VARIOUS REVENUE AND TARIFF BILLS

HEARING

BEFORE THE

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UNITED STATES SENATE

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SECOND SESSION

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VARIOUS REVENUE AND TARIFF BILLS

TUESDAY, AUGUST 24, 1976

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 7:55 a.m., in room 2221, Dirksen Senate Office Building, Hon. Russell B. Long (chairman of the committee) presiding.

Present: Senators Long, Talmadge, Nelson, Bentsen, Hathaway, Curtis, Fannin, and Packwood.

The CHAIRMAN. I will call this hearing to order.

We are pleased to have with us today Hon. Lee Metcalf, U.S. Senator from Montana.

Senator, we are happy to have you here. We agreed to hear you on the amendment that you offered on the floor.

STATEMENT OF HON. LEE METCALF, A U.S. SENATOR FROM THE STATE OF MONTANA

Senator METCALF. Thank you, Mr. Chairman. I am delighted to be back here before this committee. I enjoyed my service with you.

I am pleased to be here this morning.

Today, I am testifying in support of my bill, S. 2213, Electric Utility Tax Exemption Act. Because of its importance to consumers of electricity and the development of sound energy regulation, I proposed my bill as amendment number 1840 to the Tax Reform Act of 1976—H.R. 10612, as the chairman very well knows, on which he worked so hard.

I withdrew my amendment after receiving assurance from Senator Ribicoff, the acting floor manager, that this committee would hold a hearing on S. 2213 prior to final adjournment of the 94th Congress. From our colloquy at the time I withdrew my amendment, I know that Senator Haskell is concerned about the serious problems for consumers which have evolved from application of the Federal income tax laws to electric utilities.

I believe that the other members of this committee are also concerned over the financial hardships which working families and those living on fixed incomes have been forced to endure during the past few years as a result of skyrocketing electric rates.

Application of the Federal income tax laws in setting electric rates has unnecessarily aggravated the burden of rapidly rising electricity prices for residential customers and businessmen. Congress may not be

able to control some of the factors behind the increased cost of electricity, but we can eliminate unnecessary cost burdens resulting from the Federal income tax laws.

I introduced S. 2213 as one practical way for Congress to correct the ratemaking abuses which have resulted from the application of existing Federal income tax laws. This bill will work because electric rates would no longer be subject to the unfair and contradictory accounting techniques which are used to charge customers for Federal income tax that utilities do not pay.

The Electric Utility Tax Exemption Act provides simply that investor-owned electric utilities would be relieved of all obligations and benefits arising under the Federal income tax laws. I want to emphasize, Mr. Chairman, that they are not only relieved of obligation, but the benefits that they acquire from the tax laws are what we are aiming at in this legislation.

Information compiled by the Federal Power Commission confirms that enactment of S. 2213 would have a relatively limited impact on Treasury receipts when compared to the vast amounts of customer overcharges which would be prevented.

Data from 1974—the most recent available, and that is the data that Treasury is going to use in the statement they will make after me—shows that the entire electric utility industry paid only $528 million in Federal income taxes on total electric operating revenues of $37.2 billion. That was actually a 48-percent decrease in absolute dollars from the $1 billion paid in Federal income taxes by the electric utilities in 1955—20 years ago.

More than one-third of the major electric utilities paid no Federal income taxes at all in 1974. Instead, those utilities accumulated over $218 million of tax credits.

On a relative basis, the amount of Federal income taxes paid by investor-owned electric utilities declined from 14.7 percent of revenues in 1955 to only 1.4 percent of revenues in 1974.

Since taxes are based on income, it should be noted that the electric utilities' profitability, as measured by their return on common stock equity, was the same in 1955 and 1974. In both years, they averaged a 10.8 percent return on equity.

The abuses present in the existing tax laws are best illustrated by comparing total Federal income taxes paid by electric utilities in 1974 with the Federal income taxes charged to customers on just the amount of rate increases granted in a single year.

Based on a recent survey of State regulatory commissions, the Library of Congress estimates that investor-owned electric utilities were granted additional general rate increases totaling $3.3 billion in 1975 alone.

Approximately one-half of that amount—more than $1.6 billion—was earmarked for the payment of Federal income taxes on the additional amount of utility revenues.

The $1.6 billion charged to customers for incremental Federal income taxes supposedly due on rate increases in 1975 was three times the amount of Federal income taxes actually paid by electric utilities on their total operating revenues in 1974. How is it that customers can be charged $1 billion more for taxes in a single year of rate in-

creases than the entire electric utility industry paid for Federal income taxes on total revenues the previous year?

The answer lies in the extensive array of complicated tax benefits which were available to electric utilities in 1974. Since 1974, Congress has provided more benefits by raising the investment tax credit for utilities from 4 to 10 percent, and removing the restrictions on its applicability.

The major problem with existing, complex provisions to aid electric utilities is that they do not also benefit consumers hard-pressed by vastly increased electricity rates. Many Members of Congress have mistakenly believed that voting for complicated accelerated depreciation and investment tax credit provisions would reduce rates for consumers.

Mr. Chairman, when I am talking about these various accelerated tax provisions and investment tax credits, I am talking only as that legislation applies to these regulated utilities, especially the electric utility industry, rather than to the general industry, where the chairman knows, and I know, that there are extensive benefits from this accelerated test rates and investment tax credits.

The present tax benefits for investor-owned electric utilities do not generally pass through to consumers because the electric utilities continue to charge customers for Federal income taxes as if the tax benefits did not exist. The electric utilities are able to do this with the aid of sophisticated accounting techniques which permit them to keep two sets of books—one showing little or no taxes owed for use by the IRS, and one showing substantial taxes owed for use in setting rates.

The difference can be quite dramatic. For example, a regulatory commission which determines that a utility needs an income increase of $10 million may order a rate increase for customers of almost $20 million. The doubling of the income required to determine the rates charged customers is to permit the electric utilities to pay Federal income taxes at the theoretical 48 percent on the amount of rate increase, and still have $10 million left for income.

Of course, nearly all investor-owned electric utilities pay little or no Federal income taxes. Instead, they keep the extra money charged for taxes, and customers are left holding the bag because of a fine point of accounting theory.

The process of charging customers for income taxes which are not paid to the Federal Government has led to vast overcharges that are not related to increased costs of service. At the end of 1974, the investor-owned electric utilities were holding $5.3 billion which had been charged to customers for Federal income taxes.

Past experience indicates that customer money being kept by utilities for Federal income taxes will never be paid to the Federal Government. New tax deferrals and credits always exceed past tax obligations coming due, so the total amount of kept taxes is constantly increasing.

My bill extends the Federal income tax benefits given electric utilities to their customers. By exempting electric utilities from the Federal income tax laws, they will no longer be able to claim a 100 percent bonus on every rate increase, based on a charge for Federal income taxes that will never be paid.

The investor-owned electric utilities will benefit from S. 2213 because it assures that they will remain free from the burden of paying Federal income taxes. Their customers will benefit from S. 2213 because electric rates will not include allowances for unpaid Federal income taxes.

A decision by a regulatory commission that an electric utility needs increased income of $10 million will result in a rate increase for customers of $10 million, not $20 million.

The goal of regulatory reform will also be advanced significantly by enactment of S. 2213. The confusion and expense resulting from two sets of books, special tax accounts, complex accounting procedures and voluminous recordkeeping would be eliminated from rate proceedings.

Federal interference in State regulatory proceedings through tax provisions would be stopped by enactment of my bill. For example, section 46(E) was enacted by Congress in 1971, the vast majority of State regulatory commissions had decided that it was unfair to require utility customers to pay a profit on funds they had previously paid to the utility for Federal income taxes.

Section 46(E) denies State regulatory commissions the ability to exercise their sound discretion in setting fair electric rates for their citizens. Enactment of S. 2213 would restore to the States complete authority to determine the fairness of electric rates.

Exempting electric utilities from the Federal income tax laws may actually increase U.S. Treasury receipts. In 1974, shareholders of some electric utilities received a total of $649 million in dividends which were not subject to personal Federal income taxes.

This was an unintended benefit which Congress has unsuccessfully tried to correct. Enactment of S. 2213 will insure that electric utility dividends are fairly taxed by the Federal Government.

S. 2213 would reform tax-related abuses in setting electric rates by simply exempting electric utilities from the provisions of the Internal Revenue Code. Another approach would be to reform accounting procedures which have been developed to provide legitimacy for these abuses of the regulatory system.

The Reports, Accounting and Management Subcommittee, of which I am chairman, has been studying the development and application of accounting procedures that have resulted in misleading and inconsistent information being reported to the public. One of the major problem areas in accounting is the use of more than one set of books to report different financial results to different parties.

Parenthetically, Mr. Chairman, I was a member of the Montana State Legislature in 1937. I, at that time, introduced a bill to require the Montana Power Co. to keep one set of books for tax purposes and one set of books for ratemaking purposes. I have been on this little minor crusade for a long, long time.

I failed at that sort of approach, but it seems to me that this approach is a little bit more logical. Anway, this is no new idea.

Commonsense often gives way to absurd, but expedient, accounting theories when corporations are required to report on the results of their activities to Government authorities or the public. Unfortunately, accounting for Federal income taxes in setting electric rates has been one

of the most fruitful areas of resourceful creativity in developing misleading accounting procedures.

I received the Treasury Department's comments on S. 2213 only last Thursday, but its objections to my bill demonstrate some of the problems I have described.

Treasury points out that $528 million is too much revenue for the Treasury to lose. Treasury does not mention the $5.3 billion of unpaid Federal income taxes which electric utilities were keeping at the end of 1974.

If utility customers were not overcharged that amount, that money would undoubtedly be spent in other sectors of our economy, including such depressed areas as automobiles and housing. Those expenditures would probably yield more tax revenues for the Federal Government than would be lost by enactment of S. 2213.

The Treasury Department also states that the losses and meager income shown by electric utilities for Federal income tax purposes is a more realistic indication of their true earnings than publicly reported utility earnings. Even the investor-owned electric utilities and their high-priced tax lawyers and accountants have not tried to push that nonsense.

Our studies clearly indicate that accounting procedures used by utilities in reporting to the public are developed with a primary concern for promoting the utilities' interests.

Finally, the Treasury Department believes that S. 2213 conflicts with the "goal of achieving increased energy independence" by wastefully encouraging energy consumption. We know that it is a major policy of the present administration to raise the cost of basic and necessary energy supplies for consumers.

Congress has not accepted that policy, and I believe such a policy disregards the magnitude and effects of cost increases which have already occurred.

Mr. Chairman, I do appreciate that the Treasury Department did, before I appeared, provide me with a copy of their statement. Since both of our statements are based largely on the same statistics, I am glad to be able to answer in advance some of the propositions that they raised.

The electric utilities have not supported S. 2213 because, unlike their customers, they have successfully turned the concept of Federal income taxation into a cost-free source of ready cash. They call it "cash flow," and speak of the benefits existing Federal tax policies bring to customers.

I call it taxkeeping, and say that it is unfair to require hard-pressed residential customers and businessmen to pay "phantom" Federal income taxes. I have not yet met a customer who believes that he should pay for property used by monopolies to provide basic and necessary electric service at a healthy profit.

However, I have heard from angry customers who are outraged at being charged for Federal income taxes which are not being paid by their electric utilities.

Millions of customers can no longer afford the unnecessary and extravagant "cash-flow" provisions for electric utilities which are embedded in the present Federal tax laws.

I urge that this committee give serious consideration to S. 2218 and the reform it would bring to the process of setting electric rates. I also urge that the Finance Committee staff work with the staff of my subcommittee in further exploring ways in which accounting procedures bring confusion and inequity into the computation of Federal income taxes.

I believe that a joint effort would be very helpful to Congress in reforming our tax laws, and understanding the importance of proper accounting procedures.

Mr. Chairman, I would like to submit for the record a list of my remarks in the Congressional Record concerning Federal income taxes paid by electric utilities.

I may say that I am delighted that the Treasury Department has read some of those remarks and cite them in the statement they make. Sometimes we put things in the record and think it is buried, but at least it has done some good.

Those remarks contain much detail which I have omitted from my testimony today. I also include for the record a copy of my amendment 1840 to H.R. 10612, with correction of two typographical errors in the printing of that amendment.

I also submit for the hearing record an article from the September 13, 1975 Philadelphia Inquirer. It shows how utility consumers are overcharged for phantom Federal taxes.

I described that, but that is also described in an article that I am submitting for the record.

Mr. Chairman, the most outrageous part of the utility tax ripoff is yet to come, if the utilities get their way. They want to sell their unused tax credits.

The board chairman of Pacific Power and Light, Don C. Frisbee, testified on that point before the Ways and Means Committee last year.

He recommended that utilities be allowed to sell unused investment tax credits. I wonder how much that would cost the Treasury, which did not even mention, in its comments on my amendment, the more than $5 billion the utilities were keeping at the end of 1974.

So the utilities don't want to settle for just being tax keepers, rather than taxpayers. They want their cake, their frosting, and the pan.

I urge this committee to bring an end to this nonsense by adoption of my proposal.

The CHAIRMAN. The material will be received for the record.

[The material referred to follows:]

[H.R. 10612, 94th Cong., 2d sess.]

AMENDMENT Intended to be proposed by Mr. Metcalf to H.R. 10612, an Act to reform the tax laws of the United States, viz: At the appropriate place insert the following:

SEC. . EXEMPTION OF ELECTRICAL UTILITIES FROM INCOME TAX.

(a) IN GENERAL.—Section 501(c)(3) (relating to list of exempt organizations) is amended by adding at the end thereof the following new paragraph:

"(20) A corporation engaged predominantly in the sale of electrical energy, if the rates for such sale have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, or by a public utility or public service commission or other similar body in the District of Columbia or of any State or political subdivision thereof.".

(b) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Section 46(c)(3) (relating to public utility property) is amended by striking out "electrical energy," in subparagraph (B)(i).

(2) Section 167(l)(3) (relating to definition of public utility property) is amended by striking out "electrical energy," in subparagraph (A)(i).

(3) Section 247(b)(1) (relating to definition of public utility) is amended to read as follows:

"(1) PUBLIC UTILITY.—The term 'public utility' means a corporation engaged in the furnishing of telephone service or in the sale of gas or water if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof or by an agency or instrumentality of the United States, or by a public utility or public service commission or other similar body of the District of Columbia, or of any State or political subdivision thereof.".

(4) Section 7701(a)(33) (relating to definition of regulated public utility) is amended by striking out "electric energy," in subparagraph (A)(i).

(c) EFFECTIVE DATE.—The amendments made by this section apply to taxable years beginning October 1, 1977.

STATEMENTS BY SENATOR LEE METCALF IN THE CONGRESSIONAL RECORD REGARDING FEDERAL INCOME TAXATION OF INVESTOR-OWNED ELECTRIC UTILITIES

September 11, 1974; p. S16345—"Utility Consumers Simonized."

July 29, 1975; p. S14090—Introduction of S. 2213.

September 10, 1975; p. S15679—Competition Keen Among Utilities For Taxkeeper of the Year Award.

September 15, 1975; p. S15930—"Competition Keen Among Utilities for Tax Keeper of the Year Award."—Corrections of typographical errors in tables.

March 4, 1976; p. S2901—"The $649 Million Tax-free Bonanza for Utility Investors."

March 23, 1976; p. S3997—"More Tax-free Dividends for Utilities."

June 14, 1976; p. S9136—Introductory remarks to amendment No. 1840 to H.R. 10612—The Tax Reform Act of 1976.

The CHAIRMAN. Thank you very much, Senator Metcalf, for a very thoughtful statement.

Next on our list of witnesses this morning—we have a rather ambitious schedule here—we will hear from Mr. Wallace D. Barlow, executive director, Stock Option Writer's Association.

Our witnesses are limited to 5 minutes, from this point following.

STATEMENT OF WALLACE D. BARLOW, EXECUTIVE DIRECTOR, STOCK OPTION WRITER'S ASSOCIATION, BETHESDA, MD.

Mr. BARLOW. I will brief my statement orally.

I am Wallace Barlow of Bethesda, Md. I have been trading stock options for the last 48 years. I am here on behalf of the independent stock option writers, whose existence is threatened by H.R. 3052; also by the Mikva bill, which has now been added to the so-called tax reform bill, of which you gentlemen will be conferees on this bill.

This bill would transfer income from the pockets of the independent writers to the pockets of the tax exempt organizations. Our option lapse income would be taxed at ordinary income rates; theirs would no longer be considered "unrelated business income" and would not be taxed.

How important is option lapse income to the writer, or seller, of stock options? My own experience is typical. In the last 10 years, an average of 66 percent of our options lapsed. In 1973, 79 percent lapsed and in the first half of 1976, 40 percent lapsed. In 1975, our option

lapse income was 80 percent of the total; dividends were 20 percent; capital gains were zero.

H.R. 3052 is, in effect, a private bill for the relief of the Chicago Board Options Exchange—CBOE—also the ASE and the PBW exchanges, in that it would enlarge their markets. In this new market, the exempt organizations would have an unfair advantage over the independent writers.

Already, since the advent of "listed" options, in 1973, most of the independent writers are bankrupt. The few remaining writers of conventional, or nonlisted, options have suffered, in that premiums on the listed options are much lower than on the nonlisted options. In 1976, to date, our annualized premiums as a percentage of the amount at risk, amounted to 44.9 percent on the nonlisted calls and 21.6 percent on the listed calls.

We need 45 percent per year to survive, since our investment may be 10 times as large as that of the buyer. Also, we need a cushion to protect us against the accumulation of "rejects." For example, when Canadian Javelin fell from $21 to $2, and was delisted, we gained some option lapse income. However, we stand to lose far more than this on the ultimate sale, or charge off, of 2,200 shares.

We regard H.R. 3052 as rank and offensive discrimination and we ask the committee to protect our people against the ruinous competition of tax exempt organizations.

Thank you for the privilege of testifying.

The CHAIRMAN. Thank you very much, sir.

Are there any questions, gentlemen?

Senator BENTSEN. Let me understand this a little better. You say your option lapse income, yours would be taxed at an ordinary income rate, and theirs would now be considered unrelated business income and not be taxed.

Would they not also have a setoff, offset on their other income?

Mr. BARLOW. I am not a tax accountant, Senator. I am sorry, I do not know. Maybe the Chicago Board witness can answer that question.

Senator BENTSEN. All right, thank you.

The CHAIRMAN. Thank you, sir.

Next, we will call Mr. Leon Pomerance, chairman of the board of directors, Chicago Options Exchange.

STATEMENT OF LEON POMERANCE, CHAIRMAN OF THE BOARD OF DIRECTORS, CHICAGO OPTIONS EXCHANGE; ACCOMPANIED BY DANIEL B. SKELTON, VICE PRESIDENT AND ERNEST S. CHRISTIAN, JR., SPECIAL TAX COUNSEL

Mr. POMERANCE. I am Leon Pomerance, chairman of the board of directors of the Chicago Board Options Exchange. With me are Daniel B. Skelton, vice president of the exchange and Ernest S. Christian, Jr., special tax counsel.

The Chicago Board Options Exchange, known as CBOE, is a national securities exchange registered under the 1934 act of the SEC. It was the first exchange in the United States to provide a central marketplace for trading option contracts for the purchase and sale of stock, popularly known as "puts" and "calls."

Presently we trade only calls. We expect we will be trading puts in the early part of next year.

The Chicago Board Options Exchange strongly supports the bill, H.R. 3052, affectionately known as the Ruskincosky bill, affectionately, because it has taken quite a few years to come before this point, which removes a barrier to the participation in the options markets on the part of exempt organizations. Present law unnecessarily discourages exempt organizations from writing options to buy or sell securities by inconsistently applying the unrelated business income tax to certain income which exempt organizations receive from writing options.

Right now, for exempt organizations, dividend income, capital gains, interest income, is known as exempt income. The only thing that was not exempt was anything that is related to doing business, and the Revenue Code 512(b)(5) indicated that income from a lapsed option to be construed as doing a business.

H.R. 3052, which has the support of the Treasury Department, throws all income that results as income into an exempt category. This is really a strange bird, because when an exempt institution writes an option—in other words, they are giving somebody the right to buy their stoccks—they receive $1,000 income. They do not know what it is going to be under the old law. If it is called away, it becomes part of a capital gain.

It is only if it lapses that it becomes ordinary income, so that it is a deterrent for an exempt organization to decide to do something or not to do something, and it appears to us that it would be unfair to put it into a category that is just like any other income related to stocks and bonds and investment opportunities that exempt organization can do.

Writing calls is just another form of investment management that has been created by the Chicago Board Options Exchange and recognized as such.

The CHAIRMAN. Sir, your 5 minutes has expired. We will study your statement.

Are there any questions, gentlemen?

Senator Bentsen?

Senator BENTSEN. As I understand this piece of legislation, what we plan to do is take care of the situation where you have a loss, but they have been taking it as a charge against ordinary income.

Mr. POMERANCE. What has been happening, under H.R. 3052, if an exempted organization receives income, they are subject to tax on it, even though, if they have income, it means that the security on which they wrote it on is down so they have an unrealized capital loss, or realized capital loss, and then have to suffer the indignity of having to pay tax on income which is certainly not intended for an exempt organization.

Senator BENTSEN. All right. You have not, at that point, realized that specific loss.

What happens when you realize that loss?

Mr. POMERANCE. For an exempt institution, they have no relief. They just have a tax loss.

Senator BENTSEN. What do you charge the tax loss against?

Mr. POMERANCE. Nothing. For an exempt institution, there is no tax treatment for capital losses and capital gains, but there is this in-

dignity of having to pay income on an income that is subject to their whole concept of doing a trade or doing an investment.

In other words, you can buy 1,000 shares of Eastman Kodak, take the risk reward of Eastman Kodak going up and down, or they can say, I will write $1,000 Eastman Kodak and take in 10 percent as a premium.

Three out of four ways, that institution will do better if the stock goes down. At least they have the income. If it stands still, they can still make their 10 percent. If it goes up less than 10 percent, they are still ahead. It is only if it appreciates more, so therefore, they are willing to give up a greater reward for a lower risk strategy, but if they have to pay income on it, if Kodak went down to 90 from par, they would have to pay income on that 10 percent.

Senator BENTSEN. We sold options as an insurance company very many years ago.

Mr. POMERANCE. You were one of my accounts.

Senator BENTSEN. That is right, many years ago.

All right, then.

The CHAIRMAN. Thank you, sir.

[The prepared statement of Mr. Pomerance follows:]

STATEMENT OF LEON POMERANCE ON BEHALF OF THE CHICAGO BOARD OPTIONS EXCHANGE

SUMMARY

The Chicago Board Options Exchange ("CBOE") strongly supports H.R. 8052 which removes a barrier to the participation in the options markets on the part of exempt organizations. Present law unnecessarily discourages exempt organizations from writing options to buy or sell securities by inconsistently applying the unrelated business income tax to certain income which exempt organizations receive from writing options.

Most exempt organizations are acutely aware of their need for additional funds. One effective method to increase the yield from their securities portfolio is an investment strategy known as "covered option writing." In covered option writing, an investor who owns a stock writes a "call" (an option to buy that stock at a specified price within a specified period of time). The option writer foregoes the possible appreciation in the value of the stock during the option period in return for the premium he receives when he writes the option. This premium income is similar to other passive income, such as dividends, which an exempt organization derives from investment activity and which is not subject to the unrelated business income tax.

The "unrelated business income tax" is imposed on the net income derived from any unrelated trade or business of certain exempt organizations. However, the unrelated business income tax is not applicable to investment income such as dividends, interest, annuities, royalties, and capital gains from the sale of investment assets. Under present law there is an anomaly in the application of the related business income tax to exempt organizations. If an exempt organization writes an option which is later exercised, the gain or loss realized upon the exercise is treated as capital gain or loss, and is thus exempt from the unrelated business income tax. In contrast, if the option lapses or the organization terminates its obligation under the option by entering into a closing transaction, the gain or loss is treated as ordinary income or loss and is subject to the unrelated business income tax.

H.R. 8052 amends Internal Revenue Code § 512(b)(5) to exclude from the term "unrelated business taxable income" all gains on the lapse or termination of options to buy or sell securities, if the options have been written in connection with an exempt organization's investment activities. Thus, H.R. 8052 removes the anomaly in present law: the change would bring the tax treatment of lapse and closing transaction income into line with other passive income derived by an exempt organization from its investment activities.

Sound tax policy dictates that H.R. 3052 should be adopted. First, for more than four years the Congress has attempted to make this change and has recognized that all passive investment income derived from an exempt organization's investment activities should be treated consistently: not subject to the unrelated business income tax. Income from lapses or terminated options is such passive investment income.

Second, the inconsistent treatment of income from options should be corrected, since such treatment discourages exempt organizations from writing options in their overall investment strategy. When an exempt organization writes a call option, it cannot know whether that option will be terminated through exercise, lapse, or closing transaction. The possibility that the unrelated business income tax will apply to the income derived from writing options deters some exempt organizations from writing options. We do not feel that the Congress intends to discourage option writing on the part of exempt organizations in this manner.

Finally, the purpose of the unrelated busines income tax—to prevent tax exempt businesses from unfairly competing with taxable businesses—is not furthered by applying the tax to income derived from the lapse of, or closing transaction in, options written by exempt organizations in connection with investment activities. Production of investment income, such as capital gains, by exempt organizations simply does not involve competition with taxable businesses.

H.R. 3052 is closely related to an amendment to H.R. 10612 (the Tax Reform Act of 1976), and H.R. 12224 which passed the House on July 20, 1976. The amendment to H.R. 10612 and H.R. 12224 are substantially the same and relate to the tax treatment of income derived from writing options. These provisions correct another example of inconsistent treatment of transactions in options, and amend Internal Revenue Code § 1234 to provide that gain on the lapse of, and gain or loss from any closing transaction in, options shall be treated as short-term capital gain or loss.

The CBOE supports the principles of consistency and neutrality in the tax treatment of options and believes that those principles underlie the amendment to H.R. 10612 and H.R. 12224. We therefore supported H.R. 12224 in testimony before the Ways and Means Committee and suggested changes which were ultimately adopted in that bill. We wish to point out that the amendment to H.R. 10612 and H.R. 12224 will be disruptive to transactions on our exchange and other options exchanges if they were to contain an effective date which is significantly prior to the date on which the bill is enacted into law. Since these provisions change the character of gain on the lapse of, and gain or loss from any closing transaction in, options from ordinary income to short-term capital gain, investors will be uncertain about the tax treatment of their transactions in options between the effective date of the bill and the date of enactment. Such uncertainty will deter many transactions. We believe that both the House and the Senate recognized and appreciated the severity of this problem and wrote into H.R. 12224 and the amendment to H.R. 10612 an effective date which is their estimates of when the bill would likely be enacted into law. We trust that the Conference Committee will establish an effective date which is not prior to the date of the provision's enactment.

STATEMENT

I am Leon Pomerance, Chairman of the Board of Directors of the Chicago Board Options Exchange. With me are Daniel B. Skelton, Vice President of the Exchange, and Ernest S. Christian, Jr., special tax counsel.

The Chicago Board Options Exchange ("CBOE") is a national securities exchange registered under the Securities Exchange Act of 1934. It was the first exchange in the United States to provide a central marketplace for trading option contracts for the purchase and sale of stock, popularly known as "puts" and "calls". The CBOE has overcome the deficiencies of the over-the-counter market by providing an efficient and continuous options market in which a position previously taken can be liquidated at any time. At the present time, trading exists in call options on stocks which are listed on the New York and American Stock Exchange. The CBOE expects that trading in puts will begin soon, and that the number of listed stocks in which options are traded will be increased.

CBOE's Position on H.R. 3052

The CBOE strongly supports H.R. 3052 which removes a barrier to the participation in the options market on the part of exempt organizations. H.R. 3052 modifies the provisions of present law which unnecessarily discourage exempt organizations from writing options by applying the unrelated business income tax to certain income which exempt organizations receive from writing options to buy or sell securiites.

The Importance of Option Writing to Exempt Organizations

The options exchanges provide exempt organizations with an important new source of income from their investment activities. The options markets, as sources of additional funds, are important to most exempt organizations, particularly colleges and universities, since they cannot attract sufficient funds from contributions or grants, and therefore must look to their investments for additional income.

An investment technique, known as "covered option writing," is a low-risk investment strategy and should not be discouraged by the tax law. On the contrary, the covered writer risks only the possible appreciation in the value of the stock during the option period. The writer foregoes this potential growth in return for the premium he receives when he writes the option. This premium income is similar to other passive income, such as dividends, which an exempt organization derives from investment activity and which is not subject to the "unrelated business income tax."

Covered option writing may be illustrated by an example. Assume that a university has stock in its portfolio with a value of $10,000 on January 1, 1976, and that it intends to hold the stock as a long-term investment. The stock will undoubtedly fluctuate in value; and at the end of the year, the university will have an unrealized gain or loss on the stock. However, except to the extent that the university has received a dividend on the stock during the year, it will not have realized any income from its investment.

Instead, suppose that the university writes a call option with a $10,000 strike price on January 1, and receives a premium of $1,000 for doing so. If the stock declines in value or even remains the same during the option period, the option will become worthless and will not be exercised. The university will realize $1,000 of income when the option lapses, and will also retain the stock which will then have a value of $10,000 or less. Alternatively, if the stock increases in value during the option period, the option will probably be exercised. The university will realize the same $1,000 premium from writing the option, but rather than having the stock with a value in excess of $10,000, it will receive $10,000 in cash for reinvestment.

Present Tax Treatment of Option Writing by Exempt Organizations

The "unrelated business income tax" is imposed on the net income derived from any unrelated trade or business of certain exempt organizations. However, the unrelated business income tax is not applicable to investment income such as dividends, interest, annuities, royalties, and capital gains from the sale of investment assets.

Under present law, there is an anomaly in the application of the unrelated business income tax to exempt organizations. The tax treatment of income which an exempt organization derives from writing puts and calls depends on whether the option is exercised, lapses, or is terminated in a closing transaction. If an exempt organization writes a call in connection with its investment activities and the call is exercised, the underlying stock is sold by the exempt organization. The premium previously received for writing the option is treated as part of the capital gain or loss from the sale of the underlying stock. If a gain has occurred, the entire gain on the sale, including part or all of the premium, is not taxed since present Internal Revenue Code § 512(b)(5) provides that "unrelated business taxable income" excludes all gains or losses from the sale, exchange, or other disposition of capital assets.

On the other hand, the anomaly arises if an option written by an exempt organization is not exercised, and the option lapses or the writer terminates his obligation under the option by entering into a closing transaction. In the case of both a lapse and a closing transaction, any gain or loss realized is classified as ordinary income or loss rather than capital gain or loss. The Internal Revenue Service has ruled that income realized by an exempt organization from call options which lapse is income subject to the unrelated business income tax. Rev. Rul. 66-47, 1966-1 C.B. 149.

The Change in Present Law Effected by H.R. 3052

H.R. 3052 amends Code § 512(b)(5) to exclude from the term "unrelated business taxable income" all gains on the lapse or termination of options to buy or sell securities, if the options have been written in connection with the exempt organization's investment activities. Thus, H.R. 3052, which has Treasury Department support, removes the anomaly in present law: the change would bring the tax treatment of lapse and closing transaction income into line with other passive income derived by an exempt organization from its portfolio securities.

Reasons for the Change Made by H.R. 3052

More than four years ago, in reporting H.R. 11196 (a bill similar to H.R. 3052), the Committee on Ways and Means recognized that income from lapse or termination of an option should not be treated differently from income upon the exercise of an option, when the options have been written in connection with investment activities of the organization. The Committee concluded that in such circumstances both types of income should be exempt from the unrelated business income tax because both types constitute investment income traditionally exempted from that tax. H.R. 3052 again recognizes that the taxation of income from options which are written by exempt organizations and which lapse or are terminated is inconsistent with the generally tax-free treatment accorded to exempt organization's income from investment activities.

The inconsistent treatment of income from option transactions by exempt organizations should be corrected, since such treatment discourages exempt organizations from using options in their overall investment strategy. When the university in the above example writes a call option, it cannot know whether that option will be terminated through exercise, lapse, or closing transaction. As explained, the covered writer foregoes part of the possible appreciation in the value of the stock during the option period in return for the premium it receives when it writes the option. To the extent that under some circumstances (that is, lapse or closing transaction) the premium may be taxed as unrelated business taxable income, this potential tax will deter some exempt organizations from writing options. We do not feel that the Congress intends to discourage option writing—a basically conservative investment strategy—on the part of exempt organizations.

Finally, the purpose of the unrelated business income tax—to prevent tax-exempt businesses from unfairly competing with taxable businesses—is not furthered by applying the tax to income derived from the lapse of, or closing transaction in, options written by exempt organizations in connection with investment activities. The production of investment income, such as capital gains, by exempt organizations simply does not involve competition with taxable businesses. All of this passive investment income, including gains from the lapse or closing transactions in options, should therefore be exempt from the unrelated business income tax.

H.R. 3052 and the Percy Amendment No. 325 to H.R. 10612 (Tax Reform Act of 1976)

In addition to our testimony in support of H.R. 3052, the CBOE believes that it would be remiss if it did not point out to the Committee the closely related provisions of Amendment No. 325 to H.R. 10612 (Tax Reform Act of 1976) which amendment was offered by Senator Percy and agreed to on August 6, 1976, and H.R. 12224 which is substantially the same as the Percy amendment and was passed by the House on July 20, 1976. The Percy amendment and H.R. 12224 deal with another example of inconsistent treatment of transactions in options, and amend Internal Revenue Code § 1234 to provide that gain on the lapse of, and gain or loss from any closing transaction in, options shall be treated as short-term capital gain or loss. Investors who buy and sell stocks and securities receive capital treatment for gains and losses derived from their investment activities. Similarly, investors who buy and then resell options receive capital treatment on their gains and losses. The inconsistency in present law occurs in the tax treatment of option writers whose options lapse or are terminated through a closing transaction. Under rulings from the Internal Revenue Service, gain or loss derived by an option writer from the lapse of, or closing transaction in, options is ordinary income or loss to the option writer. The Percy amendment and H.R. 12224 remove the inconsistency in present law by providing that a writer's gain on the lapse of, and gain or loss from any closing transaction in, options is treated as short-term capital gain or loss.

