliminate the small lessor from the equipment leasing business.

As a small businessman who has written a number of leases largely finan l through non-recourse loans, I would, in similar situations, be unwilling to write the same leases if required to assume the added burden of recourse financing. If other small lessors throughout the country are also unwilling to assume this additional burden, the leasing business will become even more concentrated in the hands of the large lessors, including the banks, most of which have leasing company affiliates. The obvious lessening of competition will serve to increase costs to not only prospective lessees but also equipment manufacturers since such manufacturers will have fewer leasing company outlets.

I have spent a few minutes of your Committee's valuable time to outline the basics of the equipment leasing business and to point out some of the problems raised for the small lessor by the "at risk provisions." However, I would like to add that it would be extremely unfair to the small lessor if the effective date of the "at risk provisions" is January 1, 1976, as proposed in the draft bill.

Amendment 1986, as proposed by Senator Vance Hartke of Indiana and as co-sponsored by Senator Bennett Johnston of Louisiana, would alleviate the retroactive effect of the present draft bill for leases entered into before July 1, 1976. If Amendment 1986 is not accepted, the small lessors will suffer irreparable harm from the imposition of an income tax burden which was not calculated in their lease rates.

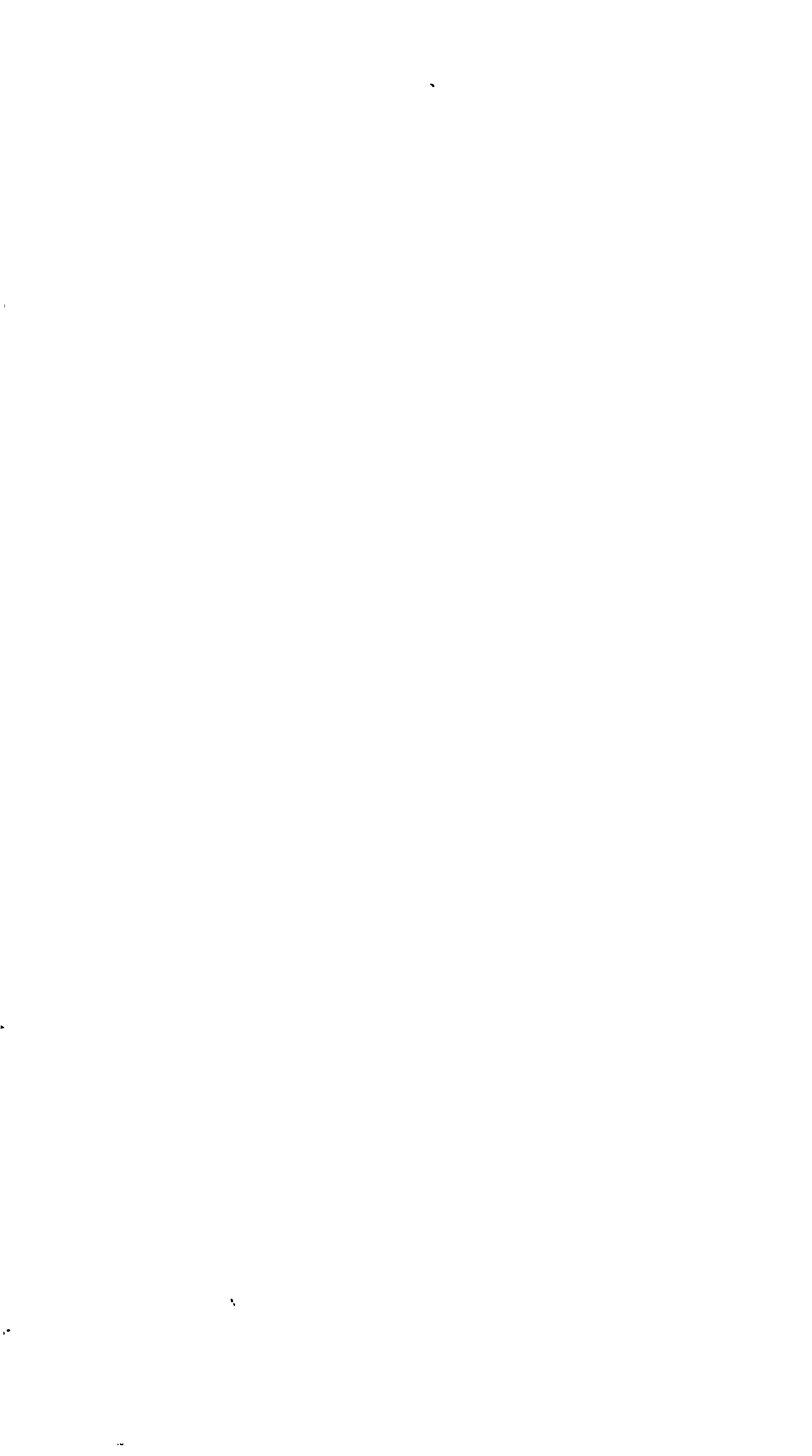
Because of the severe competition from the large leasing companies, including the banks, these lease rates frequently offer only a small return to the small business lessor, a return which would be even smaller or, in some cases, negative if current available tax deferral is retroactively eliminated.

The current draft of your Committee's bill affects all leases whether entered into prior to or subsequent to January 1, 1976 since the bill, as drafted, disallows losses arising subsequent to December 31, 1975 except to the extent of a lessor's equity investment in his property. A small businessman lessor who entered into a lease prior to 1976 and who used non-recourse financing will not be able to deduct losses arising from his leased property subsequent to December 31, 1975 except to the extent of his equity investment. Since he has probably already written off this investment, no tax benefits will be available from his leased property commencing after December 31, 1975. I would submit that this treatment is unfair and discriminatory to the small lessor.