Removal of this inconsistency was the subject of extensive public hearing in the Committee on Ways and Means, is supported by the Treasury and results in a revenue gain of about $10 million.

Options traded on the CBOE should be taxed no more and no less favorably than other similar securities and transactions. We support the principles of consistency and neutrality in the tax treatment of options and believe that those same principles underlie the Percy amendment and H.R. 12224. We therefore support those provisions.

We wish to point out that the Percy amendment and H.R. 12224 will be disruptive to transactions on the CBOE and other options exchanges if they were to contain an effective date which is significantly prior to the date on which the bill is enacted into law. H.R. 12224 changes the character of gain on the lapse of, and gain or loss from any closing transaction in, options from ordinary income to short-term capital gain. Thus, it can readily be appreciated that between the effective date of the bill and the date of enactment investors will be uncertain about the tax treatment of their transactions in options and will therefore be deterred from making commitments which they otherwise would have made.

We believe that the Committee on Ways and Means recognized and appreciated the severity of this problem and wrote into H.R. 12224 an effective date which reflected its judgment concerning when the provision would likely be enacted into law. Similarly, in adopting the Percy amendment to H.R. 10612, the Senate provided for an effective date of September 1, 1976, which is its estimate of when the provision would likely be enacted into law. We trust that the Conference Committee will establish an effective date which is not prior to the date of the provision's enactment, and thus will avoid retroactive treatment of investors.

In conclusion, Mr. Chairman, we thank you for your attention and consideration of our views concerning these two important provisions relating to the tax treatment of options.

The CHAIRMAN. Next, we will call, with regard to H.R. 3055, Mr. John F. McCarren, general counsel of the Distilled Spirits Council of the United States, Inc.

STATEMENT OF JOHN F. McCARREN, GENERAL COUNSEL, DISTILLED SPIRITS COUNCIL OF THE UNITED STATES, INC.

Mr. McCARREN. Thank you for this opportunity to appear before the committee, Mr. Chairman.

The Distilled Spirits Council has submitted a detailed statement in support of H.R. 3055, and accordingly, my comments this morning will be very brief.

H.R. 3055 would simplify and encourage the exportation of distilled spirits. This is the principal purpose of this bill.

In addition, the bill would liberalize the removal of samples for research, development, or testing and would relax existing requirements for the mingling and blending of distilled spirits in bond.

Production of gin with greater uniformity and without loss in quality would be permitted. Finally, the bill would extend to bulk spirits brought into the United States from Puerto Rico or the Virgin Islands the same loss provisions presently applicable to imported and domestic spirits thereby curing an inequity in the present law.

There would be no loss of revenue as a result of the amendments contained in the bill. There would be a short-term lag in revenue of an undetermined, but not major, amount resulting from section 8 of the bill.

The Treasury Department does not object to any provisions contained in the bill. The Distilled Spirits Council urges adoption of these amendments in keeping with our need and desire to improve our export position in all fields.

Once gain, I thank you for the opportunity to appear here this morning.

The CHAIRMAN. Thank you.

Are there any questions, gentlemen?

Thank you very much.

[The prepared statement of Mr. McCarren, follows:]

STATEMENT OF THE DISTILLED SPIRITS COUNCIL OF THE U.S., INC.

The Distilled Spirits Council of the U.S., Inc. (DISCUS), the national trade association of the domestic distilling industry, whose members produce approximately 95% of all distilled spirits produced in the United States, supports the provisions of HR 3055 for the reasons set forth in attachment A to this statement (attachment A sets forth the purposes of each section, the revenue impact, if any, and the reasons in support of enactment). Attachment B is a section by section explanation of HR 3055.

The bill would simplify and encourage the exportation of distilled spirits. In addition, the bill would liberalize the removal of samples for research, development, or testing and would relax existing requirements for the mingling and blending of distilled spirits in bond. Production of gin with greater uniformity and without loss in quality would be permitted. Finally, the bill would extend to bulk spirits brought into the United States from Puerto Rico or the Virgin Islands the same loss provisions presently applicable to imported and domestic spirits thereby curing an inquity in the present law.

There would be no loss of revenue as a result of the amendments contained in the bill; there would be a short-term lag in revenue of an undetermined, but not major, amount resulting from Section 8 of the bill.

In keeping with our need and desire to improve our export position in all fields, DISCUS urges adoption of these amendments. We appreciate this opportunity to present our views on pending legislation and request favorable consideration.

SUMMARY OF PRINCIPAL POINTS INCLUDED IN THE STATEMENT OF DISTILLED SPIRITS COUNCIL OF THE U.S., INC., BEFORE THE COMMITTEE ON FINANCE, U.S. SENATE, IN SUPPORT OF HR 3055

A. *Benefits of Bill*

1. Simplification of export procedures.
2. Liberalization and simplification of plant procedures.
3. Equalization of loss provision applicable to all distilled spirits.

B. *Revenue Effect*

1. No loss of revenue.
2. Short term lag in revenue in minor amounts.

SUMMARY OF PROVISIONS OF H.R. 3055, 94TH CONGRESS, FIRST SESSION

A. Sets forth the purpose of the Section
B. The revenue impact, if any
C. The reasons in support of enactment

Section 1

(a) Would eliminate the requirement of showing on the label of gin and vodka botted in bond for export the name of the distiller.

(b) Revenue effect—none.

(c) Would simplify the labeling of gin and vodka for export and thereby facilitate export sales.

Section 2

(a) Would extend to bulk imported goods which are bottled in the United States for export the same tax benefits presently permitted for domestically produced goods bottled for export.

(b) Revenue effect—none.

(c) Would broaden market for goods to be exported from the United States.

Section 3

(a) Would create an export facility on distilled spirits plant premises.

(b) Revenue effect—no loss of revenue but a short-term lag in revenue of undetermined, but not major, amount.

(c) Would simplify export procedures and encourage further development of export markets.

Section 4

(a) Would liberalize export procedures by permitting transfer to any Customs-bonded warehouse for export.

(b) Revenue effect—none.

(c) Would eliminate needless restrictions on movement within this country of spirits consigned for export.

Section 5

(a) Would make reasonable extension of the purposes for which samples may be removed without payment of tax.

(b) Revenue effect—negligible.

(c) Would recognize commercial necessity for testing of samples which are never sold or entered into commerce.

Section 6

(a) Would permit the mingling in bond of distilled spirits within 20 years of the date of original entry rather than the existing 8 years.

(b) Revenue effect—none.

(c) Would simplify plant operations by permitting mingling of eligible spirits during the entire period of allowable storage in bond.

Section 7

(a) Would authorize the use of natural oils of juniper berries and other aromatics in the production of gin without incurrance of the rectification tax in addition to the present system of redistillation of a pure spirit over juniper berries and other aromatics.

(b) Revenue effect—none.

(c) Would permit the use of modern techniques to produce a uniform, high-quality product.

Section 8

(a) Would extend to bulk spirits brought into the United States from Puerto Rico or the Virgin Islands the same loss provisions made applicable to imported and domestic spirits.

(b) Revenue effect—none.

(c) Would correct an oversight in prior law whereby loss allowances applicable to domestic and imported spirits were not made applicable to products from Puerto Rico and the Virgin Islands.

Section 9

Provides only for effective date.

H.R. 3055, 94TH CONGRESS—FIRST SESSION

EXPLANATION OF THE BILL

This bill makes a series of amendments to the distilled spirits plant provisions of the Internal Revenue Code which in general are designed to remove restrictions which are not necessary for effective enforcement of the revenue and regulatory aspects of these provisions and which would facilitate and encourage exportations. These amendments will have no adverse effect on the revenue. They can be summarized as follows:

Section 1. Name of distiller on label of gin and vodka bottled in bond for export

Section 1 of the bill would eliminate the requirement of showing, on the label of gin and vodka bottled in bond for export, the name of the distiller. Such information serves no useful purpose, and since gin and vodka are produced from neutral spirits, compliance with the statute means showing the distiller of the neutral spirits which may be a person different from the producer of the gin or vodka; the showing of such distiller on the label could even be deceptive to the consumer.

Section 2. Drawback for bulk imported goods bottled in United States

Section 2 of the bill would authorize allowance of drawback of tax on bulk imported goods which are bottled in the United States and exported therefrom. Because of the limitation to goods "manufactured or produced in the United States" in existing law, imported distilled spirits are not subject to drawback under section 5062(b). However, by virtue of section 5523, IRC, reduction in proof and bottling or packaging are deemed to constitute manufacturing under section 311 of the Tariff Act of 1930. (19 U.S.C. 1311) This amendment would make the export standards of Sec. 5062(b) consistent with those in Section 311.

Section 3. Distilled spirits returned to bonded premises

Section 3 of the bill would permit the bottler or packager to return to an export storage facility on bonded premises distilled spirits which would be eligible for drawback under Section 5062(b). The return of the spirits must be solely for the purpose of storage pending withdrawal for export, or other withdrawal without payment of tax authorized under Section 5214(a), or free of tax under Section 7510.

This section also permits the bottler to return to appropriate storage facilities on the bonded premises distilled spirits which he had bottled in bond after tax determination. Such spirits may be withdrawn for any purpose for which distilled spirits bottled in bond before tax determination may be withdrawn from bonded premises.

Appropriate amendments are made to provide for the remission, abatement, credt, or refund of tax on spirits returned to bonded premises under this section.

The amendments made by this section are designed to simplify and encourage export transactions.

Section 4. Withdrawals to customs bonded warehouses

Section 4 of the bill would authorize withdrawal of distilled spirits from bonded premises without payment of tax for transfer to any customs bonded warehouse. This provision applies to spirits bottled in bond for export and to spirits returned to bonded premises under section 5215(b). The amendment is designed to simplify and encourage export transactions.

Section 5. Removal of samples for research, development, or testing

Section 5 of the bill would make a reasonable extension of the purposes for which samples may be removed without payment of tax to include plant research in addition to laboratory analysis. This amendment is similar to the recent amendment to Section 5053 relating to beer.

Section 6. Mingling and blending of distilled spirits

Section 6 of the bill would permit distilled spirits plant proprietors to commingle distilled spirits within 20 years of the date of original entry rather than the existing 8 years. The section also eliminates the requirements of existing law that the mingled spirits be placed in the same barrels and that the mingling must be for further storage in bond. Proper administration of the distilled spirits tax and regulatory provisions does not require the limitations on commingling to 8 years or the return of the distilled spirits to bonded storage. From a practical standpoint, the use of the same package is an unnecessary restriction.

Section 7. Use of juniper oils in production of gin

Section 7 of the bill would authorize the use of the extracted oils of juniper berries and other aromatics in the production of gin without incurrence of the rectification tax in addition to the present system of redistillation of a pure spirit over juniper berries and other aromatics. This amendment will permit production of gin with greater uniformity and without loss in quality.

Section 8. Loss provisions for spirits brought in from Puerto Rico and the Virgin Islands

Section 8 would extend to bulk spirits brought into the United States from Puerto Rico or the Virgin Islands the same loss provisions now applicable to imported and domestic spirits.

Due to an oversight when the law was amended to permit entry of such spirits into bond the provisions applicable to imported and domestic spirits were not extended to spirits brought in from Puerto Rico or the Virgin Islands. Enactment of this section would cure inequities in the present law.

Section 9. Effective date

The act would become effective on the first day of the first calendar month which begins more than 90 days after enactment. This will give the Treasury Department and the distilling industry sufficient time to modify procedures under the statutes amended.

The CHAIRMAN. Next, we will call to testify on H.R. 5161, Income of Magazine Sales for Display Purposes, Mr. Townsend Hoopes, president, Association of American Publishers.

STATEMENT OF TOWNSEND HOOPES, PRESIDENT, ASSOCIATION OF AMERICAN PUBLISHERS; ACCOMPANIED BY MARTIN P. LEVIN, VICE PRESIDENT, TIMES MIRROR CO., CHAIRMAN OF THE BOARD OF NEW AMERICAN LIBRARY, INC.

Mr. HOOPES. Good morning, Mr. Chairman. My name is Townsend Hoopes, I am president of the Association of American Publishers. Accompanying me is Martin P. Levin, vice president of the Times Mirror Co., and chairman of the board of New American Library, Inc., which is the book publishing subsidiary of Times Mirror.

We appear today on behalf of the association and its mass market paperback book division, whose members publish more than 90 percent of the paperback books published in this country.

We are here to urge extension of the provisions of H.R. 5161 to include publishers of mass market paperback books. The House of Representatives approved this bill on the basis that magazine publishers and distributors are adversely affected by present tax law.

This requires a current tax on magazines distributed for promotional or display purposes, even though the parties expect that such magazines will be, in fact, returned to the publisher unsold in the following taxable year.

The taxpayers inability to offset the presumed sale by deducting the anticipated return in the same taxable year departs from generally accepted accounting principles which results in an overstatement of taxable income.

To avoid this distortion, the House has agreed that relief for magazine publishers should be provided.

We wish to stress that the same consideration which prompt adoption of H.R. 5161 for magazine publishers, apply to publishers of mass market paperback books. These books are marketed in virtually the same way as magazines, especially with respect of distributions of large quantities of books to assure adequate display at the retail level.

This basic parallelism argues for equal treatment of mass paperback books and magazines under this bill. There are additional characteristics which would argue that the two types of publications should be treated alike.

First, like magazines, mass market paperback publishers ship more copies of their books than they anticipate will be sold, chiefly for promotional and display purposes.

Second, like magazines, display distributions of these paperback books are substantial, amounting to approximately 35 percent of total distribution, as shown by annual surveys conducted by the Association of American Publishers.

Third, like magazines, mass market paperback publishers are legally obligated to accept all unsold books for a full refund or a credit.

Fourth, like magazines, mass market paperback books have a very short retail shelf life. The paperback industry as a whole releases approximately 400 new titles per month. Older books must be removed from the shelf to make room for the lastest publications.

A recent survey conducted by the association indicates that the average shelf life of a mass market paperback book is only 47 weeks.

Fifth, frequently the same wholesaler distributes both magazines and mass market paperback books to the same retail outlets having the same potential customers.

There are other similarities, Mr. Chairman, but the critical point here is that mass market paperback publishers have at least as strong a case as the magazine publishers for relief under this bill. Limiting these provisions to magazines would create inequity between similarly situated tax forms.

The Association of American Publishers strongly urges that the bill be amended to avoid such an inequity.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, very much.

Are there any questions?

Senator Fannin?

Senator FANNIN. I am not in any disagreement with what you said, I just wonder if I understood it correctly.

You say the books that are returned within the first 3 months of the following year would be subject to the same treatment as books returned during the prior year. Is that correct?

Mr. HOOPES. That is the thrust of the legislation, yes, sir.

Senator FANNIN. Is this a custom that you have maintained over the years, or is this the contractual obligations that you have with the company that is selling?

Mr. HOOPES. I wonder if Mr. Levin might answer that question?

Mr. LEVIN. This is a contractual obligation to take the book back. When we ship the book to the customer, we agree to take back any book he wants to return at any time, so it is a contractual obligation we have.

Mr. FANNIN. Thank you.

The CHAIRMAN. Thank you, sir.

[The prepared statement of Mr. Hoopes follows:]

STATEMENT OF THE ASSOCIATION OF AMERICAN PUBLISHERS

SUMMARY OF PRINCIPAL POINTS

1. *Proposed Amendments to H.R. 5161 Would Avoid Unjust Discrimination.*—H.R. 5161 ameliorates a hardship in the magazine distributing business by adopting a tax accounting rule which is more consistent with the generally accepted accounting principle of matching income and expenses. It provides that

distributions made primarily for display purposes (and which are returned within 2½ months after the taxable year) are not includable in taxable income. The bill, however, is limited to magazines, and failure to accord display distributions of mass market paperback books the same treatment would result in unjust discrimination between similarly situated taxpayers.

2. *Mass Market Paperbacks Meet the Substantive Tests of H.R. 5161.*—The House bill would prescribe two requirements for determining whether publications have been distributed for display purposes. Mass market paperback publishers and distributors, like magazine publishers and distributors, meet these requirements. In both businesses—

(a) Excess quantities of publications, intended for retail display, are distributed with no expectation that they will be sold.

(b) Publishers and distributors are legally bound to accept returns of the excess distributions.

3. *Mass Market Paperbacks and Magazines Have Other Significant Characteristics in Common.*—Apart from meeting the substantive requirements of H.R. 5161, mass market paperback books have other characteristics in common with magazines which strongly militate against disparate treatment of the two types of publications. In both businesses—

(a) The display distributions are substantial in amount (about 35% for paperbacks). Therefore, treatment of such distributions as completed sales may have a significant distorting effect on taxable income, particularly during periods of inflation.

(b) The publications have very short retail shelf-lives.

(c) Unsold distributions have little or no economic value and are almost never resold. Display distributions are generally returned in the form of covers which have been stripped from the books.

(d) The publications are generally distributed by the same wholesalers, and often to the same retail outlets with the same potential customers.

4. *Summary.*—For the foregoing reasons, the improved accounting method which H. R. 5161 would provide for magazine publishers and distributors should be extended as well to publishers and distributors of mass market paperback books.

I. SUMMARY

A. Problem Addressed by H.R. 5161

H.R. 5161, approved by the House of Representatives on August 2, 1976, would go a long way toward eliminating a disparity which exists between the book and income tax accounting of accrual basis taxpayers in the magazine publishing industry.

The disparity arises because, under Internal Revenue Service interpretation, current law does not permit magazine publishers and distributors to deduct from gross income amounts which they place in reserve, in accordance with generally accepted accounting principles, to provide for refunds payable with respect to magazines distributed in a taxable year and returned to them after the close of that year. Such reserves are considered nondeductible for tax purposes even though the publisher or distributor intentionally oversells periodicals to wholesalers to assure adequate display at the retail level and is legally obligated to accept for refund all returns of the excess distributions.

In the periodicals industry, the law as so interpreted may result in significant distortions of taxable income. Excess distributions of periodicals which the parties never expect to be sold are nonetheless included in income. When this occurs in the latter part of the tax year, most returns of the excess distributions are not taken into account until early in the succeeding year. The result is that taxable income may be overstated during periods of rising sales, and understated during periods of declining sales.

Without affecting existing law relating to the nondeductibility of estimated expenses, H.R. 5161 would ameliorate the income-distorting effect on publishers and distributors of periodicals. The House-passed bill, which the Treasury Department has stated it does not oppose, would accord those taxpayers an elective right not to include in income distributions of periodicals made for display purposes (as defined) where the taxpayer can establish, within two and one-half months after the close of the year of distribution, that the periodicals have not been and will not be sold.

B. Position of Association of American Publishers

As described in detail below, accrual basis publishers and distributors of mass market paperback books are in the same tax position as periodicals publishers and distributors.

In both industries:

Large quantities of publications are distributed for display purposes with no expectation that the excess distributions will be sold;

The substantial excess distributions which are put on display are in fact a method of advertising for retail sales;

Publishers and distributors are legally bound to accept all returns of the excess distributions for full refund or credit, and the returns are normally in the form of covers which have been stripped from the books;

The two types of publications have very short retail shelf-lives. Publishers release hundreds of new paperbacks on a monthly basis and, because of the scarcity of retail shelf space, many older titles are withdrawn each month;

Most returns early in a particular tax year are attributable to the prior year's excess distributions, and the returns are almost never resold;

The publications are often distributed by the same wholesalers;

The two types of publications are often displayed at the same retail outlets with the same potential customers.

Under these circumstances, mass market paperback publishers and distributors have as strong a case as do periodicals publishers and distributors for the relief which H.R. 5161 would provide. Limitation of its provisions to periodicals would create an inequity between similarly situated taxpayers and it is strongly urged that H.R. 5161 be modified to avoid this inequity.

II. EXPLANATION OF H.R. 5161

H.R. 5161 would add a new subsection (e) to section 451 of the Internal Revenue Code. The new provisions would apply to sales of magazines or other periodicals "for display purposes." Such sales are defined in paragraph (2) of H.R. 5161 as those made "in order to permit an adequate display of the magazine or other periodical . . . if at the time of sale the taxpayer has a legal obligation to accept returns of such magazine or other periodical." For transactions meeting this definition, paragraph (1) authorizes accrual basis taxpayers to elect not to include in gross income of the taxable year receipts from sales which are returned by the 15th day of the third month of the next year,[1] or with respect to which the taxpayer otherwise establishes that sales have not occurred and will not occur (in accordance with regulations to be prescribed by the Secretary or his delegate). An election under these provisions would be binding for subsequent years and would otherwise be tried as a method of accounting.

In effect, H.R. 5161 would authorize a tax treatment for excess distributions of magazines which is more consistent with economic realities than is the present treatment. Periodicals publishers and distributors would no longer be required to report artificially created income attributable to shipments in the latter part of the year of excess quantities of periodicals which the parties know will not be sold provided the taxpayer also eliminates equally artificial off-setting deductions now taken for returns made in the following taxable year. Excess distributions returned within the statutory period would be ignored for purposes of taxation.

III. REASONS FOR EXTENDING H.R. 5161 TO MASS MARKET PAPERBACK PUBLICATIONS

In its Report on H.R. 5161, the Committee on Ways and Means stated:

"Your committee believes that when periodicals are shipped to retailers for display purposes with no expectation on the part of the parties that these periodicals will be sold, it is not appropriate to treat the shipment as income to the publisher or distributor."

Since mass market paperback books are distributed under substantially the same arrangement, H.R. 5161 should cover these publications as well as magazines and other periodicals.

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[1] The two-and-one-half month cutoff coincides with the date on which corporate tax returns are normally due.

A. Nature and Size of Mass Market Paperback Business

Mass market paperback books, like periodicals, represent a distinct segment of the publications industry. They are nontechnical paperbacks of standard "rack-size" (approximately 7" by 4¼" or smaller) intended for general consumption and characteristically having lower prices and shorter shelf-lives than special interest books or "trade" paperbacks (*e.g.*, those educational publications, reprints of classics, and religious and scientific books which have a limited appeal). For both internal and industry-wide reporting purposes, these characteristics distinguish mass market from other paperback publications. The annual *Industry Sales Statistics* survey of the Association of American Publishers indicates that mass market paperbacks accounted for approximately $819 million in net sales in 1975.[8]

Distribution of mass market paperback books is highly competitive. It is estimated that the average retail outlet contains fewer than 120 "pockets" for displaying rack-size paperbacks. However, in recent years mass market paperback new releases alone have exceeded 5,000 separate titles annually. Considering the large number of releases of mass market paperback publications, the relatively infrequent use of media advertising and the scarcity of retail display space, it becomes obvious that steps to assure adequate retail display are central to the sales strategies of mass market paperback publishers.

To reach the maximum number of retail outlets, mass market paperbacks, like periodicals, are distributed direct to retailers and through a system of independent wholesalers and jobbers. Indeed, in most cases periodicals and mass market paperbacks are distributed by the same wholesalers. As a result, as described below, the methods of marketing the two types of publications are substantially the same.

B. Distributions for Display by Publishers of Mass Market Paperback Books

Distributions—technically in the form of sales—for purposes of display within the meaning of H.R. 5161 are as prevalent in the mass market paperback business as in the periodicals business. Mass market paperback publishers and distributors regularly and deliberately make excess distributions of their publications for the same reason as do periodicals publishers: experience has shown that net sales will suffer unless sufficient quantities of books are shipped to assure adequate display at retail outlets. In a very real sense, for mass market paperbacks, perhaps even more so than for periodicals, the books themselves are their own advertisements.[9]

The Association of American Publishers believes all U.S. mass market paperback publishers employ the sale-for-display marketing technique. As in the periodicals industry, mass market paperback publishers and their customers have no expectation that the excess distributions will in fact be sold. Under agreements with their wholesalers and jobbers, mass market paperback publishers and distributors have a legal obligation to accept for full refund or credit all returns of books not sold at the retail level. The proportion of shipments which are in fact returned is clearly substantial. AAP surveys indicate that 35 to 37 percent of the mass market paperback books shipped in 1973 through 1975 were returned to the publishers for refund pursuant to legal right and would qualify as sales for dsplay purposes under H.R. 5161.

In brief, excess distributions of mass market paperback publications meet the definition of "sales for display purposes" set forth in H.R. 5161. The excess distributions are made to assure adequate display at retail outlets, and mass market paperback publishers and distributors are legally bound to accept all returns. Furthermore, as with periodicals publishers, the distorting effect of treating as income excess distributions of mass market paperbacks may be substantial, since such excess distributions amount to more than one-third of all mass market paperbacks shipments. And with inflation a continuing problem, the distortion of income problem promises to be even more serious in future years.

[8] Total net sales of all books (hard cover and paperback) by U.S. publishers in 1975 amounted to approximately $8.81 billion.

[9] A recent article from the *Washington Post* which describes the marketing of mass market paperbacks is appended to this memorandum. Based on industry sources the article indicates that "the book has to display well," and "if it displays, it sells." Further, it is stated that "Our ad campaigns are so tiny, they are laughable. We don't rely on grand promotions. Each paperback that we display is an advertisement for itself."

C. Short Retail Display Period of Mass Market Paperbacks

While the definition of "sales for display purposes" contained in H.R. 5161 is not explicitly limited to publications that have short retail shelf-lives, it is clear that this characteristic of most periodicals is an important part of the rationale underlying the proposed legislation. Like periodicals, mass market paperback books also typically possess very short retail shelf-lives. Thus, this characteristic distinguishes mass market paperbacks a well a periodicals from other publications and different kinds of goods sold at retail outlets.

In the case of mass market paperbacks, a short retail display period is a matter of practical necessity. A publisher who releases 25 to 35 new titles each month must have assurances that older titles will be regularly removed from limited display space as new titles reach the retailer. In practice, this is what occurs.

Mass market paperback publishers release approximately 400 new books on a monthly basis. These monthly distributions are prescheduled for months in advance. In order to provide adequate retail shelf space, many older titles must be withdrawn each month. A recent survey of publishers who are members of AAP's Mass Market Paperback Division indicates that the expected retail display period of newly released mass market paperbacks ranges from 1 to 12 weeks, with most of the paperbacks having an average shelf-life of four to seven weeks.[4] Monthly paperback return figures requested as part of this survey bear out the publishers' estimates. Given the short retail display period involved, excess distributions of mass market paperbacks in the latter part of a taxable year are just as likely to produce distortions of income under present tax law as are excess distributions of periodicals.

While it is true that magazines are dated and mass market paperbacks are undated, this has no significance from the standpoint of adopting a proper tax accounting rule. All a date indicates is that there is a great likelihood that the magazine will be returned for credit; for paperbacks, this same point is demonstrated by historical statistics and the monthly publication schedules. Thus, dating has no bearing on the real issue—that is, whether it is appropriate to change a tax accounting rule which (1) fails to take into account the unique nature of the business (*e.g.*, the need for significant display distributions subject to an unlimited right of return), and (2) produces a serious distortion of income.

D. Destruction of Mass Market Paperback Returns

Mass market paperback books and periodicals have still another characteristic in common which distinguishes them from the products of many other taxpayers. Like periodicals, mass market paperbacks generally have little or no economic value to the publisher once their initial retail display period has ended. Therefore, rather than incur the freight charges which would be involved in requiring returns of full books, mass market paperback publishers—like periodicals publishers—accept as returns either covers stripped from books or affidavits from wholesalers and retailers certifying that the books have been destoyed. The recent AAP survey of members of the Mass Market Paperback Division indicates that more than 90 percent of all returns of mass market paperback books accepted for refund or credit take the form of stripped covers or affidavits. The small proportion of full-books which come back to publishers are for the most part damaged and, therefore, not saleable.

Within the context of H.R. 5161, the foregoing practice, which is universal among mass market paperback publishers, has double significance. First, it shows that the excess distributions of mass market paperbacks are, in fact, made for display purposes. Publishers have no expectation that they will be able to resell returned books and therefore do not require full-book returns. On the other hand, mass market paperback publishers do require physical documentation that the excess distributions for which refunds are sought have been rendered nonsaleable. Without altering their existing practices they are, therefore, in a position to meet the requirement under H.R. 5161 that the taxpayer establish that a book to be excluded from income "has not been sold and will not be sold."

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[4] The shelf-life of a periodical will vary depending upon whether new issues are releases on a weekly, monthly, quarterly, or less frequent basis.

E. *Conclusion*

Because the sale-for-display practice prevails among publishers and distributors of mass market paperbacks and the marketing arrangements in that segment of the industry are in all relevant respects similar to the methods used by periodicals publishers and distributors, the Association of American Publishers urges that the mass market paperback industry be permitted to adopt the more realistic accounting rules provided in H.R. 5161. Their exclusion would result in discriminatory treatment of taxpayers which are similarly situated.

IV. REVENUE EFFECT

Based on the recent AAP survey of members of the Mass Market Paperback Division and the 1975 amended *Industry Sales Statistics* (adjusted for 1976 sales), it is estimated that the extension of the provisions of H.R. 5161 to mass market paperback publishers—assuming they all make the election—will result in a one-time revenue loss of $16 million, spread evenly over a 10-year period.[5]

V. SUGGESTED AMENDATORY LANGUAGE

The change in H.R. 5161 proposed by the Association of American Publishers can be accomplished by including specific references to "mass market paperback books" in paragraphs (1), (2) and (3)(B), of the bill as approved by the House of Representatives. These changes are reflected in the proposed revision of H.R. 5161 which is attached to this memorandum.

ATTACHMENT

PROPOSED AMENDMENT TO H.R. 5161

[Language to be added is in italic; language to be deleted is indicated in brackets.]

(e) Special rule for *certain publications* which are returned—

(1) In general.—In the case of sales of magazines, [or] other periodicals *or mass market paperback books* for display purposes, a taxpayer who is on an accrual method of accounting may elect not to include in gross income for the taxable year the income attributable to the sale of any magazine, [or] other periodical *or mass market paperback book* which is returned not later than the 15th day of the third month after the close of the taxable year (or with respect to which the taxpayer otherwise establishes in the manner provided by regulations prescribed by the Secretary or his delegate that the periodical has not been sold and will not be sold).

(2) Sales for display purposes defined.—For purposes of this subsection, a sale is for display purposes if such sale is made in order to permit an adequate display of the magazine, [or] other periodical *or, mass market paperback book* and if at the time of sale the taxpayer has a legal obligation to accept returns of such magazine, [or] other periodical *or mass market paperback book.*

(3) Display sales to which subsection applied.—

(A) Election of benefits.—This subsection shall apply to sales for display purposes if and only if the taxpayer makes an election under this subsection with respect to the trade or business in connection with which such sales are made. An election under this subsection may be made only with respect to a taxable year beginning after December 31, 1975, and may be made only with the consent of the Secretary or his delegate. The election shall be made at such time and in such manner as the Secretary or his delegate may by regulations prescribe.

(B) Scope of election.—An election made under this subsection shall apply to all sales of magazines, [and] other periodicals *and mass market paperback books* made for display purposes in connection with the trade or business with respect to which the taxpayer has made the election. An election made under this subsection shall not apply to any sales made for display purposes before the first taxable year for which the election is made.

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[5] The House Report indicates that the adjustment in the transition year is to be spread over a ten-year period.

APPENDIX A

Communications Received by the Committee Expressing an Interest in this Hearing

Statement of Senator William D. Hathaway on Behalf of S. 1904

Mr. Chairman, I very much appreciate this opportunity to testify on behalf of S. 1904, my bill designed to institute some measure of control over an abused loophole in the tariff schedules covering certain wool fabrics imported into the United States by way of one of our insular possessions.

Under present law, a substantial tariff is levied upon imported woven wool fabrics. However, such textiles which have been manufactured abroad and which have then received a simple "shower-proofing" treatment in the Virgin Islands are allowed to enter the United States duty free.

In particular, a heavy wool fabric, made in Romania and Italy enters the United States by means of this procedure and escapes all duty. This results in an unfair competitive advantage to foreign manufacturers over American makers of this fabric.

Over the past few years, domestic consumption of wool textiles has suffered a dramatic decrease and both American production and Virgin Islands exports are well below their former amounts.

The harm in the present situation is that the mainland textile industry is threatened without corresponding benefit to the Virgin Islands. The "shower-proofing" process is accomplished with very few workers but its product competes with similar domestically produced textiles which represent the labor of thousands of workers in the United States.

To allow this situation to continue unchanged means that we shall jeopardize further or eliminate those American jobs. And because that will not benefit the Virgin Islands in anywhere near equal measure, the only beneficiaries will be Italy and Romania who, if they were exploring these textiles directly to the United States, would be paying a heavy tariff.

But I do not wish to see the Virgin Islands suffer and that is why I do not in my bill propose applying normal duties on Virgin Islands textiles. Instead, S. 1904 sets a quota on such imports which are not arduous and which will give our shrinking textile industry the capacity to compete fairly with imports.

The bill has the support of the Administration and is endorsed as well by all relevant trade associations.

For the record, Mr. Chairman, I offer a copy of the letter of February 18, 1976 from the Treasury Department; a statement in support of H.R. 8124, a corresponding House measure; and a letter from the Northern Textile Association dated March 10, 1976, all of which are in support of S. 1904 and elaborate upon my brief remarks today.

THE GENERAL COUNSEL OF THE TREASURY,
Washington, D.C., February 18, 1976.