Senators Hartke's and Johnston's Amendment 1986 eliminates the retroactive effect of the "at risk provisions" for leases entered into prior to July 1, 1976. Amendment 1986 is not a special interest amendment. It will benefit many small lessors who calculated rates under existing leases based upon existing laws. At minimum, the adoption of a July 1, 1976 cutoff date will give fair notice to the small businessman lessor that he can no longer calculate his lease rates

based upon the use of the tax deferral permitted by present law.

I have been deeply involved in the study and application of the tax laws for more than 20 years. I have not seen Congress adopt a retroactive provision which has the unfair and discriminatory effect of the "at risk provisions" as they apply to equipment leases. Although I would agree that a retroactive tax law might be justifiable if it benefitted the economy as a whole, the "at risk provisions", with the exception of the small amount of revenue that it will produce, does not benefit the economy. Quite the opposite, it will probably, as pointed out above, have the effect of lessening competition in the leasing industry. At minimum, Amendment 1986, which continues the tax deferral provided under existing laws for leases entered into prior to July 1, 1976, has the desirable effect of putting a small business lessor on notice that commencing July 1, 1976 the rules of his business have been changed.



STATEMENT OF CARL W. SEBITS, INDEPENDENT OIL AND GAS OPERATOR

Before the

UNITED STATES SENATE

COMMITTEE ON FINANCE on H. R. 10612 (TAX REFORM ACT OF 1976)

July 22, 1976

SUMMARY OF PRINCIPAL POINTS:

1. Pertains to "Retailer Exclusion" provision
2. Pertains to Exception to Transfer Rule for Beneficiaries of Trusts

PICKRELL DRILLING COMPANY
LITWIN BUILDING • SUITE 206
110 NORTH MARKET STREET
WICHITA, KANSAS 67202

My name is Carl W. Sebits and my office is in Wichita, Kansas. I am a managing partner of Pickrell Drilling Company and I appear today in that capacity and as Chairman of the Tax Committee of the Independent Petroleum Association of America. I am also a member of the Executive Committee of that association.

RETAILER EXCLUSION

Pickrell Drilling Company is an exploration and oil and gas producing company with nearly all of its opeations in the state of Kansas. Our company operates two rotary drilling rigs continuously, in a search for oil and gas, and also operates approximately 3000 barrels daily oil production. The company operates about 20 million cubic feet of gas per day.

For many years a small group of investors has participated with us in our exploration program as a part of their diversified business investment programs. They and we are quite naturally concerned about tax measures which would make exploration investment less attractive and this statement bears more specifically upon the "retailer exclusion" provision in the new tax proposals which would deny percentage depletion to a taxpayer who is classified as a "retailer" of oil or gas or products derived from oil or gas.

One of our investor-participants in our exploration program is a large grease manufacturer, and although nearly all of his sales are at the wholesale level, some small part of his sales would classify as retail sales of grease and related lubricant products.

Still another of our investor-participants is an owner-operator of

retail stores handling western wear clothing and related items. Many of the items which he stocks and retails are manufactured from petroleum chemical derivatives, such as polyester suits and dress materials, and other retail items which have as their base material some kind of petroleum derived source. In fact it would be quite difficult for most retailers of general merchandise to avoid handling and selling products which did not in some way have their origin in petroleum derivatives, since petroleum chemicals have become so predominantly used in almost the entire gamut of consumer products manufacturing.

Still another of our investor-participants owns and either operates or leases out to lessees on a participation basis several retail gasoline filling stations, as a part of his diversified business investment program. Whereas this man's operations could not in any way be compared to a major integrated oil company, the narrowness of definition of the "retailer excluded" provision would undoubtedly prevent this investor from the deduction of precentage depletion.

Each of the previously described investors has informed our company that in the event that a too narrow interpretation of a "retailer" lessens the feasibility of investing in oil and gas exploration, since we all recognize it as a high-risk venture, then it is quite possible that they will withdraw from our program and in turn we will be forced to decrease the scope of our exploration effort. In time this could result in a complete shut-down of this program.

A provision exempting a taxpayer whose annual gross receipts from the retail sale of oil or gas or products derived therefrom would not exceed $5 million for the taxable year would surely be most helpful. It would

eliminate a too-narrow definition of the "retailer excluded" provision and assure the above described investors that they could continue to spend their dollars in a search for more oil and gas production within the United States. We and our investor-participants are indeed hopeful that such an amendment will be given favorable consideration.

PICKRELL DRILLING COMPANY
LITWIN BUILDING • SUITE 206
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WICHITA, KANSAS 67202

EXCEPTION TO TRANSFER RULE FOR BENEFICIARIES OF TRUSTS

The Committee on Finance of the United States Senate has added an additional exception to the transfer rule contained in paragraph (9) of Section 613A (c) of the Internal Revenue Code. This additional exception expands the exception provided by present law for transfers of oil and gas property at death. The new provision extends the exception to changes of beneficiaries of a trust if the change occurs by reason of the death, birth, or adoption of any beneficiary provided the transferee was a beneficiary of the trust prior to the event or is a lineal descendant of the grantor or any other beneficiary.

Such transfers by reason of death, birth or adoption obviously are not the type of transfers which the statute sought to prevent to avoid a proliferation of proven oil and gas reserves which when produced are eligible for percentage depletion. This exception is considered necessary to clarify the normal transfer of beneficial interests in trusts (as opposed to the sale of oil and gas property) to intended beneficiaries and to insure that the right to percentage depletion of property in the trust will continue to be enjoyed by the beneficiaries thereof.

SUPPLEMENT STATEMENT ON BEHALF OF THE NATIONAL LP-GAS ASSOCIATION SUBMITTED TO THE SENATE FINANCE COMMITTEE AT HEARINGS ON FEDERAL EXCISE TAX REVISION BY ARTHUR C. KREUTZER, VICE PRESIDENT AND GENERAL COUNSEL

July 22, 1976

This statement supplements the written statement previously delivered to the Committee. It is requested that the filed statement be made part of the record with correction of the last line of its attached proposed revision to read:

"(Strike remaining language of §.4041 (b))"

We requested special motor fuel tax revision covering use of propane in other than a highway vehicle, for the sole reason of correcting an existing inequity and discrimination whereby comparable taxation is not imposed on competitive fuels similarily used in an industrial lift truck. This tax imposition is unfair to both the LP-Gas dealer supplying propane and the users. There are also related side benefits in creating tax equality in environmental improvement and energy conservation.

In view of Senator Kennedy's listing the requested tax relief as a special interest benefit, we add comment on that allegation.

It is apparent that the Senator is misinformed when he relates benefit to the Eaton Corporation.

We are mystified by the injection of the name of the Eaton Corporation into this tax situation. The only possible relationship is that the Eaton Corporation manufactures industrial lift

74-659 O - 76 - 27

trucks - but they are only one of several companies so engaged. Nine including Eaton, make LP-Gas fueled lift trucks but also make lift trucks powered by other types of fuels. It would profit none to have an inequitable tax paid by the user removed on one typo of fuel when they can as easily sell other fuel type lift trucks.

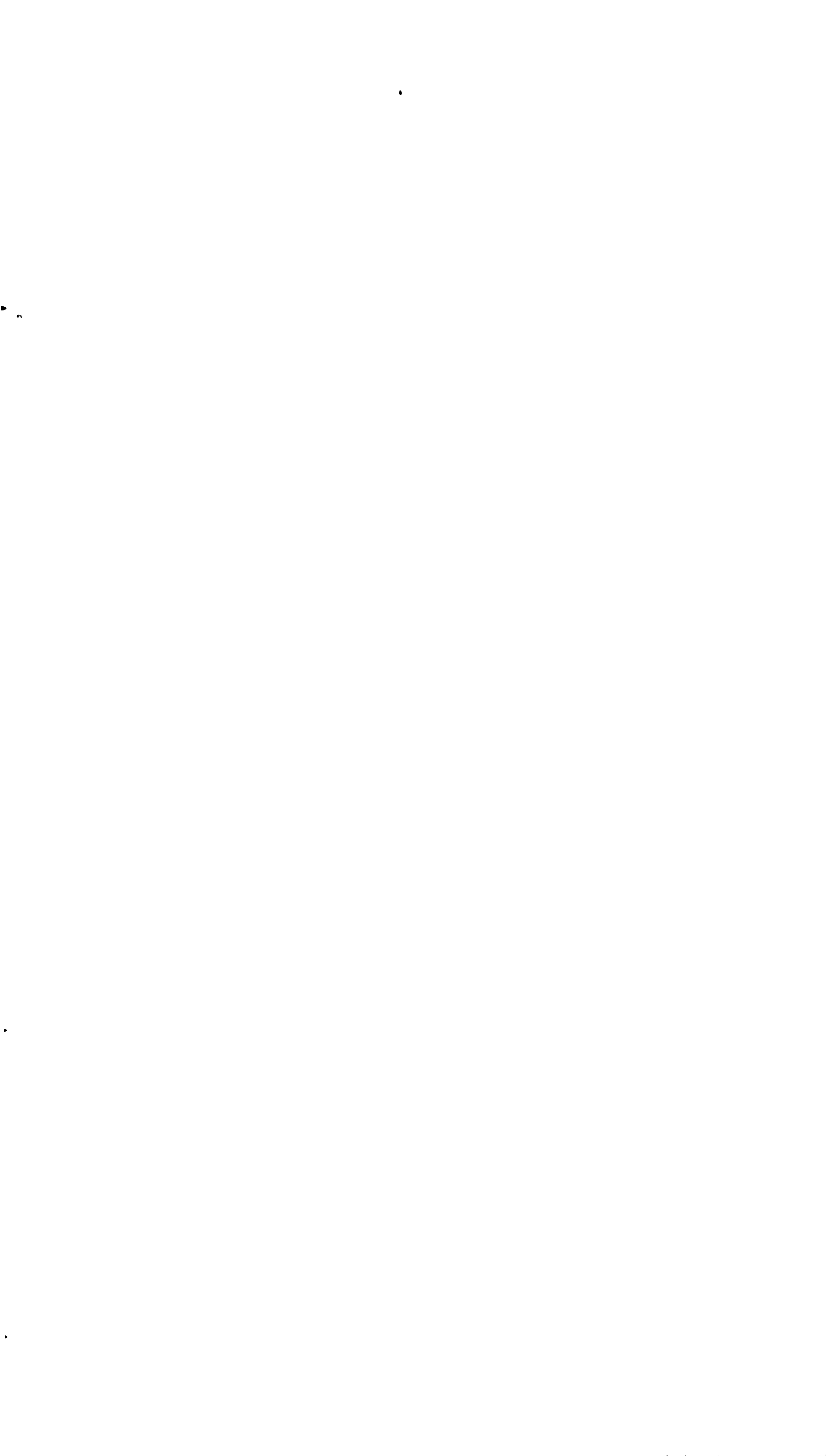
It is our viewpoint that the Committee in the bill sought to remove an existing inequity and discrimination that confronts some 5,000 LP-Gas dealers, and uncounted thousands of industrial and commercial users of LP-Gas fueled lift trucks. The Committee action could well be viewed, not as a tax benefit, but as a removal of an unjust penalty. It will correct what we consider an unintended result of the original tax statute language and IRS interpretation of the term motor vehicle that was solidified before the industrial lift truck was born.

Correction of this inequity was urged in full "sunshine" and over our extended period.

It was presented to this Committee in a statement on April 13. However, we have presented this inequity at earlier times to the House Ways and Means Committee and individual members of Congress, but an appropriate vehicle for revison was not at hand. The House Committee has not considered excise tax revision recently. It had also been discussed

with the IRS and the Treasury Department on several occasions. Neither has the tax effect been concealed and as outlined in our statement, it is not significant.