Hon. RUSSELL LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: Reference is made to your request for the views of this Department on S. 1904, a bill "To amend the Tariff Schedules of the United States in order to change the customs treatment of certain woven fabrics of wool if products of an insular possession of the United States but imported into such possession as fabric for further processing."

The proposed legislation would amend the Tariff Schedules of the United States (19 U.S.C. 1202) by imposing a quantitative limitation (1,000,000 linear yards in 1975 and 500,000 linear yards in subsequent years) on the duty-free entry under General Headnote 3(a) of the Tariff Schedules of certain foreign woolen fabrics which have undergone further processing in an insular possession of the United States located outside the United States customs territory. Beyond these limits, fabrics from the islands would be subject to the same U.S. tariff as woolens from any other most-favored-nation source. The woven woolen fabrics to which the proposed legislation relates are those described in items 336.50, 336.55, and 336.60 of the Tariff Schedules of the United States.

Presently, under General Headnote 3(a) of the Tariff Schedules, fabrics are entitled to duty-free entry if they are deemed to be a manufacture or product

(not fabrics merely further processed) of the insular possessions and if they meet the value requirements set forth under that provision. In recent years a growing volume of trade in woolen fabrics has been entering through the Virgin Islands, where woolens frequently undergo further processing to meet the 50 per cent value-added criterion for duty-free entry into the United States. The increased value of such shipments from this insular possession—$300,000 in 1968, $5.2 million in 1973, and $2.7 million in 1974—has given rise to protests from the U.S. textile industry against the discriminatory loophole in General Headnote 3(a) of the Tariff Schedules, as presently written, which, if continued, could bring about substantial unemployment in that industry.

Although the Treasury normally would oppose any measure which would create a new tariff or a nontariff barrier to trade, the instant situation would seem to warrant amendatory action. No unusual administrative difficulties are anticipated if the proposed legislation is enacted. Therefore, the Department would have no objection to enactment of S. 1904.

The Department has been advised by the Office of Management and Budget that there is no objection from the standpoint of the Administration's program to the submission of this report to your Committee.

Sincerely yours,

RICHARD R. ALBRECHT,
General Counsel.

STATEMENT OF R. REED GRIMWADE, TREASURER, CHARLTON WOOLEN MILLS, CHARLTON CITY, MASS.

Mr. Chairman, my name is R. Reed Grimwade. I am testifying on behalf of the Northern Textile Association, 211 Congress Street, Boston, Massachusetts 02110, of which I am a Director. The Association represents textile manufacturers which use all the principal fibers, including wool manufacturers. NTA's member firms are located primarily in the Northeast.

I am the principal officer, namely Treasurer, of the Charlton Woolen Company of Charlton City, Massachusetts. I am accompanied by Mr. Jack Crowder who is general counsel of the American Textile Manufacturers Institute.

I appreciate this opportunity to testify on H.R. 8124, the Bill now before this subcommittee. My statement on behalf of the Northern Textile Association is also supported by the American Textile Manufacturers Institute, the largest trade association in the textile industry, which is headquartered in Charlotte, North Carolina, and by the National Wool Growers Association of Salt Lake City, Utah. These three organizations together represent virtually the entire wool and textile industries in the United States.

We support H.R. 8124 which would reduce, but not eliminate, the quantity of woolen fabrics which are processed in the Virgin Islands and then re-exported to the U.S. on a duty free basis. Most of these imports are heavy weight woolen fabrics which compete with fabrics manufactured chiefly in the states of Massachusetts and Maine by firms which employ several thousand workers.

These imported fabrics are manufactured principally in Italy and Romania, sent to the Virgin Islands for a "shower proofing" process, and then re-exported to the U.S. duty free. If these woolen fabrics were imported directly from Italy or other countries where they are made, they would be subject to the standard rate of duty for similar woven fabrics of wool valued at not over $2 per pound—namely, a tariff of $1.135 per pound.

The shower proofing process in the Virgin Islands is a simple and inexpensive operation requiring a small number of workers. It does not change the appearance or end use of the fabrics and has a minimal effect upon their value and utility. In fact, most U.S. textile mills sell shower proofed fabrics at no additional cost to the consumer.

When the shower proofed cloth is shipped to this country from the Virgin Islands, it is asserted that the foreign materials do not constitute more than 50 percent of the total value. The declared value for customs purposes is placed at twice the value of the cloth when it entered the Virgin Islands. This enables the goods to qualify for duty free treatment. Attachment A shows the U.S. Tariff Schedule provisions for tariff treatment of products of insular possessions.

Some time ago, the Virgin Islands government was persuaded that it should limit the quantity of fabric undergoing the shower proofing process. In 1964, the Virgin Islands imposed a quota limitation of 2.8 million linear yards. The U.S. domestic industry in 1964 produced 247 million linear yards of wool fabrics. By 1974, the quota had risen to 3.5 million linear yards and U.S. production had dropped to 72.7 million linear yards. Based on the production rate during the

first nine months of 1975, domestic production for calendar year 1975 will be even lower—about 68.1 million linear yards.

Nearly all the shower proofed fabrics from the Virgin Islands are heavy weight woolen fabrics which disrupt the market for similar fabrics in this country. The general decline of wool consumption, coupled with the impact of the recent national recession upon the industry, have made the situation even more critical.

As you will note in Attachment B, conditions in the U.S. market have deteriorated to the point where the Virgin Islands has been unable to sell the quota amounts. Although complete figures for 1975 are not yet available, imports are not expected to exceed one million linear yards.

Mr. Chairman, we believe that this is an appropriate time to reduce the quotas. Since the level of imports has declined, such a reduction in the quota would not require a rollback. Further, it would insure that a potential business recovery is not thwarted by a flood of imported goods of this type.

The value of this trade to the Virginia Islands is minimal since only a few workers are employed on a part-time basis in the shower proofing activity. The damage to U.S. mills which spin, weave and finish the cloth while providing several thousand jobs is disproportionate to any possible value to the Virgin Islands.

In closing, I would like to reemphasize that since these imported fabrics enter the U.S. duty free, a quota remains the only method by which their entry may be limited. Further, there is no compelling reason why the Virgin Islands should be exempted from both tariffs and quotas.

Mr. Chairman, the wool and textile industries of the United States believe that the serious market conditions which have developed in recent years require that the quota on these duty free imports be reduced. We urge this subcommittee to act favorably on H.R. 8124.

We will be pleased to answer any questions you may have.

Thank you.

ATTACHMENT A

TARIFF SCHEDULES OF THE UNITED STATES ANNOTATED (1976)

GENERAL HEADNOTES AND RULES OF INTERPRETATION

1. *Tariff Treatment of Imported Articles.*—All articles imported into the customs territory of the United States from outside thereof are subject to duty or exempt therefrom as prescribed in general headnote 3.

2. *Customs Territory of the United States.*—The term "customs territory of the United States", as used in the schedules, includes only the States, the District of Columbia, and Puerto Rico.

3. *Rates of Duty.*—The rates of duty in the "Rates of Duty" columns numbered 1 and 2 of the schedules apply to articles imported into the customs territory of the United States as hereinafter provided in this headnote:

(a) *Products of insular possessions*

(i) Except as provided in headnote 6 of schedule 7, part 2, subpart E, [and] except as provided in headnote 4 of schedule 7, part 7, subpart A, articles imported from insular possessions of the United States which are outside the customs territory of the United States are subject to the rates of duty set forth in column numbered 1 of the schedules, except that all such articles the growth or product of any such possession, or manufactured or produced in any such possession from materials the growth, product, or manufacture of any such possession or of the customs territory of the United States, or of both, which do not contain foreign materials to the value of more than 50 percent of their total value (or more than 70 percent of their total value with respect to watches and watch movements), coming to the customs territory of the United States directly from any such possession, and all articles previously imported into the customs territory of the United States with payment of all applicable duties and taxes imposed upon or by reason of importation which were shipped from the United States, without remission, refund, or drawback of such duties or taxes, directly to the possession from which they are being returned by direct shipment, are exempt from duty.

(ii) In determining whether an article produced or manufactured in any such insular possession contains foreign materials to the value of more than 50 percent, no material shall be considered foreign which, at the time such article is entered, may be imported into the customs territory from a foreign country, other than Cuba or the Philippine Republic, and entered free of duty.

(iii) Subject to the limitations imposed under section 503(b) and 504(c) of the Trade Act of 1974, articles designated eligible articles under section 503

of such Act which are imported from an insular possession of the United States shall receive duty treatment no less favorable than the treatment afforded such articles imported from a beneficiary developing country under title V of such Act.

(b) *Products of Cuba*

Products of Cuba imported into the customs territory of the United States, whether imported directly or indirectly, are subject to the rates of duty set forth in column numbered 1 of the schedules. Preferential rates of duty for such products apply only as shown in the said column 1.[1]

(c) *Products of countries designated beneficiary developing countries for purposes of the generalized system of preferences (GSP)*

(i) The following countries and territories are designated beneficiary developing countries for purposes of the Generalized System of Preferences, provided for in Title V of the Trade Act of 1974 (88 Stat. 2066, 19 U.S.C. 2461 *et seq.*):

INDEPENDENT COUNTRIES

Afghanistan
Angola
Argentina
Bahamas
Bahrain
Bangladesh
Barbados
Bhutan
Bolivia
Botswana
Brazil
Burma
Burundi
Cameroon
Cape Verde
Central African Republic
Chad
Chile
Colombia
Congo (Brazzaville)
Costa Rica
Cyprus
Dahomey
Dominican Republic
Egypt
El Salvador
Equatorial Guinea
Ethiopia
Fiji
Gambia
Ghana
Grenada
Guatemala
Guinea
Guinea Bissau
Guyana
Haiti
Honduras
India
Israel
Ivory Coast
Jamaica
Jordan
Kenya
Korea, Republic of
Laos
Lebanon
Lesotho
Liberia
Malagasy Republic
Malawi
Malaysia
Maldive Islands
Mali
Malta
Mauritania
Mauritius
Mexico
Morocco
Mozambique
Nauru
Nepal
Nicaragua
Niger
Oman
Pakistan
Panama
Papua New Guinea
Paraguay
Peru
Philippines
Romania
Rwanda
Sao Tome and Principe
Senegal
Sierra Leone
Singapore
Somalia
Sri Lanka
Sudan
Surinam
Swaziland
Syria
Taiwan
Tanzania
Thailand
Togo
Tonga
Trinidad and Tobago
Tunisia
Turkey
Upper Volta
Uruguay
Western Samoa
Yemen Arab Republic
Yugoslavia
Zaire
Zambia

[1] By virtue of section 401 of the Tariff Classification Act of 1962, the application to proudcts of Cuba of either suspended. See general headnote 3(e), *infra*.

ATTACHMENT B

[In thousands of linear yards]

	Virgin Islands production quota	Shipments from Virgin Islands to United States	U.S. domestic wool apparel fabric production
1975	3,500	453	[1] 68,100
1974	3,500	1,468	72,661
1973	3,500	2,368	99,674
1972	2,500	2,173	95,841
1971	2,500	2,841	108,851
1970	2,500	3,734	171,975

[1] Estimate.

NORTHERN TEXTILE ASSOCIATION,
Boston, Mass., March 10, 1976.

Re H.R. 8124

Hon. WILLIAM J. GREEN,
Chairman, Subcommittee on Trade, Committee on Ways and Means, Longworth House Office Building, Washington, D.C.

DEAR CHAIRMAN: This is to further support my testimony of February 20, 1976 before your Committee in favor of H.R. 8124 and in response to the statements of the Delegate from the Virgin Islands, Honorable Ron deLugo and others on March 2 in opposition to the Bill.

As the Virgin Islands witnesses pointed out, there is now only one company in the Virgin Islands which processes imported wool fabrics. Even at the peak of activity in the Virgin Islands in 1973 when five companies were in operation, not more than 80 to 100 persons were employed on a part-time or seasonal basis. The witnesses asserted that the processing activities in the Virgin Islands has not resulted in the loss of jobs by textile workers on the mainland. This is not true.

A modern, efficient mainland mill will employ about 525 textile persons to manufacture the 3.5 million linear yards of the heavy weight woolens equal to the quota. In addition to the 525 textile jobs lost, there is an equal number of jobs in supporting industries such as chemicals, transportation, fuel and fibers.

A quota of 3.5 million linear yards of fabrics imported from Romania and Italy via the Virgin Islands costs the mainland industry and labor over 1,050 jobs. The benefit to the Virgin Islands is, at most, only 80 to 100 seasonal jobs. This is an expensive exchange. It benefits the foreign producers substantially; the Virgin Islands only marginally; and costs the United States (mainland *and* Islands) close to a thousand jobs.

Substantial tariffs were imposed by the United States on these fabrics in 1960 for which Italy and other exporters were paid compensation. Hence, these fabrics are not imported directly from such countries. The Virgin Islands shower proofing and processing is just another loophole to evade this tariff. Unemployment in mainland mills is increased thereby.

We are not proposing, however, the elimination of all processing of wool fabrics in the Virgin Islands. We propose a reduction to reflect the changed market for such products.

All the witnesses agree that there has been a drastic decline in the consumption of wool textiles in the United States. The quota should be reduced to reflect this. The decline in the market for wool textiles in the United States is a result of a long-term trend. While this has been going on, the Virgin Islands quota has actually been increasing. The quota was 2.5 million yards a few years ago. Although this was too high, our protests to the Virgin Islands Government and to the Governor, as well as our personal visits and pleas, were not only ignored but were not even acknowledged. Instead the quota was unilaterally and peremptorily increased by 40% to 3.5 million yards.

In 1975, Virgin Islands processors were not even able to fill the quota. Now is a propitious time to adopt this legislation as it will not involve a rollback in the level of imports of these foreign fabrics via the Virgin Islands.

The Virgin Islands witnesses suggested that the reduction of the quota to a half million yards at one time is excessive. H.R. 8124, which was filed last year, proposed reductions in two steps, namely, one million yards in 1975 and 500,000 yards in 1976. We would be willing to accept an amendment to the bill to make

the quota for 1976 one million yards with a reduction to 500,000 yards in 1977 and thereafter.

The witnesses attempt to isolate Northern Textile Association as the only organization opposed to the high level of the quota and the only supporters of the Bill. It should be noted that the H.R. 8124 is supported by the American Textile Manufacturers Institute, the National Association of Wool Growers, as well as United States Government Agencies.

Consideration by you and members of the Subcommittee is appreciated, and we urge that the Bill be reported favorable.

Very truly yours,

R. REED GRIMWADE,
Treasurer, Charlton Woolen Co.
WILLIAM F. SULLIVAN,
President, Northern Textile Association.

U.S. SENATE,
Washington, D.C., August 20, 1976.

Hon. RUSSELL LONG,
Chairman, Senate Finance Committee, Dirksen Senate Office Building, Washington, D.C.

DEAR RUSSELL: We are writing to urge the enactment of H.R. 8283, a bill to amend the Internal Revenue Code of 1954, with respect to the type of flavors permitted to be used in the production of Special Natural Wines.

As Senators representing the State of California, which produces approximately 90% of the wines produced in the United States, we are significantly interested in this legislation.

We understand that this bill has the support of the wine industry throughout the United States and that the Department of the Treasury has no objection to the enactment of this legislation. In fact, we are not aware of any opposition to this bill on May 13, 1976, passed the House of Representatives without objection.

Attached[1] is a copy of the statement of Arthur H. Silverman, Washington Counsel for Wine Institute, in which we concur.

Sincerely,

JOHN V. TUNNEY,
U.S. Senator.
ALAN CRANSTON,
U.S. Senator.

Enclosure.

U.S. SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, D.C., June 10, 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: As you may be aware, I have been interested for some time in H.R. 2181, a measure providing duty-free treatment of any aircraft engine used as a temporary replacement for an aircraft engine being overhauled within the United States if duty was paid on such replacement engine during a previous importation. The measure passed the House May 17.

I had written Chairman Corman of the House Ways and Means Committee last year expressing my support of the measure, and the record of that committee contains my endorsement along with my views concerning the necessity that it became law. As you can imagine, the bill has sizeable importance to the aviation industry in California in view of its substantial impact on the state's economy.

Accordingly, I will appreciate your assistance in bringing the measure formally before your committee, thence to the floor of the Senate for early consideration.

Best personal regards.

Sincerely,

JOHN V. TUNNEY,
U.S. Senator.

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[1] Mr Silverman's testimony appears at page 33 of this hearing.

STATEMENT OF HON. RICHARD L. OTTINGER

Mr. Chairman, on January 29, 1976, I introduced along with my colleague Mr. Richmond, legislation to suspend for a three year period the rate of duty on mattress blanks made of foam rubber latex. I would like to briefly describe the compelling circumstances facing the foam rubber mattress industry which made the introduction of this bill necessary.

Last year in a nationally known case of arson, the nation's only producer of natural foam rubber latex, a rubber plant in Shelton, Connecticut, was totally destroyed, thus leaving the United States without a domestic supplier of this commodity. However, the 15 percent ad valorem duty on the material has remained in effect, a fact which has imposed a severe hardship on the manufacturers of foam rubber mattresses and box spring sets, as they have no alternative now but to import all the foam rubber necessary for production. This unfortunate situation was brought to my attention by Mr Jack Freilicher of Yonkers, N.Y., President of Rite Foam Sleep Products, and it has been certified by the U.S. International Trade Commission.

The entire rationale for imposing a duty on imported merchandise is to protect an American manufacturer of a like or similar product. Yet, such a situation does not exist with regard to natural foam rubber latex, as there is no longer any domestic industry producing the material. Thus, there is clearly no basis for the continuation of a tariff imposition on the foam rubber imports of Rite Foam and other such firms.

Economic conditions as they are today make it extremely difficult for many small businesses to operate successfully. It seems inexcusable to me that the government would allow an obsolete duty to remain in effect and further add to the burden certain small businesses must bear. I therefore call for my colleagues to join me in support of this measure.

MILLER & CHEVALIER,
Washington, D.C., August 24, 1976.

HON. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: This letter is in response to your August 10, 1976 announcement of public hearings on various revenue and tariff bills currently pending in the Committee. It is submitted on behalf of the National Interfraternity Conference and the two general types of organizations treated as exempt social clubs under the Internal Revenue Code. The letter pertains, specifically, to the qualification test that must be satisfied in order to be an exempt social club.

SUMMARY

Under existing law, tax exemption is available to social clubs and similar organizations such as college fraternities and sororities, only if they are organized and operated "exclusively" for pleasure, recreation and other non-profitable purposes and no part of their net earnings inures to the benefit of any private shareholder. As a result of the Tax Reform Act of 1969, the investment income of social clubs and the income they derive from other non-member sources, no matter how small the amount, are considered unrelated business income and are subject to the regular income tax. Since the outside income of social clubs is now fully subject to tax, we suggest that there is no longer any need for the strict requirement that a social club be organized and operated "exclusively" for pleasure, recreation and other nonprofitable purposes.

We recommend that this requirement be deleted from the law and that there be substituted the requirement that "substantially all" of the club's activities be for the above-noted purposes. This will make it clear that social clubs can have a limited, but reasonable, amount of income from non-member sources without losing their exemption. Specifically, we endorse the approach recommended by the Committee on Ways and Means in H. Rept. 94–1353 on H.R. 1144 (94th Cong.) to the effect that social clubs be permitted to receive up to 35 percent of their gross receipts, including investment income, from sources outside of their membership without losing their exempt status so long as they do not derive more than 15 percent of their gross receipts from the use of their facilities by the general public.

DISCUSSION

Among the present categories of organizations exempt from income tax under § 501(c)(7) of the Internal Revenue Code of 1954, are social clubs and other similar nonprofit organizations such as the national organizations of college fraternities and sororities. Present law provides that these organizations must be organized and operated "exclusively" for pleasure, recreation and other non-profitable purposes with no part of the net earnings inuring to the benefit of any private shareholder.

It has been the published position of the Internal Revenue Service to question the exempt status of a social club if the income derived from providing goods and services to persons other than members and their guests is more than $2,500 or more than 5 percent of the total gross receipts of the organization. In such a case, the Service applies a rather indefinite and vague facts and circumstances test in determining whether the organization continues to qualify for exempt status. (Rev. Proc. 71-17, 1971-1 C.B. 683.) In the case of investment income, the Service has no specific percentage rule that it applies but instead tries to determine whether a substantial part of the club's income is from investment sources (Rev. Rul. 66-149, 1966-1 C.B. 146).

As a practical matter, social clubs find it exceedingly difficult to comply with the Service's outdated audit standards which do not take into account their modern-day operational requirements. Quite often it is simply not realistic or even desirable for a social club to turn away certain types of non-members. For example, clubs are frequently asked for the use of their facilities by church and hospital groups, Y.M.C.A. groups, school associations and other similar organizations which technically may not be the guests of any particular member with the result that the income derived from these organizations is non-member income. Nor is it realistic or desirable to expect the national organizations of college fraternities and sororities to let their funds lie idle by not investing them during the period they are awaiting commitment to an exempt purpose. Yet such investment generates investment income which can endanger the exempt status of the organization.

Prior to the Tax Reform Act of 1969, social clubs, as well as many other types of exempt organizations, were exempt from tax on the income derived from their unrelated activities. Thus, the non-member income of social clubs was not subject to tax. However, the 1969 Act extended the regular income tax to the unrelated business income of social clubs, including investment income. Accordingly, there is no longer any reason why social clubs should not be permitted to exceed the Service's audit standards so as to receive a limited but reasonable amount of non-member income commensurate with realistic operating requirements.

RECOMMENDATION

It is our request that the Committee adopt the solution to the social club problem set forth in H.R. 1144.

Respectfully submitted.

DAVID W. RICHMOND,
NUMA L. SMITH, Jr.

MILLER & CHEVALIER,
Washington, D.C., August 18, 1976.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The following comments are submitted on behalf of The Sperry and Hutchinson Company for consideration by the Committee on Finance in response to the invitation contained in your press release dated August 10, 1976, announcing a hearing on various revenue and tariff bills, including H.R. 11997, relating to the tax treatment of divestitures made by bank holding companies.

SUMMARY

We urge the prompt enactment of H.R. 11997, which would provide appropriate tax relief for divestitures which one-bank holding companies are required to make pursuant to the Bank Holding Company Act Amendments of 1970.

STATEMENT

The adoption of the Bank Holding Company Act Amendments of 1970 effected a very significant change in national policy by subjecting one-bank holding companies to the Bank Holding Company Act and requiring these holding companies to divest either their non-banking assets or their banks.

At the time the 1970 Amendments were adopted, it was specifically contemplated that appropriate tax relief would be provided for the divestitures required thereunder, as has been done with respect to divestitures required under the 1956 and 1966 bank holding company legislation.

Although the matter of appropriate tax relief for these divestitures has received consideration in the period since 1970, no final action has been taken. The prompt enactment of appropriate tax relief, as embodied in H.R. 11997, is vitally necessary if one-bank holding companies are to be able to carry out the divestitures required by the 1970 Amendments in an orderly manner.

H.R. 11997 would provide two forms of tax relief for divestitures required under the 1970 amendments. First, the assets or stock of the bank or nonbank corporation could be distributed tax-free to the shareholders of the bank holding company. Second, since in many cases such a "spin-off" divestiture is not feasible, a bank holding company selling either bank or nonbank assets would be permitted to pay the tax on the gain realized on the sale in equal annual installments over the period beginning in the year after the sale and ending in 1985 (or, if later, ten years after the due date for the return for the year of sale). Interest would be imposed on installments due after 1985, but not on those installments due prior to that time.

We believe the tax treatment of divestitures by one-bank holding companies pursuant to the 1970 Amendments that would be provided under H.R. 11997 is reasonable and appropriate. It is very important that the form of the tax relief to be provided for divestitures one-bank holding companies are required to make under the 1970 Amendments be promptly clarified by the enactment of H.R. 11997. Until this is done and one-bank holding companies have certainty as to the tax treatment of the required divestitures, it will remain most difficult for those companies to formulate orderly plans for compliance with the divestiture mandates of Federal law.

Respectfully submitted.

DAVID W. RICHMOND.

ARTHUR YOUNG & Co.,
Washington, D.C., August 23, 1976.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

MY DEAR MR. CHAIRMAN: We respectfully wish to bring to the attention of the Committee a transitional inequity concerning the provision relating to corporate acquisition indebtedness.

The Tax Reform Act of 1969 contains a provision which, in general, denies a deduction for interest on certain debt obligations which one corporation issues to acquire another corporation (section 411 of the Tax Reform Act of 1969 (Pub. Law 91-172)).

This provision was an outgrowth of an earlier bill (H.R. 7489) introduced in February 1969 to limit certain corporate takeovers. During the legislative consideration of this very complex area the tax-writing committees made several substantial changes.

However, it was not until the Conference Committee met in late 1969 and issued its report on December 21, 1969 that taxpayers were able to discern with certainty whether and how several key rules were to apply, such as the debt equity test, the interest earnings test, the effective date and transitional rules.

The Congress, and especially its tax-writing committees, has a tradition of assuring that its laws are applied fairly and without trace of unreasonable retroactivity. Likewise, in the early days of the Federal tax the Supreme Court considered retroactivity in enactment of a tax law and stated . . . The taxpayer may justly demand to know when and how he becomes liable for taxes—he cannot foresee and ought not be required to guess the outcome of pending measures. The future of every bill while before Congress is necessarily uncertain. The will of the lawmakers is not definitely expressed until final action thereon has been taken." *Untermeyer* v. *Anderson* (1928) 276 U.S. 440.

Thus, this new provision contains rules to exempt those "transitional situations where the transaction had previously been undertaken" (Report of Senate Finance Committee, No. 91–552, p. 144). For example, if an acquiring corporation had effective control of the acquired corporation (50 percent or more of the stock) on October 9, 1969, it may deduct the interest on debt issued subsequent to that date to acquire control of that corporation for tax purposes (80 percent of the stock of the corporation). Any interest paid on debt issued to acquire stock of a corporation above the 80 percent ownership figure is not deductible by the taxpayer. (Section 279(i) of the Code).

The latter rule has an unfortunate retroactive impact in those cases where a corporation already had control (80 percent or more) of another corporation prior to the time the Committee on Ways and Means indicated it would consider this area for legislation (Committee Press Release February 10, 1969).

The inequity is more pronounced in the case of publicly traded corporations with thousands of shareholders where the acquisition can normally take an extended period of time from initiation to completion due to the need to comply with a variety of detailed requirements of Federal and State Regulatory law enacted to protect shareholders, and the public. In addition, protective requirements of the pertinent stock exchanges must be complied with.

One illustration of the retroactive impact of the "more than 80 percent disallowance rule", referred to above is the acquisition of Seaboard Finance Company by Avco Corporation, a client. Avco Corporation carries on activities in three general business groups: financial services, products and research, and recreation and land development. For years it has engaged in manufacturing defense and consumer goods in the United States. During World War II Avco was one of the nation's major producers of defense material, principally aircraft and naval equipment. In 1963 nearly 75 percent of its sales related to defense and space programs of the United States Government. Thereupon, management considered it advisable to expand further its consumer and commercial operations in order to balance its substantial dependence on defense and space programs.

In the spring of 1968, in pursuance of this corporate policy Avco management began discussions with the management of Seaboard Finance Company concerning Avco's acquisition of Seaboard.

On December 20, 1968, Avco Corporation offered to acquire all the outstanding common and convertible preferred shares of Seaboard Finance Company in exchange for Avco convertible bonds or Avco bonds with warrants. Acceptance of this offer was recommended to the Seaboard shareholders by the Seaboard Board of Directors and management.

On January 21, 1969 with nearly 90 percent of the outstanding voting shares of Seaboard having been tendered, the offer became effective, thus, binding on both Avco and the Seaboard shareholders. Avco continued to accept shares which were tendered until September 20, 1969 at which time the offer was actually finally terminated because of the expiration of the nine month effective period of Avco's registration period relating to the offer. At that point, approximately 94 percent of the outstanding common and convertible preferred shares of Seaboard had been tendered. In the meantime, trading of Seaboard shares had ceased on the Pacific Coast Stock Exchanges with the result that the holders of 350,000 shares of Seaboard had no regular market for their securities. Thus, a situation has developed that dramatizes the concern expressed recently by the Committee on Ways and Means in its favorable report on the proposed amendment:

"In addition, minority shareholders of a corporation which is 80-percent controlled may find themselves without a ready market for their stock, unless the controlling corporation is able and willing to purchase their shares." (H. Rep. No. 94–1345, 94th Cong., 2d Sess., p. 4)

In an effort to help these stockholders and complete its acquisition in the fairest possible way Avco decided to pursue a plan, with the permission of the Securities and Exchange Commission, whereby it would acquire all the remaining common and convertible preferred shares of Seaboard on the same basis as that contemplated by the original offer except that since Avco's 5½ percent convertible debentures were felt to be a more conservative security than the 7½ percent debentures with warrants, the convertible debentures were used.

The remaining shares were acquired by December 12, 1969 and the acquisition was completed.

As indicated, the Conference Committee issued its report on December 21, 1969. The Act was signed by the President on December 30, 1969.

The final sentence of section 279(i) of the Code would disallow interest on obligations used to acquire a remaining minority interest, such as that in Seaboard Finance Company, i.e., stock acquired after October 9, 1969. Thus the transitional rule inadvertently does not embrace this "transitional situation(s) where the transaction had previously been undertaken". (Report of Senate Finance Committee No. 91-552, p. 144).

In summary, Avco began the plan of acquisition in the spring of 1968, nearly a year prior to the Committee's press announcement indicating this area would be the subject of Committee consideration. On January 21, 1969, the month previous to the Committee's announcement, 90 percent of Seaboard had been acquired which transaction was legally binding. The acquisition was completed on December 12, 1969. Later that month, December 21, 1969 the Conference Committee issued its report specifying which rules in key provisions would apply, i.e., in the debt equity test, interest earnings test and effective dates. However, the obligations issued by Avco after October 9, 1969, to help the remaining shareholders of Seaboard, who had no regular market for their shares, and complete the acquisition, are subject to the disallowance of interest rule of section 279. We can only believe that this retroactivity was inadvertent and not intented to apply to these and similar "transitional situations where the transaction had previously been undertaken" (Report of the Senate Finance Committee, No. 91-552, p. 144).

Therefore it is respectfully requested that this type of retroactivity be remedied by statutory amendment with appropriate safeguards. More specifically, in those cases where a taxpayer corporation owned at least 50 percent of a subsidiary on October 9, 1969, that such taxpayer corporation should have the right to complete its acquisition of 100 percent of a subsidiary without penalty of interest disallowance. Furthermore, it is respectfully requested that amending legislation designed to achieve this result be made effective as of the effective date of section 279, in order to prevent an asymmetrical gap in the Code.

Respectfully submitted.

ARTHUR YOUNG & Co.

DAVIS POLK & WARDELL,
New York, N.Y., August 20, 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: In connection with various revenue bills presently pending before the Committee, we wish to request you to consider an amendment to the Internal Revenue Code which would clarify the status of payments received by pension funds, mutual funds, educational institutions and other exempt foundations in respect of loans of securities in their portfolios. The draft amendment, attached hereto, provides in essence that payments in respect of securities loans which satisfy the requirements of the Securities and Exchange Commission should be treated by such investors in the same manner as if they were dividends or interest.

The lending of securities is a natural adjunct to portfolio management activity which increases the income yield from securities acquired and held, for the long term, on their investment merits. We understand that arrangements for borrowings of securities vary with respect to the nature of the collateral furnished to the lender, and the manner in which the lender is compensated. All arrangements which satisfy the requirements of the Securities and Exchange Commission for regulated investment companies require that the loan be fully collateralized, with adjustments on collateral made on a daily basis, if necessary, and that the loans be callable on notice of no more than five business days. Certain borrowers furnish short-term, marketable securities as collateral and pay a fee to the lender, or permit the lender to retain all or a portion of the income on such securities. Others furnish cash as collateral; in such cases, the lender may retain some or all of any interest or dividends attributable to investments made with the cash. If the loan of particular securities extends over a record date the borrower is required to pay the lender an amount equal to the dividends or interest which the lender would have received if the borrowed securities had been registered in its name on the record date; the amount of any stock dividend,

or rights issued would generally be added to the loans with appropriate adjustment of collateral.

The income earned by the lender under each structure is in the nature of passive income. The legislative history of Section 512 and its predecessor section clearly indicates that an exclusion from unrelated business taxable income was to apply to "passive income", *i.e.*, "dividends, interest, royalties, most rents, capital gains and *similar items*." H. Rep. No. 2319, 81st Cong. 2d Sess. 38 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 30–31 (1950) (emphasis supplied). However, there is no explicit authority for the proposition that income on securities loans comes within the exclusion for dividends, interest, annuities and royalties presently contained in Section 512(b). In addition, there is not direct precedent upon which lenders may rely with assurance to establish that income derived from securities loans is exempt because it results from an investment activity and not from a "trade or business". Similarly, it may not always be clear that all of such passive income qualifies in a technical sense as income derived from dividends, interest and gains from the sale of securities under Section 851(b)(2) for the purpose of making a determination of eligibility for regulated investment company status.

Enactment of the amendment would eliminate the existing uncertainty loans. We have been advised that in the absence of legislation a large number of pension funds and exempt institutions, which hold a substantial percentage of common stocks and corporate bonds, are reluctant to lend such securities.

It has been the position of the SEC that increased availability of securities for lending would have a most salutary effect in reducing the number of uncompleted transactions in the securities markets, and could improve the efficiency of the clearance and settlement functions in these markets. Despite efforts to eliminate the necessity for physical delivery of corporate stock and bond certificates, such delivery is still the principal means of consummating transactions in corporate securities. The Securities and Exchange Commission and securities industry self-regulatory organizations have instituted a number of reforms, including the use of clearing facilities and depositories, designed to improve the processing of securities transactions and thus to reduce the number of uncompleted transactions. However, many uncompleted transactions are unavoidable, because parties to transactions are not members of these facilities or depositories. Consequently, the borrowing of securities to settle securities transactions can be a useful and desirable technique to improve the securities processing mechanism and reduce uncompleted transactions.