We, therefore, consider the Tax Reform Act revision of special motor fuel tax handling fully justified in correcting existing inequity and are grateful to the Committee for so acting. In the bill draft this is accomplished by a refund on non-highway use. We suggest that in the interest of simplified handling, and elimination of cost to both user and government alike initial imposition of the tax be limited to use in a highway motor vehicle, similar to diesel tax imposition, rather than requiring the paperwork of refund.



SUMMARY OF TESTIMONY OF DOUGLAS T. SNARR

PRESIDENT OF SNARR ADVERTISING, INC.

COMMITTEE ON FINANCE - UNITED STATES SENATE

H.R. 10612 - The Tax Reform Act

July 20, 1976

1. Implementation of the Highway Beautification Act of 1965 resulted in the condemnation and purchase of many non-conforming billboards and forced many small sign companies out of business.

2. In an effort to protect the injured small sign companies, Congress amended the Beautification Act in 1970 to permit the acquisition of billboards on a company-by-company basis and gave a preference to the small sign companies for early acquisition.

3. The small sign companies cannot reinvest the proceeds from condemned billboards in other billboards and qualify for tax-free reinvestment under IRC Section 1033(g) because (1) the Beautification Act prohibits new signs in rural areas; (2) the large sign companies control the conforming areas in cities and business locations; and (3) the condemnations have taken so many signs that the small companies can no longer conduct business.

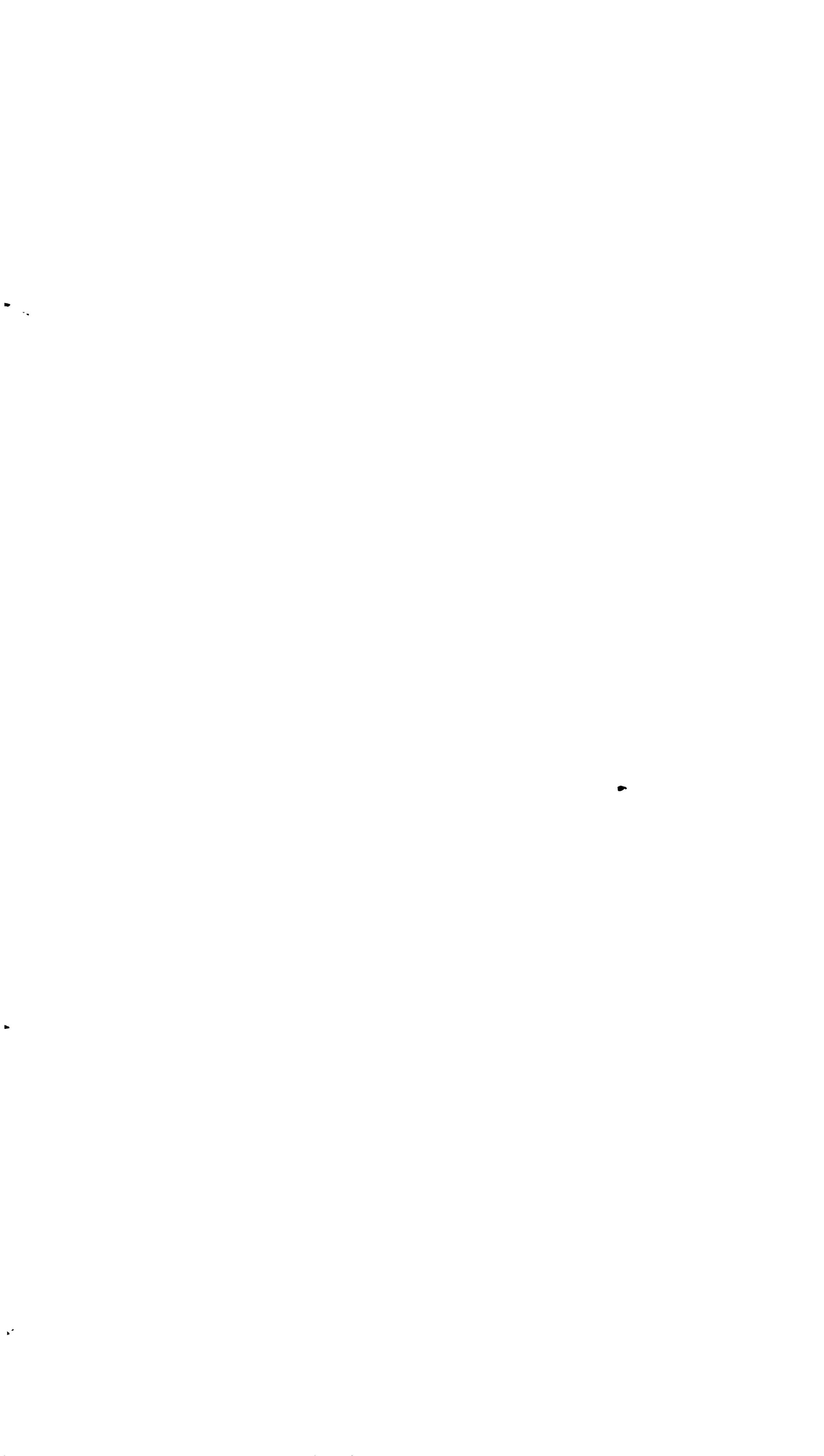
4. At the time of the 1970 amendments, the small sign companies were assured by congressional delegations and their staffs that billboards were considered real property (a revenue ruling had been issued to that effect in 1968) and that Section 1033(g) of the IRC would permit the tax-free reinvestment of condemnation proceeds in other real property.

5. The small sign companies have treated the billboards as real property and have not claimed investment credit or accelerated depreciation. They have reinvested the condemnation proceeds in other real property.

6. The IRS now takes the position that billboards are personal property and that the proceeds of condemnation of billboards cannot be invested in real property under the protection of Section 1033(g). The small sign companies have thus lost the advantages of investment credit and accelerated depreciation, and are now being denied the opportunity of tax-free reinvestment of the condemned billboards.

7. The proposed amendment merely provides that sign companies who have treated billboards as real property for tax purposes and who have not claimed investment credit or accelerated depreciation, will be allowed to make a tax free conversion of the proceeds of condemned billboards into other real property under provisions of Section 1033 (g). Sign companies who have treated the billboards as personal property, will be required to continue to do so and will not be able to claim the benefits of Section 1033(g).

8. The proposed amendment would not result in a tax preference or loss of revenue, but will allow small sign companies to defer the recognition of gain resulting from the condemnation of their injuries.



WRITTEN STATEMENT OF DOUGLAS T. SNARR

COMMITTEE ON FINANCE - UNITED STATES SENATE

H.R. 10612 - The Tax Reform Act

(Tax Treatment of Billboards)

July 20, 1976

Honorable Chairman Long and members of the Committee on Finance. My name is Douglas T. Snarr and I am president of Snarr Advertising Company, a small sign company located in Salt Lake City, Utah. I appear before you today to testify concerning an amendment to H.R. 10612 which provides certain tax treatment for condemned billboards by amending Section 1033(g) of the Internal Revenue Code.

The problem which the proposed amendment on page 10 of the Committee Action of June 11, 1976, seeks to correct arises from the implementation of the Highway Beautification Act of 1965 whereby Congress sought to remove billboards from the interstate and primary highways and provide "just compensation" to the billboard and property owners. Pursuant to the provisions of the Highway Beautification Act of 1965, a large number of outdoor advertising signs have been purchased and removed by state governments with federal participation. However, in implementing the provisions of the act, it was found that there was a substantial difference in the effect of the act upon outdoor advertising companies which had billboards primarily concentrated in business districts and smaller companies which concentrate their advertising in rural areas.

During the initial implementation of the act it was determined that the large national sign companies and those located in the city business districts were not particularly affected by the provisions of the Highway Beautification Act. They merely took the proceeds of the sign condemnations and reinvested the proceeds in upgrading their conforming advertising structures in business or commercial areas. However, the small and medium size sign companies that operated primarily in rural areas were irreparably damaged by the Highway Beautification Act condemnations. Because the Highway Beautification Act prohibits the reinvestment of sign condemnation proceeds in other signs in non-conforming rural areas, the small and medium sized sign companies were unable to reinvest the monies received from condemnation in advertising structions and were thus effectively forced out of the outdoor advertising business.

This matter was brought to the attention of the Congress and hearings were held during two Congresses that resulted in amendments to the Highway Beautification Act of 1970 to alleviate the hardship being suffered by the small sign companies. The 1970 amendments allowed the Department of Transportation and the states to proceed to acquire signs on a company by company basis, rather than on an individual sign basis. The legislation further provided that the smaller and hardship sign companies were to be dealt with first. This legislation recognized that the small highway sign companies could not

remain in business as outdoor sign companies because after the taking of their non-conforming highway signs, their remaining conforming signs were not sufficient to constitute an economic unit. The larger sign companies had moved quickly to secure control of the remaining conforming areas where signs could be placed and thus the small companies had no choice but to take the condemnation proceeds from the sale of their non-conforming signs, sell their few remaining conforming signs to the larger sign companies, and then try to establish a different type of business. There was in effect a forced removal of the small highway sign companies from the outdoor advertising business and a movement of the larger sign companies to an oligopolistic market.

The 1970 amendments to the Highway Beautification Act attempted to save the small sign companies by handling their cases first and by allowing them to move quickly into some other form of business. At the time of the 1970 amendments it was recognized that any reinvestment of sign condemnation proceeds would require reinvestment in real property and inquiry was therefore made of congressional leaders and committee staff as to whether or not an amendment would be required to I.R.C. 1033(g) to permit the reinvestment of sign condemnation proceeds in other real property. (Section 1033(g) allows the reinvestment of proceeds from condemned real property in other real property without imposition of an income tax on the in-

voluntary conversion). In a series of meetings held in early 1970 with staff of the Joint Committee on Internal Revenue Taxation, it was decided that no additional tax legislation was required because of the published position of the Internal Revenue Service that billboards were real property. (Rev. Rul. 68-62, 1968-1 C.B. 365). It was clear at the time that had there been any question on the matter, legislation would have been introduced to assure the sign companies that they would receive the benefits to Section 1033(g). Being assured that such legislation was unnecessary, the small sign companies and operators promptly settled condemnation proceedings with the states, sold their remaining conforming signs to the larger interstate companies, and often even entered into covenants not to further compete. The small companies then purchased other real estate or real estate business with the proceeds of the sales. In all this, the small sign companies proceeded on the assumption that the reinvestment of the proceeds in real estate was a tax-free exchange and totally relied upon the existing stated attitude and rulings of the IRS.

However, in 1975, two major sign companies brought actions in the U.S. Court of Claims seeking a determination that billboards are "tangible personal property" and thus available for the investment credit. Alabama Displays, Inc., 75-1 USTC 9116; National Advertising Company, 75-1 USTC 9117. In these cases the U.S. Court of Claims held that the taxpayers were

entitled to investment credit on billboards because billboards were "tangible personal property" for purposes of section 48(a)(1)(A) of the Internal Revenue Code. The position of the large sign companies in these cases is understandable. Because these companies are continuing in the sign business and are not liquidating, they prefer that signs be considered personal property so that they can qualify for investment credit and accelerated depreciation provisions.

In reliance upon these two cases, the IRS has reversed its previously announced position concerning billboards and now holds that they are "personal property" for the purposes of both Sections 48 and 1033 of the IRC. On March 25, 1976, the National Office of the IRS issued a technical memorandum in response to a request for a private ruling from Snarr Advertising, Inc. holding that billboards do not qualify as "real property" under IRC 1033(g).