We urge the Committee to give favorable consideration to the proposed amendment. It is in the public interest, and clarifies the character of payments on securities loans in a manner entirely consistent with the spirit and the letter of existing Code provisions whch recognize that income from investments should be: (i) a tax-free source of revenue for employee benefit trusts and educational or charitable entities, and (ii) taxable to a regulated investment company only if it is not distributed currently.

Respectfully submitted.

LYDIA E. KESS.

A BILL To amend the Internal Revenue Code of 1954 with respect to amounts received on certain loans of securities

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 512(a) of the Internal Revenue Code of 1954 (relating to the definition of unrelated business income) is amended by adding at the end thereof the following new paragraph:

"(5) DEFINITION—The term 'payments on securities loans' shall include all amounts received in respect of a security (as defined in section 1236(c)) loaned by the owner thereof to another person, whether or not title to the security remains in the name of the lender, including amounts in respect of dividends or interest thereon, fees computed by reference to the period for which the loan is outstanding and the fair market value of the security during such period, income from collateral security for such loan, or income from the investment of collateral security provided that the agreement between the parties provides for:

(1) reasonable procedures to implement the obligation of the borrower to furnish collateral to the lender with a fair market value on each

business day during the period the loan is outstanding at least equal to the fair market value of the security at the close of business on the preceding business day, and

(2) termination of the loan by the lender at any time on notice of no more than five business days, whereupon the borrower is required to return certificates for the borrowed securities to the lender."

(b) Section 509(e) of the Internal Revenue Code of 1954 (relating to the definition of gross investment income) is amended by inserting "payments on securities loans (as defined in section 512(a)(5))," after "dividends,".

(c) Section 512(b)(1) of the Internal Revenue Code of 1954 (relating to modifications of the definition of unrelated business taxable income) is amended by striking out "and annuities," and inserting in lieu thereof "annuities, and payments on securities loans (as defined in paragraph (5) of subsection (a)).".

(d) Section 851(b)(2) of the Internal Revenue Code of 1954 (relating to limitations on the definition of a regulated investment company) is amended by inserting "payments on securities loans (as defined in section 512(a)(5))," after "interest,".

(e) Section 4940(c)(2) of the Internal Revenue Code of 1954 (relating to the definition of private foundation gross investment income) is amended by striking out "and royalties," and inserting in lieu thereof "royalties, and payments on securities loans (as defined in section 512(a)(5)),".

(f) *Effective Date.*—The amendments made by this Act shall apply to amounts received after December 31, 1975.

LAW OFFICES OF HAMEL, PARK, MCCABE & SAUNDERS,
Washington, D.C., August 19, 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: Pursuant to Press Release No. 44 of the Committee on Finance the following written statement is submitted on behalf of The Hardaway Company of Columbus, Georgia, with respect to a portion of H.R. 11997, the "Bank Holding Company Tax Act of 1976," on which the Committee is holding hearings among other matters on August 24.

The Hardaway Company, which is, and for more than 75 years has been, engaged primarily in the construction business, owns slightly over 7 percent of the stock of the First National Bank of Columbus, Georgia.

Under the Bank Holding Company Act Amendments of 1970 ownership of more than 5 percent of any class of voting securities of a bank establishes a rebuttable presumption that such company controls the bank and hence is a bank holding company. Ownership of this stock of First National Bank of Columbus, Georgia was acquired by The Hardaway Company prior to July 7, 1970, in fact prior to 1955.

Hardaway actually received a ruling from the Commissioner of Internal Revenue that the distribution of its bank stock to its shareholders would be tax free if the Federal Reserve Board made the proper certification. The Federal Reserve Board in Atlanta, Georgia made a preliminary finding that by reason of Hardaway's stock ownership Hardaway controlled First National Bank and instructed Hardaway to advise whether it was going to rid itself of its bank stock or its construction assets.

When this matter came before the Federal Reserve Board here in Washington the General Counsel of the Federal Reserve Board disagreed with the Commissioner's interpretation of the Internal Revenue Code and refused to clear the Federal Reserve Board's issuance of the certification called for by the bank holding company provisions of the Code until Congress clarifies its intent.

The General Counsel of the Federal Reserve Board takes the position that, even though the circumstances are exactly the same today as they were in 1955, and even though Hardaway's stock ownership creates a presumption that Hardaway controls the bank—a presumption that, although rebuttable, Hardaway does not rebut—Hardaway is a bank holding company only when the Federal Reserve Board says it is and not before. Thus, the Board says that Hardaway can in no event qualify for a tax-free distribution under present law, even though if it had a larger number of shares creating a non-rebuttable presumption of control under the Act, it could qualify. Although the Commissioner of Internal Revenue disagrees, Hardaway has not been able to obtain the certification from the Federal Reserve Board required by the statute.

We called this matter to the attention of the House Ways and Means Committee when it was considering H.R. 11997 last January. We are advised by the staff of the Joint Committee on Internal Revenue Taxation that it believes that it has now been made clear that if the Board makes a determination of control on the basis of shares owned as of July 7, 1970, a subsequent spin-off bank stock will qualify to the same extent as if it were automatically classified as a bank holding company by reason of its ownership of bank stock on July 7, 1970. At the instruction of the Ways and Means Committee the following explanation appears in the report of that Committee.

"Generally, this definition includes a company which directly or indirectly owned 25 percent or more of the stock of a bank or another bank holding company on July 7, 1970. In addition, the definition includes a company subsequently determined to be a bank holding company by the Federal Reserve Board because it exercises a 'controlling influence' over a bank if the determination was made on the basis of the bank shares owned as of July 7, 1970, by the company."

There is a possibility that, pending enactment of the legislation, First National Bank may create a 100 percent ownership bank holding company, which exchanges all of its stock for all of the stock of the bank, in which event, Hardaway will be required to exchange its bank stock for stock in the new bank holding company. It will then own slightly more than 7 percent of the stock of the new bank holding company, which will be subject to the same distribution requirements of the Bank Holding Company Act Amendments of 1970 as the stock in the bank itself which Hardaway now owns. Hardaway will have acquired such bank holding company stock in a tax-free exchange described in Section 368(a)(1)(B) of the Internal Revenue Code and having acquired its bank stock prior to July 7, 1970, when it is required to divest itself of the bank holding company stock which it received in exchange for its bank stock, Hardaway should be permitted to distribute such bank holding company stock to its shareholders free of tax to such stockholders, in the same manner as in the case of a 100 percent ownership bank holding company distributing prohibited property acquired before July 7, 1970 as required by the Bank Holding Company Act Amendments of 1970. This matter was also called to the attention of the Ways and Means Committee at its hearings last January 27 and the following language has been included in H.R. 11997:

"[Sec. 1101] (c) PROPERTY ACQUIRED AFTER JULY 7, 1970.—

"(1) IN GENERAL.—Except as provided in paragraph (2) and (3), subsection (a) or (b) shall not apply to—

"(A) any property acquired by the distributing corporation after July 7, 1970, unless . . . (iii) such property was acquired by the distributing corporation in a transaction in which gain was not recognized under section 305(a) or section 332, or under section 354 or 356 (but only with respect to property permitted by section 354 or 356 to be received without the recognition of gain or loss) with respect to a reorganization described in section 368(a)(1) (A), (B), (E), or (F), . . ."

* * * * * * *

"(D) any property acquired by the distributing corporation in a transaction in which gain was not recognized under section 354 or 356 with respect to a reorganization described in section 368(a)(1) (A) or (B), unless such property was acquired by the distributing corporation in exchange for property which the distributing corporation could have distributed under subsection (a)(1) or (b)(1)."

We are advised by the Staff of the Joint Committee on Internal Revenue Taxation that the reference in Section 1103(b)(2)(A) to "property acquired . . . on or before July 7, 1970" is intended to include property literally acquired by a distributing corporation after July 7, 1970, if it meets the requirements of Section 1101(c)(1)(A)(iii) or (D) just quoted, and that this will be made clear in the accompanying explanation in the Committee, thus resolving any problem that might be raised by such exchange.

Upon this understanding, The Hardaway Company supports enactment of H.R. 11997 as passed by the House.

Respectfully submitted.

HAMEL, PARK, MCCABE & SAUNDERS,
By K. MARTIN WORTHY,
Counsel for The Hardaway Co.

STATEMENT OF ALLEN PRODUCTS CO., INC.

SUMMARY

1. The proposed legislation would accord mixed animal feeds containing soybeans the same treatment as feeds containing grain.
2. Mixed animal feeds containing soybeans are not inferior in quality to those containing grain.
3. We incorporated soybeans in our product because of erroneous advice from the U.S. Customs Service that soybeans would be treated like grain for Customs' purposes.
4. The soybeans used are of United States origin.
5. No other product or company would be affected and no significant amount of trade or revenue loss would result.

STATEMENT

Mr. Chairman and members of the subcommittee, my name is James Schmoyer, and I am Vice President for Quality Control and Scientific Services of Allen Products Company, Inc. I am submitting this statement in support of legislation to amend the Tariff Schedules to provide for mixed animal feeds containing soybeans. This legislation was moved in this Committee by The Honorable Carl Curtis of Nebraska, and was approved by the Committee at its meeting on December 16, 1975. It was also proposed as a Senate floor amendment (No. 1266) to the silk yarn bill, H.R. 7727. This legislation has not been passed by the Senate.

The proposed legislation would add to the definition of mixed feeds "admixtures of soybeans or soybean products." The term "mixed feeds" presently embraces products that are admixtures of grain or grain products.

For more than forty years Allen Products has been engaged exclusively in the manufacture and sale of dog food. We are headquartered in Allentown, Pennsylvania, and we have manufacturing plants in Crete, Nebraska, and St. Paul, Minnesota, as well.

One of our products—ALPO Beef Chunks Dinner in the large size can—is imported from Canada. This represents less than 8 percent of the dog food that we market in the United States. We are increasing our U.S. production of ALPO Beef Chunks Dinner in the large size can, but our domestic production capacity is not yet sufficient to meet U.S. needs and, for the time being, we must continue to import this size can from Canada.

The imported ALPO Beef Chunks Dinner is primarily a meat product, but may contain varying amounts of soy flour. About two years ago we increased the soy flour to at least 6 percent. If this product had contained at least 6 percent grain, instead of 6 percent soy flour, it would have come in free of duty under item 184.70 of the Tariff Schedules of the United States, as contrasted to the 7½ percent rate of duty we actually paid.

When we increased to 6 percent the soy flour in our imported product, we did so on the basis of official information to the effect that soybeans for purposes of the Tariff Schedules would be considered a grain, and that including at least 6 percent soybeans or soy product would qualify the product for duty-free entry. Subsequently, the Classification and Value Division of the U.S. Customs Service overruled the District Director of Customs, and concluded that soybean flour is not grain or grain product for the purpose of item 184.70 TSUS. Thus a product containing at least 6 percent soy flour is still dutiable at the 7½ percent rate.

The amendment which we are supporting would accord to mixed feeds containing at least 6 percent soybeans, the same treatment as is now accorded to mixed feeds containing at least 6 percent grain, and we believe that this is fully justified for two reasons. First, the specially textured soy flour used in the product is exported from the United States. Secondly, a meat or meat by-product dog food containing 6 percent soy flour has higher quality protein (better amino acid profile) than a similar feed containing grain. It also has a higher quality protein than a similar product containing meat and meat by-products.

It has been suggested that this legislation should not be enacted because of the general rule that unilateral concessions should not be made during the multilateral trade negotiations. It is our belief, however, that this would be useless for trade negotiations for a number of reasons. The composition of the product which determines the tariff treatment is within the control of the manufacturing

company. i.e., it can include more or less soybeans depending upon the tariff consequences. Also, the legislation would affect a relatively trivial amount of trade, the estimated difference in revenues being approximately $106,000 annually, not a significant amount for trade negotiations.

Furthermore, to fail to enact this legislation would deprive us of needed relief with no possibility at all that any relief would occur through trade negotiations. This is a perfect example of the bureaucracy applying a useful principle to a case to which it has no applicability. It is not right to insist that this be reserved for trade negotiations when there is no reasonable expectation that it will ever become the subject of negotiation.

It has also been suggested that this legislation should not be enacted because the Government of Canada subsidizes the price of flour. I assure the Committee that no foreign processed flour is included in ALPO Beef Chunks Dinner, the only product which would be affected by the proposed legislation, but that all of the specially textured soy flour used in our product is exported from the United States, incorporated in the product, and returned to the United States.

So far as Allen Products is aware, no other importers or significant importation would be affected by this legislation. It is estimated that the probable impact on revenues will vary between $106,000 and $200,000 per annnum depending upon the precise percentage of soybeans incorporated in the product.

We urge the Committee to report out this legislation for consideration by the Senate. A copy of the proposed legislation is attached for your convenience.

PENNSYLVANIA WIRE ROPE CORP.,
Williamsport, Pa., August 20, 1976.

Senator RUSSELL LONG,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: I am writing to you in regard to The House Ways and Means Committee's bill H.R. 12254 which is now before the Senate Finance Committee. This involves the suspension of duties on bicycle parts. We request that H.R. 12254 be amended to provide for the restoration of 15 percent duty on imported caliper brake systems.

As a domestic manufacturer, we have been attempting to sell caliper brakes to the bicycle industry for two years. We have the necessary plant capacity and capital equipment to produce these parts. The primary obstacle to sales has been the flood of low-priced brake systems, imported principally from Japan, Taiwan, and Korea. These parts are currently imported duty free.

The implication in H.R. 12254 that caliper brakes are not available domestically is inaccurate. The subsidiary of a Japanese firm manufactures brakes in Asheville, N.C. under the name Dia-Compe. Williams Engineering in Cleveland, Ohio, manufactures a caliper brake system used on bicycles this year. Our Martinsburg, W. Va. plant is ready to produce caliper brakes within 120 days.

Your opposition to H.R. 12254 will help American industry to compete with imports from low wage countries and it will increase employment in the areas mentioned above.

Thank you for your thoughtful consideration of our request.

Yours very truly,

RALPH A. MILLAR,
Director, Commercial Sales.

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION

H.R. 5071—HOLDING COMPANY COMMON TRUST FUNDS

The American Bankers Association is an organization representing 13,200 banks or 92 percent of the banks in this country. The Association strongly supports H.R. 5071 which would allow banks in a holding company to use a jointly maintained common trust fund or a fund maintained by one bank in the holding company without loss of the funds tax exempt status.

Common trust funds are maintained by banks and trust companies to provide needed diversity and investment economy for many fiduciary accounts. A common trust fund must be a certain size before it can effectively serve this purpose. Some banks maintain a variety of common funds i.e.: a common stock fund, a

bond fund and a tax exempt fund. Some banks do not manage sufficient assets for such a variety of funds and in fact many smaller banks do not manage sufficient assets for one common fund.

In a number of states multi-bank holding companies sought state legislation which would allow member banks of a holding company system to invest assets held as a fiduciary in a common trust fund maintained by one member bank. The legislation was enacted but the IRS ruled that section 584 did not exempt a common trust fund that received contributions from another bank even if it were an affiliated bank.

Unless section 584 is amended many smaller banks in bank holding company systems will not be able to serve their trust customers through a common trust fund investment vehicle even though in their state such investment is authorized on a holding company-wide basis.

We urge the Committee to approve H.R. 5071 which will allow the customers of smaller banks to enjoy the more efficient and effective operation of common trust fund investment.

H.R. 3052—GAINS ON LAPSE OF OPTIONS

Some tax-exempt organizations including charities and pension funds strive to increase investment income by writing options on securities in their portfolio. This practice has been approved by the Comptroller of the Currency. If the option is exercised the money received for the option is treated as part of the proceeds of the sale of the security itself and any gain is tax exempt. However, if the option is not exercised but allowed to lapse or is maintained, then the money received by the tax-exempt organization is taxed as unrelated business income. This inconsistency should be corrected. The writing of options is just another investment media and any income derived therefrom should not be treated differently than other investment income. Therefore, the Association urges the Committee to approve H.R. 3052.

Statement of GATX Corp. Respecting Proposal for Tax Treatment of Dispositions Pursuant to Bank Holding Company Act Amendments of 1970

This statement is submitted on behalf of GATX Corporation ("GATX") in connection with a consideration by the Senate Finance Committee of H.R. 11997, to amend the Internal Revenue Code of 1954 with respect to the tax treatment of certain dispositions required to be made by bank holding companies pursuant to the Bank Holding Company Act Amendments of 1970.

SUMMARY

1. GATX believes that H.R. 11997 as passed by the House of Representatives should be enacted in order to provide relief for one bank holding companies from Federal income taxation on the divestitures required by the Bank Holding Company Act Amendments of 1970. Moreover, such legislation should be enacted this year in order to eliminate the uncertainty respecting the tax treatment of the required divestitures which has existed for over five years.

2. In view of the retroactive nature of the divestitures required to be made by GATX and other one bank holding companies pursuant to the Bank Holding Company Act Amendments of 1970, it is essential that the tax relief provide flexibility as to the manner of effecting the required divestitures without adverse Federal income tax consequences.

3. For this reason, tax relief should not be limited to a spin-off in accordance with provisions comparable to that presently provided in sections 1101–1103 of the Internal Revenue Code, but should also include the provision for installment payment of tax attributable to a divestiture contained in H.R. 11997.

BACKGROUND FACTS

GATX was founded in 1898 and maintains its principal executive offices at 120 South Riverside Plaza, Chicago, Illinois. The principal activity of GATX is the supplying of railroad freight cars to approximately 1,000 customers through the ownership, maintenance and lease for this purpose of a fleet of approximately 62,000 freight cars, principally tank cars. As a result of a corporate reorganiza-

tion effected in 1975, such operations, together with those described below, are conducted by wholly-owned subsidiaries of GATX or lower tier subsidiaries of such subsidiaries, and GATX has been transformed into a holding company.

Through such subsidiaries, GATX also operates public terminals in various locations in the United States and abroad with facilities for the storage and handling (including mixing, blending, packaging and drumming of liquid commodities) of chemicals, petroleum and other liquid products and certain bulk dry commodities. Additional operations include the design, fabrication and field erection of facilities for chemical and refrigerated storage of various products, and research and development facilities maintained to serve GATX's operating subsidiaries as well as the Federal Government.

Subsidiaries of GATX also engage in the ownership, chartering and operation of a non-subsidized fleet of 45 ocean-going vessels aggregating approximately 2.8 million deadweight tons, the finance and finance leasing of transportation and industrial equipment in the United States and abroad, and the design, manufacture and sale of pneumatic conveying systems, cooling and heat recuperating equipment, dust and fume control equipment and other industrial equipment.

GATX directly owns approximately 84 percent of the outstanding common stock of LaSalle National Bank ("LaSalle") which it acquired in the manner described below. In addition to the premises owned or leased by GATX for its operating subsidiaries, GATX owns the LaSalle Bank Building, 135 South LaSalle Street, Chicago, Illinois, a building in which is located the main office of LaSalle.

FACTS CONCERNING ACQUISITION OF LASALLE NATIONAL BANK

LaSalle is a national banking association chartered in 1927 and acquired by GATX through two exchanges (one as of November 20, 1968 and the second as of June 30, 1969) of one share of convertible preferred stock of GATX (the "Preferred Stock") for one share of common stock of LaSalle (the "LaSalle Stock"). GATX issued 683,081 shares of Preferred Stock in exchange for shares of LaSalle Stock, constituting approximately 90 percent of the outstanding stock of LaSalle.

The exchange was treated by GATX as a nontaxable reorganization pursuant to section 368(a)(1)(B) of the Internal Revenue Code of 1954. Approximately 1,460 shareholders of LaSalle surrendered their shares as part of the acquisition. The basis of the LaSalle Stock to the surrendering shareholders cannot be accurately determined by GATX in view of the large number of such shareholders. GATX, however, estimates the aggregate basis to be between $5 and $10 million. As of the effective date of the exchange, the total redemption price of the Preferred Stock issued approximated $43.5 million.

Pertinent characteristics of the Preferred Stock are as follows:

1. The Preferred Stock bears an annual cumulative dividend rate of $2.50 per share.

2. Each share is convertible at the option of the holder at any time into 1.25 shares of GATX common stock, subject to adjustment (other than with respect to accrued unpaid dividends) upon the occurrence of specified events.

3. GATX may call the Preferred Stock for redemption after November 20, 1973 at a price of $63 per share plus accrued unpaid dividends to date of payment. The total amount of cash to be paid by GATX to the preferred shareholders (assuming that no additional holders exercise their conversion rights and that no further shares of Preferred Stock are purchased by GATX) if it exercises its right to call the share for redemption approximates $26.3 million (exclusive of dividends payable or paid.)[1] Accordingly, the excess of the redemption price of the Preferred Stock presently outstanding over the estimated basis of the LaSalle stock is approximately $16.3 to $21.3 million.

4. If GATX liquidates or dissolves, the holders of the Preferred Stock would be entitled to receive $60 per share plus accrued unpaid dividends prior to any distribution of assets to the holders of GATX common stock.

5. The holders of the Preferred Stock are entitled to one vote for each share held, but they have no preemptive rights with respect to any GATX common stock which may be issued.

6. The aggregate annual dividends payable on Preferred Stock presently outstanding issued with respect to LaSalle Stock approximates $1 million. Since

[1] Approximately 157,800 shares of Preferred Stock have been converted into shares of common stock as of June 30, 1976. GATX has also purchased in the open market approximately 107,400 shares of Preferred Stock for approximately $5,385,000.

earnings of LaSalle must equal or exceed approximately $2.02 million to avoid dilution of GATX earnings on its common stock.

In November, 1973, GATX sold approximately 14 percent of the shares of LaSalle Stock held by it to two individuals. GATX also granted the purchasers an option to purchase the remaining shares of LaSalle Stock held by it, which option will terminate on December 31, 1976. In the event an option is not exercised, GATX will be required to find another purchaser for the remaining shares in order to effect the required divestiture by December 31, 1980.

IMPACT OF BANK HOLDING COMPANY ACT AMENDMENTS OF 1970 AND NEED FOR EQUITABLE IN 1976

The acquisition by GATX of LaSalle Stock was made in full compliance with the then existing provisions of the Bank Holding Company Act as amended. Moreover, such acquisition was made by GATX with the clear intention of retaining ownership in LaSalle for an unlimited period of time. Subsequent to such acquisition, Congress enacted the Bank Holding Company Act Amendments of 1970, which legislation has a retroactive effect on GATX by requiring it to either divest itself of the LaSalle Stock or if its non-banking assets by December 31, 1980. Since, as described above, the business of GATX is essentially other than banking, it is not feasible for GATX to divest itself of its non-banking assets. Accordingly, GATX must divest itself of LaSalle Stock acquired prior to the enactment of such legislation in a transaction which was effected in full compliance with applicable law.

In view of the retroactive effect of the Bank Holding Company Act Amendments of 1970, and the fact that the involuntary divestiture of LaSalle Stock is contrary to the purposes of GATX in effecting the acquisition thereof, it is essential that legislation be enacted to provide equitable relief from Federal income taxation which would otherwise result by reason of such divestiture. The Senate Banking and Currency Committee expressly recognized the necessity for relief from "an undue tax burden" as a result of the divestiture required by the Bank Holding Company Act Amendments of 1970.[2]

In addition, such legislation should be enacted this year. More than five years have elapsed since such statement of Congressional intention to provide tax relief. It is thus important that the uncertainty which has existed as to the tax treatment of the required divestitures be eliminated at the earliest opportunity. Moreover, in view of the retroactive nature of the divestiture required by such legislation, it is essential that the tax relief provide GATX and other one bank holding companies similarly situated with the widest degree of flexibility as to the manner of effecting the required divestiture without adverse Federal income tax consequences.

SPINOFF AND REASONS WHY TAX RELIEF SHOULD NOT BE LIMITED THERETO

One approach to tax relief for such divestiture is to permit a tax-free distribution by a bank holding company of either the bank property or prohibited property either directly to its shareholders or to a newly-created wholly-owned subsidiary the stock of which is thereafter distributed to the stockholders of the bank holding company. Such proposal, as contained in H.R. 11997, provides for a tax-free distribution to shareholders which is substantially similar to that provided in sections 1101–1103 of the Internal Revenue Code for divestitures under the Bank Holding Company Act of 1956 and its 1966 amendments.[3]

However, the mere enactment of provisions comparable to sections 1101–1103 of the Code permitting a spin-off would not provide adequate tax relief to GATX with respect to the disposition of LaSalle Stock in compliance with the provisions of the Bank Holding Company Act Amendments of 1970. One reason is that divestiture by way of spin-off would not prove financially feasible to GATX. The cost to GATX of carrying the Preferred Stock (approximately $2.02 million annually before taxes) has been supported by the contribution to GATX's consolidated earnings of the LaSalle earnings before taxes (approximately $2.5 million annually). A spin-off would result in continuation of such carrying cost

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[2] See Report of the Senate Banking and Currency Committee on Bank Holding Company Act Amendments of 1970, S. Rept. No. 91–1084 (91st Cong., 2d Sess.) p. 7.

[3] Two substantive differences between the proposal in H.R. 11997 as approved by the House and existing sections 1101–1103 of the Code are that the proposal (1) would allow a non-pro rata distribution to qualify for non-recognition treatment and (2) would permit such non-recognition treatment for a divestiture of bank assets even though the bank holding company owns less than a controlling interest.

to GATX without the offsetting LaSalle earnings, thereby reducing the earnings attributable to the remaining non-banking assets of GATX. Moreover, conversion of the remaining Preferred Stock into approximately 525,000 shares of GATX common stock would produce a dilution of earnings per share of such common stock.

In addition, a spin-off would not be desirable from the standpoint of the holders of the GATX common stock. The GATX common stock is traded on the New York Stock Exchange and is held by approximately 15,400 shareholders located throughout the United States as well as in foreign countries. The LaSalle Stock, however, is not publicly traded. Thus, receipt by each common shareholder of GATX of a small number of shares of LaSalle Stock would place in their hands a security with limited marketability (absent special arrangements respecting informal or over-the-counter trading).

For these reasons, a spin-off would not be a practical method for GATX to effect a divestiture of LaSalle Stock in compliance with the Bank Holding Company Act Amendments of 1970.

INSTALLMENT PAYMENT OF TAX PROPOSAL

GATX urges adoption of the alternative contained in H.R. 11997 which would permit a bank holding company disposing of either bank property or prohibited property to pay the tax on the gain realized on the sale in equal annual installments beginning on the due date of the taxpayer's return for the taxable year in which the disposition occurred and ending on the later of the due date of taxpayer's return for 1985 or the date ten years after the due date of the return for the year of disposition. GATX strongly supports enactment of an installment payment of tax provisions of this type as an alternative form of tax relief for the required divestitures in order to provide flexibility. This is necessary since, as previously described, a spin-off is not a viable approach for GATX.

The provision should make it clear that where bank property or prohibited property is disposed of in more than one transaction, the installment period should be determined separately with respect to each disposition and the tax attributable to each disposition is payable ratably over the appropriate installment term. This would result in separate installment periods for the portion of the LaSalle Stock sold by GATX in 1973 and for the remainder of such stock when sold.

CONCLUSION

For the reasons described above, GATX believes that the tax relief to be provided for one bank holding companies required to make divestitures in compliance with the Bank Holding Company Act Amendments of 1970 should not be limited to a spin-off comparable to that provided by sections 1101–1103 of the Code, but should also include the installment payment of tax provision contained in H.R. 11997 which provides flexibility to the bank holding company with respect to the divestiture. Such flexibility is necessary in view of the retroactive nature of the divestitures required pursuant to the Bank Holding Company Act Amendments of 1970.

GATX therefore supports enactment of H.R. 11997 this year in order to eliminate the uncertainty respecting the tax treatment of the required divestitures which has existed for GATX and other one bank holding companies for over five years.

STATEMENT OF ROBERT MIKYTUCK, DIRECTOR OF MATERIALS, AIRWORK SERVICE DIVISION, PUREX CORP.

Support of H.R. 2181

STATEMENT OF FACTS

Background

Airwork Service Division of Purex Corporation, along with its major competitor Cooper Airmotive, Inc., Cooper Industries is engaged in the servicing of engines used to power corporate as well as airline aircraft. Grumman American Corporation, Beech Aircraft Corporation, and Cessna Aircraft corporation are also involved as they manufacture aircraft utilizing foreign manufactured engines.

Airwork and Cooper Airmotive can be compared to an automotive garage, only we overhaul and repair aircraft engines for domestic, international and foreign corporations.

Our companies are in direct competition with foreign overhaul shops located in Canada, England and South America. One of the tools of the trade in our business is spare engines which we rent to our customers while we overhaul or repair their engines. When the overhaul shops purchase foreign manufactured engines for rental use, they pay the normal assessed United States duties. Naturally, during our normal course of business these engines are sometimes exported outside the territorial United States in order to support our customers.

Problem

In early 1973, Airwork encountered difficulties in returning rental engines to the United States that had been previously exported in support of foreign operators. Our people visited with the Department of Treasury, United States Customs Service in Washington, D.C., in an attempt to clarify the issue and obtain an exemption under the existing tariff schedules of the United States, Item 801.00. Although the Customs Service was sympathetic to our cause they stated that they did not have the authority to grant an exemption and could not interpret the statutes as written. When asked for advice the Customs Service recommended that we take steps to introduce legislation that would amend the tariff schedules in order to permit duty free treatment of the rental engines.

Due to the world-wide acceptance of the turbine engine into aviation service our industry has been overtaken by technological progress. Although Airwork has stepped up to the challenge from a technical standpoint, we had until recently failed to address ourselves to the logistical demands required to support this broadened marketplace.

Action to correct problem

Our people assisted Congressman Sandman's staff during the second half of calendar year 1973 in drafting an amendment, Item 801.20 to provide duty free treatment of any aircraft engine used as temporary replacement for an aircraft engine being overhauled within the United States if duty was paid on such replacement engine during a previous importation.

House of Representatives Bill 13424 was introduced to the 93rd Congress on March 12, 1974, by Congressman Sandman. Unfortunately no final action was taken on the Bill prior to the closing of the 93rd Congress. Congressman Corman introduced the identical Bill under House of Representatives Bill 2181 to the 94th Congress on January 28, 1975. Congressman Hughes has also introduced a like Bill under House of Representatives Bill 4627.

We believe that it is the intention of the United States Government to encourage United States business to compete in the world marketplace in order to improve the balance of payments of our country.

Airwork alone is forecasting foreign sales of $15 to $20 million over the next five years but we must be able to provide rental engines or this business most surely will go to Canada, England or South America. It is important to note that the relief we are asking for only concerns the rental engines and related accessories which we feel are a necessary tool of the trade in order to attract foreign business. The parts required to overhaul or repair any foreign manufactured engines would still remain dutiable under existing statutes.

Statement of Warner Communications, Inc.

Bank Holding Company Divestitures—Tax Relief

This statement is submitted by Warner Communications, Inc. ("Warner") for inclusion in the printed record of the August 24, 1976 public hearing by the Committee on Finance, United States Senate, on the subject of legislation pertaining to the tax treatment of divestitures made by bank holding companies.

Background

The Bank Holding Company Act Amendments of 1970[1] (the "1970 Amendments") generally make it unlawful for one company to engage in (or own stock in companies engaging in) both banking and non-banking activities. These Amend-

[1] Enacted on and effective as of December 31, 1970.

ments extended to one-bank holding companies the policies underlying similar restrictions imposed on multiple bank holding companies by the Bank Holding Company Act of 1956, as amended in 1966. However, the Congressional committees and Government regulatory agencies concerned with the 1970 Amendments stressed that such Amendments were not intended to be punitive nor were they enacted because of, or to cure, past or existing abuses—rather, the divestiture requirement was merely designed to forestall possible future problems.

Under the 1970 Amendments, every one-bank holding company must either divest its non-banking interests if it chooses to remain a bank holding company or dispose of its banking interests so that it is no longer classified as a one-bank holding company. A ten-year period, ending December 31, 1980, was provided for completion of the required divestiture of banking or non-banking assets.

Warner is a one-bank holding company by reason of its ownership of approximately 60 percent of the stock of Garden State National Bank, Paramus, New Jersey. In 1971, in conformity with the provisions of the 1970 Amendments, Warner filed an irrevocable election with the Board of Governors of the Federal Reserve System to cease being a bank holding company by divesting itself of all elements of control over such bank by January 1, 1981.

The current problem

The Congress has often expressed the belief that anyone forced by its actions to sell or exchange an asset should not in fairness be saddled with adverse tax consequences for doing so. Thus, concurrently with both the 1956 Bank Holding Company Act and the 1966 amendments thereto, the Internal Revenue Code ("Code") was amended to provide appropriate tax relief (sections 1101–1103). Consistently, in reporting the 1970 Amendments, the Senate Banking and Currency Committee voiced the assumption "that the Congress will follow precedent and will pass a bill providing companies required to make divestitures under this legislation with relief from an undue tax burden as a result of such divestiture." [2]

The 1970 Amendments have now been in effect for over five years and less than half of the ten-year mandatory divestiture period remains. However, no legislation has yet been enacted to provide divesting one-bank holding companies with the tax relief which was promised in 1970. Until Congress enacts such tax provisions, the policy of the 1970 Amendments will not be fully or fairly effectuated. Moreover, many of the affected companies are being unnecessarily and unduly restricted from compliance while prudently awaiting the adoption of tax legislation that will make clear and definite the tax consequences of the alternative actions available to them. They are being forced to forego attractive courses of action and will have to make hasty, less economic decisions because of the legislative delay. Indeed, the long Congressional delay on the matter of tax relief seriously frustrates the basic intention of the provision of a ten-year divestiture period, i.e., to provide the affected companies with sufficient time and flexibility to accomplish complicated dispositions of extremely large assets without the dire economic consequences of an immediate forced liquidation. It is imperative that appropriate tax relief be enacted promptly to permit the orderly divestitures contemplated by the 1970 Amendments.