It should be noted that in reliance on the prior rulings of the IRS, many of the small sign companies had always treated the billboards as real property. Thus, they had not claimed investment credit or certain types of accelerated depreciation available for qualified personal property. The net effect of the new position of the IRS is as follows:

1. Small sign companies who relied on prior rulings and treated the signs as real property have been denied the opportunity to claim investment credit on the signs.

2. Small sign companies who have been forced out of business under the Highway Beautification Act and have reinvested in other real property businesses in reliance upon the IRS position, will now be taxed on the voluntary conversions of their properties.

3. Small sign companies who have not yet reinvested will be encouraged to somehow invest in new billboards in opposition to the public policy stated by Congress in the 1965 Beautification Act.

4. Large sign companies will be unjustly enriched as they will be the only operators who will be able to effectively reinvest in like kind property.

It should also be noted that the private ruling confined itself to the Internal Revenue Code provisions as they presently exist and refused to take into consideration the Congressional intent concerning the enactment of the Beautification Act and subsequent amendments. The ruling states in part:

> The Internal Revenue Code does not address itself specifically to billboards. Notwithstanding what may or may not have been the Congressional intent when the Highway Beautification Act was passed, the Service must rely on the present code and the regulations which, for purposes of Section 1033, conclude that the signs which were sold by Snarr under threat of condemnation did not constitute an interest in real property (page 5).

The position of the Internal Revenue Service is understandable only if we assume that the Service was fearful that sign companies would claim that billboards were personal property for purposes of investment credit and depreciation and real property

for purposes of condemnation, thus receiving a double benefit. To avoid this possibility of double benefit, the Service opted in favor of the position taken by the large sign companies and has ignored the severe damage being done to small sign companies who are unable to extensively litigate the issue or protect themselves. (Actually, the provisions of Section 48 and 1033 are not mutually exclusive. Section 48 was drafted to encourage investment and by its express terms covers types of property which under state law are deemed "real property".)

The proposed amendment does not affect the position of the large sign companies or the availability of the investment credit to electing sign companies. Instead, it gives sign companies an election as to how they wish to categorize and treat their billboards. If a sign company treats its billboards as "personal property" and takes investment credit and accelerated depreciation, then it cannot claim the benefits of tax-free reinvestment under Section 1033(g) IRC. However, if the sign company historically has treated its billboards as "real Property" and has not taken investment credit or accelerated depreciation, then the sign company may claim the benefits of reinvestment under Section 1033(g). It is extremely unfortunate that under the current position of the IRS, sign companies that have foregone the advantages of investment credit and accelerated depreciation available to personal property, are now denied the one remaining advantage of having treated the billboards as real property.

The proposed amendment does not give any tax preference or tax benefit. It merely makes the provisions of Section 1033(g) available to those companies who have historically treated their billboards as real property and thus foregone other tax advantages. It recognizes and implements the intent of Congress as set forth in the 1970 amendments to the Highway Beautification Act. Furthermore, it should be noted that Section 1033(g) itself is not a tax relief provision, but merely defers the tax on reinvestment of involuntary conversions of property.

We would hope that this Committee would recognize the terrible unfairness of the position the Service is taking with respect to the small sign companies. It was bad enough when we were forced out of our business and denied the opportunity to reinvest in a similar business. Now, we are told that because we didn't reinvest in other signs, we will be taxed on the involuntary conversion of our billboards. Fairness requires that we be given the opportunity to reinvest in real property businesses without the imposition of any further tax. Thank you.

APPENDIX

U.S. Treasury Department
Office of the Assistant Secretary
for Tax Policy
July 22, 1976

Administration Position on Certain Provisions of the Tax Reform Bill (H.R. 10612)

On July 20, 1976 the Administration released its statement, "Administration Position: Hearings on Certain Provisions of The Tax Reform Bill (H.R. 10612)." The Administration is pleased to have the opportunity to comment in more detail on the specific provisions of the bill.

On June 15, 1976, the Administration issued a summary statement of its position on various sections of H.R. 10612 as reported by the Senate Finance Committee. The Administration's June 15 statement was prepared on the assumption that each Section in H.R. 10612 would be voted up or down by the Senate, and that there would be little or no chance for perfecting amendments. Therefore, the pattern followed by the Administration was to state an overall judgement on each section. That judgment represented a consideration of the balance of merits and defects of the basic section and any special relief provisions it contained.

When Senator Long announced on July 8, 1976, that additional hearings would be held on certain sections, the Administration reexamined the bill with a view to evaluating the various provisions contained in each section. The merit of

each provision was separately evaluated; the Administration did not feel confined to an evaluation of the section taken as a whole. The result is the July 20, 1976, statement, "Administration Position: Hearings on Certain Provisions of the Tax Reform Bill (H.R. 10612)." The July 20, 1976, statement was prepared with a view to a markup session by the Senate Finance Committee. Naturally, in a more detailed analysis of the components of a section for purposes of a markup session, there will tend to emerge a number of positions which vary from the single decision which must be made in considering a "yes" or "no" vote on each section taken as a package. The provisions are rated on the following scale: strongly support, support, do not oppose, oppose, strongly oppose. In a few cases, the Administration has changed its position on an entire section. In general, these changes reflect further reflection and evaluation, and additional comments from Departments and agencies other than Treasury.

In seeking these positions the Administration has relied on certain broad principles which have traditionally guided the Treasury in its examination of special relief provisions.

-The Treasury does not object to reasonable transition rules, provided they are not drawn so narrowly that very few taxpayers benefit. If a transition rule has merit, it should be drawn to apply to a broad group of affected individuals and companies.

- The Treasury opposes retroactive relief, except in cases of exceptional hardship. The time to enact relief measures is when the original legislation is passed. Retroactive relief typically benefits a narrow class of insistent taxpayers, while others injured by the same legislation may go unnoticed. Moreover, retroactive relief for publicly held companies often benefits a very different group of stock holders than those injured by the original legislation, some of whom have since sold their shares.