The House bill

The House of Representatives passed H.R. 11997 (the "House Bill") on March 15, 1976, which provides tax relief provisions for divestitures pursuant to the 1970 Amendments. These provisions would offer two types of tax relief: (1) tax free distribution to the bank holding company's shareholders of the bank or non-bank stock or properties required to be divested ("spin-off"); or (2) payment of the tax on any gain on the sale of the bank or non-bank assets required to be divested in equal annual installments over a period ending with the later of 1985 or the tenth taxable year following the taxable year in which the disposition occurred.

The House's adoption of a two-pronged relief approach took into account the wide applicability of the 1970 Amendments (considerably greater than in the case of the 1956 and 1966 legislation), and the variety of situations and problems with which affected companies would be faced. Thus, although only spin-off type tax relief had been provided with respect to the 1956 and 1966 legislation, the House Bill also includes the installment payment approach recognizing that spin-off is not a reasonable possibility for many bank holding companies for one

[2] S. Rept. No. 91–1084, 91st Cong., 2d Sess. 7 (1970).

or more of the following reasons. First, the wide public ownership of many bank holding companies will render a spin-off of a relatively small bank undesirable, since it would result in a nationwide group of thousands of shareholders, each owning an insignificant interest in a local bank, which might well be unmarketable. On the other hand, if the bank holding company is closely held, a spin-off may not result in a separation of control of banking and non-banking interests and thus not accomplish the objectives of the 1970 Amendments. Finally, a spin-off may not be possible because of restrictions in loan agreements or the general credit situation of the bank holding company. It is essential that effective tax relief be provided in situations in which the bank holding company complies with the 1970 Amendments by a sale of its banking or non-banking assets rather than by a spin-off. Accordingly, Congress should enact legislation along the lines of the House Bill which provides for both installment payment and spin-off relief.

Warner's recommendations

We urge adoption of both of the tax relief provisions set forth in the House Bill subject to three simple amendments; the first two relate to the spin-off provisions and the third concerns the installment payment provisions.

1. The spin-off provisions of the House Bill permit a spin-off distribution to a shareholder of a bank holding company in exchange for its preferred stock only under limited circumstances relating to certain closely held bank holding companies. We suggest that a spin-off distribution in exchange for preferred stock should be generally permitted so long as the exchange offer is made in good faith on a uniform basis to all members of a class or series of stock of the bank holding company. This rule would better implement the policies expressed in and underlying the proposed legislation and would be consistent with the recommendations of the Department of the Treasury before both the House Ways and Means Committee and your Committee. The simple change in statutory language appropriate to give effect to this amendment is set out in the appendix attached to this statement.

2. The House Bill provides that the only situation in which a distribution in exchange for common stock is permissible is where a special purpose subsidiary has been created by the bank holding company. In many cases, however, such a special purpose subsidiary would not be practical or would add unnecessary complexity to the transaction by, for example, interposing a new holding company between a spun-off bank and the public shareholders. There is no reason to require the interposition of a special purpose subsidiary to permit a distribution in exchange for common stock. We suggest that a spin-off distribution directly in exchange for stock be permitted. The simple statutory change appropriate to give effect to this amendment is set out in the appendix.

3. The installment tax payment provisions of the House Bill allow the tax on gain with respect to a qualifying disposition to be paid in installments ending with the later of 1985 or the tenth taxable year following the taxable year in which the disposition occurred. However, interest is imposed upon any annual installment of tax due after 1985. Thus, under the House Bill, the tax on any gain resulting from a qualifying disposition could be paid interest free over a fourteen-year period if the property were disposed of in 1971, as opposed to over only a five-year period if the property were disposed of in 1980, the last year of the divestiture period under the 1970 Amendments. This rule would create significant disparities in the tax consequences to different divesting companies, depending solely on the year of disposition and would effectively impose a tax penalty on dispositions toward the end of the divestiture period. The 1970 Amendments which mandated the divestitures clearly did not require or encourage divestiture to be effected prior to 1980. The tax law should not change this policy decision by providing preferential treatment to certain taxpayers but rather should operate neutrally on all affected companies.

We suggest that there be no imposition of interest on installment payments of tax due after 1985. Under such a rule, all bank holding companies would be permitted a minimum interest-free period of ten years for the installment payment of tax, analogous to the length of the mandatory divestiture period, regardless of when consideration of the relevant business exigencies dictate the disposition of the assets required to be divested. The simple statutory change appropriate to give effect to this amendment is set out in the appendix.

Conclusion

Warner urges prompt consideration and enactment of provisions providing one-bank holding companies with the tax relief promised them in 1970. This

should be done now, before the rapidly expiring mandatory divestiture period requires a forced liquidation of assets. The House Bill constitutes an appropriate and reasonable approach to this problem and, with the three substantive changes discussed above (permitting a tender offer on a uniform basis to all shareholders of a class or series of stock, permitting direct distributions in exchange for stock and eliminating interest charges on installment payments due after 1985) should be promptly finalized and reported for Senate action.

AUGUST 24, 1976.

APPENDIX

1. Permitting a good faith offer made on a uniform basis to a class or series of shareholders.

Change House Bill section 1101(a)(3)(C) as follows:

"(C) REDEMPTIONS WHEN UNIFORM OFFER IS MADE.—A distribution meets the requirements of this subparagraph if the distribution is in exchange for stock of the distributing qualified bank holding corporation and such distribution is pursuant to a good faith offer made on a uniform basis to all shareholders of the distributing qualified bank holding corporation or to all shareholders [of common stock of such corporation.] *of a class or series of stock of such corporation.*"

2. Permitting direct distributions in exchange for common stock.

Change House Bill section 1101(a)(1)(A)(i) as follows:

"(i) to a shareholder (with respect to its stock held by such shareholder), *with or* without the surrender by such shareholder of stock in such corporation, or"

Change House Bill section 1101(b)(1)(A)(i) as follows:

"(i) to a shareholder (with respect to its stock held by such shareholder), *with or* without the surrender by such shareholder of stock in such corporation, or"

3. Eliminating interest charges on installment payments due after 1985.

Delete section 6185(c)(3)(C) from the House Bill.

NATIONAL CLUB ASSOCIATION,
Washington, D.C., August 24, 1976.

HON. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SIR: It is an honor to submit for your Committee's consideration a statement on behalf of the National Club Association in support of H.R. 1144.

The National Club Association represents the interests of the nation's private clubs, which provide for the social and recreational needs of an estimated sixteen million family members from coast to coast.

To better understand the purpose of H.R. 1144, it would be helpful to review its history and that of the tax treatment of private clubs which have been exempt from income taxation since 1916. Until 1964, clubs which were "organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder," under Internal Revenue Code Section 501(c)(7), or its predecessor, were exempt from income taxation, in part as recognition that the income private clubs receive from their members is not income in a business sense.

In addition to income received from members, private clubs have often received some small part of their revenues from incidental contacts with nonmembers. Prior to 1964, both the courts and IRS ruled that a club could do business with nonmembers and retain its exempt status so long as it did not derive "substantial revenues" from such nonmember business. In 1964, however, the IRS promulgated Revenue Procedure 64-36, which stated that any club which derived more than five percent of its total gross receipts from nonmembers would place its tax exempt status in jeopardy.

This "five percent" test quickly became the bane of the private club industry. Many private clubs, faced with the significant administrative burden of constantly monitoring member vs. nonmember business, simply banned nonmember contacts, despite the reality that club facilities are often the most suitable or only facilities available for many community, social and service functions. Likewise, clubs became reluctant to host inter-club or regional events such as golf tournaments and boat races.

The IRS originally promulgated this "five percent" limit in 1964 to discourage nonmember income which was not taxed. The Tax Reform Act of 1969, however, removed that justification since it provided that an exempt private club's nonmember income would henceforth be taxed. Apparently the IRS did not recognize this fundamental change, for in 1971 it issued Revenue Procedure 71-17 which reiterated the five percent test and added even more administrative and recordkeeping burdens to private clubs.

In 1971 Congress became more aware of these harsh restrictions on private clubs and, in December, Rep. Joe D. Waggonner, Jr., introduced H.R. 11200. The bill proposed to amend Section 501(c)(7) of the Internal Revenue Code to provide that clubs whose activities are "substantially" (rather than "exclusively") for nonprofit purposes would be eligible for tax exemption; the change would enable the IRS to raise the five percent guideline to fifteen percent. The bill was unanimously reported by the Ways and Means Committee on March 16, 1972, but was not considered by the full House. The Treasury Department did not object to the bill.

During the 93d Congress, the bill was reintroduced as H.R. 1934 and, while included in the preliminary Tax Reform Package, it was not reported out in the final bill.

The measure was resubmitted in this Congress as H.R. 1144, unanimously reported by the Committee on Ways and Means on July 21, 1976; and passed by the House today. In its Report, the Committee stated that H.R. 1144 "clarifies existing law" to permit exempt social clubs to receive somewhat larger amounts of income from nonmembers and investment income sources. The Report also reaffirmed that the provisions of the Tax Reform Act of 1969 made the strict line of demarcation between the exempt and nonexempt activities of social clubs unnecessary and that "the extent to which such (clubs) can obtain income from nonmember sources can be somewhat liberalized."

In summary, we urge your support of H.R. 1144, a tax-productive measure which will help ease IRS restrictions made necessary by the Tax Reform Act of 1969 and which, at the same time, will permit many of our nation's clubs to better serve the needs of their communities.

Respectfully submitted,

JAMES J. GLYNES, Jr., *President.*

ASSOCIATION OF BANK HOLDING COMPANIES,
Washington, D.C., August 10, 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: I am writing to advise you of our Association's support for two bills, H.R. 5071 and H.R. 11997, which are currently pending before your Committee, and to urge your favorable consideration of them.

H.R. 5071 provides that where banks which are members of the same affiliated group establish a combined common trust, this fund is to be treated as a "common trust fund" for tax purposes during the period of affiliation. The bill would enable banks affiliated with bank holding companies in the smaller communities to offer the benefits of well-diversified and well-managed common trust funds to the public, which otherwise might not be available. The Treasury Department and the Comptroller of the Currency support this bill, and we understand the bill will have no effect, or at most a negligible effect, on the revenues. H.R. 5071 was passed by the House May 13, 1976, on a voice vote.

The other bill, H.R. 11997, would provide tax treatment for divestitures required by the 1970 amendments to the Bank Holding Company Act ("Act"). The 1970 Amendments extended the Act to cover corporations controlling only one bank. Prior to 1970, the Act only applied to corporations controlling two or more banks. As a result of the 1970 Amendments, corporations controlling one bank (popularly referred to as "one-bank holding companies") were required to comply with the provisions of the Act permitting them to engage only in activities determined by the Federal Reserve Board "to be so closely related to banking or managing or controlling banks as to be a proper incident thereto." Consequently, a number of the one-bank holding companies have divested or will be required to divest by December 31, 1980, certain of their businesses, which have been determined not to be "closely related to banking."

When the Act was originally enacted in 1956, and again in 1966, when the Act was amended to extend its coverage, the Congress, on both occasions, subsequently passed legislation to provide tax treatment for corporations required to divest subsidiaries in order to comply with the statute. The Congress was concerned that, unless these statutes were enacted, shareholders of bank holding companies would suffer tax consequences as the result of the Congress forcing their companies to divest.

The same reasons that supported the enactment of equitable tax treatment legislation following the 1956 Act and the 1966 Amendments apply equally to the tax implications of divestments by the 1970 Amendments. Bank holding companies covered by the 1970 Amendments were led to believe they would receive comparable treatment. Some companies have delayed divesting their non-permissible investments for 5 years because they did not know what the resulting tax consequences would be. Thus, the intent of the Congress as expressed in the 1970 Amendments in this respect is being frustrated becasue of the lack of implementing tax legislation.

H.R. 11997 was passed by the House March 15, 1976, on a voice vote under a suspension of the rules. We understand the Treasury Department supports this legislation.

If you have any questions concerning these bills, please let me know.

Sincerely yours,

DONALD L. ROGERS, *President.*

SALOMON BROTHERS,
New York, N.Y., August 25, 1976.

HON. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: In connection with various revenue bills presently pending before the Committee, we respectfully urge you to give favorable consideration to an amendment to the Internal Revenue Code which would clarify the status of payments received by pension funds, mutual funds, educational institutions and other exempt foundations in respect of loans of securities in their portfolios. The draft amendment, attached hereto, provides in essence that payments in respect of securities loans which satisfy the requirements of the Securities and Exchange Commission for regulated investment companies[1] should be treated by the lending institutions in the same manner as if they were dividends or interest.

The underlying purpose of this amendment is to remove an unwarranted tax inhibition against securities loans, and thus increase the supply of securities available for loans to facilitate clearance and settlement functions in the securities markets. It has been the position of the SEC that increased availability of securities for lending would have a most salutary effect in reducing the number of uncompleted transactions. The former chairman of the SEC has set forth the views of the Commission in letters to the Commissioner of Internal Revenue on two occasions; his letters are attached hereto for your information.

Various government agencies with regulatory jurisdiction over institutional investors have recently taken steps to enable them to lend their securities. For example, the Securities and Exchange Commission has granted such authorization to registered investment companies, and the Comptroller of the Currency has take similar action with respect to pension funds and other accounts managed by the trust departments of national banks. The one major obstacle remaining is doubt about the tax status of income from securities loans.

A large number of pension trusts and exempt institutions, which hold a substantial percentage of common stocks and corporate bonds, have been unwilling to lend securities due to uncertainty regarding the classification of such income. The income may take the form of a fee paid by the broker-dealer, or income derived from investment of cash collateral, and may include payments made in lieu of dividends, interest and other distributions by the issuer of the securities.[2]

[1] Loans which satisfy such requirements are fully collateralized (with adjustment made on a daily basis) by cash or marketable securities with a fair market value equal to the fair market value of the securities loaned; therefore, the loans should not subject a lender's investment portfolio to any significant additional risk.

[2] Since the broker-dealer has redelivered the physical certificates which were borrowed and is not the holder of record, it is not in a position to flow through the actual distribution to the lender and can only make a payment in lieu of it.

Notwithstanding the passive nature of such income, and its close similarity to dividends, interest and royalties, certain personnel of the National Office of the Internal Revenue Service have indicated that such amounts may be treated as unrelated business taxable income in the hands of an exempt entity, and it is not clear that such sums necessarily constitute income derived from dividends or interest for purposes of the 90 percent of gross income test which must be satisfied if the conduit status of a regulated investment company is to be maintained.

If "in lieu of" payments are taxable to an exempt institution, the return realized from lending securities is drastically reduced or eliminated whenever a securities loan extends over a dividend or interest record date.[3] If tax-exempt lenders generally were to insist upon the return of their securities before a dividend or interest record date, the benefits to the securities markets from the increased securities loans during the balance of the year would be more than offset by the confusion which would occur near the time of a dividend or interest record date. Similarly, mutual funds may insist upon the return of their securities before a dividend or interest record date to avoid jeopardizing their conduit status. In any event, lending activity is unattractive to an exempt institution of income derived therefrom is taxable, because the fairly low rate of return does not warrant the inconvenience of additional detailed tax returns.

The lending of securities is an adjunct to normal portfolio management activities, and does not affect the exercise of investment judgment. Any institution which lends securities makes each decision to buy, sell or hold a security solely on the merits of the security as an investment, and without regard to the fact that the certificates for such security had been,[4] or might conceivably be, loaned to a broker. While the aggregate volume of securities loans could be expected to increase significantly if the proposed amendment were enacted (with a most salutary effect upon the efficiency of the securities markets), brokers' needs for certificates of any particular security are unpredictable. Therefore, whether a security might be borrowed, and the likely duration of such loan could not be determined in advance.

Experience has shown that most securities loans entered into by broker-dealers are outstanding for only a brief period of time, generally measured in days or weeks, rather than months. The amount which institutions receive as compensation for lending a security is related to the broker's loan rate on commercial bank borrowings during the term of the loan. If securities of tax-exempt institutions were available for lending, it is reasonable to anticipate that the compensation would not exceed half of the "prime" rate for commercial bank borrowing by the broker during the term of the loan, and it is possible that the compensation could be significantly less. At present, major institutional lenders earn a yield of about 8 percent on loans of equity securities, approximately 2 percent on loans of corporate bonds, and one-half to three-quarters of 1 percent on loans of U.S. government bonds. Consequently, the compensation received by a lender at the

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[3] At present, the average securities loan remains outstanding for approximately 1 month. If, for example, the fee on securities loans were 3 percent per annum, the after-tax yield for a one month loan would be approximately 0.13 percent of the value of the securities:

	Percent
3 percent annual rate for 1 month yields	0.25
48 percent on fee reduces yield by	0.12
Net yield to lender	0.13

Unless a stock, paying dividends quarterly, yielded significantly less than 1.2 percent per annum, the fee would not compensate for the after-tax yield lost due to the tax upon the payments in respect of dividends.

100,000 of stock yielding 1.2 percent annually

Stock not on loan:	
Quarterly divided not taxed	$300
Stock on loan at 3 percent for 1 month:	
Quarterly dividend	800
Fee	250
Total before taxes	550
Tax (48 percent)	(264)
Net after taxes	286

The same principle is applicable to corporate bonds, and since such bonds yield substantially more than 1.2 percent, and command a lower borrowing fee, no bonds would remain on loan over an interest payment date.

[4] Loans are generally terminable by the lender on five days notice. If notice of termination is given on the day the securities are sold, the lender will have five days following the trade date within which to make timely settlement on the sale by delivery of physical certificates.

present time might be as much as 3 percent on an annual basis, but if a loan of securities were outstanding for two months (a period which is longer than the vast majority of cases), the lender's actual yield for that loan would be 0.5 percent of the value of the security. Such a nominal return could not cause an institution to acquire a security (even if a potential loan were assured rather than unpredictable, as is in fact the case) when weighed against the possibility of a diminution in the market value of the investment and total brokerage charges of from 0.5–1.0 percent of the value of the security which would be incurred in connection with an acquisition and sale thereof. Similarly, it could not act as a disincentive in the event that a sale would otherwise be deemed advisable in light of market conditions or the outlook for the issuer, since a 3 percent annual yield provides a return of only 0.25 percent per month, which is much less than ordinary fluctuations in market price within such period.

We respectfully urge that the proposed amendment be given favorable consideration. If the proposal is enacted, pension trusts, other exempt organizations, and regulated investment companies, will be afforded the opportunity to receive a modest amount of additional passive income upon the investment portfolios they own (by lending the physical certificates representing certain of the securities included therein), while simultaneously facilitating the settlement of securities transactions.

Very truly yours,

SALOMON BROTHERS.

Attachment.

A BILL To amend the Internal Revenue Code of 1954 with respect to amounts received on certain loans of securities

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 512(a) of the Internal Revenue Code of 1954 (relating to the definition of unrelated business income) is amended by adding at the end thereof the following new paragraph:

"(5) SPECIAL RULE FOR PAYMENT ON SECURITIES LOANS.—The term 'payments on securities loans' shall include all amounts received in respect of a security (as defined in section 1236(c)) loaned by the owner thereof to another person, whether or not title to the security remains in the name of the lender, including amounts in respect of dividends or interest thereon, fees computed by reference to the period for which the loan is outstanding and the fair market value of the security during such period, income from collateral security for such loan, or income from the investment of collateral security provided that the agreement between the parties provides for:

"(a) reasonable procedures to implement the obligation of the borrower to furnish collateral to the lender with a fair market value on each business day during the period the loan is outstanding at least equal to the fair market value of the security at the close of business on the preceding business day, and

"(b) termination of the loan by the lender at any time on notice of no more than five business days, whereupon the borrower is required to return certificates for the borrowed securities to the lender."

(b) Section 509(e) of the Internal Revenue Code of 1954 (relating to the definition of gross investment income) is amended by inserting "payments on securities loans (as defined in section 512(a)(5))," after "dividends,".

(c) Section 512(b)(1) of the Internal Revenue Code of 1954 (relating to modifications of the definition of unrelated business taxable income) is amended by striking out "and annuities," and inserting in lieu thereof "annuities, and payments on securities loans (as defined in paragraph (5) of subsection (a)),".

(d) Section 851(b)(2) of the Internal Revenue Code of 1954 (relating to limitations on the definition of a regulated investment company) is amended by inserting "payments on securities loans (as defined in section 512(a)(5))," after "interest,".

(e) Section 4940(c)(2) of the Internal Revenue Code of 1954 (relating to the definition of private foundation gross investment income) is amended by striking out "and royalties," and inserting in lieu thereof "royalties, and payments on securities loans (as defined in section 512(a)(5)),".

(f) *Effective Date.*—The amendments made by this Act shall apply to amounts received after December 31, 1975.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., March 19, 1975.

Re availability of corporate securities for lending to facilitate settlement of securities transactions.

Hon. DONALD C. ALEXANDER,
Commissioner of Internal Revenue Service, Department of the Treasury, Washington, D.C.

DEAR MR. ALEXANDER: Last year, the Commission determined that I should write to you to advise you of its views with respect to the availability of corporate securities for lending to facilitate the settlement of securities transactions. At that time, we were aware that some institutional investors were contemplating requesting revenues rulings to clarify the tax status of the payments that would be made to them if they were to lend securities. Since that time, we understand that requests have been made for revenue rulings by at least some institutional investors who, in the absence of a favorable ruling, have indicated their reluctance to become lenders of securities.

As I indicated to you in my prior letter, the Commission, of course, is not purporting to express any opinion on matters of tax policy or any interpretation of the Internal Revenue Code. We do believe, however, that favorable rulings could result in substantial additional borrowings, significantly reducing "fails" in the securities markets and, concomitantly, could improve the efficiency of the clearance and settlement functions in these markets with resulting savings for the securities industry. Since the time of my first letter, the aggregate dollar value of "fails" has decreased, due to the important strides that have been made over the last five years by the Commission and the securities industry to maintain regulatory control over this situation. Nevertheless, the very recent increase in trading activity we have been witnessing has been accompanied by an increase in the dollar value of fails generally; a favorable tax ruling would permit these fails to be reduced by the lending of securities, augmenting continuing regulatory efforts. Indeed, since our last letter, the dollar value of fails in the corporate bond area has increased by at least ten percent, and this particularly is an area where the corporate lending of securities could prove most salutary.

In light of our interest in this matter, the Commission would appreciate it if you could apprise us of the current status of any requests you have received on this matter. Naturally, if we can be of any assistance to you in your consideration of this matter, you should feel free to call upon us.

Sincerely yours,

RAY GARRETT, Jr., *Chairman.*

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C.

Re availability of corporate securities for lending to facilitate settlement of securities transactions.

Hon. DONALD C. ALEXANDER,
Commissioner of Internal Revenue Service, Department of the Treasury, Washington, D.C.

DEAR MR. ALEXANDER: The availability of securities for lending to facilitate the settlement of securities transactions is a matter of some concern to the securities industry. Because current and future tax policies may have some bearing on this matter, I am taking this opportunity to apprise you of the situation and its ramifications.

When a broker-dealer sells a security as agent for a customer, it settles the transaction by receiving the security from the customer and redelivering it to the appropriate clearing facility or directly to the buyer. On the other hand, when a broker-dealer purchases a security as agent for a customer, it receives the security from the clearing facility or directly from the seller, or its agent, and redelivers it to the customer, in general, after transferring the security into the customer's name. In either event, if the broker-dealer fails to receive the security, it likely will not be able to deliver it, unless other identical securities of the same issuer are readily available for borrowing. Similar situations occur when the broker-dealer is acting as principal rather than as agent.

These situations may arise from a variety of circumstances, including, among others: the customer's securities are in "legal form" and must first be transferred

into "good deliverable form"; the customer has not sold his entire holdings and must have the certificates broken down into smaller denominations for delivery; or the seller has sold the securities short. One of the most common reasons, however, is that the seller or his broker-dealer has itself failed to receive the security from a previous seller. (For example, customer X of Broker A sells to Market-maker B, who sells to Trader C, who sells to Broker D for its customer Y; if customer X fails to deliver to Broker A, as a consequence, four additional incomplete transactions may be created.) It was the realization of this possibility of an initial failure to complete a transaction to create a continuous chain of incompleted transactions that was one of the primary causes of the securities processing crisis of the late 1960's and early 1970's.[1]

Over the last few years the Securities and Exchange Commission and the securities industry self-regulatory organizations (the stock exchanges and the National Association of Securities Dealers, Inc.) have instituted a number of reforms designed to improve the processing of securities transactions and thus to reduce incompleted transactions. The level of incompleted transactions between broker-dealers may be reduced through the use of sophisticated clearing facilities by netting transactions among participants and thereby reducing the number of securities movements which are necessary to complete transactions and eliminating chains of incompleted transactions.[2] Such clearing facilities or depositories, however, cannot reduce the level of incompleted transactions where the parties to such transactions are not members of these clearing facilities or depositories but rather are customers of broker-dealers or, the particular securities are not cleared through any clearing facility or included in a depository. Thus, many such incompleted transactions are unavoidable. Even so, if the broker-dealer obligated to deliver a security can borrow an identical security from another holder, and use the borrowed security to make delivery, at least a chain of incompleted transactions may be avoided. And, when the original security is received, the borrowed security can be returned.

Consequently, the Commission believes that the borrowing of securities to settle securities transactions can, depending upon the circumstances, be a useful and desirable technique to improve the securities processing mechanism and reduce incompleted transactions. The rules promulgated by the Board of Governors of the Federal Reserve System appear to foster such an approach, since those rules permit broker-dealers to borrow securities for the purpose of making deliveries of such securities, without regard to the margin limitations otherwise imposed by Regulation T.[3]

The borrowing of securities by broker-dealers to complete deliveries, to avoid "fails" and to cover short sales is thus quite extensive. The New York Stock Exchange reports, for example, that, at the end of December, 1973, its members had outstanding borrowings of securities of approximately $1 billion.

A principal obstacle to increasing the borrowing of securities appears to be the limited supply of such securities available for loan. A portion of the securities currently borrowed are securities in customers' margin accounts and the supply, we are advised, is not adequate to meet demand because a large percentage of common stocks and most corporate bonds are held by institutional investors, primarily pension funds, investment companies and insurance companies.

We understand that, with the very recent exception of insurance companies, these institutional investors have not been lenders of securities because of their doubts about the tax status of the payments that would be made to them. These payments include not only the borrowing fee, but also any payments made in lieu of dividends, interest and other distributions by the issuer of the securities.[4] The characterization of those payments for income tax purposes may be determinative of whether it is profitable for various types of institutional investors to make securities loans. If the source of such borrowings is inhibited or eliminated because institutional investors will incur adverse tax consequences if they lend their securities, both the level of incompleted transactions could increase

[1] See, Securities and Exchange Commission, "Study of Unsafe and Unsound Practices of Brokers and Dealers," H.R. Doc. No. 92-231, 92d Cong., 1st Sess. (1971).

[2] Depositories also reduce securities movements by holding large amounts of securities and effecting delivery between participants solely by book entry and without the necessity for actual receipt and delivery of certificates by the participants.

[3] See 12 CFR 220.6(h).

[4] Since the broker-dealer has redelivered the security to its purchaser and is not the holder of record, it is not in a position to flow through the actual distribution to the lender and can only make a payment in lieu of it.

and the ability to effect short sales could be reduced. On the other hand, to the extent an increased amount of borrowable securities is available, it is quite possible that the current level of incompleted transactions could be further reduced.

We are advised that a number of such investors may have filed, or may be about to file, requests for revenue rulings to resolve the question with respect to the proper classification of such payments. These requests involve complicated provisions of the Internal Revenue Code and of tax policy as to which the Commission, of course, does not have any expertise. If, however, favorable revenue rulings are issued, thereby encouraging institutional investors to lend their securities, based on the current volume of fails, knowledgeable members of the brokerage industry estimate that substantial additional borrowings could take place, significantly reducing "fails" in the securities markets. This would improve the efficiency of the clearance and settlement functions in these markets with resulting savings for the securities industry, which needs to operate as efficiently as it can in order to discharge its responsibilities.

We hope that this background information will be useful to the Internal Revenue Service in considering any requests for rulings you have received or may receive on this important subject.

Sincerely yours,

RAY GARRETT, Jr., *Chairman.*

LYKES CORP.,
New Orleans, La., August 23, 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance,
Senate Office Building,
Washington, D.C.

DEAR MR. CHAIRMAN: This statement is submitted on behalf of Lykes Corporation of New Orleans, a publicly held steel and ocean shipping concern, in response to your Press Release No. 44 dated August 10, 1976, with reference to H.R. 11997, Bank Holding Company Tax Act of 1976, relating to the tax treatment of certain divestitures of assets by bank holding companies.

Under the Bank Holding Company Act of 1956 as amended by the Bank Holding Company Amendments Act of 1970, Lykes is a bank holding company since it owns Lykes Financial Corporation which in turn owns 25 percent or more of the voting stock of First National Bank in Palm Beach.

It was clearly intended that such divestitures should have no adverse tax consequences—that is, that the bank holding company could distribute to its shareholders the bank stock without the recognition of gain to the respective shareholders. This was specifically spelled out in the 1956 act which amended the internal Revenue Code of 1954 to that effect, and the legislative history leaves no doubt that Congress intended that no tax be assessed if the divestiture requirements were approved. Similar tax relief was afforded in 1966 when the Bank Holding Company Act of 1956 was amended.

The 1956 Act defined bank holding companies to be those companies having the required interest in two or more banks, but the 1970 amendments enlarged the definition to include companies having such an interest in one or more banks. It was the latter amendment which brought Lykes within the scope of the bank holding company laws.

When the 1970 amendments were adopted, they did not include a provision for tax relief for distributions made, although the legislative history makes it clear that Congress intended that divestitures required by those amendments receive the same tax treatment as was afforded under the prior legislation. It was apparently contemplated that legislation would be passed separately to deal with the problem and this intention is noted in the legislative history.

To date, legislation affording this tax relief has not passed, and Lykes requests that action be taken as soon as possible on H.R. 11997, in order that it may proceed with planning for implementation of divestiture in an orderly fashion within the time limit imposed by law.

Bank holding companies which are required to divest have only until December 31, 1980 to exercise and effectuate that choice. It must be remembered that a great deal of advance planning is necessary, and business conditions or other considerations often dictate timing of divestiture. Among the requirements, for example, are that the Federal Reserve approve of the proposed divestiture. Experience has demonstrated that this is not merely a formality. Difficulties may also be encountered in finding suitable purchasers, especially in view of the

recent history of performance in the banking industry. It is necessary that companies have adequate time to make their divestiture plans after the appropriate tax relief is provided. In the context of the many procedures and requirements that must be fulfilled before a divestiture may be accomplished, time is growing short.

Thus, we believe it is imperative that the legislation now before you be enacted and signed into law this year. Efforts to accomplish this have been under way since 1972 and in 1974 it was tentatively agreed that relief should be provided. Moreover, it has been six years since the Senate Banking and Currency Committee (in S. Rept. 91-1084) indicated that Congress would follow precedent and enact legislation to allow companies required to make divestitures relief from an undue tax burden as a result of such divestiture. We fully concur in the assessment that it would be inequitable to require divesting companies to commit themselves to a divestiture plan without knowledge of the tax consequences.

I believe it is also important to note that the bill now before you does not allow taxpayers to escape tax if the "spinoff" method is utilized; it merely defers payment of the tax until distributee-shareholders dispose of their stock interest. Thus, this bill is not a "tax forgiveness" measure.

It has been indicated that the tax treatment for companies affected by the 1970 amendments should be essentially the same as was provided in connection with the 1956 and 1966 legislation. Certainly, it would seem highly inequitable to deny this relief to companies which, through no fault or action of their own, were in 1970 brought within the terms of the Bank Holding Company Act, especially in view of the prior legislation in 1956 and 1966 with respect to companies similarly situated.

Although we are fully conscious of the demands on your time, we hope very much that your committee will be able to move ahead expeditiously on this problem.

We find a somewhat parallel situation now to that existing at the time of the 1970 amendments: (i) Bank holding companies are reluctant to commit themselves to a divestiture plan without knowing the tax consequences; (ii) the state of the economy is far from ideal; and (iii) if a large number of banks will be divested as the result of the approaching 1980 deadline, it will be a buyer's market and sellers may be unable to get fair value for the assets they are divesting. The impact of this factor in the banking industry should not be underrated. Further, divestiture by a public company requires considerable lead time in order that compliance may be had with applicable regulatory agency requirements and the mechanics of divestiture may be appropriately implemented.

To summarize the points we are attempting to make, we would emphasize the following:

First, tax relief is appropriate, has been recognized as such, and the legislative history of the Bank Holding Company Act appears to mandate the same.

Second, to prevent distress divestiture, such relief should be provided well before 1980.

Third, early action on tax relief is necessary because of lead time required for other regulatory filings or approvals.

Respectfully submitted.

S. W. MURPHY,
Secretary and Counsel.

REPUBLIC OF TEXAS CORP.,
Dallas, Tex.

Re Bank Holding Company Tax Act of 1976 (H.R. 11997).