- If an existing provision of the Code imposes an inequitable or unintended burden on certain taxpayers, then the relief provisions should be drafted to encompass all affected taxpayers, and not merely the small group of taxpayers which brings the provision to the attention of the Congress.

- The special relief should not entail excessive revenue costs and should not impose undue administrative burdens on the Internal Revenue Service.

- The special relief should not undermine non-tax policies embodied in other legislation.

Set forth below is an explanation of the Administration's position on certain specific provisions with respect to which the position stated on July 20, 1976, differs from that stated on June 15, 1976. In addition, the attached table summarizes Administration positions on July 20, 1976 (focusing on individual provisions of each section) and June 15, 1976 (focusing on each section as a whole).

74-659 O - 76 - 28

Apparent differences in the Administration position between its June 15, 1976, statement and its July 20, 1976, statement have been noted by some witnesses appearing before the Senate Finance Committee. The more important instances are noted below.

Section 1024. Shipping Profits of Foreign Corporations.

In the June 15, 1976 statement, the Administration did not object to Section 1024. The decision not to oppose the section reflected the judgment that it would amend the subpart F provisions with respect to shipping profits in one respect which the Administration considered important, namely the exclusion of income derived from operations within a single country in which the corporation is created and the vessel is registered. This exclusion conforms the treatment of shipping income to that of foreign base company sales and service income. Subpart F was not intended to affect income earned solely within the country of incorporation of the foreign corporation; on the contrary its principal thrust is to tax the income of foreign corporations which do business largely or entirely outside the country of incorporation. The Administration supported that change.

That change was accompanied by two other changes which the Administration does not support, but decided to accept rather than oppose the whole section. Those changes would exclude from the subpart F provisions certain income which

is from international transport and which is consistent with the broadened scope of subpart F. One of the changes concerns income from the shipping of men and supplies from onshore to a continental shelf or any adjacent continental shelf. This could be a full time business, moving men and supplies from one area to another and servicing rigs on the continental shelf of one country or, as in the North Sea, of a number of countries with adjoining shelf areas. It is difficult to see why, other than tax advantages, a U.S. company would carry on this business through a foreign subsidiary. The second change would exclude income from chartering vessels to a related U.S. company under certain circumstances. Both cases represent income which properly falls within the scope of the subpart F shipping provisions.

The Administration does note that the subpart F shipping provisions may operate inequitably. The law provides an easy escape for taxpayers with growing shipping activities by excluding shipping profits reinvested in shipping, but taxpayers for which shipping is a constant, declining, or occasional activity do not enjoy the same relief. This aspect of the law is objectionable, but carving out special relief measures is not the way to solve it.

There is a fourth subsection to Section 1024 which the Administration also opposes, but on the grounds that it is not necessary, clutters up the law needlessly, and could be misleading. We are not aware of any criticism of this position as a change from the June 15 statement.

Section 1031. Requirement that Foreign Tax Credit be Determined on Overall Basis.

The Administration position on the eliminatior of the per-country limitation has been consistently one of not opposing the change. However, the Administration does oppose the special three year exception for mining companies on the grounds that if a provision is desirable it should be general and not apply only to a specific industry (in this case part of an industry) or group. That same reasoning might seem to apply to the three year exclusion for possessions corporations, which the Administration does not oppose. However, the possessions corporations represent a class of corporations, not limited to a particular activity, which Congress has chosen to set aside as a distinct class for historic reasons, and which it has chosen to maintain during various reconsiderations; so possessions corporations differ somewhat from the usual understanding of a special interest group. In addition, the three year exception for possessions corporations is a cutback from the initial proposal of an unlimited exception; the more limited

rule is a considerably less objectionable departure from the general principle of requiring the overall limitation.

Section 1035. Foreign Oil and Gas Extraction Income.

The Administration opposes several subsections of Section 1035 which it did not single out for objection in the June 15th statement. The objections are primarily objections to trying to improve an unsatisfactory underlying provision by granting exceptions which are retroactive and/or limited to a narrow group of taxpayers.

Sections 1035(a) and (b). Transitional Rules for Foreign Tax Credit Limit and the Recapture of Foreign Losses.

The Administration supports transitional rules in many cases and would have supported reasonable transition rules in these cases had they been considered and enacted along with the legislation which made the basic changes in policy (in this case the Tax Reduction Act of 1975). We think the practice of retroactive relief is objectionable and should not become a substitute for careful legislation. For that reason we oppose these specific provisions.

Sections 1035(c)(1)(B) and (c)(3). Definition of Oil Related Income: Gain from the Sale of Stock and Certain Public Utility Income.

The Administration objects to both of these provisions because of their narrow scope. In the first instance the principle is logically sound. We would not object if the provision were drafted in general terms; but we do not accept that a provision which is acceptable on its merits should be available

only to certain corporations in contiguous countries. In the second case we object to the provision because it says that income from the transportation and distribution of oil and gas, which clearly belongs in the category of oil and gas related income, is not oil and gas related income if derived by certain types of utilities; we oppose such narrow relief measures. Both of these measures illustrate the inevitable problems of isolating an "oil basket" of oil and gas income. There are bound to be hardships among some taxpayers who find their income put into that basket and others who find their income excluded from it. The solution is not to patch up the concept with exceptions but to replace it by a limitation of the credit for foreign taxes on oil and gas extraction income to 48 percent.

Section 1308. Personal Holding Company Income Amendments.

After a careful and detailed analysis we concluded that the proposal would create an unwarranted technique for circumventing the personal holding company provisions. In addition, we concluded that the 1964 effective date was unwarranted. Accordingly, we changed our position from no objection to opposed.

Section 1311. Franchise Transfers.

Section 1311 of the Bill contains two essentially unrelated provisions. Section 1311(a) eliminates a potential avenue of abuse under present law where a partnership transfers a franchise; we have consistently supported this provision.