Senator RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR CHAIRMAN LONG: In response to the invitation contained in your press release dated August 10, 1976, the Republic of Texas Corporation hereby submits its statement concerning the Bank Holding Company Tax Act of 1976 (H.R. 11997) for consideration by the Committee on Finance and for inclusion in the printed hearing record. The Republic of Texas Corporation (hereinafter "Republic"), a registered bank holding company located in Dallas, Texas, urges the Finance Committee to approve H.R. 11997. The enactment of this bill into law would fulfill the express commitment of Congress to provide tax relief to those

bank holding companies which were forced to divest property as a result of the 1970 Amendments to the Bank Holding Company Act.

HISTORY OF H.R. 11997

In 1956, Congress passed the original Bank Holding Company Act in order to compel bank holding companies to separate their banking from their non-banking activities. Under Section 4 of that Act, a covered bank holding company was required within specific time limits either to divest its non-banking assets or to divest its banking assets and to cease being a bank holding company. Corporations which were classified as bank holding companies in 1956 (because they controlled two or more banks) were permitted by that Act to make tax free distributions, or "spin-offs," of those banking or non-banking assets which they were required to divest. Congress enacted the spinoff provision because it recognized that it would be unfair to require bank holding companies to restructure their businesses by divesting property (which, in the absence of legislation, they would have continued to hold) without providing equitable tax treatment for the proceeds which would be received upon the disposition of the prohibited assets.

In 1970, Congress amended the Bank Holding Company Act and thereby expanded the definition of "bank holding company" to include any company which directly or indirectly owns, controls, or has the power to vote 25 percent or more of any class of voting securities of just one bank. By expanding the definition, Congress intended to subject each "one bank holding company" to the divestiture requirements of Section 4 of the Act.

When Congress included one bank holding companies within the scope of the Bank Holding Company Act in 1970, it recognized that unless it passed tax relief legislation, forced divestiture would create harsh tax consequences.[1] For example, under current Internal Revenue Code provisions, a bank holding company which is required by the Act to sell either the stock in, or the assets of, a non-banking subsidiary to a third party is also compelled to recognize immediately the full amount of capital gain realized from the sale, unless the strict requirements of the installment sale provisions of section 453 are satisfied. If the bank holding company decides, instead, to distribute the stock it holds in a non-banking subsidiary to its own shareholders then, unless the stringent requirements of section 355 of the Code are satisfied, the distribution will be treated as a taxable dividend, and the shareholders will be required to realize ordinary income on the fair market value of the stock they receive.

Congress clearly intended to alleviate the impact of these consequences through the contemporaneous passage of tax relief legislation. For example, the Senate Banking and Currency Committee stated that:

"It is anticipated that the Congress will follow precedent and will pass a bill providing companies required to make divestitures under this legislation with relief from an undue tax burden as a result of such divestiture. It would be inequitable to require these divesting companies to commit themselves to a divestiture plan without knowing precisely what their tax situation will be in regard to such divestiture. Accordingly, it was deemed necessary to provide a divestiture period of sufficient length that these companies will have adequate time to make their divestiture plans after the appropriate tax relief measure is passed by Congress." [S Rep. No. 91-1084, 91st Cong., 2nd Sess. (1970)].

Later in the same report, the Committee stated that it wished ". . . to insure that required divestitures are made as quickly as possible, as efficiently as possible, and with as little economic loss to the divesting company as possible."

In order to carry out the express intent of Congress, the House Ways and Means Committee tentatively approved legislation in November, 1974 which provided three alternative methods of tax relief for bank holding companies which make divestitures that the Federal Reserve Board certifies are necessary or appropriate to carry out the purposes of the Act. The first method was a "spin-off" provision similar to that provided in 1956. The second method, which was termed "rollover" treatment, allowed the tax on the gain from a sale of non-banking or banking property to be deferred, if the proceeds of that sale were reinvested in "qualified replacement property" and appropriate reductions in the basis of the qualifying replacement property were made. The third method

[1] Congress also amended the Bank Holding Company Act in 1966, and tax relief was provided to those bank holding companies brought within the divestiture provisions of the Act at that time.

permitted the installment payment over a specified period of time of taxes on capital gain realized from a sale of non-banking or banking property.

This draft legislation was not reported out of the Ways and Means Committee in 1974, and consequently, the Committee began its deliberations anew in 1976. Hearings were held on January 27, 1976, and the Republic of Texas Corporation and other interested parties testified. The product of those hearings and subsequent markup sessions was H.R. 11997, the "Bank Holding Company Tax Act of 1976." H.R. 11997 was overwhelmingly approved by both the Ways and Means Committee and the full House of Representatives and was referred to the Senate Finance Committee on March 16, 1976.

EXPLANATION OF MAJOR PROVISIONS OF H.R. 11997

In general, a corporation subject to the divestiture provisions of the Bank Holding Company Act is given its choice of alternative routes—to remain a bank holding company and divest its prohibited non-banking property, or to dispose of its interest in banking property and, as a result, cease to be a bank holding company. Republic has decided to remain a bank holding company. Accordingly, it must divest itself of any "prohibited property," i.e., non-banking property, by a specified statutory deadline.

H.R. 11997 provides two alternative methods of tax relief for Republic's divestitures of non-bank property. First, the bill (like the 1974 draft), provides a spin-off option under which a bank holding company may distribute its non-banking assets to its own shareholders (or, in some cases, security holders) without an inclusion in income or a recognition of gain by these stock (or security) holders, but with appropriate basis adjustments. This "spin-off" approach is generally the same as that adopted with respect to divestitures under the original bank holding company legislation enacted in 1956 and 1966.

Second, the bill permits a bank holding company to sell its non-banking property in a taxable sale or exchange and to pay the income tax incurred at the corporate level in installments over at least a ten-year period.

Republic fully supports the House measure, i.e., the spin-off and the installment payment methods.[3] It is imperative that the Finance Committee approve the House bill in order to mitigate the hardship faced by bank holding companies in making their required divestitures.

CONCLUSION

The Republic of Texas Corporation strongly supports the passage of H.R. 11997. If legislation is not passed during this Session of Congress, bank holding companies may face disastrous tax consequences which Congress expressly intended to avoid. We hope that Congress will act now to fulfill its 1970 commitment to provide tax relief legislation to bank holding companies affected by the passage of the 1970 amendments to the Bank Holding Company Act.

Sincerely,

JAMES D. BERRY, *President.*

WILLIAMS & JENSEN,
Washington, D.C., August 24, 1976.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: This letter is written in repsonse to the August 10, 1976 press release of the Committee on Finance requesting comments on the Bank Holding Company Tax Act of 1976, H.R. 11997, which was recently passed by the House and is now before the Committee.

Under the bill, proposed section 1102(h) of the Internal Revenue Code of 1954 would extend the tax relief benefits to certain closely held bank holding companies if the companies make elections to divest themselves of all their banking

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[3] The third form of relief, i.e., "rollover", contained in the 1974 draft bill was not adopted by the House. In two statements on bank holding company tax relief legislation previously submitted to the Senate Finance Committee on April 22 and May 10, 1976. Republic urged the adoption of a revised "rollover" provision, similar in concept to that approved by the House Ways and Means Committee in 1974. However, Republic is no longer seeking the inclusion of a rollover provision in the Bank Holding Company Tax Act of 1976. Instead, we support the bill as passed by the House, which has the support of the Treasury Department and the staff of the Joint Committee on Internal Revenue Taxation.

or non-banking property. We are concerned with respect to the relationship of the election to a problem unique to the family ownership exception under the Bank Holding Company Act. As you are aware, the Bank Holding Company Act provides an exception to the divestiture requirements in the case of certain family-owned bank holding companies. (There are presently approximately 178 family-owned bank holding companies and the problem addressed in this letter is applicable to all of these companies.) This exception only applies while more than 85 percent of the stock is owned directly or indirectly by the family. However, if the company ceases to qualify under the family ownership exception, the Bank Holding Company Act then triggers a forced divestiture. This triggering mechanism and the exception apply today and into the future, with no time limitation. However, the tax divestiture rules contained in the bill which is now before the Senate Finance Committee, which also recognizes the family ownership exception, provide certain tax benefits in cases where the family ownership exception is waived, but only apply to divestitures occurring before 1981.

We are very concerned about the possibility of a company failing to qualify under the family ownership exception after 1980 (with extremely harmful tax consequences following because the bill's tax provisions do not apply after 1980) because of the occurrence of an event completely beyond the control of both the company and the vast majority of its shareholders. Such a failure might occur where a former spouse, who is not a lineal descendant of the family, obtains 15 percent of the company stock by way of a property settlement in a divorce case. Another case which might occur would be where a shareholder dies and 15 percent of the company stock must be sold to outsiders in order to pay estate taxes. An even more extreme case arises where the family owns only one share more than 85 percent of the stock. In this case, the disposition of even one share of stock would cause extreme and unintended hardships for the majority of the shareholders because of events totally beyond the company's or their control.

Since the vast majority of shareholders can be adversely affected after 1980 because of the actions of a small minority where these actions are beyond the control of both the company and the vast majority of its shareholders, we propose that the bill be amended by the Senate Finance Committee in order to allow a bank holding company, which was exempt from the forced divestiture rules because of the application of the family ownership exception, to make the election to divest and allow the tax rules contained in the bill to apply to that divestiture in the limited situation where the campany finds itself no longer under the family ownership exception. This provision would be applicable to situations occurring after 1980, but only in the limited situation applicable to the family ownership exception, and with the additional provision that the election and the divestiture must occur within one year from the date that the company no longer qualifies for the family ownership exception.

Sincerely yours,

DONALD C. EVANS, Jr.

STATEMENT OF SIGNAL COMPANIES, INC.

The Signal Companies, Inc. ("Signal"), a Delaware corporation, with its principal place of business located at 9665 Wilshire Boulevard, Beverly Hills, California, submits this statement for consideration by the Committee on Finance, U.S. Senate, and for inclusion in the Printed Record of the Hearing of the Committee on August 24, 1976, with regard to legislation pertaining to the tax treatment of divestitures made by bank holding companies. (H.R. 11997)

RELIEF SOUGHT

Signal urges legislation to amend the Internal Revenue Code of 1954 with respect to the income tax treatment of certain distributions and sales pursuant to the Bank Holding Company Act Amendments of 1970. Specifically, Signal requests the Committee recommend legislation, which (in addition to other equitable and appropriate relief) would provide for the nonrecognition of gain for a corporation which on or after July 7, 1970, sells its bank or nonbank property acquired prior to that date pursuant to the Bank Holding Company Act Amendments of 1970, where the proceeds of the sale are reinvested in qualified replacement property, such as stock or assets of controlled corporations and the basis of such replacement property is appropriately reduced to reflect the nonrecognized gain.

1. BANK HOLDING COMPANY HISTORY

A. Bank Holding Company Act of 1956

The Bank Holding Company Act of 1956 brought federal regulation to bank holding companies that owned or controlled two or more banks. One bank holding companies were exempted from regulation under the Act, and certain other special situations also were exempted.

Section 4 of the Act required bank holding companies to divest themselves of nonbanking affiliates and to refrain from future acquisitions of such enterprises. Holding companies were thus given a choice of either relinquishing their banking interest in excess of one bank, or to remain bank holding companies and relinguish all nonbanking interests other than those relating to the field of finance, fiduciary activities or insurance.

Corporations classified as bank holding companies under the Bank Holding Company Act of 1956 usually disposed of either their banking or their nonbanking interests by distributing one or the other of these classes of interest to their shareholders. As a consequence, to alleviate the financial burden caused by disposing of these assets, provision was made that distribution of property acquired before May 15, 1955, could be made without tax consequence to such shareholders (Sec. 1101–1103 of the Internal Revenue Code). In the absence of the special tax provisions enacted in 1956, the stock distribution would have been treated as taxable gain to the shareholders receiving them.

Thus, since 1956 multi-bank holding companies have been under federal regulation by the Federal Reserve Board. Acquisitions of banks subsequent to 1956 required Federal Reserve approval, as did retention or acquisition of any so-called bank-related business. By and large, Federal Reserve administration of the Act was fairly restrictive with respect to retention or acquisition of bank-related businesses.

B. Amendments of 1966

In 1966, Congress (Public Law 89–485; H.R. 7371) repealed some previously existing exceptions to the Bank Holding Act. Again, Congress ameliorated the effect of divestitures required by the 1966 Amendments by providing for similar tax relief as it did in 1956. The 1966 legislation provided that any corporation required to divest its bank or nonbanking interest held before April 12, 1965, was to have tax-free treatment available. It is interesting to note that May 15, 1955 under the 1956 Act and April 12, 1965, under the 1966 Amendments are the dates upon which the two proposed pieces of legislation were respectively introduced.

C. Events subsequent to 1966

When the Bank Holding Company Act of 1956 was enacted, Congress excluded from the legislation any company controlling only one bank in the belief that a one bank holding company presented no economic danger sufficient to be covered by the Act (S. Report No. 1095, 84th Congress 2d Session (1955)). Although this assumption may have been justified in 1956, by 1969 its validity was in question. In 1956 there were an estimated 117 one bank holding companies with assets of $11 billion. By the end of 1969 this number had grown to more than 890 one bank holding companies with commercial deposits exceeding approximately $181 billion (1970 Federal Reserve Bulletin 200). This rapid growth of unregulated one bank holding companies focused attention on the need for a comprehensive revision of the 1956 Act and the 1966 Amendments aimed at covering one bank holding companies. The rationale for the Bank Holding Company Act Amendments of 1970 (legislation that was aimed at regulating one bank holding companies) was presented by the Honorable Charles E. Walker, then Under Secretary of the Treasury, in his statement before the Senate Banking and Currency Committee on May 12, 1970:

"Legislation to restrict the nonbanking activities of one bank holding companies is preventive legislation. It would reasonably, but effectively, stop a trend toward the merging of banking and commerce which began to develop almost two years ago and which threatened to change the nature of American private enterprise. . . . Our economy could shift from one where commerce and financial power is now dispersed into a structure dominated by huge centers of economic and financial power . . ."

The Secretary continued by indicating that the simple purpose behind the 1970 amendments, "is to draw a fair but firm line between banking and commerce."

D. The 1970 amendments

The Bank Holding Company Act Amendments of 1970 (Public Law 91–607) removed the exception contained in the 1956 Act for one bank holding companies. The 1970 amendments, require, in general, that a one bank holding company divest its nonbank interests if it chooses to remain a one bank holding company or to divest its banking interests in order not to be classified as a bank holding company. However, the 1970 Amendments permit a one bank holding company which acquired its bank before July 1, 1968, to continue activities in which it was lawfully engaged on such date and has been continuously engaged in since that date ("grandfather clause"). In the case of one bank holding companies controlling a bank having bank assets in excess of $60 million, review by the Federal Reserve Board was required prior to December 31, 1972, to determine if its grandfather status was to be terminated. The Honorable Charles E. Walker stated on May 12, 1970:

"We recommend a 'grandfather clause' date of June 30, 1968. This date is not so far back in time that forced divestitures would disrupt the operations or threaten the viability of most of the smaller, 'traditional' one bank holding companies. On the other hand, the date is early enough to include the greatest majority of new companies whose organization has pushed the total assets involved to such a high level.

"Future activities on the part of the conglomerates which acquired banks before July 1, 1968—and therefore could retain them under the 'grandfather clause'—would be restricted to the lines of business or activities in which they were engaged on June 30, 1968. This is a stringent restriction; in effect it means that any conglomerate which wishes to diversify—and many of them do—would be forced to dispose of its bank."

Furthermore, it was indicated the Congress would follow precedent established in 1956 and provide tax relief for companies required to dispose of their assets by reason of the 1970 Amendments. The Committee on Banking and Currency of the Senate affirmed its position for tax relief by stating:

"It is anticipated that the Congress will follow precedent and will pass a bill providing companies required to make divestitures under this legislation with relief from an undue tax burden as a result of such divestiture."

E. Committee tentative decision

In 1974 the House Ways and Means Committee issued its tentative decision with respect to bank holding company divestitures, which provided, among other things, that a sale of property, the divestiture of which is necessary or appropriate under the Bank Holding Company Act Amendments of 1970, may qualify for nonrecognition of gain treatment, provided the divested property was acquired on or before July 7, 1970 and sold on or after that date. July 7, 1970, is the date that the Senate Banking and Currency Committee publicly announced it would support passage of the Bank Holding Company Act Amendments of 1970. The Committee, of course, recognized that it would be inequitable not to provide relief for those companies who disposed of their holdings in anticipation of the imminent passage of the Bank Holding Company Act Amendments of 1970.

2. STATEMENT OF FACT

In 1967 the Signal Companies, Inc., then named Signal Oil and Gas Company entered into a merger agreement with Arizona Bancorporation. The shares of Arizona Bancorporation were exchanged for shares of newly created preferred stock issued by Signal. Following the acquisition Arizona Bancorporation's name was changed to Signal Equities. Arizona Bancorporation was a holding company headquartered in Phoenix, Arizona. Its principal investments were 52 percent of the capital stock of The Arizona Bank, all of the capital stock of the Exchange Finance Company, 53 percent of the capital stock of Allison Steel Manufacturing Company and all of the Capital stock of Pharma-Med Company, Inc. The Arizona Bank had deposits standing at $238 million on December 31, 1966.

When the Senate Banking and Currency Committee announced on July 7, 1970 it would support passage of legislation affecting one bank holding companies, it became evident that the legislation would be enacted. It was also apparent that Congress would follow precedent established in 1956 and 1966 and provide legislation giving companies required to divest under this legislation

relief from the undue tax burden which may result by reason of such divestiture (Senate Report No. 91-1004).

Signal sold its interest in Signal Equities for cash on September 30, 1970, and reinvested the proceeds in other wholly-owned subsidiaries of Signal. William E. Walkup, Chairman of the Board of Signal, publicly stated that the divestiture was made in anticipation of pending one bank holding company legislation which would make such sale economically mandatory. Taxable gain was realized on this transaction in the amount of $7.5 million. This amount was comprised of a $5.1 million gain on the sale of the banking assets and a $2.4 million gain on the nonbanking assets.

Signal is a highly diversified multi-industry company with strong strategic positions in the transportation and aerospace industries. It is apparent that the remarks of the Honorable Charles E. Walker, set forth above, were particularly applicable to Signal. Signal was forced to sell its banking interests after it became apparent that the 1970 Amendments would be passed. Signal did not want to be locked into a situation where it would have to make a forced sale and would not be able to pick the purchaser, nor even possibly negotiate a reasonable price. Accordingly, Signal was, in a manner of speaking, forced to sell Signal Equities to the first prospective bona fide purchaser.

3. POSITION

When the Senate Banking and Currency Committee announced on July 7, 1970, it would support legislation affecting one bank holding companies, it became evident that Congress would enact legislation which would affect one bank holding companies in the same manner as the 1956 Bank Holding Company Act regulated bank holding companies. Furthermore, it was repeatedly stated that Congress would follow the precedent established in 1956 and provide legislation giving companies required to divest under the 1970 Amendments relief from an undue tax burden as the result of such divestiture (116 Congressional Records Section 20-641 (Daily Edition December 18, 1970)). (Remarks of Senator John J. Sparkman). It is therefore reasonable to conclude that existing bank holding companies would anticipate tax relief provisions with datal sequence similar to those used in the 1956 Act and in the 1966 Amendments.

Signal acted in good faith in its attempt to comply with the spirit and intent of the then proposed 1970 Amendments. As stated above, William Walkup, Chairman of the Board of Signal, publicly remarked that the divestiture was made in anticipation of one bank holding company legislation which would make such sale economically mandatory. Signal would have been unable to continue to diversify its business, which, as a multi-industry corporation, it is committed to do on a long-range basis. As stated before, the Honorable Charles E. Walker recognized the economic compulsion inherent in the 1970 Amendments for multi-industry corporations in his statement on May 12, 1970.

In many respects the divestiture of bank or nonbanking property forced by the Bank Holding Company Act Amendments of 1970 is analogous to an involuntary conversion. Divestiture of stock in the circumstances presented is not dissimilar to the divestiture of property due to destruction, or condemnation. One forced to make such a divestiture deserves the same tax relief as those whose property had been destroyed or condemned. Accordingly, it seems appropriate to offer relief patterned after the involuntary conversion provisions of the Internal Revenue Code (Sec. 1033 of the Code). The analogy of the sale by Signal of its bank assets to the threat or imminence of divestiture provision of Section 1033 (a) of the Code is certainly sufficient to warrant the tax relief sought by Signal and recommended by the Committee in its tentative decisions of 1974. Furthermore, the forced divestiture by Signal is very similar to the type of divestiture afforded involuntary conversion treatment by Section 1071 of the Code (referring to gain from sale or exchange to effectuate policies of FCC), and we believe entitled to similar relief. We also refer the Committee to Section 1081 of the Code (referring to nonrecognition of gain on exchanges or distributions in obedience to orders of SEC) for another example of tax relief in a transaction analogous to the transaction in question.

In the cases covered in Section 1071 and Section 1081, and similarly in Signal's case, the sales or exchanges are compulsory transactions, whether initiated by the Government or by the corporations affected. These nonrecognition Sections strongly suggest a policy inherent in the Internal Revenue Code to postpone rec-

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ognition of gain on compulsory transactions until a voluntary realization occurs. Signal suggests and the Committee has recommended in its 1974 tentative decisions that a similar policy should prevail for sales made compulsory by the 1970 Amendments. Therefore, our position follows the recommendation of the Committee that the recognition of the gain realized on a sale caused by the 1970 Amendments should be postponed through the mechanism of the basis adjustment to qualified replacement property.

In closing, we reiterate that since the purpose of the 1970 Amendments is preventive in nature and is not penal; and since the divestiture by Signal was made in a good faith attempt to comply with the spirit and intent of the 1970 Amendments, that is, the separation of banking and commerce, Signal should not be required to recognize the gain from this forced sale until such time as the gain is triggered through the basis adjustment to the replacement property.

For these reasons Signal strongly supports the Committee's 1974 tentative decision to provide nonrecognition of gain treatment to property acquired on or before July 7, 1970 and sold on or after that date by reason of the Bank Holding Company Act Amendments of 1970.

APPENDIX B

Description of Tax and Tariff Bills Listed for Hearings by the Committee on Finance on August 24, 1976

94th Congress }
2d Session } COMMITTEE PRINT

DESCRIPTION OF TAX AND TARIFF BILLS LISTED FOR HEARINGS BY THE COMMITTEE ON FINANCE ON AUGUST 24, 1976

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

COMMITTEE ON FINANCE

AUGUST 1976

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1976

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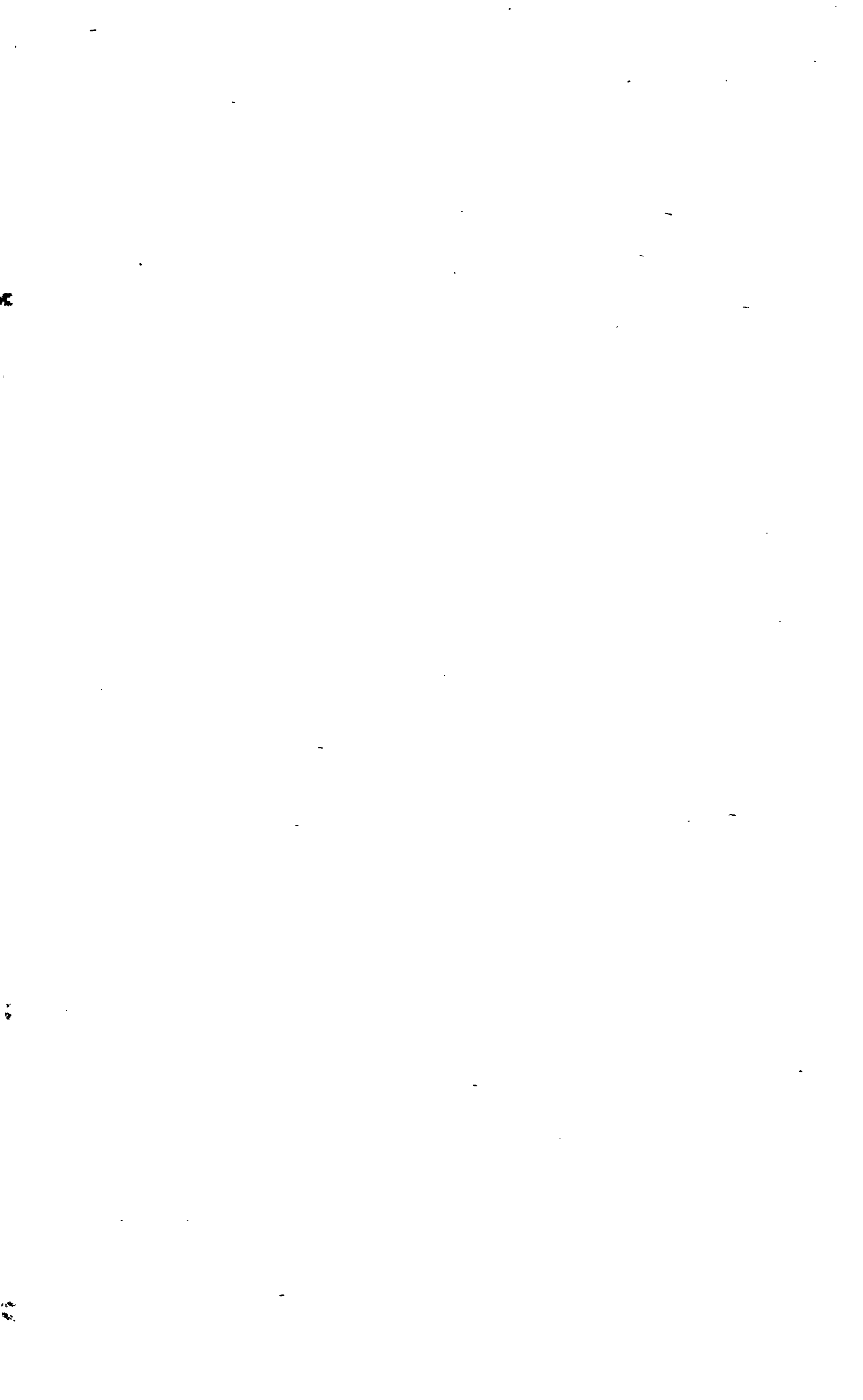
INTRODUCTION

This pamphlet contains descriptions of the various tariff and revenue bills listed for public hearings by the Committee on Finance for August 24, 1976. Several bills which are pending before the committee have been excluded from the scope of the hearings because action has previously been taken with respect to the subject matter of those bills. Thus, descriptions of those bills have not been included in this pamphlet.



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TARIFF BILLS

H.R. 1386

For the Relief of Smith College, Northampton, Mass.

Present law.—Carillons containing more than 22 bells are dutiable at 7 percent ad valorem under item 725.36 of the Tariff Schedules of the United States (TSUS) (19 U.S.C. 1202) unless they are produced in a beneficiary developing country eligible for duty-free treatment under the Generalized System of Preferences.

House bill.—Directs the Secretary of the Treasury to admit duty free a carillon for the use of Smith College. If the duty has already been paid, the bill requires a refund to be paid.

Effective date.—Date of enactment.

Revenue effect.—A one time loss of approximately $2,550.

Administration position.—No objection to the bill.

H.R. 2177

To Exempt From Duty Certain Aircraft Components and Materials Installed in Aircraft Previously Exported From the United States Where the Aircraft Is Returned Without Having Been Advanced in Value or Improved in Condition While Abroad

Present law.—Airplanes are dutiable at 5 percent ad valorem under item 694.40 TSUS unless they are produced in a beneficiary developing country eligible for duty-free treatment under GSP. Any item wholly produced in the United States which is exported and then reimported into the United States is eligible for duty-free treatment under item 800 TSUS if the item has not been advanced in value abroad.

House bill.—Provides that the duty under item 694.40 shall be assessed on the full value of the plane minus the value of U.S. produced components if—

(1) The plane was previously exported from the United States;

(2) The components were installed in the United States after the plane was operational;

(3) The plane has not been advanced in value while abroad; and

(4) The plane was entered into the United States for consumption before 1970 but the entry has not been liquidated as of the date of enactment of this act.

Effective date.—Date of enactment. Any request for liquidation of the entry of a plane under this act must be filed with Customs within 30 days after the date of enactment.

Revenue effect.—A one-time loss of approximately $24,640.

Administration position.—No objection to the bill.

H.R. 2181

To Amend the Tariff Schedules of the United States to Provide Duty-Free Treatment of Any Aircraft Engine Used as a Temporary Replacement for an Aircraft Engine Being Overhauled Within the United States if Duty Was Paid on Such Replacement Engine During a Previous Importation

Present law.—Piston type aircraft engines are dutiable at 4 percent ad valorem under item 660.44 TSUS and nonpiston aircraft engines are dutiable at 5 percent ad valorem under item 660.46 TSUS.

House bill.—Provides a new item 801.20 TSUS permitting duty-free entry of an aircraft engine if—

(1) The engine was previously imported and duty was paid on the importation;

(2) The engine was used abroad as a temporary replacement for an aircraft engine being repaired in the United States; and

(3) The engine is imported by the person who previously exported the engine.

Effective date.—Date of enactment.

Revenue effect.—An annual loss of approximately $2.5 million.

Administration position.—Department of Commerce favors the bill. Other agencies have no objection.

H.R. 4047

For the Relief of Jack R. Misner

Present law.—Under item 864.05 T.S.U.S., foreign articles may be entered duty free for repairs upon the posting of a bond guaranteeing the articles will be exported within 1 year. The bond may be extended for not more than 2 additional years. Yachts are dutiable at 2 percent ad valorem under item 696.05 T.S.U.S. or, if their value exceeds $15,000, 5 percent ad valorem under item 696.10 T.S.U.S.

House bill.—Directs the Secretary of the Treasury to extend the expiration date of the temporary import bond posted by Jack R. Misner on the schooner *Panda* until September 18, 1977.

Effective date.—Date of enactment.

Revenue effect.—No loss.

Administration position.—No objection.

H.R. 8656

To Amend the Tariff Schedules of the United States in Order to Provide Duty-Free Importation of Loose Glass Prisms Used in Chandeliers and Wall Brackets.

Present law.—Prisms for use in chandeliers are dutiable at 12 percent ad valorem under item 545.57 T.S.U.S. unless they are produced in a beneficiary developing country eligible for duty free treatment under GSP.

House bill.—Deletes item 545.57 and adds items 545.58 and 545.59. Under item 545.58, loose glass prisms for use in chandeliers would be duty free. Under item 545.59, other prisms would be dutiable at 12 percent ad valorem.

Effective date.—Date of enactment.

Revenue effect.—Annual loss of approximately $60,000.

Administration position.—No objection.

H.R. 11259

To Lower the Duty on Levulose Until the Close of June 30, 1978

Present law.—Levulose is dutiable at 20 percent ad valorem, if exported from a country receiving nondiscriminatory or most-favored-nation tariff treatment, and 50 percent ad valorem, if exported from a non-MFN country, under item 493.66 T.S.U.S.

House bill.—Adds a new item 907.90 to the T.S.U.S. establishing an MFN duty of 0.6625 cents per pound of levulose and a non-MFN duty of 1.9875 cents per pound.

Effective date.—Date of enactment through June 30, 1978.

Revenue effect.—An annual loss of less than $100,000.

Administration position.—No objection.

H.R. 11321

To Suspend Until July 1, 1978, the Duty on Certain Elbow Prostheses if Imported for Charitable Therapeutic Use, or for Free Distribution, by Certain Public or Private Nonprofit Institutions

Present law.—Externally powered electric elbow prosthetic devices are dutiable at 10 percent ad valorem under item 709.57 T.S.U.S. unless they are produced in a beneficiary developing country eligible for duty free treatment under GSP.

House bill.—Adds a new item 912.05 to the T.S.U.S. providing for duty free entry of externally powered electronic elbow prosthetic devices for juvenile amputees if imported solely for distribution free of charge by any public or private nonprofit institution.

Effective date.—Date of enactment through June 30, 1978.

Revenue effect.—An annual loss of approximately $75,000.

Administration position.—No objection.

H.R. 11605

To Suspend for a Temporary Period the Rate of Duty on Mattress Blanks of Rubber Latex

Present law.—Mattress blanks of latex rubber are dutiable at 15 percent ad valorem under item 727.86 T.S.U.S. unless they are produced in a beneficiary developing country eligible for duty free treatment under GSP.

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House bill.—Adds a new item 912.08 to the T.S.U.S. providing for duty free entry of mattress blanks of rubber latex.

Effective date.—Date of enactment through June 30, 1978. In addition, entries made after March 31, 1975, and before the date of enactment would be eligible for duty free treatment upon request.

Revenue effect.—An annual loss of no more than $7,500.

Administrative position.—No objection.

H.R. 12254

To Suspend the Duties on Certain Bicycle Parts and Accessories Until the Close of June 30, 1978

Present law.—Generator lighting sets for bicycles enter duty free under item 912.05 T.S.U.S. which expires on December 31, 1976. Parts of generator lighting sets are currently dutiable at 19 percent ad valorem under item 653.39 T.S.U.S. unless they are produced in beneficiary developing countries which are eligible for duty free treatment under GSP.

Derailleurs, caliper brakes, drum brakes, three-speed hubs incorporating coaster brakes, click-twist grips, click stick levers, and multiple freewheel sprockets enter duty free under item 912.10 T.S.U.S. which expires on December 31, 1976. Coaster brakes, alloy butted frame tubing, frame lugs, alloy cotterless crank sets, alloy rims, and parts thereof are dutiable at 15 percent ad valorem under item 732.36 T.S.U.S.

House bill.—Adds parts of generator lighting sets to item 912.05 T.S.U.S. and coaster brakes, alloy butted frame tubing, frame lugs, alloy cotterless crank sets, alloy rims, and parts thereof to item 912.10 T.S.U.S. making all those goods duty free. The bill extends the termination date of items 912.05 and 912.10 to June 30, 1978.

Effective date.—Date of enactment through June 30, 1978.

Revenue effect.—An annual loss of aproximately $3.6 million.

Administration position.—No comment.

HOUSE PASSED REVENUE BILLS

H.R. 2984

Treatment of Payment or Reimbursement of Government Officials for Expenses of Foreign Travel by Private Foundations

Present law.—The Tax Reform Act of 1969 added a provision to the Internal Revenue Code of 1954 (sec. 4941) which in general prohibits enumerated acts of "self-dealing" between private foundations and certain designated classes of persons, commonly referred to as "disqualified persons," by imposing a graduated series of excise taxes on the self-dealer (and also on the foundation manager who willfully engages in acts of self-dealing). Under this provision, the payment or reimbursement of expenses of a Government official by a private foundation generally is classified as an act of self-dealing.

A limited exception to this provision permits a private foundation to pay or reimburse certain expenses of Government officials for travel

solely within the United States. Under this exception, it is not an act of self-dealing for a private foundation to pay or reimburse a Government official for actual transportation expenses, plus an amount of other traveling expenses not to exceed 125 percent of the maximum per diem allowed for like travel of employees of the United States for travel solely within the United States. However, no such payment or reimbursement is permissible for travel to or from a point outside the United States.

House bill.—The House bill amends present law (sec. 4941(d)(2)(G)) to provide an exception to the self-dealing provisions of the Code for payment or reimbursement of a limited amount of foreign travel expenses of a government official by a private foundation. The travel expenses which are eligible to be reimbursed are for travel between a point in the United States and a point outside the United States. The amount which can be reimbursed for any one trip by a government official is the sum of (1) the lesser of (a) the actual cost of the transportation involved, or (b) $2,500, plus (2) an amount for all other traveling expenses not in excess of 125 percent of the maximum amount payable under section 5702(a) of title 5, United States Code (relating to like travel by U.S. employees) for a maximum of 4 days, or the number of actual days if less. Under section 5702(a), in the case of travel outside the continental United States, the President or his designee has the authority to establish the maximum per diem allowance for the locality where the travel is performed.

This new exception to the self-dealing rules does not apply where the private foundation making the payment or reimbursement normally receives more than one-half of its total support from any business enterprise, trade association, or labor organization, whether such support takes the form of interest, dividends, other income, grants, or contributions.

Effective date.—This provision is to apply with respect to travel beginning after the date of enactment of this bill.

Revenue effect.—It is not expected that this bill will have any direct revenue effect.

Administration position.—The Treasury Department supports this legislation.

H.R. 3052

Treatment of Option Lapse Income of Exempt Organizations

Present law.—With the exception of social clubs and employees' beneficiary associations,[1] the investment income of exempt organizations generally is not subject to the tax on unrelated business income. The types of investment income sources listed as being free of this tax include dividends, interest, annuities, royalties, and capital gains from the sale of investments.

The tax treatment of income which an exempt organization receives from writing options to buy or sell securities generally depends on whether the option is exercised, lapses, or is terminated. If an option

[1] In this description of H.R. 3052 further references to "exempt organizations" do not include these two categories (secs. 501(c)(7) and (9)).

written by an exempt organization on a security is exercised and the security is required to be sold (a "call") by the exempt organization, the premium received for the option is treated as part of the gain or loss from the sale. In this case the entire gain on the sale—including the premium on the option—realized by the exempt organization is free of tax since under present law (sec. 512(b)(5)) the term "unrelated business taxable income" excludes all gains or losses from the sale, exchange, or other disposition of property (except in the case of inventory and property held for sale to customers). Similarly, if the option written on a security is exercised and the security is required to be purchased (a "put") by the exempt organization, the premium income received for the option is treated as reducing the purchase price of the security. Subsequently, if the security is sold, this reduced purchase price means a larger capital gain on the sale of the security, which as noted above is excluded from the tax base of the exempt organization (except in the case of inventory and property held for sale to customers).

On the other hand, if an option is not exercised by the exempt organization (in the case of either a put or a call) and the option lapses, the premium which the exempt organization receives generally is treated as ordinary income rather than as income from the sale of property.[2] As a result, the premium received by an exempt organization on a lapsed option generally is subject to the unrelated business income tax.

In some cases, the writer of an option may "buy in" an option which he has previously written (or an option identical to one which he has previously written) and which has not yet been exercised. This offsetting transaction, known as a closing purchase, terminates his obligation under the first option. The option writer would receive a gain in the amount of the excess of the premium received for the original option over the amount paid for the second option purchased to terminate the first. As in the case of lapsed options, the gain from terminated options (which are necessarily unexercised options) is also generally ordinary income.

House bill.—The bill amends present law (sec. 512(b)(5)) to exclude from the term "unrelated business taxable income" all gains on the lapse or termination of options to buy or sell securities, when the options have been written in connection with the exempt organization's investment activties. Thus, the term "unrelated business taxable income is to exclude all premiums received by an exempt organization on options which it writes under these circumstances, regardless of whether the option is exercised, lapses, or is terminated. This bill has

[2] Present law (sec. 1234(a)) provides that gain or loss in the case of the sale or exchange of an option is to be given the same treatment as would the gain or loss on the sale of the property to which the option relates. However, in the case of the failure to exercise an option, this provision indicates that only in the case of a loss is the failure to be treated as having the same character as the underlying property. On the basis of this, where there is a gain on the failure to exercise an option, the regulations provide (sec. 1.1234-1(b)) that this gain represents ordinary income to the writer of the option (even though the payment of the premium by the holder of the lapsed option results in a capital loss to that holder).

Under present law (sec 1234(c)) gain from the lapse of an option written as part of a "straddle" (a simultaneously granted combination of an option to buy and an option to sell the same quantity of security at the same price during the same period of time) is treated as gain from the sale or exchange of a capital asset held for not more than 6 months on the date that the option expired (see regulation sec. 1-1234-2(f), example (3)). Consequently, option lapse income from "straddles" is already excluded from unrelated business taxable income of exempt organizations (other than the social clubs and employees' beneficiary associations referred to above).

the effect of overriding for the future a 1966 Internal Revenue Service ruling that income realized from unexercised call options is subject to the unrelated business income tax.

Effective date.—This amendment applies to gains from options which lapse or are terminated on or after January 1, 1976.

Revenue effect.—It is estimated that this bill will have no effect, or at most a negligible effect (under $1 million) on the revenues.

Administration position.—The Treasury Department has no objection to this bill.

H.R. 3055

To Amend Certain Provisions of the Internal Revenue Code of 1954 Relating to Distilled Spirits and For Other Purposes

Present law.—Under present law, the manufacture, bottling, storage, transportation, and sale of distilled spirits are subject to regulations promulgated by the Secretary of the Treasury, pursuant to provisions of the Internal Revenue Code. For example, under present law (sec. 5233(c)), no trademark may be placed on any bottle of distilled spirits bottled in bond unless the name of the actual distiller or of the company in whose name the spirits were produced and warehoused is also placed on the bottle. Also, for example, a drawback equal to the amount of the tax determined or paid on wines or distilled spirits that are exported is allowed if the wines or distilled spirits were manufactured or produced in the United States (sec. 5062(b)). Another provision of present law allows distilled spirits withdrawn from bond on payment or determination of tax to be returned to bonded premises for various specific purposes (sec. 5215). Present law also allows distilled spirits to be withdrawn, without payment of tax, from the bonded premises of distilled spirits plants for exportation, but there is no comparable provision allowing withdrawal without payment of tax for transfer to customs bonded warehouses for storage pending exportation (sec. 5214(a)(4)). Similarly, under present law (sec. 5214(a)(9)), distilled spirits may be withdrawn from the bonded premises of a distilled spirits plant free of tax for use as samples in making tests or laboratory experiments, but the permitted uses are very narrowly defined. Under present law (sec. 5234(a)(2)), distilled spirits mingled on bonded premises must be returned to the same packages (barrels) from which removed and the mingling must be for the purpose of further storage in bond. Present law (sec. 5025(b)) allows an exemption from the rectification tax (in general, a tax on redistilling to achieve a different product) in the case of the production of gin by redistillation of a pure spirit over juniper berries and other natural aromatics, but does not allow such an exemption where natural oils are used. Present law (sec. 5008) also provides for abatement or refund of tax in the case of distilled spirits lost or destroyed under certain circumstances, but by oversight the abatement of taxes does not apply in the case of distilled spirits from Pureto Rico or the Virgin Islands.

House bill.—The House bill consists of a series of amendments to present law. The House bill—

(1) eliminates the requirement that the name of the distiller be placed upon gin or vodka bottled in bond for export;

(2) extends to distilled spirits that are imported and then packaged or bottled in the United States for export the same tax drawback benefits given to domestically produced spirits that are packaged or bottled for export;

(3) allows distilled spirits to be returned to bonded premises of distilled spirits plants or to export storage facilities, with benefit of tax credit or refund, etc., for storage pending exportation and certain other preferred dispositions (e.g., use on vessels and aircraft transfer to foreign-trade zones);

(4) allows spirits bottled in bond, or returned to an export storage facility for export, to be transferred without payment of tax to customs bonded warehouses for storage pending exportation;

(5) allows spirits to be withdrawn from bonded premises without payment of tax for purposes of research, development, or testing;

(6) relaxes the conditions under which bonded spirits may be mingled;

(7) allows gin to be made with the extracted oils of juniper berries and other aromatics, as well as with the juniper berries or other aromatics themselves, without payment of the rectification tax;

(8) enables taxes on distilled spirits brought into this country from Puerto Rico or the Virgin Islands to be abated, remitted, credited, or refunded in appropriate cases of loss or voluntary destruction just as are the taxes imposed on domestic distilled spirits; and

Effective date.—The amendments contained in the House bill take effect on the first day of the first calendar month which begins more than 90 days after the bill's enactment.

Revenue effect.—The Ways and Means Committee estimated that sections 3 and 4 of the bill would result in a one-time revenue loss of $3 to $5 million; the other sections of the bill were estimated to have little or no revenue effect. The Treasury Department concurred with the estimates.

Administration position.—The Treasury Department has no objection to this bill. However, it recommends one change. Section 1 of the bill would amend section 5233(c) of the Code to eliminate, in the case of gin and vodka for export, the requirement that the label show the real name of the distiller in whose name the spirits were produced if the label contains a trademark. This label requirement is now applicable to all spirits bottled in bond. While Treasury has no objection to this change, it recommends that comparable treatment be accorded all distilled spirits exported, not just gin and vodka. Moreover, as the name of the actual distiller is not required to be shown on distilled spirits not bottled in bond, it believes that the label requirement for spirits bottled in bond serves no useful purpose; and it recommends complete repeal of section 5233(c) in lieu of the amendment proposed by section 1 of the bill.

H.R. 5071

Maintenance of Common Trust Fund by Affiliated Banks

Present law.—Under existing law a bank may maintain a "common trust fund" which fund itself is neither subject to Federal income taxation nor considered a corporation. A fund qualifies as a common trust fund if it is (1) maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed by the bank in its fiduciary capacity, and (2) maintained in conformity with rules and regulations of the Comptroller of Currency pertaining to the collective investment of trusts. The income (including gains and losses from the sale of property) from the fund, representing amounts contributed from various separate trusts, is included in the gross income of each participant in the common fund on the basis of its proportionate share of the income.

The purpose of the common trust fund provision is to permit diversification in the investment of trust funds for which a bank has fiduciary responsibility.

The Internal Revenue Service has taken the position (Rev. Rul. 70–302) that a fund maintained by a member bank of a bank holding company will not qualify as a "common trust fund" if it accepts contributions to the fund by other member banks (or trust companies) acting in a fiduciary capacity. The Internal Revenue Service holds that under present law the common trust fund must be "maintained" by the bank which contributes the moneys to the fund for investment. The staff also understands that the Internal Revenue Service holds that a fund maintained by various members of a bank holding company will not qualify even if each member bank acts as a cotrustee of the common fund.

House bill.—The bill amends the provision of the code dealing with common trust funds (sec. 584) to provide that when banks are members of the same affiliated group (within the meaning of sec. 1504) they are, for purposes of this provision, to be treated as one bank for the period of their affiliation. Consequently, if banks are affiliated (as defined in sec. 1504) they may contain a common trust fund to which they can contribute funds held in their capacity as trustee, executor, administrator or guardian.

It is not necessary under the bill that banks contributing money to the fund act as cotrustees of the common trust fund. The affiliated group of banks may maintain a common trust fund if any member of the group serves as trustee. (Of course, one or more members of **the affiliated group may serve as cotrustees, but this is not required.)**

Effective date.—The bill would apply to taxable years beginning after December 31, 1975.

Revenue effect.—This bill is estimated to have a negligible revenue effect.

Administration position.—The Treasury Department supports this bill. The Comptroller of the Currency urges favorable action on the bill.

H.R. 5161

Tax Treatment of Magazines Used for Display Purposes

Present law.—Generally, taxpayers using the accrual method of accounting for income must include sales in income for the taxable year when all the events have occurred which fix the right to receive the income and the amount can be determined with reasonable accuracy. Generally, the method used by the taxpayer in determining when income is to be accounted for is accepted by the Internal Revenue Service if it accords with generally accepted accounting principles consistently used by the taxpayer from year to year. As an example, the income tax regulations (Regs. § 1.446-1(c)(1)) provide that a taxpayer engaged in a manufacturing business may account for sales of the product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping books. When products are returned to a taxpayer during a taxable year the return is generally treated as a reduction from gross sales for purposes of financial and tax accounting.

Tax accounting differs from financial accounting in that tax accounting does not permit deductions for estimates of future costs. Thus, tax accounting does not permit an offset in the year in which the sale is made for the return of magazines in the following year.

Magazine publishers and distributors often distribute to retail outlets more copies of a magazine than it is anticipated the retailer can sell. The extra copies are distributed to assure the retailers an adequate number of copies for display purposes. When the next issue of the magazine is published and shipped to the retailer, the earlier issue is treated as being "off-sale" and the retailer returns the unsold copies of the magazine to the publisher.

Many publishers have for a number of years accounted for their returns of magazines on a net basis (by calculating the estimated returns) at the time of shipment. The Internal Revenue Service has taken the position that accrual basis publishers and distributors must include the sales of the magazine in income when the magazines are shipped to the retailers and may only exclude from income returns of the magazines when the copies are returned by the retailer during the taxable year.

House bill.—The bill provides that in the case of sales of magazines or other periodicals for display purposes, a taxpayer may elect not to include in gross income for the taxable year in which the magazines or other periodicals are shipped the income attributable to the sale of any magazine or other periodical which is returned not later than the 15th day of the third month after the close of the taxpayer's taxable year (i.e., the date on which the corporate tax return is generally due). The election applies only to taxpayers using an accrual method of accounting for the trade or business for which the election is made.

A sale is for display purposes under this provision if the sale is made in order to permit an adequate display of the magazine or other periodical and if at the time of sale the taxpayer has a legal obligation to accept returns of the magazine or other periodical.

These provisions apply to sales for display purposes if and only if the taxpayer makes an election under this provision with respect to the trade or business in connection with which the sales are made. An election under this provision may be made only with respect to taxable years beginning after December 31, 1975, and only with the consent of the Secretary or his delegate. The election is to be made in the time or manner as the Secretary may by regulations prescribe.

An election of this provision applies to all sales of magazines and other periodicals made for display purposes in connection with the trade or business with respect to which taxpayer has made the election. However, the election does not apply to sales made for display purposes before the first taxable year for which the election is made. Once an election is made, it is effective for the taxable year with respect to which it is made and for all subsequent taxable years unless the taxpayer secures the consent of the Secretary or his delegate to the revocation of the election. The computation of taxable income under an election under this provision is treated as a method of accounting. Thus, the provisions of the code relating to adjustments required by changes in method of accounting (sec. 481) apply to the making and the revocation of the election.

Effective date.—The bill is to apply to taxable years beginning after December 31, 1975.

Revenue effect.—It is estimated that this provision will result in a decrease of $10 million in tax liabilities in the first year that it is effective.

Administration position.—The Treasury Department has no objection to this legislation.

H.R. 7228

Devices Other Than Stamps on Distilled Spirits Containers as Evidence of Tax Payment

Present law.—Under present law, evidence of the payment of the Federal excise tax on distilled spirits is required to be demonstrated by attaching to the container what is commonly known as a "strip stamp." This is a paper stamp that is attached to the container in such a manner that it will be broken (thereby voiding it) on opening the container. Present law restricts the preparation and distribution of the strip stamps to the Secretary of the Treasury or his delegate. The stamps are now made by the Bureau of Engraving and Printing.

Recent developments in the technology of bottle container closures indicate that it may become simpler and less costly in the future to use devices other than paper stamps as evidence of payment of the excise tax on distilled spirits. For example, the evidence of this tax payment may be printed on a metallic strip used to form the closure of a bottle; this strip also will be broken and thereby voided when the bottle is opened.

House bill.—The bill amends present law to allow the Treasury Department to authorize the use of forms or devices (other than paper stamps) as evidence of payment of the excise tax on distilled spirits. The bill further allows the Secretary of the Treasury to authorize the preparation and distribution by persons outside of the Federal Government of stamps and other forms of evidence of tax payment. In

addition, the Secretary is to prescribe whatever controls are necessary for the protection of the Federal revenues involved when persons outside of the Federal Government are authorized to prepare and distribute stamps or other devices for evidence of excise tax payment.

Effective date.—The amendments made by this bill would become effective upon the date of enactment.

Revenue effect.—The staff estimates that this bill will have no effect on Federal revenues.

Administration position.—The Treasury Department favors enactment of this bill. In 1972 and 1973, the Treasury Department sent identical bills to the Congress asking for their consideration and enactment.

H.R. 8283

Types of Flavors Permitted To Be Used in the Production of Special Natural Wines

Present law.—Under present law, for purposes of the code provisions relating to cellar treatment and classification of wines (secs. 5381–5388), special natural wines may be made with the addition (before, during or after fermentation) of "natural" flavorings and natural herbs, spices, fruit juices, aromatics, or essences. Flavors other than natural are not permitted to be used in producing special natural wines.

House bill.—The bill amends present law (sec. 5386(a)) to permit flavors other than natural to be used in producing special natural wines. This change means that the addition of flavors other than natural to "special natural wines" would have to be approved in advance by the Secretary of the Treasury or his delegate before they could be used in the making of such wines. The bill does not affect the circumstances under which natural herbs, spices, fruit juices, aromatics, and other natural flavorings may be used in producing these wines.

Effective date.—The bill is effective upon the date of enactment.

Revenue effect.—It is estimated that the enactment of the bill would have no effect on tax revenues, and, further, that the additional costs to be incurred by the Government under the proposed change would be negligible.

Administration position.—The Treasury Department has no objection to the bill.

H.R. 10101

Exemption From Fuel and Use Excise Taxes for Certain Aircraft Museums

Present law.—Under present law (secs. 4041 and 4081 of the code) gasoline and special fuels used in noncommercial aviation, including use by aircraft museums, are subject to manufacturers and retailers excise taxes totaling 7 cents per gallon of gasoline or special fuel. Exemptions from the gasoline and special fuels taxes are presently provided where the aircraft is used by commercial airlines, for farming, or as supplies for vessels or aircraft engaged in foreign trade, by

a State or local government, or a nonprofit educational organization.[1] In those cases where the manufacturers excise taxes have been paid, a mechanism is provided for refunds of these taxes if the gasoline or special fuel is consumed by an exempt user.

There is also imposed an annual excise tax upon the use of civil aircraft. This tax (under sec. 4491) is based largely upon the weight of the aircraft.[2]

House bill.—This bill exempts aircraft museums (of the type specified below) from the retailers and manufacturers excise taxes which apply to gasoline and special fuels used for noncommercial aviation purposes. A mechanism is also provided for refunds or credits of manufacturers excise taxes where they have already been paid on gasoline used by an aircraft museum. In addition, aircraft operated by an aircraft museum are exempted from the use tax on civil aircraft. An aircraft museum is defined, for these purposes, as an organization described in code section 501(c)(3) which is exempt from Federal income taxes under section 501(a). Also, the organization must be operated as a museum under State (or District of Columbia) charter and must be operated exclusively for the procurement, care, and exhibition of aircraft of the type used for combat or transport in World War II.

For the exemption or refund to be available, the fuel must be used in an aircraft or vehicle (such as a ground servicing vehicle for aircraft) which is owned by an aircraft museum and is used exclusively for the procurement, care, and exhibition of aircraft of the type used for combat or transport in World War II.

Effective date.—The amendments pertaining to exemptions from and refunds of the gasoline and special fuels taxes apply to fuel sold or used on or after October 1, 1976. The exemption from the aircraft use tax would take effect on July 1, 1976.

Revenue effect.—It is estimated that these amendments will result in a revenue loss of approximately $50,000 per year.

Administration position.—The Treasury Department opposes this bill. Treasury notes that an argument presented in support of the bill is that the planes of the museum do not use the expensive electronic facilities of the airway system and points out that the cost allocation studies of the Department of Transportation indicate that noncommercial aviation is greatly undertaxed. In the case of the annual use tax, the tax is actually a charge for the availability of facilities, and a similar situation exists with the highway use tax in the trucking industry for seasonal operators and those who drive a limited number of miles each year. Finally, Treasury points out that the only exemption from the airway user taxes is for aircraft fuel used by state and local governments and private nonprofit schools. The state and local governments, and the private schools, pay all the other taxes, including the annual aircraft use tax.

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[1] An educational organisation for these purposes is, in general, one which maintains a faculty and curriculum to conduct onsite educational activities.

[2] The annual tax rate is $25 plus 2 cents per pound of takeoff weight over 2,500 pounds in the case of a non-turbine-powered aircraft, and 3½ cents per pound in the case of a turbine-powered aircraft.

H.R. 11997

Bank Holding Company Tax Act of 1976

Present law.—In general, the Bank Holding Company Act Amendments of 1970 require a bank holding company (generally any company controlling a bank) to divest either its banking or nonbanking properties on or before December 31, 1980. At the time of enactment, it was anticipated that the Congress would later consider the need for legislation to provide relief from any tax burden resulting from the divestitures required under the 1970 Amendments.

With respect to distributions previously required under the Bank Holding Company Act of 1956 (and its amendment in 1966), bank holding companies which controlled two or more banks were permitted to make tax-free distributions (referred to as "spinoffs") of either their bank or nonbank assets, as the case may have been. This special treatment provided for the nonrecognition of any gain to the shareholders, upon the distribution to them of banking or nonbanking property, including stock of a subsidiary. The tax on any gain realized by shareholders, or on any property received by them, would be imposed upon their later disposition of stock or other property received in the spinoff.

House bill.—The House bill provides two possible methods in which tax relief may be obtained by individuals and corporations for divestitures made by a bank holding company of either bank or nonbank property pursuant to the Bank Holding Company Act Amendments of 1970.

First, the bill provides that a bank holding company may distribute either the bank or nonbank assets to its own shareholders (or, in some cases, security holders) without inclusion in income or recognition of gain by these stock (or security) holders. However, any loss realized by a shareholder (or security holder) as a result of a distribution may be recognized. This "spinoff" approach is generally the same as that adopted with respect to divestitures under the bank holding company legislation enacted in 1956 and 1966.

Second, the House bill permits a bank holding company to sell its banking or nonbanking assets in a taxable sale or exchange and to pay the income tax incurred at the corporate level in installments over at least a 10-year period with respect to sales or exchanges made under the divestiture requirements of the Bank Holding Company Amendments of 1970.

The methods of tax relief for divestitures permitted by the House bill are not intended, however, to be exclusive. As a result they do not limit the availability of any tax relief for dispositions covered specifically by other provisions of the code. For example, a bank holding company could make a required divestiture by means of a spinoff covered at the shareholder level by section 355 of present law (distribution of stock of a controlled corporation) if the specific requirements of that provision are otherwise fully satisfied.

With respect to the spinoff approach, the bill generally adopts the provisions contained in present law (secs. 1101–1103), which applied to divestitures made pursuant to the 1956 and 1966 bank holding company legislation.

In general, a corporation coming within the terms of the bank holding company legislation of 1970 is given its choice of two alternative routes—to remain a bank holding company and divest its prohibited nonbanking assets, or to dispose of its interest in banks and, as a result, cease to be a bank holding company.

If a corporation decides to remain a bank holding company, subject to supervision by the Federal Reserve Board, it must divest itself of any "prohibited property" (that is, nonbank property). Under the "spinoff" approach, nonbanking property (including stock) may be distributed to a bank holding company's shareholders without recognition of gain by them on the distribution.

The distribution of "prohibited property" may be made either directly to the shareholders of the corporation which is a bank holding company (with or without a surrender by the shareholders of some of their stock in the holding company) or may be transferred, together with other nonbank property, to a wholly owned subsidiary created expressly for purposes of receiving the prohibited property.[7] In the latter situation, the stock of the subsidiary must be immediately distributed to the shareholders of the corporation which is a bank holding company if the distribution is to qualify for nonrecognition of gain to (or noninclusion in income of) the shareholders.

If a corporation which qualifies as a bank holding company decides to cease to be a bank holding company (that is, if it wants to continue its nonbank activities), it must divest itself of its bank property. Under the "spinoff" approach, it may distribute to its shareholders any bank stock or other property of a kind which causes it to be a bank holding company, without the recognition of gain to the distributee shareholders (if they exchange some of their stock in the holding company) or without current inclusion in their income (if they retain their stock in the holding company). As in the case where a bank holding company divests its nonbanking property, as indicated above, nonrecognition is available whether the bank stock or other similar property is distributed directly to shareholders or whether it is first transferred to a wholly owned subsidiary expressly created for that purpose and the stock of the subsidiary is then immediately distributed to the shareholders of the parent company.

The spinoff provisions will not apply to a distribution of prohibited property if the bank holding company has made distributions of bank property or has made an election under the installment payment provision with respect to the sale of bank property. Conversely, the spinoff provisions will not apply with respect to distributions of bank property if distributions of prohibited property have been made by the bank holding company under the spinoff provisions, or if it has made an election to pay the tax in installments with respect to prohibited property.

In general, distributions must be pro rata either with respect to all shareholders of the distributing bank holding company or with respect to all holders of common stock of the company. In the case of distribu-

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[7] In case where a wholly owned subsidiary is created to receive the prohibited property, certain amounts of working capital may be transferred in addition to the prohibited property. However, the nonrecognition provisions of this bill would not apply if the subsidiary receives a greater amount of working capital than is necessary under the circumstances or if other evidence indicates the existence of a plan one of the principal purposes of which is to distribute earnings and profits of a corporation.

tions to several classes of shareholders, the determination of whether the distributions are pro rata is to be made on the basis of the respective fair market values of classes of stock.

A limited exception is provided in the bill to permit non pro rata distributions where the Federal Reserve Board requires it in order to effectively separate banking and nonbanking businesses, e.g., if the result of a pro rata distribution would be that the same small group of shareholders would continue their respective interests in two corporations rather than one. This exception applies only in the case of a qualified bank holding corporation which does not have more than 10 individual shareholders (other than an estate) at any time during the period beginning on July 7, 1970, and ending after the final distribution required under the Bank Holding Company Act is made. Further, this exception is to apply only if the Board certifies that a pro rata distribution is not appropriate to effectuate the policies of the Bank Holding Company Act and that a disproportionate distribution is necessary or appropriate to effectuate such policies. In this case, the Board is to make such certification only after consultation with the Secretary of the Treasury or his delegate.

Where distributions of divestiture property (banking or nonbanking property as the case may be) are made directly by a qualified bank holding corporation, the distributions may be pro rata with respect to common shareholders without the surrender of shares of the distributing company held by them. In the case where the divestiture property is transferred to a wholly owned subsidiary and then the stock of the subsidiary is distributed, the common stock of the subsidiary may be distributed to all shareholders or only to the common shareholders of the distributing corporation without the surrender of shares in the distributing corporation. In addition, preferred stock or common stock in the subsidiary may be distributed in redemption of the holding company's own common and preferred stock (subject, however, to the tender offer requirement under the pro rata rule in the bill). In addition, if the exception to the pro rata requirements applies, the holding company may distribute preferred or common stock or securities of the subsidiary in exchange for the holding company's own securities.

If shareholders of a bank holding company do not recognize gain on a distribution of property to them in exchange for stock or securities held by them in the holding company, the basis of the property received by a shareholder is the same as the basis of the stock securities exchanged. If property is received by such shareholders without an exchange of stock by them, the shareholder is required to allocate his basis in the stock of the bank holding company between such stock and the property distributed to him. Thus, the tax which would have otherwise been incurred by a shareholder with respect to a distribution is generally postponed until the shareholder disposes of the stock or property which is received.

As a result of the Tax Reform Act of 1969, present law taxes any gain to a corporation which distributes appreciated property in redemption of its own stock (sec. 311(d)). However, a number of exceptions

were provided to this rule at that time.[8] The bill adds another additional exception providing that gain will not be recognized by a corporation distributing appreciated stock of a pre-existing banking or nonbanking subsidiary in redemption of its own stock.

This additional exception to section 311(d) is not to be available for distributions of assets other than stock. Moreover, the exception is to be available only for distributions made directly by the holding company (under new secs. 1101(a)(1) or (b)(1)) and does not apply to distributions of stock of any newly created subsidiary.[9] This exception is not to apply where the distributee is a tax-exempt organization.

The second form of tax relief provided by the bill permits the taxpayer to make installment payments of the tax attributable to a divestiture accomplished by a sale of bank or nonbank property, as the case may be. Under the installment payment provision, a bank holding company selling bank property or nonbank property, after July 7, 1970, may elect to pay the tax attributable to this sale in equal annual installments. The first installment is to be due on the due date of the taxpayer's return of taxes for the taxable year in which the sale occurred. The installments are to be paid annually thereafter with the last installment payable on the due date of the taxpayer's return in 1985 or, if later, on the corresponding date 10 years after the due date for the year in which the sale occurred. If the taxpayer makes more than one sale under the 1970 bank holding company legislation, the tax attributable to each sale may be paid on an installment basis beginning in the year after each sale was made.

As indicted above, the bill provides for a minimum installment period of 10 years. Thus, in the case of a sale in 1980, the installment period would be available until 1990 (rather than 1985). However, interest is not imposed upon the deferred tax in the case of installments due through 1985, but is payable with respect to installment payments due after 1985.

The installment payment of tax is not to be available for a sale of nonbank property if the bank holding company elects to apply the provision to the sale of bank property or if the company has distributed bank property under the spinoff provisions. Conversely, the installment payment of tax is not to apply with respect to a sale of bank property if the bank holding company elects to pay the tax in installments with respect to nonbank property or has distributed nonbank property under the spinoff provisions. If the bank holding company elects to report gain on a sale under the regular installment method (section 453), it is not to be entitled also to elect for this sale the special installment method provided here.

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[8] The rule does not apply to (1) a distribution in partial or complete liquidation of a corporation, (2) a distribution of stock or securities in a divisive reorganization, (3) certain complete redemptions of a 10-percent shareholder, (4) certain distributions of a stock of a 50-percent controlled corporation, (5) certain distributions of stock or securities pursuant to the terms of a judgment requiring divestiture under the antitrust laws, (6) certain distributions in redemption of stock to pay death taxes, (7) certain distributions to a private foundation in redemption of stock, and (8) certain distributions by a regulated investment company in redemption of its stock.

[9] If stock of a newly created subsidiary could be distributed under the protection of the new exception to sec. 311(d), the rule limiting the exception to stock distributions could be circumvented by transferring business assets to a newly created subsidiary and then distributing the stock of that subsidiary to the shareholders of the bank holding company.

If the company elects to pay the tax in installments, the payments are to be accelerated and the tax paid in full if (i) an installment is not paid on or before its due date; or (ii) the Federal Reserve Board fails to make a certification, within the time prescribed that the company has disposed of all the property the disposition of which is necessary to effectuate the policies of the Bank Holding Company Act or that the company has ceased to be a bank holding company.

If the company elects to pay the tax in installments, the Secretary of the Treasury or his delegate may, if he feels that it is necessary to ensure payment of the tax, require the company to furnish a bond. The provision relating to bonds (sec. 6165) where the time to pay the tax has been extended, is to apply as though the Secretary is extending the time for the payment of tax. The running of the period of limitations for the collection of the tax attributable to a sale is to be suspended for the period during which there are any unpaid installments.

The tax relief provided under the bill is available for divestitures occurring from July 7, 1970, through December 31, 1980. In general, a bank holding company must be qualified as such and the property being divested must have been held as July 7, 1970. This date is the date upon which the Senate Banking and Currency Committee announced that it was reporting out a bill dealing with one-bank holding companies. This restriction is considered necessary to preclude tax relief for acquisitions made after it became clear that the separation of banking and nonbanking businesses was to be required of the one-bank holding companies.

Since the Bank Holding Company Act of 1970 requires all divestitures to be made by December 31, 1980, the tax relief is made available only for those divestitures which will have taken place by that date.

Effective dates.—The "spinoff" amendments made by the bill are to be effective with respect to distributions after July 7, 1970. The bill, however, is to take effect on October 1, 1977. The effective date of the bill is postponed until October 1, 1977, so that there will be no revenue loss until fiscal year 1978.[10]

In the case of distributions occurring before enactment of the bill, the period of limitations for refunds or credits is extended for one year following the October 1, 1977.

The provision relating to nonrecognition of gain by a corporation using appreciated property to redeem its stock is to apply to distributions made after December 31, 1975. However, the bill also provides that this provision is not to take effect until October 1, 1977.

The installment payment of tax provision is to apply to sales made after July 7, 1970. The bill, however, is not effective until October 1, 1977. As in the case of the spinoff approach, the postponement of the effective date of the bill is provided so that there will be no revenue loss until fiscal year 1978.