Section 1311(b) is a grandfather provision which is extremely narrow in applicability, and which we have concluded after careful consideration is totally unwarranted. We therefore clarified our position to indicate opposition to this latter provision.

Section 2106. Income from Fairs, Expositions and Trade Shows.

The Administration would have no objection to the portion of the provision which provides an exemption for trade shows if the provision did not also change qualification requirements for exempt organizations. After further considering the retroactive effective date of the provision and its overly broad nature, as well as the change in qualification requirements, we changed our position from no objection to opposed.

COMPARISON OF ADMINISTRATION POSITION ON JUNE 15, 1976 and
JULY 20, 1976 ON CERTAIN SECTIONS OF TAX REFORM BILL (H.R. 10612)

Bill section	Brief description	June 15, 1976 Administration position on the entire section (H.R. 10612 as reported by the Finance Committee to the Senate)	July 20, 1976 Administration position on special relief parts of the section (H.R. 10612 reopened hearings)
1013 (f)	Foreign trusts with U.S. beneficiaries taxed currently to grantor	Support	Strongly support provision but oppose delay in effective date.
1021	Amendment of provision relating to investment in United States property by controlled foreign corporations	Support	Support basic concept; oppose special relief provisions.
1024	Shipping profits of foreign corporations	No objection	Support the first of four special relief provisions; oppose the other three.
1025	Limitation on definition of foreign base company sales income in the case of certain agricultural products	No objection	Prefer no special exception for agriculture, but if such an exception, Senate version better than present law or House version.
1031	Requirement that foreign tax credit be determined on overall basis	No objection	No objection to basic concept; oppose special exception for mining companies.
1032	Recapture of foreign losses	Support	No objection.
1035	Foreign oil and gas extraction income.	No objection with modification.	
1035(a)	Foreign oil and gas extraction income; transitional rule for foreign tax credit limit		No objection in principle; oppose because of retroactivity.

Bill Section	Brief description	June 15, 1976 Administration position on the entire section (H R. 10612 as reported by the Finance Committee to the Senate)	July 20, 1976 Administration position on special relief parts of the section (H.R. 10612 reopened hearings
1035(b)	Foreign oil and gas extraction income, transitional rule for recapture of foreign oil related losses.		Oppose because of retroactivity; do not object in principle.
1035(c)(1) and(2)(A)	Foreign oil and gas extraction income, definition of oil related income.		No objection; but emphasize superiority of Treasury proposed 48 percent rule and difficulties inherent in "oil basket."
1035(c)(1)(B)	Foreign oil and gas extraction income; definition of oil related income-gain from sale of stock		Oppose because of narrow scope; would not oppose broader provision.
1035(c)(3)	Foreign oil and gas extraction income; certain public utility income.		Oppose because affected income appears to fall in "oil basket," but repeat superiority of Treasury proposed 48 percent rule.
1035(d)	Foreign oil and gas extraction income; foreign oil related income earned by individuals.		Support; analogous to Treasury proposed 48 percent rule for corporations.
1035(e)	Foreign oil and gas extraction income; certain payments not to be considered taxes.		Oppose; but would support a 5 year, 20 percent rule.
1035(f)	Foreign oil and gas extraction income.		Oppose.

Bill Section	Brief description	June 15, 1976 Administration position on the entire section (H R. 10612 as reported by the Finance Committee to the Senate)	July 20, 1976 Administration position of special relief parts of the section (H.R. 10612 reopened hearings)
1036	Underwriting income.	No objection.	Support.
1041	Portfolio debt investments in United States of nonresident aliens and foreign corporations.	Support.	Strongly support.
1042	Changes in ruling requirements under Section 367, certain changes in Section 1248.	Support	Strongly support changes in Section 367; strongly oppose retroactive special relief
1043	Contiguous country branches of domestic life insurance companies.	No objection.	No objection but should not be regarded as precedent.
1052	Western Hemisphere Trade Corporations	Support.	Support repeal of WHTC; oppose narrow transitional rule but would not oppose transitional rule if general.
1207	Treatment of certain individuals employed in fishing as self-employed individuals.	Support.	Oppose In light of the Committee amendment which would increase the number of crewmen to ten we concluded that the provision would extend unwarranted relief to substantial business enterprises.
1307	Interest of original issue discount on certain obligations.	No objection.	Oppose. The June 15 statement of no objection was an error.
1308	Personal holding company income amendments.	No objection.	Oppose. (See discussion in attached memorandum).
1310	Repeal of excise tax on light-duty truck parts.	No objection.	Support.
1311	Franchise transfers.	No objection.	Support in part and oppose in part. (See discussion in attached memorandum).

Bill section	Brief description	June 15, 1976 Administration position on the entire section (H.R. 10612 as reported by the Finance Committee to the Senate)	July 20, 1976 Administration position on special relief parts of the section (H.R. 10612 reopened hearings)
1314	Qualification of Fishing Organization as Tax Exempt Agricultural Organization	No objection.	The Administration defers to the Postal Service on this provision which is intended to allow fishing organizations to obtain favorable postal rates.
1317	Amendments to rules relating to limitation on percentage depletion in case of oil and gas wells.	Support.	Position clarified to indicate that the Administration has no objection to two provisions of the section and supports the other two provisions of the section.
1321	Taxation of certain barges prohibited.	Support.	Oppose. This provision does not relate to Federal taxation; upon further reflection and consultation with OMB the Administration position was changed.
1507	Study of salary reduction pension plans.	No objection.	No objection to the freeze imposed by the provision. The Administration, however, recommends that the period of the freeze not extend beyond January 1, 1978 so that the issues involved in salary reduction plans can be promptly resolved.
1701	Railroad provisions.	Oppose.	The Administration position has been clarified to indicate support for certain provisions of the section and opposition for others.
2106	Income from fairs, expositions and trade shows.	No objection.	Opposed. (See discussion in attached memorandum).