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[10] In the case of any distribution which takes place on or before 90 days after the date of the enactment of this bill, the requirement that the Federal Reserve Board certify that the distribution is necessary or appropriate to effectuate the purposes of the Bank Holding Company Act is to be treated as made before the distribution if an application for certification is made before the close of the 90th day after the date of enactment. The final certification (required by section 1101(e)) is to be treated as made before the close of the calendar year following the calendar year in which the last distribution occurred if application for that certification is also made before the close of the 90th day after the date of enactment.

In the case of any sale which takes place on or before 90 days after the date of enactment, a certification by the Federal Reserve Board is to be treated as made before the sale if application for the certification is made within 90 days after the date of enactment.

In the case of a sale occurring before enactment of the bill, refunds or credits are to be available for the portion of the tax attributable to the sale not yet due on October 1, 1977 under the installment payment provision. Under the bill, no refund may be made or credit allowed under the provision before October 1, 1977.

Any refund due under this provision may be used by the Internal Revenue Service as an offset to any outstanding deficiencies as provided under present law (sec. 6402). In the case of refunds attributable to sales, in two or more taxable years the refunds attributable to the sales are to be used in the order of time as offsets to the deficiencies arising in the order of time and in the manner provided under present law where the taxpayer does not specify the liability being satisfied (first as to interest, second as to penalties, and third as to tax liabilities).

In the case of an overpayment arising from the installment provisions interest to the taxpayer is to be allowed for only for periods 6 months or more after the later of the date of enactment, the date on which application for refund is filed. or the due date for filing the income tax return for the taxable year in which the sale occurs.

Revenue effect.—The bill would become effective on October 1, 1977, so that there would be no revenue effect for fiscal year 1977. Thereafter, the revenue loss is estimated to be approximately $50 million in fiscal year 1978, $25 million in fiscal year 1979, $50 million in fiscal year 1980, and $60 million in fiscal year 1981. Of this amount, $125 million would be returned to the Treasury during the period 1981 through 1990 as installment payments are made with respect to the taxes deferred under the installment payment method.

Administration position.—The Treasury Department supports this legislation. With respect to the spinoff provisions, however, it recommends that non-pro-rata distributions be generally permitted rather than being limited as in the bill, to cases where a non-pro-rata distribution is required by the Federal Reserve Board.

REVENUE BILLS PENDING ON HOUSE CONSENT CALENDAR

H.R. 1142

Tax Treatment of Cemetery Perpetual Care Fund Trusts

Present law.—The position of the Internal Revenue Service is that perpetual care fund trusts established by a taxable cemetery are subject to tax.[1] The Service also has held that the deduction for income distributed to beneficiaries of trusts (under secs. 651 and/or 661) is not to be allowed to perpetual care funds because they do not have any specific beneficiaries. The Service's position in this regard is that

[1] In Rev. Rul. 64-217 (1964-2 C.B. 153), the Service held that a perpetual care fund, the income of which is turned over to a profitmaking cemetery company for use in connection with the maintenance of cemetery sites and burial lots, is not entitled to exemption from Federal tax.

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the benefit of the trust is diffused among the owners of the lot, the cemetery companies, and the public in general.

However, in a recent and related case, *Graceland Cemetery Improvment Fund* v. *U.S.*, 515 F. 2d, 762 (Ct. Cl. 1975), the Court of Claims held that a corporation formed for the perpetual care of a taxable cemetery was entitled to deduct as ordinary and necessary business expenses all payments made for cemetery care and upkeep.

House bill.—The bill amends the trust provisions (sec. 642) of present law to provide a deduction for those amounts expended by perpetual care fund trusts for the care and maintenance of gravesites. The deduction allowed is to the lesser of the amount actually distributed during the year for such care and maintenance or $5 per gravesite. Since perpetual care funds are established for the care of gravesites that have been previously sold by cemetery corporations, the deduction is to apply only for amounts expended for the care of gravesites sold before the taxable year in question. For the same reason, the deductions are to be available only with respect to the care and maintenance of gravesites with respect to which the fund actually has an obligation of care.

The bill would have the effect of eliminating the taxable income of substantially all of these perpetual care fund trusts since the deduction provided by the bill in almost all cases is more than is usually needed to provide for the care and maintenance of the gravesites.

Effective date.—The amendment is retroactive and applies to amounts distributed during taxable years ending after December 31, 1963, which is when the Service first gave public notice of its position regarding the tax treatment of perpetual care funds of profit-making cemeteries.

Revenue effect.—The estimated annual revenue loss is $10 million. The revenue effect pertaining to taxable years ending after December 31, 1963, and beginning before January 1, 1976, cannot be estimated with any degree of accuracy. In any event, it is understood that the Internal Revenue Service has not been imposing any tax in these cases in the past which means that the bill in effect would forestall any revenue collections for the prior years.

Administration position.—The Treasury Department supports this legislation.

H.R. 1144

Tax Treatment of Social Clubs and Other Membership Organizations

Present law.—

Income from nonmembers and investment sources.—Among the present law categories of exempt organizations are social clubs and other somewhat similar nonprofit organizations, such as national organizations of college fraternities and sororities. Present law (sec. 501(c)(7)) provides that these organizations must be organized and operated exclusively for pleasure, recreation, and other nonprofit purposes with no part of the net earnings inuring to the benefit of any private shareholder. The regulations under this provision state that a club which engages in business is not organized and operated exclusively for nonprofitable purposes and, therefore, is not exempt.

Generally, the Internal Revenue Service has not challenged the exempt status of these organizations if the income derived from providing goods and services to persons other than members and their guests is small in relation to the total activities of the organization. Thus, as an audit standard (Rev. Proc. 71-17, 1971-1 C.B. 683) the Service has indicated that it generally will not disturb a social club's exempt status solely on the basis of its nonmember activities if the club's annual income from outside sources is not more than the higher of $2,500 or 5 percent of the total gross receipts of the organization. Where gross receipts from nonmember dealings exceed this 5-percent figure, all facts and circumstances are taken into account in determining whether the organization continues to qualify for exempt status. In the case of investment income, the Service applies no percentage rule, but instead looks to whether a substantial part of the club's income is from investment sources (Rev. Rul. 66-149, 1966-1 C.B. 146).

In the Revenue Act of 1950, Congress imposed the regular income tax on the income certain tax-exempt organizations receive from active business enterprises which are unrelated to their exempt purposes in order to prevent such tax-exempt organizations from enjoying a competitive advantage over other businesses. Social clubs, national organizations of college fraternities and sororities and certain other tax-exempt organizations were not subjected to the unrelated income tax imposed at that time.

In the Tax Reform Act of 1969, however, Congress extended the unrelated business income tax to virtually all of the exempt organizations not already subject to that tax because many of the exempt organizations not subject to the unrelated business income tax were engaging in substantial business activity. As a result, social clubs and national organizations of college fraternities and sororities are subject to tax on all of their unrelated business income.

In addition, the 1969 act extended the unrelated business income tax in the case of these social clubs and employees' beneficiary associations to cover investment income as well as the unrelated business income. Investment income was made taxable in the case of these membership organizations because not to do so would have permitted them to provide recreational or social facilties and services out of income other than membership fees, and as a result, would have allowed individuals to devote investment income, free of tax, to personal activities.

Dividends received deduction for exempt social clubs, etc.—Generally, under present law the tax on unrelated business income does not apply to investment income. However, in the case of social clubs and employee beneficiary associations, "investment income" is included in the tax base. This result is accomplished in the case of these organizations by defining their unrelated business taxable income (sec. 512(a)(3)) as gross income (other than exempt function income) less allowable deductions directly connected with the production of gross income (again excluding exempt function income).

One of the deductions allowed corporations in the computation of the regular corporate income tax is the dividends received deduction. Generally, this allows corporations a deduction equal to 85 percent of dividends received from taxable domestic corporations. The proposed Treasury regulations on social clubs and employee beneficiary associations provide that the dividends received deduction is not

allowed for purposes of computing the unrelated business taxable income for social clubs and employee beneficiary associations, because it is not an expense directly connected with the production of income.

Dividends received deduction for nonexempt membership organizations.—The third section of the bill also relates to the dividends received deduction in the case of investment income, but in this case where the dividends are received by nonexempt membership organizations. The Tax Reform Act of 1969 (sec. 277 of the code) provided that in the case of taxable membership organizations the deduction for expenses incurred in supplying services, facilities, or goods to the members was to be allowed only to the extent of the income received from these members. This was provided in order to prevent taxable membership organizations from escaping tax on business or investment income by using this income to provide services, facilities, or goods to its members at less than cost and then deducting the loss from the membership activity against the investment income.

House bill.—

Income from nonmembers and investment sources.—The first amendment made by the bill (subsection (a) of the bill) substitutes for the present law requirement that clubs which are exempt from tax under section 501(c)(7) must be organized and operated "exclusively" for pleasure, recreation, and other nonprofitable purposes, the requirement that "substantially all" of such a club's activities must be for these purposes.[1]

The effect of this change is twofold. First, it is intended to make clear that these organizations may receive some outside income, including investment income, without losing their exempt status. Second, it is intended that the level of income a social club can derive from the use of its facilities or services by nonmembers be somewhat higher than was previously the case, without the organization losing its exempt status.

Dividends received deduction for exempt social clubs, etc.—The second amendment made by this bill (subsection (b) of the bill) denies a corporate dividends received deduction to tax-exempt social clubs and voluntary employees beneficiary associations (described in secs. 501(c)(7) and (9)) in computing their "unrelated business taxable income." Under present law the unrelated business taxable income of these organizations is defined as their gross income (excluding any exempt function income) less the deductions under this chapter "which are directly connected with the production of the gross income" (again excluding exempt function income). The bill provides that the corporate dividends received deduction is not to be considered as a deduction which is "directly connected with the production of gross income."

Dividends received deduction for nonexempt membership organizations.—The third amendment made by this bill (subsection (c) of the bill) denies a corporate dividends received deduction to taxable social clubs or other membership organizations operated primarily to furnish services or goods to members (referred to in section 277 of the code). These organizations, with certain exceptions set forth in

[1] The bill continues the present law requirement that no part of the net earnings of the organization may inure to the benefit of any private shareholder.

present law, are permitted deductions attributable to furnishing services, insurance, goods or other items of value to their members only to the extent of the income derived from members or transactions with members. The bill provides that the corporate dividends received deduction (secs. 243, 244, and 245 of the code) is not to be allowed to corporations to which this provision of law applies.

Prohibition of discrimination.—The House bill also provides that an organization otherwise exempt from income tax under section 501 (c)(7) is to lose its exempt status for any taxable year if, any time during that year, its governing instruments or written policy statements contain a provision which provides for the discrimination against any person on the basis of race, color, or religion.

Effective date.—The amendment with respect to the changes in the requirement for exempt status of clubs under section 501(c)(7) is to apply retroactively to taxable years beginning after December 31, 1969, the effective date of the provision in the Tax Reform Act of 1969 extending the unrelated business income tax to social clubs, college fraternities, etc.

The amendment denying the corporate dividends received deduction to tax exempt social clubs and voluntary employees beneficiary associations applies retroactively to taxable years beginning after December 31, 1969, the effective date of the provision of the 1969 act taxing unrelated business taxable income (including investment income) of social clubs and voluntary employees beneficiary associations.

The amendment denying the corporation dividends received deduction to taxable social clubs and other membership organizations operated primarily to furnish services or goods to members applies to taxable years beginning after December 31, 1970, the effective date of the provision of the 1969 act limiting the deductions of taxable membership organizations.

Revenue effect.—It is estimated that the revenue effect of this bill will be a small revenue gain, probably less than $100,000 a year.

Administration position.—The Treasury supports the provisions of H.R. 1144 which would allow social clubs, including college fraternities and sororities, to earn limited income from nonmember sources and investments without losing their general tax exemption. The Treasury also supports the provisions of the bill which would deny the dividend received deduction in computing taxable investment income of social clubs as well as taxable membership organizations. Section 2(a) of the bill provides that organizations which have a written policy of discrimination on the basis of race, color, or religion would lose their exempt status under section 501(c)(7) of the Internal Revenue Code. Since about one-quarter of the 40,000 social clubs, which are exempt under section 501(c)(7), are organized on the basis of a common bond of religion or ethnic origin, the Treasury opposes section 2(a) of the bill. There is no apparent reason for discouraging social clubs organized on the basis of such a common bond. The practical consequences of denying tax exempt status to section 501(c)(7) social clubs would be that they would have to file corporate tax returns. Since such clubs would seldom, if ever, have any taxable net income, paperwork burdens would be imposed on both the clubs and the Internal Revenue Service.

H.R. 6521

Exemption From Tax for Farm Trailers and Horse or Livestock Trailers

Present law.—Section 4061(a)(1) of the Internal Revenue Code imposes a 10-percent tax on the sale by the manufacturer, producer, or importer of enumerated articles including truck trailer and semitrailer bodies and chassis.

Section 4061(a)(2) provides an exclusion from the tax, however, for sales of bodies and chassis of "light-duty" trucks, buses, and truck trailers, and semitrailers. To qualify for the exemption, the truck trailer and semitrailer chassis and bodies must be suitable for use with a trailer or semitrailer having a "gross vehicle weight" of 10,000 pounds or less (determined according to Treasury regulations). In addition, the truck trailer or semitrailer itself must be suitable for use with a towing vehicle with a gross vehicle weight of 10,000 pounds or less.

House bill.—The bill would provide an exemption from the manufacturers excise tax in the case of trailers, semitrailers, and bodies and chassis for trailers or semitrailers that are suitable for use with a towing vehicle with a gross vehicle weight of 10,000 pounds or less. To qualify for the exemption, however, the trailer or semitrailer must be designed for use for farming purposes or for transporting horses or livestock. In addition, parts or accessories suitable for use with an exempt trailer, semitrailer, or trailer or semitrailer body or chassis are also to be exempt.

To avoid creating competitive disadvantages because of the relative size of dealers' inventories, and in conformity with prior practice, the bill would provide for floor stocks refunds with respect to all articles exempted by the bill that are still in dealers' inventories on the day after the bill's enactment.

Effective date.—The exemptions proposed by the bill would apply with respect to articles sold on or after the date of enactment.

Revenue effect.—The revenue loss from this provision is expected to be less than $2 million annually.

Administration position.—The Treasury Department opposes this legislation because of the resulting discrimination against single-unit trucks (that is, without trailers or semitrailers) and non-farm trailers and semitrailers. The argument is made that heavy-duty trailers and semitrailers designed to be used on a farm or for transporting horses or livestock make infrequent use of the highways and, therefore, should be exempted from the highway use tax. But there are many types of vehicles (electric company trailers, construction equipment, etc.) that may be in a similar situation. The highway use taxes are appropriately a combination of taxes that seek to recover the costs of making highway facilities available (e.g. highway vehicle excise taxes and annual use) and taxes that reflect highway usage (e.g. the gasoline tax). It is impractical to differentiate vehicles by the extent of highway usage for purposes of the vehicle excise taxes and annual use taxes.

H.R. 2474

Refunds in the Case of Certain Uses of Tread Rubber and Tires

Present law.—Present law (sec. 4071) imposes a tax of 5 cents per pound on tread rubber used for retreading tires of highway-type vehicles and a tax of 10 cents per pound on new tires used on highway vehicles.[1]

In the case of new tires, a credit or refund of tax is provided where the tire is exported, is sold for use as supplies for vessels or aircraft engaged in foreign trade, or is sold for exclusive use by a State or local government or by a nonprofit educational organization (sec. 6416(b)).

There are several instances under present law where a manufacturers tax is imposed on tread rubber when in a similar situation a manufacturers tax would not be imposed (or a credit or refund would be allowed) on a new tire.

First, rubber wasted in manufacturing new tires is not subject to tax since the tax is imposed when the completed tire is sold and is imposed only upon the material actually in the completed tire. The tax on tread rubber is imposed before the completion of a major manufacturing process—the recapping or retreading of a used tire. Wastage of tread-rubber in that process occurs after the tread rubber tax liability has been determined, and under present law no refund or credit is provided for any portion of the tax imposed on tread rubber which is wasted.

Second, under present law, where the sale of a new tire is adjusted on account of a tread mileage or road hazard guarantee or other similar arrangement, a credit is allowed for a portion of the tax in accordance with the amount of the adjustment in price. However, if the sale of a retreaded tire is adjusted under the same circumstances, no credit or refund of the tread rubber tax is provided.

Third, a credit or refund of the tax on new tires is available when the tire is exported, sold to a State or local government, sold to a nonprofit educational organization, or used or sold for use as supplies for a vessel or aircraft. A credit also is available where a new tire is mounted on a new automobile that is then disposed of in any of the above ways. However, no credit or refund is available for the tread rubber tax when a recapped or retreaded tire (or the car on which it is mounted) is disposed of in any of those ways.

In addition, the present credit or refund of tax which is permitted in cases of new tire guaranty or warranty adjustments may be computed incorrectly because the amount of the refund is based on the price of the replacement tire (not the original tire) and because the refund is not available where an individual other than the original buyer receives the adjustment.

House bill.—The bill would make a credit or refund of the tread rubber tax available in three situations. These changes are intended to

[1] The tax is scheduled to be eliminated for tread rubber and to be reduced to 5 cents per pound for new tires on October 1, 1977 (sec. 4071(d)).

permit a credit or refund of the tax on the tread rubber used on a recapped or retreaded tire, under the circumstances where a credit or refund would be available for the tax on a new tire.

First, the credit or refund is to be available where rubber is destroyed, scrapped, wasted, or rendered useless in the recapping or retreading process.

Second, the credit or refund is to be available where the tread rubber is used in the recapping or retreading of a tire if the sales price of the tire is later adjusted because of a warranty or guarantee.

Third, a credit or refund of the tread rubber tax is to be available to the manufacturer for the tread rubber on a recapped or retreaded tire if the tire is by any person (1) exported, (2) sold to a State or local government for the exclusive use of a State or local government, (3) sold to a nonprofit educational organization for its exclusive use, or (4) used or sold for use as supplies for a vessel or aircraft.

Where a retreaded tire is sold by a second manufacturer on or in connection with another article (for example, a truck) manufactured by him, the bill provides that a credit or refund of the tread rubber tax is to be allowed to the further manufacturer if the article is exported or sold for any of the above purposes. Also, a credit or refund of the tread rubber tax is to be available to the manufacturer of the recapped or retreaded tire if that retreader sells the tire on or in connection with any other article manufactured by him, and that other article is exported or sold by any person for one of the purposes described above.

In addition, the bill makes it clear that present credit or refund for any tire tax paid in cases of guaranty or warranty adjustments is to be based on the adjusted price of the tire being returned (not the replacement tire) and is to be available whether or not any replacement tire is made by the same manufacturer as the tire being returned and whether or not a replacement tire is obtained. The bill also modifies the statute of limitations so that a credit or refund of the tread rubber or new tire tax can be obtained for a period of 1 year after the warranty or guaranty adjustment is made. Finally, the bill imposes a tax on tread rubber used in recapping or retreading tires abroad, if those tires are then imported into the United States.

Effective date.—The amendments made by this bill are to take effect on the first day of the first calendar month which begins more than 10 days after the date of the bill's enactment.

Revenue effect.—The bill is expected to result in a negligible revenue loss, less than $200,000 annually.

Administration position.—The Treasury Department favors enactment of the bill, but recommends elimination of the provision, in new section 6414(b)(2)(ii), which permits a deemed overpayment of tax to be computed on the basis of advanced price adjustments in lieu of warranty adjustments based on actual loss.

H.R. 8046

Exclusion From Income of Rental Value of Parsonage Furnished to Surviving Spouse of Minister

Present law.—Under present law (sec. 107 of the code), a minister of the gospel is entitled to exclude from his gross income the rental value of a home furnished to him as part of his compensation or the allowance paid to him for housing.

This provision applies to anyone who is an ordained, licensed, or commissioned minister of the gospel and performs such services as normally considered functions of such a person. The exclusion does not apply to the surviving spouse of a deceased minister.

Under present law, if the surviving spouse of a deceased minister continues to receive the same housing benefits which were provided tax-free to the minister during the performance of his ministerial duties, then these amounts are included in the gross income of the surviving spouse. However, the housing benefits furnished a minister of the gospel during his lifetime were a part of his compensation and if furnished to his surviving spouse after his death could be considered to be furnished because of the prior services rendered by the minister.

House bill.—The bill provides, generally, that if the widow or widower of a deceased minister of the gospel continues to be furnished a home after the death of the minister and if the rental value of the same home was excludable by the minister under present law (sec. 107), then the widow or widower may likewise exclude from gross income this amount. The exclusion by the widow or widower, however, is to apply only with respect to the 1-year period beginning on the date of the minister's death. The exclusion is to apply only if the home is furnished to the surviving spouse, and not to any allowance which might be furnished in lieu of the home. Also, remarriage by the surviving spouse terminates eligibility for the exclusion.

Effective date.—The amendments made by this bill are to apply with respect to taxable years ending on or after the date of enactment.

Revenue effect.—It is estimated that enactment of this bill will result in a decrease in tax liability of approximately $500,000 a year.

Administration position.—The Treasury Department opposes enactment of this bill. It sees no justification for extending the section 107 exclusion, which has itself been the subject of criticism.

H.R. 10155

Tax Treatment of Certain Income of Political Organizations

Present law.—Under present law (sec. 527 of the code) political organizations (such as political parties or committees) are generally subject to Federal income taxation on income from investments and income from any trade or business. However, the exempt function income of such organizations is not taxable.

Under present law, "exempt function income" includes contributions of money or other property and membership fees, dues, or assessments from members of the organization. Exempt function income also

includes proceeds received from political fund raising or political entertainment events, or proceeds from the sale of political campaign materials, which are not received in the ordinary course of any trade or busines. Thus, proceeds received from casual sporadic fundraising events or political entertainment events, such as political dinners, receptions, or an annual athletic exhibition, are to be treated as exempt function income. However, in all of these cases the income is exempt function income only if the event is a political event and is not carried on in the ordinary course of a trade or business. Factors to be taken into account in determining whether an activity is a trade or business, for purposes of this section, include the frequency of the event, the manner in which the event is conducted, and the span of time over which the event is carried on. Whether an event is a political fund raiser or a political entertainment event will depend upon the facts and circumstances of the particular event, taking into account the extent to which the event is related to a political activity aside from the need of the organization for income or funds.

In addition, amounts received on the sale of campaign materials are eligible for exempt function income treatment under present law if the sale is not in the ordinary course of a trade or business, and is substantially related to the political activities of the organization. Thus, proceeds from the sale by a political organization of political items such as political memorabilia, bumper stickers, campaign buttons, hats, shirts, political posters, stationery, jewelry, or cookbooks are generally not to be taxable to the political organization where the sale is closely related to other political activity such as distributing political literature, organizing voters, etc. However, where these materials are sold in the regular course of a trade or business, the income derived from the sale is to be taxable.

House bill.—The bill provides that income received by a political organization from any trade or business which is regularly carried on would not be taxable if substantially all the work in carrying on the trade or business is performed for the political organization without compensation. Thus, the bill provides that a political organization would not ordinarily be taxed on income from political fund-raising or entertainment events, or from the sale of political campaign materials, even if the events or sales are regularly carried on, if substantially all the work performed in connection with the events and sales is normally performed by unpaid volunteers. This would have the effect of treating political organizations in a manner similar to tax exemption organizations (under sec. 501), since these other organizations are not generally subject to the tax on income with respect to any trade or business regularly carried on "in which substantially all the work in carrying on such trade or business is performed for the organization without compensation" (sec. 513(a)(1)).

Effective date.—The bill applies to taxable years beginning after December 31, 1975.

Revenue effect.—It is estimated that the bill will have a negligible effect on revenues, a loss of less than $100,000 annually.

Administration position.—The Treasury Department has no objection to this bill.

H.R. 10902

Tax Treatment of Securities Acquired for Business Reasons and Not as an Investment

Present law.—Under present law, the treatment of gain or loss on a sale or exchange of a stock or other security depends on whether the security is a capital asset in the hands of the taxpayer. Any stock or other security which is held for investment is treated as a capital asset and if held for more than 6 months is accorded the more favorable long-term capital gain treatment (that is, only one-half of the gain is subject to tax). Capital losses, however, are limited for both individuals and corporations as to the amount that may be deducted in a year. If a stock or other security is held for business purposes, generally it would not be treated as a capital asset and, therefore, any gain would be treated as ordinary income and any losses would be treated as ordinary losses (which could be deducted in full in the current year). As a result, if a taxpayer has a gain on the sale of a stock or other security, he would prefer to have capital gain treatment. However, if there is a loss from the sale, he would prefer to have ordinary loss treatment.

The question of whether a security (or any asset) is a capital asset is factual and depends on the facts and circumstances of the particular case, i.e., whether the taxpayer acquired and held the security as an investment or whether he acquired and held it for sale to customers in the ordinary course of business or held the stock for use in his business. In some situations, individuals or corporations which have acquired stock in another company and later sold such stock at a loss have successfully argued that they purchased and held the stock to assure themselves a source of supply of the other company's products or for similar business reasons. As a result these taxpayers have often been upheld in treating their loss as ordinary rather than capital. Few, if any, situations have arisen, however, where in similar circumstances a gain on later sale of the stock or securities has been held to be ordinary income.

Under present law (sec. 165(g)(1)) a loss resulting from a security becoming worthless during the taxable year is a capital loss if the security is a capital asset. The loss is ordinary if the security is not a capital asset in the taxpayer's hands. A special statutory rule also provides ordinary loss treatment for a security held by a parent corporation in a controlled subsidiary where the security becomes worthless during the taxable year (sec. 165(g)(3)).

House bill.—The bill adds a new provision (sec. 1254) which requires a taxpayer (including individuals and corporations) to notify the Secretary within 30 days after initially acquiring a security that the acquisition was not made as an investment in order to obtain ordinary loss treatment on a sale or exchange of the "security" (as defined in present section 165(g)(2)). The bill authorizes the Service to issue regulations concerning how the notice must be given and the information it must contain. The giving of notice would not guarantee ordinary loss treatment for a taxpayer; he would still have to establish

that he did not acquire and hold the stock as a capital asset. The bill simply adds a threshold condition for ordinary loss treatment that, in any event, the taxpayer must have filed the required notice within the required period.

If a taxpayer filed the necessary notice and realizes a gain when he sells the security, the bill provides that his gain shall be ordinary income and not capital gain. In such a situation, ordinary income treatment is automatic; the bill does not permit the taxpayer to show that on the particular facts he held the stock as a capital asset.

These rules operate together to prevent a taxpayer from subsequently coloring his description of his original purposes in acquiring a security, depending on whether he suffers a loss or realizes a gain on sale of the security.

The bill also adds a notice requirement in order for a worthless security to be treated as producing an ordinary loss. Where a security becomes worthless during the year, the taxpayer may obtain an ordinary loss only if he establishes that the security was not a capital asset in his hands and also that, within 30 days after he initially acquired the security, he notified the Service that he held the security other than as an investment.

This notice requirement would not be imposed, however, in the case of a worthless security in an affiliated corporation (under the provisions of present section 165(g)(3)), but would be imposed in the case of a sale or exchange of a security in such a corporation.

The new section would also not apply to a securities dealer. Present law (sec. 1236) creates uniform treatment for securities dealers by providing capital gain or loss treatment on sale or exchange if, within 30 days after he acquires a security, the dealer clearly identifies it in his records as held for investment and also if he does not later hold the security for sale to customers. A dealer who does not identify his securities in this manner receives ordinary income or loss when he sells the security.

The new rule also would not apply to losses on stock in a small business investment company operating under the Small Business Investment Act of 1958, or to losses on certain other small business stock where ordinary loss treatment is prescribed by other provisions of present law (secs. 1242, 1243, and 1244). Finally, the new rule would not apply to losses on sales or exchanges of certain kinds of securities held by banks or other financial institutions if, and to the extent, such losses are governed by section 582(c) of present law.

Effective date.—The bill applies to taxable years ending after the date of enactment. However, the new rules would not apply to any sale or exchange occurring before the issuance of regulations under the new code provision.

The bill also contains a transition rule for securities acquired on or before the date of enactment of the provision, or acquired after that date but before the issuance of the first regulations under the new section. In such cases, the taxpayer's notice must be given to the Service within 30 days after such regulations have been issued (rather than within 30 days after he initially acquired the security).

Revenue effect.—It is estimated that enactment of this provision will not have a significant revenue effect during the first two years.

However, in the later years this provision could generate annual revenue gains in the range of $20–$30 million.

Administration position.—During the Ways and Means Committee consideration of this bill, the Treasury Department opposed the bill on the grounds that it would not entirely eliminate the problem (taxpayers might forget that they had filed the required notice or hope to escape detection on audit, and they might still claim an ordinary loss) and that the requirement of a notice would introduce some additional complexity and would tend to catch taxpayers who are ignorant of the rule. The Treasury Department has reconsidered that position and has now withdrawn its opposition. It believes that the bill would substantially eliminate an existing tax abuse.

H.R. 10936

Recapture as Ordinary Income of Property for Which a Business Expense Deduction Was Allowed

Present law.—Under present law (sec. 1245), gain realized upon the sale or exchange (or certain other dispositions) of section 1245 property (generally tangible personal property and certain other property subject to an allowance for depreciation or amortization) is subject to recapture as ordinary income (rather than as capital gain) to the extent of any depreciation or amortization allowed with respect to that property after December 31, 1961 (or, in certain cases, later effective dates). Also, in the case of the contribution of property to charity, the deduction otherwise allowable with respect to that contribution is to be reduced by the amount of ordinary income which would have been realized by the taxpayer had the property been sold for its fair market value (sec. 170(e)). This has the effect of disallowing the deductions for any amounts which are subject to recapture under section 1245.

There is no provision under present law which provides that where the cost of property is deducted, instead of being depreciated or amortized, the amount deducted is to be subject to recapture as ordinary income if the property is later sold or otherwise disposed of at a gain.

House bill.—Under the bill, in the case of property acquired after December 31, 1975, if the purchase price of the property was deducted as an expense (and the deduction was not disallowed), the purchase price is to be subject to recapture under section 1245. Thus, for example, if the taxpayer purchases a professional periodical which has a useful life of less than one year, and deducts the purchase price as a trade or business expense, any gain (up to the amount of the deduction) realized on the later sale of the property would be treated as ordinary income. Also, if the property were contributed to a charitable or educational instituton, a charitable deduction would be allowed only to the extent of the sum of (1) the remaining basis and (2) the excess of the unrealized appreciation over the trade or business deduction claimed previously.

The bill does not apply with respect to research and development expenses allowed as a deduction under section 174 or to intangible

drilling and development costs allowed as a deduction under section 263(c).

Effective date.—This provision would apply to property acquired after December 31, 1975, and disposed of after the date of enactment of this bill.

Revenue effect.—It is estimated that the enactment of this bill will result in an increase in revenues of less than $5 million a year.

Administration position.—The Treasury Department supports this bill.

H.R. 7929

Interest on Corporate Debt To Acquire Another Corporation

Present law.—Under present law, a corporation generally is allowed to deduct interest paid or incurred on its indebtedness, but is not allowed a deduction for dividends paid on its stock or equity. However, under certain circumstances, a corporation is not allowed an interest deduction (either for stated interest or unstated interest such as original issue discount) for indebtedness which it issues as consideration for the acquisition of stock in another corporation, or for the acquisition of assets of another corporation (sec. 279).

A number of exceptions or modifications are provided under existing law to this interest disallowance rule. Generally the disallowance of the deduction for interest in the case of acquisition indebtedness applies to interest paid or incurred with respect to indebtedness incurred after October 9, 1969. However, this provision is inapplicable in certain cases where the issuing corporation had at least a 50-percent voting interest in another corporation on October 9, 1969, even though the obligation is issued after that date; this exception does not apply to indebtedness issued to acquire stock in excess of the amount necessary for control for tax purposes (i.e., 80 percent).

The interest disallowance provision was added to the Code in 1969 because of a Congressional concern over the increasing number of corporate mergers in which debt, rather than equity, was being exchanged for control of acquired corporations. This trend was thought to have adverse implications for the economic well-being of the companies involved (by increasing corporate debt to dangerous levels) as well as for the economy as a whole. The purpose of the exception for acquiring corporations having 50-percent or greater control of another corporation on October 9, 1969, was to permit such acquiring corporations to obtain the 80-percent control of the acquired corporation necessary for certain tax purposes.

House bill.—The House concluded that the 80-percent limitation imposed in connection with pre-October 10, 1969, control situations does not appear to serve the purpose of the interest disallowance provision (which is to discourage the future use of debt acquisitions under certain prescribed circumstances). This is so since the acquisition, in such cases, has already occurred. In addition, minority shareholders of a corporation which is 80-percent controlled may find themselves without a ready market for their stock, unless the controlling corporation is able and willing to purchase their shares.

Under the House bill, the provision denying a deduction for interest on corporate acquisition indebtedness is not to apply where a corporation which had acquired at least 50 percent of the total combined voting power of all classes of stock of another corporation by October 9, 1969, incurs acquisition indebetedness in increasing its control over the acquired corporation. Thus, the 80-percent limitation (contained in sec. 279(i) of the Code) which applies under present law in such situations, is to be removed.

Effective date.—The bill applies to taxable years ending after October 9, 1969.

Under the bill, any refund or credit resulting from the removal of the 80-percent limitation is not to be barred (by the statute of limitations, by *res judicata* in a litigated case, by a closing agreement, or otherwise) if the claim is filed within 1 year of the date of enactment.

Revenue effect.—It is estimated that this bill will result in a onetime revenue loss of less than $1 million.

Administration position.—The Treasury Department has no objection to this bill.